

FACING THE TAX PROBLEM

A SURVEY OF TAXATION IN THE UNITED STATES AND A PROGRAM FOR THE FUTURE

*Prepared Under the Auspices of the
Committee on Taxation of the
Twentieth Century Fund, Inc.*

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A TWENTIETH CENTURY FUND INVESTIGATION AND PROGRAM

The Trustees of the Fund approved the plan for this investigation, underwrote its expense and appointed the Special Committee which had charge of the study and drew up the program for action. The Trustees, however, have not assumed responsibility for the factual findings or the recommendations included in this volume.

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PREFACE

Taxation is obviously one of the leading public issues of the day. This volume is intended, first, to give the general reader an understanding of the tax system as it now exists—federal, state, and local; and, second, to suggest specific ways by which it can be improved.

The survey has been undertaken by a method which the Fund has used previously in dealing with other issues: through an *ad hoc* research staff and a special committee. The committee, whose members are listed on page iv, was appointed by the Trustees of the Fund in October 1935. It has had general charge of the entire undertaking. The research staff, whose names are listed on pages v and vii, presented to the Special Committee a factual and analytical picture of the American tax system, with their own conclusions and recommendations—included in Chapters 1 to 26 of this volume. The Special Committee studied these findings and, largely on the basis of them, has prepared the series of specific recommendations for action in improving the tax system which are contained in Chapter 27.

The Trustees of the Fund believe that by this procedure scientific methods can best be applied to the formulation of economic policies. The essential facts are assembled by a staff of economists specially experienced in the particular subject. A committee, representing diverse points of view and chosen on grounds of recognized integrity, disinterestedness and practical experience, takes these facts and, solely in the interest of the general public, proposes concrete measures to deal with problems which the facts disclose.

The Committee on Taxation, like other committees of the Fund, came to its task without any preconceived policy as a group, and with widely diverse personal opinions. That its members have reached unanimous agreement on all but two recommendations is evidence both of their determination to deal with facts objectively and of the validity of the program they propose. This procedure is refreshing and should be genuinely corrective, in a world which is played upon so often by the partisan propaganda of special interests.

In presenting this volume to the public the Trustees and officers of the Fund are glad to express their appreciation of the unselfish labor which the members of the Committee have put into this project. Special appreciation also goes to the staff which, with great patience and in the best traditions of disinterested research, has dealt with exceedingly complex and intractable material.

The facts summarized in this volume have been drawn largely from the published records of previous research. In some instances, however, the staff was obliged, by the lack of available data, to undertake its own original studies. The detailed results of these special investigations are contained in a separate volume entitled *Studies in Current Tax Problems*, soon to be published by the Fund, and in articles to be published in scholarly journals.

EVANS CLARK, *Executive Director*
The Twentieth Century Fund

330 West 42d Street
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March 1, 1937

FOREWORD

BY THE DIRECTOR OF RESEARCH

This foreword serves to give a general expression of appreciation for the helpful assistance rendered by the large number of persons who at one time or another came in contact with the work. It also indicates, through a statement of the major contributions of the associate directors, members of the research staff, and others, how much the project has been the result of co-operation.

Professor Roy Blough and Professor Mabel Newcomer, as associate directors, in addition to participating in the planning of the volume and in the critical analysis of all the manuscript, have each contributed several chapters. Professor Blough wrote the chapters (Chapters 9-14) dealing with the tax system as an instrument of social control. Professor Newcomer wrote the chapters on expenditures (Chapter 7), distribution of the tax burden (Chapter 16), and intergovernmental tax relations (Chapter 24). Both joined in writing the conclusions and recommendations in Chapters 25 and 26.

The organization of the office force and the editing of the manuscript for matters of style were handled by Mrs. Cranston Holman, who was assisted, in the first task, by Miss Dorothea Higgins.

The other members of the research staff contributed basic memoranda. Their contributions will be noted in detail, and some of them will be reproduced in full, in the forthcoming companion volume, *Studies in Current Tax Problems*. Memoranda cited without reference to that volume (see for example page 64) will be made available

either through publication in journals or in mimeograph form.

The staff has been fortunate in the assistance that it has received from the many persons who gave freely of their time and effort. Only a brief statement of acknowledgment to a few of these is possible here. Professor Edwin R. A. Seligman was specially generous in reading the manuscript in both the preliminary and the later stages. The members of the Special Committee, whose names appear on page iv, assisted by giving detailed comments in the course of the committee meetings and at other times. I particularly appreciate the opportunity to express my indebtedness to Professor Robert Murray Haig, whose advice and encouragement, both in the past and during the present work, have been fundamental to the development of the research in this survey. Thanks are also due to Dr. Louis Shere for many important improvements made as a result of his comments after reading the manuscript in proof.

The numerous and extremely helpful suggestions on both form and content made by Mr. Evans Clark, Director of the Twentieth Century Fund, resulted in extensive revisions. Dr. Frederic Dewhurst, Economist of the Fund, also assisted by a close reading of the entire manuscript. Many valuable suggestions for form in preparation for printing were made by Miss Elizabeth Mann, Publications Associate of the Fund.

The tax officials of the various governmental jurisdictions again exhibited that willingness to supply information and to comment on preliminary drafts that is one of the most encouraging signs for the future of tax research in the United States. Business organizations and individuals were likewise helpful in their responses to inquiries. The results of the co-operation from these groups will be particularly evident in *Studies in Current Tax Problems*. Acknowledgment is made to Columbia

University for its generosity in providing working space for the staff.

In no case, of course, does any responsibility for statements of fact or opinion in the staff's report attach to those who assisted us in the ways just noted. Moreover, the statements in Chapters 25 and 26 reflect only the opinion of the three directors of research, and the other members of the staff bear no responsibility for that section of the report.

CARL SHOUP, *Director of Research*

Columbia University
New York City
March 1, 1937

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Book One

BACKGROUND

Chapter 1

INTRODUCTION

On an average, every person in the United States pays \$100 a year in taxes. Some of course pay much more and some much less. In one way or another, however, a yearly total of \$12,500,000,000 is being collected by the federal, state, and local governments. This is the highest amount in the nation's entire history. An even greater amount is being spent, the excess being covered chiefly by borrowing. Another \$15 to \$20 a person would be needed if borrowing were to be ended and expenditures were to continue undiminished.

More than one-fifth of what the statisticians call national income is used to pay taxes—and the tax money, when it is paid out in government expenditures, in turn accounts for more than one-fifth of the national income. The fraction would be close to one-fourth if borrowing were to be replaced by an increase in taxes.

Directly or indirectly, every person pays something. If he does not pay directly to the government, he at least helps others pay through increased rent and prices for food, clothing, and other necessities of life. Sometimes he is reminded of his indirect role by the tax stamps on the cigarette package or liquor bottle, or by the pennies and tokens of the sales tax. Taxes so high and so widespread are bound to awaken public interest.

In the United States, moreover, the unusually large degree of local self-government leads to conflict among the 175,000 taxing jurisdictions. The recent shift of powers from localities to states and from states to nation has

broken up traditional tax patterns and has stimulated the search for federal, state, and local tax co-ordination.

TAX REFORM

Legislators, government administrators, specialists in taxation, and many kinds of taxpayers' organizations have been planning, promoting, and actually carrying into effect programs for tax reform. In some of the programs, taxation is simply a means of raising revenue; in others, it is a way of assuring government control over economic activities.

Thirty-six states have had their state and local tax systems thoroughly examined by special commissions and committees in the eight-year period 1929-36.¹ The federal government has passed ten major revenue acts in the same period.² Of the 932 opinions that the Supreme Court rendered from 1929 through 1935, approximately 250, or 27 per cent, concerned tax cases.³ Since 1929, six textbooks or compilations of readings on public finance have been published in the United States—some of them in more than one edition.⁴ At the same time, a stream of comments on the tax system has flowed from the presses in newspapers, magazines, and pamphlets.

A CATALOGUE OF COMPLAINTS

Out of this intense activity, much of it critical, several major complaints about the tax system have emerged. They are listed below. Not everyone will agree that all of them are justified, or that they are the most important. They are not wholly consistent, partly because different complaints often come from different groups. Whatever their shortcomings, however, the criticisms

¹ See Note 1, *Special Comprehensive Reports on State and Local Taxation in the Period 1929-36*, p. 509.

² See Note 2, *Federal Revenue Acts in the Period 1929-36*, p. 509.

³ See Note 3, *Supreme Court Tax Cases in the Period 1929-35*, p. 510.

⁴ See Note 4, *Textbooks and Books of Readings in Public Finance in the Period 1929-36*, p. 511.

are important in the degree of dissatisfaction that they indicate.

(1) The federal tax system is said to be dangerously unproductive in view of the enormous government expenditures. If expenditures are not sharply cut, it is claimed, the yield of the federal tax system must somehow be greatly increased in order to avoid disastrous inflation.

(2) The tax system is charged with being too sensitive to changes in business. According to this view, the highly sensitive taxes, such as those on incomes and estates, shrink alarmingly during a depression, when the burden on government grows and revenue is most needed. In prosperous periods, these taxes are said to encourage wasteful spending, owing to the large yields that such periods produce.

(3) On the other hand, the tax system is criticized for not being sensitive enough to changes in business. In depressions, according to this view, taxes ought to drop even more than they have done, in order to encourage governmental borrowing and creation of new purchasing power, which will tend to promote recovery. In prosperous periods, this doctrine demands heavy taxes in order to prevent excessive speculation.

(4) The tax burden is said to be so heavy that it is crushing the country by stifling business initiative and other aspects of private enterprise. The government is seen as a voracious silent partner whose exactions discourage business ventures, especially the risky ones.

(5) The tax burden is a crushing load, according to a variant of this complaint, which charges that it is eating into the capital of the country and is preventing the accumulation of new capital.

(6) The tax laws are said to distribute the burden of taxation unfairly. Real estate values (or cigarettes, or high incomes, or low incomes, etc., etc.), it is said, are

taxed too heavily compared with other property, or with persons. Special provisions in many taxes—for example, the treatment of capital gains and losses in the income tax, and the exemptions given to certain organizations under the property tax—are branded as unfair.

(7) The tax laws are unfairly administered, according to another complaint. For example, property tax administration is said to be careless and even intentionally discriminatory. Some taxpayers find the federal income tax administrators irritating in their meticulousness. They are charged with being partial to the government at the expense of the taxpayer, and are said to employ subordinates who do not show even a minimum of courtesy to the taxpayer whose personal accounts they examine.

(8) Some critics say that the tax system is being diverted from what they believe to be its only proper function—the raising of revenue. They declare that it is being transformed into an instrument for the control of business and for other non-fiscal purposes. For example, they believe that corporation finance policy is unduly influenced by the tax on undistributed profits, and that the federal taxing power is being used to coerce the states into levying death taxes and social security taxes.

(9) Again, the tax system is condemned as a chaos of conflicting taxes, which cause the government heavy expenses in administration and also cause the taxpayer who tries to comply with the law heavy expenses in time and money. For example, federal, state, and local governments all have their own administrative forces to collect their own gasoline taxes, on the same gallon of gasoline. Tax differentials may also cause changes in location or business practice. Taxpayers have to take state income tax laws into account in deciding whether to live in the state where they work, or commute from another state and so avoid part of a state tax. In order to avoid paying a sales tax, consumers seek refuge in cum-

bersome mail-order methods, where there is interstate delivery.

These complaints are serious. In so far as they are true and can be remedied, they call for action. Some doubt is proper, though, both of their truth and of the possibility of relief. Their truth may be questioned because no one ever likes to pay taxes, and consequently complaint is universal and perpetual. They cannot all be remedied because no tax system can accomplish all the ends that the complainants seek. Nevertheless, they must be considered with care and sympathy.

HOW THE VOLUME HAS BEEN PLANNED

This volume has been planned to give the general public a working knowledge of (1) what the present tax system is, (2) how the various forms of taxation fulfil the tests that can be applied to them, and (3) what should be done to improve the system and its various parts.

Book One gives a broad background in order to create a proper perspective. Besides this introduction a brief description is presented of the American tax system as of January 1, 1937. Another chapter sketches the changes of the past quarter century. A final chapter outlines the way in which the tax system will be analyzed and judged in the succeeding chapters.

Book Two is divided into two parts. The first part analyzes the tax system in the light of what are, in practice, its primary aims—the collection of revenue and social control. The other part is devoted to secondary aims—tax justice, ease of administration, and so on. These secondary aims are not reasons for levying taxation, but they guide the choice among taxes, once the primary aims have been clearly defined.⁵

⁵ See Note 5, *Explanation of the Order of Presentation*, p. 511.

Book Three contains the conclusions and specific recommendations of the directors of research.

Book Four is the report of the sponsoring committee, which presents some detailed conclusions on the more pressing problems of taxation.

Chapter 2

THE AMERICAN TAX SYSTEM: 1937

The \$12,500,000,000 in tax revenue that is being raised in the United States comes from federal, state, and local systems. The largest share is federal revenue—\$5,500,000,000. The states are receiving about \$2,500,000,000 and the localities about \$4,500,000,000.¹

The thousands of local systems and the state systems are all more or less independent of each other and of the federal system. The result is a much greater degree of tax decentralization than in any other major nation of the western world. Indeed, the decentralization is so marked that the entire body of taxes in the United States is rarely thought of as one system. The term "system" will, nevertheless, be used in the present survey to cover the aggregate of taxes levied by the federal government, the state governments, and the local units within the states. The term may be misleading in some ways, but at least it draws attention to the importance of considering all these taxes as a single group, not as isolated units.

A tax system that is the same in all parts of the country cannot be expected under a decentralized government. The federal government's tax system, it is true, is required by the Constitution to be uniform in the geographical sense. For example, the federal government could not set the rate of its gasoline tax at 2 cents a gallon in one part of the country and at 3 cents a gallon in another.² The state governments, however, divide the

¹ For the sources of these and other statements of yield, see chap. 6; Note 1, *Federal Tax Collections, 1913-37*, p. 514; and Note 1, *State Tax Revenues, 1936*, p. 529.

² See Note 1, *Uniformity Requirement for Federal Taxes*, p. 512.

country into forty-eight different tax systems (forty-nine, if the District of Columbia is included). Moreover, a state system is sometimes not geographically uniform. In Arkansas, for example, the rate of the gasoline tax at interstate bridges and in towns near the border is the same as the rate in the adjoining state, regardless of the rate levied in the rest of Arkansas.³

In addition, each of the 175,000-odd counties, cities, school districts, and other local units into which the states are subdivided has its own tax system, but only on sufferance of the state.⁴ The units sometimes overlap—for instance, counties and school districts. Only rarely do any two local units have exactly the same tax structure, including the same rates, although all local units depend almost entirely on the property tax in some form.

As a result of this overlapping, the United States is split up into hundreds of thousands of areas differing each from all the others in the cumulative federal-state-local tax burden directly applicable to the property or persons within its borders. The "tax system" of the United States is multi-layered, dual-sovereign, and geographically heterogeneous. This complexity makes it especially difficult to view the system as a whole.

A first step in understanding the system is a description of the place occupied in it by each of the principal taxes as of January 1, 1937. Unless otherwise indicated, the data on yield are estimates for the twelve-month period ending June 30, 1937, and are evened off to the nearest hundred million dollars. They are shown in graphic form in Chart 1.

PROPERTY TAX

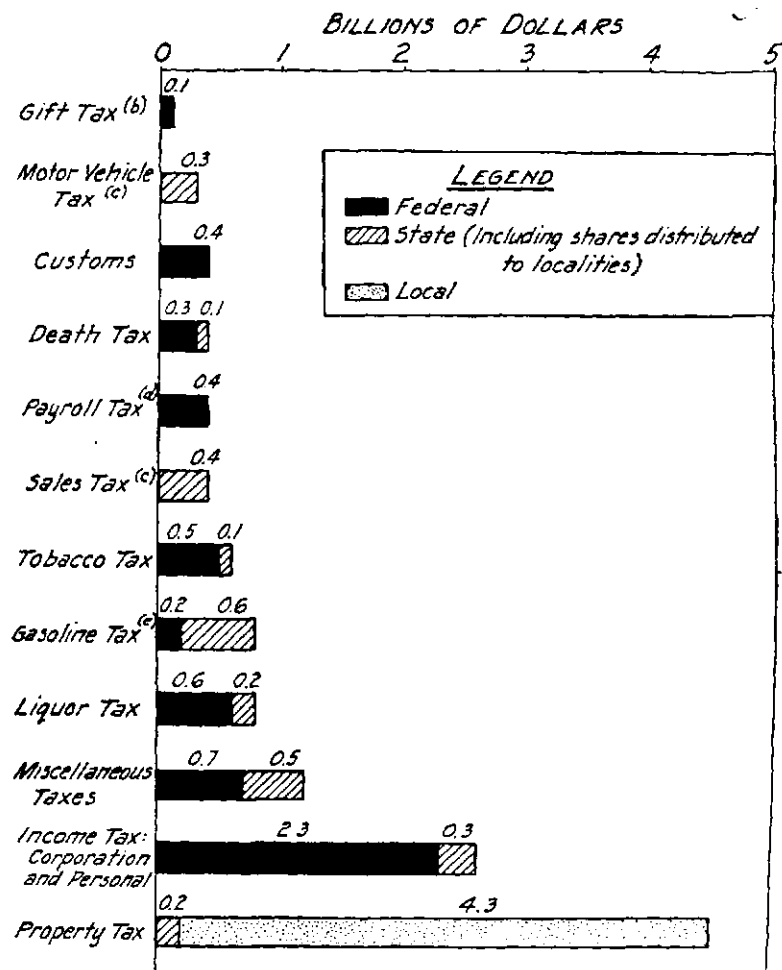
The property tax is practically the sole taxing instrument of all the local units in every state. It provides

³ Raymond E. Manning, "State Tax Legislation, 1935," *Proceedings of the . . . National Tax Association*, 1935, p. 30.

⁴ See Note 2, *Number of Local Units*, p. 513.

CHART I

SOURCES OF TAX REVENUE IN THE UNITED STATES, 1937*



* Figures are estimates to the nearest tenth of a billion dollars, for the twelve months ending June 30, 1937, taken from the text of this chapter. For estimates appearing in the budget message of January 5, 1937, see Note 2, *Revenue Estimates in Budget of January 5, 1937*, p. 538. This chart shows separately only those taxes that are yielding \$300,000,000 or more a year (except the gift tax, shown because of its close connection with the death tax). The capital stock tax might deserve inclusion—the official federal estimate for 1937 is \$139,000,000, and several states employ it. It is not known, however, whether the state yield from this tax—distinguished from all other corporation taxes—is enough to bring the aggregate to \$300,000,000.

^b The state revenue from this source is apparently well below \$50,000,000.

^c The local revenue from this source is apparently below \$50,000,000.

^d See text, pp. 17-18. Including taxes under the first in invalidated railroad pension act, however, the total is \$460,000,000.

^e The state collections may be over \$650,000,000 in 1937, despite the 1-cent reduction in the New York State tax in 1936.

about one-third of the total tax revenue—federal, state, and local—and is the most productive tax in the entire system.

In a sense, however, it cannot be considered one tax. The meaning of the word "property" differs for tax purposes among the states. In a few states it means practically nothing but real estate. In most states it also covers tangible personal property, such as the stock in trade of stores, farm implements, automobiles, clothing, jewelry, etc., as well as at least some of the so-called intangibles—shares of stock, bonds, money, credits, etc.⁵

In contrast with most of the other taxes in the United States, the property tax is levied on the value of property as of a given date—not on gross income, or net income, or amount produced, or other bases that require measurement of a certain flow of money or goods over a period of time. The tax is normally levied once a year. In some states the valuations are checked and revised only once every two or three years, or at even more infrequent intervals.

The rate, which usually varies from year to year, differs widely throughout the country. In those communities where property is greatly undervalued by the tax assessors, the rate is of course apt to be very high. Any general statement about the size of the existing rates is thus bound to be wrong. However, a hypothetical rate on actual values, as contrasted with assessed values, that would supply the present revenue would probably exceed $1\frac{1}{2}$ per cent in the majority of areas. The rate is always proportional, never progressive, in the sense that, for a given kind of property, a single taxing jurisdiction levies the same rate on all parcels, no matter who owns the property or how large it is.

Most of the state governments make some use of the property tax, but they get a much smaller proportion of

⁵ See Note 3, "Intangibles," p. 513.

their tax revenues from it than the local governments do. The property tax is producing about \$4,500,000,000 a year, or about two-thirds of total state and local tax revenues. The states get between 5 per cent and 10 per cent of their revenue from this source, or about \$200,000,000.⁶

The federal government levies no property tax, for reasons explained elsewhere.⁷

INCOME TAX

Next in importance in total yield is the income tax on individuals and corporations. Its use by the three levels of government is precisely the reverse of that of the property tax. The federal government depends heavily on it. The yield for the fiscal year 1936 was \$1,400,000,000, or about one-third of all federal tax revenue, and the estimate for 1937 is \$2,300,000,000—about two-fifths. In more prosperous years the tax has supplied nearly two-thirds of federal revenue. In 1936 the yield was about evenly divided between the corporation income tax and the personal income tax.

The personal exemptions are high enough to exempt the majority of income receivers from the federal personal income tax. For the income year 1934, about 3,300,000 persons were directly represented by taxable returns under this tax,⁸ and preliminary data for 1935 incomes indicate an increase of 18 per cent, which would bring the total to 3,900,000.

The income tax, corporate and personal, is used by only about two-thirds of the state governments, ordinarily as a minor source of revenue. In 1936 the states received in all about \$250,000,000 from personal and corporation income taxes—\$150,000,000 from the former

⁶ National Industrial Conference Board, *Cost of Government* series, especially *Cost of Government, 1923-1934* (1934), pp. 28-29, 31, and *Cost of Government in the United States, 1733-1931* (1936), pp. 27, 45. For state property tax yield, see also Note 1, *State Tax Revenues, 1936*, p. 529.

⁷ See Note 1, *Uniformity Requirement for Federal Taxes*, p. 512.

⁸ Including dependents. See p. 355.

and \$100,000,000 from the latter.⁹ In 1937 the total may be as high as \$300,000,000. Thus the income tax supplies about one-fifth of the nation's total tax revenue. The states that levy the tax are shown in Chart 2.

The yearly income on which the tax is levied is defined in a highly technical manner. It differs in only a few important respects, however, from the income that an accounting firm would call net income for a business or that an individual would call his income when applying to a bank for a loan. No state law is exactly like any other, or the federal law, in defining taxable income. However, in general, considerable uniformity exists among the states, even on the treatment of capital gains, dividends, and the income of non-residents.

The federal income tax rate schedule for individuals is progressive. Starting at 4 per cent on the first \$4,000 of the taxpayer's taxable net income, it reaches 79 per cent on that part of the income above \$5,000,000. The state rates are usually heavier than the federal rates in the lower ranges of income and always very much lighter in the higher ranges. The federal normal rate on corporations is progressive only in the very low ranges of income, and averages slightly less than 15 per cent, to which may be added the tax on undistributed profits described below. The state corporation rates are all much lower than 15 per cent.

The most striking feature of corporation taxation is the annual tax on undistributed profits levied by the federal government in the Revenue Act of 1936. This tax is imposed on that part of the corporation's net income that is not paid out, in the year in which it is earned, in the kind of dividends that are immediately taxable in the hands of the stockholders. Thus, if a corporation earns \$1,000,000 in a given year and distributes among

⁹ See Note 1, *State Tax Revenues, 1936*, p. 529.

its common shareholders \$1,000,000 in par value of its own common stock as a stock dividend, it has not distributed any of its profits, from the point of view of the undistributed profits tax, since such a dividend is not at once taxable to the stockholders. In general, dividends are immediately taxable to stockholders when the corporation (1) pays the dividend in cash, or (2) pays to a preferred stockholder a dividend in the company's own common stock, or (3) pays to a common stockholder a dividend in the company's own preferred stock, provided some preferred shares are already outstanding, or (4) pays to any stockholder a dividend in its own obligations, securities of other corporations, or other property.

The rate of the tax depends on the proportion of the net income (after deducting the regular corporation tax payable) that is undistributed. If the amount undistributed is not over 10 per cent of the net income, the rate is 7 per cent of the undistributed amount—at the most, therefore, 7/10 of 1 per cent of the corporation's income. Higher rates apply to such parts of the undistributed amount as may be in excess of 10 per cent. The maximum rate is 27 per cent of that part of the undistributed net income in excess of 60 per cent of the entire net income.

The tax does not apply to banks and trust companies, insurance companies, corporations that are in bankruptcy or receivership or are insolvent, and certain minor groups of corporations that are not fully subject to the ordinary corporation tax. Relief provisions are granted for reserves that must in certain cases be built up under the Banking Act of 1933, under the National Housing Act, and under private contracts executed before May 1, 1936, in so far as they expressly prohibit the payment of dividends.¹⁰

¹⁰ See Note 4, *Details of Undistributed Profits Tax*, p. 513.

PAYROLL TAXES

The federal payroll taxes levied as part of the old-age benefits and unemployment compensation program in the Social Security Act of 1935 do not yet produce much revenue. The federal budget estimates for 1937 place the yield at \$300,000,000, or 6 per cent of federal tax revenue, most of it from the old-age benefit taxes. However, if the similar taxes that the states are encouraged to impose for unemployment compensation are included, the payroll taxes promise to equal, and perhaps exceed, the income tax after five or ten years.

The payroll taxes form a specialized and crude type of income tax since they are levied on one kind of income—wages and salaries—without any deductions. The duty of paying is in every instance placed upon the employer. The amount of tax will depend upon the wages and salaries that he pays. The plan is not to become effective in its entirety until 1949, when the two taxes will equal 9 per cent of payrolls.

One of the taxes is to create an old-age annuity fund. The tax rate is to rise every three years, until by 1949 it is 6 per cent. Half the tax is to be deducted by the employer from the employee's stated wages, and the other half is to be contributed by the employer. The rate starts at the 2 per cent level for 1937-39.

The unemployment compensation tax differs in some important respects from the old-age fund tax: The rate will not go higher than 3 per cent, but it reaches this level in 1938, starting at 1 per cent on 1936 wages. None of the tax is to be deducted from the employee's stated wage. The tax does not apply to firms with less than eight employees. It is based on total payroll, while the old-age fund tax is not assessed on that part of any compensation from any one employer to any one employee that is over \$3,000 a year. Finally, and most important,

it is primarily not a federal revenue measure, but a device to induce the states to levy unemployment compensation taxes. It allows the employer to deduct from the federal tax otherwise due any unemployment compensation tax paid to a state up to 90 per cent of the federal tax. By February 5, 1937, thirty-five states and the District of Columbia had passed unemployment compensation laws that had been approved by the Social Security Board. All of them imposed a payroll tax on employers, and ten of them imposed a payroll tax on employees.¹¹ No estimate is attempted here of the yield of these state taxes for the year ending June 30, 1937. The revenue that the federal government gets from the tax in so far as it results from lack of state action is used, not for the unemployment compensation program, but for general fund purposes.

Both the old-age fund tax and the unemployment compensation tax exempt certain broad classes—notably agricultural labor, domestic service in a private home, and employees of non-profit institutions.

A similar special tax is imposed on railroads to provide employee retirement pensions, and will yield more than \$100,000,000 in 1937. In turn the railroads and their employees are exempt from the old-age payroll tax of the Social Security Act.

HIGHWAY TAXES

The highway network of the United States, especially that part of it built in the past ten years, has been financed largely by state taxes on gasoline and on motor vehicles. Every state (and also an occasional local unit) now imposes a tax on gasoline. The rates differ widely, but they are always in terms of cents per gallon.

The state and local yield of \$600,000,000, or possibly

¹¹ Letter of February 8, 1937, Informational Service, Social Security Board, Washington, D. C.

\$700,000,000, with the added \$200,000,000 that the federal government derives from its tax of 1 cent a gallon, makes the gasoline tax, in point of revenue, the largest tax in the country levied on a single article. It supplies 3 per cent of federal tax revenue, 9 per cent of state and local revenue, and 7 per cent of total tax revenue. Almost all the money is collected from refiners and wholesale distributors, not retailers.

Every state collects an annual registration tax from owners of motor vehicles, but in some states the tax is as low as \$3.00 or \$5.00 a year. Part of the yield in certain states should be considered simply as a substitute for exemptions granted to motor vehicles under the personal property tax. Usually the tax is a certain number of cents per hundred pounds of weight of the vehicle, laden or unladen, or per horse-power. In contrast with the gasoline tax, however, the ways of measuring the tax base differ so widely from state to state that no general statement means much.

The motor vehicle tax reaches more people directly than any other one tax. Probably from 15,000,000 to 20,000,000 families out of the 30,000,000 families in the United States pay the tax.¹²

Some localities make use of the registration tax, but virtually all the \$300,000,000 annual revenue represents state moneys. The tax supplies about 13 per cent of state taxes but only about 2 per cent of total federal, state, and local taxes. The federal government collects no similar annual registration tax but covers certain parts of the automotive field by its special manufacturers' taxes, to be described below.¹³

LIQUOR AND TOBACCO TAXES

The federal liquor tax alone is yielding about \$600,000,000 a year, or 11 per cent of federal tax revenues.

¹² See pp. 352-53.

¹³ See Note 4, *Federal Automotive Excises as Distributors of Benefit Taxation on a Cost-Caused Basis*, p. 534.

The states are getting another \$200,000,000.¹⁴ The tobacco tax revenue is \$500,000,000 for the federal government, but only slightly more than \$50,000,000 for the states.¹⁵

The federal tobacco tax is built up of a number of rates on different tobacco products. Most of its revenue is produced by the cigarette tax of \$3.00 a thousand cigarettes—equivalent to a tax of 6 cents on a package of twenty. Similarly, the federal liquor tax is composed of several taxes, chiefly the tax on beer and the tax on distilled spirits (whiskey, etc.), which contribute approximately equal amounts. The federal government can and does confine itself for the most part to collecting the liquor and tobacco taxes from manufacturers. While the states, too, get something from the liquor manufacturers, they depend largely on taxes applied to the wholesale and retail trade or on state distributing monopolies.

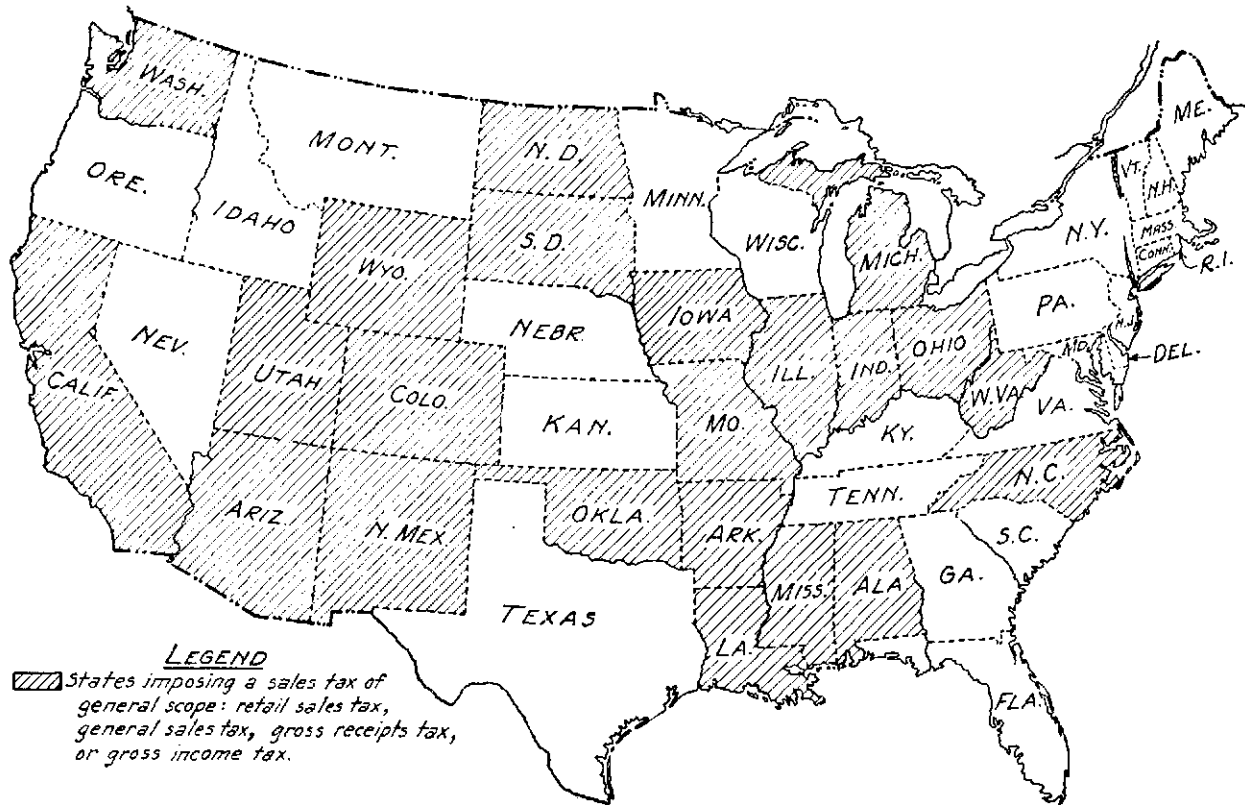
SALES TAX

In recent years nearly half the states have experimented with the sales tax, which is levied, at a more or less uniform rate, on sales of most articles and many services. Important exemptions—for example, food—are sometimes granted. Almost all the revenue comes from the taxation of retail sales rather than sales by manufacturers or wholesalers. New York City, with its 2 per cent retail sales tax, and New Orleans, with a newly introduced 2 per cent tax of somewhat less general scope, are the only important local units employing the tax. On January 1, 1937, it was in force in twenty-two states, as shown by Chart 3.

The federal government has no sales tax; but, if it did, the tax would probably be confined to sales by manufacturers or wholesalers, since collection would be easier

¹⁴ See Note 1, *State Tax Revenues, 1936*, p. 529.

¹⁵ *Ibid.*

STATES IMPOSING THE SALES TAX, JANUARY 1, 1937^a

^a Sources: Correspondence with state officials; state statutes; *Tax Systems of the World*, Sixth Edition, and 1936 Supplement to Sixth Edition; and *The Tax Magazine*. New York City and New Orleans also employ the sales tax.

and the federal government would not need to fear the emigration of manufacturers, as the states do.

In a few states that use a rate of 2 per cent or 3 per cent the sales tax supplies more than one-third of the total revenues of the state government. All together, the state governments are obtaining slightly more than \$350,000,000 from the sales tax, and New York City and New Orleans, about \$50,000,000. Thus, the sales tax is supplying about \$400,000,000 a year—6 per cent of total state and local tax revenues.

The tax is often stated to the ultimate consumer as a separate item in his bill. In this respect the sales tax and the gasoline tax, among the major taxes, stand alone. The retailer, or other business firm, is the one who pays the money to the government, though he may not be the one who bears the burden of the tax.

DEATH TAXES AND GIFT TAX

The transfer of property at death is governed by state laws, not federal laws. The states, however, make less use of taxes on transfers at death than the federal government, and the local units do not use them at all. The states are collecting only slightly more than \$100,000,000 a year from this source, or about 4 per cent of state taxes and less than 2 per cent of state and local taxes combined.¹⁶ Nevada is the only state that does not impose a death tax.

The federal government has far higher rates. Its maximum is 70 per cent on that part of the estate above \$50,000,000. However, the taxpayer is allowed to deduct from the federal tax otherwise due much of the tax that he pays to any state. The net return to the federal government is \$300,000,000 a year—5 per cent of total federal taxes.

Like the property tax, the death tax is based on the

¹⁶ See Note 1, *State Tax Revenues, 1936*, p. 529.

capital value of property. Like the income tax, it is levied at rates that increase as the size of the tax base increases. It also depends on many technical definitions to determine the base.

Death taxes are of two kinds: the estate tax, levied on the value of the decedent's estate as a whole, and the inheritance tax, levied separately on the share received by each beneficiary. The federal tax is an estate tax, but no general statement can be made about the state taxes. Some states levy both forms.

The high federal rates create an obvious inducement to give property away before death. Some of the gifts can by certain technicalities be taxed under a death tax. The possibilities of avoidance have seemed great enough, however, to warrant a federal tax on gifts. Its yield, though small compared with that of the other chief federal taxes—less than \$200,000,000 in 1936, or 4 per cent of federal tax revenue—, has been larger than was expected. It is estimated to be \$100,000,000 for 1937. Collected annually, it has the unique feature of rates that rise with the cumulated amount of gifts made throughout the years by any one donor. The rates are fixed at exactly three-quarters of the estate tax rates. Only three states impose gift taxes.

CUSTOMS DUTIES

The federal Constitution forbids any of the units of government to impose a tax on exports, and it grants to the federal government alone the right to levy taxes on imports. Some of the taxes that are imposed by the federal government under this authorization are designed to balance existing taxes on domestically produced articles. Part of the liquor tax collected at customs, for example, is of this sort. For the most part, however, the \$400,000,000 a year collected on imports represents the "tariff"—that is, a series of special taxes on imported

articles of certain kinds. This amount now represents only about 7 per cent of total federal tax revenues. Shortly before the war, however, customs supplied nearly 50 per cent.

Some articles are purposely taxed at such a high rate that they are imported not at all or in much smaller amounts than they would be without the duty. Some are on the "free list"—untaxed. Many are between these two extremes. The rate schedule is bewildering in its variety, since a special rate is assigned to each taxable group of commodities.

MISCELLANEOUS TAXES

The total estimated yield of the taxes mentioned above, for the twelve months ending June 30, 1937, is \$11,300,000,000, or 90 per cent of the estimated total of \$12,500,000,000. The rest of the taxes—federal, state, and local—comprise a miscellany, of which no one item produces an important amount of revenue.

Chief among the miscellaneous federal taxes are those applying to goods and services that Congress has seemingly considered to be luxuries or semi-luxuries. Automobile bodies and chassis, lubricants, tires and tubes, automobile accessories, furs, toilet preparations, radio parts, phonograph records, mechanical refrigerators, sporting goods, cameras and lenses, chewing gum (but not candy or soft drinks), matches, playing cards, fire-arms and ammunition, electrical energy (for domestic and commercial, but not for industrial, consumption), and toll telephone calls, telegraph, cable, and radio messages are taxed upon sale by the producer or importer. Admissions priced at more than 40 cents, safe deposit rentals, club dues, issues and transfers of stocks and bonds, transfers of title deeds, sales for future delivery, and transportation of oil by pipe line are also taxed. In most cases the rates range between 2 per cent and

10 per cent. Some of the taxes provide for exceptions and other qualifications not noted in this summary.

Corporations in general pay a federal capital stock tax that is linked with a so-called excess profits tax.

Miscellaneous federal taxes imposed for regulation rather than revenue include those on narcotics, adulterated butter, process or renovated butter, oleomargarine, filled cheese, mixed flour, and crude petroleum. The special tax on coconut and other processed oils—essentially a protective tariff duty—continues as a remnant of the agricultural adjustment tax program. All together, the miscellaneous federal taxes named above produce about \$700,000,000 a year, or 13 per cent of federal tax revenue.

Some of the states levy "severance taxes" on natural resources, such as oil, gas, coal, and minerals, removed from the earth. In some states the property tax as applied to forests is modified to encourage forestry. Annual corporation taxes at light rates—for example, \$2.00 per \$1,000—based on authorized or outstanding capital stock are found in most of the southern states and middle western states. A tax on insurance companies, levied at rates near 1 per cent or 2 per cent and based on premiums received, is common. Special taxes on chain stores are widespread. Many localities levy special assessments on real estate at irregular intervals. They are not taxes, strictly speaking, but payments for direct benefits to the property resulting from local improvements, such as sewers, sidewalks, and street lighting.¹⁷

FEDERAL-STATE-LOCAL TAX RELATIONS

The tax system in the United States is decentralized because governmental activities in general are decentral-

¹⁷ For detailed information on taxes in the United States, see Tax Research Foundation, *Tax Systems of the World*, (6th ed., Chicago), *passim* (hereafter cited as *Tax Systems of the World*), and "State Tax Calendar" in *The Tax Magazine*, the usual sources of statements in the present survey on the number of states levying a given tax, and the rates imposed.

ized. If a local school district is to be independent, it must have some financial resources of its own. If its income is received entirely from the state or federal government, it loses either its independence or its sense of responsibility.

On the other hand, the greater the freedom of small units to levy their own taxes, the more disorganized the system is as a whole. Multiple taxation, accounting difficulties, and other problems, noted elsewhere, arise.¹⁸ Moreover, the local units face certain economic restrictions on their power to tax. They may find, for instance, that wealthy residents will move if certain taxes are placed at too high a level. As a result, the tax revenue that the local unit can get may not be enough to carry the function, such as education, that is assigned to the unit.

The present system in the United States meets these difficulties in a variety of ways.

The local units depend almost entirely upon the property tax for their own revenues. In many states they receive substantial sums in addition as shares in state-collected taxes, and as grants-in-aid from the states and the federal government. In 1935, 41 per cent of total local revenues (not including earnings, fees, etc.) came from federal and state aid and shared taxes.¹⁹

The state governments use about as wide a variety of tax sources as the federal government. They are prohibited by the Constitution from imposing a tax on imports. Otherwise one state or another makes use of every important tax employed by the federal government, and many state governments depend also on the property tax.

The only major provision that has been adopted to co-ordinate federal and state tax measures is the tax crediting device, used with the death taxes and with one of the payroll taxes. The federal government allows

¹⁸ See pp. 366-68.

¹⁹ See p. 379.

the taxpayer to deduct from his federal tax otherwise due the amount of tax paid to the states, with certain limitations. In the death tax, the deduction is limited to 80 per cent of that part of the federal tax as computed under the provisions of the 1926 federal estate tax law. This device, in effect, allows any state to levy a death tax up to that level without imposing any added burden on the taxpayer. The limit to the payroll tax credit is 90 per cent of the federal tax.

The states do not receive any share of any particular federally collected tax, but federal grants for highways and, in recent years, for relief have been large.

Co-ordination of federal, state, and local tax systems is thus still in a rudimentary stage. The only exceptions are elaborate systems of grants to localities, chiefly for education, that exist in a few states.

Chapter 3

CHANGES SINCE 1914

An understanding of the rapidity and diversity of the tax system's growth during the war and post-war periods is essential in order to form an intelligent judgment on the system in its present form. A brief review of these changes follows.

THE WAR DAYS

Federal Taxes

The first of the revenue acts that was influenced by the war was voted on October 22, 1914, and extended for a year on December 17, 1915. It provided for low-rate stamp taxes, an increase in the beer tax, and miscellaneous minor tax provisions. The next revenue act, much more important, was the Revenue Act of 1916, which imposed the first of a series of rate increases in the personal income tax, recently introduced by the act of October 3, 1913. The increase was small: on incomes up to \$150,000 an added 1 per cent or 2 per cent tax. The maximum rate, however, was moved up to 15 per cent. It applied only to that part of the taxpayer's income above \$2,000,000. The former maximum was 7 per cent on that part of the taxpayer's income above \$500,000.

The other lasting provision of the 1916 act was the introduction of an estate tax. The highest rate of the new tax was only 10 per cent, applicable to that part of the net estate in excess of \$5,000,000. This was a modest beginning compared with the maximum rate of 70 per

cent in 1936, applicable to that part of the net estate in excess of \$50,000,000.¹

For the rest, the 1916 act depended chiefly on the munitions manufacturers' tax, which was merged in 1917 in a general excess profits tax.

War Taxes on Incomes and Profits

The next two years brought a fundamental change in the federal revenue system. A belief in the superior "productivity" of the "indirect" or consumption taxes has always been widespread. Despite this belief, the United States was able to revise its tax system so that its participation in the war was almost entirely financed by taxes on net income and excess profits, so far as it was financed by taxes at all. To some extent this revision was forced by the loss of liquor revenues through prohibition. In the main, however, it reflected a conscious effort to push direct taxes far beyond their previous limits.

An act passed on March 3, 1917, levied an excess profits tax. The War Revenue Act of 1917, approved October 3, 1917, strengthened the excess profits tax and increased the income tax sharply. The size of the change in the income tax is indicated in Table 1.

The Revenue Act of 1918, delayed in its enactment until February 24, 1919, provided another sharp increase in income tax rates, which also is illustrated in Table 1. In addition, the top rate under the war profits section of the excess profits tax was 80 per cent.

The peak of federal tax collections was reached in the fiscal year ending June 30, 1920. Of the total \$5,700,000,000 collected in that year, the customs duties supplied only \$300,000,000. The income and excess profits taxes supplied 73 per cent of the remaining \$5,400,000,000.²

¹ See pp. 44, 87.

² For sources of data on federal revenues, see Note 1, *Federal Tax Collections, 1913-57*, p. 514.

TABLE 1
 PERSONAL INCOME TAX RATES AT CERTAIN LEVELS^a
 (NORMAL TAX AND SURTAX COMBINED)
 1916-18

That Part of Taxpayer's Income Falling within Range Indicated (Block of Income) (In Dollars)	Rate (In Per Cent)		
	1916 Act	1917 Act	1918 Act
5,000- 6,000	2	5	13
10,000- 12,000	2	7	16
20,000- 22,000	3	12	21
50,000- 52,000	4	16	36
75,000- 76,000	5	21	48
100,000-150,000	7	31	64
Over 2,000,000	15	67	77

^a The rates given are the aggregate of normal tax and surtax. Since the surtax rate was at this time based on net income, while the normal tax rate was based on net income less certain credits, it is slightly misleading to cite the two rates in combined or aggregate form, as has been done above. However, the error introduced in this simplification is not significant for present purposes.

Excise and Consumption Taxes

The relative size of the yield given by the taxes on incomes and excess profits is the more surprising in view of the long list of other sources that were tapped by the war revenue acts. Taxes were placed on payments for transportation and communication, on admissions and club dues, on bond and stock issue and transfer, on documents of various kinds, and on the production of various "luxuries," such as automobiles, soft drinks, chewing gum, sporting goods, and so forth.

This large and miscellaneous assortment of taxes gives an impression of vast revenue resources. Yet the admissions tax, for example, even in the fiscal year 1920 when its 10 per cent rate applied to virtually all admissions, produced but \$77,000,000—slightly more than 1 per cent

of the total internal revenue for 1920. The tobacco tax remained the chief consumption tax. The rate of the cigarette tax, the major producer of the tobacco group, was twice as high under the 1918 act as it had been under the 1914 and the 1916 acts. Of the other miscellaneous revenue measures, one of the more important was the increase in postal rates in the Revenue Act of 1917, which had the effect of laying a special tax on the senders of first-class mail.

Unimportance of Estate Tax

The estate tax played an unimportant role in the federal government's war financing. In part this reflects the claim of the states to a vested right in death taxes. Forty-two states were levying them at low rates in 1916. (In contrast, only three or four states were making a serious attempt to collect an income tax.)³

The 1916 act set the rate at 1 per cent on that part of the net estate—that is, the gross estate minus all deductions including the minimum exemption—below \$50,000. The first 1917 act increased it to 1½ per cent, the second 1917 act increased it to 2 per cent, and the last World War revenue act lowered it to 1 per cent. Similarly, for that part of the net estate between \$150,000 and \$450,000, the rate went from 4 per cent to 6 per cent to 8 per cent and back to 4 per cent.

In the higher ranges, the rates were at least not decreased by the last war revenue act. For the \$2,000,000–\$3,000,000 bracket, the rates in the successive acts were respectively 7 per cent, 10½ per cent, 14 per cent, and 14 per cent. The maximum percentages under the respective acts were 10, 15, 25, and 25. Rates such as these explain why the peak yield of the federal estate tax for

³ See Note 2, *Sources for Recent History of State and Local Taxation in the United States*, p. 519.

the war and immediate post-war period was only \$154,000,000 (1921).

Unused War Revenue Sources

The extent to which the federal government relied on income taxes and excess profits taxes is further surprising in view of the opportunities for other taxes that were not levied at all.

A gasoline tax had passed the House in 1914, and President Wilson urged it on Congress in 1915. However, a federal gasoline tax was not enacted until the depression of the '30's. In 1917 the Senate Finance Committee suggested revenue duties on coffee, tea, and cocoa, to be collected, of course, upon importation, but these "breakfast table taxes" found no place in either the war or the depression financing of the federal government.⁴

Considerable agitation developed during the war and shortly afterward for a general manufacturers' sales tax, to be levied only once on each finished product. Finally, there was always the technical possibility—even if it was a political impossibility—of raising substantial sums of money through high-rate taxes on such necessities of life as salt and bread.

A capital levy would have required an amendment to the Constitution, since it would almost surely have been considered a direct tax, and, as such, would have fallen under the apportionment clause in the Constitution. As is explained elsewhere,⁵ this clause requires that any federal direct tax not specifically exempted from its provisions must be apportioned among the states on a population basis. Thus, in the absence of an amendment, the rate of a tax on capital would have to be high in poor states and low in rich states.

⁴ H. G. Hendricks, "Federal Income Tax Rates, 1913-1922," *Bulletin of the National Tax Association*, XVIII, Nos. 3, 4 (December 1932, and January 1933), 79, 80, 105.

⁵ See Note 1, *Uniformity Requirement for Federal Taxes*, p. 512.

*State and Local Taxes*⁶*Experimentation with Existing Taxes*

For the states and the local units of government the period 1914-20 was primarily marked by a reform of existing taxes rather than the adoption of entirely new types of tax. The chief example of this tendency was the experimentation with new methods of reaching personal property, particularly intangibles.

One method involved classification, achieved in a number of ways. Several states adopted constitutional amendments granting to the legislatures a broad power to classify all property; other states restricted the legislatures' power to tax at low rates to certain specified types of property. Low-rate annual taxes, particularly on intangibles—stocks, bonds, etc.—, were then enacted. Minnesota and one or two other states achieved classification by incorporating in their constitutions fractional valuations for different classes of property. Some states substituted for the general property tax on mortgages and other secured debt low-rate once-for-all taxes collected at registration. Special treatment was developed for shares of stock in national banks.

Another method involved a restricted use of income rather than capital value as a tax base. Thus, public service corporations were taxed on gross receipts, mines and forests on a yield basis, and special income tax laws were enacted to reach the income from intangibles that escaped the property tax. In some states the income tax, although general in scope, was used in part as a supplement to the property tax, since property tax receipts were accepted in payment of it.

A widespread movement to reform local assessments resulted in the consolidation of assessment districts, the

⁶ See Note 2, *Sources for Recent History of State and Local Taxation in the United States*, p. 519.

centralization of control over local assessors, and the creation of better machinery for putting assessments in the various districts at a uniform ratio of assessed to true value. A number of states established permanent tax commissions with broad powers over the administration of state and local property taxes. A few large cities adopted definite formulae for assessing property, notably the unit-foot rule for land and the cubic-foot rule for improvements.

Use of Taxes Other Than Property Tax

The increase in the use of general income taxation by the states during the years 1914-20 was not startling. The number of states imposing the personal income tax effectively grew from two in 1914 to eight or nine at the end of 1920.

Somewhat more than one-fourth of the states either adopted death taxes during this period for the first time or extended them to direct heirs, who had been exempt in contrast with collateral heirs. Modest rate increases in the death taxes were common. Death taxes and income taxes in the states were even less important in terms of total revenue than they are today.

The state and local liquor taxes were fairly important at the beginning of the period, but they disappeared when prohibition took effect.

Several states raised their motor vehicle license fees. In 1919 Oregon introduced the gasoline tax. It was joined in the same year by Colorado, New Mexico, and North Dakota, and by Kentucky in the year following.

Fairly extensive changes in the state taxing systems were achieved in Connecticut (1915), Virginia (1916), Maryland (1916), Kentucky (1917), Missouri (1917), New York (1917-19), Alabama (1919), New Mexico (1919), North Dakota (1919), and possibly in one or two

more. However, even in these states the property tax remained of overwhelming importance in local finance.

THE PERIOD OF PROSPERITY

Federal Taxes

Tax Reduction

Alone among the major combatants of the war, the United States furnished a laboratory test of how the structure of a powerful tax system may be altered when tax reduction in huge amounts is possible. The revenue acts of 1921, 1924, 1926, and 1928 sheared away large segments of the federal tax base and cut the tax rates deeply. The first major change was the abolition of the excess profits tax by the revenue act that was approved November 23, 1921. Surtax rates came down slightly. The 1921 act put the combined maximum surtax and normal rate at 58 per cent on that part of the income over \$200,000. Throughout the scale the rates remained well above those of the Revenue Act of 1917 (in the higher ranges they were much closer to the rates of the 1918 act than to those of the 1917 act). The estate tax rates were left unchanged, while among the special taxes only those on transportation and a few minor excises were repealed.

To preserve a proper balance in viewing the changes made in the Revenue Act of 1921 and subsequent acts, certain quantitative relations may be emphasized.

Personal Income Tax and Corporate Income Tax

In the fiscal year 1920, when federal tax collections reached their peak, the personal and corporation income taxes and the excess profits tax produced 69 per cent of the total federal tax revenue. By the fiscal year 1931 the excess profits tax had been repealed, personal income tax rates had been slashed drastically, and the corporation tax rate had been raised only slightly—

yet the corresponding percentage for the fiscal year 1931 had dropped only to 66. Never in any of the years 1918-31 inclusive did it go below 53, the level reached in 1923.

The steadiness of the percentage shows the extent to which the decrease in need for revenue allowed a repeal or lowering of many other taxes. It also indicates the great responsiveness of the income tax to a period of prosperity. The figures in Table 2, showing total normal tax and surtax rates applicable to certain blocks of personal income, indicate how drastic the cuts in rates were.

TABLE 2
PERSONAL INCOME TAX RATES AT CERTAIN LEVELS^a
(NORMAL TAX AND SURTAX COMBINED)
1918-26

Block of Income (<i>In Dollars</i>)	Rate (<i>In Per Cent</i>)			
	1918 Act	1921 Act	1924 Act	1926 Act
5,000- 6,000	13	8	4	3
10,000- 12,000	16	10	7	6
20,000- 22,000	21	16	11	10
50,000- 52,000	36	31	24	18
75,000- 76,000	48	43	33	23
100,000-150,000	64	56	43	25
Over 2,000,000	77	58	46	25

^a See note a to Table 1.

A tax reduction of 1 per cent of the income subject to normal tax was granted on 1929 incomes. With this one exception, the 1926 rates remained unchanged until the Revenue Act of 1932.

For each of the fiscal years 1925-31 inclusive the corporation income tax produced over 50 per cent of the income tax revenue. Segregated data for earlier years in the period from 1918 to 1925 are not available on a fiscal year basis. The importance of the corporation

income tax contrasts with the greater publicity usually given to the personal income tax. The range of the yield during the seven years was narrow—from 52 per cent to 60 per cent. This is worth noting since the corporation tax rate was changed but slightly during this period while the personal rates were cut severely by the 1926 act.

Prosperity had a greater effect on the yield of the personal tax than on that of the corporation tax. The most abrupt change in the corporation rate was from 10 per cent, on 1921 income, to 12½ per cent, on 1922 income. The cause of this increase in an era of tax reduction was the abolition of the excess profits tax, which, except for a brief period, had applied only to corporations.

Customs and Cigarette Tax Yields

The customs revenue was raised from its insignificance of 1918 by the two tariff acts of 1921. These removed some articles from the free list and increased the rates on others. The general improvement in international trade also increased customs receipts. In 1918 the duties produced only 5 per cent of total federal tax revenue. By 1923 the percentage had risen to 18. It stayed within the range 16–18 through the fiscal year 1930. In 1931 it receded slightly, to 13 per cent, as the trade-restricting tariff of 1930 took effect and the depression deepened. Even 18 per cent, however, is a weak showing compared with 1913, when customs duties supplied 48 per cent of federal tax revenue.

The spread of the cigarette habit increased the yield of the cigarette tax remarkably—from \$151,000,000 in 1920 to \$359,000,000 in 1931. The rate of \$3.00 a thousand levied by the Revenue Act of 1918 was the only important excise rate that was not reduced after the war.

Continued Unimportance of Estate Tax

The estate tax remained an unimportant source of revenue to the federal government. During the period from 1916, when it was introduced, through the fiscal year 1931, it reached its highest proportionate yield in 1923—4 per cent of the total federal tax revenue. In each year from 1922 through 1931 its absolute yield was much lower than that of the cigarette tax.

The moderate rates of the war years were not raised during the decade of post-war prosperity. An increase approved in the 1924 act was retroactively repealed by the 1926 act, which put the rates nearly back to the level of the early part of 1917. The maximum under the 1926 act became 20 per cent on that part of the net estate exceeding \$10,000,000. Moreover, the crediting device, which had been tentatively inaugurated at a lower rate two years earlier, gave the states the privilege of taking 80 per cent of the tax for themselves. In the fiscal year 1930, when collections were reflecting the high prices of 1928 and 1929, the tax produced but \$65,000,000.

Repeal of Excise and Consumption Taxes

The miscellaneous assortment of war-time special taxes that had given variety, but not much else, to the tax system was soon discarded. To name only the more important: the 1921 act dropped the passenger, freight, and express taxes; the 1924 act dropped the telephone and telegraph taxes and the soft drink and candy taxes; the 1926 act dropped the capital stock tax, the documentary stamp taxes, the tires and tubes tax, and the automobile truck tax; the 1928 act dropped the passenger automobile tax. In addition, the admissions tax was whittled down by exemptions until it produced but \$3,000,000 in 1931.

The only war-time tax of this kind that thrived in the post-war era was the stock transfer tax. It was well

sued to the peculiar character of this period of prosperity. Without a change in the rate the yield rose from \$8,000,000 in 1919 to \$47,000,000 in 1930. It dropped to \$26,000,000 in 1931.

Relative Importance of Each Tax

By 1930 the federal tax system was yielding \$3,600,000,000 a year, compared with \$5,700,000,000 in the peak year 1920. Of this total, the corporation income tax was producing 35 per cent, the personal income tax 32 per cent, the customs duties 16 per cent, and the tobacco taxes 12 per cent. In 1931 the absolute amount of revenue was sharply lower, but the percentages were about the same. Even in 1932 the only pronounced shift, relatively, was upward for the tobacco taxes and downward for the personal income taxes.

Throughout the boom period and nearly until the depths of the depression the various parts of the federal revenue system maintained remarkably constant relations. The extremes shown by each tax in the percentage that it produced of total federal tax revenue during the years 1925-32, inclusive, are shown in Table 3 (with 1916 percentages given as contrast).

TABLE 3
RELATIVE IMPORTANCE OF CERTAIN FEDERAL TAXES
1925-32 AND 1916

Tax	Extreme Percentages of Total Federal Tax Revenue	Percentage of Total Federal Tax Revenue
	1925-32	1916
Corporation income tax ..	29 ^a - 38 ^b	8
Personal income tax.....	23 ^c - 32 ^d	9
Customs duties.....	13 ^e - 17 ^f	29
Tobacco taxes.....	11 ^g - 21 ^o	12
Liquor taxes.....	h	34

^a In 1925.

^b In 1928.

^c In 1932.

^d In 1930.

^e In 1931.

^f In 1925, 1927, 1929, and 1932.

^g In 1925, 1926, and 1927.

^h No revenue because of prohibition.

State and Local Taxes⁷

The state and local tax systems, as a whole, expanded while the federal system was being trimmed to fit prosperity. Unfortunately for those who would like a compact and precise statement of what happened, many of the necessary facts have never been assembled.

Dependence on Property Tax

The chief source of revenue remained the property tax. In urban areas the real estate speculation of the '20's boosted assessed values and, with them, ~~tax-revenues~~. In rural areas, however, the long-continued post-war liquidation resulted in a far less cheering picture. Certain modifications in the property tax laws influenced revenue: for example, the gradual extension of low-rate taxation or complete exemption of bonds, stocks, etc., and exemptions for veterans.

Growth of Highway Taxes

The gasoline tax, first used in the United States in 1919, reached a total yield of about \$400,000,000 by 1929 and \$500,000,000 by 1931. With the aid of a few rate increases here and there, the total revenue from this source decreased very little in 1932 and 1933.⁸ By spreading through every state in the eleven-year period 1919-29 the gasoline tax made a record that is not likely to be approached for some time, save possibly by the payroll tax for unemployment insurance.

The motor vehicle license tax had been extensively used even before 1920. With increases in rates and in the number of registrations, its revenue grew in importance up to 1930. In some states the tax was supplemented by

⁷ See Note 2, *Sources for Recent History of State and Local Taxation in the United States*, p. 519.

⁸ Finla G. Crawford, *The Gasoline Tax in the United States, 1934* (Chicago, 1935), p. 5.

special taxes on commercial vehicles for hire or common carriers.

Income and Other Taxes

The personal income tax spread slowly and was generally levied at low rates. At the end of 1920 it was in force in ten states including one or two that administered it with little effectiveness; at the end of 1925, in eleven; at the end of 1929, in fourteen. These figures do not include the New Hampshire and Tennessee taxes, restricted to income from certain securities, etc. The corporation income tax had much the same record.

A few of the oil, metal, and coal states passed severance taxes, in the form of a certain percentage of the value extracted or at certain rates by the ton or barrel, etc. Many states increased the rates of the death taxes in the first half of the decade, partly because of the federal government's action. Bank taxes (particularly when a Supreme Court decision in 1921 upset the existing system), insurance company taxes, and capital stock taxes attracted much attention but still produced relatively little revenue. The embryonic forms of a general sales tax appeared in West Virginia and Georgia, and a few states tried a tax on tobacco products (or merely on cigarettes) with indifferent success.

DEPRESSION

Federal Taxes

The structure of the federal tax system has been markedly changed through a series of revenue acts caused by the depression. The change has certain curious aspects. The income tax rates have been put back on the war-time level, and the estate tax rates have been raised higher than ever before; yet the percentage of total federal tax revenue coming from incomes, profits,

and estates has been very low. In each of the years 1933-36 it has been lower than in any year since 1917.

The depression has of course reduced the productivity of high income tax rates, high estate tax rates, and the excess profits tax. Also the recovery and reform program has seemed to those in power to demand the use of other new revenue measures—for example, the processing taxes that financed for a while the farm relief program. The repeal of prohibition made available a revenue source that no government, whatever its preference for income taxes, would dare neglect. These three factors alone go far toward explaining the high percentage of total revenue supplied by taxes other than those on income and estates.

The transformation of the federal tax system was largely completed during the calendar years 1932 and 1933.

The Revenue Act of 1932

The Revenue Act of 1932, passed before the elections of that year, included a large increase in income tax rates. The rate scale was copied from the 1921 act except that the progression (normal tax plus surtax) extended to 63 per cent on that part of the income above \$1,000,000, instead of stopping at 58. The 1921 scale, it will be recalled, was on the average higher than that of the Revenue Act of 1917 and not far below the all-time peak reached by the schedule in the Revenue Act of 1918. Thus the 1932 act had the second highest rate schedule in United States history.

The other main achievements of the 1932 act were a doubling, roughly, of the estate tax rates, coupled with the imposition of a gift tax, and the introduction of a series of automotive taxes, chiefly a tax on gasoline—the first the federal government had ever enacted. The first-class postage rate was also increased.

Changes in 1933-34

Beer and wine of not more than 3.2 per cent alcohol by weight were termed "non-intoxicating" by Congress early in the next year (March 22, 1933) and were subjected to certain taxes. The \$5.00-a-barrel tax on beer has proved a surprisingly large source of revenue. The Liquor Taxing Act of 1934, approved January 11, took account of the repeal of the Eighteenth Amendment by imposing a tax of \$2.00 a proof gallon on spirits.

Meanwhile, on May 12, 1933, the Agricultural Adjustment Act was adopted. Its processing taxes were destined to yield at the rate of \$500,000,000 a year before they were invalidated by the Supreme Court early in 1936. Shortly after the agricultural legislation, came the National Industrial Recovery Act (June 16, 1933) with its capital stock tax and so-called excess profits tax.

Changes in 1934-36

Since the Liquor Taxing Act of January 1934 three important federal taxes have been the subject of legislation: the estate tax, the income tax, and the social security taxes.

The rates of the estate tax—and, with them, those of the gift tax—were materially increased by the Revenue Act of 1934 and again by the Revenue Act of 1935. Under the latter act they have reached a level almost twice as high as that of the 1932 act, and this was twice as high as the level that prevailed from 1926 to 1932. A comparison of the rate levels at selected points is given in Table 4.

The income tax was revised by the Revenue Act of 1935 to increase surtaxes on incomes above \$50,000. The Revenue Act of 1936 makes dividends subject to the personal normal tax even though they come from corporations that have paid a corporation income tax. The

1936 act also imposes a special tax on the undistributed profits of corporations.

The Social Security Act, passed August 14, 1935, levies taxes that are planned to total 9 per cent of payrolls, as

TABLE 4
ESTATE TAX RATES AT CERTAIN LEVELS
1926-35

Block of Net Estate (In Dollars)	Rate (In Per Cent)			
	1926 Act	1932 Act	1934 Act	1935 Act
Under 50,000	1	1 - 5	1 - 5	2 - 10
100,000-400,000	4	11	16	20
2,000,000-2,500,000 . .	10	25	34	38
Over 10,000,000	20	45	60	67 - 70

discussed elsewhere.⁹ The Carriers Taxing Act of August 29, 1935, levies similar taxes to provide for railroad pensions. It replaces in part the Railroad Retirement Act, held unconstitutional by the Supreme Court on May 6, 1935.

Changes of Twenty-Five Years

The federal tax system is indeed harder to picture in brief and simple outline than it was when the depression struck or even during the war. However, the figures in Table 5 at least suggest the revolutionary changes of the past quarter-century. They represent the percentage of the total of federal tax revenue accounted for by each of the taxes noted, in the fiscal years 1913 and 1936.

State and Local Taxes

The minor shifts in 1920-29 had somewhat prepared the states for the time when they were to be called on to give aid to the local units.¹⁰ The property tax, more particularly the real estate tax, sank under the weight of the depression to an extent that seemed at first hardly

⁹ See pp. 263-65.

¹⁰ See Table Q, p. 577.

credible in view of its record for consistent yields through the preceding decades. Counties, cities, towns, school districts, and special districts curtailed their services

TABLE 5
RELATIVE IMPORTANCE OF FEDERAL TAXES
1913, 1936

Tax	Percentage of Total Federal Tax Revenue	
	1913	1936
Customs duties.....	48	10
Taxes on incomes and profits.....	5	36
Estate tax and gift tax.....	—	10
Automotive taxes.....	—	8
Tobacco taxes.....	12	13
Liquor taxes.....	35	13
Other taxes.....	—	10
	100	100

sharply. In some states certain activities became a responsibility of the state governments—either directly, by state administration of the activities, or indirectly, by state subsidies to the local administrative units. The money was usually raised by borrowing or by the use of new state taxes.

Rapid Spread of Income Taxes and Sales Taxes

The income tax spread rapidly among the states during the depression. At the end of 1929, only fourteen were imposing personal income taxes; on January 1, 1937, the number was twenty-nine. Neither figure includes the restricted income taxes of New Hampshire, Ohio, and Tennessee. Corporate income taxes were on the books of sixteen states in 1929 and thirty on January 1, 1937. At least seven of the states that had personal income taxes in force at the beginning of 1930 raised their rates during the next seven years.

The sales tax, usually in the form of a tax of 2 per cent

or 3 per cent on all sales at retail, was in force in twenty-two states and the cities of New York and New Orleans on January 1, 1937. Gasoline tax rates were, on the whole, not greatly increased. However, in 1934 about 18 per cent of the total state and local revenue from the tax was not earmarked for the building or maintenance of highways or the servicing of highway bonds.¹¹ As a result of the repeal of prohibition, most states imposed liquor taxes, usually gallonage taxes similar to those of the federal government.

In 1935 and 1936 minor luxury taxes and selective sales taxes spread rapidly. Four states adopted a cigarette tax in 1935, and one in 1936, bringing the total number of cigarette-taxing states to twenty. The taxes are at fairly high rates, from 1 cent to 3 cents for a package of twenty cigarettes of the usual grade. Arizona in 1935 and Kentucky in 1936 imposed miscellaneous luxury taxes, some of which were repealed shortly. Kentucky, Maryland, and Pennsylvania enacted taxes on admissions.

In 1936 many states enacted payroll taxes in order to participate in the unemployment compensation plan.

Important Regional Differences

Important regional differences are apt to be overlooked in generalizing about a country of nearly 130,000,000 people. At one extreme is Nebraska, which has passed through the entire period 1925-36 without adding a single new tax of importance to its state or local revenue system except a liquor tax. At the other extreme are Michigan, Ohio, West Virginia, and other states, where the property tax plays a much less important part than before the depression, having been replaced to a large extent by sales taxes and gross production taxes.¹²

¹¹ See p. 258.

¹² See Note 3, *Notable Decreases in Property Tax Assessments or Collections, State and Local*, p. 525.

Nominal Stability of Some Property Taxes

Property tax rates in urban centers remained almost unchanged during the depression, judging by the average for cities of more than 30,000 population. This average is somewhat misleading since a study of each of the forty largest cities shows in many cases an appreciable fluctuation in tax rate from year to year. The relative stability in part reflects a stable tax base. Assessed valuations in cities, on the average, remained almost unchanged in 1931 but dropped approximately 4 per cent in 1932, 8 per cent in 1933, 6 per cent in 1934, and 2 per cent in 1935, and remained almost unchanged in 1936. The percentage drop is from year to year.¹³

In some farm areas assessed values were written down much more sharply than the average, and rates also decreased. In most localities, rural and urban, however, the assessors seem not to have lowered assessed values in proportion to the fall in market values.

With many important exceptions, the localities, and to a much lesser extent the states, held the property tax nominally at or near prosperity levels. However, owing to substantial delinquency, they had to get along on much smaller collections. Even the nominal amount was sharply reduced in some instances, particularly in states like Michigan, Ohio, and West Virginia, where low, over-all, property tax rate limits were voted into the constitutions under the stress of the emergency.¹⁴

¹³ See Note 4, *Fluctuation in Urban Property Tax Rates and Assessed Valuations During the Depression*, p. 525.

¹⁴ See Note 3, *Notable Decreases in Property Tax Assessments or Collections, State and Local*, p. 525.

Chapter 4

TESTING THE TAX SYSTEM

THE PROCESS OF JUDGING A TAX SYSTEM

In Chapter 1 some common complaints about the tax system of the United States were listed. They indicate that the system is failing to achieve certain aims. It is, therefore, in order to ask what the aims of the tax system are, or can be.

In fact only by a clear definition of what is wanted of a tax system is it possible to judge it. Once the aims are clear, however, any tax can be judged by testing its performance against each one of them. Book Two is given over to these tasks. After the aims are defined, they are applied to the various taxes, one by one, and in the end certain conclusions are drawn.

Primary and Secondary Aims

The aims of taxation fall into two groups—primary and secondary. The primary ones are so important that they may be called the main purposes of taxation. Under the existing economic system these are, broadly speaking, two: (1) to raise revenue, and (2) to control production, distribution, or consumption. Thus, a tax may be levied to supply money for expenditure on highways, education, etc., or it may be levied to restrict imports, decrease consumption of liquor, etc. Some taxes show a mixture of both of these primary aims.

Once the primary aim has been fixed in testing a tax, a number of secondary aims must be considered. For example, if the primary aim is to raise \$1,000,000,000 in

tax revenue in a given year, it can be accomplished in a number of ways. The choice must depend on what secondary aims are selected, and how much weight is given to each one compared with others that may be inconsistent with it.

Secondary aims cannot be considered the main purposes of taxation. Given an existing system, with no desire for added revenue or for a change in social control, no one would urge additional taxation simply in order to make the public more tax conscious. The secondary aims may be reasons for replacing existing taxes, as when an attempt is made to shape the relative burdens of taxpayers more closely to some pattern of tax justice. They cannot, however, be motivating forces behind taxation in general.

Relative Importance of Aims

Two secondary aims commonly held are (1) simplicity in administration and (2) a nice adjustment of the tax burden to each individual's ability to pay. Both of these aims cannot be reached within the same tax system. Some aims must therefore be sacrificed if others are to be realized. More precisely, a closer approach to one must be sacrificed so as to lessen the distance from another. This idea of how far a tax attains its aim involves measurement. Terms must be used that are comparative and, if possible, quantitative.

A quantitative statement of the administrative aim is sometimes vaguely made by appealing for a "low cost of tax administration." Ideally, the aim would be a cost of zero. In view of other aims, however, a cost as high as 2 per cent of the tax revenue may be rated as good. Some aims, particularly those concerned with justice, can never be stated in figures. Larger and smaller quantities can, however, almost always be distinguished and can

be expressed in comparative terms. The main difficulty at present is apt to be not the rough sort of measuring that is necessary, but the careful definition of the aim.

The same problem of measuring and assigning relative weights is found in the primary aims. In theory, the two aims of revenue and social control are opposed to one another. Almost no conflict can be found, however, in American practice. Aside from the customs duties, and possibly the tax on spirits, the taxes aimed at social control tap sources that apparently would never have been relied upon for large yields.

The process of testing a tax system is a purely technical one. It should be unbiased. It cannot be completely so, however, partly because the testing cannot be done without some choice of the aims to be studied, and this process of selection involves a certain amount of personal judgment.

TESTS TO BE MADE

The tests that have been selected for use in Chapters 5 to 24 are based on the two primary aims mentioned above and a number of widely recognized secondary aims. As far as possible, the tests have been devised to enable the reader to judge the present tax system on the basis of the aims that he himself favors. In this section of the book no judgments at all on policies are intended and no suggestions offered for action. These matters are reserved for Chapters 25 to 27 inclusive.

The tests are applied to the entire existing tax system of the United States—federal, state, and local. In the process of testing the system, individual taxes are considered, one by one. Occasional summaries, however, are given where they are needed to present a balanced view of the system as a whole.

There follows a brief résumé of the tests that are to be made.

The Two Primary Aims

Revenue

In considering the aim of raising revenue, attention must first be given to the question of whether a nation has a definite "taxable capacity."¹ This leads naturally to a study of the specific amounts of revenue that can be expected from specified changes in rates, tax base, etc.² By comparing these figures with estimated expenditures,³ the problem of balancing the budget may be outlined.⁴

Social Control

The other primary aim—social control—accounts for many features of the present tax system in the United States.⁵ Some persons, however, will not agree that this should be a primary aim. They claim that any effects that the tax system has on the consumption of certain products, such as liquor, or on the volume of certain kinds of production, such as domestic production sheltered by a tariff wall, should be purely incidental. In their view social control should, at the most, be a secondary aim.

Social control through taxation has had several objectives in the United States. Sometimes the objective has been to promote certain industries.⁶ Reform of business organization and practice has been another.⁷ A miscellaneous group of other industrial controls also deserves attention.⁸ The government has regulated through taxation certain types of consumption that may become socially dangerous—for example, the consumption of liquor.⁹ Finally, the redistribution of wealth and income is a possible objective of importance.¹⁰

¹ See chap. 5 (pp. 57-68.)

² See chap. 6 (pp. 69-93.)

³ See chap. 7 (pp. 94-120.)

⁴ See chap. 8 (pp. 121-18.)

⁵ See chap. 9 (pp. 129-40.)

⁶ See chap. 10 (pp. 141-52.)

⁷ See chap. 11 (pp. 153-87.)

⁸ See chap. 12 (pp. 188-94.)

⁹ See chap. 13 (pp. 195-202.)

¹⁰ See chap. 14 (pp. 203-14.)

Secondary Aims

One of the most important of the secondary aims of a tax system is to distribute the burden among the persons in the community on a fair or just basis.¹¹ The actual distribution of the burden of the whole system is very difficult to measure and describe, even in broad terms.¹² The distribution of certain parts of it, however, is known. This knowledge, though fragmentary, has practical value. For example, it is evident that some widely discussed changes in the real estate tax would in effect amount to a random distribution of gifts by the government.¹³ Likewise, the existing system can be examined to find out the extent to which it distributes the burden on the basis of benefit¹⁴ and on the basis of the social undesirability of certain kinds of income.¹⁵ The adaptability of the system to the personal status of the taxpayer, chiefly in an effort to tax according to ability to pay, can be described.¹⁶

Relative stability of revenue is another important secondary aim. Two different tax systems may raise the same amount of revenue over a certain length of time, but the revenue may come in steadily under one system, and irregularly under the other. Thus one of the secondary aims for a tax system may be cyclical stability, or, on the contrary, cyclical instability. A closely related problem is the effect of an inflationary period of rapidly rising prices on the tax system.¹⁷

Another series of tests can be made to reveal the ease or difficulty with which the tax system is administered, and the extent to which taxes are evaded. Data can be obtained on the cost of administration and also on the cost of compliance. The latter topic includes the extent to which business firms are used as unofficial tax collectors.¹⁸

¹¹ See chap. 15 (pp. 217-220).

¹² See chap. 16 (pp. 221-37).

¹³ See chap. 17 (pp. 238-54).

¹⁴ See chap. 18 (pp. 255-70).

¹⁵ See chap. 19 (pp. 271-93).

¹⁶ See chap. 20 (pp. 294-321).

¹⁷ See chap. 21 (pp. 322-35).

¹⁸ See chap. 22 (pp. 336-51).

The tax system influences public attitude toward taxation by producing tax consciousness. This may be a mere feeling of irritation or a genuine interest in improving the system. If it is the latter, it becomes an important secondary aim that can be applied as a test.¹⁹

Finally, the tax system in the United States operates under a decentralized form of government. As a result, special devices have to be used in order to get a generally acceptable tax system without sacrificing state and local self-government. The degree to which any given tax is adaptable to these conditions is the last of the tests made in this book.²⁰

¹⁹ See chap. 23 (pp. 352-64).

²⁰ See chap. 24 (pp. 365-87).

Book Two

ANALYSIS

PART I. PRIMARY AIMS

Section A. Revenue

Section B. Social Control

Chapter 5

TAXABLE CAPACITY

One of the primary aims of taxation is the raising of revenue. This problem may be considered both in general terms of taxable capacity, as is done in this chapter, and in terms of the yield that may be expected from each tax, a matter that is covered in Chapter 6.

The rapid growth of public expenditures in the United States during the past few decades and the prospect of further growth¹ raise the question whether there is any limit to the taxable capacity of the country. This question applies to the tax system as a whole and will therefore be considered before any estimates of the revenue that may be expected from specified taxes are given.

NON-ECONOMIC LIMITS TO TAXABLE CAPACITY

Taxable capacity in the United States cannot be defined by a single rigid limit. It cannot be expressed in terms of a definite sum of money. Several successive limits can be set instead, which can be overstepped, one after another, under certain specific conditions. Some of these are legal, others political, and still others are economic.

Constitutional Restrictions

Constitutional restrictions on the taxing power may in a sense be regarded as limits to taxable capacity. When a state constitution forbids a locality, such as a county, to levy a property tax at more than a certain specified rate, the power of the county's tax system to

¹ See Table 19, p. 118.

produce revenue is for all practical purposes strictly limited. Such limits, however, apply only to a sub-system, such as that of a county, within the entire system. They are therefore more properly discussed in connection with specified taxes. Furthermore, the limit is not a fundamental one. It can be eliminated simply by amending the constitution. If amendment is impossible in practice, the constitutional provisions reflect underlying political and economic forces that must be isolated and analyzed.

Political Limits

A limit to taxable capacity may be set by political forces—that is, by the unwillingness of the voters to pay taxes. This political limit may be reached long before the economic limits to be explained below take effect. It depends of course on innumerable factors, and it changes with them from day to day.² The degree and kind of tax consciousness are major conditioning factors.³ A large number of taxes at low rates rather than a small number of taxes at high rates may increase the political capacity to pay. A gradual increase in taxation may yield larger tax collections in the long run than a smaller but abrupt increase. Perhaps, indeed, if the tax were imposed gradually enough, the amount that could be raised would be far greater than is commonly supposed.

Another major factor is the purpose for which the tax money is raised. The political capacity limit expands as those in control expand their demands for services. This expansion is found in an extreme form in war expenditures. In contrast, the limit will remain restricted as long as small minority groups that favor various expenditures work only for their separate interests. The limit expands when the minorities consolidate their programs.

² See Note 1, *Political Limits to Taxable Capacity*, p. 528.

³ See pp. 352-64.

ECONOMIC LIMITS TO TAXABLE CAPACITY

Most of the popular discussions of taxable capacity, however, seem to be concerned less with these political limits and more with what is assumed to be an economic limit. Beyond that limit, the argument runs, the people would be crushed by a tax load too heavy to bear. It is important, therefore, to determine whether an economic limit of taxation actually does exist, and, if it does, how near the existing level of taxation has come to it.

Limits Dependent on Nature of Expenditure

The position of the limit—indeed, perhaps its existence—depends upon the way the tax money is spent by the government.

The limit will be near if the revenues are spent in such a way that nothing is ever added to the flow of consumers' goods and services. The nation's production is then decreased and hence the income from which tax revenues flow. The process cannot be carried far without starting to dry up the sources of revenue.

Unproductive expenditure usually occurs when the government requisitions goods for destruction or pays to have productive factors held idle.

Another example is the use of tax revenues to support certain groups of people who themselves contribute nothing. The people may be government employees, and the failure to contribute is then a result of inefficient government, as when a department is overstaffed or staffed with incompetent persons. They may, on the other hand, consist of those who are idle because of involuntary unemployment, or because of old age, or injury, or sickness. The government relief program for this latter class, however, may indirectly increase the productive efficiency of the employed. They may pro-

duce more efficiently because they worry less about their own future or the present insecurity of their friends or relatives. Moreover, unemployment relief payments may result directly in an increased flow of consumers' goods and services. Governmental spending brings into play economic forces whose full significance cannot be given in simple terms. Despite all qualifications, however, the support of large numbers of idle persons is the kind of expenditure that brings the taxable capacity limit near to the existing level of taxation.

The limit is farther away if the tax money is used to supply the community with goods and services, even though the goods and services do not include the basic necessities of life.

If the tax money is to be used to produce the necessities of life, the limit of taxable capacity becomes remote. At least, the community does not destroy its own productive power by producing too little of the things that are needed to maintain the persons who produce. The government might, for example, take so much money to spend on even such a valued service as education that the taxpayers would not be left enough money for food. The government—the taxing-spending machine—decides what the producing persons in the community shall do with a certain part of their effort. If they are forced to spend too much time otherwise than in keeping themselves alive and in working condition, their efforts inevitably slow down and cease. A limit of taxable capacity will then have been reached.

Limits Not Dependent on Nature of Expenditure

The economic limits to taxable capacity that have been discussed above depend on the nature of the expenditures. They are not, therefore, purely tax limits. Another kind of economic limit suggested by some observers depends, instead, simply on the volume and kind

of taxes. If it were passed, private business would, it is claimed, decrease and in time practically disappear, chiefly because business initiative would be stifled, and private savings would no longer be accumulated.⁴

The soundness of these statements is obviously a matter of great concern. Unfortunately, the available facts with which to test them are few or are in a state of confusion. A qualified appraisal may be made by reasoning from facts that are generally known. Even this appraisal may turn out to be little more than an expression of personal opinion. Nevertheless, it is worth while to attempt it.

Effect of the Tax System on Business Initiative

People must be induced to risk money if the private capitalist system is to function. Of course, the investor is not the only one who assumes a risk. In practice, however, more options are open to him than to others, and the effect of tax policies on his decisions is generally both the most powerful and the most direct.

His willingness to risk money is only one part of business initiative. Another is the willingness to exert effort in promoting and managing businesses. This factor, however, seems even more uncertain and will not be covered in the present analysis.

The taxes that are most commonly accused of weakening the willingness to risk are income taxes, death taxes, and gift taxes, when they are levied at progressive rates—that is, rates that increase as the amount to be taxed increases.

To some extent, investors weigh the chances of success and failure before placing their money. By imposing an income tax on profits, the government claims a share in the gains without offering to share in the losses. The result is something like an unfavorable shift in gambling

⁴ See Note 2, *New Fabian Research Bureau Report*, p. 529.

odds, and it may be enough to deter the investor. Whether it will or not depends on the other courses of action open to him, and how they appeal to him.

He may turn to some other field of business that offers less reward and also less risk. Since a tax at progressive rates, such as the federal income tax, takes a smaller proportion of the income as the income shrinks, the government will claim a smaller proportion of the less spectacular reward.

Suppose, for example, that an investor estimates roughly that he has one chance in ten of succeeding in venture A, where success will bring \$500,000, and one chance in two of succeeding in venture B, where success will bring only \$50,000. Suppose, further, that the two ventures are about equally attractive to him until he considers the income tax. A steeply progressive income tax that will cut down the net reward of venture A by a much larger percentage than it will the reward of venture B will induce him to choose venture B.

If personal exemption, earned income credit, etc. are disregarded and if the venture to be chosen is the investor's only source of income for the given year and is conducted as an unincorporated business, the present federal tax will cut the return from the risky venture, A, from \$500,000 to \$194,000. Similarly the gain from the relatively safe venture, B, will be cut from \$50,000 to \$40,300. A comparison of \$194,000 with \$40,300 is of course quite different from a comparison of \$500,000 with \$50,000.

Although nothing is known of the actual extent of such influences, it seems reasonable to assume that the present federal income tax is exerting an effective pressure on many investors to turn away from high-risk ventures to relatively safe fields of business.

The pressure depends on both the high rates of the tax and the progressive feature. The investor may be

so rich that he is already in the top parts of the income tax schedule, where the progression is slight. If the choice between venture A and venture B as described above is to be made by an investor who already has a net income of \$1,000,000, the problem changes. Since that part of his income over \$1,000,000 but less than \$2,000,000 is taxed at 77 per cent, in effect the \$50,000 from venture B and the \$500,000 from venture A will be taxed at the same flat rate. The rate is so high that the investor may decide to select neither venture, but at least the degree of weighting against the risky enterprise that was noted in the first example no longer exists.

The investor may, of course, purchase state or municipal bonds or short-term federal securities and thus avoid entirely both the federal surtax and the federal normal tax. His investment in such securities does not necessarily deprive business of capital funds, as has been often charged. For every buyer there is a seller, and the person who sells the bonds now has the same investment problem that the buyer used to have. The only way in which the tax-exempt feature can hamper business initiative by depriving it of capital is by increasing the total amount of tax-free securities outstanding.

In other words, for state and local issues, the proper question is: how much fewer securities would the states and localities sell if the interest on their bonds were not exempt from federal income tax? This is another way of asking whether these bodies, when deciding whether to incur a debt, attach much importance to the rate of interest that they have to pay. The answer is largely a matter of opinion. The writer's present impression is that the volume of state and local debt has not been much influenced by exemption from the federal tax.

The taxes or the rates that happen to be in force at the moment are not decisive. The taxpayer looks to the

future. What may be is more important to him than what is. A constant threat of a high income tax rate even if no such tax is ever levied is a stronger deterrent to the investor and promoter than the actual existence of such a tax over an extended period coupled with a constantly renewed hope of repeal.

The present study cannot carry the analysis of taxation and business initiative further. No factual evidence has been gathered on the subject—at least on conditions in the United States—, nor has any substantial theoretical analysis been offered. Partly in order to discover whether taxation's effect on business initiative has interested economists who are not specialists in public finance, a survey has been made of some thirty or forty books by British and American authorities in the field of general economic principles, money and banking, trusts and corporation problems, etc. The period covered was 1925-36, a time when the federal income tax rates in the United States and many of the income taxes abroad were the subject of considerable popular discussion—especially their effect on business initiative. The result of the survey was almost completely negative.⁵ The public finance specialists, on their side, have contributed practically nothing on the subject during the past decade or so in the United States. Judgment must therefore be suspended. Decisions on tax measures must for the present at least be made very largely on other grounds than the possible effect exercised by various kinds of tax on business initiative.

Effect of the Tax System on Saving

An economic limit may be reached through a discouragement of saving rather than of willingness to risk. The two are closely related, as has been seen. If the possible winnings in a risky enterprise are cut down by

⁵ These statements are based on a memorandum by C. Lowell Harriss.

taxation while the chances for loss remain as before, capital may not enter that field. Perhaps the capital that would have gone into the risky field under a different tax system will not be accumulated at all. Thus a progressive income tax, if high enough, may tend to restrict capital accumulation.

Taxes that do not have an especially strong effect on risk-taking may nevertheless affect capital accumulation. Even a tax system consisting wholly of taxes on commodities might therefore affect the amount of savings. Fundamentally, the answer depends on how much the taxpayers would have saved if the money had been raised by some other kind of tax—assuming the government's expenditures to be unchanged. If possible reductions in expenditures are to be considered too, the problem becomes one of comparing what the taxpayers would have done with the money and what the government does do with it. If all the taxpayers would have saved for investment all the money they now pay in taxes, and if the government invests none of it, the tax and the expenditure decrease the amount of capital that would otherwise have been accumulated.

In any case, no tax exerts a uniform influence on all taxpayers. The taxation of an estate or an inheritance, for example, may or may not lead to a decrease in the nation's savings. Some decedents might have saved correspondingly less to pass on to their heirs had it not been for the prospect of high death taxes. Likewise, some beneficiaries might have spent the money that was taken in taxes instead of saving it.

The direction of the net effect of some taxes is evident. For instance, so much of the saving done by corporations and by wealthy individuals seems to be the result of a simple failure to spend rather than a painful self-denial that an increase of the tax burden on these firms and persons would almost surely result in a net decrease

not in their consumption, but in their savings. Thus the community's savings are probably less when a given amount of revenue is raised by a progressive income tax than when it is raised by a general retail sales tax.⁶ However, any measurement of these effects is not yet possible.

For present purposes, therefore, the search for a taxable limit in an economic sense has chiefly negative results. Positive statements should be distrusted. The faulty logic of many current statements—as, for example, that death taxes are necessarily capital-destroying taxes—should be clearly recognized. Finally, decisions on tax policy will usually have to be based on tests other than the effect of taxation on business initiative and the accumulation of capital.

Tax Total Expressed as a Percentage of National Income

Popular writings during the past few years have often compared the total tax bill with the national income. Thus, if the national income is estimated at \$60,000,000,000 a year, and if the total tax collections equal \$12,000,000,000 a year, the writers in question point, usually with alarm, to the fact that the taxes equal 20 per cent of the national income.

From what has already been said in this chapter, it must be evident that any such percentage figure, standing by itself, has a restricted meaning. Depending on a number of factors, such as the uses to which the tax revenues are put, a percentage of 20 may or may not give cause for concern.

Two specific warnings may be given against using such percentages in discussions of the existing tax system.

The first is based on the meaning of the term "national income." The totals in common use do not include many important services that have a value but do not appear in money terms. They do not include, for example, the

⁶ A. C. Pigou, *A Study in Public Finance* (London, 1929), pp. 79-84.

value of housewives' services, or the net rental value of relatively durable consumer goods used by their owners (homes, automobiles, etc.). If these items were included, the percentage of the total represented by taxes would drop sharply, especially in times of depression, since these services are, like government services, a relatively stable part of the total.

The other warning is based on the double counting of taxes. The national income figure is designed, in the main, to show the total amount available to individuals to spend on themselves as consumers. One method of computing the national income is to add up income that is paid out to individuals in the form of dividends, interest, salaries, wages, rents, and profits. If this figure is, for instance, \$60,000,000,000, it means that \$60,000,000,000 is available to ultimate consumers to meet personal expenses, such as clothing, food, and shelter. Some part of it must be used to pay for items supplied by the government. The payment is usually made in the form of taxes.

Some of the taxes, however, do not have to be met out of the \$60,000,000,000. They have already been paid—at the source, so to speak—by business concerns, out of funds destined for investors or employees. Part of the \$60,000,000,000 comes from dividend payments, for example. Suppose that \$1,000,000,000 of the total taxes were paid out of corporation profits. If this \$1,000,000,000 had instead been raised from taxes on the individual, the corporations would have been able to pay out \$1,000,000,000 more in dividends. The national income would then have been \$61,000,000,000. By a mere change in the kind of tax, the national income, as usually computed, would be increased. If total tax collections are \$12,000,000,000, the proper comparison to make is between \$12,000,000,000 and \$61,000,000,000—or possibly, for certain purposes, \$11,000,000,000 and \$60,000,000,000.

This point is usually overlooked in popular discussions. The resulting percentage of tax payments is therefore too high. How much too high it is cannot be determined without further research. There is evidence, however, that, out of the \$12,000,000,000 or so in taxes currently paid, at least \$1,000,000,000 should be deducted if a comparison is to be made with the net figure of \$60,000,000,000 for national income. This latter figure is perhaps not far from what the data for 1937 will show, but it is used here chiefly for illustrative purposes.

The business taxes in question must be taxes that cannot be shifted. In so far as the business concern shifts them to consumers in higher prices, they must be met out of the consumers' income—in the example above, out of the \$60,000,000,000.⁷

⁷ The national income paid out in 1935 has been estimated at \$53,587,000,000, and the national income produced in 1935, at \$52,959,000,000. Department of Commerce, *National Income in the United States, 1929-35* (1936), pp. 22, 26. The statements on pp. 66-68 above are based largely on a memorandum by C. Lowell Harriss on national income.

Chapter 6

REVENUE YIELDS: PRESENT AND FUTURE

NATURE OF THE ESTIMATES

Taxable capacity as discussed in the preceding chapter is of long-range importance and a matter of billions of dollars. The present chapter deals with the immediate past and the near future, and the analysis will be in terms of specified taxes and hundreds of millions of dollars.

No attempt will be made to predict outright the course of revenues over the next few years—a task for the budget-maker, which involves, among other things, a prediction of business conditions. Another limitation to the data in this chapter concerns the effect of the tax rates on the amount of income, property, etc. reported for taxation. For example, high income tax and estate tax rates may tend to prevent the accumulation of large taxable fortunes and tend to decrease the number of large taxable incomes. At extremely high levels they may not be feasible from an administrative point of view. Uncertainty about the extent of these effects, however, makes it impracticable to take them into account in this survey.

The estimates for the income taxes and the death tax are based directly on data reported in the federal government's *Statistics of Income*¹ for various years. For example, one of the estimates shows the amount of revenue that the 1936 income tax law would produce if it were applied to the incomes that were received in 1928.

The data deal chiefly with the federal government.

¹ Treasury Department, Bureau of Internal Revenue, *Statistics of Income . . . Compiled from Income Tax Returns and Including Statistics from Estate Tax Returns*. Hereafter cited as *Statistics of Income*.

State and local figures are difficult, and in some cases impossible, to obtain. Moreover, the elaborate computations involved in the graduated-rate taxes, such as those on incomes and estates, did not seem justified for any single state, and the computations for all the states as a group were far beyond the resources of the survey.

Data on actual amounts yielded by various federal and state taxes are given in detail elsewhere.² In the present chapter they will be used chiefly in connection with estimates based on certain assumptions. The basic summary estimates for income and estate taxes are given elsewhere,³ but brief summary tables appear in this chapter. Unless otherwise specified, all data on yields are given for the fiscal year ending in the calendar year stated and are evened off to the nearest tenth of a billion dollars.

FEDERAL TAXES

Federal Personal Income Tax

In considering the estimates of the possible yield from the federal personal income tax under the rates and exemptions of the Revenue Act of 1936, the unusual height of the rates must be kept in mind. The surtax rates, which are the same as those in the Revenue Act of 1935, and which have not been changed by any of the subsequent acts up to January 1, 1937, are almost as high, on the average, as the peak rates effective in the Revenue Act of 1918.⁴ The normal tax rate, a flat 4 per cent, compares with the peak normal rates of 6 per cent and 12 per cent, in force on 1918 incomes. The average personal exemption was somewhat lower under the 1918 act than under the 1936 act. Moreover, the 1936 act, in contrast with the 1918 act, allows the personal exemptions, including

² See Note 1, *Federal Tax Collections, 1913-37*, p. 514, and Note 1, *State Tax Revenues, 1936*, p. 529.

³ See the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*.

⁴ See p. 36.

the credit for dependents, to be deducted in computing not only the normal tax but also the surtax.

In the first part of the discussion below,⁵ the changes made by the Revenue Act of 1936 will be disregarded. Those changes, so far as they are important for the present estimates of personal income tax revenue, were (1) the introduction of a tax on undistributed profits of corporations, which tends to force larger dividend payments, and (2) the taxation of dividends by the normal tax of 4 per cent. Both of these factors will be considered later.⁶

Changes in Rates and Exemptions: Prosperous Period

In view of the current trend of business conditions, estimates for a period of prosperity will be made first.

If the 1936 rates and exemptions were applied to incomes for 1928, the peak year of incomes reported in *Statistics of Income*, the personal income tax would yield \$2,900,000,000—\$400,000,000 from the normal tax and \$2,500,000,000 from the surtax. This total, \$2,900,000,000, is substantially more than twice as much as the tax has ever yielded.⁷ It could be raised to \$3,400,000,000 if the personal exemptions were lowered from \$2,500 (married) and \$1,000 (single) to \$1,000 and \$500, and if the credit for each dependent were lowered from \$400 to \$200.⁸ This figure, \$3,400,000,000, is nearly two-thirds of the total amount of \$5,500,000,000 expected from all federal taxes for 1937, which in turn is close to the peak of federal tax revenue—\$5,700,000,000 in 1920.

Of course the amount and distribution of 1928 incomes will not be exactly duplicated in any year. In general, however, the data indicate that, if the present personal income tax is left unchanged, a year of extreme prosper-

⁵ See pp. 71-77.

⁶ See pp. 77-80.

⁷ See Note 1, *Federal Tax Collections, 1913-37*, p. 514.

⁸ See Note 2, *Increases in Returns from Changes in Exemptions and Earned Income Credit*, p. 573.

ity at somewhat above present price levels will produce between \$2,500,000,000 and \$3,000,000,000. This estimate does not take into account the effect of the Revenue Act of 1936 either in forcing out added dividends to stockholders by the operation of the undistributed profits tax, or in the taxation of dividends by the normal tax. In 1936 the personal income tax—without these new provisions—produced only \$700,000,000. This yield reflected partly 1934 incomes and partly 1935 incomes.

If an attempt is made to reduce the government debt, new tax revenue may be needed. Estimates have therefore been made in Table 7 of the yield from two schedules of surtax rates that are even higher than those in the 1936 act. These schedules are given in part in Table 6. They are somewhat arbitrary and are not recommendations of the writer. They are presented only because the discussion of possible increases in revenue would otherwise be too vague to be useful.

Surtax Schedule A starts imposing a surtax on \$4,000–\$5,000 incomes as does the 1936 act, but at a 1 per cent instead of a 4 per cent marginal rate. It increases the percentage, as incomes increase, faster than the present law does up to incomes of \$90,000. On income above that amount, Surtax Schedule A and the present law are the same. For example, incomes of \$9,000 to \$10,000 would pay a 10 per cent marginal rate under Surtax Schedule A, compared with 6 per cent under the present law, and 30 per cent as against 19 per cent on \$28,000–\$30,000 incomes.

Surtax Schedule B starts as does A, but the increases are steeper than in A, and the maximum rate of the 1936 act—75 per cent—is applied to all incomes above \$75,000.

Surtax Schedule A is estimated to yield about \$500,000,000 more than the 1936 surtax rates when applied to 1928 incomes. Thus, Surtax Schedule A, together with the normal tax of 4 per cent, would yield about \$3,400,-

TABLE 6

SURTAX RATES USED IN ESTIMATES OF YIELDS*

Income Brackets (In Thousands of Dollars)	Marginal Rate Applicable to Surtaxable Income Within Bracket ^b (In Per Cent)				Average Rate of Surtax on a Sur- taxable Income Equal to Upper Limit of Bracket ^c (In Per Cent)			
	1936 Act	Sched- ule	Sched- ule	Sched- ule	1936 Act	Sched- ule	Sched- ule	Sched- ule
		A	B	C		A	B	C
0- 1.....	0	0	0	10	0	0	0	10
4- 5.....	4	1	1	14	1	4	4	12
9- 10.....	6	10	11	19	3	4	4	15
14- 15.....	9	15	21	29	5	7	8	18
19- 20.....	13	20	31	39	6	10	13	22
28- 30.....	19	30	41	49	10	15	21	30
48- 50.....	27	50	61	64	15	25	33	41
74- 75.....	47	52	74	75	23	34	45	51
98- 100.....	55	55	75	75	30	39	52	57
400- 500.....	68	68	75	75	57	59	70	71
750-1,000.....	72	72	75	75	64	65	73	73
2,000-5,000.....	74	74	75	75	72	72	75	75
5,000 and over ..	75	75	75	75	—	—	—	—

* Only selected portions of the surtax rates are given. For details, see the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*.

^b These rates are the kind that appear in the law and that are commonly noted in discussions of income tax rates. For example, if a taxpayer has a surtax net income of more than \$4,000, the 1936 act taxes the part of the income that lies between \$4,000 and \$5,000 at a surtax rate of 4 per cent.

^c These rates are computed from the marginal rates. They do not appear in the law and are commonly ignored in current discussions, but they are usually more illuminating than the marginal rates. For example, a taxpayer with a surtax net income of \$5,000 pays a surtax of approximately 1 per cent of the \$5,000, under the 1936 act.

^d Less than $\frac{1}{2}$ of 1 per cent.

000,000 on 1928 incomes, and, if exemptions and the credit were lowered to \$1,000, \$500, and \$200, it would yield about \$3,900,000,000.

Surtax Schedule B, applied to 1928 incomes, is estimated to yield about \$700,000,000 more than Surtax Schedule A—or \$1,200,000,000 more than the 1936 rates—or, added to the yield of the 4 per cent normal rate, a total of \$4,100,000,000. With exemptions lowered to \$1,000 and \$500, and the credit lowered to \$200, the total becomes \$4,700,000,000.

The additional revenue to come from lowering exemptions and the credit for dependents and retaining the 1936 rates is, as indicated in Table 7, about the same as

TABLE 7
ESTIMATED YIELD OF PERSONAL INCOME TAX ON VARIOUS ASSUMPTIONS*

	1924 Incomes	1928 Incomes	1931 Incomes	1933 Incomes	1934 Incomes	1934 Incomes	1934 Incomes	1934 Incomes	
Exemptions	Married ^b	\$2,500,	\$2,500,	\$1,000,	\$2,500,	\$2,500,	\$1,000,	\$2,500,	\$1,000,
	Single	\$1,000,	\$1,000,	\$500,	\$1,000,	\$1,000,	\$500,	\$1,000,	\$500,
	Dependent	\$400	\$400	\$200	\$400	\$400	\$200	\$400	\$200
<i>In Millions of Dollars</i>									
Normal tax at 4 per cent ^c . .	294	432	826	192	105	282	121	334	
Surtax:									
1936 Act	978	2,474	2,574	617	379	407	413	454	
Schedule A	1,262	2,965	3,096	770	487	523	530	582	
Schedule B	1,610	3,693	3,854	963	618	662	669	729	
Schedule C	2,543	4,908	6,163	1,581	973	1,512	1,177	1,804	
Total tax:									
1936 Act	1,272	2,907 ^d	3,401 ^d	808 ^d	483 ^d	689	533 ^d	788	
Schedule A	1,556	3,397	3,923 ^d	962	591 ^d	805	651	916	
Schedule B	1,904	4,126 ^d	4,681 ^d	1,154 ^d	722 ^d	943 ^d	789 ^d	1,063	
Schedule C	2,838 ^d	5,340	6,990 ^d	1,772 ^d	1,077 ^d	1,794	1,297 ^d	2,138	

Normal tax at 4 per cent on Dividends ^a	f	160	f	f	57	f	61	f
Tax on additional Dividends ^b	f	1,400	f	f	120	f	340	f

^a For normal tax at 4 per cent and for various surtax schedules and for incomes as returned for 1924, 1928, 1931, 1933, and 1934. The net income subject to normal tax and surtax is as defined by the Revenue Act of 1936, except that, up to the last two lines, the taxation of dividends under the normal tax and the effect of the undistributed profits tax are ignored. For details, see the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*.

^b Or, "head of family."

^c Dividends assumed exempt from normal tax.

^d Discrepancy between sum of items and total given arises from evening off to nearest million.

^e Additional revenue obtained by removing the exemption of dividends from the normal tax, as was done by the Revenue Act of 1936 (without assuming any additional dividends because of the undistributed profits tax).

^f No estimate made. However, in so far as the lowering of the exemptions is concerned, the increase in this item would be slight.

^g It is assumed that enough additional dividends are distributed so that the corporations have no undistributed profits tax to pay. Most of this revenue must be considered a temporary increase, since it is obtained at the expense of revenue that would otherwise have been received in later years. A small portion, probably not more than 25 per cent at the most, may be considered permanent, not advance, net revenue. It is the result of the action of the tax in checking avoidance, and also in saving interest on amounts the government would otherwise have to borrow.

the increase from Surtax Schedule A over the 1936 rates. Under 1928 income conditions, a lowering from \$2,500, \$1,000, and \$400 to \$1,000, \$500, and \$200, with no change in rates from the 1936 act, would increase the yield of the personal income tax by \$500,000,000—from \$2,900,000,000 to \$3,400,000,000. However, \$400,000,000 of the increase would come from the normal tax—that is, in large part from the inclusion of new taxpayers of small income—whereas the increases under Surtax Schedules A and B come wholly from surtax, and almost entirely from those taxpayers with net incomes of more than \$25,000.⁹

Changes in Rates and Exemptions: Other Periods

The 1936 rates and exemptions would produce only \$500,000,000 on the incomes received in 1933—the lowest taxable-income year of the depression—compared with \$2,900,000,000 on a 1928 base. Surtax Schedule A would yield only \$100,000,000 more than the 1936 rates if both were applied to the 1933 base, and Surtax Schedule B would yield only the same increase over Surtax Schedule A. Lowering the exemptions and credits as indicated above, with 1936 rates, would increase the yield about \$200,000,000 on the 1933 base. The great pressure on the taxpayer by Surtax Schedule B with the lower exemptions and credit would yield a total of only \$900,000,000 on 1933 incomes.

At various stages between the 1928 and 1933 figures come the estimates based on incomes reported for the years 1924, 1931, and 1934, for which data are also given in Table 7. The 1931 figures show increases of \$300,000,000 or \$400,000,000 over 1933, while the 1924 figures show increases of from \$800,000,000 to \$1,200,000,000 over 1933—with 1936 exemptions and credit for dependents.

⁹ See the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*.

Estimates for Extreme Scale

Estimates were also made for a relatively high surtax schedule, called Surtax Schedule C, shown in part in Table 6, which starts with a rate of 10 per cent on the first \$1,000 of surtax net income and reaches the maximum 75 per cent level at that part of the income between \$70,000 and \$72,000.

Obviously, such a schedule would be considered only in the event of an extreme fiscal crisis. Estimates based on it are subject to a particularly wide margin of error because of the unpredictable forces of avoidance and evasion that such rates would produce. Use of the same estimating technique that was employed for other data above gives a yield of \$5,300,000,000 on 1928 incomes, of which \$400,000,000 is normal tax and \$4,900,000,000 surtax. If the low exemptions of \$1,000, \$500, and \$200 are used, the total reaches \$7,000,000,000, of which \$800,000,000 is normal tax and \$6,200,000,000 is surtax.

Estimates of yield under almost any surtax scale can be made with the help of the ready reckoning table given in another volume.¹⁰

New Taxes in the Revenue Act of 1936

None of the estimates above takes into account the changes made in the Revenue Act of 1936. While this act did not increase the rates of the personal income tax, it tends to increase the yield for the next few years in two ways—by eliminating an exemption and by transferring into present years some income that normally would not appear until future years. In part, therefore, the act raises genuinely additional revenue, and in part it raises advance revenue—that is, revenue obtained in the present at the expense of the future.

The genuinely additional revenue comes from the taxation of dividends under the normal tax of 4 per cent.

¹⁰ *Ibid.*

Hitherto dividends were subject only to the surtax if they came from corporations taxable under the corporation income tax. The 1928 income statistics indicate an additional yield of \$160,000,000 from this change; the 1933 statistics, \$60,000,000; and the 1934 statistics, likewise, \$60,000,000. For present purposes, \$100,000,000 may be used as a general estimate. These estimates assume no pressure from an undistributed profits tax for an increase in dividends. Details of the computation are presented elsewhere.¹¹

The advance revenue—revenue raised in the present at the expense of the future—is the revenue that will come from the normal tax and surtax on dividends that would not have been paid out until later, if at all, had it not been for the undistributed profits tax of 1936. If this tax induces larger dividend payments, future years will show smaller dividend payments unless the corporation would have retained the earnings permanently. In the latter event, the stockholders' shares would often have shown a corresponding increase in value. Frequently this increase would eventually have been realized by sale. Thus the larger dividend payments induced by the new tax also tend to result in relatively smaller capital gains and larger capital losses for stockholders. Certain exceptions to this statement, however, might occur. The corporation might lose the money that it would retain were there no undistributed profits tax. Owing to a loophole in the law, the stockholder and his heirs might forever escape taxation if the stockholder did not sell and if no dividends were distributed as long as he or his heirs held the stock. Despite these and other qualifications, the general effect on the personal income tax is to shift the tax base from the future to the present.

The estimate problem is therefore a peculiar one. If the estimate is for the specific near-term years, 1937, 1938,

¹¹ *Ibid.*

etc., the effect is a genuine revenue increase. If the estimate is an average, long-term figure, little increase should be counted on. However, the government will certainly gain by the amount of interest it would have had to pay on borrowings.¹²

If all corporation earnings had been distributed as dividends in the income year 1928, the amount and distribution of the added income to stockholders would have resulted in an additional \$1,400,000,000 in personal income tax under the rates of the Revenue Act of 1936. With 1933 income figures, the estimate is only \$100,000,000, and with 1934 figures it is \$300,000,000. These figures, shown in Table 7, are of course maxima, and are almost surely much too high, since the undistributed profits tax will scarcely force 100 per cent of earnings out in dividends.

The assumption about undistributed dividends also affects the estimate of the yield of the corporation surtax on undistributed profits. The estimate for the latter tax that is given in Table 9 below is a practical maximum (the minimum is zero). It assumes that the new tax has no effect on dividend policy.

The two maxima cannot, of course, be added. To the extent that one tax is productive, the other cannot be. The entire prospect is so uncertain that no summary of the revenue effect of the undistributed profits tax can be made, except that it will add several hundred millions of dollars—perhaps \$500,000,000 in an average year—in the form either of corporation tax or of personal tax, largely at the expense of the yield of future years.

The rates of the undistributed profits tax are graduated, and in many cases corporations may be expected to follow the policy that is calculated to minimize the total tax. Actual revenues from the undistributed profits tax plus actual revenues from the personal tax on additional

¹² See note g to Table 7.

dividends will therefore probably be less than the revenue under either of the assumptions in the present computations. No basis exists, however, for estimating the size of this difference.

Changes in Treatment of Capital Gains and Losses

In all the estimates given above, the definition of net income is assumed to remain unchanged as fixed by the Revenue Act of 1936. However, the inclusion of capital gains or losses in the tax base has been the subject of much debate. Capital gain or loss is, broadly speaking, gain or loss from the sale of non-business assets and of business assets aside from stock in trade and inventory generally. Should such gain or loss be excluded from the tax base? If it is included, how should it be treated?

Estimates have been made of the revenue results that might be expected from any one of four methods of treating these items. The estimates are for the income years 1928 and 1931 only, and they assume that in all other respects the tax law is that of 1936, except that the new provisions of the 1936 act affecting dividend payments are ignored.¹³ Brief summary results are given in Table 8, and the basic summary is presented elsewhere.¹⁴

The four bases on which the estimates are made are called: (1) the "percentage plan," (2) the "no-net-loss plan," (3) the "equal-treatment plan," and (4) the "no-tax plan." What each of these plans involves and the estimates of revenue that each would produce may be summarized as follows.

(1) The percentage plan, contained in the act of 1936, taxes a decreasing percentage of the gains according to the length of time the asset has been held. If the period is not more than one year, the full amount of the gain is taken into account in computing net income. If the

¹³ See pp. 77-78, 84-85.

¹⁴ See the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*.

period is more than one year but not more than two years, only 80 per cent of the gain is taken into account; if more than two years but not more than five, 60 per cent; if more than five but not more than ten, 40 per cent; and if more than ten, 30 per cent.

The object of this plan is to avoid taxing a long-accumulated gain at high surtax rates merely because it happens to be realized all in one year instead of bit by bit over a number of years. Capital losses are given the same treatment, but their deduction is allowed only as an offset for capital gains of the same year, plus an extra allowance of \$2,000 that is designed for the small taxpayer.

The estimates already presented show that, if the provisions of the percentage plan in the 1936 act were left unchanged, the surtax yield on 1928 incomes would be \$2,500,000,000, the normal tax yield \$400,000,000, and the total, \$2,900,000,000.

(2) Under the no-net-loss plan, all capital gains are taxed at their full amount regardless of the length of time that the capital asset is held. Capital losses are deducted at their full amount, regardless of the length of time that the asset is held, but are allowable only to the extent of the taxpayer's capital gains of the same year. Under this plan the surtax yield on 1928 incomes would increase by \$700,000,000 to \$3,200,000,000, and the normal tax yield would increase by \$100,000,000, giving a total increase of \$800,000,000. On 1931 incomes, on the other hand, the total increase, normal tax and surtax, would be only \$300,000,000.

(3) Under the equal-treatment plan all capital gains are fully taxable and all capital losses fully deductible regardless of the length of time that the asset is held. On 1928 incomes this plan would yield a total increase of \$700,000,000 over the percentage plan. This increase is only slightly smaller than that of the no-net-loss plan.

The important difference between the no-net-loss plan and the equal-treatment plan shows clearly in 1931 incomes. On this basis the equal-treatment plan gives \$100,000,000 less than the percentage plan, whereas, as has been seen, the no-net-loss plan gives \$300,000,000 more than the percentage plan. This equal-treatment plan assumes that capital losses cannot be carried over from one year to another.

(4) Under the no-tax plan capital gains and capital losses are both entirely ignored. If this were done, the total yield on 1928 incomes would drop sharply from the \$2,900,000,000 yield under the percentage plan to \$1,600,000,000—a decrease of \$1,300,000,000. On 1931 incomes, a slight gain of \$100,000,000 over the percentage plan is estimated.

In short, the government would probably be a heavy loser in revenue over a period of a decade or so if it substituted a no-tax plan for the percentage plan. It would probably lose even more if it selected a no-tax plan in place of an equal-treatment plan.

By taking the most one-sided of the plans—the no-net-loss plan—the government could increase its revenues even in a depression year compared with the percentage plan. In prosperous times the increase would be large. About the same increase over the percentage plan can be gained in a prosperous period under the equal-treatment plan, but in a depression year the government would have to accept a slight loss compared with the percentage plan.

Federal Corporation Income Tax

Graduation of the corporation tax rate, introduced by the Revenue Act of 1935 and continued by the Revenue Act of 1936, complicates the task of estimating the yield. However, the problem is not yet serious since the graduation is slight.

On 1928 incomes, as is indicated in Table 9, the corporation normal tax of 1936 would yield \$1,800,000,000—\$500,000,000 above the peak yield of 1927. The same

TABLE 8

ESTIMATED YIELD OF PERSONAL INCOME TAXES UNDER VARIOUS PLANS FOR TAXING CAPITAL GAINS AND LOSSES^a

(In Millions of Dollars)

Income Year	Percentage Plan ^b	No-Net-Loss Plan ^b	Equal-Treatment Plan ^b	No-Tax Plan ^b
1928				
Surtax.....	2,474	3,198	3,132	1,298
Normal Tax	432	497	489	310
Total....	2,907 ^c	3,695	3,621	1,608
1931				
Surtax.....	617	845	553	711
Normal Tax	192	235	187	213
Total....	808 ^c	1,080	740	924

^a The estimates are based on incomes for 1928 and 1931. Other provisions are assumed as in Revenue Act of 1936. For qualifications concerning dividends, see p. 80 and then pp. 77-78, 84-85.

^b For definitions of plans, see pp. 80-82.

^c Discrepancy of total and sum of items results from evening off to nearest million.

amount, \$1,800,000,000, would be produced by the slightly different scale of rates and provisions in the Revenue Act of 1935. On 1933 incomes the 1936 act normal tax would give only \$500,000,000, and on 1934 incomes, \$600,000,000.¹⁵

Within reasonable limits, a certain percentage increase in the average rate of the tax ought to be accompanied by a corresponding percentage increase in the yield. Thus, if the average rate were increased to 20 per cent, the yield would probably increase by about one-third. At present, the rate progresses from 8 per cent on the first \$2,000 of a corporation's income to 11 per cent on that part of the income above \$2,000 and not above \$15,000, 13 per cent on that part above \$15,000 and not above \$40,000, and 15 per cent on all the income above \$40,000.

¹⁵ *Ibid.*

About four-fifths of corporate income will, in a prosperous year such as 1928, be income above the \$40,000 level.¹⁶ Thus, the average rate is close to 15 per cent.

The surtax on the undistributed net income of corporations, introduced in 1936, poses practically insoluble estimating problems. The figures given here present only a rough indication of the maximum yield that may be expected.

On the assumption that corporations would follow the same dividend practices as in the past, an income year like 1928 would produce average undistributed profits equal to 37 per cent of what the law defines as the "adjusted net income." The highest rate of the undistributed profits tax that would be applicable would therefore be 17 per cent.¹⁷ The amount of undistributed income would be \$4,200,000,000, and the yield of the undistributed profits tax would be \$500,000,000. However, if deviations from the average practice were as wide as a recent

TABLE 9
ESTIMATED YIELD OF CORPORATION NORMAL TAX AND
SURTAX^a

(In Millions of Dollars)

	Income Years		
	1928	1933	1934 ^b
Normal tax	1,785	499	622
Surtax on undistributed profits:			
Assuming no deviation from average ^c . . .	546	62	254
Assuming deviation from average ^c	804	92	375
Total corporation tax:			
Assuming no deviation from average ^c . . .	2,331	561	876
Assuming deviation from average ^c	2,589	591	997

^a Under the Revenue Act of 1936.

^b These estimates are subject to a wider range of error than estimates for 1928 and 1933 owing to the lack of data, at the time that they were made, on distribution of net income by income classes and on dividends received and cash dividends paid.

^c See pp. 84-85.

¹⁶ *Ibid.*

¹⁷ See p. 514.

sample indicates, the yield would be \$800,000,000.¹⁸ On 1933 incomes the total corresponding to \$800,000,000 drops sharply to \$100,000,000, and on 1934 incomes, to \$400,000,000.

Actually, the undistributed profits tax will almost surely increase dividend distributions. Hence the direct yield of this tax will be smaller than these estimates.

In summary, the total corporation income tax as it stands in the Revenue Act of 1936 would yield, under the most favorable assumptions used here, \$2,600,000,000 in an income year like 1928, and in a depression income year like 1933, \$600,000,000.

Federal Estate Tax

Present Rates

In 1936 the federal estate tax produced \$200,000,000. For 1937 the official budget estimate of September 2, 1936, put the yield at \$300,000,000. On the basis of the returns filed in 1930, which covered chiefly the prosperous period of 1928 and 1929, the yield under the present rates would be \$600,000,000, as shown by Table 11.¹⁹ If, instead of the filing year 1930, the filing year 1926 is used, the estimate is \$400,000,000. Lowering the specific exemption from \$40,000 to \$10,000 would increase the yield only by \$100,000,000.

All these estimates are for the tax payable by the taxpayer to the federal government—that is, the total “tentative tax” levied by the law, minus the credit for any death taxes paid by the taxpayer to state governments up to 80 per cent of the federal tax as computed under the old 1926 provisions. This credit was in the aggregate \$100,000,000 in 1926 returns and again in 1930 returns, while in 1933 returns it was only a small fraction of that amount.²⁰

¹⁸ See the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*.

¹⁹ For basic data, see *ibid.*

²⁰ *Ibid.*

Yields of Hypothetical Rates

Estimates of the estate tax yield are given under two sharply higher hypothetical schedules, called Schedule A and Schedule B. These schedules are shown in part in Table 10, and in detail elsewhere.²¹ As with the hypothetical income tax schedules, their use here for illustrative purposes does not imply that they are recommended.²² The rates shown in the schedules are for the "tentative tax," and in general they represent the combined burden of federal and state death taxes. The federal government gets only what is left after deduction of the credit for death taxes paid to state governments.

Schedule A imposes the same marginal rate as at present on estates under \$5,000, but increases the rates with increases in estate more sharply than does the present law, reaching the peak of 70 per cent on estates of \$5,000,000 and over instead of those of \$50,000,000 and over.

Schedule B raises the present rate to 3 per cent on estates under \$5,000 and increases the rates much more rapidly than in Schedule A, reaching 72 per cent on estates of \$750,000 to \$800,000, compared with 26 per cent under the present act, and going up to 75 per cent on estates of \$5,000,000 and over.

The federal government would get \$1,000,000,000 from Schedule A on returns filed in 1930 and \$300,000,000 on those filed in 1933. The tax credit would be the same as that given above in the discussion of the 1935 act yields.²³ Lowering the exemption from \$40,000 to \$10,000 would produce an added revenue in the neighborhood of \$100,000,000 in either case.

The federal government would get \$1,600,000,000 from Schedule B on returns filed in 1930, and \$1,800,000,000 if

²¹ *Ibid.*

²² See p. 72.

²³ See p. 85.

the exemption were lowered from \$40,000 to \$10,000. On returns filed in 1933 it would get only \$500,000,000, and \$700,000,000 if the exemption were lowered.

TABLE 10

 ESTATE TAX RATES USED IN ESTIMATES OF YIELDS^a

Estate Brackets after Deduction of Specific Exemption (In Thousands of Dollars)	Marginal Rate Applicable to Estate within Bracket ^b (In Per Cent)			Average Rate of Tax on an Estate Equal to Upper Limit of Bracket ^c (In Per Cent)		
	1935 Act	Schedule A	Schedule B	1935 Act	Schedule A	Schedule B
Under 5	2	2	3	2	2	3
40- 50	10	12	27	6	8	16
90- 100	14	26	55	10	13	29
450- 500	23	42	68	18	31	57
900- 1,000	29	50	72	22	40	64
4,500- 5,000	53	66	74	38	56	72
9,000-10,000	65	70	75	50	63	73
50,000 and over ..	70	70	75	...	...	...

^a Only selected portions of the rates are used. The rates given in this table are the "tentative tax" rates. After the tax has been computed from them, the amount of death taxes paid to states is subtracted (within a certain limit) and the remainder only is paid to the federal government. For details of schedules, see the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*.

^b These rates are the kind that appear in the law and that are commonly noted in discussions of estate tax rates.

^c These rates are computed from the marginal rates. They do not appear in the law and are commonly ignored in current discussions, but they are usually more illuminating than the marginal rates.

TABLE 11

 ESTIMATED YIELDS OF FEDERAL ESTATE TAXES ON VARIOUS ASSUMPTIONS^a

(Yield Figures in Millions of Dollars)

Rate Schedule	Returns Filed in 1933		Returns Filed in 1930		Returns Filed in 1926	
	Specific Exemption \$40,000	Specific Exemption \$10,000	Specific Exemption \$40,000	Specific Exemption \$10,000	Specific Exemption \$40,000	Specific Exemption \$10,000
1935 Act.....	180	228	603	685	422	480
Schedule A.....	308	380	983	1,107	659	748
Schedule B.....	534	671	1,559	1,789	1,040	1,206

^a After deduction of credit for state taxes paid. Net estates are assumed as in returns filed during calendar years 1926, 1930, and 1933. For details, see the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*. The net estate, except where the specific exemption is given as \$10,000, is as defined in the Revenue Act of 1926 as amended by later acts through 1936.

Other Federal Taxes

No special technique has been devised for estimating the other federal taxes, and no definite estimates are offered. Either the data at hand are too inadequate, as for the gift tax and the payroll tax, or the rate and exemption structure is so simple that no special technique is justified, as for the tobacco tax. However, a few remarks may be made on some of the chief taxes. These are based largely on recent revenue yields, as given in Table 12.

Gift Tax

The large gift tax yield in 1936 was partly the result of a rush to avoid the pending higher federal gift tax and death tax rates. The volume of gifts may drop as more states impose gift taxes. At the end of the year 1936 only three states had such taxes. On the other hand, the cumulative effects of the rate scale²⁴ will result in higher rates, and thus higher taxes, for any one donor as the years pass. The net result is an uncertain outlook. A variation of \$100,000,000 or so in either direction seems possible over the next few years.

TABLE 12
YIELD OF FEDERAL TAXES, FISCAL YEARS 1934-37^a
(In Millions of Dollars)

Tax	1934	1935	1936	1937 ^b
Customs.....	315	345	387	402
Internal revenue:				
Income tax.....	817	1,099	1,413	2,303
Personal income tax.....	420	527	674	°
Corporation income tax....	398	572	739	°
Estate tax.....	104	140	219	268
Gift tax.....	9	72	160	110
Stamp taxes etc.	294 ^d	243 ^d	252 ^d	°
Telephone, telegraph, etc. tax	19	20	21	°
Capital stock tax.....	80	92	95	°
Admissions tax.....	15	15	17	°

²⁴ See pp. 23, 316.

REVENUE YIELDS: PRESENT AND FUTURE

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Tax	1934	1935	1936	1937 ^b
Stock transfer tax.....	38	16	33	°
Check tax ^a	41	26	2	...
Coconut, etc., oils processed.	f	24	28	°
Other stamp taxes etc.	100	49	57	°
Agricultural adjustment taxes ^g	371	526	72	h
Manufacturers' excise taxes...	390	342	383	409
Automotive taxes.....	299 ^d	267	299 ^d	°
Auto bodies and chassis..	38	44	55	°
Parts and accessories.....	6	6	7	°
Tires and tubes.....	28	27	32	°
Gasoline.....	203	162	177	°
Lubricating oils.....	25	28	27	°
Electrical energy tax.....	33	33	34	°
Toilet preparations tax.....	11	13	13	°
Other manufacturers' excises	46 ⁱ	29 ⁱ	37 ⁱ	°
Tobacco taxes.....	425 ^d	459	501 ^d	532
Tax on small cigarettes.....	350	385	425	°
Tax on manufactured tobacco and snuff.....	62	61	62	°
Tax on cigars.....	12	12	12	°
Other tobacco taxes.....	2	1	1	°
Liquor taxes ^j	259	411	505	589
Wine taxes.....	4	6	9	°
Spirits taxes.....	86	189	247	°
Beer etc. taxes.....	169	216	249	°
Tax on unjust enrichment ^k....	...	...	...	82
Taxes on carriers and employees ^l	...	...	m	135
Social security taxes ⁿ.....	...	...	...	325
Total federal tax revenue	2,987^o	3,644^o	3,907^o	5,477^o

^a See Note 1, *Federal Tax Collections, 1923-37*, p. 514.

^b As estimated in *Statement by the President on the Summation of the 1937 Budget*, September 2, 1936. For the estimates in the budget that was submitted January 5, 1937, which show a total of \$5,636,000,000 instead of \$5,477,000,000, see Note 2, *Revenue Estimates in Budget of January 5, 1937*, p. 538.

^c Data not available in segregated form.

^d Discrepancy between total of items and total given is due to evening off.

^e Lapsed December 31, 1934.

^f Introduced by Revenue Act of 1934.

^g Including cotton ginning tax and tobacco sales tax.

^h Declared invalid in 1936.

ⁱ Obtained by subtraction.

^j Includes excise tax but not customs duties on imported liquor.

^k Introduced by Revenue Act of 1936.

^l Introduced in 1935.

^m Less than \$500,000.

ⁿ Introduced by Social Security Act of 1935.

^o The totals of the items given are \$2,984,000,000 (1934), \$3,637,000,000 (1935), \$3,892,000,000 (1936), and \$5,155,000,000 (1937). The discrepancies result from some omissions and evening off to the nearest million.

Stamp Taxes Etc.

The taxes lumped under this category are fairly stable in yield, except the stock transfer tax. The total seems unlikely to fluctuate much from the present \$250,000,000 level.

The capital stock tax rate is \$1.00 per \$1,000. A doubling of the rate would add nearly \$100,000,000 in revenue, provided the corporations were not given another chance to declare their value.²⁵ The admissions tax yield is low because all admissions of 40 cents or less are exempt. If all above 10 cents were taxable, the yield would be increased by \$80,000,000, according to Treasury estimates.²⁶ A check tax of 2 cents on each bank check or draft would yield about \$50,000,000.²⁷

Manufacturers' Excise Taxes

The recent decrease shown in the gasoline tax yield reflects a change in rate. The gasoline tax is fairly steady in yield, and, at the existing 1-cent rate, seems likely to stay at approximately \$200,000,000 a year. The yields of the other excises are not likely to fluctuate much more in the aggregate than the yield of the gasoline tax.

Probably the gasoline tax could be increased by another cent without decreasing consumption appreciably. Thus another \$150,000,000 or \$200,000,000 could be obtained. The tax on auto bodies and chassis is 3 per cent of the manufacturers' sales price (2 per cent for trucks). It could probably be doubled without appreciably decreasing the sales volume. The electrical energy tax applies only to domestic and commercial but not industrial consumption. The law forbids it to be passed on to consumers as a separate item. Its rate is 3 per cent, and in 1936 it yielded \$34,000,000.

²⁵ See pp. 271, 560.

²⁶ *Revenue Act, 1936*: Hearings before the Committee on Ways and Means, House of Representatives, 74 Cong., 2 sess., p. 623. Hereafter cited as *Revenue Act, 1936*: House Hearings.

²⁷ *Ibid.*

Tobacco Taxes

The tobacco taxes in the aggregate may show an appreciable and steady increase in yield, judging from their behavior in recent years.

The tax on small cigarettes is at the rate of \$3.00 a thousand, which amounts to 6 cents per package of 20 cigarettes. Perhaps an increase of a cent or two would not cut consumption materially. Nearly half the states, however, have cigarette taxes, some of them as high as 3 cents a package. The other federal tobacco taxes are at a very much lower rate, and account for only 15 per cent of the tobacco tax revenue.

Liquor Taxes

The liquor tax yield is very uncertain since it depends largely on the extent to which the illegal trade in spirits is checked. Likewise, any estimate of yield under different rates is very hazardous.²⁸

Social Security Taxes

The yields of the taxes on carriers and their employees and the taxes on payrolls under the Social Security Act are so uncertain that no attempt is made here to estimate them.²⁹

STATE AND LOCAL TAXES

Nothing very specific can be said on the possible yield of state and local taxes under various rates, exemptions, etc., and under various business conditions, for reasons already noted.³⁰ However, a few general comments can be made.

Property Taxes

The rates of the property tax are already so high that, politically speaking, an important increase in yield due

²⁸ See pp. 197-202.

²⁹ See pp. 263-65.

³⁰ See p. 70.

to higher rates can hardly be expected during the next few years. Not only a popular feeling against such increases but also rigid constitutional over-all rate limitations in some states are obstacles to larger yields.³¹

Business improvement, with its accompanying increase in realty values, will tend to increase revenues. The improvement is apt to be slow, however—more probably around 5 per cent a year than 25 per cent. The only probable source of sudden increase in revenue is the payment of huge accumulations of delinquent taxes. Many of these, however, have already been cleared up. Meanwhile, if homestead exemptions spread,³² and if more states abandon the property tax for state purposes,³³ property tax collections, even in a period of improving business, will remain relatively stable around the \$4,500,000,000 level.

Income Taxes

The state income taxes, personal and corporate, are yielding about \$300,000,000 a year. In contrast with the property tax, this yield is capable of much expansion, since the tax is used by only about two-thirds of the states. As to the possibility or advisability of raising rates or lowering exemptions, much difference of opinion can be expected. The rates are often low. Even in conjunction with the federal income tax, the burden is scarcely severe on incomes, for example, of \$10,000. A single taxpayer with no dependents, and a \$10,000 income from salary, bears a combined federal and state personal income tax equal to 10 per cent of his income in Idaho, 7 per cent in Minnesota, and 9 per cent in North Carolina. These are a few examples of the heavier bur-

³¹ See the memorandum by Thomas J. Reynolds on homestead exemptions and rate limitations in the forthcoming volume, *Studies in Current Tax Problems*.

³² *Ibid.*

³³ See the memorandum by Thomas J. Reynolds on state property tax rates in the forthcoming volume, *Studies in Current Tax Problems*.

dens. Further examples and details are given elsewhere.³⁴ Moreover, the recent spread of state income taxes indicates a favorable political atmosphere for the tax.³⁵ If the burden of the payroll taxes does not prove too severe, a large part of the prospective increase in the cost of state government over the next few years may be met by income taxation.

Other Taxes

The existing \$1,000,000,000 of state and local revenue from gasoline and registration taxes scarcely promises much increase in the near future. The high level of present gasoline tax rates and the political strength of the opposition will limit increases. If motorists decide that the present highway system must be thoroughly overhauled to prevent accidents, however, they may be willing to pay part of the bill through increased highway taxes.

Less than half the states and only two large local units are using the sales tax. From the point of view of revenue the most important base is retail sales. The highest rate is 3 per cent—used by only a few jurisdictions. Consequently, were it not for the unfavorable political reactions that the tax has lately encountered, the \$400,000,000 a year now being received might be doubled or trebled.

The other state taxes, except the payroll tax for social security, and in some states, possibly, the poll tax, offer relatively little prospect of much revenue increase in the near future.

³⁴ See the memorandum by Carl Shoup, Bernard L. Shimberg, and William Vickrey on combined federal and state income tax burden in the forthcoming volume, *Studies in Current Tax Problems*. These figures are after giving effect to the provisions concerning deduction of income taxes paid to other jurisdictions in computing net income.

³⁵ See p. 45.

Chapter 7

EXPENDITURES ESTIMATED TO 1940

PROBLEM OF ESTIMATING EXPENDITURES

Public expenditures in the United States must play an important part in determining both the kind and the rate of taxes to be imposed. Some estimate of the amount of public expenditures, for the immediate future at least, is essential before any changes in the tax system can be recommended.

The particular jurisdiction incurring these costs must also be considered. Taxes that are well adapted to central administration may be wholly unsuitable for local administration. Since the transfer of revenues from one jurisdiction to another becomes difficult when large amounts are involved, a tax, otherwise inferior, may be preferable because it is adapted to local administration.

In addition, the purposes of the public expenditures should be considered. Some governmental activities may be made largely self-supporting. Others can be best financed, perhaps, through benefit taxes. Still others must be maintained from the general tax revenue.

An attempt is made in this chapter to estimate the costs of government in the United States in the immediate future.¹ The estimates cover the range within which it is believed that public expenditures will fall between now and 1940. No guess has been made as to the most probable expenditure within this range. Estimating government expenditures for even one year in advance is

¹ For basic data and more detailed explanation of method, see the memorandum by Mabel Newcomer on estimated federal, state, and local expenditures in the forthcoming volume, *Studies in Current Tax Problems*.

hazardous, as recent federal budget estimates have demonstrated. Estimates can be made of upper and lower limits, however, that will hold, short of war and uncontrolled inflation. Such estimates are given below. Attention must be called beforehand, however, to the inadequacy of the data that underlie them.

The best guide to future governmental expenditures is those of the past. Though important changes can take place in a single year, probably only war or uncontrolled inflation could double, or more than double, expenditures within a one-year period. The failure of the federal government in recent years to spend as much as its budgets anticipated suggests that the machinery of government cannot be so completely revolutionized in a short space of time as to expand or contract expenditures to this extent.

Federal Expenditures

Accurate, detailed, and up-to-date records of federal expenditures are available on which estimates can be based. A single act of Congress, however, can influence the total to an important degree. The advance payment of the bonus, alone, increased the 1936 expenditures by nearly one-fourth. In the same way the passage of the Frazier-Lemke Farm Mortgage Bill would have increased the 1937 expenditures over the present official estimate by 40 per cent. It seems reasonably safe to fix the upper limit of federal government expenditures during the period under consideration at not more than double the 1936 level (barring war and uncontrolled inflation) and to fix the lower limit within a narrower range. But the margin is much too broad to make the estimate useful.

Relief expenditures will probably continue to be large for some years, but they may not continue to fall primarily on the federal government. Probably the excessive demands of the Townsend plan will not have to be

met. The veterans, however, having exhausted their bonus payments, may demand—and receive—substantial pensions in another year or so. Supreme Court decisions may limit governmental activities, and therefore expenditures, or they may stimulate them. For example, rural power programs seem to have been encouraged by the Tennessee Valley Authority decision. The inauguration of a costly housing program is under consideration, and the Frazier-Lemke bill for farm mortgage relief would add \$3,000,000,000 to the budget at a single stroke. The threat of war in Europe has already led to unprecedented army and navy appropriations. It makes future military expenditures highly uncertain. And the cost of war itself, should it come, is beyond prediction.

State and Local Expenditures

State and local expenditures are not subject to such wide fluctuations as those of the federal government. They are influenced, of course, by prosperity and depression, but the brunt of the costs of depression—and also war—will always fall on the central government. Moreover, the total of state and local expenditures cannot be materially increased by a single act of a single state or local legislative body. Federal legislation, however, sometimes effects important changes in state and local finance. The Social Security Act, for example, will probably add materially to the cost of state and local governments, as well as to that of the federal government. Expenditures of the states and localities may also increase substantially, even with prosperity, if the federal government returns to them the burden of relief.

The absence of complete and accurate data for actual state and local expenditures for any past year and the impossibility of getting any recent data at all present a greater problem than the possibility of wide fluctuations in a single year. The former publications of the Bureau

of the Census, *Financial Statistics of States and Financial Statistics of Cities of 30,000 Population and Over*, have been discontinued. The latest state figures are to be found in the Bureau of the Census' *Financial Statistics of State and Local Governments: 1932*. These are sufficiently complete and detailed for the purpose in hand, but they are not recent enough to reflect the full effect of the depression. At best, four full fiscal years have passed since the latest one recorded, and in four states the data are for the year ending June 30, 1931. For local governments, likewise, no data more recent than 1932 are available except for cities of 100,000 population and over. For them data can, at this writing, be obtained for 1934, and, in part, for 1935. The deficiency is more serious for local governments than for state governments. The inadequacy of the most recent records available—those for 1932—has made it impossible to classify expenditures according to function in many important cases. Without adequate knowledge of the purposes of expenditures the difficulties of estimating future trends are multiplied.

Basis of the Estimates

The estimates in this chapter for state expenditures for 1933, 1934, and 1935 are based on the actual financial statements published in such official state reports as could be obtained and on letters from state officials. Data have been obtained for forty-five states for the fiscal years ending in 1933 and 1934, and for thirty-nine states for 1935. The forty-five states were responsible for 94 per cent of all state expenditures in 1932, and the thirty-nine states accounted for 85 per cent of all state expenditures in the same year. In estimating the expenditures for all states, it has been assumed that the trend in the missing states from 1932 to 1935 was the same as that in the states for which data were found. Because the number of states for which the data are missing is small, the

estimate for the total should be fairly reliable. Variations in the classification of expenditures in the different state reports may, however, be responsible for some error.

Data are more limited for local government expenditures than for state expenditures. Consequently, the use of past expenditures as a basis of estimates for future expenditures of local units has been abandoned in favor of past revenues, for which fairly extensive data are available.²

Definition of Expenditure

Expenditure has been defined to conform to the Census publications' usage. For the federal government, however, the expenditures included differ in three ways. Where agencies such as the Reconstruction Finance Corporation are receiving money from repayment of former loans, the receipts have been deducted from new loans so that only the net figure has been included. Thus, the figures correspond with those reported in the annual reports of the Secretary of the Treasury. For the public service enterprises, also, the figure given is net. Third, the official federal figures include sinking fund payments.

The first two deviations from Census procedure are, for some purposes, of material importance in every year because of the large postal receipts deducted from Post Office expenditures, and in all recent years because of the large receipts from repayments of loans. They are not important, however, for the purpose in hand, since the figure for the amount to be covered by taxes is the same whichever procedure is used. The additional work involved in making the federal, state, and local figures uniform would, consequently, not be justified.

The third deviation is of course important in that it may imply a debt reduction program. Care is therefore

² See Note 1, *Estimates of Federal, State, and Local Expenditures, 1936-40*, p. 538, for details of the estimate of local expenditures.

taken in the estimates to specify whether this implication is in fact made.

PAST EXPENDITURES: 1920-35

With these limitations and difficulties in mind the estimates can be approached. Since future trends must be based upon past experience, a clear picture should first be obtained of actual government expenditures—federal, state, and local—during recent years.

Federal

Federal expenditures have increased fairly steadily for the past twenty-five years, except for a period following the war. The post-war decline, however, spent itself by 1925, leaving the cost of the national government at \$3,518,000,000—which even then was nearly two and one-half times as great as in 1915. Interest on the debt, payments to veterans, and higher prices were primarily responsible for the higher expenditure level. Increased population and the expansion of non-military activities also played their part. Table 13 gives the figures in detail.

Federal expenditures increased gradually from 1925 to 1930. The total increase in these five years—from \$3,518,000,000 to \$3,792,000,000—was less than 10 per cent. Thereafter they rose rapidly with depression demands, nearly doubling in the five years from 1930 to 1935, when the total—compiled, as noted, in accordance with Treasury technique—was \$7,272,000,000.

State

State expenditures, also included in Table 13, show somewhat different trends. They did not reach the high war peak of federal expenditures, and they also failed to show any post-war decline. Moreover, where federal expenditures in 1930 were only four times the 1910 level of \$918,000,000, state expenditures rose in the same twenty

years from \$323,000,000 to a level nearly seven times as high—\$2,143,000,000.³ Better highways and higher state

TABLE 13
NET EXPENDITURES PAYABLE FROM FEDERAL, STATE, AND
LOCAL REVENUES, 1920, 1925, 1930-35^a
(In Millions of Dollars)

	1920	1925	1930	1931	1932	1933	1934	1935
	From all sources ^b							
Federal ^c	6,041	3,518	3,792	3,905	4,618	4,881	7,064	7,272
State ^d	861	1,443	2,143	2,276	2,237	1,994	2,124	2,222
Local ^e	3,344	5,584	7,217	7,074	6,438	5,181	5,386	5,459
Total.....	10,246	10,545	13,152	13,255	13,293	12,056	14,574	14,953
	From taxes and loans ^f							
Federal.....	5,453	3,318	3,548	3,651	4,556	4,731	6,947	7,135
State.....	702	1,209	1,830	1,973	1,920	1,677	1,807	1,905
Local.....	2,444	4,084	5,571	5,576	5,129	4,026	4,244	4,309
Total.....	8,599	8,611	10,949	11,200	11,605	10,434	12,998	13,349

^a Expenditures from grants-in-aid have been credited to jurisdiction making grant. Expenditures from state-administered taxes that are distributed to local governments have been credited to local governments. State and local expenditures are governmental cost payments as defined in *Statistics of State and Local Governments*. Federal expenditures differ from these in including sinking-fund payments, excluding expenditures of government industries (such as the Post Office and the Panama Canal) covered by receipts from these industries, and including the net figure of government loaning units such as the Reconstruction Finance Corporation.

^b To avoid double counting, expenditures from money received as grants-in-aid have been omitted, and the grants-in-aid themselves have been treated as expenditures of the jurisdictions making the grants.

^c Obtained from annual reports of the Secretary of the Treasury. These figures differ from the total cash expenditures given in Table 2 of these reports, partly owing to the deduction of receipts from industries other than the Post Office, partly because in classifying expenditures it was necessary to substitute "checks issued" for cash in a few instances. The figures include sinking fund payments.

^d Figure for 1920 from M. Newcomer, "Financial Statistics of Public Education in the United States, 1910-1920," *Educational Finance Inquiry*, VI (1924); figure for 1925, 1930, and 1931 from Department of Commerce, Bureau of the Census, *Financial Statistics of States: 1925, 1930, and 1931*; for 1932 from *Financial Statistics of State and Local Governments: 1932*; for 1933, 1934, and 1935 estimated as explained in text. The statement in the text referring to 1915 is based on Newcomer, *op. cit.*

^e Figure for 1920 from Newcomer, *op. cit.*; for 1925 from National Industrial Conference Board, *Cost of Government, 1923-1934* (1934); for 1930 estimated by applying the percentage increases for cities with 30,000 population and over to total expenditure reported by National Industrial Conference Board for 1929; for 1931 estimated by finding ratio of 1931 to 1932 expenditures for cities with 100,000 population and over, and applying this to 1932 expenditures; for 1932 from *Financial Statistics of State and Local Governments: 1932*; for 1933, 1934, and 1935 estimated as explained in text.

^f Obtained by subtracting non-tax revenues from net expenditures above.

standards for schools were the chief causes of this increase, but the states were also extending their activi-

³ Federal expenditures figure for 1910 is from *Report of the Secretary of Treasury*; state expenditures figure for 1910 is from M. Newcomer, "Financial Statistics of Public Education in the United States, 1910-1920," *Educational Finance Inquiry*, VI (1924).

ties in the fields of health, welfare, and police protection. Growing population and rising prices were other factors.

With depression, state expenditures at first increased: from \$2,143,000,000 in 1930 to \$2,276,000,000 in 1931. They declined between 1931 and 1933 to \$1,994,000,000, and then increased again. The 1935 expenditures reached approximately the 1932 level, with a total of \$2,222,000,000.

The pressure of declining tax yields was not seriously felt until 1932, but beginning in that year it was undoubtedly an important restraining influence. The rise in 1934 and 1935 is the reflection not so much of improved business conditions, as of the failure of local governments to maintain their usual share in government activities and the consequent necessity for greater state aid. The development of new taxes, especially the sales and liquor taxes, made the 1933-35 expansion possible.

Local

Local expenditures, given in Table 13 also, show much the same trend as those of the states. As with the federal and state governments, growing population and rising prices played a part in increasing costs. The increase from the 1910 figure of \$1,593,000,000⁴ to a total of \$7,217,000,000 in 1930, however, was largely the result of a growing demand for governmental services, particularly roads and schools. State expenditures for these purposes supplemented rather than replaced local expenditures. In fact, state aid was designed, for the most part, to stimulate local expenditures. Increases in local expenditures were not so great, relatively, as increases in state expenditures, but they exceeded federal increases.

With depression, local expenditures declined promptly—from \$7,217,000,000 in 1930 to \$5,181,000,000 in 1933. Circumscribed by tax and debt limits, which have been

⁴ The 1910 data are from Newcomer, *op. cit.*

increased rather than relaxed in recent years, local governments have had no choice but to cut expenditures. Some increase is apparent in 1934 and 1935—up to \$5,-459,000,000; but local expenditures in the latter year were still far below their 1930 level of \$7,217,000,000. Very little of the increases in 1934 and 1935 was met from locally administered taxes.

The marked decline in local expenditures that had to be met from local revenues was inevitable. Local governments have only one really important source of revenue, the property tax.⁵ But this tax had been developed before the depression to its political, if not its economic, limit by most local governments. With depression, both the economic and the political limits of this tax were greatly contracted. Even when assessed valuations were maintained at their prosperity level, it was not possible to collect the same sums from real estate owners confronted with shrinking assets and no cash income. Moreover, the normal irritation of the taxpayer was magnified by his financial difficulties. This irritation was expressed in new legislation prescribing narrower tax limits, in political pressure on local officials to reduce taxes, and in tax delinquencies when levies were not actually reduced. The result was a decline in property tax levies and an even greater decline in tax collections.

Local expenditures could be maintained under these conditions only through borrowing or aid from federal and state authorities. But borrowing likewise had its limitations. Debt limits were rigid and widespread, and many municipalities had exhausted their borrowing capacity under these limits during more prosperous years. Moreover, the limits were stated as percentages of the tax base. Such municipalities as had a substantial margin under prosperity assessments found this margin shrink-

⁵ The property tax provided 93 per cent of local tax revenues in 1932. Most of the remaining 7 per cent came from state taxes distributed to local governments.

ing, with no change in their indebtedness. Municipalities with no margin, and debts falling due, had no recourse but to pay these debts from current income. Hence the astonishing spectacle of a reduction in municipal debts in the midst of depression, in 1933. Some increase in borrowing took place in other years, but in no year since the depression began was the increase very great. The total net increase in local bonded debt in the five years from the end of 1930 until the end of 1935 was less than the average annual increase in the preceding five years.

The only other important source that was available for localities was state and federal aid. This aid has been given liberally, and it accounts for a large part of the growth of federal and state expenditures. The increases in aid, together with the small increases from new loans, were not sufficient, however, to offset the losses from local sources until 1934, and with a rapidly growing relief burden drastic cuts in the other local expenditures were called for.

The possibility of reduction was greatest in capital outlays. Local expenditures for capital outlays are estimated to have been about \$2,000,000,000 in 1930. Barring a work relief program, most of such expenditures could be deferred. Capital outlays had shrunk to less than \$1,500,000,000 in 1932, and, if trends elsewhere are like those in large cities, to \$800,000,000 in 1934.

Other evidence of the reduction of local expenditures is at hand. One of the heaviest local costs is for teachers' salaries. Teachers' salary scales were drastically cut, and for the most part they have not yet been restored. The largest single decrease in current expenses in cities of over 100,000 population between 1930 and 1933 was in school costs. Another factor of some importance in reducing local costs has been the centralization of administration of certain governmental functions. The outstanding, but

not the only, example is the transfer of schools and roads in North Carolina from local to state hands. State expenditures for these formerly local functions are not reflected in state aid figures since the expenditure is direct.

Against these decreases the rising burden of relief may be set. In 1934, 82 per cent and in 1935, 86 per cent of this burden, however, fell on state and federal funds.

In the light of all these factors it is not surprising that local expenditures falling on local revenues (including state-administered taxes shared with local governments) were reduced from \$7,200,000,000 in 1930 to \$5,200,000,000 in 1933. They were still below \$5,500,000,000 in 1935.

ESTIMATES OF FUTURE EXPENDITURES: 1936-40

With this background of federal, state, and local expenditures from 1920 to 1935, the stage is set for estimating the outlays for the five years from 1936 to 1940. Two kinds of estimate have been made. The first is based on a detailed study of the kind and purpose of the expenditures of the immediate past and an adjustment of them for the future in the light of changing economic conditions, new legislation, and any other events that seem likely to occur. Since the estimates have been made for each function of government separately in most cases, they are called functional estimates.

The second is based on a projection into the future of past trends of expenditures in two periods somewhat similar to what may be expected in 1936 to 1940. These are called trend estimates.

Functional Estimates

The first estimates—the functional estimates—have been made on each of two assumptions: (1) that the federal government will withdraw completely from direct relief in 1939 and (2) that it will continue relief con-

tributions. In the first case it has been assumed that the federal relief load diminishes very rapidly: \$1,800,000,000 in 1937 (the minimum in the budget for 1937 as of September 2, 1936), \$100,000,000 in 1938, and nothing in 1939. In the second case it is assumed that the federal relief load is gradually diminished: \$2,300,000,000 in 1937 (the maximum set by President Roosevelt in his revised budget of September 2), \$1,800,000,000 in 1938, \$1,300,000,000 in 1939, and \$800,000,000 in 1940.⁶ In either case it is assumed that state and local relief expenditures remain constant at \$500,000,000 a year. The total relief expenditure estimated for 1940 under the second assumption would provide public support for approximately 4,000,000 families at the 1935 level of relief allotments (\$2.8 per month).

The two estimates (in Tables 14 and 16) are given because of the great uncertainty of the future relief burden. The future cost of some of the other functions is likewise very uncertain, but either the amount is too small to justify another estimate or it is too uncertain to warrant more than passing mention. The effect of an adverse Court decision in the case of social security expenditures can hardly be estimated since it cannot be determined when such a decision might be expected, nor can it be guessed when, or in what form, a substitute might be adopted. The effect of uncontrolled inflation or war is even less predictable.

In the estimates in this chapter, all totals of federal expenditures and of federal, state, and local expenditures include statutory sinking fund payments by the federal government. Social security expenditures for old age and unemployment compensation include the estimated cost of the non-contributory old-age pensions plus an amount equal to the yield of the federal and state payroll taxes

⁶ See Note 2, *Federal Budget of January 5, 1937*, p. 540, for later estimates of relief expenditures for 1937 and 1938.

for unemployment insurance, but do not include payments to the old-age reserve fund. The summary tables 14 and 16 show three sets of totals: expenditures from all sources, expenditures from taxes and loans, and expenditures from taxes. For purposes of future tax policy the second set is probably the more important. It shows the amount that has to be raised either by tax revenue or by borrowing. The differences between the totals in this set and in the first set represent non-tax revenue such as fees and interest received. The third set, expenditures from taxes, is chiefly of interest as a historical record. It shows, for 1930, 1935, 1936, and 1937 the amounts that were in fact covered by taxation.⁷ For 1938, 1939, and 1940 it shows only a small difference from the second set—a difference that represents an assumed modest amount of borrowing by state and local governments.

A full account of the assumptions and the technique employed is given elsewhere.⁸

Result of Assuming Federal Relief Ceases

Assuming that federal relief payments will rapidly decline and cease altogether in 1939, it is estimated that total expenditures of all three classes of government would be about \$17,399,000,000 in 1936; that they would fall off only slightly in 1937 and then drop to \$15,956,000,000 in 1938, recovering to \$16,610,000,000 in 1939 and \$17,350,000,000 in 1940. Federal expenditures were \$8,880,000,000 in 1936, and are estimated to fall to \$7,737,000,000 in 1937 and to show a much sharper drop to \$5,307,000,000 in 1938, remaining at about that level in 1939 and 1940. State expenditures would increase each

⁷ All 1937 data are estimates. The 1937 state and local tax totals differ slightly from the data in chap. 2 because of somewhat different basis of estimate. The chap. 2 totals are minima, and in fact will probably be somewhat exceeded. See p. 9 and Note 1, *State Tax Revenues, 1936*, p. 529.

⁸ See pp. 121-22 and the memorandum by Mabel Newcomer on government expenditures in the forthcoming volume, *Studies in Current Tax Problems*.

year, from \$2,639,000,000 in 1936 to \$4,698,000,000 in 1940, with the largest increases in 1937 and 1938. Local expenditures would also increase every year but with less variation—about \$300,000,000 a year after 1937. The figures are given in Table 14, which also shows the totals of expenditures to be met from taxes and loans and from taxes only. Table 15 gives a detailed estimate of federal expenditures for each future year compared with actual outlays for 1930, 1935, and 1936.

Assuming Continuance of Relief

On the assumption that federal relief contributions will decline only gradually, the estimates show considerably larger figures for federal expenditures: \$8,237,000,000 for 1937, \$7,007,000,000 for 1938, \$6,584,000,000 for 1939, and \$6,152,000,000 for 1940.⁹ State and local expenditures would be the same as on the first assump-

TABLE 14

TOTAL EXPENDITURES, ACTUAL (1930, 1935, 1936)^a AND ESTIMATED (1937-40) ON FIRST FUNCTIONAL BASIS
(In Millions of Dollars)

	1930	1935	1936	1937	1938	1939	1940
	From all sources						
Federal.....	3,792	7,271	8,880	7,737	5,307	5,284	5,352
State.....	2,143	2,222	2,639	3,152	4,009	4,356	4,698
Local.....	7,217	5,459	5,880	6,310	6,640	6,970	7,300
Total.....	13,152	14,953	17,399	17,199	15,956	16,610	17,350
	From taxes and loans						
Federal.....	3,548	7,135	8,693	7,598	5,217	5,104	5,282
State.....	1,850	1,905	2,319	2,812	3,649	3,976	4,298
Local.....	5,571	4,309	4,580	4,910	5,140	5,370	5,600
Total.....	10,949	13,349	15,592	15,320	14,006	14,550	15,180
	From taxes						
Federal.....	3,548	3,469	3,929	5,501	5,217	5,104	5,282
State.....	1,641	1,748	2,179	2,672	3,509	3,836	4,158
Local.....	4,756	4,152	4,380	4,660	4,840	5,020	5,200
Total.....	9,945	9,369	10,488	12,833	13,566	14,060	14,640

^a For state and local governments, 1936 data are estimated, not actual.

⁹ Total federal expenditures are estimated at \$8,256,000,000 for 1937 and at \$7,155,000,000 for 1938 in the federal budget of January 5, 1937. These figures include estimated additional expenditure for relief, but exclude payments to the old-age reserve account. For further details of differences between the estimates for 1938 given here and those given in this recent budget statement, see Note 2, *Federal Budget of January 5, 1937*, p. 540.

TABLE 15
 FEDERAL GOVERNMENT EXPENDITURES, ACTUAL (1930, 1935, 1936) AND ESTIMATED (1937-40)
 ON FIRST FUNCTIONAL BASIS^a
 (In Millions of Dollars)

No.	Purpose	1930	1935	1936	1937 ^u	1938 ^u	1939	1940
1.	General government ^b	35	31	34	35	35 ^c	36 ^c	36 ^c
2.	Departments ^b	896	897	995	1,031	1,153	1,222	1,291
	i War and navy.....	547	519	666	627	650 ^d	675 ^d	700 ^d
	ii Civil.....	349	378	329	404	503 ^d	547 ^d	591 ^d
3.	Independent offices ^b	125	1,043	889	1,261	1,045	1,146	1,237
	i Regular.....	120	113	134	166	182 ^e	202 ^e	221 ^e
	ii Emergency.....	5	187	185	105 ^f	^g	^g	^g
	iii AAA.....	..	743	542	585	500 ^h	500 ^h	500 ^h
	iv Social security.....	..	..	28	405	363 ⁱ	444 ⁱ	516 ⁱ
4.	Interest.....	660	821	749	825	870 ^j	905 ^j	930 ^j
5.	Pensions.....	690	548	624	561	550 ^k	550 ^k	550 ^k
	i Military.....	665	527	585	511	500	500	500
	ii Civil.....	25	21	39	50	50	50	50
6.	Grants-in-aid.....	148	2,230	857	636	435	337	340
	i Highways.....	78	282	244	280	220 ^k	220 ^k	220 ^k
	ii Relief.....	..	1,877	503	259	100 ^l	1	1
	iii Other.....	70	71	110	97	115 ^d	117 ^d	120 ^d
7.	Territories.....	11	10	9	8	9 ⁿ	9 ⁿ	9 ⁿ
8.	Industries (net).....	98	41	97	58	55 ^m	45 ^m	35 ^m

9. Capital outlay (includes WPA).....	227	464	2,125	2,370	800 ⁿ	700 ⁿ	600 ⁿ
10. CCC.....	..	347	537	300	°	°	°
11. Bonus prepayment.....	..	..	1,673	560	..	..	..
Net total.....	2,890	6,432	8,589	7,645	4,952	4,950	5,028
12. Loans and investments.....	156	266	-112	-488	-200 ^p	-200 ^p	-200 ^p
13. Debt payments.....	746	574	403	580	555 ⁱ	534 ⁱ	524 ⁱ
Gross total.....	3,792	7,272	8,880	7,737	5,307	5,284	5,352
14. Non-tax revenues.....	244	137	187	139	90 ^q	80 ^q	70 ^q
Expenditure from taxes (or loans).....	3,548	7,135	8,693	7,598	5,217	5,204	5,282
15. Payroll taxes.....	..	..	..	325	709 ^r	716 ^r	1,062 ^r
Expenditure from ordinary taxes (or loans) ^t	3,548	7,135	8,693	7,273	4,508	4,488	4,220

^a Figures for 1930-35 are actual expenditures as reported in the annual reports of the Secretary of the Treasury. Figures for 1936 are from *Daily Statement of the United States Treasury*, June 30, 1936, with some details not given in this statement from the *Budget of the United States Government for the Fiscal Year Ending June 30, 1937*, 74 Cong., 2 sess., House Document No. 339. Figures for 1937 from *Statement by the President on the Summation of the 1937 Budget*, September 2, 1936. Figures for 1938-40 are estimates based on the assumptions stated for each. For further details see the memorandum by Mabel Newcomer on government expenditures in the forthcoming volume, *Studies in Current Tax Problems*.

^b Excluding capital outlay (except for minor improvements), grants-in-aid, pensions, industries, and loans and investments. For the War and Navy departments, only the costs of military activities have been included, and among these the cost of construction of naval vessels and airplanes has been classified under No. 9 below as capital outlay.

^c Both the nature of these expenditures and past experience suggest the gradual increase in the expenditures indicated here.

^d Rate of increase for 1937-40 assumed to be the same as rate of increase for most recent normal three-year period, 1927-30. Equal absolute increase assumed for each intervening year.

^e Estimated in same manner as civil departments (see footnote d above), with additions for payments to railroad retirement reserve funds of \$45,000,000, \$48,000,000, and \$50,000,000 for 1938, 1939, and 1940 respectively. The railroad retirement reserve funds are included because these are available for immediate payments, whereas the old-age benefits are not available during the period in question.

^f Only \$15,000,000 of this is definitely allocated to emergency independent offices. The remainder is the supplemental item in the budget that has not been assigned to any specific expenditure.

NOTES TO TABLE 15 (Cont'd)

^a It has been assumed that with business improvement relief is returned to the states and emergency expenditures are abandoned.

^b It has been assumed that maximum expenditures under the 1936 law will be incurred.

^c Estimated cost falling on federal general revenues, and hence not including the amounts put into the old-age reserve fund from the payroll taxes for old-age security.

^d It has been assumed that there will be no increase in the debt after 1937, and that the existing debt will be reduced at the rate of 2.5 per cent per year, after deducting obligations of foreign governments to us. It is assumed, further, that the increase in interest on short-term loans in 1938, 1939, and 1940, in consequence of rising interest rates, will more than offset the decrease in the debt.

^e Amount of appropriation passed by Congress for 1938 and 1939.

^f It has been assumed that relief grants will be drastically cut for 1938 and will be given up entirely in 1939.

^g The largest part of this item is the postal deficit. This will vary with business conditions and postal rates. It has been assumed that improved business conditions and the same rates will result in a small reduction in this cost.

^h It has been assumed that this will decline with the abandonment of work relief by the federal government, beginning in 1938, but not to the pre-depression level, owing to the increased armament program, rural electrification, and power development.

ⁱ It has been assumed that this will terminate in 1937. However, see Note 2, *Federal Budget of January 5, 1937*, p. 540.

^j It has been assumed that there will be no new loans on the part of governmental agencies, and that the government will realize on its net assets in these agencies at the rate of 5 per cent per year.

^k It has been assumed that the largest item, interest, will decrease with repayment of loans.

^l Tax for old-age security plus 10 per cent of tax for unemployment insurance. In so far as states fail to take advantage of the 90 per cent credit the federal share will be larger than this.

^m These expenditures do not change materially in a short space of time in the absence of new legislation.

ⁿ Most of the payroll tax revenue in the line immediately preceding is destined to cover the payments into the old-age annuity fund, and these payments are not included in the expenditure items in this table. In effect, this last line shows what is needed in tax revenue to keep from increasing that part of the public debt that is outstanding in the hands of the public, as contrasted with the debt held by a government reserve fund.

^o See Note 2, *Federal Budget of January 5, 1937*, p. 540, for differences between these estimates and those of the latest available federal budget figures.

tion. Total government expenditures would, therefore, be on a higher level each year, rising from \$17,699,000,000 in 1937 to \$18,150,000,000 in 1940. Table 16 gives the figures in detail.

TABLE 16

TOTAL EXPENDITURES, ACTUAL (1930, 1935, 1936)^a AND ESTIMATED (1937-40) ON SECOND FUNCTIONAL BASIS

(In Millions of Dollars)

	1930	1935	1936	1937	1938	1939	1940
	From all sources						
Federal.....	3,792	7,272	8,880	8,237	7,007	6,584	6,152
State.....	2,143	2,222	2,639	3,152	4,009	4,356	4,698
Local.....	7,217	5,459	5,880	6,310	6,640	6,970	7,300
Total.....	13,152	14,953	17,399	17,699	17,656	17,910	18,150
	From taxes and loans						
Federal.....	3,548	7,135	8,693	8,098	6,917	6,504	6,082
State.....	1,830	1,905	2,319	2,812	3,649	3,976	4,298
Local.....	5,571	4,309	4,580	4,910	5,140	5,370	5,600
Total.....	10,949	13,349	15,592	15,820	15,706	15,850	15,980
	From taxes						
Federal.....	3,548	3,469	3,929	5,501	6,917	6,504	6,082
State.....	1,641	1,748	2,179	2,672	3,509	3,836	4,158
Local.....	4,756	4,152	4,380	4,660	4,840	5,020	5,200
Total.....	9,945	9,369	10,488	12,833	15,266	15,360	15,440

^a For state and local governments, 1936 data are estimated, not actual.

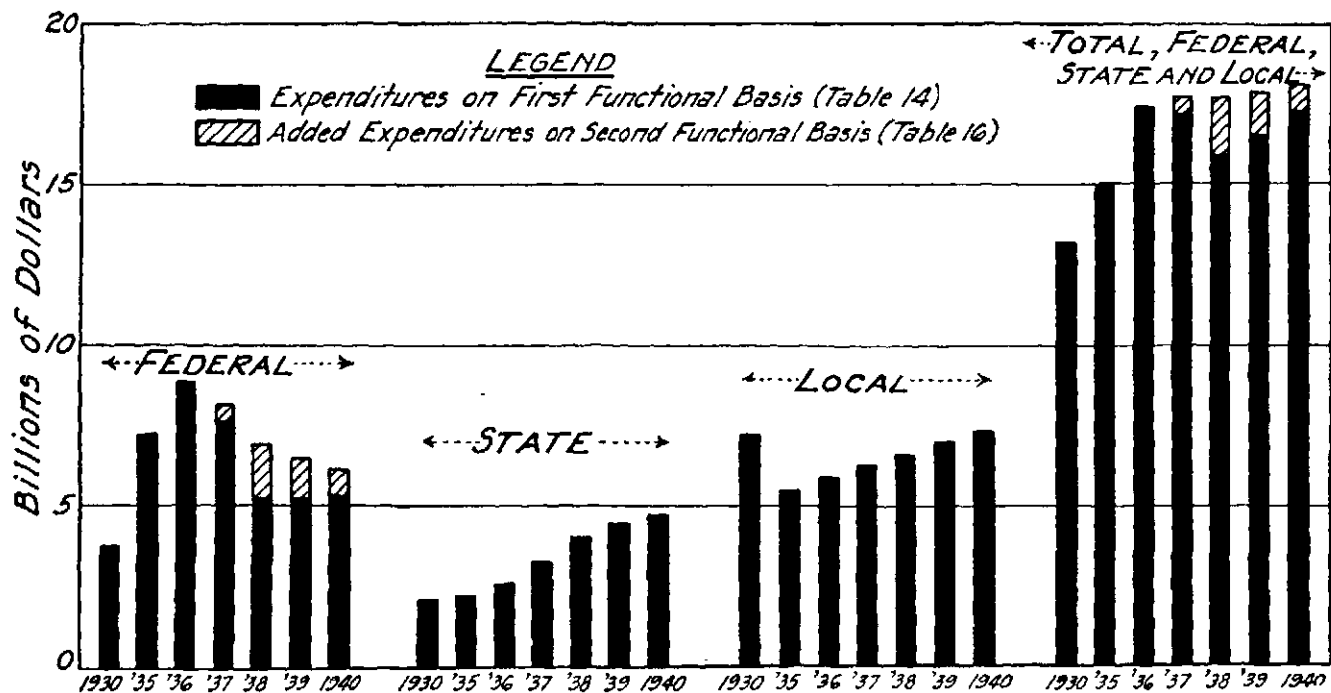
Possible Variations

It should be repeated that the many assumptions on which the estimates shown in Tables 14 and 16 and Chart 4 are based are not beyond question. Other plausible assumptions will bring very different results.¹⁰

If it is assumed, for instance, that the social security program will be abandoned, and that the unemployed allowed for in the Table 14 estimate will be supported by home relief rather than work relief, the total tax requirements will be reduced from \$14,600,000,000 in 1940 to \$12,600,000,000. If it is assumed, further, that the federal government, as well as state and local governments, will continue to increase debts, so that at least

¹⁰ See the memorandum by Mabel Newcomer on government expenditures in the forthcoming volume, *Studies in Current Tax Problems*.

CHART 4
 TOTAL EXPENDITURES FROM ALL SOURCES, FUNCTIONAL
 ESTIMATES, 1930, 1935-40



half the cost of the capital outlays estimated for all governments will be met from borrowed funds, the immediate charge on taxes will fall to \$11,700,000,000.

On the other hand, if the unemployed are reduced by only one-half in the next four years and work relief at present standards is provided for all, the tax burden will increase by a little over \$4,000,000,000 from the Table 14 estimates, to \$18,700,000,000 by 1940. If, in addition, state and local credit should fail, or these governments should choose for some other reason to adopt a pay-as-you-go policy, so that no net increase in their debts occurred, another \$600,000,000 would be added to taxes. Expenditures from all sources would then amount to about \$22,000,000,000.

All the increases assumed are the result of increased governmental services. If, in addition, price levels should increase materially during the next four years, expenditures would also rise above the estimates given. This rise, however, would bring with it higher taxable incomes so that the proportion of the national income paid in taxes would not necessarily increase in consequence.

Other possibilities should also be taken into account. An expensive housing program is under consideration. The Wagner bill proposed an expenditure of \$250,000,000 per year, of which only \$150,000,000 would ultimately be repaid. This or a similar bill may be considered in the near future by Congress. A farm mortgage bill comparable with the defeated Frazier-Lemke bill might be passed. The veterans might demand another bonus, or pensions. And the possibilities of war and uncontrolled inflation hang over all human affairs.

One thing is certain: government expenditures and taxes will not drop to pre-depression levels. Just as expenditures after the World War failed to return to their pre-war level, so expenditures following depression will doubtless fail to return to their former level. There is the

same aftermath of debts. The residual relief burden is not unlike the earlier problem of compensation for veterans. And inflation may still come. Under these conditions the estimate of expenditures in 1940 that is approximately one-third greater than expenditures in 1930 (Table 14) is probably a conservative one. The increase in 1925 over 1915 was more than 150 per cent.¹¹ The national debt has not increased so greatly, it is true, during depression as during the war; but the dollar has been devalued, as it was not during the war. If the change in the gold value of the dollar is fully reflected in the price level by 1940, the cost of the 1930 standard of government will be greater than the costs given in the maximum estimate.

Trend Estimates

Of the second group of estimates—those based upon past trends—the first one (projecting the four-year 1921–25 federal period and the five-year 1925–30 state and local period) shows much lower figures than either of the two groups of functional estimates just considered. The figures of the other trend estimates (based on the four-year 1926–30 federal and five-year 1920–25 state and local periods) are very much the highest of all. The former trend estimates show total expenditures declining slightly each year, from \$17,049,000,000 in 1937 to \$16,908,000,000 in 1940. The latter show them rising sharply each year, from \$18,760,000,000 in 1937 to \$22,263,000,000 in 1940. Tables 17 and 18 give the figures for each of these estimates in detail.

First Estimate

The four-year period 1921–25 was one of declining expenditures for the federal government. There are certain similarities in conditions now and in the early '20's that might result in a similar trend of federal expenditures in

¹¹ The 1915 figure is from Newcomer, *op. cit.*

the near future. At both times federal expenditures had risen very rapidly in the preceding period to meet a national emergency, and the government was faced with an unprecedented debt. Also, in both periods important reductions in expenditures were promised by the federal administration.

If the rate of decrease used for the 1936-40 estimate were the rate of the first four years of decline after the 1919 peak (to correspond to the estimated four-year decline from the 1936 peak), the estimated federal expenditures for 1940 would be much lower. In fact, expenditures would be lower than they have been at any time since the war. Such a rate of decrease cannot be expected, however, in view of (1) the debt, which is larger than at any previous time in the history of our national government, and (2) the fact that the expenditures for the 1936 peak are less than half those for the 1919 peak. Furthermore, prices in the earlier period were declining from

TABLE 17

TOTAL EXPENDITURES, ACTUAL (1935, 1936)^a AND ESTIMATED (1937-40) ON FIRST TREND BASIS^b*(In Millions of Dollars)*

	1935	1936	1937	1938	1939	1940
			From all sources			
Federal.....	7,272	8,880	8,299	7,717	7,135	6,553
State.....	2,222	2,437	2,653	2,868	3,084	3,300
Local.....	5,459	5,778	6,097	6,416	6,735	7,055
Total.....	14,953	17,095	17,049	17,001	16,954	16,908
			From taxes and loans			
Federal.....	7,135	8,693	8,124	7,555	6,985	6,415
State.....	1,905	2,090	2,275	2,460	2,645	2,829
Local.....	4,309	4,561	4,813	5,065	5,316	5,567
Total.....	13,349	15,344	15,212	15,080	14,946	14,811

^a For state and local governments, 1936 data are estimated, not actual.

^b Rate of decrease for federal expenditures 1936-40 same as rate of decrease 1921-25 (1925 expenditure 73.8 per cent of 1921 expenditure); equal annual decreases assumed for intervening period. Rate of increase for state and local expenditures 1935-40 same as rate of increase 1925-30 (1930 state expenditure 148.5 per cent of 1925 expenditure, 1930 local expenditure 129.2 per cent of 1925 expenditure); equal annual increases assumed for intervening period. Expenditures from taxes and loans have been assumed to increase or decrease at the same rate as expenditures from all sources.

their war peak, whereas prices in the next four years are more likely to rise than to fall.

The trend for state and local expenditures used in the first estimate—that for 1925-30, in Table 17—shows an increase that was lower than for any five-year period between 1910 and 1930. A smaller increase than this can hardly be expected. The probability of rising prices and the accumulation of needs during the lean depression years tend to offset the effect of a reduced local tax base and the tendency to centralize the administration of some governmental functions. The result may well be exceptional increases in state and local expenditures.

Second Estimate

The trend for federal expenditures used in the second estimate—that for 1926-30, in Table 18—shows a period of slowly rising expenditures. No such increase is expected at present. The year 1936 is regarded as a maximum for some time to come. An increase is not impossible, however, in view of (1) the growing demands on the federal government for the development of its welfare activities and (2) the devaluation of the dollar.

The trend for state and local expenditures used in the second estimate—that for 1920-25, in Table 18—reflects a period of unusually rapid growth, stimulated, doubtless, by both the growing tax bases and the curb on state and local expenditure during the war period. The years from 1935-40 may well resemble those of this trend period because they follow a period when expenditures have been held in check. The fact that expenditures actually declined in the years preceding 1935 whereas they had increased in the years preceding the 1920-25 period argues for an even greater increase now than before.

Moreover, the possibility that the federal government will return the relief burden to state and local governments increases the chance of rapidly rising state and

local expenditures. On the other hand, tax bases—especially those of the local governments—have been impaired in recent years, whereas they had expanded just before the 1920-25 period. Rapid recovery in the next

TABLE 18

TOTAL EXPENDITURES, ACTUAL (1935, 1936)^a AND ESTIMATED (1937-40) ON SECOND TREND BASIS^b

(In Millions of Dollars)

	1935	1936	1937	1938	1939	1940
			From all sources			
Federal.....	7,272	8,880	9,015	9,151	9,286	9,422
State.....	2,212	2,522	2,822	3,122	3,423	3,724
Local.....	5,459	6,191	6,923	7,655	8,386	9,117
Total.....	14,953	17,593	18,760	19,928	21,095	22,263
			From taxes and loans			
Federal.....	7,135	8,693	8,825	8,958	9,090	9,213
State.....	1,905	2,162	2,420	2,677	2,935	3,193
Local.....	4,309	4,886	5,463	6,040	6,618	7,196
Total.....	13,349	15,741	16,708	17,675	18,643	19,612

^a For state and local governments, 1936 data are estimated, not actual.

^b Rate of increase for federal expenditures 1936-40 same as rate of increase 1926-30 (1930 expenditure 106.1 per cent of 1926 expenditure); equal annual increases assumed for intervening period. Rate of increase for state and local expenditures 1935-40 same as rate of increase 1920-25 (1925 state expenditure 167.6 per cent of 1920 expenditure, 1925 local expenditure 167.0 per cent of 1920 expenditure); equal annual increases assumed for intervening period. Expenditures from taxes and loans have been assumed to increase at the same rate as expenditures from all sources.

three or four years may offer state governments the same possibility of expanding revenues that they had in the early '20's, but the local governments can hardly expect an equal opportunity. Consequently, while state expenditures may rise even faster than in the years 1920-25, it seems very doubtful whether local expenditures will rise as rapidly.

Comparison of Estimates

A comparison of all four of the estimates is now in order. Table 19 gives the details both in absolute figures (for total government expenses) and in indices of increase over 1935. Chart 5 shows the relationships in graphic form.

The minimum estimate for 1940—the first of those

based on trends (Table 17)—shows a decrease below the 1936 level but not below the 1935 level. The probability of expenditures returning to pre-depression levels is so slight, however, that it has not been given serious consideration. The maximum estimate for 1940—the second of the trend projections (Table 18)—is far above even the 1936 level, and it shows no decrease in federal, state, or local expenditures in any year. The first functional estimate (Table 14) lies between the two trend estimates in 1940, although it is lower than either of the others in 1938 and 1939. The second functional estimate (Table 16) lies between the two trend estimates throughout.

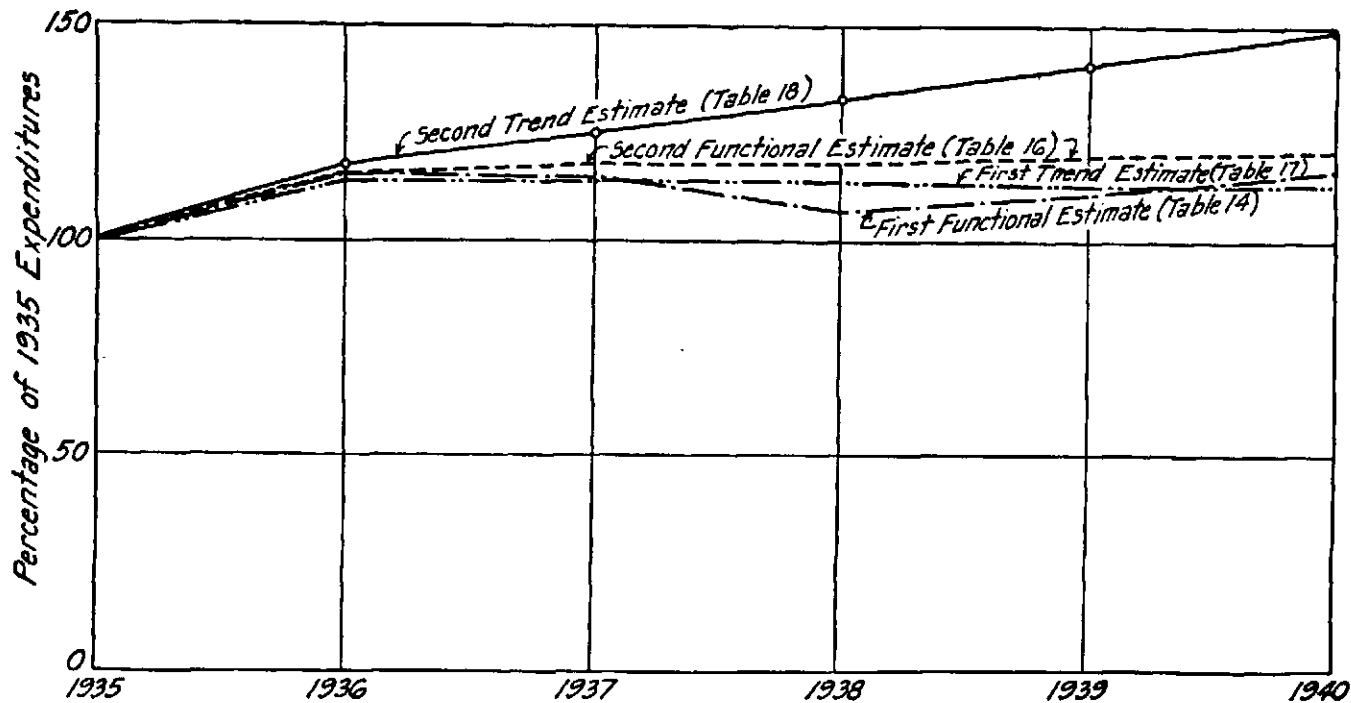
When the individual estimates for federal, state, and

TABLE 19
COMPARISON OF ESTIMATES OF FEDERAL, STATE, AND
LOCAL EXPENDITURES, 1936-40^a

Estimate	1935	1936	1937	1938	1939	1940
ABSOLUTE AMOUNTS (In Millions of Dollars)						
From all sources						
1	14,953	17,399	17,199	15,956	16,610	17,350
2	14,953	17,399	17,699	17,656	17,910	18,150
3	14,953	17,095	17,049	17,001	16,954	16,908
4	14,953	17,593	18,760	19,928	21,095	22,263
From taxes and loans						
1	13,349	15,592	15,320	14,006	14,550	15,180
2	13,349	15,592	15,820	15,706	15,850	15,980
3	13,349	15,344	15,212	15,080	14,946	14,811
4	13,349	15,741	16,708	17,675	18,643	19,612
INDEX OF CHANGE						
From all sources						
1	100	116	115	107	111	116
2	100	116	118	118	120	121
3	100	114	114	114	113	113
4	100	118	125	133	141	149
From taxes and loans						
1	100	117	115	105	109	114
2	100	117	119	118	119	120
3	100	115	114	113	112	111
4	100	118	125	132	140	147

^a Estimate 1 is that in Table 14; estimate 2 is that in Table 16; estimate 3 is that in Table 17; estimate 4 is that in Table 18.

CHART 5
 TOTAL FEDERAL, STATE, AND LOCAL EXPENDITURES FROM
 ALL SOURCES, ALL ESTIMATES, 1937-40*



* From Table 19.

local governments for 1940 are compared, it is apparent that both of the functional estimates are lower than either of the trend estimates for the federal government, and higher than either of the others for the state governments. Only the local government functional estimates fall between the two trend estimates. Either functional estimate is believed to be more reliable than either trend estimate.

Chapter 8

COMPARISON OF REVENUES AND EXPENDITURES

The estimates of revenue and expenditure given in Chapters 6 and 7 may now be summarized and compared. All years are fiscal years ending June 30 of the calendar year stated, except that some of the state and local data are for fiscal years ending in some other month but during the same calendar year.

EXPENDITURES

Total expenditures—federal, state, and local—will fall somewhere between \$17,000,000,000 and \$18,000,000,000 in 1937. This total will probably fluctuate between \$16,000,000,000 and \$18,000,000,000 through 1940. It includes about \$500,000,000 a year of statutory debt retirement by the federal government but no debt retirement by state or local governments. It includes actual payments to beneficiaries under the existing social security program. It does not include the amounts put into the old-age annuity fund by the federal government; this matter is discussed in the revenue summary below.

Non-tax revenues will reduce the total to be met by taxes, particularly for localities. If an optimistic view of the relief situation is taken, the amount of tax revenue required to cover all government expenditures without borrowing is \$15,300,000,000 for 1937, \$14,000,000,000 for 1938, \$14,500,000,000 for 1939, and \$15,200,000,000 for 1940.

Of these totals, the part to be covered by federal tax revenue, without borrowing, is estimated at \$7,600,-

000,000 in 1937, \$5,200,000,000 in 1938 and 1939, and \$5,300,000,000 in 1940. The figure for state tax requirements mounts steadily from \$2,800,000,000 in 1937 to \$4,300,000,000 in 1940. The local expenditures to be met from taxes, still assuming no borrowing, increase slowly from \$4,900,000,000 in 1937 to \$5,600,000,000 in 1940. Of course it is evident that for 1937, actual tax receipts will not be sufficient, at least for the federal government, to obviate borrowing. Moreover, it is not likely that states and localities will abstain entirely from borrowing.

These assumptions are of course highly tentative and subject to a wide margin of error. They anticipate a continuation of business recovery, so that in 1939 and 1940 the federal government will be spending nothing on relief, and the states and localities, \$500,000,000 a year. They assume no substantial rise in the price level, no increase in veterans' pensions, and no increase in the present housing or mortgage refinancing programs. On the other hand, they do allow for many kinds of increase that seem highly probable, such as that due to payments to beneficiaries of the social security program.

If the relief load should decline more gradually and the federal government should support a large share of it even in 1939 and 1940, the total annual amount required from taxation to cover expenditures would increase to nearly \$16,000,000,000 in each of the years 1938-40. All the increase is in the federal figure, which rises to \$8,100,000,000 in 1937, \$6,900,000,000 in 1938, \$6,500,000,000 in 1939, and \$6,100,000,000 in 1940.¹

REVENUES

All the local units together raise almost as much tax revenue as the federal government. Until a few years ago, they raised more. ~~The state governments raise in all~~

¹ See p. 111; and the memorandum by Mabel Newcomer on government expenditures in the forthcoming volume, *Studies in Current Tax Problems*.

considerably less than either the federal government or the local governments. Their total, however, is growing rapidly.

The federal government will obtain about \$5,500,000,000 in tax revenue during the year ending June 30, 1937. This will leave a gap of \$2,600,000,000 (second functional estimate). The total of state taxes during the same period will apparently be close to \$2,500,000,000, and possibly as high as \$2,700,000,000. Therefore, state budgets in the aggregate may be within \$100,000,000 of being balanced. An estimate of total local tax collections is the most hazardous of all. Data on actual tax collections of all local units in the United States have only occasionally been assembled. A reasonable estimate for the same twelve-month period seems to be about \$4,500,000,000, but the total may be as high as \$4,700,000,000, which would leave the localities with about \$200,000,000 to borrow. The state and local tax total of \$7,000,000,000 may be compared with totals of \$6,400,000,000 given by the Census Bureau for 1932 and \$5,900,000,000 estimated for 1934 by the National Industrial Conference Board. The estimated grand total of federal, state, and local taxes, \$12,500,000,000 at a minimum, is considerably higher than for any previous year in the country's history, including the war years.²

Estimates for a Year of Great Prosperity

The revenue estimates for 1938-40 differ, as has been shown, rather widely according to the different assumptions that have been made. The variations, however, have been computed only for the federal tax system. For the state totals, either the information is not available or the task of computation is too laborious. For local governments, the probable yield of the property tax, under conditions of moderate prosperity, has been esti-

² See Note 1, *Estimates of Tax Revenues*, p. 540.

mated for the years 1938, 1939, and 1940 as a basis for the local expenditure estimates.

The existing federal tax system, excluding the social security taxes, could yield \$8,200,000,000 if one of the next few years were a peak prosperity year generally similar to 1928. The magnitude of this \$8,200,000,000 total may be appreciated by recalling that the peak yield thus far for federal tax revenue was \$5,700,000,000, in 1920, and that the lowest yield since 1929 was \$1,900,000,000 in 1933. This estimate includes the effects of the extraordinary capital gains of the 1928 period and is therefore decidedly optimistic.

Federal old-age payroll taxes, under the existing law, will yield a surplus over actual payments to social security beneficiaries in each of the years 1938-40. This surplus will be about \$300,000,000 in 1938, and again in 1939, and \$500,000,000 in 1940.³ Presumably the surplus, being invested in federal securities, will make the total debt outstanding in the hands of the public less by a corresponding amount. Technically, it does not result in a "reduction" of the debt. If it is to be considered a debt reduction for purposes of calculating over-all deficits or surpluses, these figures must be added to the surplus figures or subtracted from the deficit figures given in this chapter. The federal unemployment compensation payroll tax is assumed to yield practically nothing after 1937, owing to the enactment of state taxes to absorb the credit offered by the federal tax. State payments for unemployment compensation are assumed to equal, roughly, the state credit-absorbing taxes.

Of the \$8,200,000,000, the personal income tax would yield \$3,100,000,000; the corporation normal tax, \$1,800,000,000; the estate tax, \$600,000,000; the gift tax, probably \$200,000,000 or more, although it should be noted that this constitutes largely a prepayment of

³ Derived from Table 15, pp. 108-9.

estate taxes; the manufacturers' excises, perhaps \$500,000,000; the tobacco taxes, \$600,000,000; the liquor taxes, \$600,000,000; customs, \$500,000,000; and the stamp taxes and miscellaneous special taxes, about \$300,000,000. Included in the personal income tax estimate above is \$200,000,000 permanent revenue expected from the provision of the Revenue Act of 1936 repealing the exemption of dividends from the normal tax.

As has been explained,⁴ the effect of the 1936 act was to create a source of genuinely additional revenue and also a source of advance revenue—revenue that is only temporary, since it obtains present revenue to a major extent⁵ at the cost of future revenue. If the advance revenue is included, the total rises to somewhere near \$9,000,000,000. Although the tax on undistributed profits will yield genuinely additional revenue, its prospects are very uncertain. However, if an extreme figure of total possible revenue is desired, another \$500,000,000 may be added, but the total, which would be somewhere near \$9,500,000,000, had best not be used until some conservative adjustment is devised to take account of the economic repercussions and the administrative difficulties that such a high level of taxation involves.

Federal expenditures for the years 1938-40, exclusive of statutory debt retirement and payments to the old-age reserve fund, range, under the functional estimates, from \$4,700,000,000 to \$6,400,000,000, depending on the year and the assumptions made about relief expenditures.⁶ Under extremely favorable conditions, therefore, the present federal revenue system would make it possible to reduce the debt (including statutory debt retire-

⁴ See pp. 77-79.

⁵ See p. 75, Table 7, note g.

⁶ See pp. 107-11, Tables 14, 15, and 16. The maximum of \$6,400,000,000 has been obtained by deducting the estimated amount of statutory debt retirement (\$555,000,000) from total expenditures for 1938 under the second functional estimate (Table 16). The minimum of \$4,700,000,000 has been obtained by deducting the estimated amount of statutory debt retirement (\$534,000,000) from total expenditures for 1939 under the first functional estimate (Table 14).

ment) from about \$1,800,000,000 to about \$3,500,000,000 in a year like 1928, on the basis of an \$8,200,000,000 tax yield.

Estimates for a Year of Moderate Prosperity

In a moderately prosperous year—similar, for example, to 1924—the yield of the existing federal tax system (still excluding social security taxes, advance revenue, and the uncertain future revenue from the undistributed profits tax) would be about \$4,900,000,000.

As shown in Table 7 in Chapter 6, the personal income tax would produce \$1,300,000,000. To this may be added a rough estimate of \$100,000,000 for permanent revenue obtained from repealing the exemption of dividends from the normal tax (still assuming no pressure from the undistributed profits tax for more dividends). No estimate was made for the corporation tax for such a year, but, judging from the data for 1928, 1933, and 1934,⁷ the tax would probably produce somewhat more than \$1,000,000,000. As with the 1928 estimate above, nothing is included for the undistributed profits tax. Thus, the income tax total would be \$2,400,000,000. The September 1936 budgetary estimate is \$2,300,000,000 for the fiscal year 1937, but this includes, presumably, amounts for (1) the undistributed profits tax, and (2) advance revenue for the personal income tax as explained above.⁸

The existing estate tax, it is estimated, would produce for the federal government \$400,000,000 on returns such as those filed in 1926. This may be reduced to \$300,000,000 to bring it closer to 1924 conditions. Estimates for the other taxes are: gift tax, \$100,000,000; manufacturers' excise taxes, \$400,000,000; tobacco taxes, \$500,000,000; liquor taxes, \$500,000,000; customs, \$400,000,-

⁷ See the memorandum by Susan Burr and William Vickrey on federal income and estate tax estimates in the forthcoming volume, *Studies in Current Tax Problems*.

⁸ See Note 2, *Federal Budget of January 5, 1937*, p. 540.

000; and stamp taxes and miscellaneous special taxes, \$300,000,000.

Comparing these revenues with the estimated expenditures on the various assumptions, it follows that a surplus as high as \$200,000,000 or a deficit as high as \$1,500,000,000 might result. Actually, however, it may not be too optimistic to rely on an additional \$400,000,000 or \$500,000,000 of advance revenue and undistributed profits tax revenue. This would make the range of possibilities lie between a surplus of about \$700,000,000 and a deficit of about \$1,100,000,000.

Estimates for a Year of Depression

Finally, it is well to recall the possibilities of a year of deep depression, such as 1933. In such a year even the present federal personal income tax rates would yield only \$500,000,000, including the permanent revenue from the taxation of dividends under the normal tax. The corporation normal tax would yield another \$500,000,000. The estate tax would yield \$200,000,000; the gift tax, perhaps \$100,000,000; manufacturers' excises, \$300,000,000; tobacco taxes, \$500,000,000; liquor taxes, \$500,000,000; customs, \$300,000,000; and stamp taxes and miscellaneous special taxes, \$200,000,000. The total is only \$3,100,000,000. Even if advance revenue and revenue from the undistributed profits tax are added, the total would not be likely to pass \$3,300,000,000. With expenditures at a \$6,000,000,000 or \$7,000,000,000 level—or possibly higher, owing to emergency expenditures—the deficit would be \$3,000,000,000 or more.

Sources of Additional Revenue

If additional revenue should be needed, the income taxes and the estate taxes could yield several hundred million dollars more if the rates were raised. While the new rates would undoubtedly be heavy, they would

probably not be considered politically impossible in a fiscal crisis.⁹ Lowering of exemptions promises possibilities of several hundred million dollars more. Other parts of the system, while capable of less spectacular yields under favorable conditions, offer chances for substantial increases that are probably not beyond the political limit of capacity to pay.

In general, then, if the federal government fails to balance its budget in the near future, it will probably be either (1) because expenditures rise in some manner not indicated in the functional analysis in Chapter 7, or (2) because business fails to stay above such moderate conditions as those in 1924 and as a result the relief load fails to drop markedly. In either case, the budget can be balanced if some of the more obvious revenue possibilities are employed. This statement, however, does not imply that existing or prospective expenditures are justified or that the tax load is not too heavy. No judgment at all is passed here on expenditures. The point is, rather, that the existing federal tax system has great revenue potentialities for a period of prosperity. Little reason exists for saying that new federal taxes will inevitably be necessary in the next few years if the budget is to be balanced. The answer depends upon the trend of business conditions. If, on the other hand, an effort is to be made to reduce the debt, even by only half the increase since 1930, additional taxation will be necessary unless a prolonged period of great prosperity ensues.

⁹ See pp. 73-75.

Section B. Social Control

Chapter 9

TAXATION AS AN INSTRUMENT OF SOCIAL CONTROL

NON-REVENUE ASPECTS OF TAXATION

All activities of government react on one another, and tax policies cannot be isolated from other governmental policies. Thus, even when a tax is being levied primarily for revenue, it will be judged partly by its effect on other governmental policies. Furthermore, the primary aim in imposing taxes is frequently not revenue but regulation. In this chapter and Chapters 10 through 14 the relation between current tax policies and other important governmental policies of the United States will be examined. In the present chapter an analysis is made of the problem in general, while in the five following chapters special types of governmental policy are discussed.

Governmental Policy in Relation to Economic Activity

The prevailing attitude in the United States concerning the proper relation of government to economic life is based on a belief in the value of self-interest and free enterprise. The system of private capitalism reflects an assumption that in the main the general welfare is best promoted by giving wide play to individual freedom of choice and action. Disturbance and diversion of economic activities are thought to diminish the general welfare.

However, this faith is not unlimited, nor is it so complete as formerly. In many respects the public has

deliberately diverted economic activity from the courses it would otherwise have followed. Examples are the regulation of public utilities, banks, labor relations, foreign commerce, and so on, and the prohibition of monopoly and other undesirable economic activities. Thus the general principle that the government shall exercise no influence on economic activity is qualified in practice by the control of certain activities in which laissez faire is thought undesirable.

Taxes disturb free enterprise, since they always have some influence on economic activity. From this point of view, one of the secondary aims in choosing among taxes would be to keep restrictive or distorting effects at a minimum. In sharp contrast, governmental control as a primary aim for taxation is designed to influence economic activity in certain specific ways, regardless of revenue.

Opposition to Social Control through Taxation

To minimize the influence of taxation on economic activity is commonly recognized as a valid and important object of tax policy. The intentional use of taxation for purposes of control, however, has been vigorously opposed.

Those who object to all kinds of governmental regulation of economic life by any method are quite consistent in opposing the use of taxation for that purpose. Others may not be so consistent. People often favor governmental use of the taxing power to promote and protect their business, while they vigorously oppose its use when it would impose any restraints on their business or affect the distribution of wealth or income in a manner unfavorable to them.

Those opposed to the use of taxation for social control advance the following arguments. Taxation deals with result rather than with causes. It is a crude method of

control, incapable of being used with fine discrimination and consequently likely to result in much harm. Finally, the difficulties of devising a sound tax system are enormously increased by adding another primary aim to that of raising revenue.

All taxation, however, affects economic life. A refusal to consider the relation of tax policies to other governmental policies would allow some of the former to nullify some of the latter. Even if social control were not a primary aim of taxation, a valid secondary aim would be to see to it that the effects of taxation supported and did not nullify other governmental policies.

Opposition to the use of taxation for social control has not stopped such use. Society rarely refuses to use any known powerful instrument of economic and social adjustment in attaining its ends. The actual use of taxation for control is common enough to require an analysis of it as one of the primary aims of tax policy.

Types of Control through Taxation

Taxation may be used for social control in at least three ways: (1) It may be used to redistribute wealth and income in order to offset an undesirable distribution caused by the economic system. This use is discussed below in Chapter 14. (2) It may finance subsidies that are granted in order to encourage and control private activities. Subsidies to shipping companies to induce expansion of operations and subsidies to farmers to induce restriction of crops are examples. Since in these cases taxation has the purely passive role of producing revenue and the control is achieved through expenditure, this method is outside the scope of this study. (3) Finally, taxation exerts pressures upon the activities of individuals and business concerns. The protective tariff is an example. The present chapter and the four follow-

ing chapters are devoted to an analysis of the use of tax pressures for control purposes.

THE OPERATION OF TAX PRESSURES

All taxes bring about economic effects by the pressure that they exert on economic life. When taxes are imposed, activities that previously gave the maximum profit and satisfaction for the outlay may no longer do so. Thus, an individual who formerly employed labor rather than machinery might, after the imposition of a heavy tax measured by payrolls, find it profitable to buy more machinery and employ less labor. Again, a housewife who used to buy beef because it gave her the best value for her money might, after the imposition of a tax on beef, buy pork instead, which now offered her the best value.

Furthermore, some actions are made impossible by taxation. A person with a \$1,500 income cannot spend so much in buying goods if he is obliged to pay a \$150 tax as he could spend if no tax were imposed.

Not only do all taxes have economic effects, but—contrary to a common claim—the effects of the various taxes differ widely in nature and degree. In the following paragraphs some of the reasons for these differences are reviewed.

Factors Influencing Effects of Taxes on Activities

Whether the pressure of a tax will cause a change of activities depends on a number of factors, including the mobility of the tax base, the rate of the tax, the extent to which the tax is a general one, the nature of the tax base (whether the tax is on net return or gross receipts), and the situation of the person taxed.

▼ Mobility of the tax base means the ease with which the taxpayer may change his economic activity so as to avoid the tax. A payroll tax has been mentioned that

might cause a change from the employment of labor to the installation of additional machinery. If a tax were imposed on machinery instead of on labor, the mobility of the tax base would be less—that is, a shift from machinery to labor would be less profitable. The whole working life of the machine would already have been bought and paid for, and little money could be saved by abandoning it before it wore out. Similarly a tax imposed in a single state on industrial income or sales would more probably cause light manufacturing business than public utilities or gold mines to migrate from the state. Gold can be mined only where it exists. The public utility must be in physical contact with customers. The manufacturing establishment, however, may move into another state that does not impose the tax and ship its goods to market in interstate commerce, which, under the federal Constitution, is exempt from taxes imposed by the states.

The importance of the rate of the tax may be seen in the case of the tariff. A low tariff on the importation of some manufactured commodity—for example, watches—may have little, perhaps no, effect on the amount imported. On the other hand, by more than offsetting the cost advantage of foreign producers, a high tariff may completely stop the importation.

A general tax or one imposed over a wide area is less likely to affect economic activity than a special one or one imposed in a small area. A manufacturing establishment has no inducement to move if the income tax or sales tax that it wishes to avoid is levied in all states, instead of being limited to one. Similarly, a tax imposed on only one industry is likely to cause more people to shift from that industry to others than a tax imposed on all industries.

Again, taxes on net return will as a whole affect economic activity less than taxes on gross receipts. A tax

imposed on gross receipts may drive some concerns that are not making profits into bankruptcy. A tax on net profits will not, since only profitable concerns need pay it.

Finally, differences in the situations of persons influence the effects of taxes. For example, suppose that a special tax were imposed on the incomes of all practicing lawyers. The lawyers that it would induce to abandon their profession would be those who were making only about the same income that they might earn in some other occupation and who had already been debating a change. Similarly, a tax imposed on the manufacture of radios would induce some concerns to shift into the manufacture of another commodity, while others would find it more profitable to remain in the radio industry and pay the tax.

Effects of Special Taxes

Special taxes imposed on particular industries, forms of business organization, or other tax bases repress the concerns on which they are imposed, since they add to the costs of doing business. In a competitive industry that is specially taxed, either prices must be increased at once to overcome the increased cost, or firms will—if their capital is fairly mobile—tend to leave the industry for more attractive opportunities elsewhere. As a result those remaining in the business can increase prices. When prices are increased, some consumers will reduce purchases, while others will cease buying the product and will turn instead to an untaxed substitute. Consequently, the industry producing the untaxed substitute will be able to increase prices and will enjoy greater prosperity. Other business men in turn will be encouraged to enter it.

Similarly, when a special tax is imposed on a form of business organization or business practice, the added

cost of doing business in the manner subject to the tax will cause, or at least encourage, a shift to methods not subject to the tax.

Effects of Tax Exemptions

General taxes, such as the general property tax, general retail sales tax, and general net income tax, are not in themselves well adapted for economic control. Their pressure cannot be concentrated in a sufficiently specific manner. However, special exemptions from general taxes work broadly in the same way as special taxes. If a particular plant or industry is given a special exemption from a general tax, such as the property tax, it is placed in a favored position. Either its operators can pocket the amount of the tax exemption, or they can use their lower cost position to attract customers away from competing products.

Exemption under a general tax produces its promotional effect somewhat differently from a special tax. The exemption is a special relaxation of pressure at a given point in an area of general tax pressure. The immediate effect is one of benefit to those receiving the exemption. From this benefit harm flows to competitors and to taxpayers generally—to competitors because of the favored position in which the exempt industry or establishment is placed, and to taxpayers generally because the taxes escaped by those who are exempt must be borne by others. To summarize: in the special tax, repression at a specific point results in benefits to others; while in the exemption, release from taxation at a specific point results in injuries to others.

CONSTITUTIONALITY OF TAXATION FOR NON-FISCAL PURPOSES

The use of taxation in the United States for control rather than revenue has not gone unnoticed or un-

limited by the courts. They have faced a dilemma in determining the constitutionality of such legislation. If the courts restrained the imposition of every tax that had repressive economic effects, there would be little or no revenue for government. However, the power of taxation to repress and destroy is great. If governments were not limited in its exercise, they could enforce a control otherwise far beyond their power, and they could thus warp and perhaps completely alter the framework of economic life. To draw a line allowing free play to legislative bodies in their revenue policies and yet not giving them undue powers of social control through the taxing power has been a difficult judicial task. Confusion as to the precise location of the line is due in large part to this difficulty, although changes in the social philosophies of the judges are also important.

Federal Power to Impose Taxes for Non-Fiscal Purposes¹

The point beyond which taxation shall not be used for control has been particularly difficult to fix in federal legislation because all national regulation must be based on powers specifically delegated in the Constitution. The most important in this connection are the commerce power and the taxing power. The former, however, applies only to interstate and foreign commerce. The temptation for the federal government to use the taxing power for other than revenue purposes is therefore greater than it might be if it had more police powers.

The position of the Supreme Court of the United States on taxation for non-fiscal purposes is not entirely clear. It has frequently upheld taxes imposed in fact for such purposes. The existence of a collateral purpose in addition to that of raising revenue has been held not to

¹ See Note 1, *Cases on Federal Taxation for Non-Fiscal Purposes*, p. 542, for cases illustrating the points in this section.

invalidate the tax.² The fact that the tax is so heavy that the business is destroyed and no revenue is produced has in some cases been held by the Court to be immaterial.³ Furthermore, the Court has at times upheld regulatory provisions that, while ostensibly included in the law to aid in the collection of revenue from the tax, were obviously imposed as a means of control.⁴

However, where the Court has concluded from the language of the statute that regulation was the actual purpose, it has held the charge imposed to be a penalty rather than a real tax, and thus not a proper exercise of the taxing power. This conclusion has been reached when the form of the tax measure has indicated that the charge was intended to force those on whom it was levied to conform to collateral prohibitions or restrictions imposed by the act.⁵ Another factor has sometimes been the weight of the tax, although this has in some cases been disregarded.⁶

When the Court finds the charge to be a penalty and not a true tax, the constitutionality of its imposition depends on whether Congress could under some other delegated power legally impose the restrictions that the payment was intended to enforce.⁷ In a recent case⁸ the Supreme Court has added a further restriction. It has held that a tax may not legally be employed to raise the money with which to achieve by monetary inducement a control that Congress has no power to exercise directly.

It is difficult to harmonize all the decisions of the

² See *Hampton and Co. v. United States*, 276 U.S. 394, 412, 413 (1928); *United States v. Doremus*, 249 U.S. 86, 93, 94 (1919).

³ See *Veazie Bank v. Fenno*, 8 Wall., 533, 19 L. Ed. 482, 488 (1869); *McCray v. United States*, 195 U.S. 27, 60 (1904); *Magnano Co. v. Hamilton*, 292 U.S. 40, 45 (1934); *Fox v. Standard Oil Co.*, 294 U.S. 87, 99 (1935).

⁴ See *Felsenfeld v. United States*, 186 U.S. 126, 132 (1902); *United States v. Doremus*, 249 U.S. 86, 94 (1919).

⁵ See *Bailey v. Drexel Furniture Co.*, 259 U.S. 20, 38 (1922); *Hill v. Wallace*, 259 U.S. 44, 67 (1922); *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936).

⁶ See *Trusler v. Crookes*, 269 U.S. 475, 482 (1926).

⁷ See *Bailey v. Drexel Furniture Co.*, 259 U.S. 20, 39 (1922); *Hill v. Wallace*, 259 U.S. 44, 68 (1922).

⁸ *United States v. Butler*, 297 U.S. 1 (1936). In this case the Agricultural Adjustment Act was declared unconstitutional.

Court on the use of taxation for non-fiscal purposes. The position of the Court has been somewhat indecisive. As a result, past decisions often furnish precedents for deciding almost any given case whichever way it wishes.

The federal power to use taxes for purposes of control is also limited by constitutional restrictions on the types of tax that may be employed. Indirect taxes must be uniform throughout the United States. Export duties are prohibited. Direct taxes, with the exception of the income tax, must be apportioned among the states according to population.⁹ Instrumentalities and agencies of state governments may not be taxed. These restrictions prevent the imposition of certain forms of control that might otherwise be used. If no requirement for uniformity existed, taxation could favor the development of one geographical section at the expense of another. If export duties were permitted, they could be used to reinforce the protective tariff. If apportionment of direct taxes were not required, the experiment of a modified "single tax" might be tried on a national scale. If the taxation of state governmental instrumentalities and agencies were permitted, the federal power to control state action would be greatly increased.

*State Power to Impose Taxes for Non-Fiscal Purposes*¹⁰

To the states are reserved all powers not delegated to the federal government and not denied to the states. The Constitution specifies some restrictions on state taxation, and others have been developed by the Supreme Court. States may not tax federal instrumentalities or impose burdens on interstate commerce, nor may they go beyond the limits set by the Fourteenth Amendment.

The Court has developed restrictions on state taxation, especially in its interpretation of the clauses of

⁹ See Note 1, *Uniformity Requirement for Federal Taxes*, p. 512.

¹⁰ See Note 2, *Cases on State Taxation for Non-Fiscal Purposes*, p. 542, for cases illustrating the points in this section.

the Fourteenth Amendment concerning due process of law and the equal protection of the laws. A state may not arbitrarily discriminate among persons and tax objects, but it may classify them for taxation according to some basis that the Court deems reasonable. Thus, in the chain store tax cases the Court decided that the distinction between chain stores and independents was a reasonable basis of classification that justified the imposition of special taxes on chains. The distinction between a large volume of sales and a small volume, however, was held not to be a reasonable basis to justify the imposition of a progressive sales tax.¹¹ By finding that the basis for classification is not a reasonable one, the Court may restrain the use of taxes that otherwise could be used for non-fiscal purposes. In effect, the Court is in a position to uphold those forms of control that it considers reasonable and to eliminate those that it considers unreasonable.

The federal Supreme Court apparently applies to the state governments the same rules for the weight of taxation and the imposition of penalties that it applies to the federal government. However, because of their reserved powers, the states have police powers under which regulation may be imposed. If the Court decides that a statute imposes a penalty and not a tax, the statute may still be upheld if it is deemed a proper exercise of the police power.

State constitutions, as interpreted by state courts, in general place no limit on the rate at which a tax may be imposed, regardless of non-fiscal effects. However, in a few states local license taxes must not be prohibitory or unreasonably repressive. Furthermore, if the state court finds that the "tax" charge is imposed for regulation instead of as a true tax, the rate of the charge must be related to the power of the state to impose the

¹¹ See p. 183.

regulation. The rate of a "tax" is likely to be considered by the court as one of the factors determining whether the charge is a tax or is imposed for regulation.

OTHER LIMITATIONS ON TAXATION FOR NON-FISCAL PURPOSES

Economic and administrative limitations are added to those on the legal power of the federal and state governments to use taxation for control purposes. The tax may be economically unsuited to the regulatory task to which it is put. For example, a retail sales tax on all commodities would probably reduce the consumption of liquor, but it would have too many other important consequences to warrant its adoption for the specific purpose of reducing liquor consumption. Again, a tax may place too heavy an administrative load on government. Heavy taxes to restrict the consumption of liquor, which might be very effective if the taxes could be perfectly applied, might fail because the administrative officials were not able to cope effectively with smuggling and bootlegging.¹²

¹² See Note 2, *Liquor Tax Evasion*, p. 566

Chapter 10

PROMOTION OF SPECIFIC INDUSTRIES

The promotion of industries that are deemed by government to be of special public interest has been perhaps the chief non-fiscal use made of taxation in the United States. By far the most important example is the protective tariff, but special internal taxes and tax exemptions are also employed. The subject will be discussed under those three divisions.

THE PROTECTIVE TARIFF¹

From the beginning, the tariff was understood to be imposed for promotional and control purposes as well as for revenue. The preamble of the first revenue act mentioned a necessity for "the encouragement and protection of manufactures." Similar statements appeared commonly in the titles or preambles of subsequent tariff acts. In a case before the Supreme Court in 1928, a tariff measure was attacked in part on the ground that it set out "to encourage the industries of the United States." According to the argument, it was therefore unconstitutional, since revenue was the only object for which Congress could levy customs duties. The Court held that this argument was nullified by the whole history of tariffs, and that it was contrary to the settled point of law that, "so long as the motive of Congress and the effect of its legislative action are to secure revenue for the benefit of the general government, the existence of other motives in the selection of subjects cannot invali-

¹ See Note 1, *Bibliographical Note for the Protective Tariff*, p. 543.

date Congressional action."² In 1933 the Court even went so far as to state that protective duties are laid under the commerce power rather than under the taxing power, although they may be laid under either. Apparently the tariff is now legally in the position that it has actually held since the Civil War: it is an instrument for protection and promotion, with incidental revenue aspects.

Injury to Domestic Producers

The protective tariff may seem to promote some industries without injury to any other domestic industries. This appearance is due to the mechanism of international trade, which hides the effects of the tariff.

All sales to foreign countries must sooner or later result in an equal volume of purchases from foreign countries. Unless one seller is willing to give his goods away in exchange for promises that are never fulfilled, there must be an exchange of goods and services, at the same time or later, direct or roundabout. The world's supply of gold is much too small to finance unbalanced trade for long. In the absence of tariffs, there develop certain industries, naturally favored by the kinds of resources, skills, etc. of the country, that sell their products abroad. An equal amount of low-cost products of other countries is imported in payment. When a protective tariff is introduced, imports decrease, and consequently the foreign countries must reduce by approximately the same amount their purchases from the exporting industries. Thus the restriction of imports diminishes or destroys the foreign market for certain domestic products. The domestic producer of the protected commodity is benefited both at the expense of the domestic consumer, whom he can charge a higher price for his product, and at the expense of the domestic producer for the foreign market.

² *Hampton and Co. v. United States*, 276 U.S. 394, 412 (1928).

If this promotion of one domestic industry at the expense of others were more obvious, the application of a protective policy would probably be more strongly contested than it has been. However, the effect on the domestic producer for the foreign market is diffuse and indirect. The obvious and direct sufferers are the foreign producer, the importer, and the consumer. Foreign producers have no domestic political influence, importers are neither numerically nor politically important, and the injury to each consumer is piecemeal and hidden in prices. The result is a greater willingness to encourage and promote specific industries through external taxes, such as the tariff, than through internal taxes.

Tariff Beneficiaries in the United States

In the United States manufacturing has in general been the chief beneficiary under the protective tariff. Agriculture has been mainly an exporting industry. Therefore, it has been injured rather than benefited. During the earlier decades of the federal tariff the economic life of the country was largely agricultural, and the result of the tariff was to diversify industries and to establish manufacturing by promoting infant industries.

However, after the Civil War and especially toward the end of the century, American manufacturing industries were well past their infancy. During the last half century many of them have endeavored to organize into huge industrial combinations for monopolistic control. The tariff apparently has facilitated the growth of combinations and the imposition of high prices, by excluding the foreign competition that might have kept prices at a competitive level. Thus, while the federal government has for more than forty years attempted to destroy and prevent industrial combinations and monopoly prices, it has retained, in the tariff, an instrument that encourages them.

SPECIAL INTERNAL TAXES

The repressive effects of internal taxes imposed to promote special industries are more obvious than the effects of tariffs because an internal tax is laid directly on a domestic industry. Taxed industries object strenuously to discriminatory taxation and can easily show that one group of citizens is being deliberately favored at the expense of others. This is a powerful complaint politically, and unless the political importance of the complainants is small it is likely to secure relief. For this reason internal taxes have been used only rarely for promotional purposes. Another reason is that few commodities have exact substitutes. A tax imposed on a commodity would thus not divert demand to another commodity with any precision. The diversion might be small and might also be widely scattered among many commodities in such a situation. Discrimination between producers of the same commodity would be difficult, in view of constitutional requirements of uniformity.

Bank Note Tax

There are, however, some examples of the use of internal taxation for promoting one business at the expense of another. Perhaps the earliest was the tax of 10 per cent imposed on state bank notes beginning in 1866, which is still in effect.³ The national banks had been set up during the Civil War partly to serve as a market for government bonds and partly to give the country, through their note issues, a uniform currency of standard value. Congress soon observed that the full benefits of the national bank notes could not be attained without legislation to drive the competing state bank issues out of circulation. This aim was achieved by the tax.

³ See Note 2, *Bibliographical Note for Bank Note Tax*, p. 544.

The Supreme Court upheld the tax, although it was clearly so heavy that it would not produce revenue and would destroy the note-issuing business of the state banks. The Court affirmed that the responsibility of the legislature for excessive taxation was to the people and not to the courts, and, further, that Congress had the power to regulate money and might use the taxing power for that purpose.

Oleomargarine Taxes

Another example is the taxation of oleomargarine.⁴ In 1886 Congress imposed a tax of 2 cents a pound on oleomargarine and heavy license taxes on oleomargarine manufacturers and dealers. Imported oleomargarine was subjected to a special internal revenue tax of 15 cents a pound in addition to the tariff. Congress apparently had no hostility to the domestic oleomargarine industry as such, since there was no tax on the product manufactured for export. The purpose was, of course, to protect and encourage the dairy industry, which saw in oleomargarine a threat to its markets.

This act was amended in 1902, when the general rate on oleomargarine was fixed at 10 cents a pound. For oleomargarine free from any artificial coloring that caused it to look like butter, however, the rate was lowered to $\frac{1}{4}$ cent a pound, and license taxes on dealers were greatly reduced. In 1931 the low rate was restricted to oleomargarine free from yellow color, whether artificial or not. The obvious immediate objectives of the rate on the colored product were not only to prevent the misrepresentation of oleomargarine as butter but also to discourage the use of oleomargarine. As its manufacturers complained in attacking the constitutionality of the act, the white product did not appeal to public taste. The Court upheld the tax on the grounds that it was

⁴ See Note 3, *Bibliographical Note for Oleomargarine Taxation*, p. 544.

imposed for revenue and, whatever the effects, the judicial branch of government had no reason to interfere.

While the federal tax on colored oleomargarine was sufficiently high to drive it from the market, the uncolored product continued to be sold for private consumption, a quantity of coloring matter being sold with the oleomargarine for home coloring.

Some states, however, have endeavored to eliminate all use of oleomargarine within their borders. For example, the state of Washington imposed a tax of 15 cents a pound on butter substitutes. The tax was attacked in the courts but was unanimously upheld by the Supreme Court of the United States. The principles followed were the same as those stated in the opinion upholding the federal tax. A number of other states have adopted taxes similar to the Washington tax.

Agricultural Adjustment Taxes

In the examples given above, an industry was favored by taxing the product of a competing industry. The Agricultural Adjustment Act was intended to promote the prosperity of certain agricultural industries by reducing the supply of their products and also by paying direct subsidies.⁵ The taxes were essentially of two kinds—the processing taxes and the cotton and tobacco control taxes.

The processing taxes were excise taxes imposed on concerns processing the agricultural commodities. They differed from the many other excise taxes imposed by the federal government in two essentials. First, their rates were originally determined by a formula administered by the Secretary of Agriculture, although later the amounts were fixed by statute. Second, the proceeds were paid as bonuses to the producers of specified agricultural products who limited their production in accord-

⁵ See Note 4, *Bibliographical Note for Agricultural Adjustment Laws*, p. 544.

ance with the desires of the Department of Agriculture. The taxes were, however, like the other excises in being merely a source of revenue, in the direct sense, not a measure of control.

The taxes in the acts regulating the cotton and tobacco industries, however, were used as a direct means of control. They were imposed on production in excess of the quotas allotted to growers. The rates were fixed at 50 per cent of the value of the excess cotton and from 25 per cent to 33 $\frac{1}{3}$ per cent of the value of the excess tobacco.

In the Supreme Court decision on the Agricultural Adjustment Act the processing taxes were held unconstitutional. The Court held that a tax was invalid if it was levied to finance a control that the federal government had no power to exercise. Such a tax was deemed analogous to taxes held invalid in other cases because they were penalties. Since the Agricultural Adjustment Act decision held that the federal government lacked the power to regulate agriculture, the taxes on cotton and tobacco, although they were not involved in the case, were almost certainly also unconstitutional. They would probably have been considered penalties.

TAX EXEMPTIONS

Under the heading of tax exemptions will be included various methods of lightening the tax burdens of favored concerns or industries. The difference between special taxes and tax exemptions is essentially a matter of degree. The imposition of special taxes on one or a few concerns or industries is the equivalent of exempting the many, while the exemption of one or a few is the equivalent of taxing the many.

Tax exemptions may be very narrow or very wide. The narrowest perhaps is the exemption of a single plant or concern from a general tax, such as the property tax.

The widest is the special lightening of the total tax burden on certain broad groups of concerns by failing to impose certain taxes that would rest heavily upon them. The latter is not an exemption in the legal sense, but it is included in this discussion because of the difficulty of drawing a line. Economically it is similar to exemption. In both cases, the method is to create a point or area of lower tax pressure in a field of relatively higher pressure.

Exemptions and unequal taxes may have two effects. One is to encourage the location of a given economic activity in certain taxing jurisdictions. The other is to encourage the economic activities that are granted the exemption and to discourage other economic activities.

Exemptions Affecting Location

Where people and goods are free to pass from one taxing jurisdiction to another, as in the United States, differences in taxes and exemptions have the effect of encouraging the location of a given economic activity in the jurisdiction where the tax burden is lightest.

Some industries have difficulty in changing their locations to escape heavy taxes. When a farmer packs his goods and moves to a distant state with his moving vans placarded "driven out by high taxes," or when the owner of a stone quarry threatens to move his business out of the state if a certain tax is imposed, the protest is not regarded seriously.⁶ An essential element of the businesses cannot be moved—in the one case land, in the other raw material. Similarly, the location of railroads, public utilities, mines, and retail stores is affected relatively little by the weight of taxation.

Other industries, however, are relatively mobile. They can often be completely moved out of the high tax area without sacrificing any essential business element. Manufacturing establishments, stock exchanges, motion

⁶ See Note 5, *Tax Pressure of Mobile Industries*, p. 545.

picture studios, and grain elevators, for example, are able to convince the public that they can make good their threats to migrate.

State legislatures may have no desire to favor an industry, such as warehousing, or a whole field of industry, such as manufacturing, but the mobility of such industries gives them a peculiarly strong bargaining power in the determination of tax policies. It is immaterial that the same threats to migrate are used on all state legislatures and that the threats are not often made good. So long as the possibility appears to exist, these industries will have an advantage in state and local taxation.

Interstate tax competition of this kind is a reason that some states have, for example, failed to adopt corporation income taxes, or have allowed the specially low assessment of manufacturing machinery. Florida in 1924 passed a constitutional amendment forbidding the imposition of income or inheritance taxes⁷ and advertised the fact widely. Many states have provided special exemptions from the general property tax for particular industries.⁸ A survey in 1929 revealed constitutional or statutory provisions that granted some measure of tax exemption to manufacturing property in fourteen states. The exemptions were for limited periods, usually not over five or ten years. The exemption was rarely in the constitution; sometimes it was provided by statute; frequently it was granted only by vote of the municipal legislature or by the electors.

Such exemptions are a method of intercity, as well as of interstate, competition. In addition to legal exemptions, municipalities sometimes vote exemptions beyond their legal power, and local assessors frequently assess

⁷ Later repealed in respect to the inheritance tax. See Note 5, *Tax Pressure of Mobile Industries*, p. 545.

⁸ See Note 6, *Bibliographical Note on Exemption of Industrial Property*, p. 545.

industrial property at low rates with the tacit consent of the community.

If one state or locality grants an exemption, the natural tendency is for other states and localities also to grant exemptions. For the most part these competitive exemptions and underassessments probably offset each other. The net result is a general exemption to the industries in question. Consequently they are favored at the expense of less mobile industries.

Exemptions Not Primarily Concerned with Location

Not all exemptions of industries are primarily the result of competition with other jurisdictions. Some can be traced to the political strength of the affected group or the belief that the existing economic system does not give sufficient incentive for development. Thus agricultural property of several kinds is granted special exemptions in many states.⁹

Exemption of Dwellings

A few states exempt homesteads occupied by the owner from property taxation, the exempted value being limited in amount.¹⁰ One reason for the spread of homestead exemption is the desire to encourage home ownership and to discourage tenancy.

Occasionally, in times of housing shortage, exemptions have been offered to encourage the building of new houses.¹¹ A New York statute passed in 1920 permitted municipalities to provide for such exemptions. By a New York City ordinance passed in February 1921, exemption from assessment for real estate taxes until 1932 was granted to all housing on which construction was begun before April 1, 1922, and finished within two years. Exemptions were up to \$1,000 per room for a

⁹ See Note 7, *Bibliographical Note on Agricultural Tax Exemption*, p. 546.

¹⁰ See the memorandum by Thomas J. Reynolds on homestead exemptions and rate limitations in the forthcoming volume, *Studies in Current Tax Problems*.

¹¹ See Note 8, *Bibliographical Note on Exemption of Improvements*, p. 546.

maximum of 5 rooms in single-family houses and 5 rooms per apartment in multi-family houses. Later the period of construction was extended. The degree to which this exemption stimulated housing construction is subject to debate. A housing boom certainly followed the passage of the ordinance, but a similar boom began about the same time in other cities. In any event, measurement of the effect of the exemption is scarcely possible.

Exemption of All Improvements

The proposal for the permanent exemption of improvements—as contrasted with temporary exemption of the type cited above—has its roots in the single-tax philosophy developed and popularized by Henry George and his followers. The single-tax advocates propose that practically the full economic rent of land and natural resources shall be taken by government in taxes, and that no taxes shall be imposed on improvements, personal property, incomes, or other tax objects.

Two main arguments are presented for the single tax. First, the tax is just, because land and natural resources were originally a gift of nature, while their increase in income and value has been due to social development and the increase in population. Second, the tax is economically desirable, because land and natural resources are available for use in production without the expenditure of labor, saving, or management. Taxes placed on the rent of land, in contrast with other taxes, will not, it is said, discourage economic activity and enterprise but will encourage them.

The opposition to the single tax has been largely based on the grounds of justice¹² and inadequacy of revenue. It has been so effective that the single tax in its pure sense is not an issue anywhere in the United States. The

¹² See pp. 290-91.

rent of land, even if taken in full, would probably be insufficient today to supply the demands of government for revenue. The evidence on this point, however, is perhaps not conclusive. Furthermore, the public has shown no inclination deliberately to impose taxes equal to the full economic rent. Instead, the issue has arisen in the differentiation between land and improvements through the partial or total exemption of improvements from ad valorem taxation.

Such an exemption has been used in the Canadian Northwest. In 1913 Pittsburgh enacted a graded tax law that provided for the gradual reduction, from 1914 to 1925, of the percentage at which improvements were assessable for city taxes. The final assessment ratio was fixed at 50 per cent of value. Land continued to be assessable at 100 per cent of value.

The extent to which exemption of improvements has actually resulted in the growth of improvements is difficult to measure. It was generally believed that the effect in Canada was substantial. The effect of partial reduction in Pittsburgh has been debated. On theoretical grounds, exemption of improvements almost certainly stimulates building construction, although no general agreement exists on the desirability of such stimulation.

The exemption of improvements might be expected to play an important part in the movement for tax limitations on real estate. If real estate tax reduction is to serve as a method of social control, it may take the form of a reduction of taxes on improvements in order to encourage construction and widespread ownership of buildings. Distinctions have been made in some cases between urban and rural land, but no tax limitation law has distinguished between land and improvements, chiefly, perhaps, because such laws have been sponsored largely by farm organizations and by organizations of real estate dealers and large landowners.

Chapter 11

CONTROL OF BUSINESS ORGANIZATION AND PRACTICES

This chapter deals with the control of business organization and practices through taxation. In contrast with the preceding chapter, no account is taken of the kind of product or service.

THE SIZE OF BUSINESS UNITS

Under a strict *laissez faire* policy a government avoids encouraging large units as against small ones, or vice versa. No sentiment has developed in the United States in favor of abandoning this policy because it fosters unduly small business units. A fear has grown, however, that it permits business units to become too large. It is widely believed that through their economic power large concerns can drive smaller ones out of business even when the latter are really more efficient. The recently passed anti-price-discrimination law amending the federal anti-trust laws¹ appears to reflect this belief. Also it is thought that an undesirable and even dangerous degree of economic, social, and political control is concentrated in large business units.

Taxes Favoring Small Units

Taxes relating to chain stores and holding companies, and certain other taxes discussed below, have an incidental bearing on bigness in industry. Other tax measures, however, have been directly aimed at throwing

¹ The so-called Robinson-Patman Act, 15 U. S. C. A. secs. 13 *et seq.* (Supp. 1936). See also "The Legality of Price Discrimination under the Robinson-Patman Act," *Columbia Law Review*, XXXVI (December 1936), 1285-1321.

the balance of competitive advantage in favor of small units or preventing its being thrown in favor of large units.

For example, the taxes imposed on net incomes of corporations by the federal government and by six states are at progressive rates.² In three of the states the progression stops at the \$6,000 income level. Only in South Dakota does it extend into brackets above \$15,000. The maximum rate of 8 per cent in that state starts at \$318,000. The federal rates under the revenue acts of 1935 and 1936 are progressive up to \$40,000, the lowest rate under the 1936 act being 8 per cent and the highest rate 15 per cent. Prior to the Revenue Act of 1932 a credit or exemption of \$3,000 was allowed to corporations with incomes of \$25,000 or less.

The federal tax levied on undistributed corporate earnings³ allows a minimum of \$5,000 of retained earnings to be taxed at the lowest rate, which may give as much as \$675 advantage to corporations with small earnings.

Gross receipts taxes, although usually imposed at flat rates, occasionally are imposed at progressive rates. For example, the gross receipts taxes imposed on telephone companies in Wisconsin are graduated from 2½ per cent to 8 per cent, according to the volume of receipts.⁴ In Louisiana a retailers' license tax is imposed in such a manner as to constitute a progressive rate on sales. All progressive taxes on sales or gross receipts appear to be seriously in danger of being declared unconstitutional since the United States Supreme Court held the Kentucky progressive gross sales tax unconstitutional.⁵

² Based on *Tax Systems of the World*, pp. 128-29.

³ See pp. 14, 16.

⁴ Wisconsin Statutes, 1929, sec. 76.38.

⁵ *Stewart Dry Goods Co. v. Lewis*, 294 U. S. 550 (1935), discussed on pp. 183, 186-87.

Taxes Favoring Large Units

Some tax measures favor the large over the small unit. It has long been recognized that the administration of the general property tax commonly discriminates against small owners, since, according to most studies, the percentage of assessed to full value is higher for small properties than for large properties.⁶

Taxes on corporations at the time of their organization or their entrance into the state frequently favor large corporations. The taxes are commonly based on invested capital, and the discrimination results from four features often present: namely, (1) the fixing of a minimum tax, (2) the setting of brackets within which a flat tax is imposed, (3) regressive tax rates, and (4) in a few states, an upper limit to the amount of the tax. In a very few cases a flat amount is charged, which gives the maximum advantage to the large corporation.

Annual taxes on capital stock are usually imposed at flat rates, but some have the regressive features that are found in the corporation organization and entrance taxes.

Local license taxes are often levied at flat amounts, regardless of the size of the business, or at rates that are regressive when compared with any measure of business size.

INCORPORATED AND UNINCORPORATED BUSINESS

Prior to the nineteenth century the association of persons in a corporation was a privilege granted by a government only under very special circumstances. During the past century, however, owing to the growth of business needs and the competition of states for revenue, incorporation with almost unlimited powers has been

⁶ See Silverherz, *op. cit.*, pp. 211-12.

made practically a common right, although at law it is still a privilege granted by government.

This development has resulted in two opposing attitudes toward the corporation.⁷ One is that since the corporation has been accepted as a common right the state should not encourage either incorporated business or unincorporated business at the expense of the other. They should not, for example, be subject to different tax burdens. The other attitude is that since corporate organization is a special privilege it should be taxed as such. The purpose of this chapter is not to decide what, if any, type of business organization should bear a heavier tax burden. Rather, it is to find out whether tax discrimination exists that tends to encourage or discourage the use of some particular form of business organization.

Tax discrimination exists if the investor bears, either directly or through a tax on business, a higher tax on income derived through one form of organization than through another. Some types of taxation do not affect the form of business organization. Taxes on real estate, tangible personalty, and sales, for example, are imposed regardless of whether the business is incorporated. Taxes on income, profits, and capital stock, on the contrary, have generally been designed to rest more heavily on incorporated than on unincorporated businesses.

Special Taxes on Corporations

Certain taxes are imposed on corporations but not on unincorporated businesses. The chief examples at present are (1) state taxes imposed at the time of organization or entrance into business in the state; (2) annual state taxes on the capital stock or the value of corporate shares in excess of the assessment of corporate property; (3) the combination federal capital stock and excess

⁷ See pp. 459-60.

profits tax;⁸ (4) federal and state income taxes; and (5) the federal tax on undistributed profits.⁹ The organization, capital stock, excess profits, and undistributed profits taxes are clearly special burdens resting on corporate investors. The income tax presents a more complex problem.

The federal government and many of the states impose on corporations income taxes that are not imposed on unincorporated businesses. Only in New York State has a special net income tax been imposed on unincorporated business in addition to the personal income tax. The New York tax is an emergency tax, applying only to the years 1935 and 1936. A \$5,000 exemption is allowed, and the rate is 4 per cent, as compared with a corporation rate during the same years of 6 per cent.¹⁰ Federal and state individual income taxes require a partner or an individual proprietor to include in his personal return his entire share of the profits of the business. This requirement stands, regardless of whether any or all of the profits are kept in the business instead of being taken out for the taxpayer's personal use.

Co-ordination of Corporation and Personal Income Taxes: Earnings Paid Out

The fact that income taxes are imposed on corporations and not on unincorporated businesses does not necessarily mean that the income tax system as a whole—corporate tax plus individual tax—discriminates against corporations. For example, dividends paid by a corporation may be exempted from taxation in the hands of the individual stockholders. Moreover, discrimination depends on the rates of the tax on individual incomes and the amount of the investor's total income. Another im-

⁸ For a description of this tax, see Note 9, *Present Excess Profits Tax*, p. 560.

⁹ For a description of this tax, see pp. 14, 16, and Note 4, *Details of Undistributed Profits Tax*, p. 513.

¹⁰ New York Tax Laws, arts. 9-A, 16-A.

portant factor is the proportion of profits that is paid out currently in dividends instead of being retained in the business. For the moment, however, it will be assumed that none of the profits are retained.

A number of state income tax laws provide that dividends received from corporations subject to the state's income tax are exempt from individual income tax. This provision lessens tax discrimination between incorporated and unincorporated businesses but cannot eliminate it entirely, except in chance cases. Some stockholders receive so little income as to be exempt from the individual tax. The tax paid by the corporation, however, lessens their dividends or decreases the book value of their shares. Thus they bear a tax that they would not have had to bear if their funds had been invested in an unincorporated business. Furthermore, the losses of the incorporated business cannot be offset against the non-business income of the individual or his income from some other business enterprise. The losses from unincorporated businesses can, on the contrary, be offset in this manner.

A few states give a tax credit for the corporation tax paid, instead of exempting the dividends. In these states somewhat the same considerations apply. Discrimination against the corporate form results also from the fact that a state does not, generally, make any allowance for corporate income taxes paid to other states or for dividends received from corporations that are taxed by other states but not by the state in question.¹¹

The existence of these sources of discrimination must be borne in mind throughout the following discussion.

Co-ordination When Rates Are Both Equal and Flat

When dividends are exempt from the individual income tax, the effect on tax discrimination depends largely

¹¹ See the memorandum by Carl Shoup, Bernard L. Shimberg, and William Vickrey on the aggregate burden of federal and state income taxation, in the forthcoming volume, *Studies in Current Tax Problems*.

on the rates of the corporation and the individual taxes. If the individual rate and the corporation rate are the same and are flat, not progressive, the tax on the corporation amounts merely to a tax imposed and collected at the source of the income. Then relatively little discrimination between incorporated and unincorporated business results.

A somewhat different situation was presented under the 1913 and 1916 federal income tax acts. They exempted corporation dividends from the individual normal tax but not from the individual surtax. The normal rates on individuals and corporations were the same. Exemption of dividends from the normal individual tax almost equalized the burdens on corporate and non-corporate business if all earnings were paid out when received. The burden was not quite equalized, however. For corporation earnings, the individual surtax was applied to the dividend after payment of the corporation tax, while for unincorporated business earnings, the surtax was applied to the income before the deduction of the individual tax. The advantage was thus slightly in favor of incorporated business—except where, as previously explained, the personal exemption of the individual from the normal tax or the offsetting of business losses against other income was sufficiently important to wipe out this advantage or replace it by an advantage in favor of unincorporated business.

Co-ordination When Rates Are Unequal or Progressive

If the individual rates are lower than the corporation rates, the burden is heavier on incorporated business. For example, since 1919 the federal corporation rates have been higher than the individual normal rates. The greatest discrepancy was in the year 1935, when the highest normal rate was 4 per cent and the corporation rate was graduated from 12½ per cent to 15 per cent. When all earnings were promptly distributed as dividends, the

excess of the corporation tax rate over the individual normal rate was disadvantageous to incorporated business, since stockholders receiving corporate dividends were subject to a higher total of taxes than were investors in unincorporated businesses. The Revenue Act of 1936 repealed the exemption of dividends from the normal tax and to that extent increased the discrepancy. The increase was, however, slightly offset by the reduction of the corporation rates under \$40,000. The undistributed profits tax passed in the same act is not a factor so long as all earnings are distributed.

Rates on individual incomes might be progressive, with some rates lower and others higher than those on corporation incomes. If dividends were exempt in the hands of individuals and earnings were all distributed, the relative advantages of incorporated and unincorporated businesses would vary for different persons. Persons with large incomes would be taxed more heavily on incomes from unincorporated business. Persons with small incomes would be taxed more heavily on incomes from incorporated business.

Co-ordination of Corporation and Personal Income Taxes: Earnings Retained

In the preceding paragraphs it has been assumed that all earnings are promptly paid out as dividends. If the earnings are retained by the corporation, however, and no tax is levied on undistributed profits, the situation is quite different.

Two cases must be distinguished. In the first case, the total income of the investor is so small that the personal tax on his earnings from unincorporated business is less than the corporation income tax on an equal amount of business income. Here, the income tax system clearly favors the unincorporated form. Even without a later taxation of income derived from the corporate

shares, the tax on corporation income is larger than the tax on income from unincorporated business.

In the second case, the total income of the investor is so large that his earnings from unincorporated business are taxed at a higher rate than the corporation income tax on an equal amount of business income. Here, the tax advantage may shift from the unincorporated form to the corporate, depending on how the retention of the earnings affects the taxes of later years.

The possibility of saving taxes through the retention of earnings by the corporation exists because a corporation is a legal entity distinct from its stockholders. By the Supreme Court's interpretation of the Sixteenth Amendment, the earnings of the corporation do not become taxable income of the stockholders until distributed to them or until "realized" in the form of a capital gain by the sale of the stock.¹² Thus, if corporate profits are allowed to accumulate as surplus, the stockholder avoids individual income taxation. Where his total income is sufficient to make him subject to high taxation, he is placed under great pressure to urge the retention of earnings.

Postponement versus Permanent Avoidance

It may be objected that the withholding of dividends merely postpones the payment of the tax and does not really avoid it. This objection may or may not be true. Four cases must be distinguished.

In the first case, earnings are withheld and reinvested by the corporation for one or more years, and paid later as dividends. In this case, even if the same tax is paid, it is paid at a later date. The individual stockholder, through the corporation, has the use of the amount of the tax as an earning asset for the period during which

¹² *Lynch v. Hornby*, 247 U. S. 339, 343 (1918); *Lynch v. Turrish*, 247 U. S. 221, 229 (1918); *Eisner v. Macomber*, 252 U. S. 189, 219 (1920).

the tax is delayed. He gains the amount of the interest or earnings on this asset during the period.

At the present-day levels of individual surtaxes, this advantage is of genuine importance. For example, suppose a person who has income subject to the federal tax in the highest bracket—79 per cent—is faced with the alternative of (1) receiving \$100 as a dividend, paying the tax of \$79, and investing the remaining \$21 so that it will earn 5 per cent after all taxes except the individual tax, or (2) leaving the \$100 in the corporation for one year and then receiving it plus a 5 per cent return after corporation tax. At the end of the year, after paying his individual tax, he has in the first case \$21.22, or net earnings of \$0.22. In the second case, he has \$22.05, or net earnings of \$1.05. As a result of postponing dividends his earnings are nearly five times as much. If the highest bracket of his income tax were 50 per cent, his net earnings would be twice as great when dividends were postponed as when they were paid immediately and invested.

Aside from the interest factor, the stockholder also gains if the dividends are distributed in a year when his total income is smaller and so subject to lower surtax rates. He loses, however, to the extent that the earnings, distributed in a lump sum, force the tax base into higher brackets than an equal sum distributed in annual installment payments. He gains, again, if the dividends fall in a year when his tax return would otherwise show a loss. Any change in statutory tax rates, of course, affects him also. These factors, however, are largely matters of chance unless the stockholder is in control of the corporation.

In the second case, the earnings are permanently withheld and reinvested by the corporation, but the investor sells his stock. In this case, the reinvestment of earnings normally results in a somewhat proportional increase in

the value of the stock. When the investor sells the stock, he is subject to taxation on his capital gain. Aside from the interest and surtax factors, the amount of the tax is affected by the provision for taxing only part of the gains, from 80 per cent to 30 per cent, depending on how long the securities have been held.¹³

In the third case, the earnings are withheld and re-invested by the corporation and then lost through business reverses. No tax is collected from the individual since he never received the income. If he had received a dividend, he would have had to pay a tax even if the dividend was subsequently reinvested and lost, but in this case the tax would have been somewhat offset by the reduction in whatever capital gain (or increase in whatever capital loss) he might have realized from sale of the stock.

In the fourth case, the earnings are withheld permanently, and the stockholder does not sell the stock before his death. The tax is avoided entirely since neither he nor his heirs pay an income tax on the increase in the value of the stock prior to the time of his death. Much of what would have gone to pay income taxes goes to pay estate and inheritance taxes, but a substantial amount of avoidance is possible.

In view of the possibilities of tax avoidance in these cases, persons with large incomes would have reason to prefer investment in corporations to investment in unincorporated concerns, provided the dividend policies were subject to their control or were controlled in their interest. This inducement to incorporate depends not so much on the type of business and its size—considerations that seem most important from the point of view of efficient operation—as on the total income of the persons who happen to be engaged in the undertaking.

The 1936 tax on undistributed corporation earnings

¹³ See pp. 80-81 for details of this tax.

greatly reduces the advantages of incorporation to the wealthy stockholder if no taxable dividends are paid. The tax amounts at a maximum to 20.5 per cent of the taxable income of the corporation less the corporation normal tax. This, of course, reduces either the amount of dividends finally paid or the market value of the stock. As a result, the income of the stockholder with a small total income is subject to much higher taxation than if it had come from an unincorporated business. The advantage of the corporation to stockholders with large incomes becomes less, and the line between loss and gain is drawn at a much higher income level.

Methods of Reducing Inequalities

Taxation of Distributable Shares

As long as the progressive individual income tax is retained, only one way of eliminating the tax discrimination between incorporated and unincorporated business for every investor appears feasible. The stockholder's share of the undistributed corporation profits must be included in his taxable income while his share of corporation losses must be allowed as a deduction from his taxable income, and, in addition, either corporate business as such must be exempted from income taxation or unincorporated business must be taxed at the same rates as incorporated business. By this method the income from both corporate and non-corporate business is taxed to the individual whether it is distributed or not.

Constitutional difficulties, however, prevent the general application of this method to federal taxation in view of the Supreme Court's interpretation of the Sixteenth Amendment, whereby the earnings of the corporation do not become taxable income of the stockholders until distributed to them as dividends or "realized" as capital gain by the sale of stock.

If the stockholder were required to state in his return his share of the corporation's earnings for the year, the administrative difficulties would be great. The accounting complexities of tracing undistributed income and loss through intricate holding company arrangements to final individual stockholders would be extremely costly. The existence of non-cumulative preferred stock would make the determination of distributive shares difficult because the ability of the boards of directors to determine the time of paying dividends would affect the allocation of profits between preferred and common stockholders, although the tax law might prescribe rules for determining the ownership of the income. If the corporation's statement of income were not accepted by the tax authorities, final settlement might necessitate the reopening of a multitude of individual returns.

The undistributed profits might be reached instead by taxing all capital gain accrued, even if unrealized, during the year. The individual's net income would then reflect, not only retained corporate earnings, but the many other factors that affect the amount of capital gain accrued during a year. The share in the year's profits would not appear as a distinct item in the personal return.¹⁴

In either case, stockholders would have to pay the tax on income not received in cash, with a resulting financial strain that would play into the hands of majority stockholders who wished to force the sale of securities held by a minority.

Forced Distribution of Corporate Earnings

Another method would force the payment of all earnings to stockholders in the form of taxable dividends. It would have to be coupled, of course, with a repeal of the corporation income tax or with equal taxation of both kinds of business.

¹⁴ For a loophole that would have to be closed, see p. 302; see also pp. 477-83.

This method would come much nearer to equalizing corporate and non-corporate taxation for each investor than the existing federal income tax. However, equalization would not always be obtained, even under this plan. Losses of a corporation could not be passed on to the stockholder in the form of "negative dividends" deductible from his other income in computing his personal income tax. Incidentally, outside the field of tax policy, the government would be discriminating between corporations and partnerships in the control that it exercised over the distribution of business earnings in general.

Equivalent Tax on Undistributed Earnings

Still another method would make the relative attractiveness of corporate and non-corporate business approximately equal for a composite of investors as distinguished from individual investors. It would involve repeal of the corporation income tax and the imposition of a tax on the undistributed profits of the corporation—not, however, at a rate heavy enough to force all earnings out as dividends. Theoretically, the rate would simply be set at the point where the total taxes on undistributed profits would equal the tax that would be levied on them in the hands of individual stockholders were they distributed.

The difficulty with this method is that, while the attractiveness of the two types of business might thus be equalized for investors in general, it would not be equalized for individual investors. Some investors would find the taxes imposed on income from unincorporated businesses much higher, while others would find taxes on income from corporations much higher. Incidentally, corporations with different dividend policies would no doubt attract stockholders of different income levels.

Allowances to Unincorporated Business

A fourth method that has been suggested for equalizing corporate and non-corporate tax burdens is to place the earnings of unincorporated businesses on the same basis as the earnings of incorporated businesses. The individual would be taxed only on that part of the proprietorship or partnership earnings that was actually taken out of the business by him.¹⁵

This provision would have to be accompanied by an unincorporated business tax equal to the tax on corporations. Many difficulties, however, would ensue. To be strictly comparable, the losses of partnerships and of proprietorships would not properly be deductible from income outside the specific enterprise. Furthermore, the facility with which the distribution of proprietorship and partnership profits could be controlled by the owners would not only raise very serious administrative problems but would in itself constitute a substantial tax advantage to unincorporated business. Serious discrimination between business income and other income would result from exempting the reinvestment of business savings.

Furthermore, the desirability of encouraging the reinvestment of income within the business unit is dubious. This problem has been acute in the case of corporations;¹⁶ the suggested policy would extend it to all business.

Finally, the postponement or avoidance of the tax has certain questionable features from the point of view of a just distribution of the tax burden, even assuming that all forms of business profits are given the same chance of postponement or avoidance. The points at issue—irregularity of income, increases in value of property held until death, and the failure of a business tax to take into ac-

¹⁵ Harley L. Lutz, "Coordination of the Personal Income Tax and the Business Tax under the Model Plan for State and Local Taxation," *Bulletin of the National Tax Association*, xx, No. 3 (December 1934), 86-88.

¹⁶ See pp. 168-74.

count the personal situations of the business owners—are discussed elsewhere.¹⁷

CORPORATION DIVIDEND POLICIES

The dividend policies of corporations are matters of public interest. They affect the amount and direction of tax preference between incorporated and unincorporated businesses.¹⁸ They also influence the effectiveness of the progressive rates of the individual income tax, since the withholding of earnings nullifies the progressive rates or greatly alters their effect. Also, the amount of revenue derived from the income tax is affected.

Economic Consequences of Dividend Policies

Furthermore, dividend policies have important economic effects outside the immediate tax field. The recent passage of the federal tax on undistributed corporation profits has provoked a great deal of controversy concerning those effects. Most of the arguments lack factual support and involve highly theoretical points of a fundamental nature. Only a brief and incomplete statement indicating the character of the controversy can be given here.

On the one hand it is urged that if all earnings were promptly distributed as cash dividends corporations would be prevented from expanding naturally. This point would apply particularly to small corporations since they have less ready access to organized capital markets. Therefore, it is claimed, not only would industrial growth slacken but also competition would be weakened. Monopoly would be encouraged, since small corporations would have greater difficulty in growing large enough to compete effectively. Furthermore, it is urged that without the accumulation of reserves during

¹⁷ See pp. 303, 302, and 306-7, respectively.

¹⁸ See pp. 157-68.

years of good earnings corporations would find it impossible to pay interest and dividends during periods of depression. Thus bankruptcies would be increased and depressions intensified.

In answer to the last argument some have maintained that corporate weakness in depression is socially desirable. It would result in quicker price-cutting and liquidation, which are said to be prerequisites of recovery.

Those who favor distribution of dividends claim that withholding them results in two kinds of misapplication of funds. In the first place the corporation does the investing without consulting the individual stockholders, who would in at least some cases spend the dividend instead of investing it. In the second place the corporate directors are likely to reinvest the funds in the firm's business, while, if the stockholders made the investment on their own initiative, they would at least in part invest in other establishments and industries that would promise larger returns. These two types of misapplication, it is urged, result in socially uneconomical investment, with a tendency to overdevelop certain lines of production. Industrial maladjustments and depression result.

Furthermore, it is asserted that corporations do not immediately reinvest all the withheld earnings in plant during depression and recovery years but hold part of it in liquid form and invest it during boom years. This concentration of investment in one period of the business cycle, it is maintained, adds to the intensity of booms and to the severity of the following depressions.

The payment of dividends in shares of stock instead of cash would, so far as these arguments are concerned, be the equivalent of retaining the earnings.

It will be observed that many of the arguments on both sides involve conflicting theories of the causes and

remedies of business depressions. This is not the place to investigate either the fundamental issues involved in such theories or the results or desirability of dividend policies. Rather, the purpose of this section is to examine the effects of tax laws on the choice between paying dividends and keeping the earnings in the business.

Influence of Individual Income Tax on Dividend Payments

A previous section discussed the savings in individual income taxes that might result from the retention by a corporation of its earnings. These possible savings, of course, exert a pressure on directors to withhold earnings.

The strength of the pressure to withhold earnings has undoubtedly differed in different corporations. At one extreme is the fairly closely held corporation, where a few large stockholders can adjust dividend policies to achieve their maximum personal benefit. At the other extreme is the large corporation with such a wide stock distribution that no wealthy stockholders are in a position to dominate dividend policy. Even in the latter case, however, stockholders who faced the liability of paying high individual surtaxes would press less actively for dividends than they otherwise would. In the absence of pressure to pay dividends, pressure to retain earnings, which is continuously present, would have more effect.

The individual income tax is thus a powerful influence for withholding corporation earnings from the stockholders. Moreover, it increases in strength as the individual tax rates increase.

Measures to Encourage Dividend Payments

Because of the resulting reduction in revenues—and in some instances for other reasons as well—, attempts have been made in the income tax laws to offset the pressure to withhold earnings. Indeed, some of these attempts

go farther and aim at forcing more dividends than would otherwise be declared.

Taxation to Individuals of Undistributed Corporate Earnings

The influence of taxation on dividend payments could be avoided by including in individual taxable income the entire "distributive" share of corporate earnings—that is, not only the amount distributed but also the amount undistributed. This method was used to some extent until it was prevented by adverse Court decisions.¹⁹ The federal income tax imposed during the Civil War (act of 1864) provided for such an inclusion. The federal acts of 1913, 1916, and 1917 provided that, in case of the fraudulent use of a corporation for the purpose of evading the tax on individuals, the distributive share of the corporation's income should be taxed to the stockholders.²⁰

Beginning with the 1918 act, it has been provided that stockholders might choose such taxation in lieu of taxes imposed as penalties on corporations deemed to be accumulating profits to prevent imposition of the surtax, and more recently in lieu of special taxes on personal holding companies.²¹ In the British income tax law, the administrators of the tax may require the inclusion of undistributed income in individual returns subject to surtax.²²

Taxation of Undistributed Profits in Special Cases

Attempts have been made to stimulate dividend payments by imposing on the corporation a tax that is measured by the amount of undistributed profits, and that is sufficiently heavy to make distribution preferable to payment of the tax.

¹⁹ See p. 161.

²⁰ William Kix Miller and Arnold R. R. Baar, *Consolidated United States Income Tax Laws* (Chicago, 1913), p. 419.

²¹ *Ibid.*; Revenue Act of 1936, secs. 102, 351.

²² André Bernard, *Income Tax in Great Britain, Including a Description of Other Inland Revenue Taxes*, 70 Cong., 1 sess., House document no. 332.

The application of such a tax in certain cases began with the Revenue Act of 1918 and has continued ever since. Heavy taxes are provided for any corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." The fact that a "corporation is a mere holding or investment company, or that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business" is *prima facie* evidence of such use.²³ Still heavier taxes are imposed on "personal holding companies" of not more than five persons.²⁴ In both cases, as already noted, the special taxes do not apply if all stockholders include their entire distributive shares of corporation earnings in their individual returns.

The tax on personal holding companies is capable of fairly precise application. However, the tax imposed on corporations used to prevent imposition of the surtax is extremely difficult to administer. Intent is hard to prove, and the point at which the accumulation of earnings and profits is beyond the reasonable needs of the business is difficult to determine. The management of a corporation can almost always point to some need, present or future, certain or contingent, that makes the accumulation of earnings desirable. As a result, little success has attended efforts to enforce the special tax on corporations used to avoid individual surtaxes. Recent decisions of the Board of Tax Appeals upholding Treasury Department assessments, however, may point to greater success in future enforcement.

General Taxation of Undistributed Profits

The extension of the undistributed profits tax to all corporations, except a few specifically exempt, was

²³ Revenue Act of 1936, sec. 102.

²⁴ *Ibid.*, sec. 351.

adopted in the Revenue Act of 1936. As with the taxes of narrower scope discussed above, the purpose is to force distribution of all, or nearly all, the earnings.

The imposition of a general tax on undistributed earnings has been under consideration at least since 1917. The revenue act of that year imposed a tax of 10 per cent upon that portion of the undistributed profits that was not actually invested and employed in the business, retained for employment in the reasonable requirements of the business, or invested in obligations of the United States issued after September 1, 1917.²⁵ The tax thus applied to uninvested and unneeded profits rather than to all undistributed profits. It was not included in the Revenue Act of 1918 or in those of the following years, although, as indicated above, a special, punitive tax was imposed on profits withheld to evade the surtax.

An effort was made to substitute a tax on undistributed corporate income for the corporation income tax in 1921, but without success.²⁶ In 1924 the Senate amended the revenue bill to include taxes on undistributed corporate profits, the rates ranging up to 40 per cent. The proposal was, however, lost in conference.²⁷

A committee of the National Tax Association on the simplification of the federal income tax, reporting in 1927, proposed a flat-rate tax on undistributed corporation income, to be "considered a premium tax paid by the corporation for its stockholders, in exchange for retaining the earnings in the business and thereby postponing the normal and surtax until a future day."²⁸ The rate suggested was 10 per cent. The Joint Committee on Internal Revenue, reporting in 1927, did not propose a tax on undistributed corporation earnings but pro-

²⁵ Revenue Act of 1917, sec. 1206 (2), quoted in KixMiller and Baar, *op. cit.*, pp. 1029-30.

²⁶ *Congressional Record*, 67 Cong., 1 sess., October 27, 1921, pp. 6833, 6865.

²⁷ *Congressional Record*, 68 Cong., 1 sess., May 7, 1924, pp. 8032-33.

²⁸ "Simplification of the Income Tax: Report of Committee of the National Tax Association," *Proceedings of the . . . National Tax Association*, 1927, p. 134.

posed to allow the corporation, in computing its net income, a deduction of a fraction of the dividends paid, with certain limitations.²⁹ Apparently the tax was not again considered by Congress until recommended by the President in his message of March 3, 1936.

The Revenue Act of 1936

The Revenue Act of 1936 contained two provisions bearing on the dividend policies of corporations. One eliminated the exemption of dividends from the normal tax rate of 4 per cent. The tendency of this action is to discourage the payment of dividends.

The other provision taxed undistributed corporate earnings. This tax starts with a 7 per cent rate for an amount of undistributed net income not in excess of 10 per cent of the adjusted net income and has a maximum rate of 27 per cent for the amount of undistributed net income in excess of 60 per cent of the adjusted net income.³⁰

This measure tends to encourage the payment of earnings to stockholders in the form of taxable dividends. However, it does not counteract in a precise manner the effect exercised by the individual income tax in encouraging the withholding of dividends. If the corporation is controlled by persons who have small total incomes, the tax on undistributed profits may be much heavier than necessary merely to counteract the pressure of the individual income tax. It may therefore induce the distribution of more dividends than would be distributed if no income tax at all existed. If the corporation is controlled by persons whose total incomes are large and who pay surtaxes in the higher brackets, the tax on undistributed corporation profits may not entirely counteract the pressure of the individual income tax for the retention of profits.

²⁹ *Report of the Joint Committee on Internal Revenue Taxation (1928)*, I, 55-56.

³⁰ See pp. 14, 16, for further details.

Possible Dividend Policies

With the tax on undistributed corporation earnings in effect, a corporation may adopt any of several possible policies in regard to its earnings.

It may pay the tax and not distribute the dividends. This would burden all common stockholders proportionately. The contrasting effects on stockholders with small total incomes and those with large total incomes have already been indicated. The effect on the corporation would be to reduce the amount available for the payment of debt, expansion, or other purposes by the amount of the tax.

A second course of action would be to pay the earnings in the form of cash dividends. This would minimize the tax for the stockholder of small total income, but it might make the effective tax higher for the stockholder of large total income. The corporation would be prevented from reinvesting the earnings without definite action by the stockholders themselves. Large public corporations, with widely distributed stock, in good financial position, and with no particular need for expansion, might therefore be expected to adopt this second course of action.

If the corporation needed to retain its cash and yet desired to avoid the undistributed profits tax, it might, as a third possibility, offer the right to buy more stock at less than market price when it paid cash dividends, or, fourthly, it might offer dividends in cash or stock at the option of the stockholder. A fifth possibility arises from the language of the act and the interpretations of the Treasury Department that allow any distribution of stock dividends that is taxable to individual stockholders to be used as a method of dividend payment to avoid the tax on undistributed profits.³¹

³¹ *Treasury Decision No. 4674*, Approved August 6, 1936.

In general, the rule of the Supreme Court has been that, if a dividend to stockholders is to be taxable, it must change the relative interests of the stockholders.³² Such a change constitutes "realization" of income, which must occur before a tax can be collected. Apparently, therefore, the payment of preferred stock to common stockholders, where preferred stock of the same rank is already outstanding, or of common stock to preferred stockholders, if such payment is permitted, fulfills the conditions necessary for taxability. Thus, it is possible to distribute all earnings in the form of taxable dividends without taking any assets out of the corporation.

Certain difficulties, however, stand in the way of using the preferred stock method to pay dividends. The financial structure of the corporation might eventually become top-heavy with preferred stock. The sale of preferred stock to provide funds to pay the individual's income tax might seriously affect the prices of such shares. The value of the preferred shares might be difficult for the tax administrators to determine. Stockholders might be averse to receiving dividends in the form of shares in view of the necessity of selling them to secure funds. Since there is no allowance for the losses of bad years, the distribution of preferred stock for all earnings in good years would gradually result in a loss of equity by the common stockholders. The fact that few corporations made use of the dividend in preferred stock during the closing months of 1936 indicates that such difficulties as these may have a powerful effect in practice, at least during the first few months.

THE HOLDING COMPANY

The holding company as a method of business organization is a relatively recent development, dating from 1889. Holding companies are incorporated by the states.

³² *Kosblom v. Helvering*, Sup. Ct., May 18, 1936.

Interstate competition in granting corporate charters has prevented the states from exercising any substantial control over holding company organization or operation. The federal government can exercise control only as the affairs of the holding companies relate directly to interstate commerce or to other matters under federal jurisdiction.

Although the value of the holding company as an instrument of corporation finance is unquestioned, doubts have arisen, especially in recent years, about the social desirability of some of the uses to which it has been put. These misgivings have apparently influenced recent federal tax legislation.³³

Effect of Consolidated Returns

One recent change in federal tax laws relates to the filing of consolidated returns for the corporation income tax. Under the federal income tax laws from 1918 to 1932, closely affiliated corporations were permitted to file consolidated returns without penalty. The advantage of using the consolidated return was that, if one corporate subsidiary was incurring losses while others were making profits, the losses would be deducted from the profits and only the balance of net profit would be subject to tax. In order to come within the class permitted to file consolidated returns, it was necessary that 95 per cent of the stock of each of the corporate units involved be owned directly by one or more of the others and that the common parent corporation own directly at least 95 per cent of the stock of at least one of the other corporations.³⁴

Since 1932 the policy in regard to consolidated returns has been reversed. The revenue act of that year imposed an additional tax for the years 1932 and 1933 of $\frac{3}{4}$

³³ See the tax message of President Franklin D. Roosevelt, *New York Times*, June 20, 1935.

³⁴ Revenue Act of 1932, sec. 141 (d).

of 1 per cent where consolidated returns were used.³⁵ The additional rate was raised to 1 per cent in 1933,³⁶ and to 2 per cent in 1934.³⁷ Even more important, the 1934 act abolished the privilege of filing consolidated returns for all except railroad corporations. The 1936 act extended the privilege to street and interurban railway corporations and wiped out the additional tax.³⁸

Taxation of Dividends

The treatment under the federal corporation income tax of dividends received by one corporation from another has also been changed. The income tax law of 1913, which imposed a tax of 1 per cent on corporation income, did not exempt dividends received by a corporation. Holding company systems thus paid a tax for each company in the chain. Beginning with the war income tax of 1917³⁹ and the Revenue Act of 1918,⁴⁰ however, dividends received by corporations were fully deductible. The Revenue Act of 1935 reduced the deduction from 100 per cent to 90 per cent,⁴¹ and the Revenue Act of 1936 further reduced the deduction to 85 per cent.⁴²

Certain circumstances preceding the changes in dividend deductions indicate that they were directed against holding companies. A prominent Senator had, in 1934, proposed eliminating the dividend deduction.⁴³ The proposal was made again at a White House conference on January 21, 1935, where methods of attacking holding companies were discussed.⁴⁴ President Roosevelt in his message of June 19, 1935, called for the ultimate elimi-

³⁵ *Ibid.*, sec. 141 (c).

³⁶ National Industrial Recovery Act of 1933, sec. 217 (e).

³⁷ Revenue Act of 1934, sec. 141.

³⁸ Revenue Act of 1936, sec. 141.

³⁹ Sec. 4.

⁴⁰ Sec. 234 (a) (6).

⁴¹ Sec. 102 (h).

⁴² Sec. 26 (b).

⁴³ Senator William E. Borah, *New York Times*, March 2, 1934.

⁴⁴ *New York Times*, January 23, 1935.

nation of unnecessary holding companies by taxation.

Furthermore, the Revenue Act of 1935 facilitated the simplification of holding company systems. It exempted from recognition under gain or loss provisions any dividends of property received by a corporation in complete liquidation of a corporation controlled by it.⁴⁵

The 1936 change in dividend deductions was made ostensibly to prevent avoidance of the progressive rates of the corporation income tax laws of 1935 and 1936 by discouraging division of the income of a business among several subsidiary corporate units. However, substantial avoidance would be unpractical for a large corporation since its business would have to be divided among numerous small subsidiaries. Furthermore, such avoidance could be prevented by taxing subsidiaries at the highest rate of taxation applicable to the whole affiliated group.

A number of holding companies, some of them parts of very large corporation systems, have been eliminated since the passage of the 1935 act. In some cases the decrease in dividend deductions was specifically stated to be a cause of the action.⁴⁶

Federal Capital Stock Tax

The federal capital stock tax⁴⁷ also tends to discourage holding companies. The extent to which this tax is increased by the existence of holding companies depends on the value of the stock declared by the corporation. Whether the declared value of capital stock will be near its true value will depend in part on how much of an excess profits tax is expected to be paid on dividends received. If holding company executives do not expect the fraction of dividends subject to tax to increase beyond the present 15 per cent, they are not likely to declare the value of their stock at nearly so much as its

⁴⁵ Sec. 110. The Revenue Act of 1936, sec. 112, tightened the provisions.

⁴⁶ See Note 1, *Recent Eliminations of Holding Companies*, p. 547.

⁴⁷ See Note 9, *Present Excess Profits Tax*, p. 560.

true value. Thus, the effect of the capital stock tax in increasing the taxes of holding company groups will be reduced. If stocks are declared at full value and are earning at the rate of 6 per cent on that value, the capital stock tax amounts to $1\frac{2}{3}$ per cent of net income.

State Taxes

State taxes on intangibles, capital stock, and incomes also have possibilities for discouraging the use of holding companies. However, the opportunity of incorporating in practically any state and the resultant interstate competition are likely to prevent highly restrictive state taxes from being passed, and from being effective if they are passed.

Tax on Undistributed Corporation Profits

The tax on undistributed corporation profits, imposed in 1936, may conceivably encourage the use of holding companies. For example, if an operating corporation with \$1,000,000 earnings after corporation normal tax wishes to distribute \$250,000 to its stockholders, it may (1) pay \$250,000 directly to the stockholders, or (2) pay part of its earnings to a holding company that in turn pays \$250,000 to the stockholders. If the \$250,000 is paid directly by the operating corporation to the stockholders, the tax on undistributed profits is \$137,500. If \$500,000 is first paid to the holding company, which in turn pays \$250,000 to the stockholders, the undistributed profits tax on the operating corporation is \$75,000, the corporation normal tax on the holding company is \$10,090, and the undistributed profits tax on the holding company is \$35,633.35. The total tax by this method is \$120,723.35, or less by \$16,776.65 than when profits are distributed directly to stockholders. However, the holding company would have difficulty proving that it was not being used to avoid taxation, and that it should

not therefore be subject to the especially heavy taxation provided in the income tax law for such corporations.

Adequacy and Flexibility of Taxation to Discourage Holding Companies

The previously discussed federal and state taxes apply, at least in their main aspects, to businesses or corporations in general and not especially to holding companies. Taxes might be applied specifically to holding companies as such by any one or more of a variety of methods—gross receipts, income, capital stock, and so on. It is not clear, however, that such legislation would be constitutional. In so far as it was, the federal government would have the power to destroy the holding company completely by the use of these taxes. A further decrease in the deduction of dividends received by corporations in computing their income taxes would probably be a sufficiently heavy penalty to eliminate most holding companies.

Taxation to discourage holding companies, however, is not sufficiently flexible. It cannot be adapted to discourage only the holding companies that are deemed to be socially undesirable and to spare those that are socially desirable. It would scarcely be constitutional, even if it were administratively feasible, to classify holding companies for taxation according to the control that they exercise over industries and the manner in which that control is exercised.

Indeed, taxation is much more likely to discourage the harmless holding companies than the harmful ones. If, for example, a holding company form of organization is being employed to control a large body of capital by means of a relatively small investment, only the threat of bankruptcy is likely to induce those in control to change their form of organization. The simplification of the corporate structure would make it impossible for

them to continue their control. Consequently, simplification is not likely to be forced by taxing provisions, such as those of the federal income tax, that impose a tax of only about \$2.25 on each \$100 of dividends received by a holding company. The relatively unnecessary and socially insignificant corporate units that have been continued for their minor convenience are the ones first affected.

The relation of the holding company to the final operating company presents an opportunity for discrimination. The pyramiding of two or more holding companies is rarely necessary for operating purposes, and it facilitates manipulation. Accordingly, the corporation income tax might distinguish between the first intercorporate payment of dividends, and the second and subsequent intercorporate payments of dividends. That is, dividends paid to a holding company by the operating company would be exempt or taxed at a lower rate than dividends paid by one holding company to another. Such a tax would strongly discourage the pyramiding of holding companies and would discourage single holding companies only slightly—if at all.

CHAIN MERCHANDISING

As chain merchandising organizations have grown in importance in the United States, great political pressure has been brought upon legislatures to increase the ability of independent merchants to compete with the chains. Usually this end has been sought through special state taxation of chains.

Adoption of State Chain Store Taxes

Taxes somewhat like present-day chain store taxes date from 1917. However, the special taxation of chain stores dates from 1929, when three states passed such laws. The most influential was that of Indiana. Under this law a single store under one ownership or manage-

ment was taxed \$3.00 annually. If there were from two to five stores under one ownership or control within the state, the tax was \$10.00 on each of these additional stores. The tax per store increased with additional stores, reaching a maximum rate of \$25.00 on the twenty-first store.⁴⁸ Neither the kind of goods sold, the size of the stores, the volume of sales, nor net income affected the amount of the tax.

Another important act was passed by Kentucky in 1930. Strictly speaking, the tax that it imposed was a progressive one on gross sales rather than on chain stores. Sales of one organization were considered as a unit whether or not the organization was a chain. The rates began at 1/20 of 1 per cent of gross sales not exceeding \$400,000 and rose to 1 per cent of the excess of sales over \$1,000,000.

These two laws served as models for those passed by other states. The Supreme Court of the United States upheld the Indiana law in 1931,⁴⁹ but in 1935 it declared the Kentucky law unconstitutional.⁵⁰

Since the approval of the Indiana law, a rapid spread of chain store taxes, usually of the Indiana type, has occurred, as well as a very considerable increase in the rates at which they are imposed. On January 1, 1937, chain store taxes were in force in twenty states.⁵¹ The highest maximum rate imposed in any state was \$750.

Constitutionality of Chain Taxes

In upholding the constitutionality of the Indiana law, the justices of the Supreme Court divided five to four. The majority held that the differences in organization, management, advertising, and other business procedures between chains and other stores were sufficiently pro-

⁴⁸ Tax Research Foundation, *Federal and State Tax Systems* (3rd ed.; Chicago, 1932), p. 114.

⁴⁹ *State Board of Tax Commissioners v. Jackson*, 283 U. S. 527 (1931).

⁵⁰ *Stewart Dry Goods Co. v. Lewis*, 294 U. S. 550 (1935).

⁵¹ American Retail Federation, *Chain Store Taxes* (Washington, January 1, 1937).

nounced to justify the special classification and taxation of chains. The minority maintained that mere difference is not a proper basis of classification for a revenue tax; that the ground of the difference must have a reasonable and just relation to the object of the legislation, and that no such relation was present in this case because all the differences upon which the majority rested their decision frequently existed among independents and among chains as well as between the two types.

The Court divided in the same way in upholding a West Virginia act.⁵² This decision contained the significant statement that it was not a matter of concern to the Court that the tax was so high as to exceed the net profits of some of the stores taxed. So long as the state had the power to tax, the rate of tax was immaterial.

Adequacy of Chain Taxes for Control

Destruction of Chains

The decisions of the Supreme Court open the door to the destruction of chain organizations by state taxation, if state legislatures are so inclined. The tax can be made so high that the chain cannot afford to operate, and accordingly must reorganize as a new system of retailing or retire from the field entirely. In the petroleum industry the taxes in at least one state appear to have had substantially this effect.⁵³ It is possible, of course, that the Court may, in the future, reverse itself.

Equalization of Taxation

The chain taxes now in effect are apparently not flexible enough to achieve their less extreme objectives. They do not, for example, equalize the burden of taxation on chains and independents. It has sometimes been claimed,

⁵² *Fox v. Standard Oil Co.*, 294 U. S. 87-99 (1935).

⁵³ "Iowa Driving out Chains: Indiana Standard Begins Leasing All Iowa Service Stations," *National Petroleum News*, XXVII, No. 22 (May 29, 1935), 24-H; "Anti-Chain Tax Helps Victim," *Business Week*, No. 347 (April 25, 1936), pp. 9-10.

notably in Wisconsin, that the personal property tax on merchants discriminates against independents in favor of the chains. The contention is based on three grounds. First, the local assessor cannot place an accurate value on the property of the chains because their books are located in the main office of the company, usually in some distant city. Second, when goods are assessed at cost—the usual custom with merchants' stocks—the inventories submitted by chains carry the goods at their original cost without including the costs of transportation or of carrying on the wholesale function, while independent stores are assessed at the prices at which their goods were purchased from local wholesalers. Third, the chain has a more rapid turnover than the competing independent, and accordingly the tax is less for the same volume of business.

An investigation of specific instances⁵⁴ indicated that these claims are well founded. However, in interpreting tax comparisons, it should be noted that a "typical" chain does not exist. The popular conception of the chain store applies only to a handful of nation-wide, multi-unit organizations, which are the principal object of attack. The many regional, local, and small national chains are often overlooked. In total, however, they have more stores than the large national chains. Furthermore, rates of turnover vary widely among chains and among independents.⁵⁵ Thus, if there is tax inequality between chains and independents, it probably varies widely in amount.

If the chains have a lighter tax burden under the personal property tax, it is owing either to the insufficiency of the personal property tax as a method of business taxation or to inadequacies of administration.

⁵⁴ See F. H. Hardy, "Wisconsin's New Chain Store Tax and Its Relation to Personal Property Taxation," *Bulletin of the National Tax Association*, XIX, No. 3 (December 1933), 66-72.

⁵⁵ See Reavis Cox, "Inadequacies of Chain Store Taxation," *Bulletin of the National Tax Association*, XIX, No. 5 (February 1934), 132-41.

It is scarcely conceivable that inadequacies of administration—highly variable at best—can be offset with any degree of accuracy by a special tax imposed without regard to the amount of the personal property tax or the degree of inefficiency in administration. Such taxation is simply throwing on an extra tax for good measure to make sure that the taxes will not be too small.

If equality of tax burden is the objective, a more logical method of achieving it would be to decide what form of business taxation would be fair to both types of merchandising organization and to impose such a tax in lieu of the personal property tax.

Equalization of Competition

Another objective of chain store taxation is the equalization of competition between chains and independent stores. This aim presents equally difficult problems. It is based on the assumption that the peculiar advantages of the chain form of organization can be measured and offset by taxation. They have not been, however, by the taxes imposed so far.

With the exception of the Louisiana statute—which has not yet been passed on by the United States Supreme Court—chain store taxes do not take into consideration the total number of stores operated by the chain organization but only the total number within the individual state. A local chain, having few of the advantages accruing to large, national chain organizations, might thus be required to pay a higher rate of taxation on its stores than a national chain that enjoyed all the chain advantages but had relatively few stores within the state.

Furthermore, the rates of progression in chain taxes show no sign of having been based on any careful analysis of the competitive situation. No consideration is given to the nature of the business. Since the decision

on the Kentucky law,⁵⁶ the taxes have rarely differed according to the size of stores. A variety of different elements determines such competitive advantages as chain stores may have over independent stores. To set up the common ownership of multiple retail outlets as the sole element in determining the tax is to make the equalization of competition an impossibility.⁵⁷

⁵⁶ *Stewart Dry Goods Co. v. Lewis*, discussed on p. 183.

⁵⁷ *Cox, op. cit.*, p. 140.

Chapter 12

OTHER INDUSTRIAL CONTROLS

Although there are a variety of other ways in which taxation has been used for social control, only three will be discussed here—namely, the control of speculation, the enforcement of industrial codes, and the control of labor relations.

THE CONTROL OF SPECULATION

Control of speculation has been an occasional governmental policy. The term speculation is used here in the rough sense of the purchase or sale of anything with the expectation of a profit through later sale or purchase. The profit is thus a capital gain rather than a periodic income received while the asset is held.¹

Since the speculator ordinarily buys for a fairly rapid turnover, even a light tax on transactions will reduce his profits and increase his losses so much that his activity may be discouraged.

Although several tax measures influence speculation, only one of those discussed below seems to have been designed for that purpose.

Taxes on Stock and Commodity Transfers

The federal government imposes a tax on security transfers, amounting to 4 cents on each certificate of \$100 par value or less for shares selling at less than \$20, and 5 cents where the shares sell at \$20 or more. This tax is to be reduced to a flat rate of 2 cents on July 1, 1937.

¹ For a list of definitions of speculation see Alfred L. Bernheim and Margaret Grant Schneider, eds., *The Security Markets* (New York, 1935), p. 12.

Five states impose taxes on stock transfers. The most important from the point of view of revenue is the New York State tax, which is levied at rates of 3 cents a share on stock selling at less than \$20 a share, and 4 cents a share on stock selling at \$20 or more a share.² The maximum tax on a transaction in New York is thus 9 cents a share, or $\frac{1}{10}$ of 1 per cent of a share selling at \$90. This tax is perhaps too small materially to affect most types of speculation, but substantial increases in the tax would rapidly make certain types of speculation unprofitable.

The federal government also imposes a tax on the sales of produce for future delivery. The rate is 3 cents for each \$100 of sale, to be reduced to 1 cent on July 1, 1937. The tax is burdensome upon a special class of speculators, the floor traders, who make "complete turns" in the market within a few hours in the hope of a profit of one or two "points." It is probably not particularly burdensome on speculation generally at the present and prospective rates. It could, however, be made an effective instrument to destroy transactions in commodity futures. It might also be adjusted to fall more heavily on certain types of transactions, leaving others, which are considered more desirable, with a lower burden or none.

Such an adjustment has been made for some types of cotton futures. Under the Cotton Futures Act of 1916 a special tax of 2 cents a pound is imposed upon all sales of cotton futures except those made under three carefully defined types of contract. No revenue has been received under the act, but the result has been to force commodity exchanges to confine themselves to the specified contract types. A similar tax on sales of grain futures was

² McKinney, *Consolidated Laws of New York, Annotated*: Supplement, 1936, Book 59, Tax Law (Brooklyn), secs. 270, 270-a. On July 1, 1937, the rates become $1\frac{1}{2}$ cents and 2 cents, respectively.

imposed under the Future Trading Act of 1921,³ but this was declared unconstitutional⁴ as being part of an unconstitutional regulatory measure.

Income Taxation of Capital Gains

The capital gains provisions of the federal income tax law also have an effect on speculation. When an asset is sold within one year of purchase, the income or loss is included in the computation of taxable income at 100 per cent; if held between one and two years, 80 per cent; if held between two and five years, 60 per cent; if held between five and ten years, 40 per cent; and if held over ten years, 30 per cent. Anyone who is considering the sale of a security or other commodity will therefore have a differential tax advantage if he holds the security up to ten years.

Since the amount of capital loss deductible in computing net income is limited to capital gains plus \$2,000, the tax does not act as an inducement to sell securities in order to create a loss with which to reduce taxable income from other sources. Before this provision was enacted, the law apparently did act as such an inducement. At present the tendency is, rather, to encourage a spread of capital losses over years in which there are also capital gains.

The argument is sometimes made that any tax on capital gains encourages a longer holding of securities. The validity of this argument depends on circumstances. If the security owner has come to the conclusion that the price of a security will decrease, the fact that he must share with the government his gain from selling it should not, if he acts rationally, deter him from selling. If he does not sell at the time and the price goes down, his income, as well as his tax, is lessened when he finally does sell. The psychological dislike of paying

³ Act of August 24, 1921, chap. lxxxvi, 42 Stat. 187.

⁴ *Hill v. Wallace*, 259 U. S. 44 (1922); *Trusler v. Crookes*, 269 U. S. 475 (1926).

taxes may of course overbalance his rational judgment in such a decision.

If the future price of securities is uncertain, however, he may be deterred from selling by another consideration. If he sells the security, takes his gain, and pays the tax, he will have a smaller capital than if he does not sell. In effect, he has an opportunity to earn a return on the tax as long as payment is withheld. The importance of this factor is dependent on the length of time involved and the degree of uncertainty about future prices.⁵

The same considerations apply in the case of real estate so far as the income tax is concerned.

Taxes on Real Estate Transfers

In most sales tax laws, the sale of real estate has been exempted. The federal government imposes a small tax on real estate transfers. The gross income tax law of Indiana imposes a 1 per cent tax on the gross receipts from real estate sales.⁶

TAXATION AND THE ENFORCEMENT OF INDUSTRIAL CODES

In August 1935, Congress passed the Bituminous Coal Conservation Act,⁷ which set up a code of fair practices for the regulation of the industry. To enforce the code, an excise tax of 15 per cent of the sale price of coal at the mine was imposed, with provision for a drawback of 90 per cent of the tax to coal producers who accepted, and acted in compliance with, the code. The Supreme Court declared this act unconstitutional,⁸ holding the tax to be a penalty to enforce compliance with regulations that Congress did not have power to impose.

⁵ For a more thorough analysis of the effects of taxation of capital gains the reader is referred to a forthcoming study on this subject by Robert M. Haig. With respect to the time element, see p. 162.

⁶ Act of 1933, chap. 1.

⁷ Act of August 30, 1935, chap. dcccxxiv, 49 Stat. 991.

⁸ *Carter v. Carter Coal Co.*, 298 U. S. 238 (1936).

Presumably, if the Court had found that Congress had the power to regulate in this field, a tax useful in enforcing the regulation would have been upheld.

TAXATION AND THE CONTROL OF LABOR RELATIONS

Under the Constitution the federal government is denied the power to control labor relations or working conditions—except as they may relate to interstate commerce. In the absence of direct power, however, taxation has been used on a few occasions to achieve this end. The infrequency of the use is probably due to a number of discouraging Court decisions.

States have made little if any use of taxation to control labor relations, probably because they have other powers that can be used more effectively.

Taxes to Control Employment Conditions

Persons handling white phosphorus, as in match manufacture, are often afflicted with an occupational disease in which the jaw of the victim is eaten away. Certain substitutes for white phosphorus have been discovered that do not involve the health hazard but that are somewhat more expensive to use. A voluntary effort to eliminate the use of white phosphorus by American match manufacturers failed because of the refusal of 5 per cent of the industry to agree.⁹ On recommendation of President Taft,¹⁰ Congress imposed a prohibitive tax of 2 cents per 100 matches on white phosphorus matches in 1912 and forbade their exportation.¹¹ The act was not litigated.

An attempt to eliminate child labor by means of taxation was blocked by the Supreme Court. Congress

⁹ J. R. Commons and J. B. Andrews, *Principles of Labor Legislation* (rev. ed.; New York and London, 1927), p. 357.

¹⁰ Message of December 6, 1910, quoted in D. D. Lescoghier and E. Brandeis, *History of Labour in the United States, 1896-1932* (New York, 1918-1935), III, 361.

¹¹ Act of April 9, 1912, 37 Stat. 8.

passed a law in 1916 forbidding the shipment of products of child labor in interstate commerce.¹² The Court declared this act unconstitutional on the ground that it was not a valid exercise of the power of Congress to regulate interstate commerce, and was instead a veiled method of regulating conditions of manufacture.¹³ Congress passed an act in 1919 imposing a tax of 10 per cent on the net profits of persons or corporations employing children below certain specified ages.¹⁴ The tax was not on the labor or on the products of the labor but was imposed on all the production of a manufacturer knowingly employing any child labor. The act contained rather detailed provisions for administration, which pointed to regulation rather than revenue as its purpose.

The Supreme Court, through Chief Justice Taft, held the child labor tax act unconstitutional on the grounds that the tax was not a genuine tax but a penalty to enforce a regulation that Congress had no power to impose.¹⁵ In this case the Court developed the distinction, discussed above,¹⁶ between a tax and a penalty.

The Bituminous Coal Conservation Act, previously discussed,¹⁷ also represented a further attempt of the federal government to employ taxation to control labor relations. The code that was contained in the act included provisions that were considered important by the miners' union. The passage of the act averted a nation-wide coal strike. Invalidation of the act by the Supreme Court was in harmony with the decision in the child labor tax case. It further indicated that the Court would not approve taxation to enforce regulations otherwise beyond the power of Congress to impose.

¹² U. S. C. 432, 64 Cong., 1 sess.

¹³ *Hammer v. Dagenhart*, 247 U. S. 251 (1918).

¹⁴ Act of February 24, 1919, 40 Stat. at L. 1057.

¹⁵ *Bailey v. Drexel Furniture Co.*, 259 U. S. 20 (1922).

¹⁶ See p. 137.

¹⁷ See p. 191.

Social Security Act Tax Credit

The Social Security Act of 1935 included still another tax that was not imposed primarily for revenue purposes. It levied on certain employers an excise tax, measured by wages, to begin at 1 per cent and rise to a maximum of 3 per cent in 1938. Against this tax the employer was permitted to credit contributions paid into approved state unemployment funds up to 90 per cent of the tax.¹⁸

The Court has not yet passed on the constitutionality of the Social Security Act. Therefore, it is not known whether the provisions are to be viewed as a penalty to force state action in a field outside federal jurisdiction or as a legitimate exercise of the taxing power. The crediting provisions are modeled on those of the Revenue Act of 1924 and later years that allow a credit of state death taxes against the federal estate tax. This device has been upheld by the Supreme Court.¹⁹ There are, however, significant differences between the two acts. The death tax credit relates to purely revenue measures and makes no attempt to induce states to adopt policies falling under their reserved police powers. The tax imposed by the Social Security Act was obviously imposed to induce states to adopt unemployment compensation laws. Even the type of state law must be approved by the federal government before the tax credit is granted. While the precedent of the inheritance tax case may be followed, the line drawn in the child labor tax case²⁰ is at least approached.

¹⁸ Act of August 14, 1935, chap. dxxxii, pars. 901-3, 49 Stat. 620.

¹⁹ *Florida v. Mellon*, 273 U. S. 12 (1927).

²⁰ See pp. 192-93.

Chapter 13

CONTROL OF CONSUMPTION OF HARMFUL COMMODITIES

Almost every government regulates the consumption of commodities that are deemed socially harmful. Taxation has been used frequently to promote this policy.

Taxation imposed to reduce harmful consumption is sumptuary taxation, and it should be distinguished from taxation imposed to protect or regulate business. The latter may accomplish its aim through reduction in the purchase and consumption of commodities, but the purpose of the reduction is not to prevent harm that might result from consumption.

Sumptuary taxation should be distinguished also from modern luxury taxation. Although luxuries were often thought harmful in the Middle Ages and legislation was passed to discourage their consumption, modern luxury taxes are imposed not for this reason but because the purchase of luxuries is an indication of ability to pay. The primary purpose of luxury taxes is revenue. Any consequent reduction in consumption is incidental rather than intentional.

Few truly sumptuary taxes exist in modern tax systems. The taxes imposed on alcoholic beverages constitute much the best example of sumptuary taxation. Taxes on habit-forming narcotic drugs, alcoholic beverages, and tobacco may all be considered as having sumptuary aspects. The pressure of the appetite for habit-forming drugs, however, is so strong that taxation cannot be considered a very significant aspect of a

system for regulating their consumption. Social disapproval of cigarettes may possibly have been a factor in the imposition and retention of especially high rates of cigarette taxation, but it is now practically extinct.

Taxes are used to regulate consumption in a number of ways. One is to increase the price of the commodity and thus cut down consumption because of the expense. Another is to reduce the number of places where the commodity can be purchased and thus reduce the number of outlets and the resultant temptation to buy. A third is to make domestic manufacture unprofitable and thus to bring the whole industry under federal control through the federal power over imports. A fourth is to use the administrative regulations set up for the collection of the tax as an instrument of control.

NARCOTIC DRUGS

Under the commerce clause of the Constitution the federal government has the power to regulate the importation and exportation of narcotic drugs and their sale in interstate commerce. It lacks the power directly to regulate or prohibit their manufacture and intrastate sale. However, a system of federal narcotic control has been set up on a combined basis of the commerce power and the taxing power.

None of the taxes imposed on narcotics is expected to raise the price to consumers so high that they will cease using the drugs on account of expense. Even the internal revenue tax of \$300 per pound, imposed on the manufacturers of opium for smoking purposes,¹ was not expected to raise the price, since most of the opium used was being smuggled into the country. The tax was definitely intended, however, to prohibit the manufacture of smoking opium, and not to raise revenue. It was considered by its backers to be the only way in which

¹ Act of January 17, 1914, chap. x, sec. 1, 38 Stat. 277.

Congress could constitutionally accomplish its purpose.² This tax is an example of the third method mentioned above of using taxation for control.

An internal revenue stamp of 1 cent an ounce on narcotic drugs and occupational taxes on dealers are the basis for a detailed system of regulations. These illustrate the fourth method noted above. Although there can be no question that the primary purpose of the narcotic tax act³ was regulation rather than revenue, the Supreme Court upheld it as constitutional.⁴ It insisted, however, on strict construction of the act.⁵

ALCOHOLIC LIQUORS

Beginning with the tariff levied on distilled spirits in 1790, liquor taxation in the United States has been imposed both for revenue and for control of consumption. The relative emphasis on control has differed between federal and state legislation and from time to time.

Prior to the prohibition period revenue was the more important objective in federal liquor taxation. The plan of administration was designed solely to raise revenue, and the excise tax (\$1.10 per proof gallon) was by no means prohibitory.

Although the liquor taxes of the states and localities were imposed primarily for revenue, the burden of controlling the liquor traffic fell on these jurisdictions, and their licensing systems generally appear to have had control as the main objective. This tax objective seems to have increased in importance with the general movement against the liquor traffic.

Since the repeal of prohibition, attention has again

² *Congressional Record*, 63 Cong., 1 sess., June 24, 1913, p. 2168.

³ Acts of December 17, 1914, chap. 1, sec. 1, 38 Stat. 785; February 24, 1919, chap. xviii, sec. 1006, 40 Stat. 1130; February 26, 1926, chap. xxvii, sec. 703, 44 Stat. 96, 97; Code of U. S., Title 26, sec. 1040, 1383-90.

⁴ *United States v. Doremus*, 249 U. S. 85 (1919); *Nigro v. United States*, 276 U. S. 332 (1928).

⁵ *Linder v. United States*, 268 U. S. 5 (1925); *United States v. Daugherty*, 269 U. S. 360 (1926).

been devoted to liquor control. Its most important aspect at present is the elimination of the illicit liquor traffic.

In this field control is likely to conflict with revenue as an aim. If restriction of consumption is desired, much higher taxes are needed than those needed to achieve a maximum of revenue, assuming no serious problem of illicit traffic. Recently, conflict has arisen between revenue and the control of bootlegging. It has been claimed that the tax on spirits must be lowered in order to drive bootleggers out of business, before it can be raised to the maximum revenue level or to a level that will greatly restrict consumption.

It may be objected that the reduction of consumption through high prices is a class measure. Only the poor are deprived of intoxicants, while the wealthy can consume as freely as before. If the truth of this objection is granted, two considerations may keep it from being fatal to a high price policy. First, the social problems of liquor have always been more serious among the low income groups of society. Second, in the absence of a strong social approval of enforcement, any other method of keeping down consumption is also in effect a class measure. As the experience of the prohibition period indicates, the elimination of bootlegging is impossible where there is vigorous demand from financially able buyers.

Another aspect of control is the shifting of consumption from beverages with a high percentage of alcohol to lighter beverages. This was urged upon Congress when liquor taxation was under consideration after repeal, on the ground that the personal and social problems arising from the use of alcoholic beverages were associated almost entirely with the stronger liquors.⁶ It was pro-

⁶ *Tax on Intoxicating Liquor*: Joint Hearings before the Committee of Ways and Means, House of Representatives, and the Committee on Finance, United States Senate, 73 Cong., interim, 1, and 2 sess., p. 359. Hereafter cited as *Tax on Intoxicating Liquor*: Joint Hearings.

posed that a progressive tax on alcoholic content be imposed instead of the substantially proportional tax actually adopted.

Foreign Success with High Taxation

The experience of certain other countries has indicated that taxation is an effective instrument of liquor control. American observers have drawn two conclusions from this experience: (1) that total liquor consumption can be reduced by taxation, and (2) that consumption can be shifted from ardent spirits to the lighter wines and beer.

The experience of Great Britain is most often cited to support these conclusions. Since 1913 the taxes on spirits have increased in Great Britain more than 400 per cent, with an even greater relative increase in the tax on beer.⁷ The tax on spirits is nearly \$13 per gallon,⁸ as contrasted with a federal tax in the United States of \$2.00 per gallon, and an average total federal and state excise of \$3.00.⁹ Official British statistics show a decrease since 1913 of 60 per cent in the consumption of spirits, 41 per cent in the consumption of beer, and, furthermore, a decrease of 74 per cent in convictions for drunkenness.¹⁰

The whole change, however, cannot be attributed to the high prices caused by taxation. The economic depression, dole regulations, a reduction in the hours of sale, the spread of education, and an increase in facilities for amusement have also taken place during this period and have been partially responsible for the change. However, the costliness of becoming intoxicated is held by

⁷ D. W. McConnell, "Liquor Traffic," *Encyclopedia of Social Sciences*, IX, 505.

⁸ The British tax on beer is equivalent to about \$14.35 per United States barrel of 31 gallons, Roswell Magill, L. H. Parker, Eldon P. King, *A Summary of the British Tax System with Special Reference to Its Administration* (Washington, 1934), pp. 30-31.

⁹ Paul Studenski, "Liquor Taxes and the Bootlegger," *National Municipal Review*, XXIV, No. 1, Supplement (January 1935), 71.

¹⁰ Raymond B. Fosdick and Albert L. Scott, *Toward Liquor Control* (New York, 1933), p. 37.

observers to be an important cause of the improvement.¹¹ Similar results have been observed in Denmark.¹²

The adoption of a similar policy in the United States would not necessarily be equally successful. The size of the country, the free movement of people within it, and the length of its seacoast and borders make the control of the liquor traffic through taxation more difficult than it is in a country like Great Britain.¹³

Suitability of Different Taxes for Control

To discourage the consumption of alcoholic beverages, the tax must be capable of special application to the liquor industry. It must either raise the price of liquor, reduce the number of places of sale, or reduce the effort to sell. Many taxes, such as the inheritance tax and the real estate tax, are too general in their effects to be useful in liquor control.

Special taxes might be imposed on the incomes or profits of those engaged in the liquor business.¹⁴ A tax levied on excess profits due to monopoly or speculation might be justified on the ground that governmental policy was responsible for these gains or that the liquor industry was suspect and should be subject to special restrictions.¹⁵ The tax would probably not be shifted to consumers. Therefore, it would probably discourage the growth of greater monopoly and would prevent the industry from developing rapidly in financial strength, but it would scarcely reduce consumption.

A heavy uniform tax on all net income from the liquor industry might, and probably would, be shifted to consumers in higher prices, at least in part. It is not likely, however, as some have contended, that such a

¹¹ J. J. Mallon, "Drunkenness vs. Drink," *Survey*, LXVII (February 1, 1932), 489.

¹² McConnell, *op. cit.*, p. 505.

¹³ See p. 339.

¹⁴ See Note 1, *Special Liquor Profits Tax*, p. 547.

¹⁵ See pp. 271-72.

tax would substantially weaken the profit motive and thus destroy the driving power behind most of the abuses of the liquor traffic. Some producers might be eliminated, but those who remained would still want to make as much profit as possible. Only through government operation can the profit motive be eliminated.¹⁶

The income tax would exert less pressure to build up profits through a large volume of sales than would high, flat-rate occupational licenses, since the tax under such licenses is fixed and the profit on an increased volume is clear gain. However, the income tax would have less tendency to reduce the number of sales outlets than would flat-rate license taxes.

The tendency of flat-rate license taxes to encourage large-scale units would limit competition and create a semi-monopoly. Prices could then be increased to an uncertain extent. The pre-prohibition policy was distinctly a high license policy. On the whole, much lower licenses have been favored since repeal, probably owing to the desire to discourage bootleggers. A sharp differential in favor of sales outlets handling only beverages of lower alcoholic content appears distinctly useful in encouraging a shift to such liquors.

Taxes levied uniformly on manufacture or sale have the greatest chance, according to economic analysis, of being entirely shifted. Therefore, they offer the greatest possibilities of decreasing consumption by increasing prices. Geographical uniformity and ease of administration are furthered by levying the taxes on the manufacturer. Taxes on the manufacturer have been opposed, however, on the ground that in the process of shifting they are pyramided, and thus consumers are overburdened.

The use of a federal tax to assist states in enforcing

¹⁶ Government operation is urged by Gulick, *Tax on Intoxicating Liquor*: Joint Hearings, p. 163, and by Fosdick and Scott, *op. cit.*, chaps. v and vi.

their liquor laws was exemplified by a tax of \$1,000 imposed on all persons selling liquor in violation of any state law. This was enacted during the prohibition period, when the federal government had the power to regulate the liquor traffic, and was retained after repeal. The Supreme Court of the United States has declared the law unconstitutional on the grounds that the \$1,000 payment was not really a tax but a penalty imposed in a field in which the federal government had no power to legislate.¹⁷

¹⁷ *United States v. Constantine*, 296 U. S. 287 (1936).

Chapter 14

TAXATION AND THE DISTRIBUTION OF WEALTH AND INCOME

INEVITABLE EFFECTS ON DISTRIBUTION

Public expenditures and the taxes imposed to finance them always change the distribution of wealth and income. This is because the benefits that a person derives from governmental expenditures seldom exactly equal his tax burden.

However, it is possible to change the distribution of wealth and income without effecting a redistribution. This distinction between redistribution and change in distribution must be emphasized—especially so because in recent public discussions the possibility of such a distinction has been ignored.

Redistribution means taking from some and giving to others. A change in distribution includes redistribution. It also includes, however, the process by which some persons get something that is newly created and not taken from someone else. For example, sometimes the value of a governmental service that is rendered to a particular group in the community is much larger than its cost. Suppose the tax to support this expenditure is levied solely on the benefiting group. The net result will be a change in the relative distribution but not an actual decrease in anyone's total income or wealth. The benefits conferred by the fundamental functions of government are probably worth more to every taxpayer than their cost to him in taxes. A change in distribution—but not redistribution—occurs also when the tax money col-

lected from someone is wasted without increasing anyone's income.

Frequently, however, the total income or wealth of some people is decreased by taxation while the total income or wealth of other people is increased through the less vital functions of government. In this case redistribution takes place. A similar process occurs in the payment of bonuses, pensions, doles, subsidies, and interest and principal on debt.

The difficulty of measuring expenditure benefits and tax burdens makes it impossible to ascertain precisely the amount, and sometimes even the direction, of either redistribution or a change in distribution.

METHODS OF CHANGING DISTRIBUTION

Income

A change in distribution of income can be achieved by altering the pattern of the tax system or the expenditure system while keeping the total volume of taxes and expenditures unchanged. It can also be achieved by changing the total volume of taxes and expenditures. To secure a more equal distribution of income (1) the taxes may be so changed as to lighten the tax burden on the mass of people, or (2) the total volume of expenditures may be kept unchanged but the purposes for which they are made may be adjusted to produce greater benefit for the great mass of people, or (3) the volume of expenditures benefiting the great mass of people may be increased.

One way of using method (1) above is to replace taxes that are regressive by taxes that are progressive, or to increase the progressiveness of the taxes.¹

¹ If a tax, after being shifted to those who finally bear its burden, takes a greater percentage of the income of large income receivers than of smaller income receivers, the tax is progressive in incidence. If it takes a greater percentage of the income of small income receivers than of larger income receivers, the tax is regressive in incidence. If in its incidence the tax takes the same percentage of all sizes of income, the tax is proportional in incidence.

Wealth

Redistribution of the flow of current income can be achieved more quickly through taxation and governmental expenditure than can redistribution of accumulated wealth. People usually pay their taxes out of new increments of wealth—that is, out of income—and keep intact their accumulated principal. Governmental expenditures for services ordinarily add to the current incomes of people rather than to their accumulated wealth.

In the course of time, however, these shifts in income distribution are likely to affect the distribution of wealth. The taxed individual may save less than he otherwise would because of the reduction in his income, while the individual receiving governmental services or subsidies may be able to save more. This process is a redistribution not of existing wealth, but of wealth accumulated in the future.

Inheritance and estate taxes are sometimes said to achieve redistribution of wealth in a direct way, as other taxes do not, because they are often so heavy that investments must be sold in order to provide funds for their payment. However, such forced sales do not result in redistribution of wealth in the sense in which the term is ordinarily understood. Ownership of the investment passes from the taxpayers to someone else, who purchases it out of either current income or uninvested savings. In one sense, this transfer of ownership may be redistribution, but it is not direct redistribution to recipients of government services or bounties. Also, it is not necessarily redistribution from a person in one income group to a person in another income group.

The sale of an investment to pay inheritance and estate taxes may affect adversely the creation of new wealth. The ownership of existing wealth has been

transferred, but no new saving has taken place. To the buyer, however, the purchase may be in lieu of investment in newly created wealth.

Redistribution of existing wealth could be accomplished by a capital levy in kind followed by a distribution of the wealth thus secured. Some of the difficulties of such a distribution are discussed below.²

INCIDENTAL VERSUS INTENTIONAL EFFECTS

The effects of a given tax or expenditure measure on distribution may be incidental to some other purpose or they may instead constitute the main purpose of the measure.

The essential functions of government are required by all people. The effects that the financing of such functions exercise on distribution are purely incidental.

The government may conclude that many citizens greatly need certain services or goods—not comprised in the essential functions of government—that they cannot afford. If it is thought that the general public interest in supplying them outweighs the public interest in a light tax burden, the government will probably supply them at public expense. Free public education, public recreational facilities, health clinics, and work relief projects are examples. The result is a change in the distribution of income. A redistribution of income also probably occurs. Though accompanying the achievement of the public purpose, however, it is largely incidental. There is no desire to reduce anyone's income either absolutely or relatively but only to increase the amount of the income of some. The performance of such public activities is everywhere recognized as a proper function of government. A great difference of opinion exists, however, about the extent to which government should engage in them.

² See pp. 213-14.

On the other hand, a government may believe that some persons' incomes are too large, at least compared with the incomes of others. Taxation and expenditure can be used to reduce the large incomes. Here, redistribution becomes a primary aim of taxation. Recently proposed "share-the-wealth" programs fall in this class, as do efforts to prevent the perpetuation of "economic dynasties" by taxation.

REDISTRIBUTION AS A TAX OBJECTIVE

Whether a primary aim of the tax system should be greater concentration of wealth and income, or greater equality, or a minimum change, depends in part on the effects of redistribution and in part on the attitude of people toward inequality.

Effects of Redistribution

Opinions on the nature of the effects of redistribution are divergent. The various points of view can only be outlined briefly here.

Effect on Human Satisfaction

The idea of diminishing utility is commonly accepted. Most people assume that the more money a person has, the less utility or satisfaction he will get from an increase in wealth. Although such satisfactions are subjective feelings and cannot be compared, a dollar is assumed to give less satisfaction to a wealthy person than to a poor one. If this is true, the total satisfactions and consequently the economic welfare of the community as a whole increase with an increase in the equality of wealth and income. It is assumed, of course, that no overbalancing adverse effect occurs.

Effects on Production: Traditional View

Opinions differ as to whether such an adverse effect does occur. Economic welfare depends not only on the

manner of distribution but also on the volume of production. The volume of production depends in turn largely on the amount of machinery and other capital goods that increase the efficiency of labor. Capital goods, however, can be produced, usually, only if the community is willing to do without a certain amount of goods for current consumption—that is, if the community is willing to save. In general, a larger fraction of their total income is saved by people receiving large incomes than by those receiving small incomes. To this extent, production and thereby economic welfare tend to be promoted by the concentration of income.

However, if economic progress is to result from private saving based on inequality, the increased volume of consumers' goods that finally results from the use of the new capital must be sold. The sale will be made possible, according to the usual economic analysis, through the reduction of prices. Thus, all persons will share in the benefits of increased production. Rates of interest will also decrease as the supply of capital increases, and this decrease tends to keep the rate of capital growth from becoming excessive.

If this reasoning is sound, the use of taxation and public expenditures to redistribute wealth may result in a reduction in the rate of growth of production and, if carried far, in a decline in production.

It is also claimed that high taxes on the wealthy for the purpose of redistribution would discourage business initiative and risk-taking, and thus decrease production. It seems reasonable to believe that beyond some point, impossible to define, this would be the result.³

Effects on Production: Socialist View

Socialist writers do not accept this analysis of the economic system. Their argument has recently gained

³ See pp. 61-64 for a discussion of the effects of taxation on business initiative.

rather wide acceptance. They claim that, when income and wealth are concentrated, the amount of saving and investment is so great that consumers' goods are increased more rapidly than the power of consumers to buy them. As a result, it is held, depressions occur, and perhaps eventual collapse of the capitalist system may follow. According to a variant of this argument, saved funds are not invested because there is no prospect of profits through sale of consumers' goods; the idle saved funds result in unemployment and inability to purchase consumers' goods; and depressions follow.

Those who hold this view urge that redistribution of income and wealth does not diminish but actually increases production. Goods that would otherwise glut the market are then purchased. In turn, production and employment are encouraged. Furthermore, according to this view, the limiting factor on investment is not saving but profitable opportunities for investment, which grow out of the sale of consumers' goods. Redistribution, by encouraging the purchase of consumers' goods, thus not only stimulates immediate production, but also makes investment profitable and so increases future production beyond what it would otherwise be.

Effects on Production: Conclusions

These two views of the effects of inequality of distribution of wealth and income on the increase of production are fundamentally different interpretations of the operation of modern capitalism. They go far outside the field of taxation proper, and no attempt can be made here to analyze or evaluate them at length. Perhaps the truth is that a certain degree of inequality less than now exists would be the optimum beyond which equalizing distribution would be socially harmful.

In the opinion of the writer, if redistribution, especially of accumulated wealth, were carried to its logical

extreme—to a point of approximate equality of incomes—profound changes in the economic system would occur. It would almost certainly result in a decrease in the volume of privately saved capital and would probably mean the end of private capitalism. The persons receiving the redistributed wealth would probably have small incomes. To such persons receipt of more income at once would probably be more important than continued ownership of wealth. Much of the wealth would be liquidated as rapidly as possible. The amount of private wealth and consequently of private production would decline. To offset the decline, government saving and participation in productive industry would be necessary. The end result would be socialism.

Effects on Liberty

Some contend that the use of taxation to equalize the distribution of wealth and income is an aid to liberty, while others hold it to be a menace to liberty. On the one hand, it is claimed that liberty can exist only when there is approximate economic equality. When the economic opportunities of the many are controlled by the few, economic liberty declines and political liberty follows. On the other hand, it is asserted that taxation itself is a restriction of liberty since it takes away the freedom of the individual to determine how his income shall be expended. These two arguments are obviously based on two different views of what kind of liberty is important.

The Desire for Equality

The problem of the distribution of income and wealth is further complicated by differing personal attitudes. Relative incomes as well as absolute incomes are important. Undoubtedly some people—and if concentration were carried to extremes perhaps nearly everyone

would be in this group—would prefer a somewhat lower income in a society where there was approximate equality of incomes to a somewhat higher income in a society where other people had very much higher incomes. Furthermore, people probably differ widely in the importance that they place on equality. Some indeed may still get satisfaction and security from having people of great wealth to whom they can look as superiors.

Because of the complicated and conflicting factors involved, different people will have widely differing opinions on whether taxation should be directed toward reducing inequality, toward increasing it, or toward maintaining the existing condition.

THE LIMITS OF REDISTRIBUTION

Income

Under some other economic system the redistribution of income could be used to effect an almost complete equality of incomes. If private capitalism is to continue, however, the amount of redistribution that can actually be accomplished is limited.

In the first place income that does not exist obviously cannot be redistributed. The amount subject to redistribution is thus limited to the amount of the income. Persons advocating redistribution often grossly overestimate the income of the nation. If the entire income of the nation in the most prosperous year (1929) had been distributed equally among the entire population, the income of each person would have been only about \$673, or \$2,692 for a family of four.⁴

The redistribution of income is also limited by the existing forms of income. Income is not money, although it is ordinarily received in that form. Real income is the goods and services that money will buy. A change in the distribution of income would mean a certain amount of

⁴ Maurice Leven, Harold G. Moulton, and Clark Warburton, *America's Capacity to Consume* (Washington, 1934), Table 1, p. 148.

change in the nature of goods and services produced, and this process of change would involve not a few months or a year but rather many years. Changes in the forms of capital and the organization of business for production would have to be made. Rapid increases in taxes for the purpose of government expenditure would result in a shift of workers and in a shift in demand for the products of industry. Some capital would thus be wasted, and some businesses destroyed.

Limits to the redistribution of income also result from the volume and the types of governmental expenditures. If the amount of governmental expenditures is not increased, the amount of redistribution can be no greater than the volume of governmental expenditures. The workable maximum is much less, however. Many governmental expenditures are made for purposes that benefit all groups in society, not the poorest groups only, and the taxes cannot practicably be loaded only on the very wealthiest, to the extent of 100 per cent of the top parts of their incomes.

If the volume of governmental expenditures is not fixed, the amount of redistribution might be increased greatly, both through services and through subsidies. However, governmental services ordinarily give to the recipients types of income that do not replace the things that they have been buying—especially those in the low income levels. Education, parks, and modern highways, for example, are forms of free income, but they do not reduce the need for food, clothing, and shelter. Thus, unless government supplies the common necessities of life—as it does in public business or the direct relief of poverty—its services are relative luxuries, and the labor power of the country may be diverted from the production of necessities. Cash payments, on the other hand, while they have undesirable features, at least place in the hands of individuals the wherewithal to buy neces-

sities, and any diversion of productive effort that results will probably be to the production of necessities.

Wealth

There are also limits to the redistribution of wealth by taxation. First, of course, as with income, no more wealth can be redistributed than exists. In 1922—when the volume of wealth was about what it is today—the total wealth of the United States amounted to about \$3,200 for each person, or \$12,800 for a family of four.⁵ One-eighth of this was owned by government and so could not be redistributed.⁶ Second, most wealth is not money but land, buildings, and other physical things. Over half (55 per cent) of the 1922 wealth was in the form of real estate alone.⁷ Accordingly, a redistribution of wealth cannot in the very nature of the case be a redistribution in money. Any attempt directly or indirectly to redistribute existing wealth in money means that it cannot be transformed into cash except by selling it—an impossibility on any large scale because of the limited money supply—, or by using it as the basis of loans or money issues. The latter procedure, however, will inevitably result in rising prices, falling real incomes, and all the other effects of inflation.

If existing wealth is to be redistributed, it must be in kind. Money or credit might be used as a lubricant for the process of redistribution, but at the conclusion of the process the existing assets, not money, must be in the hands of the new owners. The most direct way would be for the government to collect a capital levy in the form of the assets themselves and divide them among the people to whom redistribution is to be made.

⁵ Wealth figure of \$353,000,000,000 from *National Wealth and Income*, a Report by the Federal Trade Commission, 69 Cong., 1 sess., Sen. Document No. 126, p. 1 (hereafter cited as *National Wealth and Income*). Population figure of 110,688,000 from W. I. King, *The National Income and Its Purchasing Power* (New York, 1930), p. 47.

⁶ *National Wealth and Income*, p. 2.

⁷ *Ibid.*, p. 29.

Much of the property is in non-corporate form, however, and in ownership units so large that they would have to be broken up. Thus, a taxpayer might give an apartment house to the government in payment of a capital levy imposed to redistribute wealth. To break this property into distributable pieces would necessitate incorporating it. Practically all large wealth ownership would have to be incorporated in order to be divided.

Taxpayers would attempt to pay their taxes in the types of asset that they had least desire for in their altered financial circumstances. The government would probably have an excellent collection of high priced estates, jewelry, and yachts, none of which would be acceptable to persons to whom distribution was being made. The government would have some difficulty in distributing even investments directly to their new owners, because persons in the financial circumstances of the latter would have different standards of preference for investments from those prevailing on the market prior to the capital levy. For example, they would probably not wish speculative investments. If they were forced to take investments that they did not want, the political storm following any losses can easily be imagined.

To meet these problems, the government might assume the ownership of the assets and issue participating certificates to those receiving the distribution. If the amount involved were large, this would make the government a large industrial owner with a substantial stake in the operation of industry. To that extent, private capitalism would almost surely be replaced by socialism.

Book Two

ANALYSIS

(cont' d.)

PART II. SECONDARY AIMS

Section A. Tax Justice

Section B. Fluctuation in Revenue

Section C. Ease of Administration

Section D. Tax Consciousness

Section E. Intergovernmental Co-ordination

Section A. Tax Justice

Chapter 15

THE NATURE OF TAX JUSTICE

The secondary aims of a tax system, to be discussed in Chapters 15 to 24, supply the grounds for choice among alternative tax measures, once the primary aims have been determined.

THE CONCEPT, TAX JUSTICE

More lip service has been paid to justice than to any other secondary aim of the tax system. With rare exceptions, everyone protests his eagerness to pay his "fair share" of the taxes. This conception of justice, however, is too vague to be of much use. It must be broken down into more specific elements.

Justice cannot always be sharply distinguished from other secondary aims. For instance, economic efficiency may be another secondary aim of a tax system. In so far as a system fails in the long run to promote economic efficiency, it also probably fails to promote certain aims of justice. On the other hand, some widely held aims of justice may run directly counter to economic efficiency. In the present discussion, the study of justice is confined to the more immediate distribution of the tax burden, without particular regard to the long-term economic consequences.

A discussion of tax justice first assumes that a given total amount of revenue is to be spent in a given manner. The question then is: what is the just way to distribute the tax burden that is required to raise this revenue? The answer must take account of the pattern of ex-

penditures. For example, the amount of money to be raised from automobile taxes may depend on the volume of highway expenditures. This survey uses the expenditure pattern that will probably exist in the United States during the next few years.¹

COMMON OBJECTIVES

At least two major difficulties beset anyone who tries to think in terms of tax justice. In the first place, opinions differ on the objectives to be reached if a tax system is to be just. However, certain objectives—although they are to some extent mutually contradictory—have gained widespread acceptance. An examination of the characteristics of the system that relate to these objectives will help anyone to form his own ideas on how just the system is.

In the present section the existing system is examined for the following four characteristics:

(1) The sort of rigidity that (a) makes it impossible to rectify, by certain tax decreases, former injustice, as when a reduction of the property tax cannot help the one who was originally injured, since he no longer owns the property; or (b) results from the creation of innocent vested interests that would be harmed by certain tax increases, as when an investor buys into a company—for example, a chain store—and then soon sees the value of his investment drop because the government unexpectedly levies a heavy special tax on his company.

(2) Charges for government services that bear some relation to the cost that each user causes or the direct benefit that he receives, as when highway users are required to pay a gasoline tax or a motor vehicle license tax.

(3) Special taxation of certain sources of gain because

¹ See pp. 94-120.

of their moral implications, as when excess profits from monopoly are specially taxed.

(4) Adaptability to differences in the personal status of taxpayers, as when progressive rates and allowances for marital status, age, etc., are used.

DIFFICULTY OF KNOWING HOW BURDEN IS DISTRIBUTED

The second difficulty that besets the student of tax justice is the necessity of considering the effect of the tax system as a whole—a subject of which he can know very little.

A proposal regarding a certain tax—for example, a lowering of the personal exemptions of the income tax—might be thought unjust if there were no other taxes in the system, but it might be thought just if the tax were only one of many. Furthermore, of two tax systems composed of many taxes, the proposal might increase the justice of one and decrease the justice of the other.

Knowledge of the system as a whole must be obtained, because justice involves the relations of individuals, and tax burdens on individuals are made up not of one tax but of the whole system of taxes. Thus, it may be necessary to ascertain, for example, how much of the total tax burden, federal, state, and local, is borne by John Smith, a middle-aged lawyer with a yearly income of \$9,000, who has a wife and four children to support, who drives his car 10,000 miles a year and lives in a city where he must pay a private agency to have his garbage removed.

Unfortunately, no one has yet succeeded in describing exactly how the burden of the entire tax system is actually distributed among individuals, or among geographic groups, income groups, or any other elements of the population. Any estimate of Smith's total tax burden must include more than personal income taxes and other taxes that he pays directly. Some of the taxes

paid by others—sales taxes, for instance—may be shifted to him in the form of higher prices for the goods that he buys. He in turn may be shifting to others some of the taxes that he pays directly.

Not enough is known about the shifting of taxes and the production habits and consumption habits of the populace to make possible any accurate statement of the distribution of the tax burden at the present time. Reasonable assumptions only can be made. The problem is presented in detail in the next chapter, with some illustrations of the range within which a few of the answers may be expected to fall.

The difficulties of ascertaining the distribution of the tax burden create an unfortunate temptation to conclude that principles of tax justice are not vitally important from the practical point of view. However, the difficulties must not be exaggerated. The skilled observer can make some progress toward an intelligent judgment. Strong probabilities can be found even when no provable facts exist. Having formed objectives of justice, the observer will frequently be able, with a fair degree of confidence, to brand a tax proposal as unjust even though he cannot be sure of what a complete and final marshaling of the facts would show. In the present state of tax knowledge, he may not always be able to decide where the balance of justice lies among entire tax systems—at least, among systems as closely similar as many of those in effect today. However, he may frequently be able to gauge the probable effect of some one tax measure on his conception of the justice of the system as a whole.

Chapter 16

THE DISTRIBUTION OF THE TAX BURDEN

The justice of a tax system depends in large part on the relative real tax burden that each person bears. This burden varies even among individuals who have the same income. The income tax itself will differ for two individuals of the same income if the sources of income and the size of family differ. Other taxes will vary with place of residence, amount and kind of property owned, and habits of expenditure.

Consequently, it is impossible to say that the taxes paid by every man with a \$1,000 income, for example, will amount to a specific percentage of his income. The most that can be said is that, if several men with \$1,000 incomes get their incomes from the same specified sources, spend them in the same manner, live in the same locality, and own property of the same kinds and amounts and assessed at the same rates, the taxes that they will pay will amount to practically the same sum.

Moreover, even a precise statement of taxes paid is inadequate. The tax burden of an individual can be measured only after knowing what amount of the taxes that he pays is shifted to others, and what amount of the taxes of others is shifted to him. In other words, the test is taxes borne rather than taxes paid. But this involves many debatable assumptions about the shifting of taxes.

In view of these difficulties, very little confidence can be placed in the tax burden figures given in the recent flood of literature on "unseen" or "hidden" taxes.¹

¹ See Note 1, *Tax Burden Studies*, p. 548.

An attempt is made in this chapter, however, to measure the tax burdens of hypothetical persons. Owing to the same difficulties, these estimates are not strictly representative of the income groups from which the cases have been selected. They are offered, rather, to indicate some of the problems involved in estimating tax burdens and to show the variations in estimates that will result from changing the assumptions. They are given in this chapter in summary form and are explained in detail in another volume.²

The taxes assumed are those in effect in the calendar year 1936, and allowance has been made for those in effect for only a part of the year. The tax burden is taken to be the amount of taxes paid that the taxpayer has been unable to shift to others or to discount in advance, plus the amount of taxes shifted by others to him. No account is taken of benefits that the taxpayer may have received in return for these taxes. On the other hand, the tax burden figures do not include special assessments, fees, or prices charged by government-owned enterprises.

THE CASES SELECTED

In selecting the hypothetical cases for which the tax burden has been estimated, a wide range of incomes, from \$500 to \$1,000,000, has been chosen. In other respects families have been assumed to be as much alike as is reasonable in view of the differences in their incomes. All the families have been assumed to be of the same size—a man, his wife, and two minor children. All are home owners; all have cars; all use tobacco; and all the urban families use liquor. All within the given state live in the same rural or urban community, as the case may be, and are, in consequence, subject to the same property tax rates.

² See the memorandum by Mabel Newcomer on the distribution of the tax burden in the forthcoming volume, *Studies in Current Tax Problems*.

Two states have been selected to indicate the differences in tax burden that may result from differences in state and local tax systems. New York has been chosen as a state that has developed income taxation to a marked degree, with personal, corporation, and unincorporated business income taxes. Illinois has been chosen as a state that is leaning heavily on the sales tax. New York has no general sales tax, except for the local tax in New York City, and Illinois has no income tax. Another important difference is that Illinois still taxes personalty whereas the New York property tax is limited to real estate. Neither state uses the property tax for state purposes, but state property taxes have been so generally reduced during the depression that these states can hardly be regarded as exceptional in this respect.³

The amount of expenditure and the amount of savings assumed for each family, and also the broad classifications of expenditure, follow the proportions indicated for the different income classes in the Brookings Institution study, *America's Capacity to Consume*.⁴ The details of expenditure have been suggested by various budget studies, especially those of the United States Bureau of Labor. No allowance has been made for differences in the cost of living in New York and Illinois, the same expenditures being assumed for the families in both states. The slight difference in taxes that would result from such an adjustment does not seem to justify this additional refinement. These hypothetical budgets are not presented as typical. They are considered to be reasonable for each income class, but the patterns of expenditure will vary widely even among families of the same income group, particularly in the higher income classes.

³ See the memorandum by Thomas J. Reynolds on state property tax rates in the forthcoming volume, *Studies in Current Tax Problems*.

⁴ Leven, Moulton, and Warburton, *op. cit.*

The kinds and value of property owned by each family have been determined as described elsewhere.⁵ As with expenditures, the figures are believed to be reasonable for each income class but not necessarily typical.

Substantial variations in the tax burden could be computed by using different, but still reasonable, assumptions concerning the amount and nature of each family's property and expenditures. Since this study must come to an end, however, and since it is primarily concerned with problems more closely related to the tax system, only one set of expenditure and property assumptions has been used. Such variations in burden as are given below result from changes in two kinds of assumptions: those concerning the shifting of taxes and those concerning changes in the ownership of property and income within the family, so far as such changes might be made deliberately in order to reduce the family's taxes. It is, of course, true that the nature of the tax system may also affect the nature of expenditures and the amount and nature of taxable property held. However, the effect is less than that on the manner in which the ownership of property is distributed within a family, since the possibility of reducing the tax burden is less and habits of consumption must be changed in order to reduce it.

THE TAXES INCLUDED

Taxes restricted to narrow fields and taxes of very minor revenue importance have not been included in these estimates.

In order to keep the problem reasonably simple, it has been assumed that all the families that hold stock are investors in a single, domestic, manufacturing corporation. Thus, special taxes on other types of corporation

⁵ See the memorandum by Mabel Newcomer on the distribution of the tax burden in the forthcoming volume, *Studies in Current Tax Problems*.

that will fall ultimately on the stockholder, such as the New York tax on banks, have been omitted. The omission of such taxes need not reduce the estimated tax burden below the amount borne by an average investor, however, since the manufacturing corporation pays taxes that are roughly equivalent.

Certain taxes, mostly specific consumption taxes, have been omitted as too small to justify estimates. Although they enter into the ultimate tax burden, they amount to less than 6 per cent of federal tax collections, and less than 1 per cent of state and local tax collections.

ASSUMPTIONS ON WHICH ESTIMATES ARE BASED

Five series of assumptions have been made about tax shifting and intra-family changes in property holdings. The tax burden for each family has been computed under each series. These series are described in Table 20. In general, it has been assumed that income, death, and gift taxes are not shifted; that business taxes, other than those on net income and capital stock, may be shifted to the consumer in part or entirely; and that land taxes may be capitalized in part or entirely. For income, death, and gift taxes some variation has been assumed, not because of shifting, but because of changes in the ownership of property and income within the family. Only business net income, capital stock, mortgage, and stock transfer taxes remain unchanged with respect to both shifting and intra-family distribution of ownership through the five series of assumptions.

THE TAX BURDEN ESTIMATES

Table 21 is a tax consciousness table rather than a tax burden table. It gives the taxes paid by each family directly to the government, including those taxes whose burden does not really rest on the family. However, the taxpayer will probably regard the total of these taxes

TABLE 20
ASSUMPTIONS ON WHICH TAX BURDEN ESTIMATES ARE BASED

Tax	Series I	Series II	Series III	Series IV	Series V
Personal income tax	Borne by payer. Husband and wife make separate returns except in the case of the \$5,000 salaried worker	Same as I	Same as I	Same as I	Borne by payer. Husband and wife make joint return
Death and gift taxes	Borne by owner of property before transfer. ^a Property divided between husband and wife, and substantial gifts made to children during lifetime of parents, except for the \$5,000 salaried worker	Same as I	Same as I	Same as I	Borne by owner of property before transfer. ^a Property all in hands of husband, and no gifts made to children
Land tax	All capitalized ^b	Same as I	Same as I	One-half capitalized. ^b Remaining half borne as in case of tax on improvements	Same as I

Taxes on improvements, personalty, commodities, gross receipts, motor vehicles, and motor fuel	Shifted entirely to final consumer	One-half shifted to final consumer; one-half borne by taxpayer (or stockholder, for the corporation)	Same as II except that one-fourth of sales tax is shifted back to producer of commodities; one-fourth borne by merchant; one-half borne by final consumer	Same as II	Same as I
Payroll tax ^a	Shifted entirely to final consumer	One-third shifted to final consumer; one-third shifted to employee; one-third borne by taxpayer (or stockholder, for the corporation)	Same as II	Same as II	Same as I
Business net income and capital stock taxes	Borne by stockholder or owner	Same as I	Same as I	Same as I	Same as I
Stock transfer tax	Borne by taxpayer	Same as I	Same as I	Same as I	Same as I
Mortgage tax	Borne by mortgagor	Same as I	Same as I	Same as I	Same as I

^a The annual burden of the estate and inheritance taxes has been assumed to be the amount of the premium on insurance sufficient to cover these taxes at death.

^b For an explanation of capitalization, see pp. 238-45.

^c Only the 1 per cent levied in 1936 is included.

as his particular burden since he pays all of them directly to the government as taxes.

Tables 22-25 give the various estimates of burden in detail. Table 22 tells part of the story of the true tax burden in terms of Series I assumptions. It shows only the taxes that are not shifted. However, it includes, besides the taxes paid directly to a government official, those that are paid to a non-governmental agency but that are more or less clearly labelled taxes, such as the gasoline tax. The latter taxes are probably also regarded by the taxpayer as a part of his burden, but he will rarely make the necessary calculation to determine the exact amount, and he will therefore be somewhat less conscious of it. Table 23, likewise restricted to the Series I assumptions, contains only the concealed taxes, such as customs duties, that are shifted to the taxpayer. They probably play no part in his tax consciousness.

TABLE 21

TAXES PAID DIRECTLY TO GOVERNMENT OFFICIALS
WHETHER OR NOT SHIFTED TO OTHERS
BASED ON ASSUMPTIONS IN SERIES I
(In Dollars)

Occupation: Income ^a	Farmers			Wage Earners		Salaried Merchant Worker		Salaried Worker		Corporation Officials	
	500	1,000	2,000	1,000	2,000	5,000	5,000	20,000	100,000	1,000,000	
New York Families											
Federal	0	0	0	0	0	21	19	805	13,515	506,438	
State..	9	13	13	9	15	49	261	765	6,358	62,937	
Local..	162	234	384	114	223	546	1,365	1,068	7,495	37,000	
Total	171	247	397	123	238	616	1,645	2,638	27,368	606,375	
Illinois Families											
Federal	0	0	0	0	0	25	31	881	15,809	562,736	
State..	8	10	10	8	12	25	38	53	78	90	
Local..	103	140	200	90	188	473	1,730	981	5,138	24,750	
Total	111	150	210	98	200	523	1,799	1,915	21,025	587,576	

^a This income figure is income actually received. It is not suitable as a base for computing the percentage of income paid in taxes. The proper base for a percentage computation is "potential income"—that is, the income that would have been received if the taxes had not existed—, since some of the taxes are in fact paid out of this potential income, not out of income actually received.

The total burden under the assumptions in Series I consists of the figures in Table 22 plus those in Table 23, and this total is shown in Table 24.

The total burden under each of the five series of assumptions is shown in Table 25.

TABLE 22

TAXES PAID AS SUCH TO GOVERNMENT OFFICIALS OR
INTERMEDIATE AGENCIES, AND NOT SHIFTED
TO OTHERS
BASED ON ASSUMPTIONS IN SERIES I
(In Dollars)

Occupation: Income ^a	Farmers			Wage Earners		Salaried Merchant Worker		Salaried Worker	Corporation Officials	
	500	1,000	2,000	1,000	2,000	5,000	5,000	10,000	100,000	1,000,000
New York Families										
Federal	^b 2	7		5	8	45	181	920	16,248	615,148
State..	5	18	26	23	33	74	286	876	6,987	99,668
Local..	32	45	73	86	167	410	410	801	4,202	18,120
Total	37	65	106	114	208	529	877	2,597	27,437	732,936
Illinois Families										
Federal	^b 2	7		5	8	49	193	997	18,543	671,444
State..	3	13	18	20	27	43	67	96	399	13,590
Local..	19	27	40	72	154	394	394	742	3,525	17,250
Total	22	42	65	97	189	486	654	1,835	22,467	702,284

^a This income figure is income actually received. It is not suitable as a base for computing the percentage of income paid in taxes. The proper base for a percentage computation is "potential income"—that is, the income that would have been received if the taxes had not existed—, since some of the taxes are in fact paid out of this potential income, not out of income actually received.

^b Fifty cents.

TAX BURDENS AS PERCENTAGE OF INCOMES

For comparative purposes the tax burden has been estimated as a percentage of income in Table 26 and Chart 6. The income figure used is not the actual income shown in Tables 21-25, but the income that the person would have received if the land tax had not been capitalized⁶ to the extent assumed, and if certain other taxes, which, it has been assumed, have been shifted to him, had not been imposed or had been shifted elsewhere.

⁶ See pp. 238-40.

TABLE 23

TAXES BORNE AS THE RESULT OF SHIFTING
BASED ON ASSUMPTIONS IN SERIES I

(In Dollars)

Occupation: Income*	Farmers			Wage Earners		Salaried Merchant Worker		Salaried Worker	Corporation Officials	
	500	1,000	2,000	1,000	2,000	5,000	5,000	20,000	100,000	1,000,000
New York Families										
Federal	7	12	18	25	42	254	73	3,079	15,060	257,167
State..	4	8	18	12	24	127	64	1,183	5,934	94,494
Local..	12	24	53	30	60	150	150	600	3,000	30,000
Total	23	44	89	67	126	531	287	4,862	23,994	381,661
Illinois Families										
Federal	9	16	25	30	51	293	95	3,441	16,844	285,282
State..	13	22	40	33	59	124	115	415	1,745	16,702
Local..	12	24	53	30	60	150	150	600	3,000	30,000
Total	34	62	118	93	170	567	360	4,456	21,589	331,984

* This income figure is income actually received. It is not suitable as a base for computing the percentage of income paid in taxes. The proper base for a percentage computation is "potential income"—that is, the income that would have been received if the taxes had not existed—, since some of the taxes are in fact paid out of this potential income, not out of income actually received.

TABLE 24

TOTAL TAX BURDEN
BASED ON ASSUMPTIONS IN SERIES I

(In Dollars)

Occupation: Income*	Farmers			Wage Earners		Salaried Merchant Worker		Salaried Worker	Corporation Officials	
	500	1,000	2,000	1,000	2,000	5,000	5,000	20,000	100,000	1,000,000
New York Families										
Federal	7	14	25	30	50	299	254	3,999	31,308	872,315
State..	9	26	44	35	57	201	350	2,059	12,921	194,162
Local..	44	69	126	116	227	560	560	1,401	7,202	48,120
Total	60	109	195	181	334	1,060	1,164	7,459	51,431	1,114,597
Illinois Families										
Federal	9	18	32	35	59	342	288	4,438	35,387	956,727
State..	16	35	58	53	86	167	182	511	2,144	30,292
Local..	31	51	93	102	214	544	544	1,342	6,525	47,250
Total	56	104	183	190	359	1,053	1,014	6,291	44,056	1,034,269

* This income figure is income actually received. It is not suitable as a base for computing the percentage of income paid in taxes. The proper base for a percentage computation is "potential income"—that is, the income that would have been received if the taxes had not existed—, since some of the taxes are in fact paid out of this potential income, not out of income actually received.

This "potential income" varies with the varying assumptions in the different series.

TABLE 25

TOTAL TAX BURDEN, FEDERAL, STATE, AND LOCAL
 BASED ON ASSUMPTIONS IN SERIES I, II, III, IV, AND V
 (In Dollars)

Occupation:	Farmers			Wage Earners		Salaried Merchant Worker		Salaried Worker	Corporation Officials	
	500	1,000	2,000	1,000	2,000	5,000	5,000	20,000	100,000	1,000,000
New York Families										
Series:										
I..	60	109	195	181	334	1,060	1,164	7,459	51,431	1,114,597
II..	79	118	198	150	276	967	1,246	7,679	52,662	1,155,622
III..	79	118	198	150	276	967	1,246	7,679	52,662	1,155,622
IV..	105	163	277	174	324	1,089	1,467	8,075	55,619	1,180,487
V..	60	109	195	181	334	1,060	1,243	8,814	69,972	1,439,551
Illinois Families										
Series:										
I..	56	104	183	190	359	1,053	1,014	6,291	44,056	1,034,269
II..	67	103	163	147	279	915	4,587	6,288	44,341	1,062,966
III..	78	122	197	147	279	990	2,875	7,488	50,341	1,167,966
IV..	84	130	207	166	316	1,006	4,736	6,599	46,334	1,079,997
V..	56	104	183	190	359	1,053	1,104	7,587	63,851	1,336,201

* This income figure is income actually received. It is not suitable as a base for computing the percentage of income paid in taxes. The proper base for a percentage computation is "potential income"—that is, the income that would have been received if the taxes had not existed—, since some of the taxes are in fact paid out of this potential income, not out of income actually received.

DISCUSSION OF ESTIMATES

If the foregoing estimates are taken at their face value, it is apparent that everyone is bearing a substantial burden of taxation. As shown in Table 26, the smallest burden under any conditions is estimated to be 8 per cent of potential income, for one of the Illinois farm families, and the largest exceeds 100 per cent, in the extreme case of a corporation official where the family has an actual income of \$1,000,000 but no steps are taken to distribute the income or property among members of the family in order to lessen income or death taxes. Even in this extreme case, the tax burden is in excess of 100 per cent of potential income only when it is assumed

that the family attempts to keep the family property intact, on the death of the head of the family, through insurance sufficient to cover death taxes.

TABLE 26

TOTAL TAX BURDEN, FEDERAL, STATE, AND LOCAL, AS PERCENTAGE OF POTENTIAL INCOME

Occupation:	Farmers		Wage Earners		Salaried Merchant Worker		Salaried Worker		Corporation Officials	
Income (In Dollars) ^a :	500	1,000	2,000	1,000	2,000	5,000	5,000	20,000	100,000	1,000,000
	New York Families									
Series:										
I.	12.0	10.9	9.8	18.6	17.2	20.8	23.9	31.6	44.3	84.5
II.	15.0	11.4	9.7	15.4	14.2	18.8	24.5	30.6	44.0	83.6
III.	15.0	11.4	9.7	15.4	14.2	18.8	24.5	30.6	44.0	83.6
IV.	19.1	15.3	13.2	17.6	16.4	20.9	27.8	31.9	45.7	84.5
V.	12.0	10.9	9.8	18.6	17.2	20.8	25.6	37.4	60.3	109.1
	Illinois Families									
I.	11.2	10.4	9.2	19.3	18.2	20.5	20.6	27.2	38.4	81.0
II.	12.7	10.0	8.0	15.0	14.2	17.7	52.9	26.5	38.6	79.9
III.	14.6	11.6	9.5	15.0	14.2	18.9	40.7	30.1	41.6	81.4
IV.	15.6	12.4	10.1	16.9	15.9	19.3	54.0	27.7	39.9	80.8
V.	11.2	10.4	9.2	19.3	18.2	20.5	22.4	32.8	55.7	104.6

^a This income figure is income actually received. It is not the base used for computing the percentage of income paid in taxes. The base used for the percentage computations is "potential income"—that is, the income that would have been received if the taxes had not existed—, since some of the taxes are in fact paid out of this potential income, not out of income actually received.

Other assumptions might reduce burdens somewhat, but as long as tax revenues amount to 20 per cent or 25 per cent of the national income,⁷ and the larger part of these revenues comes from other taxes than personal income and death taxes, few citizens can hope to escape with nominal contributions.

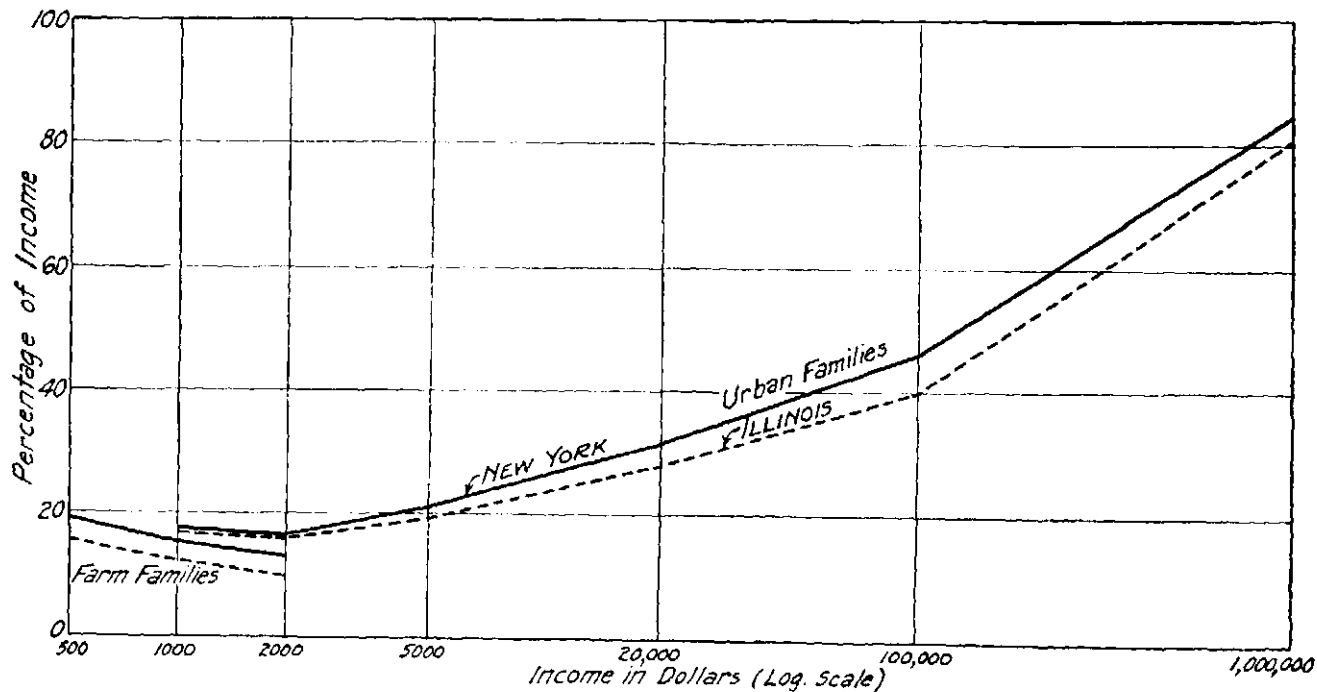
Comparison by Income Classes and Occupations

All the estimates indicate that the tax burden is regressive for those income classes not subject to income and death taxes. This regressivity is largely due to the

⁷ See pp. 3, 67.

CHART 6

TAX BURDEN, PERCENTAGE OF POTENTIAL INCOME PAID IN TAXES,
SERIES IV ASSUMPTIONS^a



^a From Table 26.

assumptions that the ratio of expenditures to income is greater for small incomes than for large incomes and that the rate of assessment is higher for small properties than for large properties. For the higher income groups, whose tax burden is dominated by personal income, corporation income, and death taxes, the burden is definitely progressive.

For families of the same income, the wage earners have a heavier tax burden than the farmers, owing primarily to the higher property taxes in urban areas. If none of the tax on land is capitalized, however, the farmer has a somewhat heavier burden since he has a larger investment in land. For the \$5,000 incomes, the merchant's burden is consistently heavier than the salaried worker's, even when it is assumed that business taxes are entirely shifted, owing to the merchant's larger property holdings and, in consequence, his heavier death taxes. When it is assumed that business taxes are only partly shifted, the difference in the burdens of these two \$5,000 income families becomes very great.

New York Compared with Illinois

In a comparison of the tax burdens in New York and Illinois, the New York burden is shown to be substantially heavier. For the wealthier group, however, the lower federal taxes in New York partly compensate for this difference. The burden of state and local taxes, under the assumptions in Series I, is \$165,000 less for the Illinois taxpayer with a \$1,000,000 income than for the New York taxpayer with an equal income. But the Illinois taxpayer loses \$84,000 of these gains to the federal government. The deduction of state taxes from taxable income in calculating the federal tax means that more than half these state taxes are "burdenless" for those individuals whose income reaches into the upper brackets. That is, if the taxpayer did not have any state

taxes to pay, his federal taxes would increase by more than half the state tax that is here assumed for him. And the poorer individuals who do not gain from this credit bear relatively little more in state and local taxes in New York than in Illinois, the New York system being more highly progressive than the Illinois system.

Results of Changing Assumptions

Comparing the difference in estimated burdens under the different series of assumptions, it is perhaps surprising to find that radical differences in assumptions result in comparatively small changes in burdens in most instances, as shown in Tables 25 and 26. A tax may or may not be shifted from producer to customer or employee; but as long as the same individual serves in all three capacities—as stockholder, consumer, and wage earner—some share of the tax will come his way, and, while his interests will not be equal in these three capacities, some will at least partly counterbalance others.

The assumption that only half, instead of all, the consumption and business property taxes and one-third, instead of all, the payroll tax are shifted to the consumer changes the estimated burden only 1 per cent or less of the potential income in nine of the twenty cases. Only the Illinois merchant who bears half the retailers' occupation tax will find a radical change in his burden (Series II as compared with Series I). The assumption that only one-quarter of the retailers' occupation tax is borne by the merchant, one-quarter being shifted back to the producer, increases the burdens of producers appreciably and brings substantial relief to the merchant (Series III as compared with Series II). The assumption that only half the land tax has been capitalized instead of the entire sum increases everyone's burden, but especially the farmer's (Series IV as compared with Series II).

The New York farmer (except the \$2,000-income farmer) and merchant have their lowest percentage burdens when it is assumed that all the taxes on business property and products are shifted and all the land tax is capitalized (Series I and Series V). The other New York families have their lowest burdens when it is assumed that only half of such taxes are shifted (Series II). In Illinois the farmer with the \$500 income, the merchant, and the corporation official with the \$100,000 income, have their lowest burdens when it is assumed that all taxes on business property and products are shifted and all the land tax is capitalized (Series I). The other Illinois families have their lowest burdens when it is assumed that only half the business property and consumption taxes are shifted (Series II).

The tax burden of the higher income groups rises materially when it is assumed that all the property and income are in the possession of the head of the family and a joint income tax return is made for husband and wife (Series V). Under these conditions the families with \$1,000,000 incomes would be unable to provide adequate insurance to keep their estates intact at death. These families can maintain their estates intact, however, and enjoy a free income of over \$200,000, after allowing for all concealed taxes, simply by dividing the property and income between husband and wife (part of the assumption in Series I). Also, they may reduce their taxes even further by sharing property and income with their children or by transferring part of their property to a personal holding corporation. It is possible for a family to be so wealthy that they cannot under any circumstances, by legitimate means, maintain their estates intact at death under the present tax system, but the *Statistics of Income* record few such cases.

Conclusions

Estimates based on innumerable other assumptions or different combinations of the foregoing assumptions

might be interesting and profitable. Those presented above, however, should be sufficient to indicate the general character of the 1936 tax burden in the two states in question, and, within wide limits, the weight of this burden. The estimates under the different assumptions do not fix upper and lower limits for individuals, or even for the average of the income and occupation groups in question. Keeping the sources of income and the amounts and kinds of expenditure and property constant throughout has set limits on the variations in burden that do not in fact exist. Moreover, when it has been assumed that half of a tax is shifted, it has been assumed that this fraction is shifted in every case. Actually, of course, if exactly half of the entire sales tax were shifted, it might still be true that one merchant was successful in shifting the entire tax while another shifted none at all. No such variation is taken into account.

It seems safe to conclude: first, that the tax system as a whole is regressive for the lower income groups, and distinctly progressive for the upper income groups; second, that the burden of the New York system exceeds that of the Illinois system, but that the weight of the New York system is moderated to an important degree by the resulting reduction in federal taxes for New York citizens; third, that urban tax burdens exceed rural tax burdens; and, fourth, that the large number of taxes that can be shifted have so diffused the burden that it would be practically impossible for any individual to escape a substantial tax burden, even though it would be quite possible to pay no tax directly. The findings of this study are too uncertain to warrant any conclusions beyond these limited generalizations.

Chapter 17

PAST EVENTS AND PRESENT JUSTICE

The mere passage of time makes certain objectives of tax justice harder to achieve. A large part of the tax system of the United States has become affected in this way. Two difficulties are involved. First, it is often impossible to rectify past injustice by reducing present taxes. Second, the imposition of new taxes or higher rates may bring an element of injustice merely because it represents a change in the system.

The first difficulty can be illustrated by the real estate tax. If an injustice was done in the past by some increase in the real estate tax, it may be impossible to rectify it by lowering the tax if the property has meanwhile changed hands.

The second may be illustrated by the excess profits tax. However desirable this tax may appear from many points of view of justice, it may on occasion be harmful to legitimate vested interests.

These points need not be the controlling ones in tax justice. Whoever considers them important, however, will discover that they make the tax system of the United States as it now exists more difficult to improve from the point of view of justice alone.

REDUCTION IN PROPERTY VALUE THROUGH TAX CAPITALIZATION

The Nature of Capitalization

The example just given of the real estate tax involves tax capitalization, a process that depresses real estate

values. Under tax capitalization, taxes that are not payable until future years burden the taxpayer in the present year. The burden is felt in a decrease in the capital value of some piece of property owned by the taxpayer. The decrease is equal to the total of all the expected future taxes on the property—the total, that is, reduced to a present value. The prospective tax payments of all future years are thus said to be “capitalized” into a present amount, which correspondingly depresses the value of the property.

Usually only a part of the tax is capitalized. Indeed, capitalization is a reflection, generally, of a difference between two taxes. It is a part of the higher tax—the part represented by the excess over the lower tax—that is capitalized. Moreover, the amount capitalized always depends on what buyers and sellers think that the future taxes will be, not on what the taxes actually turn out to be. Finally, capitalization may occur before the tax law is passed. The “present” year, the year of capitalization, is the year when the buyers and sellers first become aware of the likelihood of the future taxes. Consequently, capitalization may occur even if the tax is in fact never imposed, if only the likelihood is strong enough.

So long as he does not try to sell his property, the owner may not realize what has happened to its value, for capitalization can of course occur whether he realizes it or not.

If the burden of the prospective taxes is capitalized and thus rests in the present year on the present owner, no further burden develops for him or anyone else in the future years. The same tax cannot be a true burden twice—once in the present year and again in the future years when it becomes due. Whoever owns the taxed property in the future experiences no true burden from the tax at that time, since the burden has all been concentrated on

the one who owned the property when the tax was proposed or enacted.

Capitalization of the Real Estate Tax

Capitalization of prospective taxes is of particular importance in the United States because of the great dependence on the real estate tax. This tax, or at least part of it, is particularly susceptible of capitalization.

The greater part of the United States seems to have passed the "present year" stage, when real estate tax rates are raised and the prospective added burden through future years is capitalized. Instead, the dominant practical issue in property taxation at the moment is rate reduction. The "future years" in the example above have arrived. In order to form an opinion on the justice of a rate reduction, it must be ascertained whether the taxes currently paid by the current owners are a true burden on these owners or whether the current taxes simply represent, in whole or in part, a burden that was borne some time ago by past owners. Thus, although capitalization is essentially an anticipatory adjustment, it has a logical place in a chapter devoted to the influence of the past.

A Hypothetical Example of Capitalization

An extreme hypothetical example may serve to clarify the issue. Suppose that, in addition to the existing real estate tax, a special tax of 2 per cent per year on capital value were levied by the city of New York on all land bordering on Forty-second Street, one of the main cross-town business arteries. Suppose further that the new tax would apparently remain in force indefinitely. Landowners in the area affected would like to raise their rents in order to meet the new tax, but they would probably be unable to do so. If they had already been getting all the land rent that they could, they would not be able to

raise the rent now. Building owners using the land could not pay a higher rent, since they could not demand higher rents from their tenants, because, in turn, the tenants could not raise their sales prices to their customers. The customers could and would buy their goods and services elsewhere, from firms not too far distant from Forty-second Street.

The ultimate result would be more complex. In general, however, the owners of the land would be faced with a perpetually lower net income from their properties, after paying all taxes including the new discriminatory tax. This outlook would correspondingly depress the selling value of the land. The decrease would, of course, be much more than the amount of one year's tax. The whole series of future tax payments would be taken into account by any prospective buyer: the impact of all these future taxes would be compressed into the present moment.

If a piece of land yields \$100,000 a year to its owner, after paying all expenses including taxes, and if the going rate of interest for this kind of investment is 5 per cent, the land will sell for \$2,000,000 (\$100,000 a year equals 5 per cent on this sum); but, if a new non-shiftable, discriminatory tax of \$10,000 a year is levied on the land, the net yield drops to \$90,000 a year, and the selling value—interest still being at 5 per cent—drops to \$1,800,000. The selling value has dropped not by \$10,000, a single year's tax, but by \$200,000, that is, by the whole future series of tax payments discounted at 5 per cent.

Justice under the Hypothetical Example

If the land is, indeed, sold for \$1,800,000 after the new tax has been levied, the new owner cannot logically complain that the special tax is a discriminatory burden on him. The tax has not affected him financially. Had it not been levied, he would have had to pay \$2,000,000 for the

land. Because it was levied, he was able to obtain the land for \$1,800,000. The saving of \$200,000 exactly offsets the burden represented by the new tax—\$10,000 a year.

The new owner would, of course, gain \$200,000, or, in other terms, \$10,000 a year for an indefinite period, if the tax were now removed. Such a gain, however, would be "undeserved." The new owner would be getting something for nothing just as truly as if the city had picked him at random from a street crowd and given him a perpetual annuity of \$10,000 a year.

On the other hand, attention must be given to the unfortunate landholder who was the owner of the property at the time the tax was imposed. In effect, he was burdened by a tax of \$200,000. No longer the owner of the land, he cannot now benefit by elimination of the tax. To rectify the injustice, if there is any, the city must keep the new tax in force, find the former owner of the land, and turn the yield over to him—an unlikely procedure.

Alternative Tax-Free Fields of Investment

The amount of tax capitalization that has occurred under the real estate tax in the United States is highly uncertain. If capitalization is to occur, the tax must discriminate against one particular form of investment. If all property is taxed alike, certain repercussions on the rate of interest, the amount of saving, and the general direction of investment may result,¹ but no capitalization, as that term is used in the present chapter, will occur.

Moreover, if the money from a special tax on special property is spent to benefit the property, little or no net change may occur in its value. For example, if a property tax on a parcel of real estate is \$100, of which \$40

¹ See pp. 64-66.

is spent in such a way as to benefit the property enough to offset the burden of \$40 of the tax, only the remaining \$60 can be capitalized; and, if all other investment opportunities of equal amount are taxed \$25, only \$35 of the \$60 can be capitalized.²

In most parts of the United States, real estate is taxed more heavily than the other chief forms of investment—merchants' inventories, farm animals, shares of stock, bonds, etc. Even allowing for the benefits received by real estate from governmental services,³ some part of the increasing property tax of the past few decades has probably been capitalized and has correspondingly depressed values below the levels they would otherwise have reached. To this extent, the tax now rests as a true burden not on every present owner of real estate, but on two groups of people: (1) such present owners as have continued to hold their properties during the period of rising taxes and (2) former owners who sold after the tax increases had exercised their depressive effect on values.

More capitalization is possible for a tax on land than for a tax on buildings. Land usually wears out slowly or not at all, while buildings must eventually be replaced. Presumably no one will erect a new building to replace an old one unless the consuming market is so strong that rentals will show an indication of covering all costs, including the increased real estate tax. The tax on the new building, then, will tend to be shifted to tenants in the form of higher rentals. To the extent that shifting exists, there is no occasion for capitalization.

Proportion of Old Owners, and Past Stability of Tax Rate

Reduction of the real estate tax may on occasion give a bonus to new owners, but this reduction may be considered necessary in order to treat fairly the old owners

² See Note 1, *Relatively Tax-Free Fields of Investment*, p. 549.

³ See Note 2, *Capitalization, Benefit, and Shifting*, p. 550.

who have held throughout the rising tax period. Thus, unless a way is found to distinguish between old owners and new owners, a lowering of the tax rate may represent justice for one group and something more than justice for another. The longer the tax has been in force at an unchanged rate, the greater the proportion of new owners will be, and the less the pressure, from the point of view of the resting place of the burden, to reduce or abolish the tax.

Data on the degree of stability of property tax rates throughout the past ten years are consequently of interest in a discussion of capitalization. Details presented elsewhere show that there has been no appreciable rise in state property tax rates in many states since 1925, or in the local rates in several large cities over a somewhat shorter period.⁴ Increases in the ratio of assessed valuation to true valuation may have caused a real increase in the burden in some of these cases. On the whole, however, the real estate tax load seems to have been constant or decreasing long enough so that a large proportion of present owners consists of those who have capitalized, in purchasing, much of the present property tax.

Capitalization of Other Taxes

The effects of tax capitalization in the United States have not been thoroughly studied. Scientific discussion of the subject has been confined to the property tax, and even here it has been scanty. Further study might reveal the extent of capitalization in several other taxes, such as the "severance taxes" in some states on the extraction of natural resources, chain store taxes with their depressive effect on the price of chain store securities, some part of the corporation income tax with its depressive effect on corporation shares compared with bonds and

⁴ See the memorandum by Thomas J. Reynolds on state property tax rates in the forthcoming volume, *Studies in Current Tax Problems*, and Note 4, *Fluctuation in Urban Property Tax Rates and Assessed Valuations during the Depression*, p. 525.

with partnership interests, and such high-rate commodity taxes as those on liquor and tobacco, so far as they prevent the manufacturers from expanding to a more profitable size. Moreover, special commodity taxes or service taxes of any kind may result in tax capitalization, with effects on ownership interests. These taxes present a somewhat different problem from a real estate tax, particularly a land tax. Their effects in reducing the volume of sales will be discussed in the following paragraphs.

EFFECT OF SPECIAL TAXES ON VOLUME OF SALES

If a special tax is imposed on a particular commodity, its producers or distributors may have to raise the price so high, in order to get the money to pay the tax, that they meet with stiff resistance from consumers. They may find that unit sales, and perhaps even dollar sales, are seriously curtailed. Some firms may have to go out of business, and all firms will probably be affected to some extent. If the tax is imposed in a period of business improvement, sales may fail to decline, but unit sales will still be less than they would have been without the tax. The restrictive effect is felt not only by the producers and distributors of the taxed commodity but also by others, such as suppliers of raw materials.

The injury resulting from the restrictive effect can be avoided in part if the tax is imposed so gradually that the decrease in consumption is matched by part of the depreciation of capital that would occur anyway. By the time the depreciation has occurred, the investors are on notice not to replace all of the capital in that particular business.

The kind of tax in question here cannot be paid out of existing profits, either because its scope includes firms without profits or because it is too large. It must, there-

fore, be passed on, in whole or in part, to someone else—usually to consumers, through increased prices.

Effect of the Passage of Time

If the tax has been in force for a considerable period of time, its repeal or a reduction in its rate may do little to help the stockholders, creditors, wage earners, etc. who have been injured by its repressive effect. Therefore, no such repeal or reduction may be called for on the grounds of justice.

Two types of firm must be distinguished—those that were driven out of the business completely, and those that have stayed in on a reduced scale of operation. A third class is conceivable—firms that stayed in with sales unaffected by the tax. In practice, however, probably few of this type could be found.

The firms driven out of business are within a short time—perhaps a year or two—beyond help by a repeal or lowering of the tax. The owners and creditors will probably have scrapped, or sold at a heavy loss, the specialized assets, such as certain kinds of store fixtures and machinery. The unspecialized assets, such as warehouses and factory buildings, will have been turned to another use or allowed to deteriorate through abandonment. The special skill of the personnel—financial heads, factory managers, skilled employees, etc.—will not have vanished, but many of these people will have found occupation elsewhere.

As to the firms that have remained in the business, at least two questions are pertinent.

First, has that part of the firm's capital equipment and labor force that was rendered idle by the tax been scrapped or otherwise made unavailable to handle the business that might return under rate reduction or repeal? If the answer is yes, little opportunity exists to rectify past injustices by tax relief. Of course the owners and creditors

would not object to tax relief. Expanded sales might give an additional profit even though new capital had to be raised. Nevertheless, most of the damage would be beyond repair.

Second, has the business changed hands since the tax was imposed? If so, was the price so low that the buyer was clearly assuming that the tax would continue indefinitely? If the answer is yes, the process of tax capitalization has made it impossible to eliminate past injustices simply by reducing the tax.

Effect of Certain Existing Taxes

Practically all the commodity and service taxes levied by the federal government have been in effect uninterruptedly only since 1932. Perhaps tax reduction might yet aid many of the owners, creditors, etc. who were injured by whatever depressive effect on sales the taxes exercised. On the other hand, most of the taxes are at rates that represent less than 5 per cent of the retail price. With rates so low, a marked effect on sales is unlikely.

The three commodity taxes that carry heavy rates are those on cigarettes, spirits, and gasoline. The motor vehicle license tax, also, is substantial.

Taxes on Cigarettes

The federal tax on "small," or "Class A," cigarettes (the usual size) is equivalent to 6 cents on a package of twenty. However, the rate has been unchanged since 1919. Ownership of the largest companies has subsequently changed hands, to a considerable extent, through the sale of shares on the stock exchange. Presumably, the purchasers of cigarette company shares have been buying on the assumption that the tax would not be reduced or repealed. All these factors indicate that in its relation to the present cigarette manufacturing firms, the depressive

effect on sales, although substantial, may perhaps not be considered a just reason for lowering the cigarette tax.

The rate of the cigarette tax is indeed high compared with the rates on some other commodities—cigars, for example. The cigar tax is equivalent to about 4 per cent of the retail price, including tax, while on the same basis the cigarette tax is equivalent to nearly 50 per cent of the retail price. A mere comparison between commodities, however, is misleading from the point of view of justice to the producers and distributors. The persons affected, not the commodities taxed, must form the basis of comparison. Lowering the tax rate might not rectify the injustice in certain parts of the tobacco industry; in other parts it might.

Twenty states now levy taxes on the wholesale or retail sale of cigarettes within their borders, at rates ranging from 1.3 cents to 5 cents a package. Merchants in the taxing state are often affected when the cigarette manufacturers are not, since many smokers curtail their local patronage but purchase in tax-free states or through tax-free channels of interstate commerce. One of the taxes was first imposed in 1936, three in 1935, none in 1934, and one in 1933. Most of them, therefore, have been in force for a period of time that is considerable, from the point of view of the present discussion.

Taxes on Spirits

The federal tax rate on distilled spirits is high compared with most federal commodity tax rates: \$2.00 a proof gallon—that is, \$2.00 on a gallon containing 50 per cent alcohol. It has been in effect since the repeal of prohibition. None of the business that legal producers are now losing because of the tax could have originated before the tax was imposed. The same consideration applies to the spirits taxes levied by so many of the states,

at rates that commonly range from 80 cents to \$1.00 a gallon.

Taxes on Gasoline and Motor Vehicles

To the federal gasoline tax of 1 cent a gallon must be added state taxes ranging from 2 cents (Connecticut, District of Columbia, Missouri, and Rhode Island) to 7 cents (Florida and Tennessee), and, in a few states, county and city taxes. In a sense, however, the high rates may have increased the sale of gasoline instead of tending to decrease it, since most of the gasoline tax revenues have been used to build and maintain highways.

In a similar sense, automobile license taxes may have increased the sale of automobiles, by helping to build highways. The rates are fairly substantial compared with ordinary commodity tax rates. For example, the New York State tax amounts to \$15 a year on a private passenger car weighing 3,000 pounds unladen. Such a car sells for about \$1,000. If it is given a life of seven years, the seven taxes of \$15 each may be discounted at 5 per cent, to give a total present-value tax burden on the new car of \$87, which is 8.7 per cent of the retail price.

Other special taxes are either at rates too low, or of too restricted an application, to justify comment here.

INNOCENT VESTED INTERESTS

The discussion up to this point has related only to proposals to maintain, reduce, or eliminate a tax. Consideration will now be given to proposals to increase a tax or to levy a new tax. The point at issue is the "innocent vested interest" that would be harmed or destroyed.

In general terms, the problem is one of consistency of action on the part of the government. Suppose that those who engage in a given activity have for many years been left untouched by any special tax, and that no indication has been given that any such tax will ever be imposed.

If the government now suddenly reverses its policy and, moreover, claims to base its action primarily on grounds of justice in the distribution of the tax burden, the taxpayer may claim that the government is illogical, and is defeating its own end. If, however, the government's proposal is supported by arguments that do not bear on justice—for example, an assertion that the change will increase the productivity of the economic system—the presence of an innocent vested interest cannot prove the government's position to be illogical. The matter simply becomes one of comparing two or more basically different aims.

Real Estate Tax

In many jurisdictions, innocent vested interests have been built up that would be injured by an increase in the property tax rate. During the past decade most real estate taxpayers have probably had little occasion to expect markedly higher tax rates. A general tendency toward stability in rates has been manifest, with a growing movement toward rate reduction in some states. Consequently, those who have purchased real estate, or, what comes to much the same thing, have refused to sell their holdings, can hardly be accused of improvidence if they have done so on the assumption that tax rates would not rise.

Any increase in the rate would be all the more serious, from the point of view of justice, because of the tendency for at least part of the increase to be capitalized. Capitalization is not, however, so important in the distribution of the burden when the tax rate is unexpectedly increased as it is when the rate unexpectedly decreases.⁵ An unexpected rate decrease discriminates between two groups of property owners: (1) the old owners who have held their property through one or more unexpected rate increases,

⁵ See pp. 241-42.

and (2) the new owners who have bought only after the rate increases and hence have been able to allow for part or all of them in the purchase price. An unexpected rate increase, on the other hand, treats these two groups of owners alike. In so far as property ownership is widespread in the community, the injustice of an unexpected rate increase is considerably mitigated.

Income Tax

If the rate of the personal income tax is raised unexpectedly, no vested interest is disturbed for most taxpayers. However, an investor who has just put some money in a risky venture may claim that a sudden rise in income tax rates to very high levels is unfair. The government does not compensate him if he loses, and it now proposes to take far more of his gains if he wins than he had thought it would when he made his decision. The odds, so to speak, have shifted unexpectedly.

Similarly, an unexpected rise in rates may be relatively hard on the person whose income is irregular. Perhaps he has entered into investments or activities where the gain or fee, though practically certain, is realized in a lump sum at the end of a number of years instead of piecemeal year by year. He is thus forced far up into high surtax rates, except for capital gains under the present federal law. Changes in the definition of taxable income may disturb vested interests—for example, changes in capital gains and losses provisions, and introduction of a tax on undistributed profits. In general, however, the income tax usually has less relation to the vested interest problem than the real estate tax.

Excess Profits Tax and Customs Duties

Aside from the property tax and the income tax, the vested interest problem is of immediate importance in the United States chiefly in connection with the excess

profits tax and the customs duties. Both taxes are liable to sudden and marked change. Both of them raise complex problems of justice in relation to consistency of action.

An excess profits tax is necessarily impersonal, since an "excess" profit is "excess" no matter who gets it.⁶ The resulting conflict with vested interests creates a perplexing problem in justice.

Suppose that investor A puts \$100 into a new concern, that twenty years later his share of the earnings amounts to \$1,000 a year, and that A then sells his share in the business to B for \$20,000. Suppose that an excess profits tax is now unexpectedly imposed on the concern, decreasing the net profits, after taxes, to such an extent that B gets only 2 per cent on his investment instead of the expected 5 per cent. The person who really benefited by the excessiveness of the profit was A, and he escaped the tax entirely because he happened to sell out before anyone suspected that the tax would be introduced. Investor B, on the other hand, is deprived of part of what he regards as his normal and justifiable return of 5 per cent.

If the excess profits tax is being imposed because it will bring certain economic benefits to the community at large or will relieve certain classes from an undue burden that has nothing to do with the existing tax burden, B's complaints may be logically over-ruled. If, on the contrary, the excess profits tax is proposed simply as a means of distributing the existing tax burden more equitably, B has a forceful argument. How forceful it is will depend on the circumstances—for example, the number of present investors of the A type and the number of the B type, and the number of the B type that are really not investors in a long-term sense, but speculators who may be reasonably asked to bear the consequences of shifts in governmental policies as they expect to bear the conse-

⁶ See p. 273.

quences of other unforeseen events. Perhaps a personal element could be injected into the excess profits tax by distinguishing among various owners in the same business, and exempting the profits going to those who purchased their shares within a certain period of time. Such an attempt would of course be out of place if the purpose of the tax were something more than an equitable redistribution of the existing total tax burden.

The present federal excess profits tax can hardly be discussed from any of these viewpoints since it is primarily designed as a check on evasion under the capital stock tax.⁷ The combination of the two taxes is also useful in levying a special tax on unforeseen gains—a matter that does not involve vested interests. If a genuine attempt is made to tax excess profits from monopoly, however, the vested interest problem will have to be faced.

The protective tariff has almost certainly lowered the average standard of living in the country. Nevertheless, few economists wish to see it completely and immediately removed. Partly, their caution arises from fear of the effects of any sudden transition on the productive power of the community. Partly, too, it arises from a desire not to deal too harshly with the large amount of investment that has been built up behind the tariff walls on the assumption that protection would be continued.

Importance of Vested Interests

No one would argue that vested interests, however legitimate, must forever bar changes in the tax system that are desirable either from other points of view of justice or for economic or political reasons. Indeed, the term itself has acquired a connotation of undue assertion, by the few, of highly technical legal rights, at the expense of justice to the many. Almost any tax change will necessarily disturb some vested interest.⁸ The chief prob-

⁷ See Note 9, *Present Excess Profits Tax*, p. 560.

⁸ See Note 3, *Remote Vested Interests*, p. 551.

lem is usually one of choosing among the different interests, and deciding upon the speed of change. From the point of view of tax justice, destroying a vested interest gradually over two generations is a very different matter from destroying it suddenly.

Chapter 18

BENEFIT CHARGES AND TAX JUSTICE

Persons who directly use and benefit from certain governmental services should pay a benefit charge, according to a generally accepted standard of tax justice. A benefit charge directly burdens only the beneficiary: for instance, the fare that a passenger pays on a municipal street-car, or a gasoline tax if the revenue is devoted to highway construction and maintenance.

Benefit charges differ greatly. Some require the direct beneficiaries as a group to cover the entire cost of the service; others require them to cover only part. The cost can be divided among the individual beneficiaries in any one of several ways. In some cases great pressure is put on the direct beneficiary to use the service; in others, he is free to reject the service and the charge that goes with it.

Several classes of benefit charge are common in the United States. They are (1) prices, as when the localities operate street-car systems as a private enterprise would; (2) fees, as when the localities charge for marriage licenses; (3) special assessments, as when the localities charge the real estate owners for laying sidewalks or installing sewers in certain neighborhoods; and (4) benefit taxes, as when the state levies a gasoline tax on all users of the highways. All these are obviously user charges—the cost is paid, at least in part, by the user.

Closely akin to the user charges is something that might be called a "responsibility charge." Thus, the pro-

duction and consumption of liquor can be shown to be responsible for a certain amount of social expense—the expense of law enforcement, for example. A special tax on liquor is therefore sometimes supported on the grounds that those who are responsible for the expense should defray it—the business should “pay its way.” Aside from the liquor tax and certain minor state and local license charges, however, this reasoning has been given little application. Moreover, in practice, no effort has been made in the United States to determine the height of the liquor tax rate by the magnitude of such social expenses.

DIFFERENCES IN WEALTH AND INCOME

Benefit charges express an attitude that existing differences in wealth, income, and opportunity shall be taken for granted. In other words, the distribution of wealth and income is not likely to be greatly changed if the government finances new activities on a benefit basis. According to benefit financing, the user of the service must pay the government for the cost that he causes it by demanding the service. In its extreme form this doctrine assumes that if the would-be user is too poor to meet the cost, he cannot have the service.

If a peddler, for example, is so poor that he is unwilling to pay a license fee charged to cover the cost of regulation, the philosophy of the benefit charge says that he has no place in the business. If a would-be motorist is so poor that he is unwilling to help build and maintain a substantial part of the highway system by contributing revenue through the gasoline tax, he is deprived of the use of the highways. The same can be said about the other chief benefit charges in use in the United States: fares for street railways; charges for municipally supplied water, electricity, and gas; charges for the use of the mails; special assessments; wage taxes to build up reserves for old-age pensions; and perhaps even part of

the real estate tax, in so far as it covers the expense of such items as garbage and ash collection and fire protection.¹ At least a trace of the buying-selling relation that characterizes private trade is always found in a benefit charge: to get the thing, the user must pay for it, or at least for part of it.

In so far as a governmental activity is not financed by benefit charges, the result is a tendency to change the distribution of wealth and income. The distribution is changed, that is, from what it would be if the government did not undertake the activity. For example, the greater part of elementary education in the United States is not financed by direct benefit charges. The distribution of wealth, income, and opportunity is therefore different from what it would be if elementary education were left to private business and so were financed by fees based chiefly on the cost that each pupil causes.²

If the benefit charge is not used, the economic gaps between groups in the community may widen as well as narrow. In other words the distribution may be from the poor to the rich, through taxation of the poor to support services rendered to the rich. For some services, a change in distribution is likely to occur because of the technical impossibility of allocating benefit or cost. For example, the cost of most of the police force cannot, for technical reasons, be allocated among the beneficiaries of this service on the basis of cost caused.

BENEFIT CHARGES IN THE EXISTING SYSTEM

A relatively small part of the present expenditures of the federal government is financed by benefit charges. The postal revenues, totalling between \$600,000,000 and \$700,000,000 a year,³ are the most important example.

Some advocates of the recently imposed federal gaso-

¹ See Note 1, *Minor Examples of Benefit Taxation and Non-Benefit Earmarking*, p. 552.

² See p. 206.

³ *Annual Report of the Postmaster General, Fiscal Year Ended June 30, 1935*, p. xi.

line tax support it on the ground that the federal government spends an equal or greater amount on highways. Thus, the persons who bear the burden of the gasoline tax are given a special benefit in return. A similar argument has been offered for the federal manufacturers' excises on the production of automobiles, tires and tubes, accessories, and lubricating oil. The federal gasoline tax, at 1 cent a gallon, produces much more revenue than the other automobile excises combined. In the fiscal year 1936, the former produced \$177,000,000, compared with the latter's \$122,000,000.

In the future, if the existing social security law remains in effect, the taxes on employees and on payrolls to finance the contributory old-age pension plan will be substantial benefit charges.

The state governments are getting \$1,000,000,000, or more than one-third of their annual revenues, from taxes that are levied as benefit charges—the gasoline tax and the motor vehicle license taxes. About 18 per cent of the gasoline tax revenues in 1935 and 12 per cent of the motor vehicle tax revenues in the same year, however, were used for other than street or highway purposes.⁴ The only other benefit charge of importance as a state revenue is the unemployment compensation taxes in force at the end of 1936 in about two-thirds of the states.

The local governments, in contrast with the federal and state governments, obtain an appreciable amount of money from regularly recurring revenue other than taxes.

The ninety-four cities having a population of over 100,000 reported for the fiscal year 1934 a total revenue of \$2,700,000,000. Ten per cent of this amount came from the earnings of public service enterprises, and another 6 per cent from interest, rents, highway privileges, and

⁴ These figures are derived from two statements issued by the Department of Agriculture, Bureau of Public Roads: *Disposition of State Motor-Fuel Tax Receipts, 1935*, issued November 9, 1936; and *Disposition of State Motor-Vehicle Receipts, 1935*, issued November 9, 1936.

earnings of general departments.⁵ This latter group of revenues is also important to state governments and to other local units.⁶

Special assessments are levied on real estate to defray certain types of expenditure that tend to enhance the value of real estate in a given area. At times they have been of major importance, especially in city and special district financing. Lately, however, this method of financing has played a distinctly minor role, at least in large cities. In 1934 the same ninety-four cities noted above collected only 2 per cent of their revenues from special assessments.

The most important benefit charge, from the point of view of total revenue, is probably that part of the local real estate tax that can be justified on a benefit basis, but no data are available to indicate its size for the country as a whole.⁷

Some of the proponents of the corporation income tax look upon it as a sort of benefit tax, though not so specifically linked to benefits as the charges just noted. The government grants the favor of incorporation, and it maintains by its authority the framework of an orderly business life within which the corporation works. The corporation income tax, the argument runs, merely gives the government its due compensation for these services.

This point of view is exemplified by the New York State tax law. Corporation profits are taxed at 6 per cent and, with unimportant exceptions, dividends received from taxed corporations are not exempt from the personal income tax. The federal Revenue Act of 1936 made dividends subject to the normal tax for the first time. In

⁵ Department of Commerce, Bureau of the Census, *Financial Statistics of City Governments: 1934*, Processed Press Release of November 27, 1935, p. 1.

⁶ Department of Commerce, Bureau of the Census, *Financial Statistics of State and Local Governments: 1932*, Table 1, p. 7.

⁷ See Edwin H. Spengler, "Is the Real Estate Tax a Benefit Tax," Memorandum Number Five, *Report of the New York State Commission for the Revision of the Tax Laws: Submitted February 15, 1932*, Legislative Document (1932) No. 77.

view of the confusion of issues with the undistributed profits tax, it is not clear that Congress has definitely decided to regard the normal corporation income tax as an impersonal tax rather than a means of complementing the personal income tax.⁹ Because of the extremely general nature of the benefit that is involved, the corporation tax as a benefit tax will not be further analyzed in this chapter.

Extent to Which Cost Is Covered by the Charge

Benefit charges in the United States today fall between two extremes. At one extreme is the purchase-and-sale relation of private business. At the other is the lack of direct connection between payment and service that characterizes the major part of governmental activities.

To find out how near to either extreme any particular charge lies, it is pertinent to ask: does the revenue collected equal the amount that the government spends on the service? If income equals outgo, the activity as a whole is, superficially, close to being on a business basis. If income greatly exceeds outgo, the so-called benefit charge is really in part a general tax. If income falls far short of outgo, the deficit part of the expenditure must be deemed a matter of such general public interest that it can be charged against the general tax fund.

Judged by this test, most of the major types of benefit charge in the United States either are not fully on a business basis—for example, the automotive taxes in the states—or are on a basis not clearly defined as yet—for example, the taxes in the Social Security Act.

Highway Taxes

The federal government's revenue from the gasoline tax equalled 75 per cent of the total federal-aid highway expenditures (regular aid, plus emergency and public

⁹ See pp. 306-7.

works aid) in the fiscal year 1933, increased to 90 per cent in 1934, and dropped to 58 per cent in 1935. If the excises on lubricating oil, tires and tubes, automobiles, and parts and accessories are added, the percentages become, respectively, 105, 133, and 96.⁹ Over the past decade as a whole, federal automotive taxes of all kinds have fallen far short of federal highway expenditures. The discrepancy is justified by some observers on grounds of national defense, postal use, and work relief.

The element of general public interest in federal highway construction cannot be isolated from the individual benefit element. It is not as if so many miles of highway, costing so much, were clearly to be paid for on a business basis, while another stretch, with its own definite cost, was clearly chargeable in full to national defense. Not even the work relief element can be isolated. Every mile of highway that the government has built in the past few years probably obviated some unemployment that might have called for work relief.

In 1929 in several states, state revenues from the gasoline tax and the motor vehicle license tax were covering all highway expenditures by the state road department. The distinction between state highways and local highways is, however, somewhat artificial. Some states were in addition giving money to local units to spend on local roads. From a broad point of view, therefore, the state and local roads may be considered together, and state and local benefit charges may be considered together. In 1929 current state and local benefit charges for highways outside cities were covering only about half the current construction and maintenance costs of such highways, but this proportion would be materially increased by regarding part of the rural real estate tax as a benefit road tax. Adding federal aid for highways to the receipts does not change the percentage greatly. The proportion

⁹ *Federal Aid for Highways*, 74 Cong., 1 sess., Senate Report No. 1976, p. 14.

varied from state to state, but in no state did motor tax receipts equal or exceed the state and local expenditures on rural highways.¹⁰

The situation has of course changed somewhat since 1929. State and local highway expenditures were cut during the depression. Moreover, as noted above,¹¹ in some states part of the revenues from the state gasoline tax or the motor vehicle tax have been formally allocated—"diverted"—to some non-highway fund, such as the general fund or the education fund. Even in these states, however, no real diversion exists if total state and local highway expenditures, minus federal aid for highways, are greater than total highway benefit taxes, including those diverted revenues.

Some special business taxes and special license taxes on motor vehicles not used for pleasure have been developed in recent years in several states. These are sometimes levied at high rates, but the aggregate revenue is apparently still small.¹²

Postal Charges

The Post Office Department as a whole is run either at an appreciable loss or without loss, depending on whether certain controversial items are included or excluded from the total expenses properly chargeable against the sale of stamps. At least some of the expenses, such as those incurred in the free carriage of mail matter for Congress and all other governmental agencies, reading matter for the blind, and newspapers for delivery within the county of publication, appear logically chargeable against taxpayers in general, not against purchasers of stamps. Even if the two groups of people are

¹⁰ "Report of the Committee of the National Tax Association on Taxation of Motor Vehicle Transportation," *Proceedings of the . . . National Tax Association*, 1930, pp. 138-43.

¹¹ See p. 258.

¹² See Note 2, *Special Minor Highway Taxes*, p. 553.

almost identical, the burden is of course distributed differently.

Old-Age Benefit Taxes

The federal old-age benefit payments are being financed by two "taxes with respect to employment." Whether the old-age benefits are in fact being fully financed on a benefit-charge basis depends upon at least two important factors. First, does the burden of both taxes really fall upon the employees who eventually get the benefit? Second, will the revenue from the taxes actually be adequate?

One of the taxes is legally levied on the employee ("income tax on employees"), and the other is legally levied on the employer ("excise tax on employers"). In both taxes, however, the employer is responsible for the payment to the government. The only difference is that in the employees' tax the employer can deduct the tax from the wage, while in the other tax he cannot. He may, of course, set the wage at a lower level than he would have done if no tax had been levied. In many cases he will not be able to pay his "excise tax" out of his existing profits and will have to get the money from consumers by charging higher prices, or from suppliers by paying lower prices, or from employees by lowering wages. In the absence of special study on the allocation of the burden of this tax, no definite statement can be made.

The taxes apply to wages paid after December 31, 1936, and mount gradually from a combined rate of 2 per cent in 1937, 1938, and 1939 to a combined rate of 6 per cent in 1949 and thereafter. In each year the rate is equally divided between the employees' tax and the employers' tax. Uncertainty of course exists on the adequacy of these rates. They are expected to build up a reserve fund so large that the interest from it, together with the annual yield of the two taxes, can meet the benefit payments specified in the law. If the amount thus obtained is in-

sufficient, the present law requires Congress to make up the balance from some other source. The amount of the old-age benefit payments is not made dependent on the amount of money received from the two taxes. Indeed, the proceeds of the taxes are not specifically pledged to the old-age fund at all, but no doubt exists, of course, that they were enacted with the fund in mind.

The "old-age benefits" must be sharply distinguished from the "old-age assistance" payments. The latter are made by the states with the help of federal money, and they presumably go only to needy persons. Like relief payments in general, the old-age assistance payments cannot, by their nature, be financed on a benefit-charge basis. If the beneficiaries were able to defray the cost, they would not need the payments. The federal government has made no special provision at all for financing its share of the assistance payments. It may be able to meet a considerable part of the charge by borrowing from the reserve fund built up for the old-age benefit plan.

Unemployment Compensation Taxes

The unemployment compensation plan provided by the Social Security Act is even more uncertain than the old-age benefit plan in its benefit-charge aspects. The federal "tax on employers of eight or more" levied by the act is based on payrolls. Before allowing for the credit to be noted below, it rises from 1 per cent in 1936 to 3 per cent in 1938. None of the money, however, will be used to make unemployment compensation payments.

The chief purpose of the tax is to induce states to levy similar taxes. To this end, the law allows such state taxes as a credit against the federal tax otherwise due, with certain limitations. For business depressions as severe as the recent one the funds that can be raised by the state taxes will almost certainly prove inadequate for

even the unemployment relief load, to say nothing of the total unemployment load, including those unemployed who are not in need of relief.

Special Assessments

A local special assessment may sometimes be large enough to cover the cost of special benefit projects such as the laying of a sidewalk or the lighting of streets. In some cities, however, as in New York City, a certain improvement may be financed only in part by a special assessment on the property in the specially defined benefit area. The rest of the cost will be met by an addition to the real estate tax rate applicable to all the property in the borough or the city. The assumption is that the special benefit element is covered by the special assessment, and the element of general public benefit by the general rate increase.

In recent years many local improvements of a kind that often stimulate local land values seem to have been financed entirely without the aid of special assessments—mainly by federal grants and federal loans.

Real Estate Tax and Miscellaneous Fees

The local real estate tax bears an interesting relation to such services as garbage and ash collection and other local services that give some sort of special measurable benefit. The revenue from the local real estate tax alone is probably more than large enough in almost all the communities in the United States to cover the total cost of garbage and ash collection, sewer service, and fire protection. It is doubtful whether the revenue in some communities is large enough to cover also the cost of police protection and other services that some observers think are of measurable special benefit. Opinion differs whether these services can be logically financed by a particular kind of tax, or whether, on the contrary, they are more

like the services of a battleship, which cannot be allocated.¹³

Local prices and fees, from the scattered evidence available, are not far from covering the cost of the services in question, but practice varies widely from one part of the country to another.

In summary, the revenue system of the United States—federal, state, and local—reveals relatively few instances where a certain kind of governmental service is paid for wholly by the particular group of persons whom the service is supposed primarily to benefit.

The Distribution of Benefit Charges among Members of the Benefited Group

Another question may be asked in comparing benefit charges with the purchase-and-sale relation of private business. How is the benefit charge distributed among members of the benefited group? If a benefited group has been found, and if part of or all the cost of the service is to be covered by a special charge on the group, some principles must be devised to determine how much one member of the group shall pay compared with another.

Postal Charges

In a way, the question is simply a refinement of that discussed above.¹⁴ For example, the postal service as a whole is practically self-supporting. Whether it is really run on a benefit basis, however, depends on whether each of the sub-activities—the first-class mail, the second-class mail, and so on—is supported on this basis. Official data indicate that they are not. First-class mail paid \$109,000,000 more than enough to cover its estimated share of the cost in the fiscal year 1935. The estimate is, however, very uncertain because of the difficulties of al-

¹³ See Note 3, *Development of the Benefit Theory in Property Taxation*, p. 553.

¹⁴ See p. 260.

locating certain costs.¹⁵ The deficits shown were as follows: second-class mail, \$86,000,000; third-class mail and fourth-class mail, each, \$21,000,000; foreign mail, \$33,000,000; special services, \$13,000,000; and penalty and franked mail, also \$13,000,000.

To what extent the users of the various classes constitute different groups is not known. In any event, some important economic problems are raised by the encouragement of certain forms of activity (for instance, newspaper publishing) and the discouragement of others (for instance, certain kinds of direct-advertising campaigns).

Automotive Benefit Charges

The other benefit-charge items show no such clear departure from the benefit-charge basis. For some of them no comprehensive attempt to split up the total cost among the various sub-services has been made. Although highway engineers, for example, have carefully studied the relative part of total highway costs that can be attributed to various types of truck, bus, and pleasure vehicle, no statement for the country as a whole shows how the costs caused by a particular type of vehicle compare with the revenues received from the vehicles of that type.

The gasoline tax is the major highway charge. It is only a partially accurate instrument for distributing burden on a cost-causing basis. Fuel consumption, within certain ranges, increases at a slower rate than speed, and wear and tear on the road may increase faster than speed. Therefore, fuel consumption and gasoline tax paid may increase at a slower rate than the wear and tear on the road. Fuel consumption also may not keep pace with the damage caused by an increase in weight, and it fails to take adequate account of differences in tire equipment.

¹⁵ *Annual Report of the Postmaster General, Fiscal Year Ended June 30, 1935*, pp. 102-4.

In addition, much of the highway construction is to accommodate the occasional driver, who is responsible for the peak loads on week-ends and holidays, and who pays little gasoline tax in the course of a year.

The gasoline tax alone, therefore, cannot distribute highway costs in proportion to the responsibility for them. Most of the states supplement it by a substantial annual motor vehicle registration tax. Under this tax the amount payable depends not on mileage but usually on gross weight (weight of vehicle plus weight of estimated or actual load). Some states use net weight or horse-power.

The federal excise taxes on producers of automobiles, tires and tubes, etc. are not very helpful in distributing highway costs on a cost-caused basis.¹⁶

Other Benefit Charges

The amount of cost caused by each beneficiary is of course easy to discover when the cost consists of money payments made directly to the beneficiaries. From this point of view, the old-age benefit plans present no such problem as the gasoline tax and the motor vehicle tax. The last two taxes must be studied carefully to determine how well they measure each aspect of wear and tear on the highway.

The results of the federal unemployment compensation legislation depend upon the response of the states to the pressure put upon them by the federal general-fund tax of 3 per cent on payrolls.

Special assessment practice varies considerably in its details from one locality to another, but, in principle, the allocation is to be made on the basis of relative benefit as measured by increase in property values.

¹⁶ See Note 4, *Federal Automotive Excises as Distributors of Benefit Taxation on a Cost-Caused Basis*, p. 554.

The Degree of Compulsion on the Beneficiary

The degree of compulsion that is exercised on the so-called beneficiary to accept the service and pay the share of the cost allocated to him is another important question. If the amount demanded by the government is no more than the cost of the service, the government is at first sight not levying a general tax. However, if the beneficiary does not want the service—indeed, might pay something to avoid receiving it—the tax must seem to him as much a general charge as his income tax. Superficially, the transaction may be on a business basis. From the beneficiary's point of view, it is not.

Various degrees of compulsion are found in benefit charges. Frequently the compulsion is like that exercised in collecting general taxes. A property owner who finds himself in a minority cannot refuse to take the service and thus avoid a special assessment voted by the majority. He must pay his share or forfeit his property. The same lack of option to the individual is to be found under the property tax. Any one property owner must accept and pay for the garbage collection service, for instance, whether he wants it or not. The old-age benefit plan, too, gives as little option as the special assessment. A large majority may not wish to save for their old age, but their alternative is to give up their jobs and seek employment in some activity that is not covered by the Social Security Act.

The highway taxes offer somewhat more freedom of choice since no one need pay them if he stays off the highways. In a broader sense, however, it is doubtful whether anyone escapes all of either of these taxes. Everyone must buy clothes, food, and shelter that have been transported in whole or in part in trucks that have paid highway taxes. The taxes must usually be shifted

—to consumers or others—if the business concerns are to continue to function.

The Post Office charges are about on the same level of compulsion as the highway taxes. Both of them represent compulsion similar to that exercised by a private monopolist of a widely used commodity or service. So do many of the local fees (for example, the marriage license fee, court fees) and prices (for example, charges for government-supplied electricity and water).

Chapter 19

TAXATION OF SOCIALLY UNDESIRABLE GAINS

Special taxes are commonly advocated on gains derived by methods that violate prevailing standards of economic morality.¹ Outstanding examples are unexpected gains (windfalls) and monopoly profits.

The present tax system in the United States places relatively little emphasis on this source of gain.

The federal Revenue Act of 1936 imposes a tax on "unjust enrichment." This is aimed chiefly at business firms that profited from the decision of the Supreme Court that held the Agricultural Adjustment Act invalid. The "unjust enrichment" taxed by the act is that of firms that got more gross receipts than they otherwise would have, by including a processing tax in their selling price, and then avoided the expense of the tax either by not paying it, or by getting a refund or credit from the government, or by being reimbursed for the tax (when it was removed) by vendors who had passed it on to these firms.

The existing federal "excess profits tax" was designed primarily to prevent evasion of the capital stock tax.²

The Vinson Act of 1934 requires contractors or subcontractors to relinquish to the federal government any profit in excess of 10 per cent of the total price in any contract over \$10,000 for constructing naval vessels or aircraft, or parts for them.

Under the Gold Reserve Act of 1934, the federal government was able to obtain devaluation profits by taking gold from private hands and paying for it in non-redeem-

¹ See Note 1, *Economic Implications of Taxes on Excess Profits, etc.*, p. 555.

² See Note 9, *Present Excess Profits Tax*, p. 560.

able money. This procedure, although equivalent in many respects to a 100 per cent tax on the profits from gold devaluation that would otherwise have accrued to private interests, is not usually thought of as a tax.

The Silver Purchase Act of 1934 imposed a "transfer tax" on all transfers of silver bullion, the amount of the tax being 50 per cent of the profit on the transaction. The purpose was to prevent speculators from benefiting greatly from the change in the government's silver buying policy.

Like the federal government, the states have refrained from basing taxation to any large degree on the moral implications of income. Local governments have also rejected proposals for such special taxes as the land increment tax and the single tax on land rent.

Nevertheless, a detailed examination of the problem is advisable—especially because of the effectiveness of the federal excess profits and war profits taxes during the World War, at least in raising revenue,³ and because of the growing discussion of monopoly profits.

Some gains that have been generally considered undesirable from society's point of view have not been the object of agitation for special taxes. Little sentiment exists for special taxation of gains from illicit operations, such as illegal manufacture and sale of liquor, burglary, kidnaping, and prostitution. Receipts from these sources are taxable under the ordinary income tax. Perhaps a special tax on such activities would be considered too clear a confession of failure to suppress them more directly. Moreover, the illicit income is subject to fines and other penalties. Aside from occasional taxes on pari-mutuels, no special tax is levied on gains from pure chance, such as gambling gains and the discovery of property lost by others. Whatever the explanation, the proposals for, and enactments of, special taxes on socially

³ See p. 29.

undesirable gain have been confined almost entirely to excess profits on business capital and to landed property and income.

CHARACTERISTICS OF TAXES ON SOCIALLY UNDESIRABLE GAINS

All the taxes of this kind have at least two characteristics that distinguish them from the usual type of income tax.

Impersonality

The most striking characteristic is impersonality. In contrast with the personal income tax, the death taxes, and the gift tax, the amount of the tax on socially undesirable gains is determined without regard to the personal situation of the taxpayer. He may be rich or poor, possessed of a large family or none at all, inclined to charity or addicted to dissipation—the tax is the same. Apparent exceptions, such as the failure of Great Britain and the United States to tax the excess profits of farmers during the war, must be attributed to administrative and political influences.⁴

The basic reason for impersonality is that the income or property in question should not be allowed to get into private hands, no matter whose hands. Another reason, sometimes, is that the gain came with little effort or sacrifice. If it was thus "unearned" in a true sense, the argument runs, it can be surrendered in taxes with little sacrifice, no matter who the taxpayer may be. However, as the discussion below will indicate, this reason may call for a somewhat less impersonal tax than the other.

⁴ For excess profits taxation in war-time, see T. S. Adams, "Should the Excess Profits Tax Be Repealed?" *Quarterly Journal of Economics*, XXXV (May 1921), 363-93; Robert Murray Haig, *The Taxation of Excess Profits in Great Britain, A Study of the British Excess Profits Duty in Relation to the Problem of Excess Profits Taxation in the United States: The American Economic Review*, X, No. 4, Supplement (December 1920) (hereafter cited as Haig, *Taxation of Excess Profits in Great Britain*); Sir Josiah Stamp, *Taxation During the War*, pp. 146-212.

Restriction to Gains from Capital

The other distinguishing characteristic of these taxes is that they apply almost wholly to income from capital, not to salaries, fees, and other income from personal services.

The reason for restricting the tax to income from capital is obvious in the case of special taxes on land—the single tax and the land increment tax. It is not so obvious in the case of the excess profits tax. The explanation may be that its practical application on a wide scale originated during the World War. At that time the governments had to heed the popular protest against firms that were making profits to which they were thought to have no moral right. The special taxation of "excess" was thus directed toward income from business capital. Great Britain exempted professional men from its excess profits tax. Crude attempts in the United States to apply the profits tax to incomes from fees and salaries revealed how unfitted the prevailing conception of excess was for this purpose.

THE CONCEPT, EXCESS

Matters of administrative technique, revenue yield, etc., important though they are, only tend to confuse the issues until the term "excess" is defined. Some of the more vexing problems that are labeled "administrative" are often really basic problems of tax justice. The concept, excess, is a curious one because it is so appealing at first and then so stubbornly resists analysis. Almost everyone thinks he can say off-hand what he means by an excess profit, but if he is asked to be specific he is apt to become badly confused. The idea has shown so much vitality in theory and practice that it must have something substantial behind it, but careful searching is needed if this is to be isolated and judged.

Just Price

The excess profits tax theory concedes that, up to a certain point, profits from any business transaction are not excessive. In this respect the special taxation of excess can be distinguished from the special taxation of land increment or, under the single tax, land rent. In the last two cases the test is based on kind rather than amount. To some extent the point at which profits become excessive is dependent upon the prices charged by the taxable concern for its products. The excess profits tax is therefore directly related to the problem of the "just price," which has a long and involved history.

Excess profits taxation is in some ways an alternative to price fixing. Whether it is more desirable will depend upon the particular kind of transaction in question. The argument for price fixing may be the stronger if the transaction is one in which the government is the purchaser, since it can readily fix the price in this instance. Otherwise, effective price fixing may be impossible. If it is possible, a necessity may arise for rationing the existing supply among consumers.⁵ The factors that should guide the choice between the fixing of maximum prices and an excess profits tax deserve more consideration, however, than can be given to them here.

Sometimes an excess profits tax may be used to complement the government's policy of price fixing. For example, if rate regulation of public service corporations proves too inflexible to prevent undue profits, an excess profits tax may be useful. The recent suggestion by the Secretary of Agriculture that a special processing tax be levied on sugar refiners, who were said to be benefiting unduly from the sugar quota system, is another case in point.⁶ Possibly an excess profits tax would also serve to complement patent and copyright grants.

⁵ See Note 1, *Excess Profits Taxation as an Alternative to Rationing*, p. 556.

⁶ *New York Times*, January 14, 1937.

Monopoly

In practically all discussions of excess profits it is said or implied that monopoly is the basic cause. The term "monopoly" is not usually restricted to the extreme case of absolute control by one concern of the supply of an article or service. It refers rather to the exercise of enough control over supply to set higher prices and reap higher profits than are needed to induce production. "Imperfect competition" is in some ways a better term to use, but "monopoly" still carries to the general reader more of the connotations needed in the present discussion.

Sources of Monopoly Powers

Monopoly powers or imperfect competition of course has many different sources. Some are the result of a government grant, with no regulation or imperfect regulation of prices charged. Others arise from large-scale production and the division of labor (as in the production of automobiles), the cost of transportation (as in the cement industry), the ownership of natural resources (for example, the aluminum industry), and differentiation of product through trade-mark advertising (for example, the cigarette industry). Sometimes monopoly powers arise from temporary shortages of certain commodities, such as those caused by the huge demands unleashed by war, when such gains as they may produce are called "war profits."⁷

The lack of competition is sometimes due to the deliberate efforts of a monopolist; sometimes, on the other hand, to factors over which the monopolist had no control. A rapid rise in prices will find some dealers, by chance, more fortunately situated than others. The difference between anticipated monopoly and unanticipated

⁷ See Note 3, *War Profits Taxation*, p. 556.

monopoly may have some bearing on the kind of excess profits tax that should be levied.⁸

Monopoly Powers and Monopoly Profits

Monopoly powers, however, do not always result in excess profits. Sometimes all they can do is to prevent heavy losses from competition. These losses may occur in industries where much of the expense (for example, depreciation) does not represent a current drain on cash, and, therefore, a temptation exists to cut prices below the long-term cost level.

Co-operative control of output through trade associations, price leadership, sharing of the market, stabilization of prices, price discrimination—these and other practices, obviously widespread, involve monopoly powers. These activities may produce few or no monopoly profits recognizable as such by the casual observer. The benefits to the firms may take the form, not of excess profit, but of normal profit on excess capacity. Another possible result is a higher average profit over the term of a business cycle without an apparent excessive profit during any one period.⁹

The obvious existence of monopoly power, therefore, does not inevitably mean that monopoly profits exist on a scale wide enough to make an attempt at excess profits taxation advisable. Direct data on the extent of monopoly profits would be helpful, but, unfortunately, few are available.¹⁰

The relations between excess profits and "just price" and monopoly may help with the problems of policy that are faced in drafting an excess profits tax law. For example, the absence of a dividing line between excess

⁸ See p. 280.

⁹ The statements on pp. 276-77 above are based largely on a memorandum by C. Lowell Harriss on monopoly profits and taxation.

¹⁰ *Ibid.*

profits and non-excess profits will not be a deterrent. The lack of a definition of free competition has not deterred attacks on monopoly. The monopoly aspects of excess profits will not be the sole guide-post in the drafting and application of the law, but they will exercise great influence. For another thing, not all that is commonly regarded as monopoly will be subject to an excess profits tax. The prospector or the patentee, for example, may have a compelling argument for exempting part or all of his monopolistic profits.

THE DEFINITION OF EXCESS PROFITS

Scope of Business Unit Taxable

Combination of Different Kinds of Business

Suppose that a certain individual owns and operates two businesses, a grocery store and a printing establishment, and that the grocery store is losing money while the printing establishment yields monopoly profits. If an excess profits tax is applied collectively to the businesses of this particular individual, the losses of one business tend to offset the high profits of the other, and no tax may be due. If the tax is applied to each business separately, however, the printing establishment pays a tax.

The usual solution of this situation, at least in principle, is to tax each business separately. If monopoly profits are to be specially taxed because they represent socially undesirable income, the fact that the beneficiary of the monopoly is losing money in some other venture seems beside the point. The same problem exists and the same solution applies if the taxpayer is a large corporation that conducts complex and interlocking enterprises of which some are monopolies and some are not.

Excess profits tax laws, however—at least in the United States and Great Britain—, have paid little atten-

tion to the separation of monopoly elements from non-monopoly elements within the same ownership. Whether drafters of future excess profits tax laws find it one of their major tasks will depend upon how generally the kinds of business—or kinds of transaction, to be more strict—that yield monopoly profits are found in close association with other kinds of business. Only further research can ascertain the importance of this particular problem.¹¹

Combination of Business Assets and Non-Business Assets

When the assets of an enterprise include a greater amount of cash or securities than the business requires, a similar set of problems arises. The income from cash and securities is almost always well below the normal profit percentage allowed by an excess profits tax law. The rate of profit for the enterprise as a whole is thus lowered, and it pays a smaller excess profits tax, or none at all. The effect is accentuated if the rates of the tax are graduated in accordance with the rate of profit.

Many enterprises can utilize this method of avoiding the tax. Profits can be invested in low-yielding securities in the name of the business instead of being distributed to owners who would normally invest them in a like manner. The enterprise may even borrow in order to buy such assets if the excess profits tax counts borrowed money as part of invested capital.¹²

To prevent this kind of tax avoidance the excess profits tax must refuse to recognize as part of the business unit any assets not needed in conducting the business. The administrative difficulties caused by attempting to draw such a distinction are considerable. They are especially troublesome when the business is unincorporated and the sole proprietor or the partners are accustomed to

¹¹ See Note 4, *Separate Businesses under Single Ownership*, p. 557.

¹² See pp. 280-81.

merging their personal and business bank accounts, brokerage accounts, etc. After attempting for a while to include proprietorships and partnerships in the scope of the war-time excess profits tax, the United States restricted it to corporations.

Unanticipated Gains

If the excess profits tax is aimed primarily at "wind-fall" gains, particularly those from inflation, different considerations may influence the lawmakers. Inflation may cause an individual to lose money on balance, even though it benefits some of his enterprises. The legislator must decide whether he is more concerned over the net status of the individual, or over the fact that above-normal profits are being made in certain branches of business, necessarily at someone's expense.

Capital Entitled to Only a Fixed Return

When a business unit is financed partly by creditors or preferred stockholders, analogous perplexities arise. These contributors of capital are entitled to a fixed return only. Shall the return on the proprietors' capital, or, in a corporation, the return on the common stockholders' shares, be combined with these fixed returns of creditors and preferred stockholders when the rate of profit of the business unit as a whole is being determined?

If the proprietors are making an excessive profit on their own capital contribution, considered separately, a merging of their proceeds with those of the creditors and preferred stockholders will pull down the average rate of profit subject to tax, and the excess profits tax will be reduced or wholly avoided.

Here again the degree of impersonality desired in an excess profits tax must be the guide. Complete impersonality requires that no account shall be taken of the differences between creditor and owner. It therefore requires

that the excess profits tax shall apply to profits before interest is deducted, in contrast with the income tax, and also before preferred dividends are deducted. Correspondingly, the invested capital against which the business income is measured will include contributions by creditors and preferred stockholders.¹³

If the chief purpose of the tax is to obtain a portion of the monopoly profits for the government, the entire amount of invested capital, no matter who the contributors are, is the significant factor. If, however, inflation gains are the chief point of attack, impersonality in applying the tax may not be the governing consideration.¹⁴ The case for counting only the rate of return on the proprietors', or common stockholders', capital is strengthened. Common stockholders who make handsome percentage gains by holding a thin equity during inflation may then be taxed accordingly, without regard to the moderate average percentage return of all capital contributors to the firm.

In any event the method followed during the World War in Great Britain and in the United States was illogical. The rate of return for tax purposes was influenced by the return on preferred stockholders' capital but not by the return on creditors' capital. This equivocation sometimes had disturbing consequences.¹⁵

Scope of Unit versus Capital Entitled to Only a Fixed Return

If the excessiveness of the profit is ascertained by considering only the return on the proprietorship, or common stock, interest, puzzling problems may arise over the scope of the business.

A concern with \$1,000,000 in ordinary business assets

¹³ See Note 5, *Excluding from Invested Capital All Capital with a Fixed Return*, p. 555.

¹⁴ See p. 280.

¹⁵ See Note 6, *Disturbing Consequences of Distinguishing between Various Types of Fixed-Income Capital*, p. 558.

and \$500,000 in securities that are obviously unnecessary for the business will be taxed, under the principles noted above,¹⁶ in accordance with the rate of return on \$1,000,000, not on \$1,500,000. The \$500,000 in securities and the income from it will be ignored. If, now, the liability side of the balance sheet shows \$600,000 common stock and \$900,000 bonds, a conflict becomes evident. According to the rule that the tax shall be based only on the profitableness of the common stock capital, not more than \$600,000 and the return from it should be considered. According to the rule that only the business assets shall be considered, the return on \$1,000,000 of certain specified assets must be the basis of the tax. The conflict must be resolved in some way. Shall the amount be \$600,000, or \$1,000,000, or \$400,000 (the stockholders' pro rata share of the business assets), or some compromise among the three? If it is less than \$1,000,000, which part of the \$1,000,000, with its earnings, shall be excluded?

Unless a definite connection can be found between the borrowed money and certain specified assets, which in turn possess definitely allocable earnings, no one answer appears sounder than another.¹⁷ The dilemma simply reveals an irreconcilable conflict caused by considering the excess profits tax simultaneously as an impersonal tax based on the nature of the assets and a personal tax based on the status of the investors.

Length of Accounting Period

A highly seasonal business will in certain months show profits that might be considered excessive if the losses of the slack months were forgotten. Similarly, there are concerns that have highly profitable years and years of loss. The year-to-year fluctuations are caused by

¹⁶ See pp. 279-80.

¹⁷ See Note 7, *Conflict between Inadmissible Assets and Inadmissible Liabilities*, p. 559.

general fluctuations in business conditions and by alternate periods of experimentation and realization, as in businesses based on invention or on prospecting for natural resources.

If a month's gain can properly be offset by another month's loss, a similar offset might seem the only consistent way to treat year-to-year fluctuations. There is an important difference, however. The monthly offsets are confined within the seasonal period—a year. No logical period of definite length for allowing offsets is obvious in the second case, except in a few businesses—such as cattle-raising—that have a production cycle longer than a year. Shall the excessive gains of one year be reduced, for tax purposes, by averaging them with the losses, or subnormal gains, occurring five years later—ten years later—fifteen years later? The government cannot postpone demand for payment until the concern's life is ended. Several devices have been adopted to meet this problem. The chief ones are (1) basing each year's tax on the average yearly profits for the past few years, usually two or three, and (2) calculating each year's tax separately, but giving the taxpayer a refund, as the British did, in the years when his profits drop below the excess profits line.¹⁸

The present federal income tax law does not allow the losses of one year to affect the gains of another in defining taxable income. For this reason, among others, the net income figure obtained under the present income tax law is unsuited for use in an excess profits tax.

In the abstract, the end of the concern's life may seem a satisfactory stopping point. A final reckoning may then be made of the excessiveness of the concern's profits over its whole existence. Additional tax payments or tax refunds could be made before the accounts were finally

¹⁸ See Note 8, *Allowing One Year's Loss as a Subtraction from Another Year's Gain*, p. 559.

closed. Actually, the end may be impossible to ascertain with sufficient accuracy. If a radio manufacturer gradually evolves into an electric refrigerator manufacturer, the date when the radio business ended may be difficult to fix. The radio profits and losses cannot well be merged with those of the refrigerator operations unless the principle of separate taxation of separate businesses is abandoned.¹⁹ The principle is equally relevant whether the two kinds of business occur simultaneously or in sequence.

Moreover, to treat the concern's entire life as a unit may conflict with certain ideas about the taxation of monopoly profits. A firm may maintain a monopoly position through several years and then lose it. Should the profits of the monopoly period be reduced, for tax purposes, by averaging them with subnormal profits or with losses that the firm experiences after its grip is broken? The question is at least debatable.

Obvious difficulties arise whether the law adheres to the strictly annual standard or extends the accounting period to cover the life of the company. The decision will probably be a compromise.

Determination of Invested Capital

Whether a profit is excessive is usually determined by comparing it with the amount of invested capital from which it flows. Therefore, a taxpayer finds it to his advantage to make his invested capital figure as large as is legally possible.

Sometimes the law is so drawn that the value of the monopoly privilege or whatever it is that enables the taxpayer to make excess profits may be reckoned as part of the invested capital. Thus the invested capital grows with the profits, and the rate of return never appears ex-

¹⁹ See pp. 278-79.

cessive. To develop a conception of excess that will prevent avoidance of the tax through this writing-up of invested capital is one of the chief tasks of the proponents of excess profits taxation. An analogous problem has been faced in setting capital values for public utility rate regulation.

Using Records of the Past

The direct method of setting the capital value is to find out the amount that was paid to obtain the assets of the concern, in other words, the capital put in either by creditors or owners, directly or by the reinvestment of earnings. The task of ascertaining this amount is usually difficult and sometimes impossible. The chief reasons for this unfortunate situation are (1) the length of time that has to be covered by the investigation and the corresponding size of the task, (2) the lack of records, (3) the difficulty of placing a dollar value on certain assets that have been contributed in kind instead of in money by owners or creditors, and (4) the difficulty of ascertaining how much of the capital has been lost through depreciation, obsolescence, etc.

Moreover, a figure based on the actual amount put in may permit the writing-up of capital value. The original monopolist may have sold out to the present owners at a high price. In such a case, the invested capital figure must somehow exclude the dollars that were paid for the very excess profits privilege that is to be taxed. Otherwise, the new owners are in effect treated as having a vested interest that must go tax free.²⁰

Finally, if the price level has been fluctuating, the invested capital figure will vary from one concern to the next depending on the time at which each happened to acquire its assets.

²⁰ See pp. 251-53.

Using Current Records

None of these objections is serious in determining changes in invested capital after the tax has been initiated. Each year's changes can be taken care of as they come. Records can be examined promptly before they are lost or destroyed. The existing income tax demands an estimate of the value of new assets in kind and the amounts lost by depreciation and obsolescence so that an excess profits tax adds no administrative burden for these items. Sales at a price reflecting monopoly privilege or a rising price level will subject the vendor to a tax—probably inadequate—on his capital gain, and on a falling price level the disadvantage of a lower capital figure will to some extent be offset by allowance of a capital loss. Nevertheless, the problem is not solved so long as a possibility exists that the valuation for the first tax period includes something that it should not—namely, an amount representing the capitalized value of the excessive profits. The depreciation and obsolescence charges usually will not eliminate this element, since it will ordinarily not appear on the books at all and so will furnish no basis for depreciation or obsolescence.

If most of the excess profits are based on a recent and unforeseen upheaval, such as a war, the problem is somewhat less difficult. Because the profits were largely unforeseen, there is less likelihood that the recent book values will include a capital figure representing them. Furthermore, the excessiveness of the profits may for a time be determined chiefly by comparing them with the annual profits that the concern made before the war instead of comparing them with the invested capital. As the concern expands or contracts, and as new concerns develop, this method of determining excess profit becomes less valid. Over a period of only three or four years, however, it may be used extensively, as in Great Britain during the World War.

Immediate Inventory versus Delay

The surest way to avoid including in the first valuation something that should not be there is to make an inventory of all the assets of all the business firms as of the day when the tax is initiated. Cost of reproduction new, less depreciation and obsolescence, would presumably be the basis of the valuation, with such provisions for eliminating the influence of changes in price levels as might be desired. The magnitude and difficulty of the task are obvious.

The only other way seems to be to wait for a number of years before imposing a tax, so that tax authorities can gather data on the amount of new capital going into each concern and the amount of capital coming out. When the process of wearing out and replacement has gone far enough, an invested capital figure can be set, based on the records of capital inflow and outflow. This capital figure could then be adjusted for assets, such as land, that the concern could show had remained intact in the business throughout the period. No adjustment, however, would be allowed for any capital element that represented the monopoly privilege or any other profit source that it was desired to tax.

Something approaching the waiting plan has been in use in the United States since 1933 in the form of the so-called excess profits tax, which is merely an adjunct to a corporation capital stock tax. The rates are moderate, and the fictitious capital value used in the first year is adjusted from year to year in accordance with actual capital inflow and outflow. However, no provision has yet been made for ultimate and accurate valuation of extremely long-lived or permanent assets, such as land, or for ultimate exclusion of capital values based on monopoly privileges.²¹

²¹ See Note 9, *Present Excess Profits Tax*, p. 560.

Fair-Earnings Level and Tax Rate

If the framers of the concept of "excess" reach a decision on (1) the scope of the business unit taxable, (2) the treatment of capital entitled to a fixed return only, (3) the length of the accounting period to be used, and (4) the method of ascertaining invested capital, they must then decide (5) what percentage of capital is a fair return, and (6) what rate or rates shall be applied to the excess.

The capital percentages and tax rates that were used in the war taxes in Great Britain and the United States are not good guides. In both countries the levels set reflected an admitted failure to adjust other elements in the excess profits tax structure. The British authorities granted a high percentage of return on capital invested in mines before applying excess profits taxes, partly because the tax law allowed no deduction for depletion. They granted higher percentage rates of return to unincorporated concerns than to incorporated concerns because the law allowed no deduction for hypothetical salaries of working proprietors and partners. The United States law failed to allow refunds for bad years, in contrast with the British law, but the severity of this treatment may have been counteracted to some extent by exempting a higher percentage of return on capital, or perhaps by a lower tax rate, than otherwise.

Fair-Return Percentage

If the provisions discussed thus far have been framed as satisfactorily as possible, the capital return percentages do not need to be called upon to redress errors. They can instead reflect simply what is to be considered a normal return on capital in view of the risk involved and the time period covered.

A strong case can be made for varying the capital re-

turn percentage from industry to industry according to risk involved. Indeed, variations from firm to firm within an industry are similarly defended. A large concern may run less risk than a small one, owing to its wider range of activity. Of a large number of small wildcatters in an oil field, all but a few may show heavy losses, and the few, large profits. If the wildcatters merge into one company, the consolidated account may show no heavy loss and no great gain, but simply a moderate profit. To demand an excess profits tax from the few that got large profits before the consolidation and to decide that no excess profits exist after the consolidation seems a questionable procedure. At least it is inconsistent with the view that emphasizes the impersonality of the tax.²² If consistency is sought by an exemption of the few fortunate wildcatters in the pre-consolidation stage, the wildcatters in general must be permitted a high percentage of return on capital, or they must be allowed to mark their capital values up by using, not the actual cost of their properties, but their market values.

The excess profits tax has not usually been considered a business tax imposed because of the benefits that government gives to business. Since government activities may give particularly large benefits to some concerns, however, an excess profits tax, with low rates starting at a low percentage level, might be used as a supplementary business tax.

Tax Rate

The tax rate to be applied is not really a part of the problem of defining excess profits. Its height, however, may well be made to depend on the degree of success reached in formulating such a definition. A 100 per cent tax rate on excess profits is not feasible when there is danger that business enterprises will be ruined through

²² See p. 173.

errors in administration or failure of the law to provide for unusual cases. This danger will not disappear unless the definition is easy to understand and nearly perfect from the point of view of justice, or unless it errs decidedly in favor of the taxpayer.²³ Moreover, a 100 per cent rate may result in undesired effects on business initiative and other economic factors.

A graduated rate scale may be justified because excess profits can never be separated from fair profits with complete accuracy. Therefore, because of the chance of error, the rate that is levied close to the dividing line might be made moderate. Otherwise, graduation in the excess profits tax must depend upon a distinction between two excess profit dollars, both clearly excess but one representing a higher percentage return on capital than the other.

SPECIAL TAXATION OF LAND

Special taxes on land have been urged on the ground that private ownership of land or its proceeds is partly or wholly undesirable from a social point of view. To some extent the charge of undesirability is based on grounds of economic influences.²⁴ Another argument, however, holds that private ownership of land has no moral justification, since land is the result of no man's work or sacrifice and its value is derived from community growth and action.

The Single Tax and the Graded Tax

The extreme advocates of the single tax propose to finance all government expenditures by a tax on land rent, at a rate as high as 100 per cent, if necessary. Considerable debate over this issue has arisen from time to time. At the moment the tax gives no indication of

²³ See Note 3, *War Profits Taxation*, p. 556.

²⁴ See pp. 150-52.

being an important political issue in the United States except possibly in a few states where it is linked with other measures.

Variants of the single-tax doctrine call for the taxation of improvements on and in the land, but at a rate lower than that on land. For some years Pittsburgh has levied its real estate tax in this manner.²⁵ On the whole, even this graded tax has been given little consideration. The recent demand for a reduction of real estate rates has not differentiated between land and improvements.

The chief difficulty with proposals for the single tax and the graded tax, from the point of view of justice, is the damage that would occur to innocently acquired vested interests.²⁶ One's judgment on the justice or injustice of those proposals will depend chiefly on the importance that one attaches both to these vested interests and to the distinction between destroying them quickly and destroying them over one or more generations.

The Land Increment Tax

Instead of taxing existing land rent at an especially heavy rate, and disturbing innocently acquired vested interests,²⁷ some students favor a special tax on increases in land values. Recently the tax has been proposed as a substitute for special assessments.²⁸

It is not always clear whether the tax would apply only to future increases. Suppose that at the time the tax is enacted a landowner holds a parcel of land worth \$15,000, which he had purchased many years before at \$10,000. If, after the tax has been enacted, he sells the land for \$18,000, is he to be taxed on \$8,000 or \$3,000? If he is to be taxed only on \$3,000, and other landowners

²⁵ See p. 152.

²⁶ See pp. 249-54.

²⁷ See pp. 250-251.

²⁸ Spengler, "The Increment Tax versus Special Assessments," *Bulletin of the National Tax Association*, XX, No. 9 (June 1935), 258-61; XXI, No. 1 (October 1935), 14-17; XXI, No. 6 (March 1936), 163-67; and XXI, No. 8 (May 1936), 240-44.

are to be treated similarly, it is impossible to avoid the difficult administrative task of compiling a special inventory of all land as of the date of enactment.

A variant of this plan requires valuation of all land as of some prior year when values in general were higher than in the year of enactment. This plan is advanced when the year of enactment coincides with a depression in real estate values. The burden on the taxpayer would be lightened, but the difficulty of a land inventory is increased if the valuation must be as of some date in the past.

Many land increments are part of a development that causes land decrements in other areas. Thus, when a subway opens up new territory, it relieves pressure on other parts of the city and tends to cause a fall of rental values there. When increments and decrements occur at approximately the same time but affect different parcels of land—as in the subway example—, the only way to allow the one to offset the other is to give to the unfortunate landowner the proceeds of the tax levied on the fortunate one. Otherwise, the question arises whether it will be consistent to allow decrements to offset increments when both occur in the same parcel of land.

If land that was worth \$15,000 when the tax was enacted drops to \$10,000 a few years later and then rises to \$18,000 a few years later still, how much of the increment is to be taxed? If the land is sold at the \$10,000 level and sold again at the \$18,000 level, a tax on \$8,000—not on \$3,000—may seem reasonable. If the land is not sold at the \$10,000 level, but is sold at the \$18,000 level, application of the special tax on \$3,000—not on \$8,000—may seem reasonable. Can any reason be given, however, for making allowance, in effect, for the decrement in the latter case and not in the former? To make the difference in treatment depend on a change in ownership is to make the tax a somewhat personal one—that is,

the amount of the tax becomes dependent on personal circumstances instead of solely on the fact that a land value increment has occurred.

Consistent treatment of land decrements is more important now than it was in the early days of the country when the increments were destined to be so much larger than the decrements.

The problems just noticed do not necessarily lead to a condemnation of land increment taxation, but they suggest that proposals for it should be made so definite that the particular philosophy of tax justice that it represents can be identified.

A comprehensive and effective excess profits tax might be made to reach increments in land—at least, increments that were much above a normal interest rate. The burden might not be so heavy as most advocates of increment taxation would desire, but, if the excess profits tax succeeded in taking as much as 60 per cent or 70 per cent of all annual increments above 5 per cent or 6 per cent, little need would be felt for a special increment tax. Another substitute for increment taxation that has been proposed is a super-tax to be applied to the entire value of the land when an increase has occurred.²⁹

²⁹ See Seligman, *Studies in Public Finance*, pp. 272-77.

Chapter 20

ADJUSTMENT TO PERSONAL DIFFERENCES

The standards of tax justice discussed under capitalization, vested interests, special benefits, and socially undesirable income do not depend on the entire economic and social situation of the taxpayer. The conclusions are usually the same whether the taxpayer, when all his income and all his wealth and all his obligations are considered, is found to be wealthy or poor.

A common standard of tax justice, however, demands that some account should be taken of economic and social differences among individual taxpayers—insists, as it is usually phrased, that the individual's tax burden should be adapted to his "ability to pay." Some taxes are ready instruments for achieving this purpose. Others are singularly perverse, and even tend to have a directly contrary effect. This chapter analyzes the ability of the major taxes to take account of the taxpayer's personal status.

PROPERTY TAX

The property tax has been narrowed from its original status as a general tax on almost all a person's possessions until in most jurisdictions it now rests in practice on little but real estate. It cannot, therefore, take account of so large a part of the economic world of most taxpayers as the income tax can. Even if all forms of property were taxed both in principle and in practice, the tax would suffer from a major handicap. A person's real estate can, under established law, be taxed only by the jurisdiction within which it is located, regardless of

where the owner lives. On the other hand, personal property, with some exceptions, is taxed at the residence of the owner. A small taxing jurisdiction, therefore, may find it impossible to tax many of its residents on the basis of their total property ownership. Moreover, the residence test for personal property is apt to result in the formation of "tax colonies." Wealthy taxpayers living in these "colony" areas pay very low rates, since the expenses of the community can easily be met by a low rate on the large personal property tax base. The property tax, either state or local, has severe limitations as a general ability tax, under the existing rules of jurisdiction.

Exemptions

Unlike the income tax, the property tax in the United States cannot rely on a graduation of rates to gain adaptability to personal factors.¹ Instead it must depend on exemptions of various kinds.

A few states, most of them in the South, have exempted from the state tax small parcels of real estate used for residential purposes ("homesteads"), but only Florida has exempted the homesteads from most of the local tax also.² This device may be effective in reducing the tax burden on home owners with small incomes, but it does nothing for tenants with equally small incomes. Moreover, unless particular care is taken, the taxes levied to replace the lost revenue may weigh as heavily on the small home owners as did the property tax.

Some states segregate special classes of real estate, such as timber lands and mines, for taxation at special rates or on special bases. The reasons commonly given are the desire for conservation of natural resources, and justice in the distribution of the tax burden.

¹ See Note 1, *Graduated Property Tax Rates*, p. 561.

² See the memorandum by Thomas J. Reynolds on homestead exemptions and rate limitations in the forthcoming volume, *Studies in Current Tax Problems*.

Personal property is sometimes exempted or taxed at special low rates. However, this exemption often reflects administrative defeat at the hands of recalcitrant taxpayers, rather than an attempt to further tax justice. New York State exempts personal property altogether, and about one-fourth of the states—scattered throughout the South, East, and Far West—exempt all intangible personalty, such as stocks and bonds. A few states tax almost all kinds of personalty, at least in theory, but they sometimes tax different kinds at different effective rates.³

The exemptions commonly granted to charitable, religious, and educational organizations, and those occasionally granted to business (usually manufacturing) are chiefly to encourage certain types of activity. The business exemptions often result from interstate competition.⁴

The use of property tax exemptions for redistributing the burden is hindered by the difficulty of knowing where the burden lies and where it will lie after the change is made. Although this difficulty is common to all taxes, it is especially important for the property tax because of the size and universality of the burden.⁵

The universality of the property tax burden is often ignored in current tax discussion. Many members of the community, it is sometimes said, are "exempt" from taxes, since they are so poor that they pay no income taxes, death duties, or gift taxes, and own no taxable property. They are, however, exempt only in the sense that they have no direct contact with the tax collector. They must live in dwellings of some sort, and most of them are probably paying more in rent than they would be paying if no real estate tax had been levied for the past decade or so. The increase in rent due to the tax may be negligible for rural tenants in small scattered country

³ See Note 2, *Special Treatment of Personalty*, p. 562.

⁴ See pp. 147-50.

⁵ See pp. 353-54.

dwelling. Little or none of the tax on land—in contrast with the tax on buildings—is shifted to tenants, and in a declining community even part of the tax on buildings may have no effect on rental price. In general, however, a large part of the real estate tax enters into the rental price of dwellings. In addition, it influences the price of all other commodities and services through its burden on office buildings, factories, transportation lines, warehouses, retail stores, etc. No one, however destitute he may be, escapes the direct or indirect burden of the real estate tax for long unless he breaks all contact with the economic world and lives a self-sustaining life as a hermit.

Variations in Rates

Variations that the property tax rate has shown from time to time and place to place indicate that the tax has some adaptability to the differing economic and social positions of taxpayers. Even this elementary characteristic, however, has been greatly impaired in Michigan, New Mexico, Ohio, Oklahoma, and West Virginia, where the state constitutions have been recently amended to set a stringent maximum limit on the rate. The limit, which can usually be exceeded only by special vote of the electorate, applies to the combined property tax rate levied by all the layers of government. It is so low—for instance, 1 per cent in Ohio—that the combined rate reaches the maximum almost everywhere in the state. A similar loss in flexibility is found in other states where the rates for various political subdivisions and various public purposes are limited by statute or constitution.⁶

Discriminatory Valuations

In many parts of the country the property tax takes on a sort of perverse impersonality. One example is the

⁶ See the memorandum by Thomas J. Reynolds on homestead exemptions and rate limitations in the forthcoming volume, *Studies in Current Tax Problems*.

arbitrary discriminations that occur when taxable values are set. The assessment of values for the property tax is often so faulty that some properties are valued at two or three times as much as other properties that are almost identical. Valuation requires a high degree of individual judgment. To know what a parcel of land, for example, is worth, the assessor must in theory know what future income it will yield—or would yield, if rented—and what interest rate should be chosen to capitalize the future yield into a present value. Actually, most assessors probably do not even attempt to follow this method. Instead they use a mixed basis of past valuations, current sales of similar properties, and, in some cities, formulae based on more or less rigid front-foot value and depth and position factors. The better the assessor, the less the injustice, but whether even the best possible assessor could really cure the evils of the situation is doubtful. In this respect, the property tax contrasts with such levies as the liquor tax, which require very little individual judgment of the assessors.

Because the property tax is so heavy, and because the amount levied on any one piece of property depends so much on the exercise of the official's judgment, the tax carries the constant threat of a more crushing unfairness to a greater number of people than any other tax in the country. The meticulous detail with which the income tax laws, rulings, and court decisions provide for calculation of the precise tax due, to the cent, contrasts strongly with the amount of discretion left to the assessor under the real estate tax. The latter tax involves a far larger sum in the aggregate, and it is relatively devoid of standards whereby taxpayer and tax collector can check each other's computations.

Proposals have been made to change the base of the property tax from capital value to income, partly in the

hope that the assessor can do a fairer job if he has merely to estimate the income for the year just past. The income basis is employed in Great Britain for the local "rates," or property tax, but specialists in real estate taxation do not agree on the extent to which it would reduce discrimination in this country. A gross income base, or gross earnings base, has been substituted by a few states for the capital value tax on certain public service corporations. Also, New Hampshire, Ohio, and Tennessee use income rather than capital value for certain intangibles. Otherwise, the income base, gross or net, for the property tax has made no headway in the United States.

Representative Property and Multiple Taxation

There is multiple taxation of a kind where both intangibles and the tangibles upon which they rest are taxed—for example, when both mortgage bonds and the mortgaged properties are liable. As a result the state and local tax burdens on two pieces of real estate may differ simply because one piece is represented by an intangible, such as a bond, while the other is not. The total tax burden on a mortgaged farm equals the tax on the farm plus the tax on the mortgage, while an un-mortgaged farm feels the weight only of the tax on farms.

Multiple taxation of this kind is sometimes another example of a perverse sort of impersonality. Sometimes, of course, it can be defended as a consistent part of a consciously developed system. It cannot be, however, when it results from the conflicting actions of two or more jurisdictions—usually two or more states.⁷ In at least twenty-six states, however, so much intangible property is exempt or is taxed at such low rates that the

⁷ See pp. 367-68.

amount of multiple taxation in those jurisdictions can scarcely be considered serious.⁸

PERSONAL INCOME TAX

In contrast with such taxes as those on admissions, imports, and real estate, the income tax covers the major part of the taxpayer's economic life. Moreover, tax students agree that it is not, in general, shifted by the taxpayer to someone else. Consequently it can be refined to take account of many factors that determine how much one taxpayer should contribute compared with another.

Source and Use of Income

Should a man's tax burden be lightened because he is supporting a large family? Personal exemptions and credits for dependents can be allowed under the income tax—but scarcely under the admissions tax. Should the government favor those who devote part of their income to charity? The income tax may allow the taxpayer to deduct his charitable contributions in computing his net income, but the customs duties that are borne by each taxpayer can scarcely be modified thus. Should the man who lives on interest and dividends be required to pay more than the man who receives the same amount from his own labor? The income tax can discriminate in its treatment of the two kinds of income, whereas the basis for the distinction cannot exist under a real estate tax.

Refinements such as these are widely used under the income tax. The federal government and all but three of the income-taxing states allow deductions or credits according to the taxpayer's personal status (whether he is married or single, head of family, etc.) and the number

⁸ See *Tax Systems of the World*, pp. 94-95.

of his dependents. The three excepted states restrict their tax to income from securities. Similarly, the federal government and almost all the states permit a limited deduction for gifts to charitable and other similar organizations. The distinction between "earned" and "unearned" income has again been incorporated in the federal personal income tax law after a lapse of two years.

Unified Tax versus Series of Taxes

The income tax may be a unified tax, such as the federal tax in the United States. It may, in contrast, consist of a series of taxes, each with its own rates and exemptions. Such taxes are found in France and Italy, along with certain special income taxes that apply to all the taxpayer's income.

This contrast further illustrates the adaptability of the income tax to the personal status of the taxpayer. The series of taxes in France and Italy reflect the view that justice is best served by distinguishing sharply between different types of income. On the other hand, the unitary taxes of Great Britain and, in the United States, the federal government and of most of the income-taxing states imply that the individual is not to be split up into distinct segments. One taxpayer is not to be subdivided into a salary-earning taxpayer, a dividends-receiving taxpayer, a landlord-taxpayer, and so on.

The only important agitation for a series type of income tax in the United States in recent years has come from those who favor separate taxation of capital gains, such as profits from sale of securities. Among the states there are some examples of series income taxes, but these seem to have developed chiefly as a result of the decay of the property tax on intangibles.⁹

⁹ See p. 296.

Capital Gains and Losses

The provisions governing the taxation of capital gains and losses under the income tax give evidence of a struggle over the extent to which the personal status of the taxpayer should be taken into account.

Under the present federal law, the taxation of gains is dependent on the general economic situation of the taxpayer—that is, the gains are added in with income from other sources, and to the net result the provisions concerning personal exemptions and rates are applied. In other words, the advantage that any given taxpayer would get from the exemption of capital gains depends on his total income, his family status, etc.

The provisions concerning losses, on the other hand, tend to ignore the personal status of the taxpayer. The losses can be set off only against capital gains of the same year, plus an extra \$2,000. For example, a person with a salary of \$15,000 and a net capital loss of \$20,000 is taxed on \$13,000 (\$15,000—\$2,000).

The taxation of capital gains departs in still another way from a consistent recognition of personal status. The gain accruing to a capital asset up to the time of a taxpayer's death is exempt, largely, it appears, because of constitutional limitations on the definition of income. Still other points indicating the artificiality of present capital gains taxation can be found.¹⁰

Accounting Period

The degree to which one accounting period shall be isolated from another is important in adapting the income tax to the personal status of the taxpayer. One taxpayer, for example, may show a large loss one year and a large income the next year, but, for the two-year period as a whole, the same total income as another

¹⁰ See note 5, p. 191, and pp. 484-91.

taxpayer who returns a moderate net income each year. Under the federal income tax law, the first taxpayer cannot use the loss of the first year to offset any part of the income of the next, so he pays more tax than the other. In effect, the taxpayer is split artificially into several chronological personalities, and to this extent his true personal status is ignored.

Even if no yearly loss is ever involved, the problem remains. Some taxpayers get their income regularly and some irregularly. Owing to the progressive rate scale, an irregular income is at a tax disadvantage. A gain that has been accumulating over a number of years and then is realized and taxed all in one year is subject to heavy surtax rates compared with a gain of the same total size that is realized bit by bit, year by year. For capital gains and losses, the federal law attempts to meet this problem by decreasing the amount of the gain that is taxed (or the loss that is deducted) as the period of accrual lengthens.¹¹

*Tax-Exempt Securities and Salaries*¹²

The exemption of income from certain securities and salaries makes it difficult to adjust the income tax to the relative personal situations of individuals. It is particularly damaging to the justice of a progressive surtax.

Interest on state and local bonds cannot be taxed by the federal income tax. The total amount of such bonds outstanding as of June 30, 1935, was more than \$18,000,000,000. Apparently, however, only one-fourth or one-fifth is in the hands of individuals subject to surtax. The rest is held chiefly by banks, insurance companies, and public funds.

Because these bonds are tax exempt, the states and lo-

¹¹ See p. 190.

¹² The basis for statements made in this section is a memorandum by J. Wilner Sundelson on tax exempt securities.

calities do not have to offer so high a rate of interest as they otherwise would. The federal government thus loses in revenue, and the states and localities gain by a saving in interest payments. The two amounts are not equal, however. A wealthy taxpayer gains much more by his federal tax avoidance than he loses in accepting lower interest. This is true principally for the reason that there are so many state and local bonds outstanding that they have to bear interest rates high enough to attract buyers from the low-income groups, corporations, and others that are not subject to the high personal income surtaxes. Under the 1936 federal income tax rates, for an investor with a \$50,000 income a 2 per cent yield on a tax-exempt state or local bond corresponds to a 3 per cent yield on a bond that is not tax exempt. For an investor at the \$250,000 level, the corresponding percentages are 1 and 3. Actually, there is no such spread between interest rates of taxable bonds and exempt bonds. The states and localities have to pay more than 1 per cent—even more than 2 per cent—to compete with the taxable 3 per cent bond of the same maturity and soundness.

The wealthy investor therefore does, on balance, escape some of the burden that he would bear if no tax-exempt securities were outstanding. In other words, the effectiveness of the higher surtax rates is impaired. The surtax rates might be made even higher so that the net burden would be the same as it would be with no tax exemptions and a lower surtax rate. At best, however, this is a crude method of adjustment. It assumes, of course, that the wealthy investor would not put all his capital in tax-exempt bonds. This assumption seems justified, since data from estate tax returns indicate that taxpayers with incomes above \$60,000 have been receiving only from 10 per cent to 20 per cent of their income in tax-exempt form, despite the high tax rates.

Salaries of state and local officials are exempt from the federal income tax, with some qualifications, depending on the status of the official and the unit for which he works. Obviously, no adjustment of the tax rates can affect this privilege. Perhaps, however, the state and local taxpayers, not the state and local employees, are the beneficiaries—that is, perhaps the exemption simply results in a lower salary scale.

Apparently income from future state and local bond issues or from state and local salaries can be taxed only if the federal Constitution is amended. Such an amendment is unlikely, unless it is proposed as part of a general adjustment of federal, state, and local fiscal relations. The states have little to gain directly from such a move. Any plan to tax the income from securities already issued is open to the charge of bad faith.

The matter of tax justice is probably the most important element in the tax-exempt problem, but other elements are present. The federal government is getting from \$100,000,000 to \$200,000,000 less in revenue than it would if present rates were maintained and the state and local exemptions on outstanding securities were abolished. Furthermore, states and localities may be induced to issue a slightly larger amount of securities than they would if the tax-exempt privilege were removed.¹³

Income from federal bonds is exempt from state personal income taxes and from many state corporation income taxes. This raises a similar but much less important problem. The state income tax rates do not go high enough to be seriously distorted in their effects by the existence of exempt investments. The exemption of federal salaries from state taxation is more important in that here, again, no change of rates can touch the tax exemption privilege.

¹³ See p. 63.

Federal exemption of federal bonds is probably not a serious problem at the moment. About half the federal debt is exempt from federal surtax, but almost all of this is short-term paper held largely by institutions, which in any event bears very low rates of interest. Similarly, state and local exemption of state and local securities is relatively unimportant.

Imputed Income

The income taxes in the United States are not adjusted to the taxpayer's personal economic power in so far as it is represented by something other than current transfers of money or barter. For example, a person who owns some securities but not his home must pay an income tax on the security income, but a person who owns his home and no securities does not pay any income tax on the annual value of his home. If the security owner sells his securities and buys a home, he lessens his income tax. The income taxes could include an assumed income from the home owner's dwelling, as in Great Britain.¹⁴ Administrative problems in the United States would make this adjustment difficult, for the time being at least.

Gifts and Inheritances

The income tax does not, under existing federal and state laws, take account of the taxpaying ability represented by a gift or an inheritance. Whether it can be designed to do so is debatable.¹⁵

TAXES ON BUSINESS INCOME

Corporation Income Tax

The corporation income tax is much less adaptable than the personal income tax to the economic or social status of the ultimate taxpayer. It is essentially a cruder

¹⁴ See Magill, Parker, and King, *op. cit.*, p. 20.

¹⁵ See pp. 313, 315. See also Note 3, *Liberality in Deductions from Gross Income*, p. 562.

taxing instrument, since it strikes a group rather than an individual. The group that it is intended to strike may be the owners of the common stock of the corporation, the consumers of the corporation's products, the corporation's employees, or the people who sell to the corporation. In practice, the corporation income tax usually rests on the owners of the common stock.¹⁶

The corporation income tax is sometimes used chiefly as a supplement to the personal income tax. The profits of the corporation are taxed before they flow out of the corporation as dividends, and then the dividends are not taxed in the hands of the stockholders so severely as they would otherwise be.

Holders of stock in a large corporation are of various kinds—some are rich, some are barely well-to-do; some have large families, some have small families. The ordinary corporation tax cannot take these facts into account. It is levied on the corporation as a unit, and it reduces every stockholder's dividend by the same percentage. Whether the corporation tax is at a flat rate or at graduated rates, whether it is a tax on all net profits or simply undistributed profits, common stockholder A's share in the company's earnings is cut by precisely the same percentage as the share of common stockholder B.

In other words, provided that the burden rests on common stockholders, and not on employees, customers, or others, a corporation's income tax is equivalent to a tax at a uniform flat rate on every one of its common stockholders. A tax at a uniform flat rate may be advisable under certain circumstances, but it can scarcely be considered *highly adaptable* to the personal status of the individual.

However, the difficulties involved in any plan that relies wholly on personal income taxation, without a supplementary corporation income tax, are serious. They

¹⁶ See p. 310.

have been discussed above in connection with governmental policies as they affect corporations as against unincorporated concerns.¹⁷

Progressive Rates

Despite the fact that progressive rates on a corporation's net income are equivalent to a uniform flat rate on all its holders of common stock, six of the thirty states that impose a tax on the net income of corporations employ a progressive rate scale, and the federal government in the revenue acts of 1935 and 1936 has adopted the progressive-rate principle for corporate incomes in a moderate way. Perhaps these scales reflect a belief that corporations with large profits have common stockholders with large incomes, and corporations with small profits have common stockholders with small incomes. In so far as this is true, a progressive corporation tax will impose a heavy uniform burden only on rich stockholders and a low uniform burden only on poor stockholders. Common stock ownership is probably not distributed in so simple a pattern, however.¹⁸

Non-Resident Tax

If a corporation is owned by non-residents, the state cannot reach the owners directly with a personal income tax. In this case, the problem of correlating a corporate tax with a personal income tax does not arise. A corporation operating in New York may be owned by individuals residing in New Jersey. New York may claim that it has a right to tax all income arising within its borders, even the part that goes to non-residents. It can enforce its claim only by requiring the corporation to pay a tax, since it has no jurisdiction over the persons of the New Jersey stockholders. Consequently no question can arise of co-ordinating the New York corporation tax

¹⁷ See pp. 164-66.

¹⁸ See Note 4, *Graduated Corporation Income Tax Rates*, p. 562.

with the New York personal income tax, for these corporations.

Taxation of Unincorporated Business Net Income

New York State is the only taxing jurisdiction in the United States that employs a special business tax on unincorporated concerns, based on net income. Extension of the business net income tax in this way has been supported on the grounds of the general benefit to business that results from government.¹⁹ It is also a way of reaching non-resident owners of all the businesses, incorporated and unincorporated. Of course the latter reason alone is not adequate to support either of the New York taxes as they now stand, since they both apply to business profits going to residents, and the residents are not given any relief on that account under the personal income tax.

Any system that uses a general tax on business income taxes certain kinds of ownership income more heavily than other kinds, and more heavily than creditor income. A dollar of profit earned by an unincorporated concern or a dollar of profit earned for a corporation common stockholder is taxed twice—once under the business income tax and again under the personal income tax. A dollar of interest income is taxed only once—in the hands of the creditor. A dollar of preferred stock income is also taxed only once—in the hands of the owner of preferred stock. There is this difference, however, between the interest income and the preferred stock income: the corporation pays a corporation income tax on the profit earned for the preferred stock. The amount available for the common stockholders is of course reduced correspondingly, except to the extent that the common stockholders can float the bond and preferred stock issues at lower interest and dividend rates because

¹⁹ See pp. 259-60.

of the relative tax exemption. In a restricted sense, then, the common stockholders are triply taxed.

This comparison of the burden on various kinds of investors will seem irrelevant to those who support the business tax on highly impersonal grounds.

Incidence of Business Net Income Taxes

All the arguments cited above for the taxation of business income assume that the tax is not passed on to consumers, suppliers, or anyone other than the owners of the concern. This assumption is generally accepted among professional students of taxation, and such statistical data as are available seem to support it. The reasoning runs as follows: granted, first, that a fair degree of competition exists; second, that there are always some firms that are barely getting along and are making little profit or none at all; third, that the successful firms, no matter how successful they may be, do not dare to put their selling prices much above the level at which the no-profit firms sell, for fear of losing trade—then a net income tax cannot be added to prices and thus shifted to consumers, since a tax of this kind applies only to the successful firms. The concerns that are barely getting along pay little or no income tax, and hence they receive no impulse from the income tax to raise their selling prices. Since they do not raise their prices, the taxed firms cannot raise theirs.

Some business men insist that the corporation income tax is considered as a business cost, just as are wages, rent, etc. and is consequently taken into account in setting selling prices. This argument overlooks the fact that this particular business expense differs from wages, rent, etc., in that some of the firm's competitors do not bear it. Competition makes it difficult for a business firm to raise its selling prices just to take care of an expense that many of its competitors do not have.

DEATH TAXES

Both the inheritance tax and the estate tax—the two chief forms of death tax—appear capable of many refinements, and thus highly adaptable to the personal status of the taxpayer.

Under the inheritance tax each heir or other beneficiary pays a tax on his share. The government therefore has an obvious chance to impose a heavier tax on one type of heir—say, a nephew—than another—say, a son. The estate tax is levied as one tax on the entire estate. It, too, can be refined to discriminate among beneficiaries, but not so readily for the more extreme kinds of differentiation.

A majority of the states impose inheritance taxes, despite the example set by the federal estate tax. Some states impose both taxes, using the estate tax as a "deficiency levy" to take up whatever part of the credit against the federal tax is left unabsorbed by the inheritance tax.²⁰

*Influence of Death Taxes on Testator's Decisions
Concerning Beneficiaries*

The adaptability of either tax is more apparent than real. Provisions that distinguish between sons and nephews, levy progressive rate scales resembling those of the personal income tax, and grant exemptions varying in amount from person to person are based on an assumption that the legislator knows who bears the real burden of the tax.

To pick an example at random, when Pennsylvania's legislators put a 2 per cent rate on inheritances received by direct heirs and a 10 per cent rate on inheritances received by collateral heirs, they probably did so in the belief that the direct heirs and the collateral heirs would

²⁰ See pp. 26-27.

really bear the burden of the tax that was imposed upon them. Suppose, however, that a resident of Pennsylvania wishes his son and his nephew to share equally in what is left of his fortune after all death taxes are paid. Since the state taxes nephews at a higher rate than sons, he will have to leave the nephew more, and the son less, than if the state treated both alike. The only effect of the discriminatory rate, in such an instance, is to change the terms of the will. The heavy tax on the nephew does not really harm him, and the purpose of the rate differentiation is at least partly defeated.

On the other hand, the discrimination may work in the same direction that it was intended to, but more severely. The decedent-to-be may be determined not to let the state get much of his property. In view of the heavy tax on his nephew, he may leave his nephew less, and his son more, than he would have if the rates had been equal.

The discriminatory tax may stimulate the decedent-to-be to work harder or spend less in order to pass on to a nephew a certain predetermined amount net after taxes. In this case the heavier tax rests as a burden on the decedent-to-be, not on the nephew. Still further, a residuary legatee may be the one to suffer, to satisfy the testator's wish not to have the nephew's position—net after tax—really diminished by the discriminatory tax.

Rates Progressing by Size of Inheritance

Progression of the rates according to the size of the inheritance may also fail to reach its objective, which seems to be based roughly on the proposition that the richer a person is, the higher the tax rate should be, since the loss of a dollar means less to him.²¹ Therefore, the argument continues, a person receiving a large inheritance should pay at a higher rate than a person receiving

²¹ See pp. 320-21.

a small inheritance—for instance, one receiving \$100,000 should pay more than twice as much as one receiving \$50,000. A poor person, however, may receive a large inheritance, and a wealthy person a small inheritance. In so far as the feelings of individuals can be compared, a dollar of inheritance tax may mean more to the one who gets the large inheritance than to the one who gets the small inheritance. However, the one who gets the large inheritance will be taxed at a higher rate under the kind of inheritance tax progression that is common in the states and that was suggested for the federal government in 1935.

In practice, the problem may not be a serious one, since there is a readily observable tendency for large inheritances to go to those who are already well-to-do.

Abroad, the progressive rate scale of the inheritance tax has at times been made dependent on the amount of other wealth or income of the heir. This procedure is a step toward a "general ability tax," which allows all the major elements of ability to interact in determining the amount of the taxpayer's personal tax.

Even if the beneficiaries have identical amounts of other wealth and income, the progressive rate scale may not achieve its aim. The testator may fix the terms of his will or regulate his activity and his spending in such a fashion as to negate the influence of the progressive rates.

Justification on Impersonal Grounds

From one point of view, the death taxes are impersonal. Like excess profits, the thing taxed is considered fit for special taxation, regardless of the particular persons that may be involved. The immediate family may depend on the legacy for support, but they can be cared for by proper exemptions. The tax on all the rest of the property passing by death is, from this point of view, considered as a tax either on windfalls or on savings that

were made with little sacrifice. If the beneficiaries are the ones that really bear the burden of the tax, it is justified on a windfall basis. If the testator is the one who bore the real burden, by earning more or spending less than he would have done had no death taxes existed, the tax is supported on the grounds that the saving must have been very easy or it would not have been accomplished, in view of the remoteness of the end.

Few inheritances, however, are entirely unexpected, and some are of the nature of earned income. On the other hand, the strength of the argument need not depend on pure windfalls—rather, upon the windfall element in a partially expected inheritance. Perhaps, too, the distinction noted in excess profits is valid here. Some of the non-windfall inheritances may be regarded as gained by methods frowned upon by society, as when someone receives an inheritance simply because he chanced to be a remote relative or a casual acquaintance of the testator.²²

Other Devices That Give Adaptability to Death Taxes

When two or more deaths occur in the same family within a short time, so that the estate becomes exposed to quickly repeated taxation, the law commonly grants partial exemption or makes some other allowance. The federal government exempts from its estate tax or gift tax any estate that has paid either of those levies within five years. About one-fourth of the forty-seven states that have death taxes make a similar allowance.²³ Another plan, accomplishing the same purpose in advance, makes the amount of the inheritance tax depend in part on the age of the beneficiary—the older the beneficiary, the less the tax. This method is not used in the United States.

²² See pp. 271, 356.

²³ This statement is based on a memorandum by Carl Shoup and Bernard L. Shimberg on provisions in death tax laws affecting the liquidation of estates.

The equitable distribution of an inheritance tax between a life tenant and a remainderman, or between one with a vested interest and one with a contingent interest, offers difficulties that are far from satisfactory solution. The chief problem is that of assigning values to the various interests.

As an extension of the "unearned wealth" idea, an unusually heavy rate might be applied to property that the decedent had received as a gift or inheritance. This method is not employed in the United States, but some authorities believe that it is both practicable and justifiable.²⁴

Attempts to integrate the death tax with the entire personal situation of the beneficiary may some day lead to inclusion of inheritances as a part of the income subject to income tax. However, any such measure should probably be adjusted to lessen the burden that results from crowding so much income into one year and consequently bringing such high surtax rates into play. Such an adjustment is made, in principle, for capital gains.²⁵

These and other matters of personal status under the death taxes seem destined to be much more widely discussed in the next few years than they have been in the past.

GIFT TAXES

The gift tax in the United States is a child of the death duties. Wealthy persons were avoiding death taxes by donating property during their lifetime to children and other heirs. The gift tax, which applies only to gifts between living persons, could be chiefly a "policeman tax." Under this plan, its rates would be set high enough to discourage gifts. The transfers of property would instead yield their revenues through the death

²⁴ See Shultz, *The Taxation of Inheritance* (Boston, 1926), pp. 311-13 (Rignano plan).

²⁵ See p. 190.

tax. Congress has not viewed the gift tax in this light. Rate graduation under the federal gift tax copies that under the federal estate tax, but the rates are set at three-fourths the estate tax rates. Much money has poured over this low gift tax dam, particularly when a prospective change of rates in either the estate tax or gift tax has made existing gift tax rates seem especially attractive.

Only three states now levy a gift tax, but more will probably do so unless the federal government raises its gift tax rates in relation to those of the estate tax.

The donor's loss of interest on the gift tax thus paid in advance of death is sometimes given as the reason for the relatively low gift tax rates. However, the matter is more complicated than this argument implies. The gift tax rate scale is cumulative—that is, a donor goes up the scale into higher and higher rates year by year as he continues to make gifts. Let it be supposed that he gives \$45,000 a year to his son for ten years. The first year's gift costs him nothing at all in gift tax, because of an initial \$40,000 exemption, and an annual exemption of \$5,000 for each person to whom he makes a gift. The second year's gift will cost him little—no matter how much he intends to give away in the aggregate, eventually—, since he is starting at the bottom of the progressive rate scale. The third year's gift costs more, and so on. To the wealthy man intent on minimizing the total of gift tax plus death tax, the early gifts much more than pay for themselves in death tax avoided. In effect, the gift chops off what would otherwise have been the top part of the estate, taxable under the death tax at a high rate—perhaps, 40 per cent or 50 per cent—and transforms it into a gift taxable under the gift tax at a very low rate—4 per cent or 5 per cent. In view of this comparison, the interest loss incurred by the early payment of the tax is insignificant.

The gift tax presents some interesting problems of its own in relation to the personal status of the taxpayer. For example, if some exemption is to be granted to allow for the ordinary maintenance that a father may be deemed to owe his children, the problem arises of preventing large-scale avoidance of the tax by small but numerous gifts judiciously distributed over the years.

TAXES ON COMMODITIES AND SERVICES

The taxes imposed on the production, sale, or use of commodities or services—for example, the tobacco tax, the liquor tax, the customs duties, and the sales tax—can take relatively little account of the taxpayer's personal status. The persons whom they are intended to burden are usually once or twice removed from the one who pays the tax to the government; that is, the tax must be shifted, ordinarily by increasing the selling price of the commodity or service. The necessity for shifting destroys most of the possibilities for refinement.

Exemptions and Refunds

The merchant cannot be expected to discriminate among his customers to the extent that the government can discriminate among its income-taxpayers. A state imposing a general retail sales tax might wish to exempt all persons on the relief rolls from its burden. However, the exemption of retail sales to all such persons would put a heavy task on retailers, who would have to distinguish between their customers on relief and other customers. The tax officials, too, would have a sizeable task in checking the accuracy of the retailers' returns. An alternative would be to allow relief recipients to submit to the state their claims for refunds of the tax, with receipts, etc.

Both exemption and refund operate on the assumption that the tax is really shifted to the customer. It is always

difficult to determine whether the assumption is fulfilled in any given instance. Separate charging of the tax, so common under retail sales taxes, is no guarantee that the tax is being shifted. A retailer might sell an article at \$1.00, for instance, if there were no sales tax, while, under a 2 per cent sales tax, he sells it at "98 cents plus 2 cents tax."

Despite these difficulties, both exemptions and refunds are used in a few of the taxes on commodities and services. As of 1934, twenty-eight states allowed refund of gasoline tax paid on gasoline devoted to certain non-highway uses, and two other states permitted the sales of such gasoline to be made tax free.²⁶ Both procedures, but particularly the latter, have led to widespread complaints of fraud. With certain restrictions not pertinent here, the federal processing taxes of 1933-36 and the California retail sales tax act of 1933 allowed refunds to certain organizations or persons who had purchased taxed articles and distributed them for relief or other charitable purposes.

Discrimination by Commodity or Service

Sometimes the commodity or service taxed is sold in a variety of grades, or at a variety of prices. It is often feasible to distinguish among the different grades or prices for tax purposes. Thus, the federal tax on admissions does not apply when the admission price is 40 cents or less. This provision benefits the moving-picture public that goes to the cheaper theatres. In this manner, the admissions tax is slightly adaptable to differences in economic or social status—the exemption can be set at various levels depending on the degree of discrimination desired. The tax levied on manufacturers of cigarettes allows no such exemption, although the tax is much heavier than the admissions tax. The variety in grade

²⁶ Crawford, *op. cit.*, p. 20.

and price of cigarettes is not nearly so great as that found among moving-picture theatre admissions, and the cigarette tax has correspondingly less adaptability for distributing the tax burden.

Similar in principle to restriction of the admissions tax to high-priced admissions is the imposition of a tax on a commodity or service that is purchased only by a small group of taxpayers. Such a tax has a highly selective effect. The recent, but short-lived, federal tax on yachts, for instance, offers a better chance to impose a special burden on the very wealthy than does a tax on bread. A system of commodity taxes made up of a number of these selective taxes, each carefully chosen because of the particular group that it burdens, might seem to offer considerable possibility of adjustment to the personal status of taxpayers. However, the number of such highly selective taxes that are administratively feasible is small, and the experience of the federal government during and shortly after the war, and again during the recovery years after 1932, has shown that the revenue from these sources is almost negligible. The fact that the commodity or service has a restricted use indicates that the tax rate must be high if it is to yield much revenue, but the rate must not be so high as to render evasion inevitable. At practical rates the yield is small. The 10 per cent federal tax on certain club dues and initiation fees yielded only \$6,000,000 in 1936; in contrast, the 3 per cent federal tax on electricity sold to domestic and commercial (not manufacturing) consumers yielded \$34,000,000 in the same year.

The major commodity taxes, in contrast with the obvious luxury taxes, are useful primarily for placing on the lower economic groups a burden that cannot for administrative or political reasons be distributed satisfactorily by a more refined instrument, such as the income tax. A sales tax, for example, is a relatively heavy bur-

den on poor persons, since they spend a much greater proportion of their income on sales-taxed articles than the wealthy do.

The assumption implicit in these statements, that the tax is shifted, is a reasonable one, after allowing for a transition period when the tax first comes into effect. In the process of shifting, some business men may lose trade. The price of the taxed commodity is probably not raised at once by the precise amount of the tax above what it would be if some other tax were levied instead, or if some corresponding expenditure were eliminated. However, it may in general be assumed that, if the cigarette tax, or liquor tax, for example, were cut sharply, the retail price of cigarettes or liquor would drop by a roughly corresponding amount, and that a tax increase would be followed by a price increase. These are adequate assumptions for a discussion of this general nature.

PERSONAL STATUS AND ABILITY TO PAY

There is no agreement on the general aim to be kept in mind in adapting taxes to economic and social differences among taxpayers. It is agreed, however, that any adjustment to these differences should be designed on the basis of ability to pay. Specific interpretations of this phrase, however, differ greatly. Moreover, it is not yet possible to measure the degree to which the system departs from any of them—either because they are too vague or because the tools of measurement are lacking.

Equality of sacrifice is one of the ability-to-pay doctrines. It requires that any individual, rich or poor, feel the same sacrifice from his tax payments as any other. The present technique for measuring the actual distribution of the tax burden is so imperfect²⁷ that no attempt can be made here to indicate how far the present system fails to meet that standard. Even if the actual distribu-

²⁷ See pp. 221-22, 236-37.

tion were known, there would still be the problem of determining how much tax for each taxpayer would represent an equal sacrifice for all.

Similar considerations apply to another standard adopted by some students—that is, minimum sacrifice, or least aggregate sacrifice. Another standard is supplied by the *faculty theory*, advanced by Seligman, who takes into account both the sacrifice involved in paying the tax to the state, and the ease, through the existence of privilege, with which the taxpayer obtained the resources for paying the tax. Seligman justifies the higher taxation of unearned income largely on the basis of "the principle of privilege."²⁸

The importance of these concepts should not be underestimated. As they become more clearly defined, and as the instruments for measuring the distribution of burden are improved, they may be of much greater use in all serious attempts to analyze a given tax system.

Whatever standards are chosen, they do not, strictly speaking, apply to any one tax, though they are often loosely spoken of as if they did. They can be applied only to a tax system as a whole. Little meaning is conveyed by saying merely that a personal income tax with a certain scale of rates, exemptions, etc. conforms to the speaker's interpretation of the principle of ability to pay. The real issue is: how does some tax system as a whole appear when this particular tax forms a part of it? The conclusion must obviously depend upon the composition of the entire system.

²⁸ Seligman, *Essays in Taxation*, pp. 338-42. For recent discussions of the minimum-sacrifice and equal-sacrifice principles, see Pigou, *op. cit.*, pp. 60-63, 75-117, and J. P. Jensen, *Government Finance*, pp. 211-15.

Section B. Degree of Revenue Stability

Chapter 21

DEGREE OF REVENUE STABILITY

Some taxes fluctuate in yield much more than others when business activity or prices in general rise and fall. The extent of the fluctuation cannot always be measured by the figures of actual yield. These often reflect something more than changes due to business activity and prices. They may, for example, reflect changes in the tax law and changes that affect the particular thing taxed but that do not affect business activity in general or prices in general—for example, the spread of the cigarette habit as it affects the yield of the cigarette tax. Often the figures cannot be recast to eliminate ~~these extraneous~~ factors, and a study of fluctuations due to general business and price changes is therefore handicapped by a lack of refined data.

Recent fluctuations, chiefly in federal taxes, that have been associated with cycles in business activity and prices will first be examined. Sufficient data are not readily available to analyze collections under the most important non-federal tax—the property tax—in the same way.¹ Attention will then be given, in view of the current interest in the subject, to the effects of a prolonged upward price movement that is not necessarily followed by a return to the starting point. Such a movement is usually held to be a characteristic of inflation.

CYCLICAL FLUCTUATIONS

Sensitive Taxes

The income taxes, the death taxes, and some of the transfer taxes, such as the stock transfer tax, have been

¹ See Note 1, *Fluctuations in Property Tax Collections*, p. 563.

particularly sensitive to cyclical changes. By disregarding for the moment the influence of other factors—long-term trends, and minor changes in rates and other changes in the tax law—a general idea of the degree of sensitivity can be obtained from the data on actual yield shown in Table 27. Where no data are shown, it is because changes in the tax were so great as to destroy comparability.

The absolute magnitudes of the decreases in the corporation income tax and the personal income tax are significant. In 1933 the combined yield of the two taxes was almost \$1,700,000,000 less than in 1930—a decrease of 69 per cent—despite the increase in rates and certain other provisions of the Revenue Act of 1932, which affected part of the 1933 receipts. The decrease in the income taxes alone accounted for almost the entire decline—nearly 50 per cent—that was shown by federal tax yields from 1930 to 1933.

Much of the decrease was caused by a provision no longer in the law: the unrestricted deduction of capital losses against income from any source in the same year. Important remaining causes are the instability of net income, even aside from capital gains and losses, and the progressivity of the rate scale for the personal surtax.² The corporation normal rate has recently been made progressive, and the new undistributed profits tax is also progressive. The net result of these two innovations has been to increase the instability of the income tax system.³

The estate tax was a minor source of revenue during this period. Moreover, the decline in its yield was not so severe—54 per cent from 1930 to 1933.

The tax on club dues and initiation fees illustrates the sharp decline that may occur in the yield of some of the luxury taxes. In this case it was 46 per cent from 1930 to

² See pp. 332-33.

³ See Note 2, *Fluctuations in Progressive Rate Yields in Corporation Taxes*, p. 563.

1933. The continued decline of the yield after 1933 probably reflects certain methods of avoidance that have been recently developed—for example, lowering dues and increasing service charges.

The yield of the stock transfer tax dropped by almost the same percentage as the yield of the personal income tax, from 1930 to 1932,⁴ and it has moved erratically since 1933.

TABLE 27
YIELD OF CERTAIN FEDERAL TAXES SENSITIVE TO
RECENT CYCLICAL FLUCTUATIONS^a

1925-36

(In Millions of Dollars)

Fiscal Year	Corporation Income Tax	Personal Income Tax	Estate Tax	Tax on Club Dues and Initiation Fees	Tax on Capital Stock Transfers
1925.....	916	—	—	—	12.8
1926.....	1,095	—	—	—	17.1
1927.....	1,308	912	—	—	16.7
1928.....	1,292	883	60	—	24.2
1929.....	1,236	1,096	62	11.2	37.6
1930.....	1,263	1,147	65	12.5	46.7
1931.....	1,026	834	48	11.5	25.5
1932.....	630	427	47	9.2	17.7 ^d
1933.....	394	353 ^b	30 ^c	6.7	33.2
1934.....	398	—	—	6.0	38.1
1935.....	572	—	—	5.8	15.7
1936.....	739	—	—	6.1	33.1

^a See Note 1, *Federal Tax Collections, 1923-37*, p. 514.

^b Despite a sharp increase in rates and certain other changes designed to increase the yield, in the Revenue Act of 1932.

^c Despite a sharp increase in rates in the Revenue Act of 1932. This increase, however, probably had little effect on 1933 collections, owing to lag in payments.

^d Effective June 21, 1932, the rate was doubled for shares selling at less than \$20, and increased by 150 per cent for other shares.

Non-Sensitive Taxes

Most of the non-sensitive taxes now levied by the federal government are minor excises and special taxes that were not in force during 1928-32. An exception is

the customs duties, shown in Table 28. The yield of the customs responded little to prosperity in the period 1926-30. The decline from 1931 to 1933 inclusive and the subsequent recovery to 1937 show a much greater sensitivity. However, beginning with 1935 the figures have been appreciably affected by changes in rates.

The cigarette figures, also in Table 28, must be taken with some reserve because they reflect not only resistance to cyclical influences, but a shift from other forms of tobacco. From 1927 to 1930 the yield of the tax on large cigars dropped from \$24,000,000 to \$21,000,000. It had fallen to \$11,000,000 by 1933, and it recovered only to \$12,000,000 in 1936. The tax rates did not change

TABLE 28
YIELD OF CERTAIN FEDERAL TAXES NOT SENSITIVE
TO RECENT CYCLICAL FLUCTUATIONS*

1923-37

(In Millions of Dollars)

Fiscal Year	Customs Duties	Small- Cigarette Tax
1923.....	562	183
1924.....	546	204
1925.....	548	225
1926.....	579	255
1927.....	605	279
1928.....	569	302
1929.....	602	342
1930.....	<u>587</u>	360
1931.....	378 ^b	359
1932.....	329	317
1933.....	252	328
1934.....	315	350
1935.....	345 ^c	385
1936.....	387 ^c	425
1937 ^d	402 ^c	—

* See Note 1, *Federal Tax Collections, 1913-37*, p. 514.

^b Sharp changes in rates made by Tariff Act of 1930.

^c Influenced by changes made under reciprocal trade pacts under the Trade Agreements Act of 1934. The few changes of this kind made before the end of the fiscal year 1934 apparently did not influence the 1934 total appreciably.

^d Estimated. See Table 12, p. 88.

TABLE 29
CYCLICAL STABILITY AND SECULAR TREND OF THE ADJUSTED YIELD OF CERTAIN TAXES

Tax	Period Covered (Inclusive)	Rate to Which Yield Was Adjusted	Mean Annual Yield* (In Millions of Dollars)	Annual Rate of Increase of Trend (In Per Cent of Mean Yield)	Standard Deviation from Mean (In Per Cent of Mean Yield)	Standard Deviation from Trend (In Per Cent of Mean Yield)	Ratio of Maximum Yield to Minimum Yield	Ratio of Maximum Ratio of Yield to Trend to Minimum Ratio of Yield to Trend
Federal Taxes:								
Individual income tax								
\$0- \$5,000...	1924-34	rates	71.3	-10.89°	36.42	16.41°	3.81	2.23°
5,000- 10,000...	in-	of	72.3	- 5.97°	34.52	31.19°	3.77	3.13°
10,000- 25,000...	clusive	the	166.4	- 8.90°	40.26	31.75°	4.19	3.02°
25,000- 50,000...	but omit-	act	188.7	-10.52°	42.42	29.73°	3.65	2.27°
50,000-100,000...	ting	of	231.6	-10.85°	48.59	37.69°	4.85	2.68°
100,000 and over..	1932 ^b	1936 ^b	883.5	- 9.28°	69.98	68.72°	9.36	6.24°
Total.....			1,622.1	- 9.60°	56.47	51.35°	6.17	4.18°
Estate tax.....	1926-33	1926 act ^d	121.5	- 3.47°	37.74	39.72°	4.12	3.82°
Corporation income tax.	1918-33	10%	657.8	- 1.57	39.30	39.92	5.22	4.96
Stock transfer tax.....	1920-35	2¢ per \$100	18.67	+ 5.39	56.82	52.47	5.88	4.21
Club dues.....	1920-35	10%	8.48	+ 1.26	27.53	27.82	2.41	2.30
Sales of produce futures.	1920-35	1¢ per \$100	3.63	-11.45	60.74	27.69	9.71	4.11
Oleomargarine.....	1920-35	miscellaneous	2.71	- 2.85	29.58	27.20	2.92	2.65
Playing cards.....	1920-35	10¢ per pack	4.07	+ 3.02	20.76	15.51	2.06	1.59

Tobacco taxes:								
Cigarettes.....	1920-35	\$3 per 1,000	270.4	+ 6.26	31.44 ^a	10.29	2.85 ^a	1.37
Cigars.....	1920-35	^f	21.40	- 5.61	28.34 ^a	9.85	2.68 ^a	1.50
Manufactured tobacco	1920-35	18¢ per lb.	70.57	- 1.43	8.43 ^a	5.15	1.35 ^a	1.10
Total tobacco taxes..	1920-35		362.3	+ 4.06	21.07 ^a	8.63	1.99 ^a	1.30
State Taxes:								
Gasoline taxes:								
California.....	1924-35	1¢ per gal.	10.56	+ 5.41	21.17 ^a	8.63	1.99 ^a	1.29
Indiana.....	1924-35	1¢ per gal.	3.76	+ 5.22	20.36 ^a	8.14	1.95 ^a	1.21
Missouri.....	1925-35	1¢ per gal.	3.96	+ 6.66	23.33 ^a	7.90	2.34 ^a	1.18
Connecticut.....	1923-35	1¢ per gal.	1.87	+ 8.42	33.10 ^a	4.89	2.62 ^a	1.14
District of Columbia..	1925-35	1¢ per gal.	0.79	+ 8.80	29.55 ^a	4.82	2.47 ^a	1.13
Total gasoline taxes..	1923-35 [*]	1¢ per gal.	19.97	+ 6.71	27.14 ^a	7.73	2.15 ^a	1.21

^a The sources for the actual yields were: for gasoline taxes, Crawford, *op. cit.*; for income and estate taxes, see notes b and d; for other taxes, the annual reports of the Commissioner of Internal Revenue. Where rates varied, yields were adjusted to a common rate.

^b Two series were used—(1) figures for yield under the 1936 act from Table 7 for the years 1924, 1928, 1931, 1933, and 1934, and (2) actual yield figures for the years 1925, 1926, 1927, 1928, 1929, 1930, and 1931 under the act of 1926. Figures for 1929 were adjusted to take account of the 1 per cent decrease in normal rates. Series (2) was adjusted by the rate of the yields shown for 1931 and 1928, the two common years.

^c These figures are of doubtful significance because of the brevity of the period covered.

^d Two series were also used here—(1) figures for 1926, 1930, and 1933 were taken from Table 11, (2) figures for 1927, 1928, 1929, 1930, 1931, and 1932 were the actual yield figures under the 1926 act. The common year, 1930, was used to reconcile the two series. The gross yield, before the deduction of tax credits, was used.

^e These figures are of doubtful significance with reference to stability of yield because of the well-defined trend exhibited by the productivity of the tax.

^f Classified according to intended retail sales price: \$.75, \$2.00, \$3.00, \$5.00, \$10.50, \$13.50, per 1,000 cigars.

^{*} Figures for 1923 and 1924 estimated.

during this period. The tax on manufactured tobacco and snuff dropped from \$76,000,000 in 1923 to \$62,000,000 in 1936, with rates unchanged.

In order to compare readily the degree of fluctuation shown by the several taxes, some index of fluctuation is needed. This has been made by fitting a trend to the adjusted yield and measuring the standard deviation from the trend. The results are shown in Table 29.⁴ Another index, not so useful except for the income taxes, is also shown in Table 29—namely, the standard deviation from the average, or mean. A considerable spread between the two figures, as in the tax on sales of produce futures and the taxes on cigarettes and cigars, indicates of course a pronounced trend. This feature is also evident in the gasoline tax figures. The deviation from the trend, for total gasoline taxes, is only 8 per cent, while the deviation from the mean is 27 per cent. Even the latter figure, however, is much less than the deviation shown by the stock transfer tax during approximately the same period—52 per cent (from the trend) and 57 per cent (from the mean). In between are the federal estate and corporation income taxes, with a 37 per cent-40 per cent range.

The personal income tax indices are somewhat misleading because of the shortness of the period covered and because this period happened to include the last of a pronounced upswing and practically the whole of the subsequent decline. The trend shown is therefore spurious, and the figures for standard deviation from the trend—ranging between 16 per cent and 69 per cent for the various income groups—are too small to show the real situation. The standard deviation from the mean—ranging from 35 per cent to 70 per cent—gives a better indication of the degree of fluctuation. The greatest fluctuation is of course found in the top income group. In

⁴ For a more detailed description of Table 29, see Note 3, *Cyclical Stability of Certain Taxes*, p. 563.

a depression the taxpayers fall down through the brackets, so to speak. Many in the middle and lower brackets disappear into the sub-bracket cellar where they pay no tax, but their places are taken, in part, by the former dwellers in the higher brackets. In contrast, no source of replacement for the highest bracket exists.

EFFECT OF RAPIDLY RISING PRICES

No forecast is made here about the probability of a period of rapidly rising prices in the United States in the near future, but the current interest in the subject is recognized. Therefore an analysis is made of some of the effects on the tax system that might be expected if prices were to rise fairly steadily for five or ten years up to a new plateau several times as high as the starting point. In place of a generalization about the whole tax system, two major taxes are examined—the real estate tax and the personal income tax. Attention is restricted to revenue aspects, and the problems of justice are therefore not considered.⁵

Real Estate Tax

If prices rise and government costs rise with them, and if the yield of the real estate tax fails to keep pace, a slashing of local services or a demand on the federal and state governments for aid may result.

The problem is not one of maintaining a given dollar yield, but of maintaining an increase in dollar yield; for, with continually rising prices, government costs will rise. The yield will increase if the tax base—that is, the assessed value of the real estate—increases. The tax base will increase if the real or market value increases, and if assessors recognize the increase by raising assessed values.

⁵ The material in the remainder of this chapter is drawn from memoranda by J. Wilner Sundelson and Paul Strayer on the property tax and the income tax, respectively, in periods of rapidly rising prices. See also the analysis made by Jacob Viner, "Taxation and Changes in Price Levels," *Journal of Political Economy*, XXXI, No. 4 (August, 1923), 494-520.

Rise in Tax Base

Market values of real estate, on the average, might rise as fast as government costs, during a period of generally rising prices. The rise would be geographically uneven, however, and some of the local government units might soon find themselves in acute fiscal distress. Rent control, a common feature of European inflations, would restrict to a significant degree the increase in urban values. The value of land under long-term lease at fixed rentals would also lag. The growing value of the privilege held by the tenant under long-term leases would not be reflected in any part of the real estate tax base. This value is, rather, an intangible property right. As such, it is not subject to the real estate tax.

The homestead exemptions recently enacted in several states make the tax base more responsive to price changes, although, because of exemptions, the starting point is at a lower level.⁶ The exemptions are commonly in terms of absolute amounts—\$5,000 in Florida, for instance. A rise in value of homestead real estate will therefore result in a more than proportionate rise in the tax base. Thus, if a property is worth \$6,000 and is exempt to the extent of \$5,000, leaving \$1,000 taxable, a doubling of the property's value would make the tax base seven times as high. If all properties above \$5,000 are taxed in full, a doubling of the value of homesteads would still more than double the tax base.

Even if market values rise as fast as governmental costs, assessed values will lag behind market values and probably behind governmental costs, under prevailing methods of assessment. The most frequent period of re-assessment of real estate in the states is one year, so that a price rise can be well under way before assessed values begin to move.

For only about half the states, however, is property

⁶ See p. 295.

reassessed at this one-year interval. In nine states—almost all of them farming states with few large urban centers—the reassessment is made once every two years. Pennsylvania has a three-year interval; nine states, again chiefly farming states, have a five-year interval; Maryland and Ohio have a six-year interval and Connecticut has a ten-year interval, but both Ohio and Connecticut officials are empowered to assess annually.

The failure of assessments to rise might be offset by increases in the rate of tax, but states have imposed limits on local rates and, through constitutional amendments, on their own rates. In a few states constitutional limits have been imposed on the aggregate of state and local property taxes.⁷

Delay in Payment

Even if the tax base rose rapidly enough to match the increase in governmental costs, the customary delay between assessment and payment would cause trouble. Time must be allowed for review and equalization, and the task of original assessment alone must occupy a considerable period. Even after the liability has been fixed, common practice allows a brief period during which no penalty applies and then a long period, ranging from several months to more than a year, during which the penalty for non-payment is only a fairly high rate of interest. Taxpayers who realize the advantages of borrowing during an inflation are likely to borrow in this way from the government. Even interest rates of 10 per cent and 12 per cent a year, which represent the maximum charge in most of the states, would not deter them.

If the difficulty became acute, the states and localities might be driven to use index numbers to revise assessments in a blanket fashion and to revise amounts of tax due.

⁷ See p. 297.

Personal Income Tax

During the first year of the price rise the current revenue from the federal personal income tax would decrease steadily in purchasing power. The dollar amount would not be increasing, since it would be based on the period before prices started to rise.

After the first year, however, not only the government's dollar income but also its real income—income measured in purchasing power—would be increased. This gain would be the result of three factors: (1) the real value—purchasing power value—of the personal exemptions and the credit for dependents would decrease, (2) the average rate of tax would increase as more and more taxpayers found themselves in the higher-rate brackets, and (3) capital gains representing dollar gains but not purchasing power gains would be taxed.

Exemptions

If prices and incomes doubled, the real value of the \$2,500 exemption given to married couples and heads of families would be worth only as much as a \$1,250 exemption would be under the old price level, and the \$1,000 exemption given to single persons would drop in real value to \$500. So many people would have such increased dollar incomes—though no increase in real incomes—that millions more of them would be paying an income tax.

Effective Rates

The effective tax rate may be defined as the ratio found by dividing the tax due by the net income before deduction of personal exemptions or earned income credit. Thus, a married taxpayer with two children under eighteen, receiving a salary of \$4,000, gets a personal exemption and credit for dependents of \$3,300, under the Rev-

enue Act of 1936. He would, therefore, have a surtax base of \$700. By further deducting an earned income credit of \$400, a normal tax base of \$300 is reached. There is no surtax, since the first \$4,000 of surtax base is exempt. The normal tax is \$12, and the effective rate is \$12 divided by \$4,000, or 0.3 per cent.

If, in this illustration, the taxpayer's dollar income doubles, keeping pace with a doubling of prices in general, he has a surtax base of \$8,000 minus \$3,300, or \$4,700, and a normal tax base of \$3,900 (the earned income credit increases to \$800). This results in a surtax of \$28 and a normal tax of \$156, a total of \$184. Since the net income is \$8,000, the effective rate is 2.3 per cent. The net income doubles, but the tax increases to fifteen times and the effective rate to nearly eight times the former amount, because of the operation of the exemption provisions.

Suppose that another 100 per cent increase in prices in general brings with it another 100 per cent increase in the taxpayer's salary, to \$16,000. The surtax base is \$12,700, the normal tax base is \$11,300 (the earned income credit increases to \$1,400). The surtax is \$496, the normal tax is \$452, and the total tax is \$948. The income doubles, but, owing to the operation of the exemptions, and, this time, the progressivity of the surtax rates also, the tax increases to more than five times the former amount, and the effective rate (now 5.9 per cent) increases to about two and one-half times the former rate.

The effect is much less severe on taxpayers with very high incomes. They start from so high a level that they experience relatively little increase in rates when their dollar incomes increase. The rate of progression tapers off at the upper end and finally stops completely, since all income in excess of \$5,000,000 is taxed at a flat rate of 79 per cent. Thus, if prices and incomes triple, the taxpayer who starts out with \$4,000 (and ends with \$12,000) will have his tax, measured in dollars, multiplied by

43.5, while the taxpayer who starts with \$100,000 (and ends with \$300,000) will pay only 5.1 times as large a tax as before. The tax in terms of purchasing power—the “real” tax—will be 14.5 times as great as before for the first taxpayer and only 1.7 times as great for the second taxpayer.

Capital Gains and Losses

If prices in general double, the taxpayer who sells for \$10,000 some property that he bought at the start of the price rise for \$5,000 makes no gain in real purchasing power. However, he pays a tax on the dollar gain, which is \$5,000. Moreover, losses in real purchasing power—for instance, if the asset rises only to \$9,000—are not deductible even in part. In fact the net result may be, as in this case, a taxable capital gain unless the real loss is so great as to be also a loss in terms of dollars. Even then the deduction is severely limited.⁸

In effect, then, the income tax in an inflationary period reaches every transfer of property holdings that shows a dollar gain, regardless of whether there is a real gain or not.

Loss to Government

The absolute amount of increase in revenue that the government can obtain from the personal income tax with assumed increases in prices and tax bases cannot be estimated here. Even in real revenue, it is probably large. If the rise in prices continues very long, however, or becomes very rapid, the government may lose on balance because of one factor: the time interval between the income-year on which the tax is based and the payment of the tax. The real value of the government's claim diminishes steadily as prices rise. Over a period of years,

⁸ See p. 302.

the real value received by the government may be less than if no rise in prices and incomes had occurred at all.

If prices and incomes rise at such an extreme rate as 10 to 1 each year, the tax burden in terms of purchasing power actually decreases for a taxpayer starting from the \$20,000 income level. These calculations assume prompt payment. In practice, many taxpayers would withhold payments, thus borrowing from the government. Stiff penalties would be needed to prevent this action. If prices are rising 100 per cent each year, and if the real rate of interest is 6 per cent, the penalty rate necessary to prevent delinquency from being profitable to the taxpayer is 112 per cent.

Solutions

In any general rise of prices the course of events will of course be more complex than has been indicated above. For one thing, not all incomes will rise in the same proportion. Thus, any attempt to solve the problems of real revenue, to say nothing of the problems of justice and administration, must await detailed study. However, the probable correctives would include some index of prices to deflate money incomes and to inflate tax amounts due. Also, the time between the tax-base period and the date of payment might be shortened.

Section C. Ease of Administration

Chapter 22

EASE OF ADMINISTRATION

As will be shown below, the data on cost of tax administration in the United States reflect both efficiency and undue economy in enforcing the tax laws. They also reflect the use of business firms as unofficial tax collectors. Instead of dealing directly with millions of individuals, the authorities often collect, from a relatively small number of business firms, taxes that can be passed on to customers. These firms, like other taxpayers, undergo certain expenses in complying with the tax law. The cost of obtaining expert advice, the cost of maintaining special bookkeeping routines for tax purposes, and similar expenses represent the "cost of compliance." It is not included in the figures on cost of administration.

Evasion seems to be serious only in a few taxes. Almost every tax has a fringe of evaders who, though numerous, account for only a small part of the total revenue payable. Evasion is of course illegal, in contrast with avoidance and the minimizing of a tax, which consist merely in taking advantage of whatever avenues of escape the legislator has left.

Existing data on cost of administration are fragmentary,¹ and only one set of reliable figures is available on cost of compliance. Even when the information is accurate and precise it is usually difficult to interpret. Moreover, the differences in the cost figures for the various taxes are not striking. Little evidence is at hand, consequently, for preferring one tax to another because

¹ See the memorandum by Thomas J. Reynolds on cost of administration in the forthcoming volume, *Studies in Current Tax Problems*.

of differences in cost of collection or cost of compliance. In contrast, differences in the extent of evasion and the possibilities of checking it are in several instances obvious enough to supply a basis for choice.

COST OF ADMINISTRATION

The cost of administering a tax is usually compared with the revenue obtained from it, in order to judge whether the cost is high or low. For example, the New York State tax commission reports that in the year when it collected a record amount from the personal income tax (\$82,234,368, in the calendar year 1929) the cost of administration was \$675,187, or $\frac{4}{5}$ of 1 per cent of the yield. In contrast, the cost of administering the gasoline tax for about the same period amounted to only $\frac{1}{5}$ of 1 per cent. It does not follow, however, that the personal income tax was four times as difficult to administer as the gasoline tax. Percentage-cost figures never give a complete and accurate picture of relative administrative expense.

Ambiguity of Percentage Costs

In the first place, precise costs for each tax cannot be known. A tax-administering body usually has large overhead expenses that cannot be allocated accurately to the various individual taxes. Occasionally taxes are so closely linked in the process of collection that any segregation of their costs, while conceivable, is not practicable.

Some kinds of governmental costs are traceable to certain taxes but are never considered a part of tax administration costs. For example, salaries paid to judges who listen to tax litigants and costs of the Department of Justice incurred in prosecuting tax evaders are not figured as tax costs. Business firms acting as collection agents are sometimes recompensed by a share in the proceeds, but the published figures of tax revenue and expense usually fail to include this amount.

Furthermore, the rate of a tax must be known in order to interpret the percentage cost of its administration. Up to a limit not yet reached by most of the taxes in the United States, a higher rate of tax results in a lower percentage cost—under increasing rates, the total revenue usually grows faster than the total cost of administration. Similarly, when the yield of the tax fluctuates with business conditions, a high yield is usually accompanied by a low percentage cost.

Finally, and most important of all, the meaning of the percentage-cost figure varies with the degree of enforcement. The tax administrator is usually supposed to allow no evasion at all. He never reaches this goal, but the nearer he comes to it, the higher the average cost of administration is. Moreover, the "last" or hardest dollars of tax extracted from the least co-operative taxpayers may cost 100 per cent, or even more, while the average percentage for the tax as a whole is still not strikingly high. Any tax-administering body will show a low percentage cost if it collects only the quasi-voluntary contributions that will come in under almost all tax laws without any pressure.

Sometimes, as under a few of the state sales taxes, the law sets a limit to the percentage cost. In these cases the recorded percentage will not rise above a certain figure, no matter how great the evasion.

Despite all these limitations, percentage-cost figures must be used for want of a better standard of comparison. Properly qualified, they at least serve to correct major errors in judging administrative costs. They may also indicate when the administration of the system as a whole needs thorough reform.

Lack of Data for Federal Taxes

The information available on costs of administration is largely confined to state and local taxes. The federal government gives only one over-all figure for its in-

ternal revenue costs—except for the agricultural adjustment taxes while they were in force.² Similarly, it gives one over-all figure for customs. The 1935 figure for internal revenue other than agricultural adjustment taxes was 1.54 per cent. The processing tax figure was 0.72 per cent. The customs duties figure was 5.65 per cent.

It would be particularly interesting to know the cost of administering the federal spirits tax (to be distinguished from the beer tax). This seems to be the one important place in the federal tax system where a significant amount of revenue is being lost through evasion.³ Although cost data for the other major federal taxes would probably require no substantial adjustment for evasion, some reservation might be made in connection with the personal income tax and the gift tax. A considerable number of low-income taxpayers may be evading the former tax, and the latter is still too new to be judged.

State and Local Costs

Gasoline Tax

Among the major state and local taxes, the gasoline tax has the best record. The cost is less than $\frac{1}{2}$ of 1 per cent in about half the states and less than 1 per cent in practically all of them.

The figures are understatements to some extent, but they reflect the economy of collecting high-rate taxes chiefly from a few taxpayers—in this case, usually the refineries or other wholesalers. They also reflect an unwillingness to spend money to check an appreciable amount of evasion. Extreme estimates put evasion as high as \$100,000,000 a year; actually, the amount is probably much less. Total state and local collections were slightly more than \$500,000,000 a year when this

² See Note 1, *Federal Administration Costs*, p. 565

³ See Note 2, *Liquor Tax Evasion*, p. 566.

extreme estimate was made. However, even allowing for the lowering in cost that results from tolerating evasion, the gasoline tax at present rates seems to have an inherently low percentage cost.⁴

Motor Vehicle Tax

The reported percentage cost for the motor vehicle taxes is high, averaging about 6 per cent. Part of the cost is due to the inclusion, at least in some instances, of amounts spent for traffic regulation. In any event, the motor vehicle tax is more costly to collect than the gasoline tax.

Income Tax, Death Duties, and Sales Tax

The other important state and local taxes usually cost from 2 per cent to 4 per cent. Here and there a slightly higher figure is found for the personal income tax, particularly in rural areas. The tendency in many states, however, to neglect the enforcement of the income tax law robs the reported figures of much of their meaning.⁵ On the other hand, the income tax rates are usually so low that it would be difficult for any administrator to show an exceptionally low percentage cost.

In the state of New York, which accounts for nearly half of the personal income tax revenue of the states, and which probably enforces the law as strictly as any state, the cost has ranged from 0.70 per cent, in 1930, to 2.85 per cent, in 1921 when personal exemptions were low. Figures for the corporation income tax are usually somewhat lower than those for the personal income tax—though comparable data are few—and the sales tax costs are usually somewhat higher. Death duty costs show considerable variation, but in few states is the cost above 4 per cent.

⁴ See Note 3, *Gasoline Tax Collection Costs*, p. 567.

⁵ See Note 4, *Administration of State Income Taxes*, p. 568.

Property Tax

Practically no data exist on the cost of administering the real estate tax. Scattered evidence indicates that it usually ranges between 2 per cent and 4 per cent—an unfavorable showing in view of the high rate of the tax. Cost figures on that part of the property tax levied on personalty are of little value without a complicated adjustment for the large amount of evasion, especially in those states that try to tax intangible property at the same high rate as real estate.⁶

In general, then, the concentration of wealth, income, and business activity, coupled with an unwillingness to extract the last legitimate cent from the smallest taxpayers regardless of cost, insures that any major source of revenue in the United States will show a cost of tax administration of less than 6 per cent.

COST OF COMPLIANCE

The amount of time and money that the taxpayer spends in complying with a tax law is a cost of administration that does not appear in the official statistics. This "cost of compliance," in its broadest sense, includes items not ordinarily associated with mere compliance, such as expenditures made by honest taxpayers to check evasion by dishonest competitors, and expenses of litigation. In any sense, it includes such costs as fees to accountants for making up returns and expenses resulting from the necessity of special accounts for tax purposes.

A recent study of costs of compliance reported by a group of corporations includes the following figures: state corporation income tax, 9.5 per cent (median for a group of 76 corporations); federal corporation income tax, 4.7 per cent (median for a group of 95 corporations); state sales taxes, 3.7 per cent (arithmetical average for a

⁶ See Note 5, *Definition of Cost under the Property Tax*, p. 569.

group of 91 corporations); property tax, 1.04 per cent (arithmetical average for a group of 122 corporations) or 1.2 per cent (median for the same group). The figure for all taxes, federal, state, and local, was 2.3 per cent (arithmetical average for a group of 163 corporations). The data refer to the year 1934.⁷

An inverse relation between public costs of administration and private costs of tax compliance is suggested by these figures. This may be explained in part by the fact that under self-assessed taxes, such as the income tax, the taxpayer has to assemble all the data and even calculate the amount of tax due; under a government-assessed tax, such as the real estate tax in most states, all this work is done by the government.

The highest compliance figures are usually those of firms that are engaged in business in many states. They are bothered by a great number of tax forms and intricate problems of allocation of the tax base among the states.

A high cost of compliance is not always an unmitigated evil. The figure may simply indicate that the tax has forced on business men accounting methods that are desirable, regardless of the tax. The pressure of the federal corporation income tax, for example, has greatly improved accounting practice.

TAXPAYERS AS TAX COLLECTORS

The taxpayer becomes, in effect, an unofficial revenue officer when he is made subject to a tax whose burden he is supposed to pass on to someone else. For example, no one supposes that the federal tax on cigarettes is paid wholly out of the profits of the cigarette manufacturers, from whom it is collected. Part of the tax—indeed, probably almost all of it—is passed on, through wholesaler and retailer, to the cigarette smoker in the form of higher prices for cigarettes.

⁷ See Note 6, *Cost of Compliance Study*, p. 570.

Conceivably, the legislator might collect the tax directly from the person whom it is intended to burden. As a practical matter, however, the government cannot ask each cigarette smoker to pay a certain number of cents for each package of cigarettes that he has smoked during a certain period. Levying the tax on the manufacturer instead of on the consumer can therefore be regarded in large part as an administrative device. It obviates inordinately high costs of collection, intolerable evasion, and inconvenience to the consumer.

Disadvantages of Relying on Business Firms

Not only the taxpayer (the manufacturer) but also the others in the chain—the wholesalers and retailers—must use their distributive mechanism for tax purposes if the burden is to rest finally upon the consumer. Although the use of a private mechanism such as this is often unavoidable, it has some serious disadvantages.

Failure to Place Burden Where Intended

The government may be deceiving itself in thinking that the burden is being passed on to the consumer. It may instead be carried by the producer, or the wholesaler, or the retailer, or shifted "backward" by a reduction in wages paid, or rent paid.⁸ This point is irrelevant if the tax is laid blindly, without thought of the burden, as many undoubtedly are.

Cost Imposed on Business Firms

A second disadvantage lies, of course, in the cost imposed on the unofficial collectors. The amounts involved have been indicated in the discussion above on cost of compliance. The question may be raised, however, of the fairness of imposing such a cost.

Most complaints on this issue seem to be merged in-

⁸ See pp. 360-61.

distinguishably with complaints about cost of compliance in general—that is, the complaints are made regardless of whether the immediate taxpayer is also supposed to be the ultimate burden-bearer. If he is not supposed to be the ultimate burden-bearer, his costs of compliance may be called "agency costs." They represent costs that he incurs in acting as an unofficial government agent. Occasionally, such a tax as the recent short-lived federal tax on checks raises a clear-cut protest over agency costs. In this case, the complaint came from the banks.

The government rarely offers any compensation to its unofficial agents. Sometimes, however, the business firm is allowed to keep a certain share of the tax money. For example, wholesalers are allowed to keep 10 per cent of the cigarette tax imposed on them in Alabama. Reasonable doubt may exist whether this represents a real compensation. A reduction of the tax rate by 10 per cent ought to have the same effect. Indeed, no necessity for reimbursing the taxpayer exists if he can shift the cost, like the tax itself, forward to consumers in higher prices. Whether any given taxpayer can or cannot do this is a question requiring special study. It would be especially useful to discover whether the given taxpayer's "agency costs" are disproportionate to those of his competitors. A uniform allowance to all will not apportion reimbursements equitably among the taxpayers.

Another cost must sometimes be borne by business firms intermediate between the taxpayer and the ultimate burden-bearer. The shifting of the tax results in higher prices and the higher prices necessitate added working capital, on which interest must be paid. This cost, however, like the tax itself, may be shifted to others under certain conditions. Moreover, it is not a social cost. By incurring it, the business firms save the government interest on money it would have to borrow

if it were to wait and collect the tax when the article was consumed. Apparently no tax laws in the United States allow compensation to intermediaries (as distinguished from immediate taxpayers) for this or any other cost traceable to the tax.

Extent of Dependence on Business Firms

Only a minor part—apparently about 30 per cent—of federal tax revenue in the United States comes from taxes that are obviously not supposed to be passed on in business transactions. This includes the personal income tax, the excess profits tax, the estate tax, and the gift tax. Probably much of the state and local property tax and motor vehicle license tax also belongs in this group.

The corporation income tax, which produces about one-fifth of the federal tax revenue, is probably intended to burden not consumers but corporate stockholders. Thus the tax is not supposed to be passed on in business transactions, but the corporation acts as unofficial tax agent for its stockholders.

Almost all the other important kinds of tax—federal, state, or local—either represent a clear intent to use the business firm as unofficial agent through business transactions or give little indication of the lawmaker's purpose. In the former group are to be found the gasoline tax, most of the customs duties, the sales tax, the tobacco tax, and the liquor tax, with a number of similar commodity and service taxes of minor importance. In the latter group may be placed a large part of the property tax and the motor vehicle license tax, and the general corporation taxes except the federal tax and most of the state taxes on net income. This grouping can only be approximate since interpretation of the legislators' attitude is not easy, and the attitude differs from one jurisdiction to another.

BASIC FACTORS IN TAX ADMINISTRATION

A tax administered at a low percentage cost, with practically no evasion, and a low cost of compliance would approach the ideal from the purely administrative point of view. The taxes in the United States, as has been shown above, fall short of these objectives by an appreciable—though, in general, not an alarming—distance. The probable causes for this relative failure will now be examined.

Amount of Money Spent on Administration

Economy that is unintelligent, at least from an administrative point of view, is one of the most widespread causes. The amount of tax revenue brought in as a result of recent studies of tax enforcement carried on by white-collar relief workers has been illuminating. Two of the largest investigations—one on some federal excise taxes and another on the property tax in Texas—are said to have more than paid for themselves. The study of minor federal excises resulted in collections and assessments totalling eight times the cost.⁹ Probably few taxes in the country are being collected so vigorously that the cost of the last or marginal tax dollar received is 100 per cent of the revenue.

The taxes that would respond most favorably to increased expenditures on administration are not necessarily the taxes that are being evaded the most. Only tax administrators, and only those administrators who are especially familiar with many taxes, are qualified to hazard a guess on where an additional dollar of administrative expense would bring in the most revenue.

Centralized Administration

A proper balance between administrative centralization and decentralization is important not so much in

⁹ See Note 7, *Added Revenues Obtained from Added Expenditures*, p. 570.

changing the percentage cost of collection as in checking evasion and in helping the taxpayer to lower his cost of compliance. In the administration of the real estate tax, for example, additional centralization has been called for by most students of the problem, at least to the extent of having full-time county assessors replace a larger number of part-time, poorly trained, town or village assessors.

Whether administration would be further improved if the state were to select and control the assessors of all property still seems debatable. The experiment has not yet been tried. Certain classes of property, however, are well adapted to highly centralized assessment. Almost every state has central assessment for a large part of the property of public service corporations—railroads, light and power plants, etc. In Ohio, New Hampshire, and Tennessee, a special state-wide tax on income from certain intangibles has replaced part of or all the ad valorem tax on such property. To this extent, centralized administration has replaced local administration. Large industrial plants that extend over more than one local taxing district and intangible property, even under an ad valorem tax, offer the most attractive fields for the further extension of centralized assessment in the immediate future.

Improvement would come chiefly in two forms. Evasion, including a natural failure to protest against a relative underassessment, would be checked, and the injustices that arise through overassessment would be lessened.

Decentralization, on the other hand, has been urged for the administration of the federal income tax. The present system of referring practically every serious dispute to the central authorities necessitates expensive trips to Washington and, in general, results in long delays and a baffling feeling of remoteness. The officials outside of Washington are granted little authority to

settle matters on behalf of the administration. Decentralization similar to that under the property tax has been suggested. Each local administrator, though a federal employee, would settle practically all questions without appealing to the central authorities in Washington. Nation-wide uniformity in interpretation of the tax law would be risked to gain speed in settlement and to decrease both costs of compliance and costs of administration. Obviously, this plan would work intolerable injustices if the rank-and-file personnel were not of a high quality.¹⁰

An interesting type of centralization, midway between state administration and federal administration, is effected through the co-operative action of several states. This is of marked importance in the gasoline tax. Regional associations of gasoline tax administrators have grouped themselves into the North American Gasoline Tax Conference. The result appears to have been an appreciable decrease in evasion by clandestine transportation of motor fuel in trucks and barges across state lines. On a less ambitious scale, regional associations of administrators of state motor vehicle taxes, liquor taxes, property taxes, sales taxes, and tobacco taxes have developed within the past five years.¹¹

Fair Treatment by the Government

For most taxes in the United States at the present time, greater cultivation of a spirit of fairness toward the taxpayer would probably decrease evasion. Adequate tax administration depends upon a certain amount of cooperation by taxpayers. This will be lacking if the taxpayers feel unjustly treated.

Rightly or wrongly, a sense of unfairness seems to have become disturbingly acute among those who pay

¹⁰ See Note 8, *Centralization versus Decentralization*, p. 571.

¹¹ See Note 9, *Associations of Tax Administrators*, p. 572.

the federal income tax. The present writer has personal knowledge of a number of instances where the internal revenue agents were branded as arrogant and stupid. The complaints are disquieting because they come from persons who are not contentious or fault-finding, and who are eager to play the part of good citizens. A more fundamental and a better-established complaint is that the Bureau of Internal Revenue considers itself primarily an agent of the federal Treasury, and, as such, bound to decide all doubtful points in favor of the government. This complaint raises a basic issue of the status of a government department. The Treasury Department does at least take the part of the taxpayer by giving a refund, even when the taxpayer fails to request it, of any overpayment that is discovered in the process of checking the returns.

In large part, the sense of unfair treatment results from certain legislative provisions defining net income, over which the administrator has no control. Examples are: the taxation of capital gains with severe limitations on the deduction of capital losses, the prohibition of consolidated returns, and the refusal to allow certain expenses incurred in one year to offset income gained in another year.

Whatever the cause or the remedy may be, the federal income tax is in danger, because a self-assessed tax such as the income tax is particularly dependent upon the active co-operation of almost all the taxpayers—in contrast, for example, with the customs duties, the tobacco tax, and the death duties. On the other hand, no evidence exists that the federal income tax is in any immediate peril of falling to the low level of the intangibles taxes levied at high rates by some states and localities, where the unfairness of both law and administration and the consequent resentment of taxpayers have admittedly made a joke of the tax.

Unfortunately, the spirit of fairness may under certain circumstances lead to an increase in both cost of administration and cost of compliance. In the complicated economic and social structure of the modern world a taxing instrument must often be correspondingly complicated if it is to meet current demands for justice. The personal income tax, again, offers a good example. It is capable of a relatively close adjustment to individual ability to pay, but only at the price of added administrative difficulty. A case in point is the intricate part of the federal law dealing with reorganizations and other transactions where tax liability or tax reduction is deferred until a final settlement of the investment. Again, a motor fuel tax whose proceeds are dedicated to highway construction and maintenance is more easily administered if no refunds or exemptions are allowed to purchasers of gasoline for use, not on roads, but in farm tractors or for dry cleaning.

Height of Rate

Finally, the incentive to evasion offered simply by high rates is of great importance. The federal spirits tax at \$2.00 a gallon is a comparative failure in an administrative sense, despite the care taken in the law and regulations to prescribe in minute detail the manner in which the taxpayer's business shall be conducted. At a much lower rate evasion might almost disappear. The gasoline tax rate is high enough to induce certain expensive and partially successful attempts to evade it. For instance, non-taxable substances, such as kerosene, are known to be blended with taxed gasoline and sold to consumers as pure and wholly taxable gasoline.

There is no uniform level for all taxes at which evasion can be expected to increase markedly. The federal cigarette tax, at \$3.00 a thousand cigarettes (6 cents for a package of twenty), probably represents a higher per-

centage of the manufacturer's sales price than the federal spirits tax. The high cigarette tax rate, however, has caused no evasion of consequence. Where high rates do not cause evasion, it is usually because of the concentration of the business in the hands of a few large concerns that are easily supervised. If the business is one in which a small amount of capital is sufficient to start a productive unit, a high rate of tax will usually create a difficult problem of enforcement. In this respect, the manufacture of cigars contrasts with the manufacture of cigarettes, and the distilling of spirits contrasts with the brewing of beer.

Aside from the spirits tax, the gasoline tax, and possibly the intangible property tax, few, if any, major taxes in the United States would show an appreciable decrease in evasion with a mere lowering of the rates unaccompanied by more vigorous enforcement.

Chapter 23

TAX CONSCIOUSNESS

Various taxes differ in the number of taxpayers that they make aware of the tax burden and in the degree of tax consciousness that they arouse in each taxpayer. Thus the same amount of total tax revenue can be raised with widely varying patterns of tax consciousness.

DIRECT TAXPAYERS

Several factors determine how conscious of taxation the populace will be. The most important, of course, are the number of people who pay taxes and the amount that they pay directly to the government. When a person pays a tax as a separate transaction between himself and the government, he is far more aware of it than when he pays it as a hidden charge—for example, in rent—or as part of another transaction, as in the purchase of goods to which a separately charged retail sales tax applies. For the purposes of this discussion, a corporation is considered as but one taxpayer, while a tax on a partnership is considered as a tax paid by each of the partners. The term "family" follows the Census usage of including not only normal families but also persons living alone. Direct taxpayers—those who pay the tax money directly to the government—are considered first, and in this discussion they include both those who can and those who cannot shift the burden of the tax to others.

Motor Vehicle Tax

The tax that is paid directly by the largest number of people is that on motor vehicle licenses. The total num-

ber of motor vehicles registered for license taxation in the United States on December 31, 1935, was 26,221,052. Of this total, 22,565,347 were passenger automobiles.¹ No data have been found that indicate how many of the passenger automobiles are used by families with more than one automobile or by business firms. Perhaps from 15,000,000 to 20,000,000 families own at least one passenger car each—that is, from one-half to two-thirds of the 30,000,000 families in the United States.

Not every automobile used by a business firm represents an additional direct taxpayer. Some firms own more than one automobile, and in some cases the taxpayer is already included in the 15,000,000 or 20,000,000 families.

In any event, the number of individuals who pay an automobile license tax is large enough to create an impressive amount of tax consciousness. The tax probably falls in the range of \$3.00 \$15.00 a year for most of the families. It is ordinarily not payable in installments.² Some automobile owners, however, who are unaware of the great spread between the size of the tax and the cost of the license plate, may possibly think that the license tax is not a true tax but a payment for the license plate itself. Also the acuteness of tax consciousness is probably less if a business firm thinks that it is shifting the tax.

Property Tax

The real estate tax is close to the motor vehicle tax in the number of direct taxpayers involved. By far the largest body of real estate taxpayers consists of home owners. The United States contains 14,000,000 families that own their homes—between 3,000,000 and 4,000,000 of them farm homes. In all the states except Florida, which has extensive homestead exemption, practically every home owner pays a real estate tax directly to the

¹ Automobile Manufacturers Association, *Automobile Facts and Figures* (New York, 1936).

² *Tax Systems of the World*, pp. 152-57.

local government, and sometimes an additional tax to the state government. Therefore almost half the total families in the United States pay a real estate tax directly.³ The amounts are substantial. At 2 per cent of true value, which is not an unusually high or low rate for most of the country, a home owner with a \$5,000 property pays \$100 a year. Moreover, home owners in general doubtless realize that they are not able to shift the tax to anyone else. Payment can usually be made in not more than four installments.

The owners of the 11,000,000 rented dwellings in the United States likewise pay a real estate tax. Their number cannot be determined, but it must be far less than 11,000,000. Because of the possibility of shifting part of the tax to tenants, however, many of the owners must feel less concern about the tax than those who live in their own houses.

Probably most of the dwelling owners also pay an automobile license tax. The property tax on dwellings, added to the automobile tax, therefore intensifies tax consciousness instead of increasing its spread.

In some states the personal property tax on household goods, clothing, etc., and on intangibles causes widespread tax consciousness. In general, however, the personal property tax may, for present purposes, be considered chiefly a tax on business firms (other than dwelling owners).

Personal Income Tax

After the property tax, the personal income tax supplies the greatest number of direct taxpayers. It is probable that few of them, however, pay directly neither the automobile tax nor the property tax on dwellings. Adding the income tax to the other two taxes, therefore, brings in a few additional taxpayers, intensifies, as a second tax, the tax consciousness of a considerable num-

³ See Note 1, *Ownership of Homes*, p. 573.

ber of automobile taxpayers or property taxpayers, and acts as a third tax for a number of persons who own both dwellings and automobiles.

Number of Returns under Present and Past Exemptions

Under the federal personal income tax, 4,094,420 individual returns were filed for 1934, but less than half—1,795,920—were taxable. The tax paid equalled 6.1 per cent of the net income of the taxable returns. Husband and wife together were represented in 657,795 returns, hence almost 2,500,000 taxpayers, practically all of them adults, were represented directly by the taxable federal returns. In addition the taxable returns showed 827,084 dependents. The preliminary report for 1935 incomes filed to August 31, 1936, shows 4,473,426 individual returns, of which 2,067,736 were taxable.⁴

The number of adults represented by the 1934 returns—2,500,000—may be compared with the total number of persons of twenty-one years of age or over in the United States, in 1934, estimated at 75,000,000 out of a total population of 126,000,000.⁵

The figure, 2,500,000, loses some of its significance when the size of the tax is considered. Of the taxable single returns included in this figure, about 650,000 were for incomes of less than \$2,000. The federal tax on a single person's income of \$2,000, assuming that it is all earned income, is \$32. About 270,000 married couples living together and 20,000 single persons, heads of families, showed taxable incomes of less than \$4,000. The federal tax on a married couple, or a single taxpayer who is head of a family, with an earned net income of \$4,000 and assuming one dependent, is \$28. Consequently, for at least 1,200,000 out of the 2,500,000 taxpaying indi-

⁴ *Statistics of Income, 1934*, Tables 2 and 5, pp. 60-61 and 66-67. Treasury Department, Bureau of Internal Revenue, *Statistics of Income for 1935: Preliminary Report of Individual Income Tax Returns Filed to August 31, 1936*, p. 1.

⁵ Derived from Department of Commerce, Bureau of Foreign and Domestic Commerce, *Statistical Abstract of the United States: 1934*, Fifty-sixth Number, 73 Cong., 2 sess., House Document No. 368, Tables 11 and 27, pp. 9 and 34.

viduals the federal tax payable per return was not more than about \$30, on 1934 incomes. Moreover, since the tax can be paid in four installments, any one payment need not have been more than \$7.00 or \$8.00.

Although the amounts computed above seem small, they are not negligible—particularly since most taxpayers entertain no hope of shifting their income tax to someone else. Some doubt may exist, however, whether the tax at these levels is high enough to induce much concern over the amount of governmental expenditures.

In the fairly prosperous year of 1924 the federal exemptions were the same as those reflected in the 1934 statistics, but the form of the earned income credit did not tend to reduce the number of taxable returns, as the 1934 provision did. In 1924, 4,490,000 taxable returns were filed—two and a half times as many as in 1934. This number was exceeded only in 1920, when, with considerably lower exemptions, 5,518,000 taxable returns were filed—three times as many as in 1934.⁶

In some of the states, where lower personal exemptions are in force, the persons subject to the income tax are relatively more numerous. For example, Kansas, where the exemptions are \$1,500 for married persons, \$750 for single persons, and \$200 for dependents, received for 1934 incomes 71,500 returns, of which 48,700 were taxable.⁷ These taxable returns represented a total of 92,000 persons, out of a population of 1,848,000. Thus about 5 per cent of the populace is taxed, as against 3 per cent under 1934 federal returns. About twenty-five states have exemption levels lower than those of the federal government, partly because of the effect of the earned income credit in the federal tax.⁸

It must be recalled, however, that more than one-third

⁶ *Statistics of Income, 1920*, and *Statistics of Income, 1924*.

⁷ Kansas State Tax Commission, *Income Tax Law and Regulations 35 . . . Statistics for 1933 and 1934*, pp. 113-14.

⁸ See p. 301.

of the populace lives in states that do not impose personal income taxes.

Number of Returns under Hypothetical Exemptions

If the personal exemptions and the credit for dependents of the federal personal income tax were lowered by about 50 per cent, the number of taxable returns would be greatly increased. For incomes of less than \$5,000 the number would rise from 1,000,000 to 8,100,000, giving a total of 8,400,000 taxable returns. Both figures are for 1933 incomes, and they would of course be much larger than that in a prosperous year.⁹ Very few new taxpayers with incomes of more than \$5,000 would be discovered by this change.

The present exemptions are \$2,500 for a married couple or head of family and \$1,000 for a single person, and the credit for dependents is \$400 for each dependent. However, the effect of the earned income allowance is that all single persons with an income of \$1,111 or less and all married couples (or heads of family) with an income of \$2,778 or less are exempt.

The 8,100,000 figure assumes a lowering of the exemptions to \$1,000 and \$500, and the credit to \$200. If the reductions were only to \$1,500, \$800, and \$300, respectively, the total number of new taxable returns under 1933 conditions would be, not 7,100,000, but 2,400,000, giving a total of 3,700,000 taxable returns. Both of these hypothetical situations assume continuance of the 10 per cent earned income credit.

The total number of new returns, taxable and non-taxable, would, of course, be much greater. In 1933, the number of taxable and non-taxable returns filed from all income groups was 3,700,000. With the lower of the two sets of exemptions and credit noted above, the total returns would have been nearly 13,000,000—that is, 12,-

⁹ The 1934 figure to compare with 1,000,000 is 1,380,000. The 1934 data were not, however, available in time to compute the increase under 1934 conditions.

200,000 returns with a net income above the exemption limits,¹⁰ plus perhaps 500,000 other returns. With the higher exemptions and credit, total returns would have been between 7,000,000 and 8,000,000.¹¹ These totals, so far as they reflect non-taxable returns, are of course much more useful in indicating the administrative task involved than in showing possible tax consciousness.

Business Taxes Generally

The other taxes are of little importance in a discussion of direct taxpayers. The business tax that accounts for the largest number of direct taxpayers is the sales tax. In the United States the sales tax is restricted usually to sales by retailers. In 1933 there were 650,000 retailers in the twenty-two states that had a sales tax at the end of 1936, and another 100,000 or 150,000 can be added for New York City and New Orleans, bringing the total to 750,000 or 800,000.¹² Only a few of this group are exempt from the sales tax.

Whatever the precise figures may be, however, the number of individuals who are conscious direct taxpayers is far smaller than for the automobile tax and the others discussed above. Many consumers bear the burden of the sales tax, and even pay it in a legal sense, but they do not make the payment themselves directly to the government. The purchasers' consciousness is, therefore, not considered here but in a subsequent section. In view of the relatively small number of direct payers involved in the sales tax, it is not necessary to consider the other business taxes, which reach an even smaller number of taxpayers directly.

¹⁰ See Note 2, *Increases in Returns from Changes in Exemptions and Earned Income Credit*, p. 573.

¹¹ *Ibid.*

¹² Department of Commerce, Bureau of the Census, *United States Summary of the Retail Census for 1933*, Press Release, December 3, 1934, pp. 9-10; Carl Shoup, "The Experience of Retailers under New York City's Sales Tax," *Bulletin of the National Tax Association*, XXI, No. 4 (January 1936), 98.

Death Taxes and Gift Taxes

The death taxes and gift taxes reach relatively few taxpayers. Only 12,724 returns were filed under the federal estate tax in the calendar year 1935, and 1,614 of these were for non-resident decedents. Of the remainder, 8,655 were taxable, but 4,483 of these paid a total tax of only \$1,797,000—about \$400 each.¹³ While the lower exemptions of many of the state death taxes increase the number of taxpayers considerably, the total number affected is still relatively small.

In contrast with the income tax, almost all those—decedents and beneficiaries—who bear the burden of the death taxes are, in any one year, a new group who have not paid the tax before, or at least not for many years. For a given number of returns and a given amount of tax over a period of years, therefore, the death tax creates more tax consciousness. On the other hand, because of the general remoteness and indefinite time of payment the intensity is not so great. The taxpayer probably does not worry so much about possible future payment as he does with the income tax and other regularly recurring taxes.

Payroll Taxes

The taxes levied in the Social Security Act are of uncertain importance as instruments of tax consciousness. Sufficient data are not yet available to make a comparison with other taxes, but 26,000,000 employees will probably contribute to the old-age pensions when the plan is in full operation.¹⁴ According to the definition of direct taxpayer used in the present discussion, however, the only direct taxpayers under the act will be business firms.

¹³ *Statistics of Income*, 1934, Tables 1-5, pp. 36-47.

¹⁴ John G. Winant, Chairman, Social Security Board, *New York Times*, May 8, 10, 1936.

Number of Direct Taxpayers

Apparently about two-thirds of the families in the United States are made tax conscious in the sense that they pay a substantial amount of money in taxes each year directly to some governmental unit. Without the automobile tax, only about half the families would be direct taxpayers. Practically every business firm pays a tax of some kind. The unincorporated firms, however, consist of "families," most of whom are probably included in the direct taxpayers, just noted, under the automobile tax, the dwelling tax, and the income tax. On a strictly numerical basis, corporations are insignificant. Through their owners, creditors, and others, their tax burdens exercise a significant degree of tax consciousness; it is, however, indirect.

INDIRECT TAXPAYERS

In many states the gasoline tax and the retail sales tax create a large number of conscious indirect taxpayers. Because the amount of the tax is usually made known to all purchasers, they realize that some definite part of the purchase price is destined eventually to reach the government. They may also believe, if they stop to think of it, that the indirect burden is a real one—that if the tax were removed the price that they would have to pay would be correspondingly lower. Whether the burden is in fact a real one is not relevant. A merchant who sells an article for 98 cents plus 2 cents sales tax might possibly have sold it for \$1.00 even if no sales tax had been in force. For all practical purposes, however, the consumer does not know it and he may, in effect, be a conscious indirect taxpayer even though the tax is not shifted to him. Sometimes, the consumer does know it, as in the New York City restaurant that posts a sign reading: "All wines and liquors reduced 1¢ from prices

posted; added 1 for tax." The result is a special kind of "tax consciousness."

Sales Taxes

Fifteen of the twenty-two sales-taxing states, and New York City and New Orleans require the retailer to state the tax to the consumer as a separate item instead of hiding it in the price.¹⁵ This requirement has been sponsored chiefly by the retailers themselves in the expectation that it would facilitate shifting and would also, by keeping consumers aware of the tax, improve the chances of repeal. The seventeen jurisdictions that practice separate charging comprise about one-third of the total population of the country. In a few of the other jurisdictions the practice is more or less widespread on a semi-official or unofficial basis.

In all twenty-four jurisdictions the sales tax is so broad that, wherever a separate charging plan is used, few, if any, residents can be unaware of the tax. The kind and degree of tax consciousness that is caused, however, is difficult to ascertain. The day-by-day payment of extra pennies or the handling of metallic tokens, cardboard tax receipts, or prepaid tax coupons may develop an intelligent interest in government. They may, on the other hand, create a pin-prick irritation against taxes in general, or simply an almost unconscious response whose real meaning is lost.

Other Taxes

The possibilities of the social security taxes have been mentioned above. It will be of interest to discover whether a long-continued payroll deduction results in the employees' finally forgetting that the cause of the deduction is a tax. Perhaps the form in which they are

¹⁵ William Paul Walker and Everett C. Weitzell, *The Retail Sales Tax, with Particular Reference to Administrative Problems of Its Collection* (College Park, Md., February 1936), p. 13, and American Retail Federation, *Sales Taxes: A Digest of Each State Law* (Washington, November 18, 1936).

notified of the deduction will prevent a loss of tax consciousness.

The consumer's attention is drawn to some of the state commodity taxes by tax stamps that show the amount of tax paid by the merchant. The federal government, however, has not adopted this policy. The federal tax stamp on packages of twenty cigarettes, instead of informing the taxpayer that the manufacturer has paid a tax equivalent to 6 cents, merely states the administrative classification, "Class A." Similarly, the amount of the federal internal revenue tax on spirits, \$2.00 per proof gallon, is not stated on the tax stamp.

Landlords have on occasion considered the idea of presenting their tenants with rental bills broken into two parts: rent proper and property tax paid by the landlord. Allocation of the tax among the apartments of a building is difficult, however, and no landlord could know exactly how much of the tax he was in fact shifting. The latter problem exists for all taxes that are not borne entirely by the direct payer, but it is particularly difficult in connection with the real estate tax—partly because of the distinction that must be drawn between land and buildings.¹⁶

Wherever consciousness of indirect taxation is found, two or more strata of tax consciousness exist, since the person who pays the money directly to the government is sure to be aware of the tax.

OTHER CAUSES OF TAX CONSCIOUSNESS

A number of miscellaneous factors may increase tax consciousness.

A tax may reach such a stage of unpopularity that a large proportion of the taxpayers evade it successfully. This sort of tax consciousness, however, is scarcely considered desirable. Evasion of this degree exists in the

¹⁶ See pp. 296-97.

states that try to impose the ordinary property tax on such intangible property as stocks, bonds, etc. In some places, however, the evasion becomes so habitual and so complete that practically all consciousness of the tax is lost.

Variation in the amount of tax payable from year to year probably increases tax consciousness—compare, for example, the income tax with the real estate tax. The effect is particularly great when the variation seems to have a close relation to variations in the volume of governmental expenditures. Moreover, the taxpayer may feel that he has discounted some of the steadier taxes in his purchase price, as when he buys real estate.

Publicity of the amounts paid by income-taxpayers encourages curiosity in one part of the general public and may cause resentment in the taxpayer. Wisconsin has allowed publicity of income tax returns, and the federal government has experimented with it in 1924 and 1934 and again, with respect to salaries only, under the 1936 act.

Administration of a tax in an officious and generally tactless manner is another way to heighten consciousness into resentment.¹⁷

Well-organized publicity by private groups has at times created passing waves of tax consciousness. In some states, as in Ohio, the organized movement has aroused the taxpayer to such a pitch that drastic tax limits have been put in the constitution. It was claimed that 265,000 signatures were obtained on a petition for this constitutional amendment.¹⁸ Corporations sometimes make their shareholders aware of the burden of taxation through comments by officials in their reports or on other occasions.¹⁹

¹⁷ See p. 349.

¹⁸ Adam Schantz, "Real Property Tax Limitation," *Proceedings of the . . . National Tax Association*, 1934, p. 43.

¹⁹ See pp. 343-44.

The income taxes usually allow deduction of certain taxes paid, in computing net income. Many taxpayers have been made conscious of these taxes—with even a momentary feeling of gratitude—when they have calculated the amount that could be deducted because of taxes paid on admissions, gasoline, retail purchases, income, etc.

Finally, the cost of compliance has been an important stimulant of tax consciousness—especially in certain business circles where the problems of federal and state income taxation have required elaborate record-keeping. Among individuals this cost is often a psychic cost rather than a monetary cost. Generally, the more complex the tax, the greater the consciousness of it will be.

Chapter 24

INTERGOVERNMENTAL CO-ORDINATION

Many of the aims discussed in preceding chapters can be most nearly achieved under a centralized tax system. The taxes generally conceded to be most adaptable to the personal status of the taxpayer—notably the personal income tax—can usually be administered with the least evasion by the government that has the widest jurisdiction. Moreover, a single tax on income or business may be cheaper to administer, and its incidence can be better controlled from the viewpoint of justice, than independent federal and state taxes. And, except where special benefit is involved, taxes that are uniform in rate and base for the whole national economy are less apt to exert an undesired influence on industrial developments than taxes that vary from one jurisdiction to the next.¹

A decentralized government requires independent taxing powers, however, and independent taxing powers cannot be reconciled with a uniform and centralized tax system. Consequently, a tax that would be discarded in a centralized system as relatively inequitable, or costly to administer, might be given an important place in a decentralized system because it was one of the few taxes available to a small jurisdiction. Many of the faults of existing tax systems in the United States are directly attributable to decentralized government, and some of them cannot be remedied without sacrificing an important degree of state or local independence. In consequence, the choice lies, to some extent, between justice and efficiency

¹ Special benefit is used here to cover any advantage that a local government may offer an industry even though the cost of the superior services given is covered by a general tax levy rather than a special benefit tax or charge.

in taxation on the one hand and local self-government on the other.

In practice, the attempt to couple the virtues of centralized taxes with the virtues of decentralized government has led to a more rapid centralization of taxation than of other functions. This is not, however, a complete solution of the problem. It is important, therefore, to consider how much the tax system can be centralized without sacrificing local responsibility. In the absence of such responsibility the merits of local self-government are largely illusory.

THE CONFLICT OF JURISDICTIONS

Pressure for an integrated tax system has two sources: (1) increasing government expenditures and (2) increasing integration of the economic system of the country as a whole. Such a tax system can yield more revenue with less unwanted interference with business than independent and varying systems. This point is important to taxpayers and government alike.

Federal-State-Local

With the creation of the national government in this country, revenue sources were divided in the usual manner of federal states. The customs duties were assigned to the national government, and all direct taxes were left to the state governments. In practice there was complete separation of sources, but the tax powers of the two jurisdictions overlapped. Both governments might levy excises, and the national government had the power to levy direct taxes, although only in proportion to the population of the various states.² Actually, the national government rarely attempted to make such per capita levies.

The first permanent invasion by the federal govern-

² See Note 1, *Uniformity Requirement for Federal Taxes*, p. 512.

ment of the field of direct taxation was the income tax, permitted by the Sixteenth Amendment. The states had previously made little effort to develop this form of direct taxation. Most of them, in their earlier history, found property and poll taxes adequate for their purposes. The states also made little use of the excise taxes that have played so important a part in national finances beginning with the Civil War. Consequently, until the past quarter century practically no duplication occurred in federal and state taxes. During the past twenty-five years, however, the situation has altered. The growing demand for revenues has led to an increasing number of duplications, and investigators of the problem now number them in hundreds.

Two taxes on the same base are not in themselves harmful if they are properly integrated and the combined rates are not excessive. State and local governments shared the same taxes—chiefly the property tax—without conflict as long as rates remained low. When combined rates are high, however, an increase in the rate levied by one jurisdiction makes increases in the rates levied by other jurisdictions more difficult, and conflict arises. The conflict lies deeper than the duplication of particular taxes. Fundamentally these overlapping jurisdictions are competing for the same economic resources, whatever the form of the taxes by which the different shares are obtained.

Co-ordinate Governments

Competition is not limited to federal and state governments and state and local governments. Counties compete with towns, and towns compete with school districts. The competition is not even limited to jurisdictions that cover the same geographic area. One city may not tax real estate situated in another city; but it may, by granting tax exemption for a limited period, induce

a manufacturing concern to build new plants within its boundaries instead of in a neighboring city. In this way it may ultimately add to its taxable real estate at the expense of its neighbor.³

States may compete with one another in much the same fashion. For interstate business, state competition may take another form. One state may obtain its maximum revenue from a corporation income tax by allocating all interstate income, for purposes of taxation, to the state in which gross receipts arise. Another state may obtain its maximum by allocating such income to the state where the tangible property of the corporation is located. If each state pursues its own immediate interest, some corporations may pay taxes in both states on their interstate income while their competitors pay taxes in neither. These facts are so well known that it is hardly necessary to enlarge on them here in order to demonstrate the importance of co-ordinating tax systems.

OBSTACLES TO CO-ORDINATION

Constitutional Limitations

The obstacles to co-ordination are legal and political rather than economic. Federal and state constitutional limitations set the framework within which tax systems may be constructed.

Specific restrictions are few. The federal Constitution is generous in its grant of tax powers to the national government, and yet it does not seriously limit the tax powers of the states. It forbids the federal government to levy a direct tax except in proportion to the population of the states. Court interpretation and the Sixteenth Amendment have restricted this prohibition, for all practical purposes, to a federal property tax levy. The states, on their side, may not impose customs duties; nor may they tax interstate commerce, or property that has been held

³ See pp. 148-50.

to be beyond their jurisdiction.⁴ Neither government may levy export duties.

Within these restrictions, the whole field of taxation is open to both federal and state governments. The consequence is extensive duplication of taxes. If the federal Constitution had made a sharp division between federal and state taxing powers, the resulting separation of sources would have limited the area of conflict. This solution of the problem would bring certain difficulties, however.⁵

Effective co-ordination of tax systems does not demand complete separation of tax sources. In the absence of such a separation, however, it does demand a larger measure of control in the hands of the central government than is feasible in a federal state. This centralization of control is necessary to resolve the conflicts between national and state governments and between states.

The most significant provision of the federal Constitution, from the point of view of interstate tax relations, is the prohibition of taxation of interstate commerce. Without this provision state tax relations might be even more chaotic than they are, but it has brought problems of its own. Not only has it failed to prevent some forms of double taxation, but, with the growth of interstate business, it has offered an increased opportunity for tax avoidance, which no amount of state co-operation can abolish. The problem is particularly serious for corporation income and gross sales taxes.

The control of local taxation that is granted to state governments by their constitutions is sufficient to prevent conflicts between the state and local jurisdictions and also between one local jurisdiction and another. However, a majority of the constitutions require that

⁴ See Note 1, *Supreme Court Decisions*, p. 575.

⁵ See pp. 374-76, 383-84.

taxes should be equal and uniform. This requirement, as interpreted by the courts, has frequently barred the use of such taxes as the progressive income tax. As a result, the states have had to rely so heavily on the general property tax that its availability for local use has been seriously impaired. Co-ordination between the federal and the state governments and between the various state governments is outside the sphere of state constitutional control.

Limitations Inherent in Decentralization

Constitutional restrictions do not offer an insurmountable barrier to co-ordination. Constitutions can be amended as need arises, however slow and cumbersome the process. The real obstacle lies in the nature of decentralized government itself, not in the constitutional provisions that have created and preserved it. A uniform tax system requires a centralization of tax power, and probably also of tax administration, but both kinds of centralization are more consonant with a unitary than with a federal state.

Complete centralization of the tax system in the hands of the national government would leave state and local governments entirely at the mercy of the central government. Whatever other rights and privileges they might have would be in name only if they were denied any measure of independent financial power. The central government might, of course, grant the underlying governments substantial freedom, together with the means of financing their activities. But, whether support were provided in the form of direct subsidies or through delegation of certain tax powers, such freedom would be on sufferance, at best. If the federal form of government and local self-government are to be maintained, complete centralization of the tax system is impossible.

POSSIBLE METHODS OF CO-ORDINATION

Federal-State-Local

Co-ordination of the tax systems of jurisdictions that occupy the same geographical area does not necessarily imply complete centralization. The more serious conflicts resulting from independent, overlapping, and to some extent competitive tax systems may be avoided in other ways. Five specific methods will be briefly reviewed.

(1) The first is to adopt a complete separation of sources (using "sources" in its commonly accepted meaning of types of tax) between federal and state or state and local governments.

(2) A second method is to share the same sources, with due regard for one another's interests and the interests of the taxpayers. Independent federal and state taxes on the same base are apt to be wasteful from an administrative point of view, but they can be made practically uniform in base, reasonable in rate, and—except for the additional cost—no more injurious to the taxpayer than a single tax that produces an equal amount of revenue.

(3) A third method is to establish a uniform base for each tax and a single administration, each jurisdiction remaining free to fix its own rates. This obtains most of the desired unity without diminishing the responsibility of the rate-fixing jurisdiction. It does not, of course, resolve the conflict arising from varying rates among governmental units of the same rank. Moreover, it is probably a solution for state and local, rather than federal and state, authorities, since it practically assumes an element of compulsion. States might, of course, agree voluntarily to use a federal tax base and to avail themselves of federal administrative machinery. They would, however, sacrifice a measure of their independence in doing

so, no matter how willingly the sacrifice might be made. Actually the use of a uniform tax base, with a single administration but varying rates, resembles closely the manner in which some states share the property tax with their subordinate governments, except that administration in the latter case is local. In many states, however, the base used by state and local governments varies, and, even where it does not, local administration introduces inequalities not contemplated by law and not apparent in the nominal rates.

(4) A fourth method of co-ordinating the taxes of the different layers of government is the crediting device adopted by the federal government in the estate tax and the payroll tax for unemployment insurance.⁶ Lacking the power to force the states directly to adopt uniform taxes, the federal government has bought uniformity in this way. In both these instances, however, the end in view was not so much the avoidance of federal-state competition as the avoidance of competition among states. The states have such extensive control of their local governments that they are hardly likely to use this indirect method. It has been recommended, however, for a motor passenger carrier franchise tax in New York State.⁷

(5) A fifth—and complete—solution is central administration of all taxes with distribution of part of the yield to underlying governments. At one extreme the distribution may take the form of fixed percentages of specified taxes returned to the locality of origin. Here, the central government serves as a collecting agent, and little more, although the decision on the form of tax is in its hands. At the other extreme, the distribution may take the form of a grant-in-aid distributed in accordance with need. Here, the subordinate government usually

⁶ See pp. 26-27.

⁷ *Report of the New York State Commission for the Revision of the Tax Laws, 1932, p. 168.*

surrenders a large measure of control in spending the money and in addition loses all control of the source and amount of its income. To the extent that the tax conflict is solved by this means, local self-government and states' rights are relinquished.

Co-ordinate Governments

The co-ordination of the tax systems of local jurisdictions of equal rank will depend on the power of the superior government. Any state government can obtain complete harmony of local taxes within its boundaries. If the state fixes uniform bases for all local taxes and adopts uniform rules for the allocation of bases when the situs is not clear, the injustice of double taxation is avoided. If, in addition, it fixes rates in order to attain complete uniformity, the revenues lose their adaptability to local conditions, and the local officials lose responsibility. With these losses the chief merits of the locally administered tax disappear. If central administration is adopted, the shared tax or the grant-in-aid, or both, will be resorted to as long as local authorities are left with spending powers.

Federal control over states does not extend to requiring any marked degree of uniformity among them in tax bases or rates. The Fourteenth Amendment, as it is interpreted by the Supreme Court, prevents the taxation of (1) real or tangible personal property outside the boundaries of the taxing state, and (2) intangible personal property belonging to anyone not domiciled in the state (except possibly intangibles used in a business). But such control as the federal government can exercise must come, for the most part, through indirect channels. The crediting device, noted above, is the outstanding example, and it has been effective as far as it has been used.

The federal government might, however, buy uni-

formity in other ways. It might, for instance, use its own powers of taxation to levy a tax on a base that is also available to the states, and all or a substantial share of the proceeds might then be distributed to the states that refrained from levying taxes on the same base. If the states' shares were large enough, they would doubtless adopt such a plan. The distribution of the proceeds would not need to be in accordance with their origin. It might even take the form of a grant-in-aid for a specific purpose.

In the absence of federal control, co-operation may be used to avoid conflicts between state and state although genuinely conflicting interests will limit its application. The reciprocal provisions of state inheritance taxes are a step in this direction.

RECENT DEVELOPMENTS IN CO-ORDINATION

Federal-State-Local

Recent developments in the United States are important, both as they indicate trends and as they demonstrate which methods are, and which are not, successful in co-ordinating revenue systems under a decentralized form of government.

Separation of Sources

As noted above, the separation of sources of federal and state revenues, which prevailed in our earlier history, has been definitely, and probably permanently, abandoned. This development is not peculiar to the United States. One by one, particularly since the war, other federal states have given up the separation of sources characteristic of their earlier history.

The only important federal tax forbidden the states is the customs duties, which brought the federal government only 10 per cent of its tax revenues in 1936. The only important state tax forbidden the federal government is the property tax, which brought the states only

6 per cent of their tax revenues in 1936.⁸ The federal government does not levy a motor vehicle license tax or a general sales tax, but it competes to some extent with its automobile excises and its many specific sales taxes. In the important fields of personal income, corporation, alcoholic beverage, gasoline, and tobacco taxes, both federal and state governments have taxes on practically the same bases.

The states might conceivably give up their tobacco taxes and the federal government, in exchange, might give up its gasoline tax. It is hardly to be expected, however, that either will give up income, corporation, and alcoholic beverage taxes. These three taxes contributed more than half the federal tax revenues in 1936 and also more than half the tax revenues of some of the states. Other important overlapping taxes are death taxes and (in a few states) stock transfer taxes. According to estimates, in 1934, 90 per cent of federal tax revenue and 57 per cent of state tax revenue came from bases subject to both federal and state taxes.⁹ In 1936, 80 per cent of federal tax revenue and 55 per cent of state tax revenue came from such bases. These figures include the entire proceeds of certain federal taxes that are subject to state taxation in only a part of the states.

The trend in state and local tax duplication is the reverse of that for federal-state tax duplication. Separation of sources is increasing. In 1902 the general property tax, which supplied local governments with more than 90 per cent of locally administered tax revenue, also contributed more than half of state tax revenue. In 1925 it continued to supply the local governments with much the larger part of their tax income, but contributed less than one-third of state tax revenue. And in 1935 state tax revenue from this source had dropped to 7 per cent.

⁸ See Table J, pp. 530-33.

⁹ J. W. Martin, "Trends in Federal-State Taxation Relationships," *The Southern Economic Journal* (July 1936), pp. 71-72.

Such large states as New York, Pennsylvania, Illinois, Ohio, Michigan, California, Massachusetts, and Iowa levied no state property tax in 1936.¹⁰

Localities have not achieved financial independence, however. On the contrary, they are more and more dependent on the states for support. But both state and local governments are depending less on the locally administered general property tax and more on state-administered sources. Only in the technical sense of changes in amounts of revenue from given sources is separation of sources increasing.

Federal and local taxes overlap very little. Isolated instances may be found, such as the county income tax in New Castle County, Delaware, the recently repealed New York City estate tax, and occasional local gasoline and beverage taxes. Little reason exists to expect any important increase in this overlapping, however. Those taxes that local governments might administer with some success—gasoline and beverage taxes—are so firmly entrenched in state tax systems that there is little probability that local governments will be permitted to invade the field.

Co-operation in Utilizing Independent Taxes on the Same Base

The federal and state governments have not levied independent taxes on the same base without taking account of the taxes already in force in the various jurisdictions. Many of the taxes give evidence on this point. For example, the provisions of the state income tax laws have obviously been influenced by federal tax provisions. Differences in federal and state practice have been more often stressed than similarities, but actually the similarities are striking. Also, the federal tax provides for deduction of state taxes in computing taxable net in-

¹⁰ See the memorandum by Thomas J. Reynolds on state property tax rates in the forthcoming volume, *Studies in Current Tax Problems*.

come, and most state taxes permit deduction of the federal tax. Moreover, it is widely accepted that the high federal surtax rates preclude high state rates. Similar evidence of a consideration of the taxes imposed by other jurisdictions can be found in other taxes.

Formal co-operation is relatively new. The appointment of a Subcommittee on Double Taxation of the Committee on Ways and Means in 1932, however, gave official recognition to the problem. The first meeting of the Tax Revision Council in 1935, with representatives of federal, state, and local governments, also gives promise for the future.

Uniform Tax Bases with Varying Rates

The common European practice of permitting local governments to levy their own rates on tax bases fixed by the state, with state collection of both state and local taxes, has never gained a foothold in the United States. However, the administration of the property tax in some states, particularly the tax levied on public utilities, closely resembles this form of taxation. As state interference with local property tax administration increases, the European practice may well be adopted. This form of co-operation is open to federal and state governments only if the states are willing to sacrifice an important measure of independence.

Crediting Devices

The use of the crediting device to co-ordinate federal and state taxes, introduced in 1924 for death taxes, has been fairly successful. Its application to the income tax and to other taxes has frequently been suggested. It is used in the payroll tax for unemployment insurance for a somewhat different purpose, but it probably also assures a freedom from conflict in this new field. This indirect form of coercion is not used by the states in their local

relations, since they have more direct methods of control at their disposal.

Central Administration and Redistribution of Revenue

Strangely enough, the method of co-ordinating tax systems that is least compatible with decentralized government—centralization of taxes—is the one gaining the greatest headway in the United States at the present time. Taxes have not, of course, been transferred from local to state and from state to national governments. However, centrally administered taxes have increased in proportion to the total more rapidly than the taxes of the underlying jurisdictions. In the short space of three years, 1932-35, federal tax revenues increased from 23 per cent to 37 per cent of the total tax revenues, state tax revenues increased by a fraction of 1 per cent of the total, and local tax revenues declined from 57 per cent to 44 per cent of the total.¹¹

The rapid growth of federal tax revenues is to some extent an emergency and a cyclical phenomenon. The same development, to an even greater degree, occurred during the war period. But the proportion of federal taxes failed to return after the war to its pre-war level, and there is good reason to believe that it may not drop even to its pre-depression level in the future. The increase of state taxes compared with local taxes is not a depression phenomenon and may be expected to continue.

This increase of centrally administered taxes has been accompanied by a much smaller increase in expenditures on centrally administered functions. A large part of the adjustment has come, instead, through the increased sharing of state-administered taxes with local governments and through federal and state grants-in-aid. In 1932 local governments obtained 14.5 per cent of their

¹¹ See p. 107, *Financial Statistics of State and Local Governments: 1932; Report of the Secretary of the Treasury, 1932.*

tax revenue from state-administered taxes—9.9 per cent in the form of grants-in-aid and 4.6 per cent in the form of shared taxes.¹² The remainder of their tax revenue, 85.5 per cent, came from locally administered taxes. In 1935 local governments obtained 16.5 per cent of their tax revenue from state-administered taxes—12.0 per cent from grants-in-aid and 4.5 per cent from shared taxes.¹² This difference is not striking. In addition, however, the local governments received 24.4 per cent of their tax revenues from federal grants-in-aid for welfare, leaving only 59.0 per cent of tax revenue from locally administered taxes.

Federal aid to localities is an innovation. The federal government has for many years been developing a policy of grants-in-aid to induce the states to develop activities that the federal government had no power to force upon them. But local governments have hitherto been left entirely to state control and aid. The federal aid has passed through state hands, of course, and states have supervised its expenditure. The actual administration has been essentially local, however.

The federal government has likewise contributed substantial sums to state support through grants-in-aid for relief, highway construction, and other purposes. In 1932 such grants supplied the states with 12.5 per cent of their tax revenues, the remaining 87.5 per cent coming from state-administered taxes. In 1935 the corresponding percentages were 22.2 and 77.8.

As noted above, this extensive federal aid is essentially a depression phenomenon. But the sources of revenue that are most sensitive to business conditions are the federal and state taxes. It seems probable, in consequence, that while local revenues rise gradually with the slow recovery of property values (increased tax limitations are an additional handicapping factor), state and federal tax

¹² See Note 2, *Shared Taxes and Grants-in-Aid*, p. 575.

revenues may experience a rapid rise. Federal budget estimates for 1937 contemplate a 55 per cent increase in tax revenues over 1935. No comparable increase in local taxes can be expected.

This increased income may be applied to debt reduction rather than aid to state and local governments, but it will probably encourage a continuance of the grant policy on a somewhat larger scale than in the pre-depression years. The provisions of the Social Security Act give even more convincing evidence that in the long run federal grants can be expected to increase. Further development of state grants likewise seems probable. These have a longer history than federal grants, and, although they have grown more slowly, their steadier development makes their permanent use even more probable.

Grants-in-aid signify a loss of independence by the receiving jurisdiction. They are invariably accompanied by restrictions on their use. In addition, they frequently demand of the receiving jurisdiction a quality of service and a predetermined amount of financial participation that leaves little discretion to the authorities who receive the aid.

The practice of sharing state taxes with local governments has grown rapidly in recent years, largely as a result of the growth of highway expenditures and their support from motor vehicle taxes. More than half the state tax revenue that was shared with local governments in 1935 was from motor vehicle taxes. This form of assistance may prove less permanent than the grant.

Shared Taxes versus Grants-in-Aid

The essential difference between the shared tax and the grant-in-aid is not that the latter is usually earmarked for a specific purpose. It is, rather, that the amount of the shared tax usually varies from year to year with the yield of the tax whereas the amount of a grant is meas-

ured by the need of the receiving authority. Smaller jurisdictions probably cannot be asked to share changes of fortune over the business cycle, for example, equally with the larger jurisdiction. Local authorities are experiencing increasing difficulty in adjusting their own revenues to needs. Moreover, the revenue system of the larger jurisdiction has a much greater adaptability to economic conditions.

The grant is more readily accompanied by central control than is the shared tax, and this control will probably increase. The temptation to dictate is very great, and the distribution of increasing sums of money unaccompanied by control fosters local irresponsibility.

Between 1932 and 1935 shared taxes declined slightly in relative importance, while grants-in-aid increased—in spite of the general tendency to share the new liquor taxes and, occasionally, the gross sales taxes. The explanation is, of course, that, since grants are based on need, they are more apt to increase than decrease in time of depression, whereas shared taxes diminish with declining yields. Shared taxes may again rise rapidly as tax yields rise.

The federal government has yet to experiment with the sharing of tax yields, although plans for sharing many important taxes have been proposed. The Graves-Edmonds plan, for example, proposes federal administration and federal and state sharing of a general manufacturers' excise, and liquor, gasoline, and tobacco taxes.

Co-ordinate Governments

Conflicts between local governments are practically limited to the property tax. Even here the conflict is not so much among co-ordinate as among overlapping jurisdictions. Tax limits have protected the taxpayer to some extent, but they have only aggravated the conflict among the jurisdictions themselves. Since real estate clearly can

be taxed only by the jurisdiction in which it is located, serious conflict between county and county and city and city has been prevented.

The conflict between state and state increases, however, as the amount and variety of state taxes increase. Since the adoption of the crediting device for death taxes in 1924, the federal government has made little effort to exercise such limited control as it might have in order to reduce this conflict. It did not even extend the credit to the additional estate tax, levied in 1932 and increased in 1934 and 1935. The credit for the payroll tax is for quite a different purpose. Supreme Court decisions in death taxes have helped in some instances—notably the line of decisions starting in 1929 in which it has been held that intangibles, except possibly those used in a business, may be taxed only by the state where the owner resides.¹³ Unfortunately, however, some problems of double taxation of intangibles remain. The recent Dorrance case demonstrates that, at least until another Supreme Court decision, two states may tax the same property simply by claiming to be the state of residence of the owner. The use of the shared tax would bring uniformity between state and state, as well as between federal and state governments, but the federal government, as noted above, has yet to experiment with this device.

Co-operation among the states has progressed more rapidly in recent years than federal control. Reciprocal agreements for inheritance taxes eliminated much serious overlapping before the series of Supreme Court decisions just noted. Recognition of the interests of both the taxpayer and other states is to be found in the provision of the New York personal income tax law for reciprocal tax credits. By this provision, New York, in general, exempts residents of a state that in turn exempts New York residents. The tendency to adopt the "Massachu-

¹³ See Note 1, *Supreme Court Decisions*, p. 575.

sets formula" in preference to any other in allocating corporation income for state taxation is eliminating some double taxation in that field.

States tend to model their new tax laws on the laws in neighboring states, probably because the latter are known to be administratively feasible. Even though uniformity is not the purpose here, it is a result. Uniform tax laws do not necessarily, however, avoid double taxation, since the laws may provide for the taxation of both resident and non-resident income.

Organized efforts to achieve co-operation are relatively new, but they have aroused a great deal of interest and an enthusiastic response from state officials. The Interstate Commission on Conflicting Taxation has made important facts available and has brought the problem to the attention of those concerned. The recommendations of this committee deal with the conflict between federal and state governments rather than the conflict among the states, but the two problems are closely related, and to some extent they can be solved by the same means.

RELATIVE MERITS OF DIFFERENT ADJUSTMENTS

In judging the relative merits of the different adjustments that have been listed above, two factors must be kept clearly in mind. (1) Will the adjustment maintain the desired degree of local responsibility? And (2) can it adapt revenues to needs?

Separation of source meets the first test, but not the second under existing governmental organization. The largest share of governmental functions is still performed by local authorities and the only important tax that most local governments can administer successfully is the property tax, which is not always equal to the task. Even though local expenditures as a whole could be met from a reasonable tax rate levied on property as a whole,

separation would not offer a satisfactory solution. The fundamental difficulty is that wealth is very unequally distributed, and the localities that are poorly endowed are the ones with the greatest needs. Inequalities are in fact so great that even states are not always large enough to be self-supporting under all conditions.

Independently administered taxes on the same base, and centrally administered taxes with a uniform base and varying rates, likewise meet the test of responsibility but fail in flexibility. It is not enough to have the rates determined by the authority who receives the proceeds when the base itself is inadequate. The crediting device fails to meet either test, although this failure does not condemn its limited application.

The shared tax likewise fails to meet either test if the distribution is on the basis of origin of the tax revenue. Even when the shared tax is distributed on a per capita basis, or on some more direct measure of need, it fails in a time of emergency. Local governments have not the same powers of adjustment to falling tax yields that larger jurisdictions have. The grant-in-aid, properly distributed, meets the test of adaptability to needs but fails to meet the test of maintaining local responsibility. It can, of course, be safeguarded with adequate controls, but to the extent that controls are applied local independence is circumscribed.

The problem of tax co-ordination cannot be solved as long as a large part of our business is interstate and much of it nation-wide. There are, of course, sectional differences in industrial development, and a substantial part of our business activity is essentially local in character. Unfortunately these sectional differences do not follow state lines; and even a local business may be interstate. There is, thus, an irreconcilable conflict between our industrial unity and our political disunity. This can be alleviated, but not abolished, by financial measures.

The extensive redistribution of wealth between geographical areas through taxation and grants may be defended on economic grounds. Although it is true that an unwise state-aid policy may result in the perpetuation of submarginal communities that might better be depopulated, some communities that are too poor in tax resources to support themselves are a vital part of our national economy. The wealth that they create, in cooperation with others, simply appears in taxable form outside their legal jurisdiction. Values are rarely the result of purely local forces. Even the real estate values in large cities are not entirely local in character. They are created in the first instance by the dense local population. But large cities are the least self-sufficient communities that exist. Their taxable wealth would melt very rapidly if they were cut off completely from the surrounding territory. It is not enough, however, to justify the redistribution of revenues on these or any other grounds; some workable method of redistribution must be found.

If enough tax revenues were redistributed today, through grants-in-aid or any other means, to enable local governments to meet the standards of expenditure set by the state itself, some communities would receive more than nine-tenths of their income from the central government. And to establish the necessary safeguards to insure wise spending under these conditions would mean the practical abandonment of local self-government.

The problem is not purely a financial one. Other powerful forces are impelling centralization of government. And some centralization is apparent. The taking over of roads and schools in North Carolina recently and Virginia's state support and administration of all rural roads are isolated instances of a widespread movement. The mileage of state highways grows year by year. Welfare is more and more accepted as a national obligation.

The movement is slow, however, and it might be unfortunate to hasten it for purely fiscal reasons. Many of the best achievements of government in this country have been achievements of local government. Local administration is more adaptable to local needs and wishes. Consequently, it is important to consider what financial measures are most suitable for the present degree of centralization or decentralization.

The greatest degree of local independence could be obtained if local governments were left in full enjoyment of the tax on real estate. State governments have other sources at their disposal, and probably few would find its complete abandonment a serious hardship. Some of the poorer agricultural states would, of course, find it difficult to fill the gap. Most communities could support a substantial measure of local self-government from the proceeds of a moderate tax rate. As a result of this shift more taxes might be levied on real estate than on personal income, though the latter is in general, of course, a more satisfactory measure of ability to pay. However, this disadvantage might well be offset by the gain in local independence. This tax would of course have to be supplemented by state assistance. Grants-in-aid are more adaptable to both local need and central control than other forms of state assistance. It might be necessary, in addition, to sacrifice a large measure of local government in very poor communities.

The federal-state and interstate conflicts are complicated by legal barriers that are not present in the state-local problem. Fortunately, however, the inequality in resources is not so great among states as among local governments. Furthermore there is no reason to suppose that state governments will have to give up any large measure of independence because they are unable to support themselves. Present conditions point to a continued use of the same tax bases by both jurisdictions,

although a greater separation of sources is probably feasible. The two interests might be reconciled to some extent both through co-operative effort and through such indirect pressures as the federal government can bring to bear.¹⁴ The sharing of federally administered taxes should not weaken state responsibility or result in a maladjustment of revenues if the device is used moderately. If it is used to force a completely uniform and unified tax system, however, both these results are inevitable.

An irreconcilable conflict admits of no clear-cut solution. Complete co-ordination of the tax system cannot be achieved under a federal government. The most that can be hoped for is a series of compromises. These will not remove the fundamental conflict, but they may remove some of the consequences.

¹⁴ In order to further co-operative effort the establishment of an "impartial, disinterested commission of the highest possible dignity and standing, to represent neither the states, nor the Treasury, nor the President, nor the Congress, but the people of the United States" has been recommended. This commission would be for the purpose of formulating policies. Address by Robert M. Haig at the opening session of the Second Interstate Assembly, February 28, 1935, in *The Book of the States . . . I* (3rd ed.; Chicago, 1935), 312-13.

Book Three

CONCLUSIONS
RECOMMENDATIONS

Chapter 25

GENERAL CONCLUSIONS

The present chapter and Chapter 26 mark a sharp departure from those that have gone before. They are advisory, not factual, and give the views of the three directors of research on what should be done with the tax system. The present chapter contains general conclusions, and Chapter 26 contains specific recommendations for action based on these conclusions.

RELATION TO BOOKS ONE AND TWO

Although this chapter draws heavily on the information presented in Books One and Two, it necessarily goes outside it.

For one thing, time and space limitations have confined Books One and Two primarily to an analysis of the existing tax system. The effect of alternatives has been implied at times and has sometimes been explicitly stated, but on the whole it has been given little space. Consequently some of the statements of means and ends in this chapter will not be fully explained by the other material.

For another thing, the choice of objectives and the relative weight given to each objective must depend on innumerable other choices, many of them far removed from the field of taxation. Whether the tax on spirits should be sharply increased in an effort to promote temperance, for example, depends not only on one's views on the efficacy of the tax for this purpose, but also on one's opinion concerning the extent of intemperance and the propriety of forcing people to become more temperate.

THE TAX STUDENT AND TAX POLICY

The conclusions and recommendations presented in this and the following chapter depend on both the choice of aims and the forecast of the results that are to follow any given adjustment. Consequently, there is ample opportunity for an understandable disagreement among students of taxation with respect to the advisability of any specific tax measure.

It is sometimes implied that specialists in taxation are qualified to design a tax system that can be proved to be the best possible one. To us this view seems erroneous. The best tax system is the one that most fully promotes the public interest. Before such a system can be constructed two problems must be solved. The first problem is to determine what the public interest is. In part, the public interest reflects interests common to all persons; the task then is simply one of discovering these interests. In large part, however, ideas of what the public interest is differ radically. Often, perhaps usually, a person's idea of what is in the public interest is merely an extension of what he thinks is in his own private interest. Private interests conflict; determining the public interest involves choices and compromises among them.¹ No one can authoritatively decide whose private interests should be recognized as the public interest, although everyone has an opinion. Determination of the public interest is a political problem; it requires a highly enlightened populace acting through properly organized democratic political processes. The result is reflected in the tax aims that are chosen and in the relative importance attributed to each.

The second problem is to devise a tax system that will most nearly achieve the desired combination of aims. This is a technical, not a political, problem. Its solution is limited only by lack of knowledge about the operation

¹ See Note 1, *Model Plans*, p. 579.

and effects of taxes. The tax student may contribute technical knowledge for devising methods that will achieve desired tax aims. He may assist in discovering common interests. However, where a conflict of interests is involved, his ideas of what tax aims are in the public interest can be only opinions. These opinions will inevitably color his conclusions and recommendations.

CONCLUSIONS

Our conclusions are stated in general terms in paragraphs 1 to 102 below. The presentation follows the order of the material in Book Two. The number in parentheses at the end of each paragraph is a page reference to the relevant material in Book Two.

The conclusions of course refer only to the tax system of the United States—particularly the federal part of that system—at the present time. They also assume the existing private capitalistic system of economic enterprise, with a considerable degree of governmental control.

Economic Limits of Taxable Capacity

1. We believe that the amounts now raised by taxation and the amounts that are likely to be demanded in the near future are not beyond the economic limits of taxation in the sense that they would so stifle business initiative and saving that they would be incompatible with an economy based largely on the private capitalistic form of enterprise. However, the uncertainties surrounding any present conclusions on this matter deserve emphasis. (61-66)

2. In our judgment, the existing tax system is too heavily weighted against risky types of enterprise—particularly in view of the meagre study that the problem has been given. For example, the federal income tax and most of the state income taxes claim an appreciable share of any winnings, and they often do not allow the

taxpayer to offset his losses against his taxable income from other sources. If a certain amount of restraint on hazardous undertakings is advisable, it should be adopted consciously, not unconsciously. Lengthening the accounting period by means of carry-over or averaging provisions would eliminate some of the weighting against these enterprises. (62, 283, 302-3)

Taxation as an Instrument of Social Control

3. We believe that taxation should not be barred as an instrument of social control. However, it is usually a crude instrument for this purpose, and obviously it should not be used if a better device is available. We warn against the naivete of those who, not familiar with the difficulties of forecasting the economic effects of tax measures, the technical difficulties of tax administration, and the political tax difficulties inherent in a democratic and decentralized state, would use the tax system for important and complex social reforms. This caution should not lead to a philosophy of despair, but to a vigorous effort to devise tax techniques and otherwise extend tax knowledge in order to make the system available for such control as is desired. We especially stress the need for study on this subject. Whether or not tax students believe in a large measure of social control through taxation, they should prepare themselves to offer sound technical suggestions, in order to avoid the unsound ones that will otherwise be adopted. (129-40)

4. Although an evaluation of the aims to be sought through social control is outside the scope of this study, a discussion of the tax measures suitable for each purpose is not. The possible aims are numerous, however, and each demands detailed treatment. Consequently it is difficult to offer specific advice in a survey as comprehensive as the present one. The factual information in Book Two, particularly in Chapters 9 to 14 inclusive,

should enable the reader to form a judgment on most control objectives. Beyond these general principles, we offer a few isolated and tentative remarks. (141-214)

Promotion of Specific Industries

Tariffs

5. We regret the lowering of the general standard of living of the country that is caused by the protective tariffs, which impose a barrier to division of labor—that is, specialization in the kinds of production for which one is best fitted—and the exchange of goods that goes with such division. Any sudden abolition of the existing protective system is not, however, recommended. The process of adjustment should be slow, but it should be as complete as is possible in view of aims other than a high standard of living—for instance, self-sufficiency in preparation for war. (141-43, 249-50, 253)

Other Tax Measures Designed to Promote Particular Types of Business

6. We object, in general, to tax measures designed to promote particular types of business if they have been enacted chiefly as a result of pressure from those businesses rather than in order to further some genuine social end. In this class we place the heavy taxes on oleomargarine, designed to promote the competing dairy industries, and the taxes on chain stores, designed to promote independent stores. (135, 145-46, 182-87)

7. Granting exemptions to particular classes of activity, notably educational, charitable, and religious activities, constitutes government support without government control—a fact that should be clearly recognized. If the government is to exercise control, subsidy, not exemption, should be used. (296)

8. Whatever the desirability of state assistance to a

given activity, or of assistance with control versus assistance without control, the hardships that would be occasioned by a sudden and, above all, a retroactive shift in policy should be carefully weighed. (249-50)

Tax Measures Designed to Promote Business in Particular Areas

9. We oppose, in general, the use of exemptions from the property tax for promoting particular businesses, notably manufacturing, in a given state or locality. The exemption is always at someone's expense, it gives governmental assistance without governmental control, and in any case it is apt to be futile, since everyone can play the same game. Here too, of course, the remarks made above concerning sudden and retroactive changes in policy apply. (148-50, 249-50)

The Differential Tax on Land

10. The economic possibilities of a distinction between land and improvements under the real estate tax are extremely important. Lighter taxation of improvements, in contrast with lighter taxation of land, apparently promotes production. However, any drastic program of this kind presents grave risks of injustice. The difficulty of drawing a satisfactory line between land and improvements is also significant, particularly in view of such items as wastable soil fertility and long-lived and already installed land improvements (for example, a ditch or a space for an underground vault). The whole question certainly deserves much more recognition and careful study than tax students have usually given to it. If the public demands further substantial reductions in the property tax, the question will become acute. Meanwhile, we must suspend judgment because of lack of information on the relative effects. (150-52, 290-91)

*Control of Business Organization and Practices**Incorporated versus Unincorporated Enterprise*

11. Without attempting to explore deeply the complex problem of the proper place of the corporation in economic life, we express the belief that the issue of "bigness" in business is not likely to be satisfactorily settled by such tax measures as have recently been adopted. The present degree of graduation in corporation taxes in the United States represents an indecisive policy that has but slight merit and works considerable injustice. If big units are really to be penalized, the graduation must be much more drastic than it now is. It must also be on a more refined technical basis, with some element of size of investment entering into the determination of amount of tax. Otherwise, graduation in corporation income taxes should be abandoned. We are not convinced that big units as such need to be penalized, and we are not convinced that a graduated income tax is a suitable method of penalizing them, in any event. Hence we favor a replacement of the existing graduated taxes on corporate net income by flat rates. (153-55)

12. The present system, especially in states that tax dividends fully under their personal income tax laws, makes the use of the corporate form impossible for many small businesses that would otherwise prefer to abandon the proprietorship or partnership status. We can see no sound reason for this discrimination. (155-58, 259-60, 309)

13. The attempt by the federal government, in the Revenue Act of 1936, to put corporate investors on the same income tax basis as partnership and proprietorship investors represents an aim to which we are decidedly sympathetic. In so far as it retained the corporation normal tax, however, Congress progressed only part way toward this goal. A more logical method would be (1) to abolish the corporation normal tax and (2) to force cor-

poration shareholders to pay both normal and surtax on their full share of current corporate earnings, undistributed as well as distributed. Thus corporate shareholders would be treated as partners now are treated. Unfortunately, this procedure cannot be used without certain constitutional changes and changes in corporate financing methods, which are not likely to be obtained.

Another possibility, which may also require a constitutional amendment, is the taxation of all capital gains—or at least all gains on common stock holdings—that have accrued, whether or not realized, by the end of each taxable year. By allowing the taxpayer to select this method as an alternative to a less attractive method, an amendment might not be necessary. (160-68)

14. We regret the hasty passage of the act imposing the undistributed profits tax. Any measure with such complex economic effects should have had more careful study. However, we do not believe that this reason alone is sufficient to dictate immediate repeal. (168-70)

15. We look on this tax as a promising method, under present constitutional limitations, of integrating the corporation and individual income taxes. As such, it deserves careful study and a fair trial. One aim of this integration should be to remove the incentive for withholding corporation dividends that has been produced by the individual income tax. However, we view the tax not as a final solution but as a stop-gap either (1) until a special study has shown that the optional method is feasible for taxing accrued capital gains, or, if it proves not feasible, (2) until Congress has been granted more power by constitutional amendment to tax accrued gains and possibly also undistributed profits as such directly to the stockholder. (164-66, 170)

16. We do not believe that the effects of forcing the payment of cash or other corporation assets to stockholders have been sufficiently studied to justify the con-

clusion that they would be beneficial. We believe that the solvency of certain types of corporation would be endangered. If such payments are forced materially beyond the offsetting of the individual income tax pressure previously mentioned, we think that the act should be repealed until further study of the economic effects of such a distribution has been made. A solution may be offered by the use of the taxable stock dividend, which makes the distribution of corporate assets unnecessary. Another method that may be useful is the offering of rights to subscribe to new shares at a price well below that of outstanding shares. Thus almost any corporation may get back most of the money that it has paid out. Both methods have certain difficulties, perhaps dangers, for corporate financial structures. However, they are sufficiently promising to justify continuing the tax until their possibilities have been tested. (174-76)

17. We think, however, that the failure of the undistributed profits tax to take account of business-loss years and of capital losses in excess of capital gains endangers the financial soundness of corporations. Furthermore, we consider it grossly unfair to corporations with violently fluctuating incomes. We recommend that the act be amended so that losses can be offset against the incomes of following years, and capital losses against other income, in computing the amount of undistributed profits subject to this tax. (160-68)

18. A relatively small amount, perhaps 10 per cent, of net income should be exempted from the tax on undistributed profits in order to give the corporation some leeway. If necessary, the rates of the top brackets might be increased. (160-68)

19. The "relief provisions" should be reconsidered and their injustices rectified as far as they can be without destroying the basic purpose of the act. (16)

20. A thorough and impartial study of the economic

effects and implications of the act should be made at an early date. (168-70)

Control of Consumption

21. We do not in general favor the use of high tax rates on particular commodities or services to repress consumption. We do, however, believe that it is justified in the tax on spirits. The government, in our opinion, should be prepared to accept something less than the maximum possible revenue from the tax on spirits in order to accomplish repression of consumption. It is with considerable regret that we advocate taxation as a method of restricting consumption, since this method inevitably discriminates against those with low incomes. However, until some more satisfactory rationing plan is available, we believe that the former method, in which prices are made high because of a high tax, should be used. Whether the existing administrative situation would permit a repressive rate—by which we mean a rate above the point of maximum revenue—is a technical problem upon which we are not in a position to pass. (195-202)

Redistribution of Income and Wealth

22. In speaking of redistribution of income or wealth, we use "redistribution" to designate one of the possible ways of effecting a "change in distribution." An appreciable amount of redistribution of income, from the more well-to-do to the less well-to-do, is taking place under the existing tax system in the United States. More precisely, there is a redistribution compared with the situation that would exist if government confined itself to those activities that would be unanimously accepted as essential governmental services. We believe that this redistribution is both inevitable and desirable. We should not agree that the present amount of redistribution

should not be exceeded. An elaboration of this suggestion, however, would bring us into the field of expenditures. For example, we might not approve of redistribution in the form of veterans' pensions financed by raising income tax rates in the brackets above the \$20,000 level, but we might approve of redistribution in the form of slum clearance and low-cost housing financed in the same way. We should not approve of redistribution beyond a certain total, because of the dangers in an excessive slowing up of the productive mechanism. In summary, we approve of the principle of redistribution—provided it is from the more well-to-do to the less well-to-do—, but we may or may not approve of the amount and the kind of expenditure involved. (203-14)

A Just Distribution of the Tax Burden

23. In a general way, we are inclined to believe that in the minds of tax students justice in taxation, as it has usually been conceived, will become of less relative importance compared with the effect of taxation on the operation of the economic system. Nevertheless, much work remains in order to achieve and maintain those objectives of tax justice that we consider of great importance. (217-20)

24. Some evidence exists that the tax burden is regressive below the income tax level, and perhaps for a short distance above it. Regressive means here that the lower the income, the greater the percentage of income that is taken by taxes, direct and indirect. Such regressiveness as there is should of course be eliminated. Scarcity of information on how progressive the rest of the system is, as a whole, makes it more important to concentrate on certain injustices or dangers of injustice that are known beyond doubt than on the degree of progression. These injustices and dangers will be discussed in the paragraphs immediately following. (232-37)

*Past Events and Present Justice**Capitalization*

25. We are concerned over the current campaign for reduction of the property tax, more particularly the real estate tax, because of the certainty that any widespread reduction will give an undeserved bonus to many purchasers who bought real estate when tax rates were at their present level and on the assumption that they would remain there. We are also concerned for the many property owners of long standing who can make a telling argument for relief from some of the property tax burden. The unfortunate fact is that any blanket reduction in the real estate tax will, in our opinion, give some taxpayers what they deserve and others far more than they deserve. Therefore, each state and local jurisdiction, before it makes any appreciable reduction in the real estate tax, may well consider how many owners it will be rewarding beyond their deserts. Consideration should also be given to the number of owners, tenants, and others that will be worse off after the lowering than before, in view of the replacement taxes. The loss of local self-government that may result if real estate tax reduction necessitates state aid presents a further problem.² (238-44)

Vested Interests

26. What has been called "the innocent vested interest" impresses us as an important aspect of tax justice, but not one that can ever be allowed to bar a change if the change is made gradually. We are inclined to emphasize this interest because we feel that it has been neglected in many important discussions where it should have a place. It is fairly important when the real estate tax is raised, usually of less importance with an increase in the

² See pp. 381, 385.

income tax burden, and of major importance when an excess profits tax is levied or a protective tariff is imposed or repealed. In contrast with the capitalization problem, it is of chief interest when tax increases, rather than tax decreases, are being considered. (249-54)

Repressive Effect on Sales

27. A special tax on a particular commodity or service has a repressive effect on sales, which is usually financially damaging to its producers and distributors. We believe that too little attention has been paid to this aspect of special taxes. Because of this effect, we are opposed to further manufacturers' excises or other narrowly specialized taxes, whether levied by the federal government or the states, unless they are imposed for social control. Similarly, we do not favor any increase in the rates of the existing taxes of this kind. Whether any increase in justice to producers and distributors is to be gained by lowering the rates of the existing taxes or by abolishing them is, however, highly questionable. (245-49)

28. We doubt very much whether the cigarette tax rates need to be lowered so far as justice to producers (including tobacco growers) and distributors is concerned. The rate has remained unchanged for nearly twenty years, and many new owners—stockholders, owners of farm land, etc.—have bought in with full knowledge of the tax. The consumers whose smoking is reduced because of the increase in price caused by the high tax present a different question. We see no reason for discriminating against cigarette smokers compared with those who use other forms of tobacco or who do not use tobacco. This statement assumes that the retail price of cigarettes would be much lower if no tax existed, as it doubtless would. Consequently, we believe that, if the federal government enters an era of tax reduction, it should reduce the cigarette tax at least as soon as it re-

duces others, such as the income tax. We emphasize that the injustice to consumers is represented not only by the actual tax that they pay in the form of a high price but also by the number of cigarettes that they cannot buy at all, solely because of the high price. This aspect of the tax burden is commonly overlooked. It is never reflected in data on tax collections. (247-48, 317-20)

29. The spirits tax presents a special problem of regulation, already discussed.³ The gasoline tax and motor vehicle license taxes are discussed below, under benefit taxation.⁴ Practically all the other federal and state taxes on specified commodities and services are so light that the repressive effect on sales is probably causing little damage to producers or consumers. (24, 25, 249)

30. One of our objections to a general sales tax, such as the manufacturers' sales tax recently proposed for the federal government or the retail taxes levied by the states, is the repressive effect on sales and the consequent damage to certain producers and distributors. Correspondingly, of course, the net effect on some consumers is to deprive them of certain things that they would otherwise purchase. The injustice is likely to be much less than in the case of the special taxes, however. For a given amount of revenue, the rate will be much lighter, and the business firms affected will be so numerous that the degree of discrimination will be less. (245-49)

Benefit Taxation

31. As to benefit taxation, we are influenced in opposite directions by two sets of considerations. (255-57)

32. On the one hand, we believe that some of the strife and bitterness would be removed from the tax conflict if taxpayers knew that they were paying for a specific service by a tax directly relevant to that service.

³ See p. 400.

⁴ See pp. 405-6.

Moreover, benefit taxation, if the "beneficiaries" agree that there is a benefit, offers the government a chance to accomplish many valuable things that it otherwise could not accomplish because of the strenuous objections to general revenue taxation. (255)

33. On the other hand, we are disturbed by the emphasis that benefit taxation necessarily places on the existing distribution of economic power. We cannot, therefore, say that benefit taxation should be pushed to its technical limits—and indeed probably no one would say so. The problem is much the same as that discussed above under redistribution of income. The answer depends on certain views toward expenditures that cannot be developed here. (256-57)

Highway Taxation

34. The motor vehicle tax and the gasoline tax offer suitable methods of financing most of the cost of highways and part of the cost of city streets. Part of the highway and street costs can be met by special assessments or the real estate tax because of the benefit to real estate. Another part can be met by general fund revenue because of the general public interest that is involved. We are very uncertain, however, how satisfactorily the existing rates of these taxes distribute the burden among the various road users. Some extremely complex problems are involved. Study should be given to them, since neither facts nor theories are well enough developed to guide tax policy at the moment. Tentatively, we do not think that the state gasoline taxes and motor vehicle taxes are too high, in view of the volume of highway expenditures; therefore, we recommend no decided decrease in the rates of those taxes generally. (258, 260-62, 267-68)

35. The federal automotive excises other than the gasoline tax are technically unsuited for use as benefit taxes and should not be so used. In view of the elements

of national defense benefit and postal benefit in highway expenditures, the federal gasoline tax, at its present 1-cent rate, is high enough. It covers a large part of federal highway expenditures (58 per cent in 1935). (261)

Corporation or Business Benefit Taxation

36. The corporation income tax raises the question of why such a tax should be imposed at all if there is a personal income tax and if, in some such manner as is suggested above,⁵ the stockholder's total share in the corporate earnings is taxed each year. Business firms in general—and to some extent corporations in general as opposed to other forms of business—sometimes cause the government special costs and get special benefits that increase net profits. In our opinion, they should pay for these costs and benefits. We think that the ordinary income tax alone is not adequate, and the capital stock tax even less so. We therefore recommend that, where business firms cause special costs—for example, in court litigation and in some forms of police protection—, an attempt be made to assess special charges to cover these costs. The charges should not always be strictly on a proportion-to-use basis; to some extent they should include a flat-charge element. Otherwise the tax might have such repressive effects that the community in general would suffer. (259-60)

37. We further recommend that heavy excess profits taxation, not limited to corporations, be used to counteract in part the excessive benefits that certain governmental services may sometimes give to business firms. Such benefits will, we believe, often appear in the form of excess profits. We are not prepared, however, to recommend state taxation of excess profits. (289)

38. In view of the considerations expressed above, we favor only very light taxes on corporation net income,

⁵ See pp. 397-400.

provided always that a suitable method of taxing all the current earnings to the stockholder is used. (259-60)

39. If the corporation tax is entirely repealed, "excess" may well be made a more comprehensive concept than it has been in the past—for example, excess profits might be considered to start at 5 per cent or even lower instead of at 10 per cent. (289)

Social Security

40. The social security plan offers some extremely perplexing problems with which we are not prepared to deal. However, we see no overwhelming reason why either the unemployment compensation plan or the old-age annuity plan should be financed on a benefit basis, as they doubtless will be if all the payroll taxes really rest as a burden on the workers. (263-65)

41. We also see no reason why the rates should be so heavy that the old-age annuity taxes will in effect be covering part of the federal government's current deficit for general purposes. In other words, if the federal government is unwilling to raise enough general fund tax revenue to meet general fund expenses and thus to keep the debt outstanding in the hands of the public from growing, we cannot see why it should insist that the social security taxes shall raise more than is required by current social security needs and thus reduce the publicly held debt. The general fund and the social security reserve fund may be in water-tight compartments in an accounting sense, but they are not in an economic sense. Perhaps, however, the excess of the old-age taxes over current payments on contributory pensions will all be absorbed in paying for the non-contributory old-age pensions. (124, 263)

42. The payroll tax that the federal government is collecting under the unemployment compensation sections of the act goes almost wholly for general fund purposes.

The amount involved will become small as the states levy their own unemployment compensation taxes and thus bring the credit feature into play. If the states do not act promptly, however, we suggest that some other arrangement be sought, since we are opposed to this payroll tax as a general fund tax. (194, 264-65)

43. Even as an unemployment compensation tax the payroll tax does not particularly appeal to us. It presents the obvious danger of putting pressure on the employer to use machinery that would ordinarily be uneconomical, and thus perhaps adds to the volume of technological unemployment. (264-65)

44. A much more thorough study of the financing of social security is needed before recommendations of much value can be given. For example, a study should be made of the tax implications of financing social security by general ability taxes rather than by levies on consumers of a kind that would stress the social cost of each business. Tax students in the decade or two prior to the passage of the Social Security Act gave almost no attention to the problems of financing that any such program would entail. The act was rushed through before the financing aspects could be adequately considered. The uncertainty of the constitutional outlook for the act has discouraged special study of the effect of its specific provisions. (194)

Special Assessments

45. In our opinion, local improvements to real estate present one of the strongest cases for benefit charging. Recently such improvements have been financed, to some extent, in other ways—notably, by grants from the federal government as part of an emergency program. We are opposed to a continuation of this policy. We are also disturbed over the relative failure of special assessment theory and practice to improve in the past decade or two,

particularly in some of the large urban centers. We therefore urge that city authorities everywhere, and officials of many classes of rural districts, devote much more thought to this matter than they have done in recent years. These recommendations do not, of course, conflict with those made above for highway financing.⁶ (265)

Postal Rates

46. We can see no reason for asking the users of first-class mail to bear the burden of the partially free service given to other classes of users. Therefore we recommend that the first-class charge be reduced until it merely covers the costs of first-class mail—presumably, 2 cents would be the only practicable figure. The rates on the other services should make up the difference, or, if these services are to be subsidized for some reason, a general revenue tax could be used. (266-67)

Taxation Based on Socially Undesirable Income

47. We believe that monopolistic elements exist on a large enough scale in the United States today to justify an attempt to build up an excess profits tax for use in peace-time. Another reason for such a tax⁷ is the possibility that certain businesses may receive excessive net benefit from governmental services. It would, of course, be preferable to eliminate the causes of the excessive profits. We doubt, however, whether they could be eliminated to an appreciable extent. Modern industrial and commercial conditions seem inevitably to result in an important amount of monopoly control, using the term "monopoly" in its widest sense. (276-78)

48. Because of the technical difficulties, we favor the introduction of such a tax at substantial rates only after a considerable period of record-keeping. Furthermore,

⁶ See pp. 405-6.

⁷ See p. 406.

this delay will have the advantage of making some allowance for innocent vested interests. (252-53)

49. A set of broad recommendations such as these need scarcely specify details for an excess profits tax. However, we do recommend that a strenuous effort be made to apply the tax to unincorporated firms. Perhaps all firms below a certain size, whether incorporated or unincorporated, should be exempted—solely because of administrative difficulties. So far as possible, each business should be taxed separately. Indeed, an effort might be made to isolate and tax the monopoly productions and transactions within a single business, though this may of course prove to be impossible. The tax should be based on return from business assets. Consequently, no deduction should be allowed for interest paid, and, in effect, the structure of the liabilities side of the balance sheet should be disregarded. The accounting period should be made several years in length, by means of a carry-over of losses or averaging devices of some kind. The rate of return that is called "fair" should vary with the degree of risk. The stage at which a profit is considered at least in part excessive could be much lower than it was for the special war taxes. Finally, special attention must be paid to eliminating the excess profits element itself in determining, for tax purposes, the amount of the invested capital. (278-90)

50. The so-called excess profits tax now imposed by the federal government is clearly unsuited for the task, chiefly because of its connection with the capital stock tax. (271)

51. We have no idea how much revenue can be expected from the kind of tax that we propose. We are not drawn to it primarily as a means of capturing high profits from risky enterprises, or windfalls, or inflation profits. If it were not for the monopoly problem, we should not

recommend the tax at all, for we are impressed by its theoretical and technical difficulties. (274-90)

52. From the point of view of justice alone, we can see little or no appeal in the single tax for the United States at the present time. The graded land tax has been touched on above. Land increment taxation is certainly worth more of a trial than it has been given, but it might be incorporated as part of an excess profits tax. In framing it, care should be taken to pay due regard to innocent vested interests. (290-93)

Ability to Pay

53. A tax system cannot be precisely formulated on the basis of any existing set of principles for tax justice. Whatever may be thought of the various doctrines of sacrifice, no way has been found to reduce them to terms concrete enough to serve as guides in deciding, for example, whether the income tax rate on a \$20,000 income should be 10 per cent or 20 per cent—or more or less than either. We have, however, several remarks to make on particular aspects of particular taxes. (320-21)

Property Tax

54. In common with practically every other observer, past or present, we deplore the obvious injustices found under the property tax. We urge that they be speedily lessened, even though complete elimination is too much to hope for. Continual pressure for better assessors and better assessment under the real estate tax must be exerted. Whether state assessment rather than local assessment is called for is a matter that must be decided in each state in the light of local conditions, but we should like to see a few states, at least, try the experiment. There are substantial reasons for abolishing the tax on tangible personal property in any state that can possibly raise its revenue in another way. It is difficult to administer.

Even if it is perfectly administered, it is a poor means of measuring either the benefit to or the ability of an individual or a business firm. As to the intangibles tax, practically any new revenue source would be an improvement, at least if the intangibles tax is of the orthodox ad valorem full-rate type that is applied to practically all bonds and almost all stock, except sometimes the stock of domestic corporations. It is harder to administer than the tangible personalty tax, and the principle of the tax is even more faulty. (294-95, 297-300)

55. Exemptions under the property tax have been touched on above. It may be added, however, that from the point of view of a just distribution of the tax burden we can see no merit in the homestead exemptions recently adopted in Florida and several other states. The most obvious injustice in such exemptions is that they discriminate against the tenant, who must bear in his rent at least part of the real estate tax burden on his dwelling, and favor the person who happens to be able and willing to own his home. (295)

56. The recent property tax limits that have been embodied in some state constitutions, especially limits of the over-all type, seem to us to be ill-advised, particularly from the point of view of tax justice. They have been set so low and made uniform over so wide an area that they have disrupted long-established fiscal relations between taxpayer and government, and between different units of government. They have given undeserved bonuses to some taxpayers, inflicted heavy burdens on others who have had to supply much of the replacement revenue, and have made some localities largely dependent on the state. (297)

Income Tax

57. For the United States we favor the unified type of income tax. Therefore, we urge that capital gains con-

tinue to be a part of the income tax base, not under a separate special tax. We also urge adoption of the principle that capital gains and losses be computed annually on an accrual basis, although we realize that in practice this plan would, for some time at least, be substantially restricted in its application by serious administrative difficulties. Capital losses should be allowed as deductions against other income. Capital gains and losses on assets held until death are at present not taken into account; this anomaly should be removed. We should like to see some state experiment by taxing imputed income from home ownership and farm produce. We recommend a longer accounting period than one year, to be achieved either by a carry-over of losses or by an averaging device.

The advisability of allowing any deduction, even the present limited one, for contributions to charitable and other non-profit organizations depends upon the issue of control, mentioned above.⁸

We regret the existence of tax-exempt securities, with the consequent distortion in the operation of the progressive tax rate scales. There is no prospect of a solution in the near future, but we urge adoption of a constitutional amendment that will permit each jurisdiction to tax the future security issues of any other jurisdiction. Unhampered access to the capital market by the federal government in time of war, and perhaps in other emergencies, should, however, be guaranteed. Likewise, we recommend a change to allow non-discriminatory taxation of governmental salaries. (300-6)

58. If an increase in revenue from the income tax is needed, we believe that the rates in the middle income brackets should be raised. This measure would of course increase the tax of all persons whose total incomes fell either in or anywhere above these brackets. (70-82)

59. The personal income tax is so well adaptable to

⁸ See p. 395.

the personal status of the taxpayer that we recommend that it be extended below the present levels, to include the smallest incomes that administrative considerations allow. The new burden on these low income groups should, however, be offset by repealing other taxes. Perhaps administrative experience with the social security taxes will open the way for a genuine income tax on practically every single person receiving more than \$500, and every married couple receiving more than \$1,000. If it is not administratively practicable to put the exemptions at precisely these levels at once, at least an approach to them can be made. (354-58)

60. The corporation income tax is a relatively poor tax from the point of view of the ability-to-pay concept. If it is to be used as anything more than an impersonal business tax, we should prefer to see such use limited to two objectives. First, it might be used as a means of collecting at the source, and in advance, a personal income tax on resident holders of corporation stock. Second, it is the only means of collecting a tax on the income of non-resident holders of the stock of corporations that do business within the taxing jurisdiction. (306-9)

61. The corporation tax can be used as a partial method of taxing a particular kind of so-called "unearned income." The complex problem of earned versus unearned income cannot be discussed here. The only real distinction that appeals to us in the present connection is adequately taken care of by other recommendations, particularly those relating to death taxes, excess profits taxes, and land taxation. (273, 290, 313-15)

62. We do not favor the heavy taxation of all corporation profits, compared with partnership and proprietorship profits, that occurs, for example, under the federal income tax and in some states, such as California. Likewise, we do not favor the heavy taxation of all profits, corporate or otherwise, compared with all interest

and preferred dividends, that occurs in New York State. (306-10)

Death Taxes and Gift Taxes

63. From the point of view of justice, we should like to see the highest and widest-reaching rates in the system not in the income tax, where they are now, but in the death taxes. A limiting factor, however, is the fear of the possible repercussions on the volume of saving, since the death taxes are more likely than most taxes to be paid out of money that would otherwise have been saved for investment. (61-66, 311-15)

64. Balancing the various factors, we believe that the present federal and state death tax rates, except in the very highest brackets, are too low in view of other tax rates, and that the exemptions are too high. The death tax has important possibilities as a source of revenue, both federal and state, that have only been superficially explored. Moreover, as administration improves, serious consideration may be given to adopting genuine refinements such as the Rignano plan. We do not favor all the purposes associated with Rignano's plan. We should, however, like to see some experimentation in distinguishing between wealth that has been passed down by only one generation and wealth that has been passed down by two or more generations. (85-87, 315)

65. We believe that, for the present at least, the federal government should avoid the inheritance tax and retain the estate tax. We have no objection to graduation based on consanguinity provided it can achieve its aim, but the results can be very wide of the mark set by the legislator. Until the actual effects of the inheritance tax have been thoroughly studied, we favor the estate tax, largely because it is simpler. (311-13)

66. Although it presents many important problems, the death tax has not received the careful study that the

income tax has. We do not care to make further recommendations on matters about which so little is known.

(315)

67. The present federal gift tax is better than none at all. However, we urge that a search be made for some way to co-ordinate gift tax rates with death tax rates. At present, payment of a low gift tax on the first gifts that one makes saves payment of a death tax perhaps five or ten times as great. (315-17)

68. Because of the large current volume of gifts, many of the states will probably find it advisable to levy gift taxes. They will, however, tend to impose low rates, and obtain correspondingly slight revenue, unless the federal government extends the death tax credit to gift taxes. (316)

Taxes on Commodities and Services

69. From the point of view of a just distribution of the tax burden, taxes on commodities and services (except highway taxes and regulatory taxes) are distinctly mediocre. They should be used, so far as justice is concerned, only if some more refined instrument, such as an income tax, is not available. We urge therefore that the federal excises, except the gasoline tax and the liquor and tobacco taxes, be among the first to be repealed when a tax reduction program is effected. We also recommend that the federal government refuse to adopt a manufacturers' sales tax, and that the states search carefully for other sources before continuing or introducing a general sales tax or selective sales taxes. (317-20)

Sensitivity to Fluctuations in Prices and Business

Federal System

70. Whether the existing system is too sensitive to fluctuations in business activity and prices is a much-debated question. The great drop in federal revenues in

the period 1930-33 was caused largely by a provision of the income tax law that has since been dropped—the allowance of a deduction of capital losses against income from all sources for the year in question. The desirability of a fluctuating revenue system depends upon basic views of money and banking. It also depends upon the type of governmental unit—the federal system presents an entirely different problem from the state systems. Furthermore, it depends on one's faith in Congressional willingness to reduce the debt in prosperity somewhat in proportion to its increase in depression. (123-27, 323).

71. While we feel uncertain about some of these matters, we believe that a high degree of revenue stability in the federal government's tax system is not desirable, because it would sacrifice certain principles of tax justice that we hold more essential. For example, we do not believe that large incomes should be taxed lightly in prosperity merely because, since such incomes disappear in depression, heavy taxes on them in prosperity tend to make the tax system unstable. Moreover, because of certain economic consequences, we favor a federal tax system that is consciously designed to follow the fluctuations of the business cycle and thus exert pressure for a certain amount of federal governmental borrowing during depression and a certain amount of debt reduction during prosperity. Even the drastic drop in federal revenues in 1930-33 would not be too great if there were much more assurance than now exists that the debt would be rapidly reduced during prosperity. (322-29)

State and Local Systems

72. Most of the state systems are probably already sensitive enough, in view of the economic and legal limitations on state borrowings. We are not, however, alarmed over the present degree of sensitivity. (322-35)

73. The local tax systems present a much more serious

problem. They need stability most, if local independence is to be preserved. For a variety of reasons, property tax collections have proved much more sensitive to cyclical influences than was generally supposed. The sensitivity can be appreciably reduced by improving property tax administration, especially through stricter methods of collection. (44-45, 331, 346-47)

Reaction to Inflationary Price Rises

74. Opinions differ on the probability of a drastic inflationary rise in prices in the United States in the next few years, but few would care to deny the possibility. This would not be a cyclical fluctuation, with the rise in prices followed by a decline. It would be a more rapid and longer price rise than is usually associated with cycles, and it would not be followed by a decline to anywhere near the former levels. The kind of price rise that we have in mind, although we attempt no prediction concerning it, might develop as a result of credit conditions that already exist, largely as a consequence of devaluation of the dollar; the possibility of war is another factor. In any case, the matter seems important enough to warrant discussion. (329)

75. Both the income tax and the property tax present grave dangers in such a period. One is the probable failure of the revenue to grow with expenditures. This danger is slight or non-existent for the income tax, at least during the early stages of an inflation. The possibility of revenue failure presented by the property tax, however, is serious, chiefly because of inadequate assessing procedures, lag in payment, and rate limitations. The sluggish response of the tax to the price rise would result in increased borrowing, and, if the inflation became very great, the localities might become financially dependent on the state and federal governments and lose their present degree of independence. (330-35)

76. Another danger is an unjust change in the relative positions of taxpayers. In the case of the income tax, this is apt to result from the effect of the price rise on exemptions, graduated rates, and the capital gains provision. As to the property tax, the danger lies in the failure of assessments to register proportionate increases in actual value and the failure to exact equally prompt payment from all taxpayers. (329)

77. For the income tax, the only practicable safeguard would be the use of certain kinds of index numbers. These would be of two contrasting kinds. First, a deflating index, to be applied to the net income figure. This would lessen somewhat the extra burden on taxpayers caused by the lowering of the real, or purchasing-power, value of the exemptions, and would also lessen the increase in the real severity of the rate schedule caused by the rise in prices. Second, an inflating index, to be applied to the tax due. This would compensate the government for the loss in real value that it suffers as it waits for the tax to be paid. The property tax can be technically improved so as to aid appreciably in safeguarding local finances in such a period. Intervals between assessments should be shortened, assessment technique should be improved to make assessments more responsive to changes in prices, and collection procedure should be speeded up. The first two measures would tend to increase the cyclical instability of the tax. Despite this fact, it is urged that all three be adopted. (331, 335)

Administration

78. The technique of tax administration is a special field full of pitfalls for the uninitiated. Consequently, the recommendations made here will be among the most tentative of the entire chapter. Fortunately, associations of tax administrators, with their periodic meetings and their publications, are rapidly spreading advances in

technique. Before long an impressive body of information on these matters may be assembled. (348)

Cost of Administration

79. We do not believe that the data on cost of tax administration reveal unduly high costs. In our opinion they are more probably not high enough, because the governments do not care much about collecting taxes from small taxpayers. We oppose the unofficial exemption of a large body of small taxpayers that is granted simply because the cost of reaching them is so much greater, per dollar of tax collected, than for large taxpayers. We do not urge that collection be pushed to the point where the cost of collecting the last dollar of tax equals the amount collected. However, we believe that collection is often not pushed far enough, especially in the income taxes and the sales taxes. The responsibility is usually not that of the administrator, who has to apply a given appropriation to the most fruitful ends. It may instead be traceable to the false sense of economy of legislators or their constituents—an economy that has great potentialities in breeding disrespect for laws in general. (336-41)

80. We realize the caution with which any cost-of-collection figures must be used. Nevertheless, we think that attempts at refining the figures are justified. The federal government, for example, might make an effort to segregate at least some of its internal revenue costs among the several taxes. It would be interesting and probably valuable to see some tax administration body try to split its costs for some one tax among different types of taxpayer—particularly with a view to determining the approximate cost of the most expensive taxpayers. (338)

81. Our concern over the administration of the property tax has already been indicated. The more obvious methods of reform—replacing town or village assessors

by county assessors, and having them appointed rather than elected—have been elaborated and discussed by tax specialists many times. We offer nothing new, but merely emphasize the good advice that has already been given. (347)

82. The income tax is, to our minds, in danger from certain administrative faults. The federal government is developing in its income taxpayers an ill-will that, if it continues, will prove unfortunate indeed. Whether the remedy lies in changing the administrative provisions of the law, the administrative regulations, or the requirements for personnel are questions best answered by specialists in administration. Unless we have been misled by a few highly atypical cases, a prompt remedy is called for if the effectiveness of the income tax is not to be seriously damaged by a lack of co-operation from taxpayers. (348-50)

83. The state income taxes, on the other hand, suffer in many states from a too easy-going administration. We are of the opinion that current state tax yields could in several states be greatly increased by spending more money on income tax administration. (340)

Tax Consciousness

84. Although little direct evidence bears on the point, it appears that tax consciousness is in general a force for good government. To be effective, however, it has to make the taxpayer aware of the different levels of government, so that, for example, he will not attribute to the federal government chief responsibility for the weight of the real estate tax. It also has to show the taxpayer a connection between amount of expenditures and amount of tax. A flat tax, which does not vary even though governmental expenditures change, shows no such connection. For this reason, we do not favor a universal, flat filing fee under the income tax as much as an extension of

the regular income tax in the lower income groups as far as is administratively possible. We do not absolutely oppose the filing fee, since we realize that administrators may find it of value in checking evasion under the income tax. The federal government could promote intelligent tax consciousness by stating the amount of the tax on the cigarette tax stamps and perhaps on liquor tax stamps, provided due caution was taken to indicate that the tax may or may not have been fully passed on in the price. (354-58, 362)

85. The real problem of lack of tax consciousness is represented by the mass of urban tenants and farm tenants who do not own automobiles and do not have enough income to be taxable under existing income tax laws. They bear a real tax burden, of course, but it is hidden. We see no practicable way of bringing it out in the open except by substituting, for some of the tax they now pay indirectly, some form of income tax. This would be a difficult task, and it might prove inadvisable. For example, if the local property tax were partly replaced by an increase in the state income tax, with a return of the additional income tax revenue to the localities, the shift in fiscal responsibility from the lower jurisdiction to the higher might not be desirable. Furthermore, injustices might be caused by giving undeserved reductions in tax to certain landowners. (353)

86. We should like to see some plan developed that would make the burden of the *real estate tax on rented dwellings* apparent to the tenant, but we have not been able to devise any plan that would not be misleading. It is difficult to ascertain just how much of the tax is passed on in rent in a given case. Perhaps some inaccuracy might well be risked, but we condemn the careless statements, so common in popular discussion, that seem to assume an easy knowledge of precisely how much of each tax is shifted—for instance, an assertion that sixty-three

taxes are taking \$3.53 out of an \$18 suit. Dogmatic statements like this are ridiculous, and are apt to create a spurious kind of tax consciousness that will hinder rather than promote an understanding of the tax system. (362)

Federal-State-Local Relations

87. The conflicts arising from the overlapping tax powers of the different taxing jurisdictions in the United States can and should be materially reduced. We do not urge, however, elimination of all the conflicts, since this would necessitate a much greater degree of governmental centralization than we favor. A certain amount of inconvenience, waste, and injustice in the tax system is a price that it is necessary to pay for the benefits of a democratic and somewhat decentralized form of government. (365-66)

88. Recommendations to improve the existing situation can be conveniently treated under three headings: state-local relations, federal-state relations, and state-state relations. The fourth possible category, federal-local relations, is not likely to be of much importance in the near future, except in emergency periods. Even then the states can, if they wish, make the federal government deal through them rather than directly with their subdivisions. (366-68, 379)

State-Local Relations

89. As long as the administration of a wide variety of governmental functions is left in local hands, local independence and responsibility should be maintained except as they are conditioned by the desire to equalize burdens among districts. This point is discussed below. Independence and responsibility can best be promoted by increasing the availability of the real estate tax to the localities through reduction or abolition of state taxes

on real estate, abolition of most forms of tax limits, and diminution of exemptions. (295-97, 385)

90. No prescription for the state tax on real estate is applicable to all states, but we believe that many of the states that now use the property tax for state purposes could well use other revenue sources instead. We are not advocating an increase in the total of state and local expenditures. Rather, we are suggesting an alternative to other means of financing a given total of expenditures, such as sharing taxes. The latter procedure weakens local responsibility without giving any assurance that local revenues will be any better adapted to needs than with a local real estate tax. (380)

91. The state can aid the localities more by assisting them in administering the real estate tax than by subjecting them to tax limits embodied in state statutes or state constitutions. It can also aid them by refusing to pass measures allowing such exemptions as those of homesteads. Through these steps, with special emphasis on state assistance in assessment, the local real estate tax can be made much more equitable, and it can also be made to yield an appreciable amount of revenue to replace other, less satisfactory, local sources. We emphasize that we are not, in these recommendations, anticipating much, or even any, absolute increase in the real estate tax. Our expenditure estimates do not indicate a substantial increase in local government tax needs over the next few years. Instead, we are proposing methods for preserving local independence and responsibility, which we fear will be greatly impaired if the localities, losing faith in the real estate tax, turn to the states for aid. We have no objection to state aid if it is given for any of the reasons noted below; we do object to it if it results from a failure to use obvious and sound methods of improving the real estate tax as a means of local revenue. (104-20, 386)

92. A substantial degree of state aid is desirable. It should take the form of grants-in-aid (subventions) rather than shared taxes, since grants are more adaptable to local needs and to central control. This assistance should ordinarily consist of equalizing grants rather than stimulative grants. The latter tend to benefit most the communities that are best able to meet their own needs. (372-73, 378-80, 385)

93. Wherever grants-in-aid form a substantial part of local income, it is important to establish central controls, even though local initiative is largely limited in the process. The activities for which aid is given should be those of a peculiarly general interest. (385)

94. It is also desirable to consider (1) redistricting so that the local units can finance themselves more readily and preserve their independence, and (2) transferring complete administration of some governmental service to the state so that the state is made directly responsible for the performance of the function. In any case it is essential to guard against perpetuating submarginal communities if the ultimate liquidation of such communities might prove preferable. (385-86)

Federal-State Relations

95. Some decrease is desirable and possible in the duplicate administration and the competition for taxes between the federal government on the one hand and the state governments on the other. This is best achieved, at least for the present, by the moderate use of a number of devices rather than dependence on any one. We recommend this diversity (1) because of the great uncertainty of the results of any of the co-ordinating devices in their more drastic stages, and (2) because we think federal-state relations will be more amenable to change if no one device is pushed very far. We believe that these relations must be kept amenable to change pending the

time when a specially constituted body, such as an official federal-state committee or commission, can give a year or two of concentrated study to the problem. We favor the immediate appointment of such a commission. (387)

96. Meanwhile, a certain amount of separation of sources is feasible, and also some sharing of taxes and some use of the crediting device. Cigarette taxes might be given up by the state governments, and the gasoline tax by the federal government. We do not, however, particularly favor the federal government's giving up the gasoline tax entirely, in view of federal expenditures on highways. The federal liquor taxes might be shared with such states as would give up their own liquor taxes. Thus, power over liquor taxation would be concentrated in the hands of the federal government—an important factor in the campaign against illicit liquor. The crediting device, a co-ordinating measure also important in state-state relations, can continue to be used in the estate tax, and perhaps be extended to the gift tax. None of these devices should be carried so far that any one state depends on them for most of its revenues. Separation, sharing, and crediting are too inflexible and bear no relation to needs. Consequently, a certain amount of federal aid to the states must be expected. More attention, however, should be given to equalizing features in distributing this aid than in the past. (371-81, 383-87)

97. There is little hope that the recommendations in the preceding paragraph will be put in effect if matters are allowed to drift as they have been. The complete failure to achieve liquor tax co-ordination in 1933-34 under relatively favorable circumstances is a case in point. A series of piece-meal suggestions will simply result in a series of rejections by one or another jurisdiction. The only worth-while plan that will be accepted is a comprehensive one that includes much more than tax

features, and that offers enough to every unit to ensure its acceptance. Such a plan can be drafted only by a special body endowed with adequate funds and governmental support and given adequate time. (387)

State-State Relations

98. The remarks just made apply also to state-state relations. Until a comprehensive plan is proposed, however, some promising ways are available to the states for lessening interstate tax competition and decreasing the harassing tax compliance burdens and multiple taxation burdens on taxpayers, particularly business firms. (367-68)

99. We recommend that all the states seriously consider adopting the Massachusetts formula for allocating profits under the income tax, although we realize that some states can give reasonable arguments against it. We do not believe that interstate businesses can claim, as a right, a guarantee that they will never be subject to any multiple taxation whatsoever. (381-83)

100. Among states some degree of difference in levels of tax rates is inevitable and desirable. One state, for example, may well have need of a 6-cent gasoline tax, and another need of only a 2-cent tax. (260-62)

101. We are not so impressed as many popular writers on the subject seem to be with the threats of industries to move from one state to another as a result of tax differentials. There is practically no good evidence available that the differentials have caused such movements, outside of a few isolated cases. We realize that tax differentials among states present a real problem—one that must be considered in the comprehensive plan that we recommend be made. It appears, however, that the problem has been overemphasized in certain quarters. (149)

102. In conclusion, then, the problem of federal-state-local relations can be ameliorated even at the present

time by certain measures that have been noted. However, the degree of betterment under these measures cannot be great. A generally acceptable solution that marks a substantial advance can be achieved only by a comprehensive plan prepared by a body that is adequately constituted for such a task. Such a plan must cover many fields—for example, expenditure, debt, and political controls—in addition to the field of taxation. Finally, no one who believes in a considerable degree of democracy and decentralization can reasonably ask for a tax system with no overlapping, no conflicts, no administrative duplication, and no multiple taxation. (370, 387)

Chapter 26

SPECIFIC RECOMMENDATIONS

A program of action for changes in the tax system is herewith submitted by the Directors of Research. The numbers in parentheses refer to the relevant paragraphs in Chapter 25. Absence of a recommendation does not necessarily imply approval of the status quo; on some matters—e.g., payroll taxes—we are not prepared to make definite recommendations. With this qualification, we recommend:

I. INCOME TAX

A. That the constitutions of the federal government and the state governments be amended to give legislators greater freedom in defining taxable income—particularly to enable them to tax gains before they are realized and to tax corporate shareholders on their total current share in corporate earnings; and that the possibility of changes in the laws governing corporation finance be considered to facilitate such a taxation of corporate shareholders. (13)

B. That the federal surtax on undistributed profits of corporations be repealed unless either the taxable stock dividend or the issuance of rights to buy new stock can be shown, in the near future, to be a practicable means of avoiding loss of control, by medium sized and small corporations, over the disposition of their earnings. (16)

C. That, if the undistributed profits tax is kept, it be redrafted to lessen the pressure on certain corporations, notably those that, under state laws, find no practicable way open to them to pay dividends. (18, 19)

D. That, if the undistributed profits tax is retained and dividends are taxed under the individual normal tax, the federal normal tax on corporations be lowered to approximately a 5 per cent level. (36-38)

E. That every state's corporation income tax be integrated with its personal income tax, either by excluding dividends from taxed corporations in computing personal net income, or by taxing all dividends but either allowing a credit for the corporation tax paid against personal net income tax otherwise due or lowering the rate of the corporation tax to a point determined by considerations that are outside the scope of the income tax system proper. One consideration of this kind is the impersonal taxation of corporations on the basis of special privilege. (12, 36, 38, 60)

F. That the progressive rates now used by the federal corporation normal tax and several of the state income taxes on corporations be replaced by flat rates, regardless of the action taken on points A to E above. (11)

G. That the personal exemptions and the credit for dependents in the federal income tax be lowered possibly to the following levels: \$500 (single), \$1,000 (married), and \$200 (for each dependent), and that this new burden be offset, at least for taxpayers with low incomes, by a lightening of the concealed tax burden through a lowering or a repeal of some of the regressive taxes on consumption, particularly the import duties imposed by the customs tariff. (5, 24, 59, 69)

H. That states not now imposing a personal income tax, or imposing it at low rates, prepare to meet from this tax most of, if not all, the increase in state revenues that may be demanded in the near future. In some states the state constitution will have to be amended. This recommendation is in addition to whatever changes in the income tax follow from adoption of the recommendation in VII-A below (sales tax). (58, 59)

I. That the federal and state personal income taxes (and corporation income taxes, so far as they are retained) (1) include capital gains as a part of the regular tax base, instead of exempting them altogether or applying a separate rate to them, with a provision—perhaps the annual accrual provision discussed on pp. 166, 398, and 413—to prevent the taxation of gains, accrued over a number of years, at high surtax rates merely because the gains are realized, and therefore taxable, in a single year; (2) allow capital losses as deductions not only against capital gains, but also against other income, with such modifications as may be found desirable from the point of view of stability of revenue (for instance, there might be some degree of carry-over instead of complete deduction in the current year); and that the failure of the personal income tax to consider gains and losses accrued to death be remedied. (17, 57)

J. That some states experiment with the inclusion in the income tax base of imputed income from home ownership and consumption of farm produce. (57)

K. That both federal and state laws make the accounting period longer than one year by carrying over losses or using some averaging device. (2, 17, 57)

L. That the Constitution be amended so that the future issues of state and local securities would be liable to non-discriminatory federal taxes, and future federal issues similarly liable to state and local taxes, provided the federal government has ample access to the capital market in war and perhaps in other emergencies; and that the amendment permit non-discriminatory taxes on salaries and wages. (57)

II. PROPERTY TAX

A. That no further inducements to the delinquent payment of taxes—such as extraordinary delays and the remission or reduction of penalties—be offered, and that

the present ones be removed as soon as is consistent with good faith. (73, 75-77)

B. That, unless some particular local or regional conditions make the procedure obviously inadvisable, the interest penalty for delay in payment be raised to at least twice and perhaps three times the rate on real estate loans, so that taxpayers will not be tempted to borrow from the government by withholding taxes. (73, 75-77)

C. That assessment technique be improved by adopting the measures best suited for the particular locality; these will usually include (1) appointment instead of election of assessors, (2) use of no assessing unit smaller than a county except urban centers, (3) state assistance of and some state control over assessors, and (4) in a few states abolition of the local assessor and complete control of assessment, at least outside large urban areas, by the state. (54, 75-77, 81)

D. That property be reassessed once every year or at least once every two years in every state. (75-77)

E. That the total dollar amount of tax exemption that is given to educational, charitable, and religious organizations and other similar groups be periodically reviewed by legislatures somewhat as if it were an expenditure total, and not solely a tax matter. (7)

F. That no further exemptions from the property tax be given to business firms as inducements to locate within the taxing jurisdiction. (9, 89)

G. That, in most of the local jurisdictions, no drastic decrease be made in the real estate tax. (25)

H. That substantial increases in the real estate tax rate be made only for the purpose of financing such local activities as clearly tend to enhance the value of real estate in the community. (26)

I. That all the remaining state ad valorem taxes on intangibles at a full rate be repealed. (54)

J. That the tax on personal property, both tangible and intangible, be repealed wherever the personal income tax can be called on to replace the revenue. (54)

K. That homestead exemptions of the type enacted in the past three or four years be repealed. (55, 89)

L. That constitutional over-all property tax rate limits be repealed. (56, 75, 89)

M. That state governments work toward the abolition of the state tax on property, taking care at the same time not to lose all state control over assessment. (89, 90)

III. DEATH TAXES AND GIFT TAXES

A. That the federal death tax rates be increased and the exemptions lowered—the added revenue to go to the states (through extension of the crediting device) or to the federal government, depending upon the need for such revenue at the time the change is made. (64)

B. That the federal government study the possibilities, from an administrative point of view, of levying a specially high tax rate on property that has been passed down through two or more generations. (64)

C. That, if possible, some adjustment in gift tax rates be made so that it does not offer in its lower brackets such an inducement to avoid the upper brackets of the estate tax. (67)

D. That the federal government extend to the gift tax the crediting feature of the death tax, not necessarily immediately, but perhaps as one of the first moves in a federal program of tax reduction. (68, 96)

IV. EXCESS PROFITS TAX

A. That the existing federal excess profits tax be replaced by one that will carry only nominal rates until a basis has been provided by five or ten years of record keeping for a true excess profits tax as a permanent part of the federal revenue system. (37, 47-52, 61)

B. That the new excess profits tax embody the suggestions made in Chapter 25 above on the definition of excess profits. (39, 49)

V. BUSINESS TAXES

A. That experiments be made, both by the federal government and the states, with special service charges on business firms to cover some of the special costs of police, courts, etc. caused by the demands of business upon government. (36)

B. That each state consider the applicability of a program of business taxation such as that outlined in paragraphs 36 and 38 above.

C. That the federal capital stock tax be repealed. (36)

D. That the present chain store taxes be repealed. (6)

VI. TAXES ON SPECIFIED COMMODITIES AND SERVICES

A. That, in the event of federal tax reduction, the taxes on specified commodities and services be abolished before the personal income tax is cut severely, with the exception of the liquor taxes, and the gasoline tax, and all tobacco taxes, although the cigarette tax might be reduced somewhat. (21, 24, 27-29, 35, 69, 96)

B. That the amount of the cigarette tax be printed on the cigarette tax stamps, with some such caution as, "This tax paid by manufacturer; the government assumes no responsibility for its being passed on or not being passed on by the manufacturer, in whole or in part, to ultimate consumers"; and that the use of similar liquor tax stamps be seriously considered. (84)

C. That the federal government and all the states that now levy it repeal the oleomargarine tax within the next five or ten years. (6)

VII. SALES TAX

A. That, unless urgent considerations concerning the present level of income tax rates dictate otherwise, the

states now imposing a retail sales tax at a rate of 1 per cent or less repeal the tax, and that states now imposing a retail sales tax at a higher rate reduce or repeal the tax—in either case the replacement revenue to be obtained from the personal income tax. (30, 69)

VIII. TARIFFS

A. That the present protective tariffs be reduced gradually, perhaps with special governmental support for a time to the owners and workers in the affected industries and their allied industries, until

(1) only the following remain: (a) import duties designed as counterparts of domestic excises on similar articles, (b) import duties levied for revenue purposes only, on commodities not produced in the United States, and (c) import duties levied to prevent dumping; or

(2) some factor of public interest other than the general standard of living—for instance, desire for self-sufficiency in the event of war—dictates a certain level of protective duties and thus stops the lowering process short of the goal set in (1) above. (5, 26)

IX. POSTAL RATES

A. That the first-class mail rate of 3 cents be reduced to 2 cents. (46)

B. That the revenue lost under recommendation A above at least in part be made up by increasing the charges on other parts of the postal service so that these charges come much closer to covering the cost of the service rendered. (46)

X. ADMINISTRATION

A. That each state seriously consider the merits of substantially increased appropriations for enforcement

of the tax laws, particularly state income tax laws. (79, 83)

B. That some states experiment with detailed costing systems to ascertain the relative costs (expressed as a percentage of receipts) of collecting taxes from taxpayers of various incomes, occupations, etc. (80)

C. That the federal government segregate at least some of its total internal revenue collection costs among the several taxes. (80)

D. That the federal Treasury devote special effort to gaining the good-will of honest and reasonable income-taxpayers by showing that it is as fully aware of the taxpayer's rights and interests as of those of the government. (82)

XI. INTERGOVERNMENTAL RELATIONS

A. That both federal and state aid be based to a greater extent on equalization grants-in-aid rather than stimulative grants or shared taxes, and that grants be given only for those specific purposes of particularly strong nation-wide or state-wide interest. (92, 93, 96)

B. That some form of central control be established wherever the grants form a substantial part of the receiving unit's income. (93)

C. That a small committee with ample resources be appointed by the federal government to devote a year or two to federal-state-local co-ordination and to formulate a comprehensive plan. (95, 97)

D. That the states adopt the Massachusetts plan, or some plan closely resembling it, for allocating profits subject to the income tax. (99)

Book Four

REPORT OF THE COMMITTEE

The Directors of Research are responsible for the preceding chapters. The material in Book Four represents the views of the Special Committee on Taxation.

Chapter 27

REPORT OF THE COMMITTEE

I. FACING THE TAX PROBLEM

The tax problem in the United States is strikingly important and complex. Its importance is shown by a mere statement of revenues and expenses. The governments of the United States—federal, state, and local—are spending about \$17,400,000,000 a year. Most of this money is obtained through taxes, which yield about \$12,600,000,000, or the equivalent of about \$100 from every inhabitant.¹

Complexity of the Situation

The complexity of the problem is shown both by the multiplicity of taxing agencies and by the extreme difficulty of devising taxes that will meet various—and often conflicting—aims or standards. No less than 175,000 local government units in the United States, in addition to the several states and the federal government, have the power to levy taxes.² Often these jurisdictions overlap and actually conflict or compete with each other. Simplification and co-ordination are obviously called for, although they should not be attained at too great a sacrifice of local autonomy.

Entirely apart from a proper division of tax powers, to get a fair distribution of the tax burden among the 129,000,000 people of our nation is a stupendous task in it-

¹In this section, in contrast to other parts of this volume, it has been possible to take account of the estimates for 1937 and 1938 in the recently issued budget message. See Note 2, *Revenue Estimates in Budget of January 5, 1937*, p. 538.

²With respect to the kinds of tax that they use, the territories and possessions of the United States can in general be compared to the states.

self. To get it, and at the same time to avoid excessive intricacy and undue costs of administration and compliance, is still more difficult. The task is not made any easier if a proper degree of tax consciousness among taxpayers is to be obtained. In addition, both undue instability and undue stability are to be avoided. Tax revenues should not be too much or too little at the mercy of the swings of the business cycle.

Furthermore, taxation is being used not only as a source of revenue, its chief aim, but to stimulate or control activities that are considered good or bad. The protective tariff, the new undistributed profits tax, the tax on alcoholic spirits, the chain store taxes, are all illustrations of taxation for economic and social control. The tax system also affects the amount of saving and the course of business initiative—whether it is intended to do so or not. Taxation is, therefore, an important influence in the whole economic system.

The Committee's Recommendations

In the face of these problems, we have reached certain conclusions and have agreed upon certain recommendations for change. We have based them in part on the factual material contained in the report of the research staff. We say "in part" because no amount of such factual material can by itself supply answers to questions of tax policy. We must also call upon our own standards of justice, our philosophy of government, and our conceptions of sound economics.

In general, our conclusions are the same as those of the directors of the research staff of the survey.³ Rather than present a comprehensive summary of those recommendations, however—with such minor modifications as we might wish to make—we prefer to restrict this report to nine tax problems of outstanding current interest so

³ See pp. 391-436.

that we may go into much more detail on each point than would otherwise be feasible. The problems that we have selected are: (1) federal-state-local tax relations, (2) the taxation of incomes under the personal income tax, (3) the sales taxes, (4) the undistributed profits tax, (5) the taxation of capital gains, (6) the excess profits tax, (7) the social security taxes, (8) the estate and gift taxes, and (9) the chain store taxes.

Although we suggest changes in the present tax structure, the system we should like to see in the United States would not be drastically different from the one we now have. Furthermore, changes in a tax system should always be made with extreme caution and only after due deliberation. Their prospect creates an atmosphere of uncertainty that checks initiative; their imposition disturbs the delicate balance of our economic life. Unless they are carefully studied beforehand—more carefully studied, in fact, than many recent changes have been—they are apt to cause injustice by disrupting established economic contacts and relations upon which citizens have counted in conducting their affairs and upon which their income depends.

II. REVENUES VERSUS EXPENDITURES

The tax problem must be studied in the light of the government's fiscal needs and the revenues that can be produced by the present tax system.

In 1936, about one-fifth of the national income was paid out in taxes. By itself, this fraction gives no cause for alarm—or for congratulations. It has significance only in the light of what the tax revenues are spent for and how they are raised.

For better or worse, a larger and larger percentage of the nation's productive effort has come to be exerted through government, rather than through private, agencies. More and more, consumers are depending on

public rather than on private business, both for customary and for new goods and services.

This Committee passes no judgment on the amount and the kind of government expenditures. Likewise, we offer no advice on the extent to which the expenditures of the next two or three years should be met by loans and other non-tax receipts. The problem of when debt retirement should begin and how rapidly it should proceed is also outside the scope of this study; it is being analyzed by another committee of the Twentieth Century Fund, which expects to issue a report on this subject soon.

A proper understanding of our program requires, however, a knowledge of current government revenues and expenditures, as well as some estimates of probable government expenditures in the near future, and of revenue yields under various assumptions. We, therefore, present some basic data compiled by the research staff.

Present Taxes and Yields

At present the tax system is yielding about \$12,600,000,000 a year—more than ever before. Of this amount, the federal government gets \$5,600,000,000, the state governments, \$2,500,000,000, and local governments, \$4,500,000,000. But government expenditures are about \$18,000,000,000: \$8,500,000,000 by the federal government, \$3,200,000,000 by the states, and \$6,300,000,000 by local units. If the federal payment of \$400,000,000 into the sinking fund that is required by present statutes and the \$225,000,000 payment to the federal old-age reserve account are excluded, the total drops to \$17,400,000,000; and about \$1,900,000,000 of this reduced total is being met by regular non-tax revenues. Nevertheless, budgets on all three levels of government are unbalanced and deficits are being met by government borrowings.

The greatest single part—more than \$2,000,000,000—

of the federal tax revenue for the fiscal year 1937 will be supplied by the income taxes. The liquor taxes, the tobacco taxes, the customs duties, and the combination of death tax and gift tax are accounting for another \$2,000,000,000 in roughly equal shares. Miscellaneous sources, including a number of manufacturers' excise taxes and the payroll taxes for social security, account for the remainder of federal tax revenues—about \$1,300,000,000.

The states depend chiefly on the so-called highway taxes. Of the \$2,500,000,000 total, gasoline taxes account for \$600,000,000 (possibly \$700,000,000), and motor vehicle registration taxes for \$300,000,000. For the rest, dependence is placed on the sales tax (\$400,000,000), income taxes (\$300,000,000), property taxes (\$200,000,000), death taxes (\$100,000,000), and a miscellaneous group of taxes. Even in 1937 taxes levied to finance social security programs, including taxes on payrolls, will account for a substantial share of state revenues.

The local tax revenue is raised almost entirely from the property tax. In some localities the property tax is levied only on real estate; in others, personal property is included. Intangible personal property, however, such as bonds and shares of stock, is largely exempt by law or in practice, or is assessed or taxed at low rates.

Future Expenditures and Revenues

If budgets are to be balanced, as they must be in the long run, the tax system of the country will have to be producing \$15,800,000,000 in 1938, of which \$7,000,000,000 would have to be from federal sources, \$3,700,000,000 from the states, and \$5,100,000,000 from local sources.

By 1940, even under optimistic assumptions of continued business improvement over 1936, the total would have to be \$15,200,000,000: federal, \$5,300,000,000 (the

decrease would be caused by a decline in the relief load); state, \$4,300,000,000 (the increase would represent chiefly social security expenditures); local, \$5,600,000,000.⁴ If the debt is to be reduced appreciably, these totals must, of course, be larger.

These figures allow for certain non-tax revenues other than loans. They do not include the contributions to the old-age benefit reserve fund, and they assume only the statutory amount of federal debt retirement, which is between \$400,000,000 and \$600,000,000 a year.

If 1936 conditions continue without improvement, however, about \$16,000,000,000 in tax revenue will be necessary by 1940 if budgets are to be balanced: \$6,100,000,000 from federal sources, \$4,300,000,000 from the states, and \$5,600,000,000 from local tax agencies. No estimate has been made of the revenues that would be called for if business conditions should get worse.

If business continues to improve at its present tempo, the existing tax system will yield \$14,000,000,000 in a year or two, and might even reach \$15,000,000,000 by 1940, exclusive of the income from the federal taxes for the old-age benefit reserve fund. Since the net expenditures of all governments to be met from taxes and loans (excluding statutory debt retirements and assuming that the federal government will no longer be making contributions to relief) are estimated at \$14,700,000,000 for 1940,⁵ the increase in the public debt as a whole could be stopped without any change in the tax system.

Some of the governmental units, however, would have surpluses, and some, deficits. In the deficit groups would be several of the states.

The research staff has not found it possible to make detailed estimates of changes in state revenues that will come with changes in business conditions. Roughly,

⁴ See pp. 104-20.

⁵ That is, the figure of \$15,200,000,000 given above, less \$500,000,000 federal statutory debt retirement.

it appears that in any case the states will need between \$1,000,000,000 and \$2,000,000,000 more in tax revenue by 1940. Part of this increase can be achieved by the new payroll taxes and other taxes that the states are now imposing to finance their share in the social security program. Continued business improvement could probably supply much of the remainder. Some states, however, would face a problem of raising tax rates or imposing new taxes—a state-by-state problem that cannot be examined in detail here.

Local budgets, too, would in the aggregate be somewhat out of balance, since improved business conditions alone would probably not increase revenues quite to the \$5,600,000,000 level. The local situation would not be serious, however. A modest amount of borrowing for certain types of capital expenditure may be assumed—an assumption that may be applied also for the states.

At present tax rates the federal budget, on the other hand, would show an annual surplus of a billion dollars or so by 1939 or 1940, if business continued to improve. This surplus could be used for debt reduction. Incidentally, however, ten or twenty years of such prosperity would be needed if the federal debt were to be put back to the \$16,000,000,000 level of 1930 without increasing tax rates.

If business failed to improve over 1936, balanced budgets could be achieved by 1940 only by increasing tax revenues by \$3,400,000,000 over the 1937 level. As the figures given above for tax requirements show, state and local expenditures might be expected to be about the same as under improved business conditions, the higher relief load figure being assigned to the federal government. However, since the states could not count on an increased yield from business improvement, their tax problem would be more serious than otherwise, and possibly almost \$2,000,000,000 additional revenue from

new state taxes and higher state tax rates would be needed. The local problem would not be quite so serious as the state problem, since the local revenue system is less sensitive to changes in business conditions than the state systems. To increase state revenues by four-fifths, and to increase federal tax revenue by one-fourth, through new tax measures, would be a serious matter indeed.

The Problem

If business continues to improve, the tax problem of the next few years, with the possible exception of some states, will not be to increase present rates or to impose new taxes—unless government debts are to be rapidly liquidated. Instead, the problem is chiefly one of improving the methods of raising the revenue. This improvement, however, might call for the lowering of some rates and the raising of others, for the lowering or raising of exemptions, or for the abolition of some taxes and the imposition of others.

The recommendations of the Committee, therefore, are designed primarily to make the present system more equitable and more effective. But these very changes in themselves would make the system better able than it is today to produce increased revenues in time of great fiscal need. In that event a mere increase of rates, rather than drastic reorganization, might meet the situation.

The following sections summarize the Committee's recommendations for improving the tax system.

III. FEDERAL-STATE-LOCAL TAX RELATIONS

The Present Situation

The present lack of co-ordination among the different taxing systems, often referred to loosely as "double taxation," consists of both vertical conflicts and horizontal conflicts.

Vertical Conflicts

The federal government, the states, and the 175,000 local units of the United States each have their own taxing system. The federal government is the only one that levies customs duties. Otherwise, every major tax is used by more than one of the three levels of government. This situation creates what might be called "vertical conflicts": rivalries between two or more levels of government for revenues out of the same kind of tax.

The local units depend almost exclusively on the property tax, but some of the state governments use it too. The states depend heavily on the motor vehicle license tax, but so do a few local governments.

The federal government, every one of the state governments, and even some local units use the gasoline tax. The federal government and all but one of the states use some form of death tax.

The federal government makes great use of the income tax, but nearly two-thirds of the state governments use it too. Somewhat the same situation is found in the liquor taxes and, to a lesser degree, in the taxes on cigarettes. This kind of duplication is also growing—as part of a definite plan, however—under the payroll taxes for social security.

Horizontal Conflicts

To these vertical conflicts, horizontal conflicts are added: rivalries between governments of the same kind for revenues from the same tax. An enterprise doing business in two or more states may find that all together those states tax it on more than 100 per cent of its income because they do not agree on how much of the income arose within each state, and hence was taxable by it. Moreover, one state may tax an individual's income because it arose within the state and another state may tax the same income because it is the state where

the recipient resides. The right to tax certain property in a decedent's estate may be claimed—and exercised—by two or more states, each declaring itself to be the state of the decedent's legal residence.

Existing Tax Co-ordination

Conflicts such as these—and the list is not complete—give an impression of chaos. The situation is bad enough, but it has sometimes been made to appear worse than it is. The different units of government are not, even now, acting entirely independently of each other, as if they neither knew nor cared what the others were doing. Co-ordination is of three kinds: (1) unilateral, (2) joint, and (3) constitutional.

(1) Before any important tax measure is drafted, it is customary for those who draft it to gather information on the number and kind of similar taxes already being used by other jurisdictions. As a result, a certain amount of conflict is avoided through unilateral co-ordination. The state income tax rates, for example, usually progress steeply in the income ranges up to \$10,000 or \$20,000 and then taper off to a flat rate. This kind of scale has been adopted partly because the federal income tax has progressed slowly in the lower ranges and steeply in the upper ranges, and partly because other states have imposed the same sort of rates. The federal gasoline tax is probably lower than it would have been had the states not used this tax for many years at high rates.

(2) Joint action has mitigated conflicts in some instances. In the states many elaborately co-ordinated state and local fiscal systems now exist. This is natural, since the local units have no sovereignty of their own. Co-operation among the states has also occurred. Death tax co-ordination is an encouraging example. Movements such as the current one for uniform accounting procedure

are another hopeful sign. Associations of state tax administrators are growing in number and influence.

Federal-state co-ordination in death taxation is shown by the federal crediting provision, which allows the taxpayer to subtract from the federal tax otherwise due the death taxes paid to the states—within certain limits. Grants to the states by the federal government, such as those for unemployment relief in the past, are another example of general fiscal co-ordination that helps avoid tax conflicts. Complete federal responsibility for certain functions, as under the present WPA relief program, is still another example.

(3) Even if the governmental units did want to act entirely independently, they often could not do so without amending federal and state constitutions. Some vertical conflict is avoided by the provisions in the federal constitution that reserve the customs duties to the federal government and, in practice, prohibit the federal government from imposing a property tax. The Supreme Court's interpretation of certain clauses in the Constitution has also removed some horizontal conflict, especially in death taxes.

Reasons for the Confusion

Tax conflicts are part of the price that must be paid for a decentralized government. If the federal government had sole power over taxation, it would be possible to remove all conflicts; but then state and local self-government would not exist. Without some financial independence self-government becomes a meaningless label.

The price of decentralization has been unduly high at times, and probably is still. Some of the horizontal conflicts, especially, could be removed without any great loss of fiscal independence and responsibility. For instance, the states might well reach a closer agreement on rules that determine where a given income arises, or

what the legal residence of a taxpayer is. The vertical conflict, on the other hand, can probably not be reduced to any great extent without a corresponding loss of decentralization.

Recommendations

(1) The Committee recommends that the states continue their efforts to remove horizontal conflicts. We suggest no machinery to remedy this type of conflict, other than that already set up in recent years through the American Legislators' Association and the various associations of administrators, but we urge that the work now under way be pushed.

(2) We recommend further that tax co-ordination be made part of a comprehensive study concerning federal, state, and local fiscal co-ordination. This study should be carried on over a period of a year or two by a non-partisan committee of from five to seven members appointed by the President. The committee should consist of nationally known individuals who represent no special government interest—federal, state, or local—an no geographical section. It should be equipped with a competent research staff and a sufficient appropriation to finance investigations. It should formulate for the three levels of government an expenditure, debt, and tax program that would eliminate as many of the conflicts and other confusions as possible and yet would be compatible with a desirable degree of local independence and self-government.

We make no other specific recommendations on inter-governmental conflicts, because any major step that is to be taken now must deal with the broad fiscal problem, not be merely a tax change. For example, it is not likely that all the states will agree to give up the use of a tax—say, the liquor tax—unless the federal government agrees to turn money back to the states or agrees to assume the

burden of some state expenditure. Any such agreements involve fiscal problems that are not strictly tax problems. All the problems of tax conflicts will be handled best if they are treated as parts of a comprehensive fiscal plan.

IV. PERSONAL INCOME TAX

The Present Taxes

The federal government and over three-fifths of the states impose taxes on the incomes of individuals. The rates are graduated in an ascending scale according to the amount of income received. Some of the state tax rates are heavier on the lower income groups than the federal government rates. The yield of the federal tax is about \$1,000,000,000, and that of the state taxes between \$100,000,000 and \$200,000,000.

The personal income tax rests on a narrow base of taxpayers. Under the federal tax 4,000,000 returns were filed for 1934, but only 1,800,000 of these were taxable. Including all those represented by joint returns, about 2,500,000 adults, out of a total of 75,000,000 in the country, made taxable returns—only slightly more than 3 per cent. The greatest number of taxable returns ever filed was on 1920 incomes—5,500,000. At that time, personal exemptions were considerably lower than they are now.

Those Exempted

The present federal exemptions are \$2,500 for a married couple or a head of a family, and \$1,000 for a single person. Coupled with the allowance for earned income, these provisions exempt entirely all married couples or heads of families with an income of \$2,778 or less, and all single persons with \$1,111 or less.

Low Bracket Rates

The federal tax is very light for some distance above the exemption levels. A single man with a net income of

\$1,500 is taxed on only \$350, after allowing for the personal exemption and the earned income credit. The rate is 4 per cent, so the tax is \$14, or less than 1 per cent of his net income. If his net income is \$2,000, the tax is \$32, or about $1\frac{1}{2}$ per cent of his net income. At \$3,000 the tax is \$68, or $2\frac{1}{4}$ per cent of his net income.

A married couple with children reach even higher levels, of course, before they pay a heavy federal personal income tax. The following figures assume that all the net income is "earned"—is, for example, from salary, not from interest. If there are three children under eighteen, the couple pay no tax at all on a net income of \$4,111. If the net income is \$5,000, the tax is \$32— $\frac{2}{3}$ of 1 per cent of net income. On a net income of \$6,000, the tax is \$68—about 1 per cent of net income.

Some qualifications, of course, must be made. If the income is taxable interest instead of salary, the tax is slightly higher for net incomes above \$3,000 because of the loss of the earned income credit.⁶ If the income is dividend income from common stock, the burden is still heavier. The federal corporation normal income tax—and perhaps the federal corporation tax on undistributed profits—will be taken out of the profits before payments are made to the common stockholder.

The state tax rates vary widely. The single man in the example above who pays \$14 to the federal government⁷ pays \$15 to the state of New York or North Carolina or North Dakota in personal income tax, or \$14 to Iowa or South Dakota. On the other hand, his state tax in Minnesota is only \$3, and in California or Delaware, \$5. The married couple who pay \$68 to the federal government⁸ pay \$224 to North Dakota and \$182 to Iowa, but only \$23 to California and \$38 to Delaware.

⁶ The law assumes that all income below \$3,000 is earned income.

⁷ Actually, the federal tax declines slightly, since state income taxes paid can be deducted in computing net income for the federal tax. Some states allow a similar deduction for federal tax paid.

⁸ Here also, of course, the federal tax declines slightly owing to the deduction for state income tax paid.

Rates at \$10,000 Level

The federal tax rises slowly for some distance above \$5,000. At \$10,000, assuming that all the income is earned, it equals 5.6 per cent of the single man's income and 3.1 per cent of the income of a married man with three dependents. The state and federal taxes combined are, of course, somewhat more: 12 per cent for the single man in North Dakota, where the tax is one of the highest, but only 6.9 per cent in California, one of the lowest. The married taxpayer's percentages are, respectively, 9.3 and 3.8.

Rates above \$10,000 Level

Above \$10,000 or so it becomes difficult to state typical burdens, since the corporation income tax should be taken into account for taxpayers with large investment incomes. The following data assume that half of the taxpayer's income is from salaries and half from corporate earnings. They include the federal corporation normal tax but assume that all earnings are paid out so that there is no undistributed profits tax.

Under these assumptions, the single taxpayer pays 18.3 per cent of his income in federal taxes if he receives \$30,000 and 23.4 per cent if he receives \$50,000. The corresponding percentages for the married taxpayer are 16.4 and 21.8.

At \$70,000, the single taxpayer's federal burden is 28.3 per cent, and at \$100,000, 36.2 per cent. The married taxpayer's burden is, as usual, somewhat lighter, 26.7 per cent and 34.6 per cent, respectively.

Since the state taxes do not increase sharply in the upper ranges, they do not always materially alter the situation for taxpayers with large incomes. Even in North Dakota, the percentage for a single man with a \$30,000 income increases only from 18.3 per cent to 25.3 per cent when the state tax is added. At \$100,000 the

combined North Dakota and federal burden is 40.1 per cent.

The percentages mount somewhat less rapidly above the \$100,000 level. At the \$500,000 level the federal percentage for the personal income tax alone is about 60, and at \$1,000,000 about 65. The combined federal and state personal income tax burden is usually about 65 per cent and 70 per cent, respectively. In addition to these taxes there is, of course, the burden of the corporation income taxes.

Recommendations

(1) The Committee recommends that the base of the federal personal income tax be broadened and its weight on existing taxpayers slightly increased by lowering the exemptions, possibly to the following levels: for a single person, from \$1,000 to \$500; for a married couple, from \$2,500 to \$1,000; and for each dependent, from \$400 to \$200. In other words, it is proposed that reliance be placed on the personal income tax for a much larger proportion of tax revenues than heretofore. Likewise, the Committee recommends that state income tax exemptions be set at approximately the same level.

The staff estimates that, if the present exemptions were cut to these amounts, the total number of taxable returns would rise to 8,000,000 or possibly 9,000,000. Including non-taxable returns, the total returns might be as high as 12,000,000 or 13,000,000. The added yield, under the present federal rates, would range from \$200,000,000 in a very poor year to \$500,000,000 in a highly prosperous year.

(2) We further recommend that the lowering of exemptions be made in such a way that the total tax burden being carried by persons with low incomes will not be increased. In other words, if people in this group are made to pay an income tax for which they were not liable

before, or a heavier income tax than before, their tax liability in other directions ought to be reduced.

(3) Therefore we recommend: (a) that only a low rate be placed on incomes that would become taxable by a lowering of the exemptions; (b) that federal revenue gains from the lowering of exemptions be offset by a reduction in other taxes that now fall heavily on persons of low income, such as the tariff duties, possibly the social security payroll taxes, and the indirect internal revenue taxes (for example, the cigarette tax), and that state revenue gains from a similar lowering of exemptions be offset by reductions in sales taxes and property taxes; (c) that no increase be made in the rates on incomes in the middle and high brackets, and (d) that, if the added revenue that will be obtained from these middle and high brackets from lowering the exemptions is not needed, the rates on these brackets be reduced slightly to counterbalance the added burden of the lower exemptions.

To show how far the added \$200,000,000 \$500,000,000 of revenue from lowering exemptions might be used to reduce some of these other taxes, their yields may be noted. The cigarette tax produces \$400,000,000; customs, also \$400,000,000; and manufacturers' excises, from \$200,000,000 to \$400,000,000, depending on whether the gasoline tax is included.

In making these recommendations, the Committee emphasizes again that it passes no judgment on government fiscal policies. It has, therefore, assumed that no change will be made in the general policies toward debt retirement now in effect. It has further assumed that the present business recovery will continue for the next three years. However, if present government policies should be changed, as, for example, through a rapid retirement of government debts, or if a business recession should set in, and the government should wish to check

the increase in the debt, it is obvious that higher tax rates would be necessary.

(4) The Committee does recommend, however, that, if—for any reason, such as debt retirement—substantial increases in government revenues are required, they be obtained primarily by raising the income surtax rates in the middle brackets—that is, on net incomes of from \$5,000 to \$50,000. This will, of course, increase the actual burden both on those whose total incomes fall within these brackets and on those with higher incomes.

(5) In a number of ways the present federal income tax fails to meet the tests of justice. We cannot here go into the technical problems involved, but we recommend especially: (a) that corporations be allowed, as they were prior to 1932, to file consolidated returns without facing any kind of a penalty tax; (b) that careful consideration be given to the possibility of requiring every husband and wife to file a joint return, so that they will not escape the high surtax rates to the extent that they now do, especially when they rearrange holdings of property within the family for the purpose of minimizing the family's total tax (if, however, a joint return were required, some decrease in the death tax or the gift tax on property passing from one spouse to another might be called for); (c) that losses be carried forward whenever this is necessary in order to effect full deduction of them; (d) that the treatment of capital gains and losses be changed as hereinafter proposed.⁹

Reasons for the Recommendations

The reasons for urging a greater use of the income tax are:

(1) The personal income tax is the easiest of all taxes to adjust according to ability to pay. By varying the rates progressively, a progressive burden can be imposed

⁹ See pp. 477-84, 490-91.

on those most able to carry it, and the load can be reduced to little or nothing on those who can ill afford to add anything to their present expenses. Moreover, for two persons of equal income, the tax can be adjusted to allow for differences in family status, source of income, and expenditures of various types. No indirect tax can be so adjusted, and no other direct tax can so readily be.

(2) Everyone in the United States should be made conscious of the fact that, if he wants government services, he has to pay for them. The well-to-do may properly be asked to cover a large share of the government's costs, but nobody should expect to go "scotfree" unless perhaps he is completely dependent on the government. As a matter of fact, of course, nobody does go "scot-free." The local property tax, and also excise and other indirect taxes, enter, in part at least, into the cost of almost all goods and services. But the burden is hidden. The personal income tax is the best tax to promote tax consciousness because the taxpayer is compelled to figure out his own liability and to meet it.

(3) With some exceptions, the consciousness of taxation should increase as government expenditures increase. The income tax provides this increase in tax consciousness better than any other measure. The death taxes are not so effective because they are not paid every year, but only once. A large part of the property tax is only an indirect and unconscious burden. The gasoline tax and motor vehicle tax rates should, in general, fluctuate only when highway expenditures fluctuate. The payroll taxes are tied to social security expenditures. The retail sales tax we oppose for reasons cited in Section V below. Furthermore, this tax is not very suitable for local units except large cities. If the federal government imposed a sales tax, it would probably be levied on manufacturers, in order to save administrative expense, and

no general tax consciousness would follow. The other widespread taxes are hidden taxes. The personal income tax alone will make large numbers of taxpayers directly aware of changes in the general level of federal and state, as contrasted with local, expenditures.

Arguments against Middle and Upper Bracket Increases

The Committee does not recommend an increase in the rates on incomes in the middle and upper brackets provided business conditions continue to improve and no policy of debt retirement is adopted. The reasons for not recommending such an increase are:

(1) Present federal rates probably can be counted on to produce enough revenues to meet the federal government's fiscal needs.

(2) Taxpayers with incomes in these brackets are now bearing their fair share of the tax burden, when the present and prospective state income tax rates are considered. Moreover, as already noted, the lowering of the personal exemptions will increase the burden of these taxpayers somewhat.

(3) Increases in the highest brackets would be impracticable. The maximum federal rate alone of 79 per cent on that part of the income over \$5,000,000 is already exceedingly high, as are the rates in the brackets immediately below. At these levels, the rates give a great incentive for outright evasion and for avoidance. They may also unduly restrict the volume of saving and the amount of business initiative in hazardous enterprises. If justice calls for a still greater burden on the largest incomes, the better way is, as we have already indicated, to increase the rates in the lower brackets of the rich man's income. It is the extreme pressure at the top, or margin, of his income—the pressure to avoid taking any risk or exercising any initiative to obtain the "last dollar" of income—that is so important. Likewise

there is extreme pressure to avoid or evade the tax at the top rates.

Reductions in Other Taxes

✓ The Committee's recommendations on reductions in other taxes—to offset the gain in revenues that would follow a reduction in the exemptions—are based on the following considerations:

(1) The federal government possesses limited opportunities to reduce taxation on low income groups in other fields. Probably the best way is to lower the customs duties. These duties are a particularly heavy burden on low income groups both in the amount of the tax payments and in the higher prices that they permit domestic concerns to charge.

(2) Another study of the Twentieth Century Fund, under the sponsorship of the Fund's Committee on Old Age Security, has recommended a reliance on government contributions from general tax revenues to meet at least part of the cost of old-age benefits and a corresponding decrease in the contributions of employers and employees. This recommendation reflects a growing conviction among specialists in this subject that social security should be financed at least in part by the general public directly rather than through special payroll and earnings taxes. If this change were made, the added burden on general fund revenues might well be met by lowering the income tax exemptions.

(3) Cigarettes bear an exceptionally heavy federal tax burden, of which the masses carry a disproportionate share. Additional income tax revenue might permit a reduction in this tax.

(4) Increased state income tax revenues might well be used to abolish or reduce sales taxes. The reasons for the Committee's opposition to sales taxes are summarized in Section V below.

(5) Increased income tax revenues might also allow some states to give up the property tax and leave its benefits wholly to local government agencies.

Difficulties

We are not blind to the administrative problem that would follow a lowering of exemptions. Doubling or trebling the number of returns would necessitate a great expansion, and some reorganization, of the Bureau of Internal Revenue. The average cost of collection would undoubtedly rise appreciably above its present level. For a time an increase in evasion would occur. The task would be particularly difficult, but some reliance might be placed on collection at the source, properly devised so as to avoid a loss of tax consciousness.

All these disadvantages, however, are far outweighed by the social and economic gains to come from the change. At least, we believe, the prospective gains warrant giving the plan a trial.

V. SALES TAX

The Present Taxes

The sales tax has become an important factor in state taxation during the depression. In 1929 it was in use in only Georgia and West Virginia. At the end of 1936 it was in use in twenty-two states and in two large cities—New York City and New Orleans. In 1933 alone it was introduced in thirteen states.

Lately, however, the sales tax wave has been receding. The tax has been abandoned, after a short trial, in Georgia, Idaho, Kentucky, Maryland, New Jersey, New York State, and (the 1 per cent tax of 1932-33) Pennsylvania.

Nevertheless, the jurisdictions that now impose the sales tax comprise about half the population of the country. The annual state revenue from it is about \$350,-

000,000—about one-seventh of all state tax revenue. After adding \$50,000,000 for New York City and New Orleans, the total is \$400,000,000, which is about one-thirtieth of all the tax revenues of all the governmental units in the country—federal, state, and local.

Most of the sales tax revenue comes from retail sales, with rates of usually 2 per cent or 3 per cent. Manufacturing and wholesaling are taxed lightly or not at all, for fear that concerns in these lines of business might move to other states.

Advantages

The advantages of sales taxes can be summarized as follows:

(1) The sales tax can produce for the states a large amount of revenue on short notice. It therefore, in some instances, may make for greater state fiscal independence and may check the steady drift toward the centralization of government powers that accompanies federal aid to the states.

(2) The sales tax is neither extremely sensitive nor extremely insensitive to changes in business conditions. The volume of retail sales in the United States dropped 49 per cent from 1929 to 1933. The yield of the federal personal income tax, on the other hand, dropped 69 per cent from 1930—its peak year—to 1933, despite a strengthening of the tax in 1932. The federal cigarette tax yield, however, decreased only 12 per cent from its peak in 1930 to its low mark in 1933.

(3) The sales tax produces a moderate degree of tax consciousness. Often the retailer is required to state the tax to his customers as an item separate from the sales price. New York City has an official schedule for separate charging. Several jurisdictions require the use of fractional-cent tokens made of aluminum alloy, cardboard, etc. These separate charging practices, however, may

not last long. In other countries, a tax on retail sales has usually been hidden in the regular sales price. Retailers in this country are always under pressure to hide the tax in order to avoid offending their customers, and they often do so.

Disadvantages

To be acceptable as a permanent part of the tax system, however, the sales tax ought to have certain other virtues that it conspicuously lacks. Its defects are:

(1) It does not take account of the taxpayers' abilities to pay—except in the rough fashion that the more a person spends the more he pays. But poor people spend more of their incomes than rich people of theirs. The sales tax, therefore, takes a larger percentage of the poor man's income than of the rich man's, since it is levied at a flat, not a progressive, rate. Moreover, the sales tax cannot easily take account of the differences between persons who spend the same amount. For example, one man may be spending relief money, another his own wages. It is absurd for the government to put its relief payment at a certain level partly because it insists on taxing the relief recipient. One man may have heavy family obligations, another, none. One may draw all his income from investments, another, all from salary. The sales tax cannot differentiate.

(2) The sales tax has no overwhelming advantage in ease of administration. On the contrary, its cost of administration is fairly high—often between 2 per cent and 4 per cent of revenue. The cost would have to be still higher if evasion were to be practically eliminated among all the small retailers. The definition of a retail sale is troublesome. In practice, it has brought under the tax certain kinds of sale that have no economic reason for being there—"retail" sales of equipment and supplies to business firms. The tax has frequently been avoided

through sales in interstate commerce. Such sales are exempt under the federal Constitution. Some jurisdictions have even gone so far as to impose supplementary "use taxes" directly on ultimate consumers in order to reach these out-of-state purchases.

(3) Much of the sales tax must often be borne by merchants who cannot shift it to consumers. For the small merchant, under heavy financial pressure, this may be an unfair and unbearable burden.

Recommendation

The Committee recommends that the sales tax be repealed except in those states where pressing fiscal needs make such a step absolutely impracticable. Its lack of adaptability to individual ability to pay and its administrative defects make a shift from the sales tax to the personal income tax highly desirable. This recommendation is, of course, consistent with the Committee's desire to see the income tax base broadened.

We are especially opposed to a federal manufacturers' sales tax. It might be a little easier to administer than a state retail sales tax. This advantage would be more than offset by the failure of a federal sales tax to create tax consciousness and by the greater fluctuation of revenue. With ample power to use so powerful and adaptable an instrument as the personal income tax, the federal government has no excuse for resorting to a manufacturers' sales tax.

VI. UNDISTRIBUTED PROFITS TAX

The Present Tax

The Revenue Act of 1936 places a tax on the profits of a corporation that are not distributed to stockholders during the year in which they are earned. The rates are progressive, beginning at 7 per cent on that part of the undistributed net income that is not in excess of the first

10 per cent of the net income (after certain adjustments), and rising to 27 per cent on that part in excess of 60 per cent. The yield of this tax and the increased yield from the increased dividends taxed in personal returns are roughly estimated by the staff at \$500,000,000 for a normal year.

No tax measure in recent years has been more generally misunderstood, and few have stirred more widespread and heated discussion. Nor is this reaction surprising in view of the importance and complexity of the issues involved. Some of the misunderstanding, however, has been caused by a confusion between the primary reasons given by its proponents for imposing the tax and the supposed economic effects that have also been cited as arguments in its favor. The main reasons given for the tax should first be clearly understood.

Tax Equality a Prime Object of the Tax

The President and representatives of the Treasury have stated that, aside from the additional revenue that the tax will produce, one of its prime objectives is to put corporate stockholders on the same income tax basis as partners or individual owners of business concerns.

A partner must pay both personal normal tax and personal surtax on his entire share of the partnership's current earnings. It makes no difference whether the earnings are retained in the business or not. He pays on the distributed, plus the undistributed, share. Similarly, an individual who is the sole proprietor of a business includes in his personal return all the net profits from the business, regardless of what he does with them. The corporation stockholder, on the other hand, pays a tax only on the dividends that he receives—that is, on the distributed share—except in so far as capital gains, realized through the sale of his stock and taxed during the same year, reflect the retention of earnings by the

corporation. To the extent, therefore, that the corporation retains its earnings, the stockholder may, for the time being, escape a personal income tax on his share of them.

The stockholder may pay a tax in a later year if the dividends are simply postponed or if he sells the stock and realizes a capital gain. Even then equality will rarely be achieved.¹⁰ Moreover, there are several ways in which he may escape part or all of what would be a truly equivalent tax. For example, the law allows capital gains accrued up to the time of death to escape the income tax completely.

By the undistributed profits tax the administration aimed at bringing about equality between stockholders and other owners by one of two means: either (1) by stimulating corporations, through the heavy penalties on withheld income, to distribute all or nearly all their current earnings, which are then taxed as income received by stockholders, or (2) by taxing directly the income that is withheld by the corporation. Presumably the first method was chiefly relied upon. The second method would not take account of the personal situation of each stockholder-taxpayer, as do the taxes on partners and proprietors, and hence would not achieve the equality among the three classes of owners that was said to be one of the main objects of the undistributed profits tax.

Some critics of the tax claim that this equality is not desirable. They argue that sole proprietors or partners are in an entirely different situation from stockholders. The sole proprietor, when his business makes money, has complete control over its disposition. Likewise the number of partners in a partnership is usually so small that any one partner can exercise a voice in the joint decision on whether or not the income of a given year should be distributed among the partners or reinvested

¹⁰ See pp. 162-63.

in the business. In the case of a corporation the stock of which is at all widely held, however, the average individual stockholder has almost no direct voice in determining how much, if any, of the earnings should be distributed as dividends. The decision rests, not with the stockholders, but with the board of directors.

Moreover, it is claimed, a corporation, unlike the individually owned business or partnership, is a continuing enterprise not dependent upon the individual stockholder. The stockholder can dispose of his interest in the concern without affecting its existence. These differences between partnerships and corporations are held to justify placing the stockholders on a different tax basis from other kinds of owners.

Conclusions about Equality

The Committee believes that, although these differences in the amount of control that various kinds of owners have over income distribution are important, they are not sufficient to justify abandoning all attempts to place stockholders on practically the same footing as other owners of business concerns.¹¹ The stockholder may have little direct control over dividend policies, but he does receive a very real increase in economic power when the corporation accumulates a surplus—an increase that can often be realized at once and without impairment of his original capital, by the sale of part of his holdings. We believe that this increase in economic well-being should be taxed, even though the differences just noted may make precise equality unnecessary in principle.

The Committee, however, is convinced that the present undistributed profits tax fails to accomplish this aim in four important respects.

¹¹ We are speaking here only of the income tax as a tax aimed primarily at personal ability to pay. Impersonal business taxation, or taxation of the privilege of being a corporation, raises other issues that are not covered in the present discussion. In other words, we are not here passing on the general problem of business taxation.

(1) It is part of a tax system that includes taxes on the income, the capital stock, and the excess profits of corporations. Whether earnings are distributed or not, a greater tax burden is thus usually imposed on corporate stockholders than on partners or proprietors. While, of course, the objection implied in this statement would be largely reduced by the repeal of the corporate income, capital stock, and excess profits taxes, no such changes have in fact accompanied the imposition of the undistributed profits tax.

(2) Individual owners and partners are allowed to deduct their business losses from their other income. It is impossible, under the present tax laws, for the corporate stockholder to deduct his share of the losses from his other income in a year when a corporation shows a loss.

(3) The capital gains in an individual's return are taxed under the present federal income tax law in proportions that decline according to the length of time the property was held.¹² Dividends, however, are taxable to the individual stockholders at full amounts, although they may have been paid from capital gains on property held by the corporation—gains that would be taxable only in part if the capital asset had been held by a partner or proprietor.

(4) The only undistributed profits tax that would achieve equality on the basis of current earnings would be one of 100 per cent, since this rate alone would without question force complete distribution in every case. If the corporation retains any part of its earnings and chooses to pay the penalty tax, equality is not reached. The tax thus paid by the corporation is less than the one that would have been paid by the rich stockholder if full distribution had been made, and more than the one that

¹² See pp. 485-86.

would have been paid by the stockholder of small income.

Prevention of Personal Surtax Avoidance

Another object of the tax has been to prevent the kind of withholding of earnings that is made purposely to avoid, or at least postpone, the personal surtax on shareholders with large incomes. If the first objective—complete equality—were reached, this second aim would, of course, be achieved in the process. As we have shown, however, the present tax falls far short of achieving the equality aim.

Entirely apart from the undistributed profits tax, the law makes a special effort to check such attempts to minimize surtaxes. Section 102 of the Revenue Act of 1936 contains a provision that has been in the federal law for many years, imposing a heavy penalty tax on any corporation that intentionally retains earnings, beyond the reasonable needs of the business, in order that its stockholders may avoid surtaxes. Section 351 levies a similar penalty tax on a certain type of closely held corporation (personal holding company). In this case no intent need be proved; the nature of the corporation presumably reveals a purpose to avoid the personal tax.

The Committee is strongly in favor of these methods of checking the intentional avoidance of a personal surtax. We believe, moreover, that the present section on the personal holding company can and should be considerably strengthened.

The Economic Objectives of the Tax

Another aim of the proponents of the undistributed profits tax has been to force current earnings out of corporations into the hands of stockholders because of the effects of such a distribution on corporate practices and on the national economy. To attain this end the earnings

must, of course, be forced out in cash or its equivalent—not merely in the form of a stock dividend. Moreover, the cash distribution cannot be accompanied by any device that puts pressure on the stockholder to reinvest the dividend money in the same corporation.

Following is a brief summary of the economic arguments in favor of the tax—all of which assume that it forces a cash distribution of all, or almost all, current earnings.

(1) It is claimed that by forcing the distribution of earnings the general stockholding public, rather than corporation officials, are given direct power to decide what shall be done with corporate earnings. It is assumed by those who make this claim (a) that the stockholders have a right to decide this question directly, and (b) that they will perform this function better than corporate directors. At least, it is said, directors will then be forced to submit to the judgment of the investing public, to a much greater extent than they do now, their claim that plant expansion is necessary.

(2) It is said that forced distribution puts into the hands of consumers the purchasing power that they should have if an equilibrium between productive capacity and purchasing power—that is, between saving and spending—is to be maintained. In other words, it prevents the investment in too much capital equipment and, on the other hand, it gives consumers the spending money that they need if the finished goods made by the capital equipment are to find a market.

(3) A third argument holds that, even if there is no need to increase consumers' incomes, forced distribution prevents the misdirection of savings. A corporation's own officers and directors are assumed to be biased in favor of their own industry and their own firm. They save and invest in this industry and this firm a disproportionate amount of the corporation's earnings, while

if the stockholder received the surplus he would invest it elsewhere. As a result, some industries and some firms expand too much, and their subsequent failure damages the whole economic structure. Some industries, on the other hand, either cannot get the capital that they should have or must pay higher interest rates than they should.

✓(4) Another argument, based in part on those above, is that the severity of booms and depressions will be decreased, since a brake will be put on excessive expansion. Increase in plant will not then be made too soon before adequate consumer purchasing power has been created: Moreover, speculation will, it is said, be lessened.

(5) It is also felt by some that the tendency of the tax to discourage borrowing is a healthy one. The forced distribution of earnings tends to prevent the accumulation of equities necessary to support loans and reduces the capacity of corporations to pay off past debts.

Those who oppose the undistributed profits tax on economic grounds—again assuming that the tax does force cash distribution on a large scale—do not concede the validity of the economic analysis of those who favor the tax. They particularly object to the argument that lays the blame for depressions on the failure to divert money from savings funds into the hands of consumers, who would spend it. They believe that the business cycle is too complex to be explained in such a simple way, and, moreover, they claim that no evidence exists to show that saved money, which is invested and spent and thus reaches workers and others, tends to upset the equilibrium of the system.

In addition, the opponents believe that whatever the advantages may be, certain disadvantages, listed below, outweigh them.

(1) One disadvantage is said to be that, while the very small corporation and the very large corporation may not be greatly injured—the very small one can count on the co-operation of its stockholders to reinvest the dividends at once, and the very large one can appeal to the general investment market—, the moderately small corporation may be seriously crippled.¹³ It is too large to count on the co-operation of its stockholders and too small to appeal to the market. In effect, then, the tax will have a tendency to keep small corporations small, and to increase the relative power of large corporations.

(2) Another disadvantage of the tax is said to be the inability of corporations to pile up large reserves in good times, and the consequent lack of assets to fall back on when times are bad. If a concern cannot meet its financial obligations out of current earnings, it should be in a position to do so out of the surplus earnings of previous years. To prevent this by forced distribution will, it is said, intensify future depressions by bankruptcies that might otherwise have been avoided.

(3) Moreover, it is argued, if corporations are not permitted to accumulate reserves in the form of cash or liquid assets, they will be forced to discharge more workers, and sooner, when a depression begins, than they otherwise would. This would tend to accentuate the depression by increasing unemployment and reducing the nation's purchasing power.

(4) It is said that the inability of corporations to accumulate surpluses will reduce the equity necessary for successful borrowing. To penalize borrowing is condemned as an unsound interference with normal methods of financing, since it deprives the public of an opportunity to invest in specially secured, high-grade bonds. This tendency to hinder borrowing, it is said, will not only affect the long-term capital market, but make it im-

¹³ Unless it can exercise a coercive power of reinvestment. See pp. 473-74.

possible for some corporations to obtain bank loans to the customary extent.

(5) Another disadvantage of the tax is said to be that, because of most of the considerations mentioned above, it will be difficult for new corporations to grow, and this difficulty will be accentuated by a hesitancy of outside capital to enter new corporations. Consequently the beneficial effects of both new competition and the threat of new competition will, it is claimed, be decreased or removed.

(6) Finally, it is claimed that the directors of a corporation and not the stockholders are, after all, the ones to direct the disposition of earnings. Directors are assumed to be better informed about the needs of the business.

Conclusions about Economic Effects

Assuming that the tax will force a large-scale distribution of cash or its equivalent, the Committee is convinced that the economic effects of this process are not well enough known to draw any positive conclusions. The Committee is not in full agreement, for example, on how much, if any, pressure should be exerted to stimulate consumer purchasing power and check plant expansion. Of one thing, however, we are certain. The tax was imposed without a sufficiently thorough study of its possible economic effects and without a careful enough consideration and discussion of other methods of equalizing the tax position of stockholder, proprietor, and partner.

Furthermore, the assumption that the tax will force anything like a 100 per cent distribution in cash is open to serious question. Several methods by which this can be avoided are known. In so far as they are used, the economic objectives of the tax are not reached.

Methods of Avoiding Economic Effects

One such method is through the issuance of taxable stock dividends. A corporation may distribute dividends, not in cash, but in the form of stock. If the distribution changes the relative position of the owners, the recipients must pay a tax on the dividend. This procedure would not, therefore, be considered an evasion of the undistributed profits tax law, yet it would avoid the distribution of cash or its equivalent. The stock dividends that are taxable are those in common stock to a preferred stockholder and probably those in preferred stock to a common stockholder if some preferred stock of equal rank is already outstanding. The latter kind of dividend is the only one of practical importance in meeting the problem.

This method is available under the Revenue Act of 1936. The experience of the closing months of 1936 indicates, however, that few corporations are as yet willing to experiment by paying dividends—over and above the cash dividends that they would normally pay—in the form of preferred stock. They fear (1) a "top-heavy" financial structure, (2) complaints from stockholders who have to pay a cash tax on a non-cash dividend in the form of shares that might have no ready market, (3) difficulties in setting a value on the stock for tax purposes, and (4) the gradual loss of equity by the common stock that would result as all earnings came to be represented by preferred stock and all losses cut into the common stock equity. On the other hand, it is not yet certain whether these factors will in practice be decisive.

Another device, also available under the Revenue Act of 1936, actually involves a temporary distribution of cash, but has much the same effect as the taxable dividend in stock. This method is the payment of dividends in cash coupled with rights to buy new stock at a price

well below the market. The effect on the stockholder, or a purchaser of the rights, is coercive in nature. If the right is not exercised and the money is not put back in the corporation, the recipient suffers a loss of relative economic position compared with those who do exercise the right.

However, this device may involve registration of the new stock under the acts regulating securities and may also necessitate payment of heavy underwriting fees. If there is no ready market for the corporation's stock, some of the rights may be allowed to lapse. The corporation cannot, therefore, always be certain of getting its money back.

These two methods of avoiding the economic objectives of the tax, it should be noted, do tend to accomplish the other purposes of the tax—equality and prevention of purposeful avoidance of personal surtaxes. By taxing the stockholder on his share of the corporation's current earnings, they tend to place him on the same tax basis as the partner and the sole proprietor. Nor can the wealthy shareholder avoid paying a surtax on his share of the current earnings.

Methods of Checking Avoidance of Surtax without Economic Effects

Two other methods have been suggested that are designed to check tax avoidance by the wealthy shareholder without involving the economic effects of the undistributed profits tax. Neither of them, however, guarantees tax equality among the various types of business ownership.¹⁴

One of these methods, as has been noted, is already in the revenue law—penalty taxes at high rates on "corporations improperly accumulating a surplus" and on

¹⁴ Both methods could, of course, be supplemented by eliminating the loophole that now exists if securities are held until death. See p. 483.

“personal holding companies” that do not distribute their surpluses. In each case individual stockholders in any concern may relieve their corporation of the tax if they all voluntarily include in their personal income tax returns their share of this income retained by the corporation. Later dividends would then be tax exempt.

In so far as stockholders do this they place themselves on an equality with partners and proprietors in regard to their shares of the earnings of their concerns. As a matter of practice, however, this method can apply only to a relatively small group of stockholders, and there is no guarantee that even they will all act in this way.

It has also been suggested that the undistributed profits tax be made much heavier but that complete exemption from the tax be given (1) to all corporations that do not withhold more than 20 per cent or 30 per cent in any year, and (2) to every corporation, regardless of its earnings distribution policy, whose profit is less than, for example, \$15,000. Only a few thousand corporations would then be liable to the tax. It is proposed further that these be given the privilege of proving before an administrative board that retention of more than 20 per cent or 30 per cent of their earnings was so essential to the conduct of the business that they should be excused from the tax.

This plan would prevent certain large amounts of withheld income from avoiding taxation—at least for a while. It would, however, grant a degree of administrative discretion that has thus far been foreign to tax practice in the United States.

Achieving Equality without an Undistributed Profits Tax

The undistributed profits tax as it stands today has been designed, as we have said, (1) to place stockholders on a tax equality with other owners, (2) to prevent the avoidance of surtaxes by wealthy stockholders, and (3)

to obtain certain economic effects that would, it is claimed, follow the forced distribution of current earnings in the form of cash or its equivalent. Assuming that all three objectives are desirable, we have shown that the tax does not, and cannot, achieve all of them at once. In so far as corporations elect to withhold earnings and pay the tax, equality is not achieved. Even if earnings are distributed, it is not achieved, particularly as long as the other corporation taxes are retained. If the tax is amended so that it merely prevents avoidance, both tax equality and the forced distribution of cash are sacrificed. In so far as corporations elect to use the taxable stock dividend or the stock rights device, the economic aims of the tax also are not reached.

As has been said, however, the Committee favors two of the aims of the tax, the equality of owners and prevention of surtax avoidance, but believes that the third aim, the economic effects of forced distribution, may have dangerous consequences and that its advantages have not yet been demonstrated. In the recommendations made below we believe that we are proposing a form of taxation that will insure the tax equality of owners and prevent the avoidance of surtaxes far more effectively than the existing undistributed profits tax. Moreover, we believe that it will not subject our national economy to the dangerous results that might follow a forced distribution of corporate assets.

*Recommendations*¹⁵

(1) The Committee recommends the repeal of the undistributed profits tax as it now stands.

¹⁵ I cannot agree in these recommendations. I admit that the undistributed profits tax does not create equality. The method suggested by the committee has, to me, too great administrative difficulties; and I do not favor a tax on unenjoyed paper profits. The present law has forced a good deal of cash out of corporate surpluses, into the hands of consumers; and has not, so far, resulted to any great extent in declarations of stock dividends. This economic objective, I believe, may be wise. Therefore I should not repeal the tax until we have more knowledge of its effects.

So also I do not favor a tax on capital gains as they accrue (p. 490). I am inclined to think that this tax should be repealed; but certainly, as the committee suggests (p. 491), liberalized.—FRANCIS BIDDLE.

It is a compromise that fails to achieve any of its objectives, except in some degree the economic aims. It is not heavy enough to insure that all earnings will be distributed; it may not even induce the economic effects to any appreciable degree in the long run, in view of the stock dividend and stock right devices; and in so far as the corporation pays the tax instead of distributing its earnings, the tax fails in all of the aims.

The Committee believes that the present tax cannot be materially improved by amendments that are designed to relieve certain types of corporation, such as those with book deficits. In fact, the demand for such relief provisions simply indicates the difficulty of formulating a consistent program. Every such exception is a step away from tax equality. Another proposal that has been advanced would exempt earnings that were put back into plant and equipment. But this would simply run contrary to the views of those who look for the economic effects mentioned above, particularly the increase of consumer purchasing power at the expense of capital funds. The present act is already a confusing enough compromise between several points of view, and such amendments would only increase the confusion.

(2) The Committee recommends that, in place of the undistributed profits tax, individuals be required by law to value their shareholdings each year and enter the plus or minus difference for the year in their personal income tax returns, provided the practical difficulties of administration can be overcome.

The value of the stockholder's shares can be computed in two ways: (1) If the stock is listed, the market value as of the end of the year could be used. (2) In the case of unlisted stocks, each corporation might be required to report to its stockholders the percentage change in book value of each share during the year, and the stockholder might then be required to adjust the value declared the year before up or down by that percentage. Because

either the market value or the book value of stock will reflect the degree to which profits have been undistributed, or losses sustained—as well as any increase or decrease in the value of assets from other causes—, the stockholder will thus be put upon the same basis of tax justice as the partner and individual owner.

In the case of stock sold during any year the seller would report the realized capital gain or loss represented by the difference between the reported value at the end of the previous year (or the purchase price, if the stock was bought during the same year) and the selling price. The purchaser would use the purchase price as the base with which he would compare the value of his holdings at the end of the year—or the realized gain or loss if he sold before the year's end. Some adjustment would, of course, have to be made with respect to the year when such a compulsory inventorying method of taxation was put into effect, in order to deal with securities that had already been held over a period of years.

(3) We also recommend that, in applying this inventory plan, the capital losses in any one year that are in excess of capital gains for the same year be deducted from other income, and, if there is any excess remaining, this excess be carried forward and deducted from income of all kinds in tax returns of future years until it is entirely absorbed.

The Committee is fully aware of the many administrative difficulties and other problems involved in this inventory plan. For example, the end-of-the-year price for a security with a thin market may not furnish a fair measure of value, and even an active market may not provide an adequate basis for valuation if the block of securities in question is very large. Then, too, the tax might lead some closely held corporations to delist their securities. The use of book values to determine for tax purposes the inventory value of unlisted securities might

result in injustice to taxpayers in the event of sudden write-ups or write-downs of corporate assets, and in the event of financial reorganizations that drastically change the stated book value of a corporation's securities without involving any change in their actual values.

A more fundamental objection to nearly all methods of taxing capital gains is that it is unfair to tax a gain that merely reflects a change in the general price level. This criticism holds that a dollar gain is only a "real gain" to the extent that it exceeds the rise in the price level during the period over which it was held, and that taxation of capital gains should recognize this fact.

To state these difficulties, however, is not to imply that they cannot be overcome. The Committee believes that an unremitting effort should be made to devise some practicable plan by which annual changes in the accrued value of stockholdings can be reflected in the stockholder's income tax returns.

(4) The Committee further recommends that, to insure against the possible unconstitutionality of a law that taxes capital gains on an accrual basis, a constitutional amendment be initiated at once to ensure the legality of this particular form of income taxation by the federal and state governments.¹⁶

Until the question of constitutionality can be clarified, it may prove desirable to offer the taxpayer a choice between the inventory or accrual basis, as here suggested, and a tax on gains in full in the year of realization without the privilege of offsetting capital losses against other income or carrying them forward until absorbed. The inventory plan would be the more favorable alternative since it would permit the taxpayer to offset capital losses without limitation against income from all sources and

¹⁶The Supreme Court has ruled in a somewhat similar situation that an individual's "income" is not affected by changes in the value of his holdings until a "separation" actually occurs through a sale or exchange of his stock.

to carry forward net losses from year to year, to be deducted from future income.

(5) Because of the doubtful constitutionality of the compulsory inventory plan and the difficulties that would arise in connection with its administration, the Committee presents below various other plans that have been proposed as alternatives to the undistributed profits tax in order to achieve tax justice among stockholders and partners and individuals without bringing about the economic effects of the present undistributed profits tax. The Committee does not recommend that these alternatives be adopted but believes that they warrant careful study.

(a) One such alternative is that capital gains be taxed in the following manner. Upon its realization the amount of the gain would be divided by the number of years during which the capital asset was held, and then the annual amount of the gain thus computed would be added to the income for each of the years in question. The appropriate additional tax for each of these years would then become payable. In case of a capital loss the amount of reduction in tax for each past year would not be repaid by the government to the taxpayer, but would be carried forward by the latter as a credit against future taxes. This method would undoubtedly be constitutional, and would avoid the difficulties in measuring the accrued gains for unlisted securities. Its chief practical objection is the necessity of going back to earlier years to compute the additional tax due.

The chief theoretical objection is that the method assumes that the value of the capital asset rises (or falls) by the same amount every year that it is held. The tax due by any one taxpayer—and probably the tax due by all taxpayers even over a long period of years—would not, therefore, be the same under this method as under the inventory method, which uses the actual increase or

decrease during each year. The loss of interest to the government because of postponement of tax payment until realization is another difference from the inventory plan. With losses, the taxpayer would be the one to lose the interest. Possibly some adjustment in the amount of taxable gain or deductible loss could be made to take account of this interest factor.

Another objection is that, since the entire tax would be payable at the time of realization, this plan might deter owners of securities from selling during a bull market.¹⁷

(b) A second alternative would provide for taxation of capital gains in the following way. Upon realization the amount of capital gain would be divided by the number of years during which the security was held. The amount of this annual average would be added to the other income for the year of realization and the additional tax computed thereon. This additional tax would then be multiplied by the number of years during which the security was held and this total amount would be added to the tax on other income for the year in question. Losses would be treated in a similar way. This plan has the practical advantage of administrative simplicity since it would not involve computation of gains for past years. On the other hand, the entire tax would become payable for the year of realization—a fact that might have the undesirable effect of deterring taxpayers from taking profits during a rising security market.

The plan has the further disadvantage of making the actual rate applied to the gain depend on what other income the taxpayer happens to have in the year of realization. One aspect of this disadvantage concerns the taxpayer who holds several capital assets and realizes the gains in different years. He may pay less tax than he would under the inventory method, where the gains from

¹⁷ For qualifications on this point, however, see pp. 489-90.

each asset are, in effect, considered together year by year. In such a case the inventory method would put the taxpayer into a higher income bracket than he would reach under this alternative method.

(c) Still another alternative would involve a combination of the plans proposed in (a) and (b) above. In order to avoid the practical objections to the reopening of a long series of past annual tax returns, the pro rata distribution of the realized capital gain would be applied only to a period of from three to five years prior to the year in which the security was sold. For earlier years the plan suggested in (b) would be applied.

(d) If any alternative such as those in (a) to (c) above were adopted, it would be possible to use the inventory plan as an optional method, at least for listed securities. Each taxpayer would have the option of inventorying any particular security for tax purposes. However, of course, the election to inventory any particular security would have to be irrevocable as long as such security was held. This method would clearly be constitutional and would be adopted by those taxpayers who desired to avoid the complications involved in other calculations.

It is also possible, of course, to adopt the compulsory inventory method for certain types of security—for example, stocks listed on exchanges—and use some alternative such as those above for other securities.

These alternatives by no means exhaust the possibilities, but they illustrate the chief practical and theoretical problems involved.¹⁸

(6) The Committee recommends that, whether the compulsory inventorying method or some alternative is adopted, consideration be given to devising machinery

¹⁸ The Committee has considered the possibility of requiring every stockholder to include in his personal return his total share in the corporation's earnings for the year, no matter how much of it was undistributed, but the difficulties of this plan are too great to warrant serious consideration of it at this time. See pp. 164-65.

for distinguishing the capital increase or decrease due to a change in price level from real capital increase or decrease. While minor changes in price level are not important, if a substantial inflation or deflation were to occur, it would be highly desirable to adopt some method whereby the portion of the dollar increase or decrease in capital value due to the change in price level could be eliminated for tax purposes and only the real capital increase or decrease taken into consideration.

(7) The Committee also recommends that the income tax law be amended so that any untaxed increase in the value of a person's security holdings that exists at the time of his death shall not escape taxation, as it does under the present law. If the compulsory inventorying method is adopted, it could be made applicable to a decedent's estate with respect to the appreciation existing at the time of death. If some alternative method is adopted, some technical difficulties arise; but, in substance, a plan could be worked out whereby the cost to the decedent would be the basis for computing gain or loss upon subsequent sale by the estate or a beneficiary. Similarly, a decrease in the value of the holdings that exists at death should be allowed as a deduction. If the deduction should be in excess of the decedent's other income, some provision would be necessary for reducing the estate tax or for making the allowance effective in some other way.

(8) The Committee also recommends that as an essential step toward tax equality in this program the corporation normal income tax, the corporation excess profits tax,¹⁹ and the corporation capital stock tax be abolished—except in so far as any of them, at a low rate, is to be supported as an impersonal business or corporation tax, designed as a license or benefit tax for the privilege of doing business.

¹⁹The Committee, however, recommends an attempt at a genuine excess profits tax, applying to all types of owners. See pp. 493-94.

None of these taxes is imposed on individual proprietors and partnerships, and their continuance defeats the aim of tax equality.

The repeal of all these taxes would, of course, have to be made contingent upon the enactment of a law placing stockholders on a basis of justice in relation to other owners. Even if the present undistributed profits tax is continued, however, the corporation normal tax, capital stock tax, and excess profits tax should be repealed or lowered to the point where they can be justified as impersonal taxes, if the personal tax equality of the various types of owner is to be approximated.

The questions discussed in this section have implications that are even more important than the attainment of tax justice between stockholders and other owners. Fundamentally, they relate to the broader problem of the taxation of all kinds of capital gains—that is, of profits and losses from the sale of real estate, and all other types of capital asset, as well as corporate equity securities. The Committee believes that, if capital gains taxation in general can be placed on a just and administratively feasible basis, the problem of tax justice among various classes of owners will be automatically solved. The Committee's recommendations about the taxation of capital gains on property other than corporation stock are given in the next section.

VII. CAPITAL GAINS AND LOSSES

The Present Tax

Capital gains are gains from the sale of property that is not inventoried and is not held for sale in the ordinary course of business. Capital losses are similarly defined. The most common form of capital gain or loss is the one that results from the sale of securities or real estate by the ordinary investor, home owner, or part-

time speculator—that is, by persons who do not deal in securities or real estate as a business.

The federal income tax and, in general, the state income taxes require the taxpayer, individual or corporate, to include capital gains in his taxable income. Some other countries, on the contrary, tax few such gains.

State laws, in general, allow capital losses to be deducted in computing net income, but with important restrictions in many jurisdictions. In computing the federal tax, the total capital loss for any one year can be subtracted only to the amount of the taxpayer's capital gains in the same year, plus an extra allowance of \$2,000. For example, suppose a taxpayer makes gains that total \$7,000 and incurs losses of \$12,000 (after allowance for the percentage provisions described below). He can deduct only \$7,000, plus the extra allowance of \$2,000 of his losses, or a total of \$9,000, from his income of all kinds—capital gains, salary, dividends, etc. Moreover, the unabsorbed loss of \$3,000 cannot be carried forward to reduce the taxable income of any subsequent year.

The gains are not taxed until they are realized by the sale of the property. The sale may, of course, take place many years after the purchase. Thus, a large gain, accrued over many years, may be realized for taxation within a single year, and the taxpayer may be pushed up into the high surtax rates for that year. He pays a much larger tax than he would have paid if the gain had been made up of a series of regular small yearly gains, totalling the same amount but taxable year by year. To remedy this inequality, the law provides that the longer an individual has held the property, the smaller the proportion of gain that is taxed. If the property has been held not more than one year, 100 per cent of the gain is taxed. At the other extreme, if the property has been held more than ten years, only 30 per cent of the gain

is taxed. Identical percentages apply to deductions for capital losses.

Probably no feature of the income tax law has caused more popular discussion over the past twenty years than the provision for capital gains and losses. It has been changed several times. The most recent, and in some ways the most drastic, change was made in the Revenue Act of 1934.

The elimination of capital gains and losses from income taxation has been urged on several grounds: (1) it would make the revenue from the income tax more stable; (2) it would give a more just distribution of the tax burden; and (3) it would remove an unhealthy incentive to cling to investments in boom times. Those who favor the tax either deny that these results would follow or are not so concerned about them, and, in addition, point to artificial methods of financing, unduly frequent transfers of property, and other results that they claim would follow an exemption of capital gains. The Committee believes that the objections to taxing capital gains and allowing capital losses are not valid, or are not important enough to outweigh the advantages of taking these gains and losses into account. Our reasons, in brief, are as follows:

Revenue Aspects of the Tax

The revenue aspects of the tax raise two important questions: (1) does the government gain over a long period of time by taking capital gains and losses into account? and (2) do the total revenues of the tax system fluctuate more than they would if these gains and losses were not taken into account?

(1) The present federal tax undoubtedly yields a net revenue to the government over a number of years. In prosperous years, any one taxpayer is likely to have many and large gains and few and small losses. In

depression years, he is likely to have many and large losses, and few and small gains—but he can utilize his losses for tax purposes only to the extent of his gains, plus \$2,000. In effect, most gains are taxed and no deduction is allowed for most losses.

Even if the tax allowed the unlimited deduction of losses, to correspond with the unlimited taxation of gains, a net revenue would probably result. It might not, however, if that part of the capital loss of any one year that was not absorbed by the income of that year were allowed to be carried over and applied to reduce the income of subsequent years. The time and resources of the present survey do not allow computations on this point. Even if such computations were made, we should not be greatly concerned with the results. Any revenue loss or gain could be counterbalanced readily by changes elsewhere in the tax system.

(2) The inclusion of capital gains and the deduction of capital losses certainly make the system as a whole fluctuate more in its yield than it would if the same net revenue were obtained from most other sources. But a revenue system should be somewhat responsive to changes in economic conditions. Within limits, it is desirable for the government to be forced to face the issue of whether it shall borrow during a depression instead of insisting on a rigidly balanced budget each year. A tax that decreases in yield during depression raises the issue of borrowing in the best possible way. Likewise, the corresponding large increase in revenue during prosperity gives an opportunity for debt reduction that might not otherwise occur.

Moreover, the revenue fluctuations usually associated with capital gains and losses can be smoothed out. A system of averaging net income over a period of years is one device. Another is lag in payment. Taxpayers may object to paying heavy taxes at a time when they have

no money, but that objection is inherent in any plan for stable government revenues.

The Justice of Capital Gains Taxation

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.

Of course, capital gains that result merely from a change in the general price level are not real gains in economic power. It has been suggested that for this reason capital gains in general should be taxed at a low rate. However, this creates gross inequality between the recipient of a true capital gain and the recipient of a salary. The question is thus one of balancing the various advantages and disadvantages. No method of taxing capital gains can be completely satisfactory.

A separate tax for capital gains, with a separate rate, splits taxpaying ability into two isolated compartments. A taxpayer with a large income from other sources—salary, interest, dividends—and with a small income from capital gains, would pay a small tax on his gains. Actually, a taxpayer is not a bundle of isolated abilities to pay. One great fault of the present tax system as a whole is that it levies upon a given taxpayer too many separate items, which are not related to each other or to the taxpayer's total net ability to pay.

The present capital loss provision is a case in point. By refusing to allow the deduction of capital losses from ordinary income (except for the \$2,000 allowance), the tax law implies that any capital loss in excess of a capital gain does not reduce the taxpayer's ability to pay.

Capital gains and losses do require particular treatment within the income tax structure. The chief difficulty is the injustice that follows the concentration of many

years' gain in the taxable income of a single year. Owing to the progressive rate scale of the surtax, a larger tax than otherwise must be paid. The present percentage provisions, reducing the gain or loss according to length of time held, are, of course, an imperfect adjustment to meet this problem.

The Influence of Capital Gains Taxes on Speculation

It is often claimed that in prosperous times the owners of securities, commodities, and real estate fail to sell when they should—and otherwise would—because of the taxation of capital gains. The fact that they will have to pay a heavy tax on the profit that they will realize is said to deter them from selling. The result is claimed to be over-extended speculative positions, inordinate rises in prices, and ultimate collapse.

This argument, however, has little foundation—at least in logic—if it is assumed that rates will remain the same in future years. If the owner thinks that the security will go still higher, he should keep it, regardless of the tax. If he thinks that it is going lower, it will pay him to sell, as long as the tax is less than 100 per cent. If he does not know what to think, he would still not know what to think even if there were no taxation of capital gains.

Of course he saves interest by delaying payment of the tax. He may also gamble on the chance that rates will be reduced, or that the tax will be repealed. Moreover, the capital gains provisions of the present federal revenue law, which place a progressively heavier tax the shorter the period during which the asset has been held, do have the effect of deterring the sale of assets when a profit rather than a loss has been accrued. This is particularly true when the owner may become subject to a tax on a smaller percentage of his total profits by holding the asset for only a short additional period. These

qualifications do not, however, touch the main theme of the argument as it is usually presented.

But it must be admitted in partial answer to the argument that investors and speculators often do act irrationally. That fact must be taken into account in formulating tax policy.

*Recommendations*²⁰

(1) The Committee recommends that capital gains or losses continue to be reported in computing the individual's income tax liability; but

(2) The Committee recommends a repeal of the present system of including in the computation only capital gains or losses that are actually realized and the substitution for it of a tax on gains or losses as they accrue, even if not realized.

Specifically, provided the practical difficulties of administration can be overcome, the Committee proposes that the same plan that it has recommended in connection with the ownership of stock²¹ be applied to all forms of property, with only such exceptions as would be necessary because of difficulties in setting a value on the asset. Every holder of property, with these exceptions, would be required to report the value of his holdings at the end of the year, and enter the gain—or loss—that had accrued since the end of the previous year, or since the date of purchase if he bought within the year. Of course, realization by sale or transfer would also—as at present—be an occasion for computing gain or loss. But in this case the gain or loss would be figured from the value at the last inventory date rather than from the original purchase price unless the asset had been purchased within the same year.

For real estate, some reliance might be placed on

²⁰ For Mr. Biddle's dissent from the recommendation for taxing gains while unrealized, and certain other comments, see note 15 above, p. 476.

²¹ See pp. 477-80.

computing the value by applying to the purchase price or the prior year's value the percentage of change in the assessed valuation that takes place.

Possible alternative methods for those cases where the inventory method might prove impracticable have already been analyzed in the discussion of the undistributed profits tax.²²

(3) In any event, the Committee recommends more liberal provisions than in the present law for capital losses. They should be allowed as deductions against income from all sources. If a net loss for the year remains, it should be carried over, year after year, until it has been completely absorbed. If this provision causes a too great fluctuation in annual revenue, some device for averaging the net income and losses of several years should be established.

(4) The avoidance of tax now possible by holding capital assets until death should be eliminated.²³

(5) Some plan should be devised to avoid the taxation of capital gains or allowance of capital losses that are due only to a general rise or fall in the price level.²⁴

VIII. EXCESS PROFITS TAX

The Present Tax

The present excess profits tax is levied on the net income of corporations—but not on that of partnerships and proprietorships—in excess of 10 per cent of the value of the capital stock. This value is almost wholly artificial, however, since it consists of the figure set by the corporation, plus and minus later adjustments. The rate is 6 per cent on that part of the profits over 10 per cent but not over 15 per cent, and is 12 per cent on further profits.

The tax produced only \$7,000,000 in the fiscal year 1935 and \$15,000,000 in the fiscal year 1936. Corporations

²² See pp. 480-82.

²³ See p. 483.

²⁴ See pp. 482-83.

in general have preferred to set a relatively high value on their capital stock, thus paying a substantial capital stock tax but avoiding the excess profits tax. The chief purpose of this particular excess profits tax, in fact, seems to have been to assure adequate revenue from the capital stock tax.

Arguments for Taxing Excess Profits

An excess profits tax is an indispensable part of any war-time revenue system. The possibility of war gives some reason for imposing such a tax, perhaps at low rates, even in peace times, for it is very difficult to administer if improvised.

Even apart from the possibility of war, however, an excess profits tax is called for. The growth of large corporations and combinations in certain industries has limited the effects of free competition. Free competition tends to keep profits at just the level needed to induce the requisite amount of production. Imperfect competition often results in profits well above this level, and when an excess profit results a few people gain at the expense of society as a whole.

The most desirable remedy, of course, is to get prices down; but in many cases this is impossible. For example, it is difficult for the government to eliminate the understandings among large business units that characterize some forms of imperfect competition. It is also difficult to fix reasonable prices, even when the industry is granted monopolistic privileges under government control, as in the case of public utilities. A second-best policy may then be the use of an excess profits tax.

Problems of Principle and Administration

We are impressed, however, by difficulties in both the theory and the practice of the excess profits tax. The "excess" must be determined by finding out what per-

centage return is being earned on the capital. However, what is a fair percentage—or, to put it another way, what is “excess”? Is it the same for a hazardous business as for others? If not, how much difference is allowed for each of the more or less hazardous businesses? Is each year's profit to be considered by itself? If not, how many years are to be averaged? Is the profit to be profit before or after payment of interest and preferred dividends? Is the capital to include non-business assets, such as investment securities held by the business? If one taxpayer owns two or more businesses, can he average the high profits from one with the low profits from another? Is the capital to be what the present owners paid for the business—or what was actually spent by the business for its assets (less depreciation etc.)—or what the assets are worth the day that the tax took effect?

These questions and many others show the difficulties in the way of an excess profits tax. They are not being answered in the administration of the present tax. They may seem so formidable as to make an adequate tax impracticable. We do not, however, think that this conclusion is justified. We think that they merely indicate a need for proceeding slowly and for building soundly—on a new foundation.

It should be noted, furthermore, that the present tax does not include partnerships and proprietorships and so adds to the inequalities that the administration has sought to eliminate by the undistributed profits tax. If the excess profits of corporations are taxed, other forms of business should bear the same burden.

Recommendations

(1) The Committee recommends that the present excess profits tax be repealed.

(2) In its place we recommend that a preparatory, records-producing tax, with nominal rates, be imposed,

for a period of five years or more, under which business concerns of all kinds—corporations, partnerships, and proprietorships—would be required to file each year complete data on their capital and income.

(3) We further recommend that a well-staffed excess profits tax unit be set up in the Treasury to compute for every business firm, during the preparatory period, a capital figure upon which future taxes can be based.

(4) After these basic figures are obtained, we recommend the abolition of the nominal rates and the imposition of high progressive rates—reaching a peak of perhaps between 50 per cent and 75 per cent even in peace times, and starting on that part of the profits above a 5 per cent or 10 per cent return on the capital. However, a higher tax-free rate of return should be granted to firms in hazardous fields of enterprise, and possibly also to patent monopolies to the extent that the promotional effects of patents are deemed worthy of protection.

(5) We recommend that the excess profits tax be considered as a business tax, so that, for example, capital gains from security sales by individual investors would not be included. Whether capital gains from security sales by any other kind of taxpayer should be subject to the excess profits tax is one of the important questions of detail to which serious consideration must be given.

IX. SOCIAL SECURITY TAXES

The Present Taxes

The Social Security Act of 1935 imposes three new federal taxes: one to promote the adoption of unemployment compensation laws by the states, and the other two to finance the payment of federal old-age retirement benefits. Railway employees and employers are taxed for retirement pensions under a special act.

Unemployment Insurance

The tax for promoting unemployment benefits is imposed on all employers of eight or more employees (certain industries being exempted) at the rate of 1 per cent on 1936 payrolls, 2 per cent on 1937 payrolls, and 3 per cent thereafter. These receipts go into the general fund of the Treasury.

The chief object of this tax is to encourage the states to adopt approved unemployment compensation plans. To this end employers are allowed to deduct from the amount of their federal tax the payments that they have made to approved state plans—up to 90 per cent of the federal tax. In other words, as each state adopts unemployment insurance the federal government will get only about 10 per cent of the federal payroll tax that it would otherwise have obtained from taxpayers in the state. It is expected, therefore, that as the states fall into line the federal yield will decline to a minor item.

Old-Age Benefits

The old-age benefit taxes are assessed on all employers and employees except that certain industries are exempted and the taxes are not levied on amounts paid in excess of \$3,000 in any calendar year by any one employer to any one employee. The employer actually pays both taxes, taking the employee's tax out of his pay envelope. Each tax commences at 1 per cent of the wages paid to employees in 1937 and rises at three-year intervals until it reaches 3 per cent—hence a total of 6 per cent—in 1949. The proceeds of these taxes become a part of the general federal revenues. Another section of the law, however, provides for the establishment of an "old-age reserve account" in the Treasury Department, to which amounts coming, presumably, in part from the yield of these taxes will be credited each year. Retirement benefits will be paid out of this account.

Although tax payments begin in 1937, the first benefits will not begin until 1942. A five-year accumulation of these taxes will, therefore, be available before any benefits are paid. For more than twenty years thereafter the annual revenues from these taxes will be greater than the annual amounts due in benefits. The difference is to be invested in federal government securities that bear a rate of at least 3 per cent. By this means an old-age benefits reserve fund will be accumulated. This fund, it is estimated, will reach a total of nearly \$47,000,000,000 by 1980. After that year the estimated interest earned on the fund, plus the yield of current taxes, will be required to meet the annual cost of retirement benefits. No further surpluses will be available to swell the reserve fund.

Criticism of the Taxes

This Committee is exclusively concerned with the tax aspects of the social security program. We pass no judgment on the adequacy of benefits, the time of their payment, or the proportion of the population involved. We assume that the expenditures called for must be met. Our only interest, as a tax committee, lies in the way that these revenues are to be raised. Moreover, we are taking into account the fact that a special committee of the Twentieth Century Fund is studying the problem of old-age security, and we hesitate to make sweeping recommendations until this study has been completed.

Dangers of the Reserve Fund

We have serious doubts, both economic and political, concerning the building up of an old-age reserve fund of such enormous proportions that it will eventually far exceed the total amount of the present general federal government debt. The mere existence of such large current surpluses for so many years may lead to "raids"

upon the fund, or, more precisely, "borrowing" from it to finance expenditures of other kinds that would not otherwise have been incurred.

Above all, we question the wisdom of such heavy payroll taxes at a time when the general federal budget is unbalanced and no reductions are being made in the national debt. It is hardly consistent for the government to refuse to increase the general public's taxes to balance the budget and decrease the national debt, when, at the same time, it levies on employers and employees a tax that is much heavier than is needed to meet current old-age benefit payments, so that a surplus can be built up for future years. If general taxes cannot be increased to wipe out a deficit in one government account, why should specially heavy taxes be levied to create a surplus in another?

Furthermore, we believe that the economics of the reserve fund are dubious, if not dangerous. The surplus revenues each year will be invested in government bonds. Thus the Treasury must go into the market and buy them or fail to reissue the bonds to the public as they mature. Eventually all the federal government bonds outstanding will have to be removed from the hands of the public, since the reserve will be larger than the present debt.

The economic results of these gigantic operations have not yet been sufficiently explored. Some of the more obvious effects raise serious questions; for example, (1) possible increases in the market price of the bonds, and (2) the influence on the national economy of the sale of bonds by the banks and the individuals who now hold them. While the Treasury may have means of avoiding the first difficulty, the large and inevitable demand for outstanding federal securities will at least tend to increase the price that the reserve fund will have to pay for them. When individual holders sell government bonds on a large scale, the proceeds will probably be

spent in reinvestment rather than in the purchase of consumers' goods, because the holders bought the bonds originally as investments. When the government takes tax money and uses it to buy bonds from banks, the first effect is to decrease the total amount of bank deposits. The results of these changes, at least on the scale and at the speed planned, may not be economically wholesome.

The Committee sees no financial necessity for the operation of a government compulsory old-age retirement system on a full reserve fund basis. A private insurance plan requires a reserve fund invested in the soundest possible securities for the safety of the policy-holders. A government insurance plan, however, with the taxing power always in reserve, does not. The current costs can be met from taxation without peril to the beneficiaries. If such a "current cost" basis were adopted, the dangers of the reserve fund would be eliminated and the payroll taxes could be reduced for many years to come.

These comments on the reserve fund do not, of course, apply to reserve funds under unemployment compensation plans. Such funds are obviously essential in those measures, for they are accumulated during a period of prosperity in order to provide a surplus out of which benefits can be paid during depression.

Injustice of Payroll Taxes

The payroll taxes, furthermore, have certain obvious elements of injustice. The taxes on employers are so large that in many, perhaps most, instances they cannot be paid out of profits. In all probability, the burden will be shifted by employers either to consumers in the form of higher prices or to employees in the form of lower wages. In either event these taxes will weigh more heavily on those with low incomes and will be a comparatively light burden on those with incomes of more

than \$5,000 a year. The tax on employees' wages is a crude form of income tax. It is a gross tax that makes no allowance for differences in family status and other factors that determine ability to pay.

Other Aspects

The payroll taxes paid by the employers may put pressure on employers to substitute machinery for direct labor. Industries with a relatively large direct labor cost will be affected more than others.

Tax consciousness and a desire to make each industry more or less pay its own way are almost the only arguments that can be made for the payroll taxes.

The individual employee is made conscious, by his contribution to his own retirement benefit, of the problem of financing the system. This will serve as a check on unreasonable demands to increase benefits. Firms and industries with a greater proportion of labor costs than others may be asked, as they should be, to pay proportionately more toward caring for labor in old age and unemployment. These advantages of the payroll levy, however, are outweighed by its disadvantages.

Recommendations

For reasons given above, the Committee does not wish to make sweeping recommendations for change in the social security program at this moment. The recommendations to be listed below are therefore given with less emphasis than others in this report and should not be taken as representing a definite commitment of opinion on the part of each member of the Committee.

(1) The Committee recommends, with the limitation just indicated, that the federal payroll taxes for old-age benefits be reduced by placing the system upon a "current cost" basis, after the accumulation of a reasonable reserve chiefly for contingencies. Thus the revenues that

are required to pay the benefits would be obtained chiefly year by year as they were needed.

(2) We further recommend, with the same limitation, that additional reduction of the payroll taxes be made possible by contributions to the system from the general revenues of the federal government—from taxes on the general public rather than on the groups immediately concerned.

(3) It is urged that a thorough study be made at once of (a) the economic consequences of reserve fund financing for old-age pensions, (b) the tendency to create unemployment through the payroll tax, and (c) the degree to which revenues should be raised through general taxation; and that the results of the study be available in time for amendment of the present law during the present or the next succeeding session of Congress.

X. DEATH TAXES AND GIFT TAX

The Present Taxes

The federal death tax and gift tax can be considered together because the latter was imposed to prevent avoidance of the former, and the one is integrated with the other.

Death Taxes

The federal estate tax exempts all estates below \$40,000, but on estates above that amount it imposes a progressive levy that begins at 2 per cent on the first additional \$10,000 and reaches a 70 per cent toll on that part of the estate in excess of \$50,000,000. In the lower range, the rates go up by 2 per cent for each \$10,000 of estate above the exemption. The average over-all rate on net estates of \$100,000 is 10 per cent; on those of \$1,000,000, 22 per cent; and on those of \$10,000,000, 50 per cent.

The federal law allows the taxpayer to deduct from his federal tax the amount that he has paid to the state in death taxes within a certain limit (up to 80 per cent of the federal tax that would be due under the lower rates and higher exemption of the Revenue Act of 1926). All the states except Nevada impose death taxes. The rates given above represent, in practice, almost the total federal and state levy on estates, with exceptions in a few states.

The federal revenue from this source is estimated at \$305,000,000 for 1937, and that of the states at \$100,000,000.

Gift Tax

The federal gift tax rates are three-fourths of the estate tax rates in the corresponding brackets. This tax is unique in that it transcends annual bounds—gifts made by the same donor in earlier years are taken into account in computing the tax rate in each case.

The annual yield of the federal gift tax is about \$100,000,000. Only three states levy gift taxes, and the state yield is insignificant.

Dangers in Too High Rates

The death taxes and the gift tax, in the opinion of the Committee, meet the various standards of taxation better than almost any other tax except that on income. In some ways they are even superior to the income levy. At least the person whose gift or estate is taxed feels the burden less.

Some dangers, however, must be noted. A death tax that approached confiscation would greatly affect the volume of savings. A further study must be made of the degree to which this would occur and of the wide economic consequences before any specific conclusions about maximum rates can be drawn. Forced liquidation

is another difficulty to be noted. When there is not enough cash in an estate to meet the tax, securities and other property must be sold. Such liquidation on a large scale and within a short time has obvious disadvantages. Finally, the federal gift tax is not adequately co-ordinated with the death tax. By the first gifts that he makes, the donor escapes the top rates that would apply to his estate under the death tax and he pays only low rates in the first brackets of the gift tax.

Recommendations

(1) The Committee recommends that the death taxes and the gift tax be relied upon more heavily in the future than in the past to meet any need for increased revenues.

(2) We further recommend that this be accomplished primarily by raising the rates in the middle brackets, as in the income tax; and, secondarily, by lowering the present exemptions, rather than by increasing the rates in the highest brackets, at least until more is known about the economic effects of extremely high rates.

(3) Finally, the Committee recommends that a study be made of ways to improve the co-ordination of the gift tax with the death tax, as already indicated.

XI. CHAIN STORE TAXATION²⁵

The Present Taxes

About two-fifths of the states levy special taxes on chain stores. In most cases they are progressive taxes levied on a per store basis and increasing with the number of stores. For example, the tax may be \$10 a store for the first five stores, \$20 a store for the next five stores, and so on. The highest rate is found in Texas, which taxes the fifty-first and additional stores at the rate of

²⁵ Mr. Biddle has taken no part in writing this section and has expressed no opinion for or against the Committee's recommendation on chain store taxation.

\$750 per store. Some gross income chain store taxes have been tried, but these have run into constitutional difficulties.

The revenue from these taxes, compared with that from other sources, has been of minor importance. To a considerable extent their objective has been frankly, not revenue, but business control.

Arguments for the Taxes

The main arguments made for chain store taxation are two:

(1) The chains are said to pay less personal property tax than their independent competitors, owing largely (a) to faster turnover, (b) to the exclusion of wholesaling and transportation costs when valuing goods, and (c) to the inaccessibility of books to local assessors.

(2) The chains are said to have, owing chiefly to their size, a competitive advantage that can and should be offset by taxation.

Conclusions

We do not attempt to pass on the question of whether the personal property tax favors chains as compared with independents. The question of the personal property tax in general is discussed in the conclusions of the directors of research.²⁶ If the dangers of mere size are at issue, the problem should be approached in a broad way, so that not only chains but also other large units are taxed. The present chain taxes illustrate special interest tax legislation that is basically unsound.

In any event, the present chain store taxes are much too crudely constructed to equalize accurately whatever tax difference exists. The progressive rates of a certain number of dollars a store bear no relation whatever to any calculated differences in the personal property tax position of chains and other kinds of store.

²⁶ See pp. 411-12.

If the chains have a competitive advantage owing to the economies of the chain type of organization, the public benefits from it in lower prices. We oppose the use of the taxing system, or any other device, to maintain the status quo for the benefit of those who would be injured by the new methods of competition that benefit the public. The chain store taxes seem to have been used largely for this purpose.

Furthermore, the present taxes are obviously unjust. They ignore substantial similarities between large chains and large merchandising units that are not chains by taxing one and exempting the other. They also tend to ignore marked differences between large chains and small chains. For example, only Louisiana (in a statute that has not yet been tested in the Supreme Court) makes the amount of the tax depend on the total number of stores in the chain. The others look only to the total number of stores in the chain within the state.

Supreme Court decisions indicate that the states have the power not only to cripple but also to eliminate the chain method of doing business. Even existing taxes burden the investors in chains unfairly, and, what is more important, they tend to raise the cost of living for the large number of people with small incomes who depend on efficient merchandising to get the most for their money.

Recommendations

The Committee recommends that all special taxes on chain stores be immediately repealed.

* * *

The Committee presents the foregoing discussion of current tax problems, not as final and definite conclusions, but as suggestions that, it is hoped, will stimulate interest in, and intelligent consideration of, the factual

materials and detailed recommendations contained in the report of the research staff, which it has been the function and privilege of this Committee to sponsor.

(Signed)

THOMAS I. PARKINSON, *Chairman*

FRANCIS BIDDLE

ROBERT M. HAIG

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NOTES

CHAPTER I

NOTE 1 (p. 4).¹ *Special Comprehensive Reports on State and Local Taxation in the Period 1929-36*. The names of the thirty-six states and the dates of publication of the comprehensive reports by special committees or special commissions on state taxation published in the period 1929-36 inclusive are given below.² Reports that were not under the official auspices of the government were excluded except occasionally where the report was substantial and where responsibility for it was assumed not by one man or a few men, but by a committee or other community organization. The list does not include reports that touch only on some highly specialized part of the tax problem, for example, the old-age pension tax. It does not include special reports of regular tax commissions, except where such reports indicate that a special staff was formed for the purpose.

The list is believed to be reasonably complete, but such references are difficult to assemble, and possibly two or three states should be added to the list.³

Alabama.....	1932	Missouri.....	1929, 1930
Arkansas.....	1929	Montana.....	1933
California.....	1929, 1931, 1933	New Hampshire.....	1930, 1932
Colorado.....	1930	New Jersey.....	1931
Connecticut.....	1934	New York.....	1931-36 inclusive
Florida.....	1931, 1935	North Carolina.....	1930
Georgia.....	1930	Ohio.....	1930
Illinois.....	1929, 1931, 1933	Oklahoma.....	1935
Indiana.....	1931	Rhode Island.....	1935
Iowa.....	1930, 1933	South Dakota.....	1931
Kansas.....	1929	Tennessee.....	1930, 1934, 1936
Louisiana.....	1933	Texas.....	1929, 1933, 1935
Maine.....	1934	Utah.....	1929
Maryland.....	1932	Vermont.....	1930
Massachusetts.....	1929, 1930, 1932	Washington.....	1930
Michigan.....	1931	West Virginia.....	1930
Minnesota.....	1932, 1933	Wisconsin.....	1935
Mississippi.....	1932	Wyoming.....	1933

NOTE 2 (p. 4). *Federal Revenue Acts in the Period 1929-36*. The major revenue acts passed by Congress (all were approved by the President) in the period 1929-36 inclusive are listed below in Table

¹ Numbers in parentheses refer to first citation of each note.

² More than one date indicates more than one report, not a new edition of the same.

³ For titles, and more details on the problem of compiling a comprehensive list, see the memorandum by Carl Shoup, Marion Holman, and Bernard L. Shimberg on special state tax reports, in the forthcoming volume, *Studies in Current Tax Problems*.

A, with their official title, public law number, and date of approval. The list does not include minor acts, such as those that merely extended the life of certain minor excises or slightly reduced the rate of more important taxes, or acts not passed for revenue, such as the Bankhead cotton act and the Kerr tobacco act. Also it does not take account of changes in the customs duties made by executive action under the flexible tariff and reciprocal trade pact provisions.

TABLE A

MAJOR FEDERAL REVENUE ACTS, 1929-36

Official Title (Short Title, Where Given)	Law Number	Date of Approval
Tariff Act of 1930.....	Public No. 361, 71st Congress	June 17, 1930
Revenue Act of 1932.....	Public No. 154, 72nd Congress	June 6, 1932
An Act to Provide Revenue by the Taxation of Certain Non-Intoxicating Liquor [Beer and Wine]	Public No. 3, 73rd Congress	March 22, 1933
An Act to Relieve the Existing National Economic Emergency by Increasing Agricultural Purchasing Power [etc.] [Agricultural Adjustment Act—Processing Taxes]	Public No. 10, 73rd Congress	May 12, 1933
National Industrial Recovery Act ["Reemployment and Relief Taxes"]	Public No. 67, 73rd Congress	June 16, 1933
Liquor Taxing Act of 1934.....	Public No. 83, 73rd Congress	January 11, 1934
Revenue Act of 1934.....	Public No. 216, 73rd Congress	May 10, 1934
Social Security Act [Payroll Taxes].....	Public No. 271, 74th Congress	August 14, 1935
Revenue Act of 1935.....	Public No. 407, 74th Congress	August 30, 1935
Revenue Act of 1936.....	Public No. 740, 74th Congress	June 22, 1936

NOTE 3 (p. 4). *Supreme Court Tax Cases in the Period 1929-35*. The data cover the period beginning with the 1929 term and ending with the 1934 term—that is, from the fall of 1929 through the spring of 1935. Of the 250 tax opinions, 183 concerned federal taxes and 67 state taxes.

During the same period, there were 4,668 petitions to the Supreme Court to review lower court decisions (petitions for certiorari). Of these, 3,778 were denied or dismissed; the other 890 were of course subsequently reflected in opinions. Of the 3,778 cases, 776, or 20 per cent, were tax cases—682 federal, 82 state, and 2 territorial.

The sources of this information are: Felix Frankfurter and James Landis, "The Business of the Supreme Court at October Term, 1929," *Harvard Law Review*, XLIV (November 1930), 1-40; same, "——— 1930," *Harvard Law Review*, XL (December 1931), 271-306; same,

"——— 1931," *Harvard Law Review*, XLVI (December 1932), 226-60; Frankfurter and Henry Hart, Jr., "——— 1932," *Harvard Law Review*, XLVII (December 1933), 245-97; same, "——— 1933," *Harvard Law Review*, XLVIII (December 1934), 238-81; same, "——— 1934," *Harvard Law Review*, XLIX (November 1935), 68-107.

NOTE 4 (p. 4). *Textbooks and Books of Readings in Public Finance in the Period 1929-36*. The textbooks and books of readings in public finance (not including public finance sections of economics textbooks) published in the United States in the period 1929-36 are as follows:

Harley Leist Lutz, *Public Finance* (2nd ed.; New York: D. Appleton-Century Co., Inc., 1930; 3rd ed., 1936).

William J. Shultz, *American Public Finance and Taxation* (1st ed.; New York: Prentice-Hall, Inc., 1931; rev. eds., 1932 and 1934).

Mark Carter Mills and George W. Starr, *Readings in Public Finance and Taxation* (New York: Macmillan Co., 1932).

Elmer D. Fagan and C. Ward Macy, *Public Finance, Selected Readings* (New York: Longmans Green and Co., 1934).

Clyde L. King, *Public Finance* (New York: Macmillan Co., 1935).

Alfred G. Buehler, *Public Finance* (New York: McGraw-Hill Book Co., Inc., 1936).

On January 2, 1937, there was published *Government Finance*, by Jens P. Jensen (New York: Thos. Y. Crowell Co.).

NOTE 5 (p. 7). *Explanation of the Order of Presentation*. The order in which the material of Book Two is arranged differs from that followed by studies of state tax systems and by textbooks on public finance. The difference results from an attempt to keep steadily before the reader's mind the entire tax system or tax complex of the United States.

The usual method of presentation devotes a separate chapter or section to each tax. Practically all the material on the property tax, for example, is assembled in one place, and similarly all the material on the income tax and the various other taxes. The result, however, is a dispersion of the material on all topics that cut across a tax-by-tax grouping, such as tax consciousness, costs of administration, degree of evasion, effect of taxation on business initiative, etc. Diligent search through the several chapters on the various taxes is, therefore, necessary for the reader who wishes to know how a given tax system, as a whole, appears in the light of any one of these tests.

The customary method of presentation has undoubted advantages. Also, because it is customary, it is relatively easy for the reader to follow. Nevertheless, it is almost entirely abandoned in the present study because of a desire to emphasize the characteristics of the present taxing system considered as a system and not as a series of

isolated taxes. The material on cost of administration, for example, is assembled in one place, instead of being scattered through several chapters, so that judgment may be formed on whether the present taxing system of the United States is on the whole excessively costly to administer.

The tax-by-tax presentation, however, has not been entirely abandoned. Those readers who are not familiar with the bare technical essentials of each tax are given a brief statement in Chapter 2 of the rate of each tax, its revenue importance, and the scope of its application. Those who are already familiar with the revenue system of the United States will wish to pass over this chapter, and perhaps also Chapter 3, which sketches briefly the major changes in the system since 1914.

In such a study as the present one, the material of interest to the general reader must be distinguished from the requisite qualifying material, which is likely to interest only the specialist in public finance or the general reader who has a particular interest in some part of the field. The latter material is put in this section of Notes at the end of the book.

The result of the basic research that was necessary for some parts of the survey because of the lack of secondary material on the points in question is embodied in a series of special studies reproduced in a companion volume, entitled *Studies in Current Tax Problems*. Some of the material that was gathered in the course of the survey, but that was not used extensively in the present volume owing to a change in the plan as the work progressed, will appear in journals or will be available in mimeograph form.

CHAPTER 2

NOTE 1 (p. 9). *Uniformity Requirement for Federal Taxes*. Article I, Section 8, of the federal Constitution provides that "all duties, imposts, and excises shall be uniform throughout the United States." Uniformity here means geographical uniformity.⁴

Direct taxes, however, fall under a different rule: "direct taxes shall be apportioned among the several states . . . according to their respective numbers,"⁵ and "no capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken."⁶ That is, the average per capita tax in a poor state would have to be the same as that in a rich state. To attain this result, the rate of the tax would of course have to be higher in the poor state than in the rich state.

⁴ Shultz, *op. cit.*, pp. 258-59.

⁵ Art. I, sec. 9.

⁶ Art. I, sec. 2.

None of the taxes levied by the federal government can be considered direct from the point of view of the apportionment clauses.

Under the Sixteenth Amendment the federal personal income tax is explicitly removed from the restrictions of the direct tax clauses cited above. However, the income tax cannot be considered free from the uniformity clause.⁷ Superficially, the federal income tax is geographically uniform. Actually, the operation of state statutes governing division of income between spouses makes for a lack of uniformity. For example, of two married couples identical in every respect except that one couple lives in California and the other in New York, the former may pay a smaller federal income tax because half of the husband's earnings are considered the wife's income, and, by filing separate returns, the income can be kept out of the high surtax rates it would otherwise reach. The Supreme Court has ruled such division of income for tax purposes valid.⁸

NOTE 2 (p. 10). *Number of Local Units*. The figure is taken from a recent study, in which the author says, "Our definition [of unit of government] includes practically all taxing districts, but it includes some others which, while they do not actually levy their own taxes, are entitled to a revenue which some other body must raise for them and turn over to them for expenditure."⁹

NOTE 3 (p. 12). "*Intangibles*." The term "intangibles," as used in this book, may be defined as evidences of interests in wealth in which others also necessarily have an interest, or evidences of claims on, or interests in, legal persons. Under this definition shares of stock, for instance, are included and title deeds are excluded. The standard works of Seligman, Lutz, and Shultz have used "intangible" or "intangibles" in approximately this sense.¹⁰ The word has sometimes been used in a specialized sense to denote a franchise or some other element that gives special earning power to some business enterprise.

NOTE 4 (p. 16). *Details of Undistributed Profits Tax*. The explanation in the text omits certain technical features that may be noted here.

The tax is called a "surtax," and it is levied upon the "net income" of the corporation. Its amount is determined by a rate scale applicable to the "undistributed net income," graduated in accord-

⁷ *Brushaber v. Union Pacific R.R.*, 240 U. S. 1 (1916).

⁸ Roswell Magill, *Taxable Income* (New York, 1936), pp. 268 ff.

⁹ William Anderson, *The Units of Government in the United States: An Enumeration and Analysis*, Public Administration Service, Publication No. 42 (Chicago, 1934), p. 3.

¹⁰ Edwin R. A. Seligman, *Essays in Taxation* (9th ed.; New York, 1923), pp. 23, 25; Lutz, *op. cit.* (3rd ed.), pp. 399, 500 ff.; Shultz, *op. cit.*, pp. 406, 410. Hereafter, unless otherwise specified, references to Lutz's *Public Finance* will be to the third edition.

ance with the ratio of the undistributed net income to the "adjusted net income." The adjusted net income is the net income minus: (a) the normal corporation tax paid, (b) the income from any federal or federal corporation obligations (these are also excluded in computing the normal tax), (c) the earnings or profits devoted by a holding company affiliate, as defined by the Banking Act of 1933, to the acquisition of certain readily marketable assets in compliance with the law, and (d) the earnings or profits of a national mortgage association devoted to the acquisition of such reserves as the Federal Housing Administrator may require. The adjusted net income includes 100 per cent of dividends received, no matter from what source (the corporation normal tax is imposed after deducting 85 per cent of dividends received from domestic corporations subject to the income tax).

The undistributed net income is the adjusted net income minus the "dividends paid" credit. This credit consists of the dividends paid during the taxable year, with provision for a two-year carry-over if dividends are paid in excess of the year's adjusted net income. The allowance for earnings required to be retained because of contractual agreement comes in at this point in the form of a credit deductible from adjusted net income in arriving at undistributed net income.

The rate scale is:

Rate, in Per Cent, Applicable to the Portion of the Undistributed Net Income Indicated in Next Column	Portion of Undistributed Net Income, in Terms of a Percentage of Adjusted Net Income	
	In Excess of	Not in Excess of
7.....	—	10
12.....	10	20
17.....	20	40
22.....	40	60
27.....	60	—

If the adjusted net income is less than \$50,000, special provision is made to lighten the burden by a specific credit.

CHAPTER 3

NOTE 1 (p. 9). *Federal Tax Collections, 1913-37*. Tables B to F inclusive present data on federal tax yields for the period starting with the fiscal year 1913.¹¹ The data are carried through the fiscal year 1937, but for this year they are merely the estimates given in the

¹¹ Throughout the present volume, the year referred to in connection with data on revenues or expenditures is the fiscal year, unless otherwise indicated. The ending, not the beginning, date of the fiscal year is given. Thus the fiscal year 1913 ends during the calendar year 1913. The federal fiscal year ends June 30.

Statement by the President on the Summation of the 1937 Budget, presented September 2, 1936. Later official estimates for 1937, made public as

TABLE B
FEDERAL TAX REVENUE, 1913-37: INTERNAL REVENUE AND CUSTOMS
(Absolute Yield Figures Are in Millions of Dollars)

Fiscal Year	Total Tax Revenue:	Total Internal Revenue from Taxes ^a		Total Customs Revenue ^b	
	Internal Revenue and Customs ^a	Amount	Per Cent of Total Tax Revenue	Amount	Per Cent of Total Tax Revenue
1913	663.3	344.4	52	318.9	48
1914	672.3	380.0	57	292.3	43
1915	625.5	415.7 ^c	66	209.8	34
1916	725.9	512.7	71	213.2	29
1917	1,035.4	809.4	78	226.0	22
1918	3,879.0	3,699.0	95	180.0	5
1919	4,034.6	3,850.2	95	184.5	5
1920	5,730.5	5,407.6	94	322.9	6
1921	4,903.6	4,595.0	94	308.6	6
1922	3,553.9	3,197.5	90	356.4	10
1923	3,183.7	2,621.7	82	561.9	18
1924	3,341.8	2,796.2	84	545.6	16
1925	3,131.7	2,584.1	83	547.6	17
1926	3,415.4	2,836.0	83	579.4	17
1927	3,471.2	2,865.7	83	605.5	17
1928	3,359.5	2,790.5	83	569.0	17
1929	3,541.3	2,939.1	83	602.3	17
1930	3,627.1	3,040.1	84	587.0	16
1931	2,806.6	2,428.2	87	378.4	13
1932	1,887.1	1,557.7	83	329.4	17
1933	1,872.0	1,619.8	87	252.2	13
1934	2,987.1	2,672.2	89	314.9	11
1935	3,644.2	3,299.4	91	344.8	9
1936	3,907.0	3,520.2	90	386.8	10
1937 ^d	5,476.7	5,074.7	93	402.0	7

^a Not including certain minor inland taxes and charges not listed under Internal Revenue, such as: (1) taxes on Federal Reserve Banks, immigration head tax, etc.; (2) fees, fines, etc.

^b Including tonnage tax for all years except 1936 and 1937, for which segregated data were not available.

^c Alaska Railroad tax first included.

^d For basis of estimates, see pp. 514-15.

this volume was going to press, are discussed briefly on p. 538.

Except for 1936 and 1937, the data for the constituent items of internal revenue have been taken from the annual reports of the Commissioner of Internal Revenue, and the figures for the total have been taken from the 1935 report of the Commissioner. Both the totals and the constituent items are on a collection basis—that is, they represent collections during the fiscal year, as "compiled from reports received by the various administrative offices from collecting officers

TABLE C
 FEDERAL INCOME TAX, EXCESS PROFITS TAX, ESTATE TAX, AND GIFT TAX, 1913-37
 (Absolute Yield Figures Are in Millions of Dollars)

Fiscal Year	Total Income Tax ^a (Corporation and Individual)		Corporation Income Tax ^a		Individual Income Tax ^b		Estate Tax ^c		Gift Tax ^d	
	Amount	Per Cent of Total Tax Revenue	Amount	Per Cent of Total Tax Revenue	Amount	Per Cent of Total Tax Revenue	Amount	Per Cent of Total Tax Revenue	Amount	Per Cent of Total Tax Revenue
1913.....	35.0 ^o	5	35.0 ^o	5	—	—	—	—	—	—
1914.....	71.4	11	43.1 ^f	6	28.3	4	—	—	—	—
1915.....	80.2	13	39.1	6	41.0	7	—	—	—	—
1916.....	124.9	17	57.0	8	67.9	9	—	—	—	—
1917.....	359.7	35	179.5	17	180.1	17	6.1	1	—	—
1918.....	2,839.0 ^g	73	h	h	h	h	47.5	1	—	—
1919.....	2,600.8 ^g	64	h	h	h	h	82.0	2	—	—
1920.....	3,956.9 ^g	69	h	h	h	h	103.6	2	—	—
1921.....	3,228.1 ^g	66	h	h	h	h	154.0	3	—	—
1922.....	2,086.9 ^g	59	h	h	h	h	139.4	4	—	—
1923.....	1,691.1 ^g	53	h	h	h	h	126.7	4	—	—
1924.....	1,841.8 ^g	55	h	h	h	h	103.0	3	—	—
1925.....	1,761.7	56	916.2	29	845.4	27	101.4	3	7.5	1
1926.....	1,974.1	58	1,095.0	32	879.1	26	116.0	3	3.2	1

1927.....	2,220.0	64	1,308.0	38	911.9	26	100.3	3	—	-
1928.....	2,174.6	65	1,291.8	38	882.7	26	60.1	2	—	-
1929.....	2,331.3	66	1,235.7	35	1,095.5	31	61.9	2	—	-
1930.....	2,410.3	66	1,263.4	35	1,146.8	32	64.8	2	—	-
1931.....	1,860.0	66	1,026.4	37	833.6	30	48.2	2	—	-
1932.....	1,056.8	56	629.6	33	427.2	23	47.4	3	—	-
1933.....	746.8	40	394.2	21	352.6	19	29.7	2	4.6	1
1934.....	817.0 ^j	27	397.5	13	419.5	14	104.0	3	9.2	1
1935.....	1,099.2 ^j	30	572.1	16	527.1	14	140.4	4	71.7	2
1936.....	1,412.9 ^j	36	738.5	19	674.4	17	218.8	6	160.1	4
1937 ^k	2,303.4 ⁱ	42	1	1	1	1	268.0	5	110.0	2

^a Includes excess profits taxes and war excess profits taxes levied under revenue acts of March 3, 1917, October 3, 1917, and February 24, 1919, but not the munitions manufacturers' tax. The corporation excise tax law of August 5, 1909, was superseded by the first effective income tax law, enacted on October 3, 1913, after the Constitution had been amended to permit imposition of tax on all incomes. The munitions manufacturers' tax was enacted on September 8, 1916. This was superseded by the excess profits tax provided in the act of March 3, 1917. This in turn was superseded by the war excess profits taxes authorized by the War Revenue Act, approved October 3, 1917, which were repealed in 1921.

^b Individual tax enacted October 3, 1913.

^c Estate tax enacted September 8, 1916.

^d Gift tax first enacted June 2, 1924, repealed in 1926, and re-enacted in 1932.

^e Called excise tax on corporations.

^f This figure includes \$32,456,663 corporation income tax and \$10,671,077 corporation excise tax.

^g Segregation of items contained herein not given in official sources. See note h, this table.

^h The fiscal year reports of the federal government do not show separately the receipts from the individual income tax, the corporation income tax, and the excess profits and war profits taxes for these years. The annual *Statistics of Income* volumes, however, give figures representing, approximately, collections on a calendar-year-income basis. They are as follows (absolute yield figures in millions of dollars):

NOTES TO TABLE C (Continued)

Year When Taxable Income Was Received (<i>Statistics of Income</i>)	Total Revenue: Income and Excess Profits and War Profits Taxes		Excess Profits and War Profits Taxes		Corporation Income Tax		Individual Income Tax	
	For Fiscal Year Ending Succeeding Year (e.g., for 1917 read 1918), taken from Table C above	From <i>Statistics of Income</i>	Amount	Per Cent of Total Given in <i>Statistics of Income</i>	Amount	Per Cent of Total Given in <i>Statistics of Income</i>	Amount	Per Cent of Total Given in <i>Statistics of Income</i>
1917.....	2,839.0	2,817.7	1,638.7	58	503.7	28	675.2	24
1918.....	2,600.8	4,286.5	2,505.6	58	653.2	15	1,127.7	16
1919.....	3,956.9	3,445.0	1,431.8	42	743.5	22	1,269.6	37
1920.....	3,228.1	2,700.3	988.7	37	636.5	24	1,075.1	40
1921.....	2,086.9	1,421.0	335.1	24	366.4	26	719.4	51
1922.....	1,691.1	1,644.8	8.5	1	775.3	47	861.1	52
1923.....	1,841.8	1,600.8	—	—	937.1	59	663.7	41

¹ Less than $\frac{1}{2}$ of 1 per cent.

² This total does not include the excess profits tax levied under the National Industrial Recovery Act of 1933 and subsequent acts, since the figures are available separately on a fiscal year basis. Moreover, this excess profits tax has a natural and legal connection, not with the income taxes, but with the capital stock tax. The figures are as follows, except for 1937, for which no recent estimate is available (absolute yield figures in millions of dollars):

Year	Tax
1934.....	2.6
1935.....	6.6
1936.....	14.5

³ For basis of estimates, see pp. 514-15.

⁴ Segregated data not available.

in the field,"¹² and, as to the constituent items, are available only on this collection basis. Although the heading for the total, in the reports of the Commissioner of Internal Revenue, is "internal-revenue collections," it is evident, from details given in various tables of the reports, that the item consists practically entirely of taxes. For 1936, the items are from a preliminary Treasury statement.¹³

The data on customs duties are not available on a collections basis, and are reported here on the "Daily Treasury Statement (unrevised)" basis, as given in the summary table of receipts and expenditures (Table 4) in the report of the Secretary of the Treasury for 1935, pages 320-23, for 1916 to 1935, inclusive. For 1913 to 1915 inclusive, the data (from the same table) are on the basis of warrants issued.¹⁴ The 1936 figure is from the September 2, 1936, budget message.

Tables B-F do not exhibit certain refinements in procedure. The figures of yield are in all cases evened off to the nearest \$100,000, to conserve space and to make the summary of the data easier for the reader to absorb. For the same reasons, the percentage figures are only to the nearest full per cent.

The figures are gross, before deduction for refunds and draw-backs.

The agricultural adjustment taxes, not shown separately in these tables—but included in the internal revenue total in Table B—produced \$371,400,000 in their first fiscal year, 1934 (12 per cent of total federal tax revenue), rose to \$526,200,000 the next year (14 per cent), and dropped to \$71,600,000 in 1936 (2 per cent), the year of their invalidation by the Supreme Court. These figures consist of the yield of the processing, import compensating, and floor taxes, and the cotton ginning tax and tobacco sales tax.

The taxes not shown separately in Tables B to F are minor taxes, both in yield and in general public interest. Aside from their public interest, the taxes in Table F, except the capital stock tax and the gasoline tax, might likewise have been omitted on these grounds.

NOTE 2 (p. 31). *Sources for Recent History of State and Local Taxation in the United States.* In the absence of a detailed history of state and local taxation in the United States, reliance has been placed chiefly on the *Proceedings of the . . . National Tax Association, 1915-35, passim*, especially the reviews of current legislation by M. Markham Flannery, C. C. Williamson, O. C. Lockhart, William E. Hannan, Beulah Bailey, Harold M. Groves, and Raymond E. Manning. See also, for death taxes, Roy G. Blakey, "The New Revenue Act," *American Economic Review*, VI, No. 4 (December 1916), 844.

¹² *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1935*, p. 294. These reports hereafter cited as *Report of the Secretary of the Treasury*.

¹³ Treasury Department, Bureau of Internal Revenue, *Internal Revenue Collections, Fiscal Year 1936: Preliminary Statement, August 17, 1936*.

¹⁴ For an explanation of the several bases, see *Report of the Secretary of the Treasury, 1935*, pp. 293-95.

TABLE D
 FEDERAL LIQUOR TAXES, 1913-37
 (Absolute Yield Figures Are in Millions of Dollars)

Fiscal Year	Total Liquor Taxes ^a		Total Wine Taxes ^b		Total Spirits Tax ^c		Total Fermented Liquor Taxes	
	Amount	Per Cent of Total Tax Revenue	Amount	Per Cent of Total Liquor Taxes	Amount	Per Cent of Total Liquor Taxes	Amount	Per Cent of Total Liquor Taxes
1913.....	230.1	35	—	—	163.9	71	66.3	29
1914.....	226.2	34	—	—	159.1	70	67.1	30
1915.....	223.9	36	2.3	1	142.3	64	79.3	35
1916.....	247.5	34	2.6	1	156.1	63	88.8	36
1917.....	284.0	27	5.2	2	186.9	66	91.9	32
1918.....	443.8	11	9.1	2	308.4	69	126.3	28
1919.....	483.1	12	11.5	2	353.7	73	117.8	24
1920.....	139.9	2	4.7	3	93.2	67	42.0	30
1921.....	82.6	2	2.3	3	80.3	97	d	•
1922.....	45.6	1	1.3	3	44.3	97	d	•
1923.....	30.4	1	1.5	5	28.8	93	d	•

1924.....	27.6	1	1.5	5	26.1	95	d	"
1925.....	25.9	1	1.6	6	24.3	94	d	"
1926.....	26.5	1	1.7	6	24.8	94	d	"
1927.....	21.2	1	0.8	4	20.4	96	d	"
1928.....	15.3	"	0.9	6	14.4	94	d	"
1929.....	12.8	"	0.3	2	12.5	98	d	"
1930.....	11.7	"	0.2	2	11.5	98	—	—
1931.....	10.4	"	0.2	2	10.2	98	—	—
1932.....	8.7	"	0.2	2	8.5	98	—	—
1933.....	43.2	2	0.2	"	7.7	18	35.2	82
1934.....	258.9	9	3.9	2	86.0	33	169.0	65
1935.....	411.0	11	6.8	2	188.7	46	215.6	52
1936.....	505.5	13	9.0	2	247.3	49	249.1	49
1937 ¹	589.2	11	"	"	"	"	"	"

^a Several small items are not shown separately, but are included in the total.

^b Does not include grape brandy for fortifying.

^c Includes grape brandy for fortifying.

^d Less than \$50,000.

^e Less than 1/2 of 1 per cent.

^f For basis of estimate, see pp. 514-15.

^g Segregated data not available.

TABLE E
 FEDERAL TOBACCO TAXES, 1913-37
 (Absolute Yield Figures Are in Millions of Dollars)

Fiscal Year	Total Tobacco Tax ^a		Total Large-Cigar Tax		Small-Cigarette Tax		Manufactured Tobacco and Snuff Tax	
	Amount	Per Cent of Total Tax Revenue	Amount	Per Cent of Total Tobacco Tax	Amount	Per Cent of Total Tobacco Tax	Amount	Per Cent of Total Tobacco Tax
1913.....	76.8	12	23.1	30	17.8	23	35.0	46
1914.....	80.0	12	23.0	29	20.5	26	35.6	45
1915.....	80.0	13	21.2	26	20.9	26	34.6	43
1916.....	88.1	12	22.2	25	26.3	30	36.0	41
1917.....	103.2	10	24.8	24	38.1	37	38.5	37
1918.....	156.2	4	30.0	19	66.4	42	51.5	33
1919.....	206.0	5	36.1	18	90.4	44	62.6	30
1920.....	295.8	5	55.4	19	151.2	51	81.6	28
1921.....	255.2	5	51.1	20	135.1	53	65.1	26

1922.....	270.8	8	44.2	16	150.1	55	73.3	27
1923.....	309.0	10	47.3	15	182.6	59	76.0	25
1924.....	325.6	10	45.2	14	203.7	63	73.7	23
1925.....	345.2	11	43.3	13	225.0	65	73.7	21
1926.....	370.7	11	38.3	10	254.8	69	74.6	20
1927.....	376.2	11	23.5	6	278.9	74	72.0	19
1928.....	396.5	12	22.9	6	301.8	76	70.2	18
1929.....	434.4	12	22.5	5	342.0	79	68.3	16
1930.....	450.3	12	21.1	5	359.8	80	67.6	15
1931.....	444.3	16	18.0	4	358.9	81	65.6	15
1932.....	398.6	21	14.2	4	317.5	80	64.9	16
1933.....	402.7	22	11.3	3	328.4	82	61.9	15
1934.....	425.2	14	11.6	3	349.7	82	62.1	15
1935.....	459.2	13	11.7	3	385.5	84	60.9	14
1936.....	501.2	13	12.2	2	425.5	85	62.0	12
1937 ^b	531.7	10	°	°	°	°	°	°

^a These total figures include small miscellaneous taxes on tobacco that are not stated separately. They do not include any of the agricultural adjustment taxes.

^b For basis of estimate, see pp. 514-15.

^c Segregated data not available.

For a convenient compilation showing the status of personal income taxes in 1911, 1918, 1920, 1924, and 1930, see "The Personal Income Tax and School Support," *Studies in State Educational Ad-*

TABLE F

FEDERAL TAXES ON CAPITAL STOCK, ADMISSIONS, CAPITAL STOCK TRANSFERS, AND GASOLINE AND OTHER AUTOMOTIVE PRODUCTS, 1913-37

(In Millions of Dollars)

Fiscal Year	Capital Stock Tax	Admissions Tax	Capital Stock Transfers Tax	Gasoline Tax	Other Automotive Taxes
1913.....	—	—	—	—	—
1914.....	—	—	—	—	—
1915.....	—	—	—	—	—
1916.....	—	—	—	—	—
1917.....	10.5	—	—	—	—
1918.....	25.0	26.4	2.2	—	24.0
1919.....	28.8	50.9	7.5	—	48.8
1920.....	93.0	76.7	13.4	—	143.9
1921.....	81.5	89.7	8.8	—	115.5
1922.....	80.6	73.4	9.0	—	104.4
1923.....	81.6	70.2	9.9	—	144.3
1924.....	87.5	77.7	7.9	—	158.0
1925.....	90.0	30.9	12.8	—	124.7
1926.....	97.4 ^a	24.0	17.1	—	138.2
1927.....	9.0	17.9	16.7	—	66.4
1928.....	8.7	17.7	24.2	—	51.6
1929.....	6.0	6.1	37.6	—	5.5
1930.....	—	4.2	46.7	—	—
1931.....	—	2.8	25.5	—	—
1932.....	—	1.9	17.7	—	—
1933.....	—	15.5	33.2	124.9	49.1
1934.....	80.2	14.6	38.1	202.6	96.1
1935.....	91.5	15.4	15.7	161.5	105.1
1936.....	94.9	17.1	33.1	177.1	121.7
1937.....	b	0	0	0	a

^a Repealed, effective July 1, 1926.

^b Segregated data not available; total of capital stock tax and excess profits tax is estimated at \$121,000,000.

^c Segregated data not available.

ministration, National Education Association, Study No. 8, February 1931 (Washington). For income tax developments since 1930, see James W. Martin, "State Income Taxes," *State Government*, VII, No. 4 (April 1934), 77-84; Raymond E. Manning, series on "State Tax Legislation," *Bulletin of the National Tax Association*, March-June inclusive, 1934 and 1935; same, "State Tax Legislation, 1934," *Proceedings of the . . . National Tax Association*, 1934, pp. 17-32; same, "State Tax Legislation, 1935," *Proceedings of the . . . National Tax Association*, 1935, pp. 27-60; same, *State Tax Legislation*, 1936, pre-print. For gasoline tax history see Crawford, *op. cit.*

NOTE 3 (p. 46). *Notable Decreases in Property Tax Assessments or Collections, State and Local*. In only a few states are data available to show the aggregate state and local property tax levies or collections. Some striking instances of property tax decreases in recent years are, however, at hand. They indicate decreases in levies from \$140,000,000 in 1932 to \$91,000,000 in 1935 (Indiana),¹⁵ from \$267,000,000 in 1931 to \$159,000,000 in 1934 (Michigan),¹⁶ and from \$44,000,000 in 1932 to \$25,000,000 within a year or two (West Virginia).¹⁷ The change in the rural tax burden generally is indicated by the statement, "The farm real estate tax bill in 1935 was \$365,000,000, the smallest in sixteen years. . . . The total compares with a peak of \$567,000,000 in 1929, with \$393,000,000 in 1919, and with \$218,000,000 in 1913."¹⁸

NOTE 4 (p. 47). *Fluctuation in Urban Property Tax Rates and Assessed Valuations during the Depression*. Since the cities' chief source of local revenue is the property tax, and in view of the decreases in valuations and delays in collection that occurred during 1929-33, a steadily increasing property tax rate for city purposes might be expected, even with decreased expenditures and increased aid from the state and federal governments.

The data collected by C. E. Rightor and Rosina Mohaupt,¹⁹ however, show a remarkable stability in average rate for the cities of more than 30,000 population.²⁰ As Table G indicates, the greatest change shown by the unweighted average tax rate in any one year was a decrease of 8½ cents per \$100 of assessed value, in 1933. Five years showed increases, and two showed decreases. If the estimated rate on true value is considered instead, the greatest year-to-year change in the average is an increase of 9½ cents per \$100, in 1932. Five years showed increases, and two showed decreases.²¹

¹⁵ Statement made by Philip Zoetcher, in *Proceedings of the . . . National Tax Association*, 1935, p. 256.

¹⁶ Statement made by Melville B. McPherson, in *Proceedings of the . . . National Tax Association*, 1935, p. 263.

¹⁷ Statement by Fred L. Fox, State Tax Commissioner, West Virginia, in *Proceedings of the . . . National Tax Association*, 1934, pp. 124, 125.

¹⁸ This computation, made by the Bureau of Agricultural Economics, is in *Report Farm Tax Bill Smallest in 16 Years*, Information for the Press, July 13, 1936, Department of Agriculture, Office of Information, Press Service.

¹⁹ Published each year in the December issue of the *National Municipal Review*, e.g., "Comparative Tax Rates of 301 Cities, 1935," pp. 686-98, December 1935.

²⁰ These data usually cover between 250 and 300 cities (nearly all the cities of this size group). The figures on year-to-year changes refer only to the cities for which comparable data were available. They numbered over 200 in every year except in comparing 1929 with 1930 and 1930 with 1931. The data through 1935 were compiled by Rightor; those for 1936, by Mohaupt.

²¹ Transforming actual rates on assessed values into rates on estimated true values is

The averages, however, conceal a number of appreciable fluctuations in urban tax rates. For the ten largest cities, the actual rates per \$1,000 for 1932 and 1933 as shown by Rightor are given in Table H.

TABLE
TAX RATES AND ASSESSED VALUATIONS IN
(For source,

I. INCREASES AND DECREASES FROM YEAR TO												
Year	Actual Tax Rate, Unweighted Average (In Dollars per Thousand)					Estimated True Tax Rate, (In Dollars)						
1936	0.57 ^a increase					0.61 ^a						
1935	0.53 ^b decrease					0.19 ^b						
1934	0.26 ^c increase					0.71 ^c						
1933	0.85 ^d decrease					0.57 ^d						
1932	0.04 ^e increase					0.92 ^e						
1931	0.10 ^f increase					0.58 ^f						
1930	0.56 ^g increase					0.05 ^g						
II. RATES AND ASSESSED												
Year	Actual Tax Rate, Unweighted Average (In Dollars per Thousand)					Estimated True Tax Rate, (In Dollars)						
1936	35.29					26.30						
1935	34.72 34.55					25.69 25.84						
1934	35.08 34.56					26.03 25.99						
1933	34.30 34.66					25.28 ^k						
1932	35.51 35.03 ^j					^k						
1931	34.99 ^j 34.03 ^j											
1930	33.93 ^j											
1929												
Number	of	Cities	230	233	217	241	256	177	230	233	217	241

^a 230 cities.

^b 233 cities.

^c 217 cities.

^d 241 cities.

^e 256 cities; may include some Canadian cities.

^f 177 cities; may include some Canadian cities.

^g 154 cities; may include some Canadian cities.

For the ten next largest cities fluctuations are found in nine instead of eight cities, but on the average they are slightly less pronounced, as shown in Table I.²²

Some evidence exists that the assessed values in urban areas did

of course a hazardous proceeding, and some commentators prefer to make little or no use of such data. See John E. Burton, "The General Property Tax as a Real Estate Tax," in John M. Gries and James Ford, eds., *Home Finance and Taxation: Reports of the Committees on Finance and Taxation* (Washington, 1932), pp. 151-52.

²² In the ten largest cities, the greatest change is 6.1; in the next ten cities it is 5.2. The median change is, respectively, 1.965 and 1.04; the mean change is, respectively, 1.95 and 1.76.

not go down so rapidly as actual values, however these latter may be estimated. One observer finds that "adjusted full valuations of property assessed for tax purposes in all [the ninety-three] American cities of over 100,000 population . . . [declined] 30.4 per cent from

G

CITIES OVER 30,000 IN THE UNITED STATES, 1929-36

see text)

YEAR IN TAX RATES AND ASSESSED VALUATIONS

Unweighted Average <i>per Thousand</i>)	Total Assessed Valuation <i>(In Per Cent)</i>
increase	^b increase
decrease	2 decrease
increase	6 decrease
decrease	8 decrease
increase	4 decrease
increase	^b increase
increase	ⁱ

VALUATIONS FOR EACH YEAR

Unweighted Average <i>per Thousand</i>)	Total Assessed Valuation <i>(In Thousands of Dollars)</i>										
	64.049										
	63.969	63.241									
		64.411	63.011								
			67.334	73.504 ¹							
26.31 ⁱ				79.681 ¹							
25.39 ⁱ	25.44 ⁱ							76.889			
	24.86 ⁱ	24.31						80.363	^m		
		24.26							ⁱ		ⁱ
156	177	154	230	233	217	258 ¹	241	177	154		

^b Less than 1 per cent.

ⁱ Not given.

^j May include Canadian cities.

^k Average reduction was 0.57. Absolute figures not given.

¹ Includes Canadian figures. Of the total decrease of \$6,177,000,000, the United States cities accounted for \$6,141,000,000.

^m Aggregate increase of \$221,000,000. Includes Canadian cities.

TABLE H
URBAN TAX RATES, 1932-33, IN TEN LARGEST CITIES

	New York	Chicago	Philadelphia	Detroit	Los Angeles
1932.	26.80	67.40	27.75	35.21	43.50
1933.	24.30	73.50	27.75	32.24	42.50
	Cleveland	St. Louis	Baltimore	Boston	Pittsburgh
1932.	27.60	27.10	27.00	35.50	37.21
1933.	27.60	27.40	29.00	32.80	35.28

TABLE I

URBAN TAX RATES, 1932-33, IN SECOND TEN LARGEST CITIES

	San Francisco	Milwaukee	Buffalo	Washington	Minneapolis
1932.....	39.60	33.36	30.46	17.00	29.13
1933.....	34.80	32.97	26.88	17.00	29.21
	New Orleans	Cincinnati	Newark	Kansas City	Seattle
1932.....	33.48	20.70	38.00	33.70	36.16
1933.....	34.48	21.96	32.80	33.90	37.24

the peak valuations to the lowest valuations during the seven-year period from 1929 to 1935 inclusive." The figures totalled for the peak valuation aggregate are each city's peak-year figure—the figures are not for the same year. A similar method is used in reaching the lowest valuation.²³

CHAPTER 5

NOTE 1 (p. 58). *Political Limits to Taxable Capacity*. The boundary of political capacity to pay taxes can be located only by overstepping it—that is, by levying a tax that becomes delinquent in whole or in part. Under almost every tax law a certain number of taxpayers refuse to fulfill their legal tax duties, and escape punishment. A certain number of others pay, but only under duress. Therefore, the political limit of taxable capacity is in a sense always being overstepped. The overstepping becomes significant, however, only when it involves a large number of taxpayers. No precise number can be set, and thus the political limit is an indefinite one. When refusal to pay has reached the stage of a "taxpayers' strike," the limit has surely been passed.

An overstepping of the political limit often results from a defect in the lines of communication between the community at large and its representatives in the legislature. Changes in the limit occur too suddenly for the legislators to adapt the tax system in time. The first clear indication that they get that the limit has been exceeded may be a taxpayers' strike. Another cause of overstepping the limit is the assumption of heavy fixed charges that are scheduled to last for many years. The taxpayers, in effect, fail to gauge accurately their own future willingness—or the willingness of future generations—to pay taxes.

The political limit may be expanded by changing the structure of the tax system. In recent years some states, for example, Illinois,

²³ J. L. Jacobs, "Urban Property Tax Valuation Trends," *The Tax Magazine*, XIV, No. 5 (May 1936), 263-66, 320.

Michigan, and Ohio, seem to have been able to raise a certain aggregate amount of tax revenue within a given time only by lightening the property tax and employing some other tax.

NOTE 2 (p. 61). *New Fabian Research Bureau Report*. One example of such reasoning is found in the report of the taxation committee of the New Fabian Research Bureau, under the chairmanship of Mrs. Barbara Wootton.²⁴ This report is particularly valuable for the present discussion, since it takes account of the high tax rates of the war and post-war period. The committee is careful not to make unqualified statements concerning the location of the limit on taxable capacity, but it expresses an opinion that "it would . . . appear that the limits of redistributive taxation as an engine of social reform may soon be reached."²⁶

CHAPTER 6

NOTE 1 (p. 9). *State Tax Revenues, 1936*. The amounts of state tax collections for the latest fiscal years for which these are available are given in Tables J and K below. In all but two states these figures are for the fiscal year ending between October 1, 1935 and September 30, 1936. Where data on all tax collections during the latest year were not available, figures for earlier years have been used. For these individual taxes the period has been indicated. Also, for a few taxes, as noted, it has been necessary to estimate the yield. Most of the data were supplied by officials on uniform schedules sent to them. The figures were transcribed as given. Thus, differences in local usage of terms account for apparent discrepancies, e.g., sales tax revenue in Florida. Printed reports were used for a few states. Data not obtained directly from official state sources have been noted.

Table J gives state-administered taxes collected for both state and local use, and all locally administered taxes collected for state use. Table K gives state taxes after deducting the local share.

Tax revenues that eventually reach local governments as grants-in-aid are included even in Table K. The amount of shared taxes deducted is given, by taxes, elsewhere.²⁶

²⁴ *Taxation under Capitalism: Effects on Social Services* (London, n.d.). Hereafter cited as *Taxation under Capitalism*. Another discussion that is made against the background of recent high rates and that mentions more factors that control the effects of taxation on business initiative and savings is to be found in H. A. Silverman, *Taxation—Its Incidence and Effects* (London, 1931), pp. 120-24, 138, 167-81, 198-209, 216-23, 244-46, and 250-53. For a summary of the factors that need to be taken into consideration in defining "taxable capacity," with particular reference to comparisons between taxing jurisdictions, see *ibid.*, pp. 52-65.

²⁵ *Taxation under Capitalism*, p. 23.

²⁶ See Table R, p. 578 (estimated on a different basis, before Table K data were available).

TABLE J
STATE TAX COLLECTIONS, INCLUDING LOCAL SHARE, 1936
(In Thousands of Dollars)

State	Property	Severance	Corporation, Other Than Income	Corporation Income	Personal Income	General Sales	Liquor	Tobacco
Alabama	6,108 ^a	368 ^a	2,489 ^a	352 ^b	420 ^b	—	—	2,755
Arizona	3,218 ^a	—	141 ^o	333 ^d	480 ^d	2,680	825	468
Arkansas	4,120 ^f	346	900 ^f	181 ^d	190 ^d	2,905	1,115	1,179
California	—	—	6,381	14,989	6,526	72,189	12,854	—
Colorado	3,856	—	128	—	—	5,809	2,342	—
Connecticut	2,342	—	5,017	3,549	—	—	3,587	2,067
Delaware	—	—	3,178	—	908	—	512	—
Florida	3,137	—	1,609	—	—	420	667 ^o	2,819
Georgia	4,356	—	1,206	1,388	706	1	238	1,126
Idaho	1,518	—	415	569 ^d	380 ^d	2,320	387	—
Illinois	1,967	—	11,526	—	—	64,240	9,310	—
Indiana	6,272	—	1,838	—	—	16,629	5,669	—
Iowa	1,290	—	1,626	494	3,222	13,404	1,185	1,482
Kansas	3,622	—	1,236	534	1,049	—	—	915
Kentucky	4,915	30	1,478	—	—	7,004	5,812	292
Louisiana	10,278	3,960	1,240	1,274	925	—	2,569	2,895
Maine	4,950	—	2,138	—	—	—	1,422 ^z	—
Maryland	347 ^a	—	3,054 ^a	—	—	2,629	2,074	227
Massachusetts	—	—	17,115	2,258	16,727	—	4,113	—
Michigan	—	365	8,665	—	—	45,642	10,226	—
Minnesota	18,811	462	7,167	2,398 ^h	1,199 ^h	—	3,270	185

Mississippi	1,733	—	1,108	384 ^h	489 ^h	4,236	164	1,459
Missouri	1,919	—	3,662	1,772 ^h	2,657 ^h	5,158	4,840	—
Montana	2,418	323	314	263	228	—	1,804	16
Nebraska	4,317	—	675	—	—	—	1,579	—
Nevada	1,273	24	95	—	—	—	179	—
New Hampshire	—	—	1,340	—	405	—	1,625	—
New Jersey	17,648	—	18,538	—	—	7,100 ^h	7,630	—
New Mexico	1,989 ^o	459 ^o	98 ^o	108	72	2,362	403	—
New York	2,228	—	43,686	39,005	85,902	164	36,477	—
North Carolina	376 ^o	—	6,631 ^o	5,856	1,867	10,184	624	—
North Dakota	2,297	—	261	91	222	2,508	696	399
Ohio	—	—	15,459	—	5,681	44,994	18,460	5,996
Oklahoma	435	10,420	1,619	3,059	1,668	5,835	894	1,937
Oregon	4,555	—	1,078	855	1,679	—	1,922	—
Pennsylvania	—	—	30,862 ⁱ	12,963	—	65	24,096	8,857
Rhode Island	1,154	—	3,149	—	—	—	1,543 ⁱ	—
South Carolina	1,815 ^o	—	1,128 ^o	1,193	899	—	1,905	1,687
South Dakota	314	635	289	49 ^h	50 ^h	3,316	667	531
Tennessee	1,000	—	1,885	375	584	982	452	2,346
Texas	21,528 ^k	9,519 ^k	5,100 ^k	—	—	—	4,139	5,657
Utah	1,138	—	298	508	499	2,967	105	284
Vermont	—	—	1,546	—	564	—	655	—
Virginia	2,364	—	6,304	1,800	1,039	—	4,511	108 ^h
Washington	7,005 ^m	—	1,328 ^a	—	—	10,116 ^h	3,261	664
West Virginia	1,307 ^o	—	1,650 ^h	—	1,150	19,807	958	—
Wisconsin	419	51	10,683	6,594	5,986	—	5,225	—
Wyoming	600	—	151	—	—	1,484	305	—
Total	160,939	26,962	238,484	103,294	144,373	357,150	193,296	46,351

TABLE J (Continued)
 STATE TAX COLLECTIONS, INCLUDING LOCAL SHARE, 1936
 (In Thousands of Dollars)

State	Motor Vehicle	Motor Fuel	Death	Poll	Other	Total	Fiscal Year Ending
Alabama.....	3,146 ^b	11,234	103	210 ^a	2,592 ^a	29,777	September 30, 1936
Arizona.....	848 ^b	4,076	37	—	922 ^a	14,028	June 30, 1936
Arkansas.....	2,839	8,590	96	—	670	23,131	June 30, 1936
California.....	12,318	42,368	6,561	—	—	174,186	June 30, 1936
Colorado.....	2,021	7,263	717	—	—	22,136	June 30, 1936
Connecticut.....	5,923	7,192	2,252	—	2,571	34,500	June 30, 1936
Delaware.....	970	1,742	459	—	63	7,832	June 30, 1936
Florida.....	5,021	18,823	3,391	—	2,719	38,607	June 30, 1936
Georgia.....	1,424	15,772	96	249	1,341	27,904	December 31, 1935
Idaho.....	466	3,321	48	—	427	9,851	June 30, 1936
Illinois.....	18,632	33,486	3,869	—	4,544	147,574	June 30, 1936
Indiana.....	7,425	21,119	1,084	—	1,327	61,363	June 30, 1936
Iowa.....	10,300	12,972	1,144	—	4,156	51,275	June 30, 1936
Kansas.....	4,501	9,019	436	—	120	21,432	June 30, 1936
Kentucky.....	3,755	10,558	335	—	987	35,166	June 30, 1936
Louisiana.....	3,547	11,335	362	—	1,854	40,239	December 31, 1935
Maine.....	3,247	4,610 ^c	642 ^c	2	573	17,584	December 31, 1935
Maryland.....	4,100 ^b	8,717	1,419	—	7,045 ^a	29,612	September 30, 1936
Massachusetts.....	7,079	17,383	5,967	—	1,951	72,593	November 30, 1935
Michigan.....	17,894	23,841	2,108	—	2,659	111,400	June 30, 1936
Minnesota.....	7,023	11,241	1,235	—	3,494	56,485	June 30, 1936
Mississippi.....	2,213	8,834	89	—	1,487	22,196	June 30, 1936
Missouri.....	8,351 ^b	9,749	1,491	—	797	40,396	December 31, 1935

Montana	1,271 ^a	4,086 ^b	68	—	67	10,858 ^o	June	30, 1936
Nebraska	2,099	10,508	119	—	—	19,297	June	30, 1936
Nevada	484	1,085	—	—	128	3,268 ^p	June	30, 1936
New Hampshire	2,342	2,999	336	—	559	9,606	June	30, 1936
New Jersey	16,629	20,677	21,749	—	51	110,022	June	30, 1936
New Mexico	1,109 ^b	3,057	31	—	103 ^o	9,791	June	30, 1936
New York	44,336	60,178	26,420	—	41,253	379,649	June	30, 1936
North Carolina	6,614 ^b	18,809	540	18 ^o	1,821 ^o	53,340	June	30, 1936
North Dakota	1,618	2,104	78	—	26	10,300	June	30, 1936
Ohio	21,742	37,645	3,232	—	2,813	156,022	December	31, 1935
Oklahoma	5,087	13,395	451	—	—	44,800	June	30, 1936
Oregon	3,514	7,931	716	—	20	22,270	June	30, 1935
Pennsylvania	32,155 ^b	44,777	19,548	—	12,364 ⁱ	185,687	May	31, 1936
Rhode Island	2,416 ^b	2,147 ^a	894 ^a	—	882	12,185	June	30, 1935
South Carolina	1,849 ^b	8,806	297	—	4,292 ^o	24,971	June	30, 1936
South Dakota	903	4,402	82	—	43	11,281	June	30, 1936
Tennessee	3,749	15,649	647	—	55	27,724	June	30, 1936
Texas	15,059 ⁱ	36,242	1,150	1,117 ^k	1,454 ^k	100,965	August	31, 1936
Utah	1,259	2,899	195	—	98	10,250	June	30, 1936
Vermont	2,131	2,161	326	395	247	8,125	June	30, 1936
Virginia	5,638	13,699	930	810	3,763	40,966	June	30, 1936
Washington	3,515	12,536	627	—	641 ^m	39,693	March	31, 1936
West Virginia	4,515 ⁿ	4,654	510	300 ^b	478	35,329 ^u	June	30, 1936
Wisconsin	12,397	16,741	3,954	—	324	62,374	June	30, 1936
Wyoming	167	1,971	20	—	—	4,698	March	31, 1936
Total	325,742	652,403	116,861	3,101	113,781	2,482,738		

^a September 30, 1935.^b December 31, 1935.^o June 30, 1934.^d Division between personal and corporation income taxes estimated on basis of preceding year's return.^o June 30, 1935.^f Estimated on basis of earlier years' levies and collections^p June 30, 1936.^h Estimate in Treasury Department, *Collections from Selected State-Imposed Taxes*, 1936.ⁱ May 31, 1935.^u November 30, 1935.^k August 31, 1935.^l March 31, 1936.^m March 31, 1935.ⁿ March 31, 1934.^o Complete data for 1936, received too late for incorporation in the table, show a total of \$46,848,000 for West Virginia, and \$11,249,000 for Montana, \$391,000 of shared taxes having been omitted in the latter case.^p No record of Nevada's shared taxes has been found. They amounted to \$24,000 in 1935.

TABLE K
STATE TAX COLLECTIONS, EXCLUDING LOCAL SHARE, 1936
(In Thousands of Dollars)

State	Property	Severance	Corporation, Other Than Income	Corpora- tion Income	Personal Income	General Sales	Liquor	Tobacco
Alabama	6,108 ^a	368 ^a	2,293 ^a	352 ^b	420 ^b	—	—	2,755
Arizona	3,218 ^e	—	141 ^e	333 ^d	480 ^d	2,680	825	468
Arkansas	4,120 ^f	231	900 ^f	181 ^d	190 ^d	2,905	1,115	1,179
California	—	—	6,381	14,989	6,526	72,189	10,768	—
Colorado	3,856	—	128	—	—	5,809	2,342	—
Connecticut	2,154	—	5,017	3,549	—	—	1,800	2,067
Delaware	—	—	3,178	—	908	—	512	—
Florida	3,137	—	1,609	—	—	420	667 ^e	2,819
Georgia	4,356	—	1,206	1,388	706	1	238	1,126
Idaho	1,518	—	415	569 ^d	380 ^d	2,320	387	—
Illinois	1,967	—	11,526	—	—	64,240	9,310	—
Indiana	3,393	—	1,838	—	—	8,324	2,961	—
Iowa	1,290	—	1,626	494	1,212	6,278	1,044	1,232
Kansas	3,622	—	1,236	534	1,049	—	—	686
Kentucky	4,915	30	1,478	—	—	4,684	5,812	292
Louisiana	10,278	3,145	1,240	1,274	925	—	2,569	2,895
Maine	4,950	—	2,031	—	—	—	1,422 ^e	—
Maryland	347 ^a	—	2,895 ^a	—	—	1,629	2,074	227
Massachusetts	—	—	9,255	2,258	1,250	—	1,944	—
Michigan	—	146	8,665	—	—	23,601	10,226	—
Minnesota	18,811	462	7,149	2,398 ^b	1,199 ^b	—	3,270	185

Mississippi.....	1,733	—	1,108	384 ^h	489 ^h	4,236	164	1,459
Missouri.....	1,919	—	2,565	1,772 ^h	2,657 ^h	5,158	4,840	—
Montana.....	2,418	323	314	263	228	—	1,804	16
Nebraska.....	4,317	—	675	—	—	—	1,308	—
Nevada.....	1,273	24	95	—	—	—	179	—
New Hampshire.....	—	—	1,115	—	—	—	1,484	—
New Jersey.....	17,648	—	6,222	—	—	7,100 ^h	7,630	—
New Mexico.....	1,989 ^o	372 ^a	98 ^o	108	72	2,362	403	—
New York.....	2,228	—	43,986	27,066	74,329	164	18,533	—
North Carolina.....	376 [*]	—	6,631 ^o	5,856	1,867	10,184	624	—
North Dakota.....	2,297	—	261	91	222	108	696	399
Ohio.....	—	—	13,210	—	238	14,620	14,568	355
Oklahoma.....	365	8,321	1,420	3,059	1,668	5,835	46	1,937
Oregon.....	4,555	—	1,078	855	1,679	—	1,376	—
Pennsylvania.....	—	—	30,120 ⁱ	12,963	—	65	24,096	8,857
Rhode Island.....	1,154	—	3,149	—	—	—	595 ^j	—
South Carolina.....	1,815 ^o	—	1,913 ^o	1,293	899	—	1,238	1,687
South Dakota.....	314	635	273	49 ^h	50 ^b	3,316	334	531
Tennessee.....	1,000	—	1,885	375	321	982	452	2,346
Texas.....	21,528 ^k	9,519 ^k	5,100 ^k	—	—	—	4,139	5,657
Utah.....	1,138	—	298	240	139	2,367	105	284
Vermont.....	—	—	1,546	—	564	—	655	—
Virginia.....	2,364	—	6,304	1,800	1,039	—	4,511	108 ^b
Washington.....	7,005 ^m	—	1,328 ⁿ	—	—	10,116 ^b	2,211	664
West Virginia.....	1,307 ^o	—	1,650 ^h	—	1,150	12,334	958	—
Wisconsin.....	419	20	3,696	3,682	3,360	—	2,756	—
Wyoming.....	600	—	151	—	—	697	305	—
Total.....	157,802	23,596	206,098	88,175	107,226	275,725	155,296	40,231

TABLE K (Continued)
STATE TAX COLLECTIONS, EXCLUDING LOCAL SHARE, 1936
(In Thousands of Dollars)

State	Motor Vehicle	Motor Fuel	Death	Poll	Other	Total	Fiscal Year Ending
Alabama.....	3,129 ^b	5,617	103	210 ^a	2,587 ^a	13,941	September 30, 1936
Arizona.....	727 ^b	2,854	37	—	717 ^a	12,480	June 30, 1936
Arkansas.....	2,839	7,158	96	—	670	21,584	June 30, 1936
California.....	7,108	28,245	6,561	—	—	152,767	June 30, 1936
Colorado.....	1,011	5,084	717	—	—	18,947	June 30, 1936
Connecticut.....	5,800	7,192	2,252	—	2,423	32,254	June 30, 1936
Delaware.....	970	1,742	459	—	63	7,832	June 30, 1936
Florida.....	5,015	11,445	3,391	—	1,315	29,818	June 30, 1936
Georgia.....	1,424	13,266	96	249	1,342	25,398	December 31, 1935
Idaho.....	39	3,321	44	—	427	9,420	June 30, 1936
Illinois.....	18,632	16,556	3,869	—	4,015	130,115	June 30, 1936
Indiana.....	5,894	11,468	1,084	—	211	35,173	June 30, 1936
Iowa.....	10,000	7,207	1,144	—	4,156	35,693	June 30, 1936
Kansas.....	3,101	6,319	436	—	120	17,103	June 30, 1936
Kentucky.....	3,197	10,558	335	—	987	32,288	June 30, 1936
Louisiana.....	3,547	10,334	362	—	1,854	38,423	December 31, 1935
Maine.....	3,247	4,610 ^a	642 ^a	2	472	17,376	December 31, 1935
Maryland.....	3,400 ^b	6,974	1,419	—	7,045 ^a	27,010	September 30, 1936
Massachusetts.....	7,079	17,383	5,967	—	1,951	48,087	November 30, 1935
Michigan.....	441	21,291	2,108	—	2,476	68,955	June 30, 1936
Minnesota.....	7,023	7,494	1,112	—	1,958	51,061	June 30, 1936
Mississippi.....	185	5,147	89	—	1,487	16,481	June 30, 1936
Missouri.....	8,351 ^b	9,749	1,491	—	797	39,299	December 31, 1935

Montana.....	—	4,086	68	—	67	9,587	June	30, 1936
Nebraska.....	2,099	7,238	119	—	—	15,736	June	30, 1936
Nevada.....	484	1,085	—	—	128	3,268	June	30, 1936
New Hampshire.....	2,003	2,999	336	—	—	7,937	June	30, 1936
New Jersey.....	16,629	20,677	20,662	—	38	96,606	June	30, 1936
New Mexico.....	666 ^b	3,057	31	—	103 ^o	9,261	June	30, 1936
New York.....	33,373	52,634	26,420	—	40,291	318,724	June	30, 1936
North Carolina.....	6,614 ^b	18,809	540	18*	1,821 ^o	53,340	June	30, 1936
North Dakota.....	1,618	1,404	51	—	4	7,151	June	30, 1936
Ohio.....	6,564	16,473	1,660	—	176	67,864	December	31, 1935
Oklahoma.....	2,823	10,304	451	—	—	36,229	June	30, 1936
Oregon.....	3,514	7,931	716	—	20	21,724	June	30, 1935
Pennsylvania.....	32,155 ^b	37,314	19,548	—	12,364 ⁱ	177,481	May	31, 1936
Rhode Island.....	2,416 ^b	2,147 ^g	894 ^g	—	662	11,017	June	30, 1935
South Carolina.....	1,849 ^h	7,375	297	—	4,292 ^o	22,658	June	30, 1936
South Dakota.....	200	4,402	74	—	43	10,221	June	30, 1936
Tennessee.....	3,749	10,058	647	—	55	21,870	June	30, 1936
Texas.....	5,059 ^l	36,242	1,150	1,117 ^k	1,454 ^k	90,965	August	31, 1936
Utah.....	1,259	2,899	195	—	98	9,022	June	30, 1936
Vermont.....	2,231	2,161	326	395	247	8,125	June	30, 1936
Virginia.....	5,638	13,460	930	540	3,763	40,457	June	30, 1936
Washington.....	3,515	12,336	617	—	641 ^m	38,443	March	31, 1936
West Virginia.....	4,515 ^o	4,654	510	300 ^h	478	27,856	June	30, 1936
Wisconsin.....	12,397	16,741	3,707	—	169	46,947	June	30, 1936
Wyoming.....	167	1,487	20	—	478	3,905	March	31, 1936
Total.....	253,696	518,987	113,793	2,831	104,465	2,047,921		

^a September 30, 1935.^b December 31, 1935.^o June 30, 1934.^d Division between personal and corporation income taxes estimated on basis of preceding year's return.^o June 30, 1935.^f Estimated on basis of earlier years' levies and collections.^g June 30, 1936.^h Estimate in Treasury Department, *Collections from Selected State-Imposed Taxes*, 1936.ⁱ May 31, 1935.^j November 30, 1935.^k August 31, 1935.^l March 31, 1936.^m March 31, 1935.ⁿ March 31, 1934.

NOTE 2 (p. 89). *Revenue Estimates in Budget of January 5, 1937*. The federal budget for the fiscal year 1938 presents estimates for 1937 yields, which are somewhat, but not markedly, different from those in the September 2, 1936 statement. The new data were not available in time to be incorporated in the text of Chapter 6. The income tax total is \$2,373,000,000 instead of \$2,303,000,000; the estate tax is \$305,000,000 instead of \$268,000,000; the customs estimate is \$447,000,000 instead of \$402,000,000; and the other major taxes or groups of taxes show slight increases. The total revenue of \$5,636,000,000 compares with \$5,477,000,000 in the earlier estimate.

For the fiscal year 1938, marked increases are estimated. The total tax revenue is put at \$7,111,000,000. Of this the income tax is counted on for \$3,365,000,000; the estate tax, \$464,000,000; the customs, \$463,000,000; the liquor taxes, \$644,000,000; the tobacco taxes, \$569,000,000; and the manufacturers' excises, \$449,000,000. The social security taxes are estimated to yield \$775,000,000.

CHAPTER 7

NOTE 1 (p. 98). *Estimates of Federal, State, and Local Expenditures, 1936-40*. Records for all local expenditures are available for only seven states in 1933, four in 1934, and one in 1935. County expenditures are available for one more state in 1933 and 1934. Expenditures of all cities of 100,000 population and over are available for 1933 and 1934, and expenditures of some of these cities are available for 1935. Owing to the inadequacy of these data, the use of expenditures as a basis of estimates for local units has been abandoned in favor of revenues, for which more data are available.

Local expenditures for 1933 to 1935 have been estimated as follows: The ratio of "other revenues" to tax collections was found for 1932.²⁷ This ratio was applied to the 1933, 1934, and 1935 tax collections,²⁸ on the assumption that other revenues varied in proportion to taxes. This would seem to be a reasonable assumption since the proportion of revenues from non-tax sources in cities of over 100,000 population (for which such data are available) varied less than 1 per cent between 1932 and 1933. To the figures for revenue receipts obtained in this fashion net receipts from bond loans reported in the *Commercial and Financial Chronicle*,²⁹ have been added. In 1933 bond payments exceeded bond receipts so that a deduction was called for.

²⁷ *Financial Statistics of State and Local Governments: 1932*.

²⁸ Compiled from state reports and correspondence with state officials. These figures do not vary materially from those reported in *Cost of Government in the United States, 1933-1935*, National Industrial Conference Board Studies, No. 223.

²⁹ "State and Municipal Compendium," *Commercial and Financial Chronicle*, Part I (June 1936). Hereafter cited as *Commercial and Financial Chronicle*.

The resulting figures have been taken to be net local government expenditures.

These estimates differ from the estimates of the National Industrial Conference Board since the latter were obtained by finding the ratio of expenditures (other than those met from bond receipts and sub-

TABLE L

ESTIMATE OF LOCAL EXPENDITURES

Comparison of Method Used in this Survey with That Used by the National Industrial Conference Board in *Cost of Government in the United States, 1933-35*^a

(In Millions of Dollars)

I. N. I. C. B. method:	
Actual expenditures, 1932 (<i>Statistics of State and Local Governments: 1932</i>)	7,057
Less subventions	618
	<hr/>
From local sources, 1932 (cf. N. I. C. B. 6,448)	6,439
Net bond receipts (<i>Commercial and Financial Chronicle</i>)	193
	<hr/>
From revenues and temporary loans	6,246
Taxes	4,716
Ratio of taxes to revenues and temporary loans: 75.5 per cent	
Taxes, 1933: $4,210 \div 75.5 =$ From revenues and temporary loans	5,576
Plus bond receipts	-144
	<hr/>
Local expenditure from local sources, 1933 (cf. N. I. C. B. 5,433)	5,432
Taxes, 1934: $4,143 \div 75.5 =$ From revenues and temporary loans	5,487
Plus bond receipts	121
	<hr/>
Local expenditure from local sources, 1934 (cf. N. I. C. B. 5,621)	5,608
II. Method in this survey:	
Actual expenditures, 1932	7,057
Less subventions	618
	<hr/>
From local sources, 1932	6,439
Tax revenue	4,716
Revenue, all local sources	6,025
Ratio of taxes to revenues: 78.3 per cent	
Taxes, 1933: $4,170 \div 78.3 =$ From revenues	5,325
Plus bond receipts	-144
	<hr/>
Local expenditures from local sources, 1933	5,181
Taxes, 1934: $4,123 \div 78.3 =$ From revenues	5,265
Plus bond receipts	121
	<hr/>
Local expenditures from local sources, 1934	5,386
Taxes, 1935: $4,152 \div 78.3 =$ From revenues	5,302
Plus bond receipts	157
	<hr/>
Local expenditures from local sources, 1935	5,459

^a In this table, referred to as N. I. C. B.

ventions) to taxes in 1932 and applying this ratio to taxes in later years. Net bond receipts in these years were then added. The difference in the two estimates is to be accounted for by the fact that expenditures from temporary loans are not included in the estimate given here, and they are included in the National Industrial Conference Board estimate in so far as 1932 expenditures came from this source. Also, expenditures from bond receipts may have exceeded the sum deducted in 1932, since the data for expenditures are for the fiscal year and the data for net bond receipts are for the calendar year. Unless receipts from temporary loans exceed repayments each year, the sum of revenue receipts plus net bond receipts must, in the long run, equal expenditures. Consequently this sum has been used. Over a long period of years the National Industrial Conference Board method of estimating would run consistently high because temporary loan receipts chanced to exceed repayments in the base year. It is possible, however, that for the short period under consideration the amount of temporary loans has in fact exceeded repayments each year. In this case the National Industrial Conference Board figures will be closer to the fact than the estimates given here. In the absence of any information on this point, however, and in view of the longer period covered in the present estimates, it has seemed better to use the method that would be more accurate for the longer period.

The two methods are shown in Table L.

NOTE 2 (p. 105). *Federal Budget of January 5, 1937*. Estimates based on the 1938 budget are given on p. 541 for 1937-1938. They are comparable to those given in Table 15, which was prepared before the budget was available. The differences in totals are not great. The 1938 budget figure for gross expenditures is 6 per cent above the estimate given in the text. These figures are, however, without the bulk of the anticipated relief expenditures for 1938. If these additional expenditures rise to the \$1,537,000,000 that the President sets as a maximum, gross expenditures will rise to \$7,145,000,000. This is less than 2 per cent above the 1938 estimate based on the assumption that the federal government will continue relief expenditures.

CHAPTER 8

NOTE 1 (p. 123). *Estimates of Tax Revenues*. The *Statement by the President on the Summation of the 1937 Budget*, made on September 2, 1936, estimated that tax revenues for the fiscal year 1937 would total \$5,500,000,000.³⁰

³⁰ All figures in this note are evened off to the nearest \$100,000,000. For more recent data, not available in time to be included in the text computations, see Note 2, *Revenue Estimates in Budget of January 5, 1937*, p. 538.

FEDERAL GOVERNMENT EXPENDITURES FOR 1937 AND 1938 AS ESTIMATED IN THE 1938 BUDGET^a

(In Millions of Dollars)

No.	Purpose	1937	1938
1.	General government.....	35	34
2.	Departments.....	1,255	1,165
	a. War and Navy.....	676	715
	b. Civil.....	579	450
3.	Independent offices.....	846	960
	a. Regular.....	200	211
	b. Emergency.....	39	10
	c. A. A. A.....	468	483
	d. Social Security.....	139	256
4.	Interest.....	835	860
5.	Pensions.....	536	558
	a. Military.....	490	485
	b. Civil.....	46	73
6.	Grants-in-aid.....	761	441
	a. Highways.....	353	262
	b. Relief.....	308	72
	c. Other.....	100	107
7.	Territories.....	8	3
8.	Industries (net).....	36	15
9.	Capital outlay.....	3,049 ^b	791 ^c
10.	C. C. C.....	368	370 ^c
11.	Bonus prepayment.....	564	—
	Net total.....	8,293	5,197
12.	Loans and investments.....	-473	10
13.	Debt payments.....	405	401
	Gross total.....	8,225	5,588
14.	Non-tax revenues.....	190	180
	Expenditures from taxes (or loans).....	8,035	5,408
15.	Payroll taxes.....	325	775
	Expenditures from ordinary taxes (or loans).....	7,710	4,633

^a The classification used is that used in Table 15.^b Including \$750,000,000 from supplemental items.^c \$370,000,000 of supplemental items assigned to C. C. C. and \$80,000,000 to capital outlay.

The state figures are based chiefly on recent data³¹ obtained from state officials, and the local figures are based on estimates made by the National Industrial Conference Board and on the data in Chapter 7.³² The latest figures given by the Conference Board for state taxes and local taxes separately are for 1934, when the totals were \$1,700,000,000 and \$4,100,000,000 respectively.

Data given by the Conference Board show that combined federal, state, and local taxes during the period 1922-34 inclusive reached a peak of \$10,300,000,000 in 1930. In 1922, combined state and local taxes totalled \$4,300,000,000. This figure is undoubtedly higher than any reached in previous years. If the peak figure for federal taxes up

³¹ See Note 1, *State Tax Revenues, 1936*, p. 529.³² *Cost of Government in the United States, 1933-1935*, p. 27. For 1932 figures see *Financial Statistics of State and Local Governments: 1932*, p. 7.

to that time—\$5,700,000,000 for 1920—is added, the total is only \$10,000,000,000.

CHAPTER 9

NOTE 1 (p. 136). *Cases on Federal Taxation for Non-Fiscal Purposes.* In the cases discussed in this note federal taxes were attacked on the grounds that they were penalties to enforce a regulation that Congress had no power to impose.

In the following cases the acts were upheld:

Veazie Bank v. Fenno, 8 Wall. 533 (U. S. 1869), involving the power of Congress to levy a prohibitory tax on state bank notes.

Felsenheld v. United States, 186 U. S. 126 (1902), involving a provision of the Dingley Tariff Act against placing a promise of prizes in tobacco packages.

McCray v. United States, 195 U. S. 27 (1904), involving a federal tax on colored oleomargarine of 10 cents per pound, while the tax on the uncolored product was $\frac{1}{4}$ cent per pound.

United States v. Doremus, 249 U. S. 86 (1919), involving occupational taxes of the Harrison Anti-Narcotic Act.

Nigro v. United States, 276 U. S. 332 (1928), involving the same act as amended.

Hampton and Co. v. United States, 276 U. S. 394 (1928), involving the protective tariff.

In the following cases the acts were held invalid:

Bailey v. Drexel Furniture Co., 259 U. S. 20 (1922), involving the Child Labor Tax Act of 1919.

Hill v. Wallace, 259 U. S. 44 (1922), involving the Future Trading Act of 1921 tax of 20 cents per bushel on contracts in futures except on approved boards of trade.

Trusler v. Crookes, 269 U. S. 475 (1926), involving an additional tax contained in the Future Trading Act of 1921.

United States v. Butler, 297 U. S. 1 (1936), involving the Agricultural Adjustment Act of 1933.

Carter v. Carter Coal Co., 298 U. S. 238 (1936), involving the Bituminous Coal Conservation Act of 1935.

NOTE 2 (p. 138). *Cases on State Taxation for Non-Fiscal Purposes.* The following cases involved the validity under the federal Constitution of state taxes.

In *Pacific Fisheries v. Alaska*, 269 U. S. 269 (1925), a territorial tax on salmon canning, progressive according to number of cases canned, was upheld.

In *State Board of Tax Commissioners v. Jackson*, 283 U. S. 527 (1931), the Indiana act imposing special taxes on chain stores graduated according to number of stores was upheld.

In *Liggett Company v. Lee*, 288 U. S. 517 (1933), the Florida chain store tax providing a greater tax per store when stores are located in more than one county than when they are located in one county was held invalid on the ground that such classification was without reasonable basis.

In *Magnano Co. v. Hamilton*, 292 U. S. 40 (1934), a tax on oleomargarine of 15 cents per pound, imposed by the state of Washington, was upheld.

In *Stewart Dry Goods Co. v. Lewis*, 294 U. S. 550 (1935), the Kentucky progressive gross sales tax was held invalid on the ground that classification of vendors solely by reference to the volume of their transactions denies the equal protection of the laws.

In *Fox v. Standard Oil Co.*, 294 U. S. 87 (1935), the West Virginia chain store tax was upheld. The Court decided that equal protection of the laws was not denied by the tax even though it constituted a much heavier burden on some chains than on others.

The following cases involved the validity of state or local taxes under state constitutions.

In *Fiscal Court Owen Co. v. Cox*, 132 Ky. 738 (1909), a local license tax on four-horse wagons was held invalid as a prohibition of a useful and legitimate occupation.

In *Glenn et al. v. Field Packing Co.*, 290 U. S. 177 (1933), the Supreme Court of the United States upheld an injunction granted by a federal district court against an oleomargarine tax deemed prohibitory on the grounds that it violated the Kentucky Bill of Rights as interpreted by Kentucky courts.

CHAPTER 10

NOTE 1 (p. 141). *Bibliographical Note for the Protective Tariff*. The first revenue act was the Act of July 4, 1789, 1 Stat. 24, chap. ii.

The case in which the tariff was attacked because it set out to encourage the industries of the United States was *Hampton v. United States*, 276 U. S. 394 (1928), the quotation being at p. 412. The case involved the flexible tariff, provided by the flexible tariff act of September 21, 1922, 42 Stat. 858 (1922), 19 U. S. C. A., sec. 121 (1927). It was attacked primarily as a delegation of legislative power.

The case in which the Supreme Court said that protective duties are laid under the commerce power was *University of Illinois v. United States*, 289 U. S. 48 (1933). The interpretation may seem in-

consistent with that in the recent case of *Hampton v. United States*. However, the question at stake was the right of a state to have goods imported without paying the tariff, since the federal government may not tax the instrumentalities of the states. The Court apparently found it convenient to adopt the commerce power interpretation, although it also upset the state's contention under the taxing power, 289 U. S. at 59.

For a discussion of the relation of the tariff to trusts, see Franklin Pierce, *The Tariff and the Trusts* (New York, 1907), pp. 5, 51-66, 372-73.

NOTE 2 (p. 144). *Bibliographical Note for Bank Note Tax*. The tax on state bank notes was imposed by two statutes, 13 Stat. 484 (1865), 12 U. S. C. A., sec. 36 (1927), and 14 Stat. 146 (1866), 12 U. S. C. A., secs. 568, 569 (1927). A discussion of the history of the tax is found in D. R. Dewey, *Financial History of the United States* (11th ed.; New York, 1931), pp. 327-28. The case in which the tax was upheld was *Veazie Bank v. Fenno*, 8 Wall. 533 (U. S. 1869).

NOTE 3 (p. 145). *Bibliographical Note for Oleomargarine Taxation*. The first oleomargarine tax was imposed by the Act of August 2, 1886, 24 Stat. 209. The amending act was the Act of May 9, 1902, 32 Stat. 193 (1902), 21 U. S. C. A., sec. 25 (1927). The change from artificial coloring to yellow color as the test upon which the tax was based was made in the Act of March 4, 1931, 46 Stat. 1549 (1931), 26 U. S. C. A., sec. 972 (1935). The 1902 act was upheld in *McCray v. United States*, 195 U. S. 27 (1904).

The oleomargarine act of the state of Washington appears in Remington's Code, sec. 8358, cited in the Tax Research Foundation, *Tax Systems of the World* (6th ed.; Chicago, 1935), p. 79. The act was upheld by the United States Supreme Court in *Magnano Co. v. Hamilton*, 292 U. S. 40 (1934).

In all, twenty-two states tax oleomargarine at rates ranging from 5 cents to 15 cents a pound. Some of the laws do not apply to oleomargarine made from animal fats. *Tax Systems of the World*, p. 189.

NOTE 4 (p. 146). *Bibliographical Note for Agricultural Adjustment Laws*. The processing taxes were provided in the Agricultural Adjustment Act of May 12, 1933, c. 25, 48 Stat. 31 (1933-34), as amended by Act of August 24, 1935, c. 641, 49 Stat. 750, and by other acts, together with proclamations, certificates, and regulations of the Secretary of Agriculture issued pursuant thereto. The Act of August 24, 1935, placed the rates in the statute.

The cotton tax was included in the Act of April 21, 1934, c. 157, 48 Stat. 598 (1933-34), 7 U. S. C. A., par. 701 (1935). The tobacco

tax was included in the Act of June 28, 1934, c. 866, 48 Stat. 1275 (1933-34).

The Agricultural Adjustment Act was held unconstitutional by the Supreme Court in *United States v. Butler*, 56 Sup. Ct. 312 (1936).

NOTE 5 (p. 148). *Tax Pressure of Mobile Industries*. The case of the farmer "driven out by high taxes" and that of the stone quarry owner threatening to move came to the writer's attention in 1927, but he has no source citations. Wisconsin was the state involved.

The New York Stock Exchange in 1933 threatened to move to New Jersey on account of proposed municipal taxation. The taxes were not imposed.³³ The motion picture industry of California in 1935 threatened to move to a beckoning Florida on account of taxes under consideration by the state legislature.³⁴ The taxes were not imposed. Florida passed a constitutional amendment exempting motion picture studios from taxation for fifteen years.³⁵

The use of similar threats in states in the vicinity of Wisconsin at about the same time is described in G. W. Leffler, *Wisconsin Industry and the Wisconsin Tax System* (2d ed.; Madison, 1931), pp. 97-98.

In Ohio newspapers and business men have opposed the income tax on the ground that it would destroy Ohio industry and drive it into other states.³⁶ A representative of the Cincinnati Chamber of Commerce in 1935 made a similar statement to the writer.

Specially low assessments of manufacturing machinery were recommended in Massachusetts by a state investigating committee to prevent further loss of industry.³⁷ In Ohio the competition of low assessments in other states was an argument used in the legislature when the classified property tax law was under consideration.³⁸

Florida's constitutional prohibition of inheritance and estate taxes was repealed because of the credit provisions of the federal estate tax.³⁹

NOTE 6 (p. 149). *Bibliographical Note on Exemption of Industrial Property*. The survey referred to is Jens P. Jensen, *Tax Exemption as Means of Encouragement to Industry*, Kansas Studies in Business, No. 10 (Lawrence, 1929). See especially pp. 20-40 for a detailed list of exemptions. The form in which exemptions are voted is treated on pp. 45-47, and also in an earlier study, *Tax Exemption in the State of New York, a Preliminary Report by the Special Joint Committee on Taxation and Retrench-*

³³ *New York Times*, August 9, and September 27, 1933.

³⁴ *Ibid.*, April 7, 1935.

³⁵ *Ibid.*, November 7, 8, 25, 1934.

³⁶ *Cincinnati Enquirer*, November 25, 1934.

³⁷ *Report of the Special Committee Established to Investigate and Study the Taxation of Tangible and Intangible Property and Related Matter* (1936), p. 6.

³⁸ *Cincinnati Enquirer*, May 23, 1931, p. 16.

³⁹ Alzada Comstock, "Inheritance Taxes," *American Year Book* (New York, 1931), p. 202.

ment (Albany, 1927), pp. 257-63. This study also contains detailed information concerning exemptions.

For examples of the voting of illegal exemptions see *Quadrennial Statement by the Tax Commissioner [Connecticut] of Property Exempted from Taxation, 1917-18*, p. 227, quoted in Jens P. Jensen, *Property Taxation in the United States* (Chicago, 1931), p. 159. In recent years illegal tax exemptions in that state have diminished. See *Report of the Connecticut Temporary Commission to Study the Tax Laws of the State and to Make Recommendations Concerning Their Revision* (1934), p. 248.

For recent information concerning tax exemptions to attract industry, see *Tax Exemptions and Abatements Offered by Cities to Attract New Industries* (Washington, August 1936).

NOTE 7 (p. 150). *Bibliographical Note on Agricultural Tax Exemption*. Agricultural exemptions are treated in Jensen, *Tax Exemption as Means of Encouragement to Industry*, mentioned in Note 6. For a summary of the Minnesota classification law see *Tax Systems of the World*, p. 92.

Studies showing the tendency of local assessors to under-assess agricultural improvements in relation to agricultural land are summarized in J. D. Silverherz, *The Assessment of Real Property in the United States*, Special Report of the State Tax Commission, No. 10 (Albany, 1936), pp. 92, 135, and 159.

NOTE 8 (p. 150). *Bibliographical Note on Exemption of Improvements*. The New York City experience is discussed in Henry H. Curran, "One Hundred Million Dollars in New Housing under Tax Exemption," *National Municipal Review*, X, No. 10 (October 1921), 502-5, and in "Building Activity in New York City" and "Tax Exemption and Housing Program in New York City," *United States Monthly Labor Review*, XVIII, No. 6 (June 1924), 149-50, 150-52, respectively.

For the single-tax philosophy and the single-tax movement see Henry George, *Progress and Poverty* (New York, 1888, or more recent popular editions), and A. N. Young, *The Single Tax Movement in the United States* (Princeton, 1916).

For the Pittsburgh graded tax law see E. F. Daume, "A Critical Analysis of the Operation of the Pittsburgh Graded Tax Law," *Annals of the American Academy of Political and Social Science*, CXLVIII (March 1930), 145-56, and in the same issue, T. C. McMahon, "The Operation of the Graded Tax Law in Pittsburgh," pp. 139-44; also J. P. Watson, *The City Real Estate Tax in Pittsburgh* (Pittsburgh, 1934), especially chap. ii; also McMahon, "Pittsburgh's Graded Tax on Buildings," *Proceedings of the . . . National Tax Association*, 1929, pp. 134-40, and in the same volume, Daume, "The Graded Tax on Buildings," pp. 140-50, and the subsequent discussion.

For the experience with the exemption of improvements in the

Canadian Northwest, see R. M. Haig, *The Exemption of Improvements from Taxation in Canada and the United States* (New York, 1915). The attitude in Canada in relation to the effects of the tax is given at p. 269.

CHAPTER 11

NOTE 1 (p. 179). *Recent Eliminations of Holding Companies*. A brief and partial survey indicated that the following important companies have recently eliminated one or more holding companies and have cited the tax provisions as a reason for the action: United States Steel Corporation, Bethlehem Steel Corporation, The Borden Company, Diamond Match Company, United States Rubber Company, International Hydro-Electric System, and E. I. du Pont de Nemours & Company.

Although no reference was found indicating whether the tax was a reason for their action, the following corporations have also recently eliminated holding companies and would seem to have saved in taxes as a result: Pacific Gas and Electric Company, Union Pacific Railroad Company, Air Reduction Company, Incorporated, Nevada-California Electric Corporation, Eastern Gas and Fuel Associates, Atlas Corporation, Electric Bond and Share Company, Electric Power and Light Corporation, Northern New York Utilities Incorporated, Southern Pacific Company, Central Power and Light Company, Safeway Stores, Incorporated, McKesson and Robbins, Incorporated, Atlas Powder Company, Eastman Kodak Company, Acme Steel Company, Consolidated Oil Corporation, General Foods Corporation, Pillsbury Flour Mills Company, A. G. Spalding and Brothers, International Harvester Company, Associated Gas and Electric Company, Blackstone Valley Gas and Electric Company, and Central Maine Power Company.

CHAPTER 13

Note 1 (p. 200). *Special Liquor Profits Tax*. Fosdick and Scott recommend that, "to avoid shifting the entire tax burden to the consumer, the principle of profits taxation should be applied to both the manufacturers and the distributors of alcoholic beverages through a special liquor profits tax."⁴⁰ This solicitude for the consumer is inconsistent with the frequently repeated idea that "taxes should be

⁴⁰ Fosdick and Scott, *op. cit.*, p. 128.

levied . . . as a method of reducing the consumption of alcohol."⁴¹ The basis for the argument for special income taxes is not only that manufacturing and sales taxes on liquor are regressive,⁴² which involves the inconsistency just mentioned, but that the semi-monopolies created by regulation give rise to monopoly profits.

In an appearance before the joint hearing of the Committee of Ways and Means of the House of Representatives and of the Committee on Finance of the Senate, on December 13, 1933, Dr. Luther Gulick, who also worked on the Rockefeller liquor report, made the same recommendation. His argument was that "the gallonage tax could thereby be held at a reasonable figure, without putting into the hands of individuals in favored positions large profits."⁴³ This would indicate a belief that elements of monopoly or speculative profits were present in the industry. He gave as a reason also "that the profit motive should be eliminated as far as possible in the liquor industry."⁴⁴ His further statement that the liquor business "stands in a different position from any other business in the United States"⁴⁵ would indicate an acceptance of the punitive theory of taxation discarded by Fosdick and Scott.⁴⁶

CHAPTER 16

NOTE 1 (p. 221). *Tax Burden Studies*. Most of the recent literature on tax burdens stresses the number of taxes rather than the total burden, but the latter question has not been neglected. Almost without exception these estimates assume a complete shifting of all business taxes to the final consumer—an assumption of doubtful validity. Moreover, the statement that "the really big part of your tax burden is that which falls on the dollars you spend as a consumer"⁴⁷ is a generalization that needs some qualification, in view of the large proportion of the total taxes collected that is derived from personal income taxes and from property taxes levied on home owners, and from the motor vehicle license tax on non-commercial cars. Most income-taxpayers and most home owners, at least, would probably have to be excepted from this statement. There is even less justification for the statement, in the same article, that the man earning \$250 per week "has a larger proportion of his income left [after taxes] . . . than the little fellow has."⁴⁸ Most of the tax burden

⁴¹ *Ibid.*, p. 19; see also pp. 81-82, 108, 128.

⁴² *Ibid.*, p. 118.

⁴³ *Tax on Intoxicating Liquor*: Joint Hearings, p. 161.

⁴⁴ *Ibid.*

⁴⁵ *Ibid.*

⁴⁶ Fosdick and Scott, *op. cit.*, p. 108.

⁴⁷ Malcolm P. McNair quoted in Frank Parker Stockbridge, "Meet Your Tax Collector," *Saturday Evening Post*, CCIX (September 5, 1936), 70.

⁴⁸ *Ibid.*

estimates have, of course, been partisan in nature, and need not be taken seriously; but they have attracted so much attention recently that it has seemed important to call attention to their limitations. For a discussion of more disinterested and authoritative studies in this field see the memorandum by Mabel Newcomer on the distribution of the tax burden in the forthcoming volume, *Studies in Current Tax Problems*.

CHAPTER 17

NOTE 1 (p. 243). *Relatively Tax-Free Fields of Investment*. In New York State, where the property tax is restricted to real estate except for New York City's "use tax," conditions seem favorable for capitalizing an indeterminate amount of that part of the real estate tax whose burden is not offset by benefits from the services financed by the tax. In terms of the example in the text, almost the entire \$60 may be capitalized. The relatively tax-free investment field to which investors may go is represented by bonds and preferred stock. Bond interest and preferred stock dividends are of course subject to the New York and federal income taxes, but so is income from real estate. The \$25 tax in the example in the text must be the kind of tax that does not also rest on real estate.

However, an important qualification for the New York income tax and, indeed, all income taxes in the United States must be made. The taxes, state and federal, do not reach imputed income from real estate that is not rented but is instead used by the owner.⁴⁹ Therefore, the income tax discriminates against a bond as an investment compared with an owned home as an investment. Because of this discrimination, the pressure for capitalization of the property tax—on this kind of real estate only—is lessened. This point deserves much more study. Its importance is indicated by the high surtax rates that may apply under the income tax.

Bonds owned by residents of states that tax such intangibles under the property tax do not furnish a relatively tax-free field of investment, according to the statute book. Actually, evasion of the property tax on investments of this type is so widespread that the existence of such a field is assured to an important extent. Moreover, many states tax bonds at a much lower rate than real estate. Variations also exist in the actual treatment of preferred stock.

The tentative conclusion seems justified, then, that in so far as there is mobility of investment funds between the real estate field on the one hand and the field of high-grade bonds or preferred stock

⁴⁹ See p. 306.

on the other, there is a relatively tax-free field of sufficient importance to necessitate capitalization of a considerable part of the tax on real estate. The extent of the mobility is of course significant.⁶⁰

Securities other than high-grade bonds or preferred stock offer a less satisfactory field for relatively tax-free investment. In many cases, perhaps in most cases, these investments represent in part an ownership interest in real estate. If each increase in a non-shiftable real estate tax reduces the value of the real estate, it also reduces the value of the ownership interest in the real estate.

If all property is taxed alike, and if the rate of time preference remains the same after the introduction of the tax as before, a problem of general change in capital values arises. Any such general change is not usually referred to as tax capitalization.

NOTE 2 (p. 243). *Capitalization, Benefit, and Shifting*. The relations between the benefit aspects of the property tax and the phenomena of capitalization and shifting deserve special attention. In general, reduction of the real estate tax will result in an undeserved value increment to the existing owner only if two conditions are satisfied: first, if the existing owner has never suffered from tax capitalization a loss equal to the gain from the reduction of the tax, and, second, if the proposed reduction in tax is to be made possible by some measure other than a corresponding reduction in the services that contribute to the value of the property.

Every time that the second condition alone is satisfied, the value of the property increases, but the increase is clearly undeserved only if the first condition is also satisfied. Persons who satisfy the first condition include, it should be noted, not only post-original owners who have escaped some non-benefit increase in the tax by paying a lower purchase price, but also all original holders whose taxes have, on balance, resulted in corresponding (or more than corresponding) benefit to their properties. Actually, few if any will be found in the second class, so that the first condition can for most practical purposes be reworded as follows: if the existing owner has purchased the property after the last tax increase that did not result in a corresponding benefit to the property.

Capitalization in its relation to shifting and benefit has been discussed recently by Simeon E. Leland,⁵¹ Edwin H. Spengler,⁵² and K. M. Williamson.⁵³ For purposes of the present discussion, attention

⁶⁰ For a discussion of this factor, see K. M. Williamson, "The Taxation of Real Estate: A Survey of Recent Discussion," *Quarterly Journal of Economics*, XLVIII (November 1933), 96-128.

⁵¹ Leland, "The Real Estate Tax: Capitalization and Benefit," *Bulletin of the National Tax Association*, XVIII, No. 8 (May 1933), 227-32.

⁵² Spengler, "The Real Estate Tax: Capitalization and Benefit—A Reply," *Bulletin of the National Tax Association*, XVIII, No. 8 (May 1933), 232-35.

⁵³ Williamson, *op. cit.*

will be restricted to those few points to which, it appears, some exception may be taken.

Leland seems to assume that the benefit aspects of the property tax must be revealed in an increase in property values.⁵⁴ Actually, it is enough if the property value fails to decline despite the added tax (imposed to render the service). "If the tax is *completely* shifted it is difficult to see wherein the owner of real estate is benefited"⁵⁵—but he is benefited by not having the net proceeds (after taxes) from his property decrease. "If government merely takes over a private water supply, where is the benefit to real estate?"⁵⁶—in the fact that the added tax that the government must impose to defray the expenses of its new enterprise does not decrease the value of the property.

Spengler is not entirely clear as to whether he agrees with Leland's valid point that a benefit tax (hence a shifted tax) cannot be capitalized. "If the cost of some of the benefits derived from the government is assumed to be shifted to the tenants, the rents will be correspondingly increased by the amount shifted. This means that the net product, before taxes, to be capitalized, will likewise be increased. . . . To the extent that a part of this burden is shifted to his tenant, the rent levels at the time of purchase are correspondingly higher, and hence make the property appear more valuable."⁵⁷

The new tax and the new service that it finances must be considered together. If the tax is shifted, the net product *before taxes* increases over what it was before the new tax and new service were instituted, but the value of the property remains the same since the net product *after taxes* remains the same. This point is brought out by Williamson, who notes that "the same element of a real estate tax can not be justified upon assumption both of benefit and capitalization."⁵⁸

Williamson refuses to accept Leland's test of benefit (enhancement of property value), but he gives no positive reason for his refusal,⁵⁹ and he hence fails to develop the point that under a strict benefit tax philosophy the (gross) benefit should be exactly offset by the (benefit) tax, so that no increase in value should result. However, Williamson is perhaps more interested in the case where the gross benefit exceeds the tax levied to supply it, since he says that Leland's point about the division between owners and tenants is well taken. As he seems to imply, the point is of real interest only when benefit exceeds tax.⁶⁰

NOTE 3 (p. 253). *Remote Vested Interests*. The vested interests arising from tax policies are innumerable and extend far beyond the circle

⁵⁴ Leland, *op. cit.*, p. 231.

⁵⁵ *Ibid.*

⁵⁶ *Ibid.*, p. 232.

⁵⁷ Spengler, *op. cit.*, p. 235.

⁵⁸ Williamson, *op. cit.*, p. 113.

⁵⁹ *Ibid.*, p. 111.

⁶⁰ *Ibid.*, p. 112.

of those who pay the tax in question or bear its burden. For example, cigar producers have probably benefited from the heavy tax on cigarettes. Some of the capital in the cigar industry has been put there on the assumption that the cigarette tax would continue at a high rate. An element of injustice to vested interests in the cigar industry might be seen in a lowering of the cigarette tax, which would draw some smokers from cigars to cigarettes. Legislators can scarcely be asked always to go this far afield in weighing the ethical implications of tax measures.

CHAPTER 18

NOTE 1 (p. 257). *Minor Examples of Benefit Taxation and Non-Benefit Earmarking.* A number of minor benefit taxes are levied in various states. A short list, not intended to be comprehensive, will illustrate the kinds of state activity involved and the kinds of charge imposed to cover the expense:

Aircraft fuel tax, with proceeds devoted to airport work, in Wyoming.⁶¹

Milk tax of 2 cents per hundredweight, with proceeds devoted to milk control, in Massachusetts and Rhode Island,⁶² and 1 cent per hundredweight, with proceeds earmarked for milk control and milk publicity, in New York State.⁶³

Taxes of 1 cent, 3 cents, and 5 cents, per box, on oranges, grapefruit, and tangerines, respectively, in Florida, with proceeds to be used for advertising these products.⁶⁴

Charges for parking space at curbs, collected by parking meters.

Assessments upon insured banks for the federal deposit insurance fund (not usually thought of as a tax).

In many states certain taxes are formally dedicated to certain uses, even though no apparent reason exists for defraying the particular expense by the tax in question. Some states, for instance, earmark sales tax revenue for education. This earmarking, however, does not represent a conviction that education should be paid for by the direct beneficiaries on a cost-caused basis and that the sales tax is the proper tax to accomplish such a purpose. Thus it contrasts with the earmarking of gasoline tax revenue for roads. It may be a political device designed to gain support by confusing the issues at stake. It may reflect the opinion that, if the tax in question is not voted, ex-

⁶¹ Manning, "State Tax Legislation, 1934," *Proceedings of the . . . National Tax Association*, 1934, p. 19.

⁶² *Ibid.*, p. 21.

⁶³ Tax Law, art. 19.

⁶⁴ Manning, "State Tax Legislation, 1935," *Proceedings of the . . . National Tax Association*, 1935, p. 33.

penses will have to be cut, and that the expenses to be cut will be those for education, or whatever else the proposed tax is to be earmarked for. These remarks apply also to the frequent earmarking of poll tax proceeds for roads, or schools, or old-age pensions.⁶⁵ Sometimes a tax is earmarked for an expenditure that cannot possibly be put on a direct-benefit basis—for instance, a sales tax earmarked for unemployment relief, as in New York City.

NOTE 2 (p. 262). *Special Minor Highway Taxes*. In many states, bus and truck lines operating on a common carrier basis are taxed on their gross receipts, their passenger-miles or ton-miles, or their simple mileage. Considerable confusion of thought exists concerning the justification for these taxes. Sometimes they are supported on the grounds of the "special benefit" that these lines obtain from "free" use of the public highways. The force of this argument is not evident if the bus and truck lines are already meeting their proportionate share of highway costs on a cost-caused basis under the gasoline and other motor vehicle taxes. If the special benefit reveals itself in the form of more than normal profits, it should be classed with the other cases where the force of competition has not been sufficient to eliminate a certain amount of monopolistic power. These can be reached by an excess profits tax.

According to another argument, the special highway taxes are substitutes for a general business tax that, for administrative reasons, cannot be levied on bus and truck lines. To avoid constitutional difficulties, however, it has in some cases appeared necessary to assert explicitly in the law that the tax is levied to defray part of the cost of highways, on a benefit basis.⁶⁶

NOTE 3 (p. 266). *Development of the Benefit Theory in Property Taxation*. Developments in the past ten years or so indicate a growing interest throughout the United States in the possibility of splitting part of the property tax, either in theory or in practice, into a series of service charges based to a considerable extent on cost. In some localities, garbage is removed only by private agencies, which exact a fee. In others, the city performs the service upon payment of a special charge. A few cities are adding a sewer rental charge to their water bills. In some places abroad, the owner of a building that catches fire must pay a special charge to the governmental fire department for the specific assistance that it renders. A few municipal-

⁶⁵ *Tax Systems of the World*, pp. 158-60. For a particularly complex example of earmarking, see the description of the sources that feed the school fund in Texas, E. T. Miller, "Texas Tax Problems," *Proceedings of the . . . National Tax Association*, 1935, pp. 80-81.

⁶⁶ See the advice offered in "Some Problems of Motor Vehicle Business Taxation: Report of the National Tax Association on Taxation of Motor Vehicle Transportation," *Proceedings of the . . . National Tax Association*, 1931, p. 361.

ities in the United States levy a charge when a fire is started by design or negligence. The governmental police protection has proved so inadequate in some localities in the United States that real estate owners have assessed themselves, as a group, to hire unofficial patrolmen. Tax rate limits in West Virginia forced at least one city to devise special charges for street lighting and fire protection.⁶⁷ A research group in Los Angeles proposes "a true budget for local government in Los Angeles County that will give no place to an ad valorem property tax." This budget would be supported in large part by charges for specified services.⁶⁸

NOTE 4 (p. 19). *Federal Automotive Excises as Distributors of Benefit Taxation on a Cost-Caused Basis*. As a supplement to the gasoline tax, the federal tax on the producers of automobiles has the advantage of being independent of mileage. Hence, to some degree, it takes account of the peak-load cost. Its usefulness in emphasizing the damage to highways that results from weight is restricted. The tax is based on selling value, and some trucks (with load) weigh far more than some passenger cars (with load) that sell for a much higher price. Moreover, for several years immediately after the tax is levied a large proportion of the highway users will be driving old cars that have escaped the new tax. This escape calls attention to the fact that two motorists might do equal damage to the roads, yet pay very different taxes over a period of years. One, being perhaps more well-to-do than the other, might turn his car in for a new model every year or two, while the other might run the same car for seven or eight years. These observations assume that the tax is fully shifted by the producer to the consumer through higher prices. Whether any of the tax gets down to the highway user who buys only used cars is also an important point. All in all, the federal excise tax on automobiles ranks low as a part of a benefit-tax system designed to tax each road user in proportion to the cost that he causes.

The tax on the production of motor accessories probably bears even less direct relation to road use than the automobile tax. The transition period is not so long, but the used-accessory market is important.

⁶⁷ For details of these and other similar instances, see Spengler, "Is the Real Estate Tax a Benefit Tax," Memorandum Number Five, *Report of the New York State Commission for the Revision of the Tax Laws*, Submitted February 15, 1932, Legislative Document (1932) No. 77; A. M. Hillhouse, *New Sources of Municipal Revenue* (Chicago, 1935), pp. 60-64. Cf. the position taken by M. Slade Kendrick, *op. cit.*, who notes that "a large proportion of public activities attains the desired end of public benefit only through the benefits conferred on particular economic groups." *Ibid.*, p. 137. Fire protection, for instance, should be paid for by a tax on buildings, but not by a land-rent tax, since land does not burn. *Ibid.*, p. 137. This position is not based on the "benefit theory," in Kendrick's view, since that theory is "a doctrine of the individual in his relation to the state." *Ibid.*, p. 138.

⁶⁸ *Unified Social Government and Tax Reform*, A Report to the Citizens Committee for City and County Unification, February 1934, p. 122.

The taxes on tires and inner tubes are based not on value but on weight: $2\frac{1}{4}$ cents per pound for tires and 4 cents per pound for inner tubes. They take account of the mileage factor in somewhat the same way as the gasoline tax. Also, like the latter, they fail to take proper account of weight and peak-load use of the highways. Moreover, the used-tire market injects difficulties not found with the gasoline tax. As benefit taxes, the taxes on tires and tubes accomplish little that the gasoline tax cannot. Consequently, no reason appears for using them, aside from whatever advantages may accrue through having two taxes at relatively low rates rather than one tax at a high rate.⁶⁹

Finally, the lubricating oil tax (4 cents per gallon) is peculiar in that it is levied not only on oil consumed by users of highways, but also on oil used in any other way as a lubricant—for example, in farm tractors and in journal boxes on railroad cars. It has no advantages, as a benefit tax, over the gasoline tax, and it possesses the administrative disadvantage of a wider use off the highways. It would thus involve a more serious exemption or refund problem if it were used as a benefit tax.⁷⁰

CHAPTER 19

NOTE I (p. 271). *Economic Implications of Taxes on Excess Profits, etc.* Most of the taxes relevant to Chapter 19 are levied on income that is economically "unnecessary." For example, monopoly profits and pure land rent are unnecessary in the sense that the physical volume of production of the country would not be diminished even if 100 per cent of these incomes were taken in tax. This conclusion follows from the assumption that these forms of income cannot be considered as economic rewards: either they represent a payment for no effort at all—as in pure land rent—or they are given for a kind of effort—such as monopolizing effort—that restricts total production.

These economic effects are, therefore, closely connected with the particular aspect of tax justice under consideration. They may ultimately be recognized as the real foundation for tax justice in its broadest sense. The construction of a tax system designed to hinder production and consumption in general as little as possible may come to be generally recognized as the most important of secondary aims. Such matters as the moral implications of excess profits and of allocation on a cost-caused basis under the benefit theory would then be thrown in the background. These ideas are scarcely novel in tax theory generally, but their application to the United States tax

⁶⁹ See p. 350.

⁷⁰ See p. 318.

system awaits a development of interest in them by tax students who are familiar with the mechanisms that are available for putting them into effect.⁷¹

Property passing by gift or at death is sometimes a windfall, and, even when it is not, it is often considered to be as undeserved or as economically unnecessary as monopoly profits. Nevertheless, discussion of the death taxes and gift taxes of the United States is deferred to Chapter 20, since these taxes reflect an effort to take some account of the individual's economic situation and his relative personal ability to pay. This is in decided contrast with the impersonality of the taxes discussed in the present chapter. The distinction between earned and unearned income is for similar reasons mentioned in Chapter 20 rather than in the present chapter.

NOTE 2 (p. 275). *Excess Profits Taxation as an Alternative to Rationing.* The appropriation of part of or all excess profits cannot of course accomplish precisely the same ends as the fixing of maximum prices. The tax money will ordinarily go into the general fund, and the benefits will not accrue to the consumers of the monopolized product in proportion to their purchases, as they would under price fixing. The tax proceeds might be distributed to the consumers of the monopolized product, but administrative troubles would usually make such a plan undesirable. More important, the restriction of consumption attending high prices results in lost opportunities for economic satisfactions. No practicable plan can be devised to compensate consumers for this loss.

If the restricted supply characteristic of monopoly is allowed to continue for a period, pending complete readjustment, maximum-price fixing must be supplemented by rationing. This necessity arises from the fact that the effective demand will increase when the price is put down, and will, therefore, exceed the available supply.⁷² The excess profits tax may, under certain circumstances, be preferable to a plan that involves rationing.

NOTE 3 (p. 276). *War Profits Taxation.* Limitations of the present study make a detailed survey of war profits taxation impossible, but a brief reference to recent Congressional activity is necessary.

On May 1, 1935, the Special Committee of the United States Senate to Investigate the Munitions Industry submitted a report on a bill, which had passed the House, that was designed primarily to take the profits out of war.⁷³ The committee drafted a war-time revenue

⁷¹ See p. 217. Cf. Pigou, *op. cit.*, pp. 96, 126-35, and 171-88, for "announcement effects."

⁷² For a development of this point see Arthur Robert Burns, *The Decline of Competition* (1st ed., New York, 1936), p. 537.

⁷³ *To Prevent Profiteering in War*, Senate Report No. 577, 74 Cong., 1 sess.

measure, using the framework of existing revenue laws. The rates advocated in this report reached 99 per cent on that part of an individual's income above \$10,000 and on that part of a corporation's profits above 6 per cent. The rates in the bill as actually reported were slightly different. The committee stated that the primary purpose of its bill was to finance a war through taxation instead of borrowing, and that "taking the profits out of war" was considered incidental to the other "much more comprehensive and important purpose."⁷⁴

The dangers that are involved in using a rate as high as 99 per cent are, it is hoped, adequately implied in the text of Chapter 19.⁷⁵ In the present writer's opinion, the committee underestimates the vagueness of the concepts "invested capital," "profits," and "excess," and underestimates, too, the administrative problems involved. The chances for a crushing financial blow at almost any business, owing to the vagueness of the concepts or to actual errors, are naturally great when rates approach or reach 100 per cent.⁷⁶ The government runs a serious risk of stifling initiative and promoting extravagance with such rates. Whether the safe limit is 95 per cent, or 90 per cent, or even less, is a subject that deserves intensive study.⁷⁷

NOTE 4 (p. 279). *Separate Businesses under Single Ownership*. The problem posed in the text has only once been faced in American taxation. The only federal, state, or local unit to levy an impersonal tax on the net income of unincorporated business is New York State in its recently enacted tax on the net income of unincorporated concerns. The tax commission has had to decide whether the loss of one business should be allowed as a deduction from the profit of another business if both businesses are owned by the same person.⁷⁸ Its decision has been that the deduction should be allowed—a decision that has obvious, perhaps compelling, administrative advantages

⁷⁴ *Ibid.*, p. 2. The same preference for financing by taxation rather than by borrowing was displayed by practically all who appeared before the Subcommittee of the Finance Committee in 1936 on the same House bill. *To Prevent Profiteering in War: Hearings before a Subcommittee of the Committee on Finance, United States Senate, 74 Cong., 2 sess., on H. R. 5529.*

⁷⁵ See pp. 278-89.

⁷⁶ The chances are of course greatly increased when arbitrary definitions of invested capital and profits are written into the law. For example, the committee proposes to use the adjusted declared capital stock value arrived at under the procedure set forth in the Revenue Act of 1934, with the provision that the administration may require the use of a lower value. The artificiality of the adjusted declared value, which will only gradually be corrected, if at all, as explained in a note below (pp. 560-61), is not mentioned by the committee. Again, the committee proposes arbitrary limitations on depreciation and depletion—2 per cent of the gross income or 1 per cent of the adjusted cost, whichever is lower.

⁷⁷ Cf. Arthur A. Ballantine, *War Policies in Taxation*, Statement by . . . Assistant Secretary of the Treasury, before the War Policies Commission, May 20, 1931, p. 10.

⁷⁸ Connecticut imposes an unincorporated business tax, but it is based on gross income, and therefore does not involve the difficulty analyzed here.

but that is not entirely consistent with the idea of impersonality upon which the tax is presumably based.

A still more difficult problem is posed by partnerships. Suppose that X and Y are partners and that their partnership conducts two types of business—a grocery store and a garage. Each of the partners owns an individual proprietorship—X a laundry, and Y a fruit store. A loss is shown by the partnership's grocery store, by X's laundry, and by Y as an individual—Y has a large deduction for interest on a personal debt. A profit is shown by the partnership's garage, by Y's fruit store, and by X as an individual—X has a substantial personal income from investments. The loss incurred by the partnership's grocery store is either greater or less than the profit obtained by the partnership's garage—in either case, the question of how the tax base is to be ascertained raises problems that show the conflict between administrative considerations and the "impersonal" element in the tax.

NOTE 5 (p. 281). *Excluding from Invested Capital All Capital with a Fixed Return.* The British authorities, according to Haig, had serious doubts regarding the soundness of their policy of excluding borrowed money from invested capital under their excess profits tax.⁷⁹ Their attitude toward preferred stock capital is not known to the present writer. T. S. Adams did not believe in including borrowed capital; he did not mention the preferred stock question.⁸⁰

Even if the business is considered as a unit, it may be questioned whether the capital should include contributions by vendor-creditors—those who sell the concern materials on time.

NOTE 6 (p. 281). *Disturbing Consequences of Distinguishing between Various Types of Fixed-Income Capital.* The National Tax Association Committee on Federal Taxation in their report in 1919 recommended that either (a) borrowed capital and preferred stock capital should be included, with no deduction for interest or preferred dividends, or (b) borrowed capital and preferred stock capital should be excluded, with deduction for both interest and preferred dividends. Otherwise, corporations would save taxes by converting bonds into preferred stock—an action that was, they reported, being carefully considered at that time by many corporations in view of the existing excess profits tax law.⁸¹

The emphasis on the business as an impersonal unit would be even greater if rented capital, such as land, buildings, leased machines, etc., were included and rental payments were not allowed as deduc-

⁷⁹ Haig, *Taxation of Excess Profits in Great Britain*, p. 83, and note to p. 83 on p. 243.

⁸⁰ Adams, *op. cit.*, p. 385.

⁸¹ "Report of Committee on Federal Taxation," *Proceedings of the . . . National Tax Association*, 1919, p. 359.

tions in calculating income. Of course the owner of the land, building, etc. would then exclude its capital value and the income from it in any excess profits tax return that he might have to make.

As has been indicated, other aspects of the problem of how much capital to include are shown in (a) the distinction between temporary and permanent debt,⁸² presumably troublesome unless a daily average of invested capital is taken, and (b) the intangible element of personal credit⁸³—a matter that may be considered part of the broader problem of contingent liabilities.

NOTE 7 (p. 282). *Conflict between Inadmissible Assets and Inadmissible Liabilities.* In the American war-time laws, this problem was solved first "by practically assuming that the inadmissible assets were acquired with the borrowed money" and later by adopting "the principle that the capital and the borrowed money shall be considered to be invested in all assets in proportion." The British practice was "to consider each case in the light of its particular facts. . . ."⁸⁴

NOTE 8 (p. 283). *Allowing One Year's Loss as a Subtraction from Another Year's Gain.* In addition to the two devices noted in the text, mention may be made of the provision of the American war-time tax, not found in the British tax. By this provision, the original capital invested by the corporation in question was allowed to stand, for purposes of ascertaining whether profits were being earned at an excessive rate, with no diminution on account of subsequent losses suffered by the corporation. In effect this procedure granted the corporation an infinite accounting period, in some respects.

In explaining the American law, Haig notes:

For example, if A invests \$100,000 in a corporation in 1900, receiving therefor \$100,000 in capital stock of the corporation, and the corporation proceeds to lose \$50,000 in the course of trading during the next twenty years so that the real worth of the assets in 1920, is only \$50,000, we would give the corporation an invested capital standard of \$100,000 for the year 1920. In England the figure would be at \$50,000. . . .

This fundamental difference extends moreover into the field of depreciation. Suppose, in the case cited above, that \$50,000 of the \$100,000 received for the stock was immediately invested in machinery with a life of 20 years, and that \$2,500 was annually put in reserve for depreciation. In 1920 this reserve would consequently amount to \$50,000. In this country we, of course, do not permit the addition of this \$50,000 reserve to the \$100,000 original investment, and give the corporation an invested capital of \$150,000. What we do allow is the \$100,000 originally put in and we continue to allow that amount whether or not any depreciation deductions are made, whether the reserve which may be built up from such deductions is invested within or outside the business or whether it is lost through unwise investment or use. We even permit an increase in invested capital equal to any excessive depreciation deducted or for any realized appreciations in the value of invested reserves. A similar corporation in England, on the other hand, in 1920, when the machinery is scrapped, would receive no credit at all

⁸² Haig, *Taxation of Excess Profits in Great Britain*, p. 84.

⁸³ *Ibid.*; Adams, *op. cit.*, pp. 385-86.

⁸⁴ Haig, *Taxation of Excess Profits in Great Britain*, p. 85.

for it as invested capital except such part of the depreciation reserve of \$50,000 as had been actually reinvested in the business. During the course of the depreciation of the machinery its value for invested capital would be the original cost minus "proper deductions" for depreciation plus the depreciation reserves reinvested in the business.

As a consequence the British concept of invested capital tends to be more a "current capital" concept than ours. . . . Although neither they nor we reappraise assets periodically during their life, they tend to approach more closely the value of the assets actually at work during the current accounting period.

This distinction must not be overemphasized, however. In fact the number of American corporations which benefit by virtue of it is undoubtedly small. In the absence of full allowances for net losses from period to period such relief is probably justified.⁸⁵

NOTE 9 (p. 157). *Present Excess Profits Tax*. The following paragraphs describe briefly the development of the existing federal excess profits tax.

The tax was imposed by the National Industrial Recovery Act, approved June 16, 1933, and was designed as an adjunct to the capital stock tax passed at that time. The capital stock tax was \$1.00 on each \$1,000 of capital stock, and, in order to avoid dispute over the value of any concern's capital stock, the taxpayer was allowed to set its own value. To prevent the taxpayer from declaring much too low a value, a 5 per cent excess profits tax was imposed on all annual income above 12½ per cent of the declared value of the capital stock. Hence, if the declared value were set at zero, as was permissible, all the income would be subject to the excess profits tax; if it were set at \$800,000, for example, all income above \$100,000 a year would be subject to the excess profits tax.

Declared value, once made, was not to be changed at the will of the taxpayer in future years. Instead, it was to be adjusted, year by year, by adding actual accretions to capital or surplus—(a) cash and fair market value of the property paid in for shares of stock, (b) paid-in surplus and contributions to capital, and (c) earnings and profits—and subtracting actual drains on capital or surplus—(a) the value of property distributed in liquidations to shareholders, (b) distributions of earnings and profits, and (c) deficits, whether operating or non-operating.

Meanwhile the taxpayer who correctly guessed the course of his profits over the coming years could minimize his combined capital stock and excess profits tax. If he thought earnings were going to increase rapidly, he would declare a high capital stock value, to avoid heavy excess profits taxes in the coming years. Conversely, the prospect of continuing low profits would induce him to declare a low capital stock figure.

The original program as thus outlined was not fully carried out. Congress gave every corporation another chance, in the Revenue Act of 1934, to fix its declared capital value, because the 1934 act ex-

⁸⁵ *Ibid.*, pp. 16-17.

tended the life of the taxes indefinitely while under the National Industrial Recovery Act both taxes were to lapse following the repeal of prohibition.

In 1935 Congress again gave the corporations an opportunity to declare their capital value, because of a change in the rate of the tax. From a flat 5 per cent on that part of the profits over 12½ per cent the rate was changed to a graduated scale, appreciably heavier: 6 per cent on that part of the profits over 10 per cent but not over 15 per cent, and 12 per cent on that part of the profits over 15 per cent. At the same time, the capital stock tax rate was increased to \$1.40, but the Revenue Act of 1936 annulled this increase.

Otherwise the tax has remained substantially unchanged since 1932. The 1934 act specified in more detail the year-to-year additions and subtractions to be taken into account in "adjusting" the original declared value, and the 1935 act allowed subtraction of the ordinary corporation tax paid in computing net income subject to the excess profits tax. The Revenue Act of 1936 cancelled this last privilege. A few other minor changes need not be noted here.

The state of Ohio recently levied an "excess gross profits tax" on the manufacture and sale of spirituous liquor but repealed it because "the tax was not yielding revenue much, if any, in excess of the cost of administration. There is very little manufacture of spirituous liquor in Ohio."⁸⁶ Apparently the entire gross profits were considered "excess."

An element of taxation akin to the excess profits tax is perhaps to be found in the corporate excess and corporate "intangible" taxes that are on the statute books of the following states (though not fully enforced in every state): Alabama, Illinois, Indiana, Kansas, Massachusetts, Minnesota, Nebraska, North Carolina, Oklahoma, Rhode Island, and Tennessee.⁸⁷

CHAPTER 20

NOTE 1 (p. 295). *Graduated Property Tax Rates*. Long-established practice in some foreign jurisdictions shows that a graduated rate scale is considered useful for certain kinds of property tax. Perhaps the best-known examples are found in Australia and New Zealand, where graduated rates have been used since the latter part of the nineteenth century. The graduation, however, is restricted to the land tax. The aims, aside from revenue, have been to secure for the government some of the unearned increment, and to break up large

⁸⁶ Letter of April 30, 1936, to the author from the Ohio state tax commission.

⁸⁷ *Tax Systems of the World*, pp. 161-66.

estates and bring idle land into use or underutilized land into better use.⁸⁸

Several unfavorable factors exist in the United States—particularly problems raised by the taxation of personal property, uniformity clauses in constitutions, and refusal to allow deduction of debts.⁸⁹ Recent American textbooks on public finance pay little or no attention to graduation of property tax rates.

NOTE 2 (p. 296). *Special Treatment of Personalty*. The status of personal property in the United States under the property tax differs so much from state to state that no one general statement can be very helpful. Likewise, opinion among tax students on the proper methods is diverse. For recent summaries of the situation, see: Lutz, *op. cit.*, pp. 505-6, 524-27, 553-57; Buehler, *op. cit.*, pp. 293-300; *Tax Systems of the World*, pp. 92-98. A more detailed discussion, slightly less recent, is found in Jensen, *Property Taxation in the United States*, especially pp. 173-203, and a study of the fundamental problems in classification is supplied by Leland, *The Classified Property Tax in the United States* (Boston, 1928).

NOTE 3 (p. 306). *Liberality in Deductions from Gross Income*. The United States personal income tax is also open to some question on the basis of failure to distinguish consistently between personal expenses and business expenses. Usually, personal expenses are not deductible, but the federal income tax departs from this general rule by allowing deduction of (a) interest paid on personal, non-income producing debts, (b) non-business taxes paid, (c) bad debts not contracted in business transactions, (d) loss of non-business property through loss from fires, storms, shipwreck, or other casualty, or from theft, (e) charitable contributions.

NOTE 4 (p. 308). *Graduated Corporation Income Tax Rates*. In his message of June 19, 1935, President Roosevelt appealed for graduation of the corporation net income tax rate chiefly on the grounds that "the advantages and the protections conferred upon corporations by government increase in value as the size of the corporation increases," and that "great corporations are protected in a considerable measure from the taxing power and the regulatory power of the States by virtue of the interstate character of their businesses. As the profit to such a corporation increases, so the value of its advantages and protections increases."⁹⁰ Several issues are touched on in

⁸⁸ H. Heaton, "The Taxation of Unimproved Value of Land in Australia," *Quarterly Journal of Economics*, XXXIX (May 1925), 410-49; Seligman, *Essays in Taxation*, pp. 462-64.

⁸⁹ Seligman, *Progressive Taxation in Theory and Practice* (2nd ed.; New York, 1908), pp. 305-9.

⁹⁰ *New York Times*, June 20, 1935.

this statement; those concerned with aims of revenue and with aims of economic or social control are discussed elsewhere in this volume.⁹¹

From the point of view of tax justice, the most obvious issue is: if the value of the advantages and protections are to be measured by the profits, then does a doubling of the profits indicate only a doubling—or more than a doubling—of the value of the advantages and protections, and should the tax payable therefore be doubled—or more than doubled? Only if the value of the advantages and protections more than doubles, is graduation needed on the basis of the President's argument.⁹²

CHAPTER 21

NOTE 1 (p. 322). *Fluctuations in Property Tax Collections*. The sensitivity of the property tax to economic fluctuations has been revealed largely in delinquency, whereas in other taxes delinquency has been a minor matter compared with decreases in the tax base. Data on stability of the tax base in cities is given elsewhere.⁹³

NOTE 2 (p. 323). *Fluctuations in Progressive Rate Yields in Corporation Taxes*. Conceivably, the particular rate scale now in use for the corporation tax may result in a smaller percentage fluctuation in the revenue than the former flat rate, if the top rate is high enough and if the taxable income in that bracket is much more stable than the taxable incomes in the lower brackets. Such evidence as has been presented on this point is, however, not very convincing. The data presented by the assistant general counsel of the Treasury in 1935, for example, were admittedly "not adequate to give conclusive finality," particularly since most of them dealt with rates of return rather than aggregate absolute amounts of tax base. Nevertheless, the Treasury expressed the opinion that graduation would produce "a more reliable, predictable and steady flow of revenue."⁹⁴ As to the undistributed profits tax, periods of prosperity would almost surely yield much more revenue than periods of depression.

NOTE 3 (p. 328). *Cyclical Stability of Certain Taxes*.⁹⁵ The first step

⁹¹ See pp. 153-55, 323.

⁹² See also the statements by Robert H. Jackson, Assistant General Counsel of the Treasury Department, *Revenue Act of 1935*: Hearings before the Committee on Finance, United States Senate, 74 Cong., 1 sess., on H. R. 8974, pp. 209 ff. Hereafter cited as *Revenue Act of 1935*: Senate Hearings.

⁹³ See Note 4, *Fluctuation in Urban Property Tax Rates and Assessed Valuations during the Depression* (p. 525). For delinquency, see Lutz, *op. cit.*, pp. 512-16.

⁹⁴ *Revenue Act of 1935*: Senate Hearings, pp. 209 ff., especially pp. 210, 213.

⁹⁵ The technique for this part of the study was devised and executed by William Vickrey.

in this study was to obtain for as long a period as possible the actual yield of each of as many taxes as possible, at constant rates of tax. Some taxes, such as those on cigarettes and oleomargarine, have been levied at an unchanged rate over a considerable period of years. The income and estate tax rates were practically unchanged during the period from 1926 to 1932 (except for a temporary decrease of 1 per cent in the normal income tax rate in 1929; the slight adjustment for this was fairly easy to make). Other taxes with a simple flat-rate structure, where changes in rate did not occur too frequently, were also available, since adjustments for these changes could be made without too much difficulty. In many cases the change in the tax rate took place near the end of the fiscal year, so that adjustment for part years was avoided. With other taxes (for example, the cigar tax) the report of the Bureau of Internal Revenue gives the collections at the two rates separately in the year in which the rate changed. Where, as with the state gasoline taxes, the effective date of the change in rate could not readily be ascertained, a rough estimate was made by interpolating between the previous and the succeeding year. Most taxes, however, had to be rejected for this study because the changes in the rates were too complex or because they were not in force continuously for a sufficient period. For the income and estate taxes, estimates made in another chapter on the yield for certain years supplemented those for the period from 1926 to 1932.⁹⁶ The two series were reconciled by using the ratio between the respective yields in the one or two years common to both series.

Of course not only rate changes but also substantive changes in the tax base—either by legislation or court action—or changes in administrative technique make cyclical stability difficult to isolate. The oleomargarine yield, for instance, was probably affected by the change in 1931 in the definition of taxable oleomargarine. However, for the present degree of comparison, these changes can be ignored.

After such a series of yields was obtained on a uniform basis for a series of years, several constants were computed, which, it was felt, might be used as rather crude measures of the degree to which each tax was subject to cyclical disturbance. To have a standard of reference, the mean yield over the period covered was computed. Several of the taxes, notably the gasoline and the tobacco taxes, exhibited a rather well-defined trend during the period covered. In order to reduce the confusion caused by this factor a straight-line trend was fitted to each series by the method of least squares. When, as with the income tax, there was a gap of a year in the series of yields, the trend was computed as though the series was continuous, in order to save labor; the general unsatisfactory nature of the income tax figures did not seem to warrant a more accurate and laborious treatment. For its own interest, the rate of increase of the trend,

⁹⁶ See pp. 74-75, 87.

expressed as a percentage of the mean yield, was tabulated, although it has obviously no direct bearing upon cyclical stability of yield.

Four indices of the degree of cyclical stability were computed, none of which, unfortunately, is equally appropriate for all the taxes studied. These are: the standard deviation of the yield from the mean yield, expressed as a percentage of the mean yield; the standard deviation of the yield from the trend, expressed likewise as a percentage of the mean yield; the range of the yield, expressed as the ratio of the maximum yield to the minimum yield; and the range of the deviation from the trend, expressed as the ratio of the maximum ratio of the yield to the trend to the minimum ratio of the yield to the trend. The trend and the two standard deviations were computed by methods given by R. A. Fisher in *Statistical Methods for Research Workers*.⁹⁷

The personal income and estate taxes show a decided trend, which, however, may be classed as spurious because the period covered by the series of yields for these two taxes was relatively short and extended from a period of prosperity to a period of depression. Similarly, the trends exhibited by some of the other taxes (for example, the corporate income tax and the stock transfer tax) are also of dubious significance; for, although the period for these taxes is somewhat longer and includes the depression of 1921, this depression was by no means so severe or so long as the one at the end of the period covered. Consequently, for these taxes, less weight should generally be given to the statistics based on the trend than to the statistics based on the mean. On the other hand, for the taxes that do exhibit a definite and significant trend, the figures based on the mean are practically worthless, and only the figures based on the trend should be used as a measure of cyclical stability of yield. Thus, comparisons between the two kinds of tax are difficult. The taxes with a definite trend seem to be, in general, substantially more stable in their yield than the other taxes. No real meaning is to be attached to this point, however, since it may be accounted for merely by the fact that the cyclical influences of the unstable taxes make it much more difficult to determine whether any significant long-term trend exists in the yield of these taxes.

CHAPTER 22

NOTE 1 (p. 339). *Federal Administration Costs*. The Treasury's viewpoint on detailed figures on cost of administration has been expressed as follows: "It is not possible for the Bureau to segregate the cost of auditing back-year returns from the cost of collecting the current

⁹⁷ (5th ed.; Edinburgh, 1934).

year's revenue, as the work is interlocking to a vast extent, and any attempt to segregate such cost would require a very expensive system of cost accounting, which, in the Bureau's opinion, would not be justified by the results to be obtained. For these same reasons it is also impracticable to segregate the cost of collecting the various classes of internal-revenue taxes."⁹⁸

The percentages cited in the text for federal taxes were submitted by Treasury officials at the House hearings on the Treasury Appropriation Bill for 1937.⁹⁹

NOTE 2 (p. 140). *Liquor Tax Evasion*. J. H. Choate, Jr., director of the Federal Alcohol Control Administration, estimated in an article in the *New York Times* of April 29, 1934, that the consumption of bootleg distilled spirits during 1934, as indicated by the capacity of the illicit stills seized during the first four months of that year, was indeterminately greater than the consumption of liquor on which the federal taxes and duties had been paid, and that "the government is losing more in taxes than it gets." Dr. Paul Studenski, in a report prepared for the National Municipal League, released in January 1934, concluded that the consumption of bootleg liquor, both domestic and smuggled, in this country was at that time about 85 per cent of the consumption of tax-paid products, or about 45,000,000 gallons annually. The losses to the federal Treasury on that basis, he figured, would aggregate \$90,000,000, and the losses to the states and local governments \$45,000,000, or a total loss to all public authorities of \$135,000,000 a year.¹⁰⁰

Evidence at the present time (August 1936) points to an improvement in the situation, owing to the operation of the "raw materials" law¹⁰¹ (which permits federal agents to investigate the distribution of raw materials used in the manufacture of distilled spirits) and to the 50 per cent reduction in the import duty on whiskey, provided in the agreement with Canada effective January 1, 1936.¹⁰²

⁹⁸ Statement submitted by Frederick I. Evans, budget officer, Bureau of Internal Revenue, *Treasury Department Appropriation Bill for 1937: Hearing before the Subcommittee of House Committee on Appropriations . . . 74 Cong., 2 sess.*, p. 352. Hereafter cited as *Treasury Department Appropriation Bill for 1937: House Hearings*.

⁹⁹ *Ibid.*, pp. 288, 353.

¹⁰⁰ See Studenski, *op. cit.*, p. 69.

¹⁰¹ Public Resolution No. 41, 73 Cong., 2 sess. (June 18, 1934).

¹⁰² For statements that evasion has decreased, see testimony of H. H. Graves, assistant to the Secretary of the Treasury, *Treasury Department Appropriation Bill for 1937: House Hearings*, pp. 373, 374 (cf. p. 367), and *Liquor Tax Administration Act, Taxes on Wines: Hearings before a Subcommittee of the Committee on Finance, United States Senate, 74 Cong., 2 sess.*, on H. R. 191 . . . and H. R. 9185 . . . , Part 3, p. 257. Hereafter cited as *Senate Hearings on Taxes on Wines*. Officials of the Treasury avoid making dollar estimates of the revenue lost through evasion of the liquor taxes and confine themselves to general statements. See also, *Treasury Department Appropriation Bill for 1937: House Hearings*, p. 374. For a statement that evasion has increased, see testimony in *Senate Hearings on Taxes on Wines*, Part 3, pp. 223-27.

NOTE 3 (p. 340). *Gasoline Tax Collection Costs*. Information on cost of administration is more extensive and precise for the gasoline tax than for any other tax. Aside from the data for a few states collected in the course of the present survey,¹⁰³ the most recent figures have been compiled by Crawford.¹⁰⁴ He believes his figures to be underestimates since they do not take into account the expenses incurred by the oil companies, which do the major part of the tax collecting for the state. Only recently a few states have begun to allow the companies to deduct a small percentage from the taxes that are paid, to cover these expenses. In some cases the percentage allowed for evaporation and leakage is supposed to include something for the expenses incurred in collecting the tax.

It is possible that the increased costs of the oil companies, resulting from the necessity of keeping additional records because of the gasoline tax, have not lowered the profit margins of the companies. If competition exists among the oil distributors, then at least part of the increased costs involved in collecting the tax will be shifted forward to the retailers and the consumers, since all the companies will have suffered increased costs to a greater or lesser extent. Under these circumstances, an allowance to the oil companies does not mean a reimbursement for collection expenses that they would otherwise have to carry themselves. Instead, it simply has the effect of lowering the total burden borne by the consumer, since the allowance will presumably be passed on in lower prices. This conclusion, however, does not vitiate Crawford's argument. Expenses that are involved in collecting the gasoline tax through the agency of the oil companies should, from Crawford's point of view, be brought into account, even if these expenses as well as the tax itself are apparently recouped from the consumers. These expenses might more simply be treated as costs of compliance with the gasoline tax, and cost of collection might be restricted to the actual outlays made by the tax authorities of the states.

No doubt an appreciable part of the gasoline tax is evaded, but the present writer's impression is that the subject has been magnified in the public press beyond its true importance. During the past three or four years the states have adopted a variety of measures designed to minimize the possibilities of evasion, which is surely much less of a problem now than formerly. Among the measures are the port-of-entry system (initiated in Kansas in 1933), the border patrols (for example, along the Ohio-Pennsylvania border), limitations upon, and much more rigorous checking of, refunds and exemptions, adoption of "receipt" of gasoline in place of "sale" as the basis of levying the tax, and a general tightening of the provisions of the state

¹⁰³ See the memorandum by Thomas J. Reynolds on cost of tax administration in the forthcoming volume, *Studies in Current Tax Problems*.

¹⁰⁴ Crawford, *op. cit.* (the latest edition covers 1934).

statutes along with greatly expanded administrative, auditing, and enforcement agencies.

NOTE 4 (p. 340). *Administration of State Income Taxes*. As late as 1933 the present writer obtained a distinct impression, from reliable sources, that the personal income tax in several states was in some danger of lapsing into a position similar to that of the property tax on intangibles—and without the same excuse of a crushing rate. Since that time, however, many more states have inaugurated an income tax,¹⁰⁵ and several have placed personal exemptions and credits for dependents at levels below those of the federal tax. These events indicate an interest in possible income tax revenues that promises well for the future administration of the tax.

The states levying income taxes have been subject to two temptations to apathy in administration that have not troubled the federal government.

First, in most of the states the tax has covered a predominantly rural territory.¹⁰⁶ The income concept usually adopted for tax purposes is an exchange concept; that is, it includes only income realized by the exchange of one thing or service for another. Hence, it excludes the real economic power represented by the hypothetical interest on the capital value of goods whose user is also their owner. For example, it excludes imputed interest on the value of that part of a farm dwelling that is not counted as a business asset. It also excludes the value of services that the taxpayer renders to himself, as in growing food for himself. Indeed, in practice if not in law, in most states the farmer is probably allowed to deduct from taxable income certain expenses incurred in obtaining this non-taxable imputed income, as when he deducts wages paid to a farm laborer to grow food that is in part consumed by himself and his family. Consequently, the tax administrators in predominantly rural states have probably felt that the limited amount of money available for tax administration could be used with more obvious profit in improving the administration of other taxes.

Second, the state rates in the upper brackets have been low, partly because of the high federal rates and partly because of fear of interstate competition for wealthy residents. Notable achievements in increasing revenue by increased activity in enforcement have therefore depended on pressure against recalcitrant taxpayers of moderate and small incomes. This consideration must have seemed distasteful to both administrators and legislators because of the high cost of collection that it would exhibit and the number of votes it might lose. Moreover, the smaller the administrative unit under the income tax, the greater the chance that the taxpayer would be subject to official inquiry by some acquaintance. Under a large administra-

¹⁰⁵ See p. 45.

¹⁰⁶ Chart 2, p. 15.

tive unit the questioning is carried on by some unknown, almost impersonal embodiment of tax administration, to whom the taxpayer may divulge the details of his private finances with less embarrassment.

These comments, however, are practically without support from recent reports of special tax commissions, which appear to have almost uniformly ignored the subject of evasion under the state personal income taxes.¹⁰⁷

NOTE 5 (p. 341). *Definition of Cost under the Property Tax.* Apparently, little or no work has been done on the formulation of useful definitions of cost of administration under the property tax. The reason is perhaps obvious in view of the dearth of data to which the definitions might be applied. Even such a comprehensive volume as Jensen's *Property Taxation in the United States* devotes only slightly more than a page to cost of administration and refers to only two sources of information.¹⁰⁸

Percentage figures will probably prove especially difficult to handle intelligently for the property tax because of the large number of small jurisdictions. A state-wide average would hide a number of extreme cases worth considering. Partially overlapping jurisdictions offer perplexing problems of territorial allocation of costs if the object is to find the total cost of all property taxes collected within a certain small area, such as a town or a school district. Variation from state to state in legal treatment of personalty, particularly intangibles, will tend to invalidate comparisons among states. Variations in the degree of earnestness with which the legal provisions are applied will add to the difficulty.

Even in real estate, variations make comparison dangerous. For example, in some states assessors must devote time to valuing exempt property. The North Carolina tax commission has made the interesting suggestion that among the "indirect costs" of property tax collection should be included the interest paid on tax anticipation loans and "the loss incurred as the result of an unnecessarily large insolvent list."¹⁰⁹

These remarks are not meant to imply that property tax cost data are bound to be useless when gathered. A necessary preliminary stage, however, is the development in some detail of techniques of adjustment. Without such techniques the figures will be of little or no value in comparisons.

¹⁰⁷ An exception is Hugh J. Reber and Edwin O. Griffenhagen, *The Taxation System of Missouri: A Report to the State Survey Commission*, November 7, 1929, pp. 67-68.

¹⁰⁸ For scattered data discovered in the course of the present survey, see the memorandum by Thomas J. Reynolds on cost of tax administration in the forthcoming volume, *Studies in Current Tax Problems*.

¹⁰⁹ *Report of the Tax Commission to Governor Angus Wilton McLean*, State of North Carolina (1928), pp. 418, 419.

NOTE 6 (p. 342). *Cost of Compliance Study*. The study referred to in the text was made by Professor Robert Murray Haig, with assistance from the Council for Research in the Social Sciences of Columbia University and from the American Management Association.¹¹⁰ The sample consisted of 163 corporations, which responded in detail to the questionnaires (originally sent to 1,600 corporations). The sample consisted of large rather than small corporations, and manufacturing was heavily represented.

Professor Haig discusses the various factors that distort the figures, and states that "actual contact with the individual returns has led me to the belief that the costs of compliance are understated in more instances than they are exaggerated."¹¹¹

NOTE 7 (p. 346). *Added Revenues Obtained from Added Expenditures*. A federal project was inaugurated during August 1935 with a W. P. A. allotment, and operations to June 30, 1936, showed total collections and assessments of \$13,911,807—the total collections were only \$3,411,477—, compared with a total expense of \$1,798,981.¹¹² "Approximately 1,800 relief workers, trained and supervised by permanent employees of the Internal Revenue Service, were assigned to twenty-two Internal Revenue collection districts, comprising twenty metropolitan areas. Intensive inspections were made of the books of furriers, manufacturing jewelers, sporting goods manufacturers, cosmetics manufacturers and enterprises subject to taxes on admissions and dues."¹¹³ Presumably the delinquent tax revenue is primarily from the excise taxes rather than income taxes, though the official release is not specific on this point. The total collections from the excise taxes on those concerns were only \$43,000,000 in the fiscal year 1935.

A W. P. A. project on the income tax showed by June 30, 1936, a "net tax recommended" of \$1,578,297 compared with a cost of \$730,043; and a third W. P. A. project, on liquor taxes, showed at the same date "total additional revenue found due" of \$1,004,708 compared with a cost of \$853,046.¹¹⁴

The Texas project throws an interesting light on the relations between federal and state governments. Federal money for relief was not to be spent on projects that were merely normal functions of state or local governments. The Washington authorities, reflecting at least their own opinion of state and local tax administration standards, ruled that it was not a normal function of a state or local government to find land that was not on the property tax rolls.¹¹⁵

¹¹⁰ Preliminary findings are given in "The Cost to Business Concerns of Compliance with Tax Laws," *The Management Review*, XXIV, No. 11 (November 1935), 323-33.

¹¹¹ *Ibid.*, p. 326.

¹¹² Treasury Department, Press Release No. 75, For Release August 4, 1936.

¹¹³ Treasury Department, Press Service No. 7-28, For Release April 30, 1936, p. 1.

¹¹⁴ Treasury Department, Press Release No. 75, For Release August 4, 1936.

¹¹⁵ See statement of Leo Day Woodworth, in *Proceedings of the . . . National Tax Association*, 1935, p. 249.

Some other scattered examples indicate that taxing jurisdictions generally could get a substantial amount of additional revenue by spending more money. The chairman of the state tax commission of Michigan has estimated that \$75,000 spent in newspaper and billboard advertising brought in \$15,000,000 in back taxes.¹¹⁶ Of course, a large part of those tax payments might have been made eventually anyway. In Oklahoma, "total income taxes voluntarily reported for the years 1931, 1932, 1933, and 1934, amount to \$5,917,175.75. Additional income taxes, assessed as a result of the commission's audits from July 1, 1931 to October 1, 1935, amount to \$4,129,631.31. Additional assessments resulting from audits are 69.8 per cent of the tax liability voluntarily reported."¹¹⁷

In Kansas a reorganization of tax administration was apparently the chief reason for an increase in the yield of the cigarette tax from \$335,582.50 in the calendar year 1933 to \$678,320.86 in the calendar year 1934 and to \$782,522.66 in the calendar year 1935 (the tax rate remained unchanged).¹¹⁸ Likewise in Kansas, the port-of-entry plan, the stationing of employees at points of production, and a complete auditing organization are credited with increasing gasoline tax collections \$1,025,000 in a year.¹¹⁹ The total revenue from the gasoline tax for 1935 in Kansas was \$8,830,647.

NOTE 8 (p. 348). *Centralization versus Decentralization*. For an authoritative statement of the issues involved in centralization versus decentralization of federal tax administration, with special reference to income and death taxes, see Roswell Magill, "Federal Tax Administration," in *Government Finance in the Modern Economy*.¹²⁰ Magill favors decentralization, with elimination of the present system of time-consuming reviews—and probably with elimination also of published rulings in individual cases and much of the present elaborate interpretation of the law made in the published regulations. The machinery of the decentralized system is well explained in descriptions of the British tax administration.¹²¹

T. S. Adams complained in 1921, in reference to the excess profits tax, that the Treasury had set itself too high an ideal, in trying "to find the same and correct answer to each of the thousands of . . . questions. . . ."¹²² Adams urged that we "rid ourselves of some of the meticulous legalism which leaves each minute point practically

¹¹⁶ Statement of Melville B. McPherson, in *Proceedings of the . . . National Tax Association*, 1935, p. 262.

¹¹⁷ H. L. McCracken, "The Reorganization and Work of the Oklahoma Tax Commission," *Proceedings of the . . . National Tax Association*, 1935, p. 74.

¹¹⁸ Letter to the writer from the Kansas state tax commission, April 29, 1936.

¹¹⁹ *Loc. cit.*

¹²⁰ Paul Studenski, ed., *The Annals of the American Academy of Political and Social Science*, CLXXIII (January 1936), 179-88. Hereafter cited as *Government Finance: Annals*.

¹²¹ See Magill, Parker, King, *op. cit.*, *passim*, and Haig, *Taxation of Excess Profits in Great Britain*, pp. 93-130.

¹²² Adams, *op. cit.*, p. 373.

unsettled until it has been formally decided by a court of law."¹²³ Recently, the Internal Revenue Bureau started a decentralization experiment with the income tax in the Cleveland district.¹²⁴

Collection at the source may be regarded as a still higher form of centralization for the income tax than the system now in existence. Under it, many of the real taxpayers never come in contact with the government. One body, the business firm, acts in the place of many individuals. This system was used to a very limited extent in the federal income tax in 1913 and the following years. It provoked so much discontent that it was soon abandoned.¹²⁵

In most states administration of the state tax systems is decentralized in the sense that several more or less independently acting state bodies divide the administration of the taxes.¹²⁶ Better administration is usually possible under a unified organization.

As to centralization in the sense of increasing the power of state tax commissions over assessment of property, the recent history of state supervision indicates that some reforms of state practice are needed if great improvement is to be expected by centralization. See the criticisms by Lutz,¹²⁷ and compare the opinions of Silverherz, who favors a high degree of centralization at once.¹²⁸ A partial form of centralization is supplied by boards of equalization designed primarily to assure a uniform average ratio of assessed to true value in two or more co-ordinate jurisdictions when the assessed values therein are subject to a levy by a higher jurisdiction.

A statement of the Internal Revenue Bureau's view of administration, including the policy of notifying taxpayers of errors against themselves, is in a recent article by the assistant to the commissioner.¹²⁹

NOTE 9 (p. 348). *Associations of Tax Administrators*. Tax administrators of the states and localities have been grouped informally ever since 1907 through their contacts with the National Tax Association. In its more specific and organized forms, the movement is a recent one, as is indicated by the following dates of organization (for details, see Public Administration Clearing House, *A Directory of Organizations in the Field of Public Administration, 1936*):

¹²³ *Ibid.*, p. 374.

¹²⁴ Eldon P. King, "Collecting the Revenue—Current Developments," *The Tax Magazine*, XIV, No. 10 (October 1936), 586-92.

¹²⁵ See the complaints noted in *Readjustments in Taxation, The Annals of the American Academy of Political and Social Science*, LVIII, Whole No. 147 (March 1915), 20-28, 30-37.

¹²⁶ See the remarks by Mark Graves, "Administration of State Taxes as Viewed by an Administrator," in *Government Finance: Annals*, pp. 189-98; see also E. T. Miller, *op. cit.*, pp. 84-85.

¹²⁷ Lutz, *op. cit.*, pp. 509-12, 546-48.

¹²⁸ Silverherz, *op. cit.*, pp. 324-40. Cf. Kendrick, *op. cit.*, pp. 55-64.

¹²⁹ Wright Matthews, "U. S. Tax Administration," *The Tax Magazine*, XIII, No. 10 (October 1935), 575-77, 628-29.

- Municipal Finance Officers' Association of the United States and Canada, 1906
National Association of State Auditors, Comptrollers, and Treasurers, 1915
North American Gasoline Tax Conference, 1925
National Association of Administrators of Tobacco Tax Laws, 1927
American Conference of Motor Vehicle Administrators, 1933
National Association of Tax Administrators, February 1934
National Conference of State Liquor Administrators, June 1934
National Association of Assessing Officers, September 1934

CHAPTER 23

NOTE 1 (p. 354). *Ownership of Homes*. According to the Census of 1930 there are roughly 29,900,000 families in the United States,¹³⁰ including 2,350,000 persons living alone, each counted as a family, but not including 2,960,000 persons living in quasi-family groups, chiefly in institutions, hotels, and boarding and lodging houses.¹³¹ Of these families, 14,060,000, or about 47 per cent of the total, own the homes that they occupy. Ten and a half million own and occupy non-farm homes, and 3,560,000 own and occupy farms.¹³²

The total number of dwellings in the United States is 25,200,000.¹³³ Since only 14,060,000 are occupied by their owners, the remaining 11,140,000 are rented dwellings, some of them apartment houses. These are occupied by the 15,320,000 families who do not own their homes. If one owner were counted for each dwelling, the number of landlords affected by the property tax would, thus, be 11,140,000. Actually, one person sometimes owns several dwellings, and one dwelling is sometimes owned by several persons (directly, under a partnership, or indirectly, as under a corporation). In the absence of relevant data, however, the estimate of the number of landlords can be carried no further.

NOTE 2 (p. 71). *Increases in Returns from Changes in Exemptions and Earned Income Credit*. The following Tables, M and N, contain estimates of the number of returns that would be obtained if the provisions in the federal income tax law concerning exemptions, credits for dependents, and earned income credit were changed.

¹³⁰ *Statistical Abstract of the United States: 1934*, Table 39, p. 47.

¹³¹ United States Bureau of Census, *Fifteenth Census of the United States, 1930, Population*, VI, 5-7. Hereafter, the term "family" includes a single person living alone.

¹³² *Statistical Abstract of the United States: 1934*, Table 42, p. 50, and Table 523, p. 549.

¹³³ *Ibid.*, Table 39, p. 47.

FACING THE TAX PROBLEM

TABLE M

ESTIMATED NUMBER OF TAXABLE INDIVIDUAL RETURNS FOR 1933 WITH NET INCOME UNDER \$5,000 FOR VARIOUS PERSONAL EXEMPTIONS AND EARNED INCOME CREDIT PROVISIONS BY INCOME CLASSES
TAXABLE RETURNS ONLY^a

Exemptions:	1932 Act	1934 Act	Hypothetical Personal Exemptions			Taxable and Non-Taxable Returns ^b
			\$1,000	\$1,500	\$1,000	
Married.....	\$2,500	\$2,500	\$1,000	\$1,500	\$1,000	\$2,500
Single.....	1,000	1,000	1,000	800	500	1,000
Dependent...	400	400	400	300	200	400
Earned income credit.....	None	10%	10%	10%	10%	None

(In Thousands of Dollars)

Income Classes	SINGLE PERSONS					
	1932 Act	1934 Act	\$1,000	\$1,500	\$1,000	Taxable and Non-Taxable Returns ^b
0-1.....	972	972	972	333,734	1,416,030	216,949
1-2.....	718,669	473,890	473,890	804,195	967,972	879,294
2-3.....	125,950	125,541	125,541	125,950	125,950	138,636
3-4.....	37,462	37,462	37,462	37,462	37,462	42,667
4-5.....	17,279	17,279	17,279	17,279	17,279	20,327
Total single..	900,332	655,144	655,144	1,318,620	2,564,693	1,297,873

MARRIED PERSONS AND HEADS OF FAMILIES						
Income Classes	1932 Act	1934 Act	\$1,000	\$1,500	\$1,000	Taxable and Non-Taxable Returns ^b
0-1.....	934	934	934	934	934	163,457
1-2.....	9,663	9,663 ^c	9,663	593,385	3,857,503	583,019
2-3.....	131,991	3,583 ^c	347,848	1,002,848	1,207,186	764,159
3-4.....	222,961	137,395	253,100	323,455	328,119	383,392
4-5.....	120,139	183,536	121,027	122,859	122,859	136,079
Total married	485,688	265,111	732,572	2,043,481	5,516,601	2,030,106

WIVES FILING SEPARATE RETURNS ^d						
Income Classes	1932 Act	1934 Act	\$1,000	\$1,500	\$1,000	Taxable and Non-Taxable Returns ^b
0-1.....	7,261	7,261	7,261	7,261	7,261	17,270
1-2.....	9,319	9,319	9,319	9,319	9,319	18,404
2-3.....	7,860	7,860	7,860	7,860	7,860	11,403
3-4.....	7,337	7,337	7,337	7,337	7,337	9,022
4-5.....	5,442	5,442	5,442	5,442	5,442	6,588
Total wives..	37,219	37,219	37,219	37,219	37,219	62,687

ALL RETURNS						
Income Classes	1932 Act	1934 Act	\$1,000	\$1,500	\$1,000	Taxable and Non-Taxable Returns ^b
0-1.....	9,167	9,167	9,167	341,929	1,424,225	397,676
1-2.....	737,651	492,872	492,872	1,406,899	4,834,794	1,480,717
2-3.....	265,801	136,984	481,249	1,136,658	1,340,996	914,198
3-4.....	267,760	182,194	297,899	368,254	372,918	435,081
4-5.....	142,860	136,257	143,743	145,580	145,580	162,994
Total.....	1,423,239	957,474	1,424,935	3,399,320	8,118,513	3,390,666

^a No correction is made in this table (unlike Table 6 in chap. 6, and the corresponding table in the memorandum by Susan Burr and William Vickrey on estimates of yield from the income tax and the estate tax, in the forthcoming volume, *Studies in Current Tax Problems*) for returns that become non-taxable because of deduction of dividends. See pp. 77-78.

^b This column, giving the total number of returns actually filed in 1933, is included for comparison. In past experience, non-taxable returns range from 38 per cent to 58 per cent of all returns. See also Table N.

^c For comments on this anomaly, see the memorandum referred to in note a.

^d Returns in this category were assumed to be unaffected. See the memorandum referred to in note a.

Table M, concerned only with taxpayers with net incomes under \$5,000, shows the number of returns, by income classes, in that group. It covers taxable returns only, and hence is a better measure of tax consciousness than Table N. Since the latter shows returns for all groups (not merely those under \$5,000) and includes non-taxable returns, it is more instructive from an administrative point of view.

TABLE N

ESTIMATED TOTAL NUMBER OF POTENTIAL FEDERAL INDIVIDUAL RETURNS FOR THE INCOME YEAR 1933 WITH NET INCOME ABOVE CERTAIN EXEMPTION LEVELS BOTH TAXABLE AND NON-TAXABLE RETURNS INCLUDED^a

Single Returns		Family Returns		Total Number of Returns
Exemption (In Dollars)	Number of Returns ^b	Exemption (In Dollars)	Number of Returns ^c	
1,000.....	1,701,000	2,500.....	1,267,000	2,968,000
1,000.....	1,701,000	2,000.....	2,123,000	3,824,000
800.....	2,404,000	1,500.....	4,835,000	7,239,000
500.....	3,428,000	1,000.....	8,808,000	12,236,000

^a For taxable returns only, for net incomes under \$5,000, see Table M.

^b Including 80,000 separate returns of wives.

^c Including 16,000 community property returns.

CHAPTER 24

NOTE 1 (p. 369). *Supreme Court Decisions. Farmers' Loan & Trust Co. v. Minnesota*, 290 U. S. 204 (1930); *Baldwin v. Missouri*, 281 U. S. 586 (1930); *Beidler v. South Carolina Tax Commission*, 282 U. S. 1 (1930); *First National Bank of Boston v. Maine*, 284 U. S. 312 (1932).

It had long been admitted that real property could be taxed only by the jurisdiction of situs, and in 1905 the Supreme Court decided that a state could not tax tangible personal property that had a permanent location elsewhere. *Union Refrigerator Transit Co. v. Kentucky*, 199 U. S. 194 (1905). Multiple taxation of intangibles, however, had been quite permissible until very recently.

NOTE 2 (p.379). *Shared Taxes and Grants-in-Aid*. The following tables give the trends in shared taxes and grants-in-aid and their relative importance in government revenues in the United States.

TABLE O

FEDERAL AND STATE REVENUES DISTRIBUTED TO UNDERLYING JURISDICTIONS,
SELECTED YEARS, 1902-35^a

	1902	1912	1925	1928	1932	1933	1934	1935
	<i>(In Millions of Dollars)</i>							
Federal tax revenue...	530	633	3,137	3,364	1,889 ^b	1,855 ^b	2,954 ^b	3,621 ^b
Grants by federal government.....	3	3	159	151	269	287	1,875	2,230
State revenue from federal aid and state taxes.....	175	336	1,462	1,925	2,151	1,985	2,487	2,946
Grants and shared taxes by states.....	76	119	536	650	759	810	937	1,066
	<i>(In Per Cent)</i>							
Ratio of federal grants to federal tax revenue	0.5	0.5	5.1	4.5	14.2 ^b	15.5 ^b	63.5 ^b	61.6 ^b
Ratio of state grants and shared taxes to revenue from federal aid and state taxes	43.4	35.4	36.7	33.8	35.3	40.8	37.7	36.2

^a Data for 1902 and 1912 from Department of Commerce, Bureau of the Census, *Wealth, Debt and Taxation, 1913*. Data for federal government for remaining years from *Report of the Secretary of the Treasury*. Data for states for remaining years from *Financial Statistics of States; Financial Statistics of State and Local Governments: 1932*, and financial reports of individual states.

^b It should be recalled that in these years total federal expenditures were much greater than total federal tax revenues.

TABLE P

STATE TAX AND GRANT REVENUE, SELECTED YEARS, 1902-35^a

	1902	1912	1925	1928	1932	1933	1934	1935
	<i>(In Millions of Dollars)</i>							
State revenue from federal aid and state taxes...	175	336	1,462	1,925	2,151	1,985	2,487	2,946
From federal aid.....	3	3	159	151	269	235	491	653
From state taxes ^b	172	333	1,303	1,774	1,882	1,750	1,996	2,293
	<i>(In Per Cent)</i>							
State revenue from federal aid and state taxes...	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
From federal aid.....	1.5	0.9	10.9	7.8	12.5	11.8	19.7	22.2
From state taxes ^b	98.5	99.1	89.1	92.2	87.5	88.2	80.3	77.8

^a Data for 1902 and 1912 from *Wealth, Debt and Taxation, 1913*. Data for federal aid, 1925 to 1935, from *Report of the Secretary of Treasury*. Data for state taxes from *Financial Statistics of States* for 1925 and 1928, *Financial Statistics of State and Local Governments* for 1932, and financial reports of individual states for 1933, 1934, and 1935.

^b Includes shared taxes distributed to local governments.

TABLE Q
SOURCES OF LOCAL REVENUE
SELECTED YEARS, 1902-35^a

	1902	1912	1925	1928	1932	1933	1934	1935
	<i>(In Millions of Dollars)</i>							
Local revenue ^b	763.4	1,447.9	4,151.6	4,980.2	5,234.6	4,786.7	6,180.5	6,451.9
From state:								
Total.....	75.8	118.9	535.8	649.6	758.6	809.7	937.5	1,065.9
Shared taxes.....	17.5	32.3	195.2	267.2	239.9	244.7	263.7	292.8
Grants-in-aid.....	58.3	86.6	340.6	382.4	518.7	565.0	673.8	773.1
From federal government ^c	—	—	—	—	—	52.0	1,384.0	1,577.0
From local taxes.....	687.6	1,329.0	3,615.8	4,330.6	4,476.0	3,925.0	3,859.0	3,809.0
	<i>(In Per Cent)</i>							
Local revenue.....	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
From state:								
Total.....	9.9	8.2	12.9	13.1	14.5	16.9	15.2	16.5
Shared taxes.....	2.3	2.2	4.7	5.4	4.6	5.1	4.3	4.5
Grants-in-aid.....	7.6	6.0	8.2	7.7	9.9	11.8	10.9	12.0
From federal government.....	—	—	—	—	—	1.1	22.4	24.5
From local taxes.....	90.1	91.8	87.1	86.9	85.5	82.0	62.4	59.0

^a For sources, see footnote a to Table P.

^b Including grants-in-aid and state-shared taxes, but excluding local non-tax revenue.

^c Relief grants. Other federal money eventually reaching the local units is included in state aid.

TABLE R
LOCAL SHARE OF STATE-ADMINISTERED TAXES
SELECTED YEARS, 1902-36*

Tax	1902	1912	1925	1928	1932	1933	1934	1935	1936
	(In Thousands of Dollars)								
Income.....	—	1,168	59,832	57,505	32,682	27,141	28,868	31,002	40,059
Corporation.....	6,387	13,307	37,390	61,962	33,859	28,006	24,706	28,304	44,693
Inheritance and estate.....	197	499	3,390	4,612	3,124	2,583	2,588	2,552	3,355
Motor vehicle.....	—	905	58,246	67,020	52,553	61,463	61,885	70,414	74,299
Motor fuel.....	—	—	28,837	64,237	113,407	118,509	110,679	111,254	128,871
Sales.....	—	—	—	—	—	—	3,552	9,686	79,025
Liquor.....	10,883	14,226	—	—	—	2,494	26,443	33,767	37,308
Other.....	—	2,192	7,509	11,845	4,241	4,486	4,998	5,801	22,512
Total.....	17,467	32,297	195,204	267,180	239,866	244,682	263,719	292,780	430,122
	(In Per Cent)								
Income.....	—	3.6	30.7	21.5	13.6	11.1	10.9	10.6	9.3
Corporation.....	36.6	41.2	19.2	23.2	14.1	11.5	9.4	9.7	10.4
Inheritance and estate.....	1.1	1.5	1.7	1.7	1.3	1.1	1.0	0.9	0.8
Motor vehicle.....	—	2.8	29.8	25.1	21.9	25.1	23.5	24.0	17.3
Motor fuel.....	—	—	14.8	24.1	47.3	48.4	42.0	38.0	30.0
Sales.....	—	—	—	—	—	—	1.3	3.3	18.4
Liquor.....	62.3	44.1	—	—	—	1.0	10.0	11.5	8.7
Other.....	—	6.8	3.8	4.4	1.8	1.8	1.9	2.0	5.2
Total.....	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

* Data for 1902, 1912, and 1925 from Mabel Newcomer, "Tendencies in State and Local Finance and Their Relation to State and Local Functions," *Political Science Quarterly*, XLIII (March 1928), with some changes in classification; 1928 from R. G. Hutchinson, *State-Administered Locally Shared Taxes* (New York, 1931); from 1932 to 1935 compiled from state financial reports; 1936 compiled from data in the memorandum by Mabel Newcomer on government expenditures in the forthcoming volume, *Studies in Current Tax Problems*.

TABLE S
STATE GRANTS-IN-AID
SELECTED YEARS, 1902-35^a

(In Millions of Dollars)

Purpose	1902	1912	1925	1928	1932	1933	1934	1935
Education.....	45.4	82.1	254.1	323.1	397.4	386.8	446.3	521.8
Highways.....	—	^b	63.1	42.1	63.0	51.5	51.2	57.5
Welfare.....	^b	^b	3.9	10.3	42.1	110.1	159.8	178.7
Other.....	12.9	4.5	19.5	6.9	16.2	16.6	16.5	15.1
Total.....	58.3	86.6	340.6	382.4	518.7	565.0	673.8	773.1

(In Per Cent)

Education.....	77.9	94.8	74.6	84.4	76.7	68.5	66.2	67.5
Highways.....	—	^b	18.5	11.0	12.1	9.1	7.6	7.4
Welfare.....	^b	^b	1.2	2.8	8.1	19.5	23.7	23.1
Other.....	22.1	5.2	5.7	1.8	3.1	2.9	2.5	2.0
Total.....	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

^a Data for 1902, 1912, and 1925 from Mabel Newcomer, "Tendencies in State and Local Finance and their Relation to State and Local Functions," *Political Science Quarterly*, XLIII (March 1928); from 1928 to 1935 compiled from state financial reports.

^b Data for separate classification not available. Included in "Other."

CHAPTER 25

NOTE 1 (p. 392). *Model Plans*. No one comprehensive and uniform plan for the federal tax system has attracted widespread and favorable attention, but in the field of state and local taxation this tribute has been accorded to the report on a plan of a model system of state and local taxation that was drafted by a committee of the National Tax Association in 1918 and revised by a second committee in 1933.¹³⁴

Those who are familiar with the "model plan" will readily see, from the text of the present chapter, that the directors of the present study differ from the model plan committee members in some fundamental objectives, and, to a much less degree, in judgment on certain technical matters. As has been indicated above, differences of the first kind are to be expected to a certain extent. Differences of the second kind will undoubtedly diminish as the amount and quality of information gathered by research improves. Moreover, the model plan committee concentrated on state and local taxation. The present study has been unable to devote as much attention to this field, in view of the federal questions discussed, as would be necessary for

¹³⁴ "Preliminary Report of the Committee Appointed by the National Tax Association to Prepare a Plan of a Model System of State and Local Taxation," *Proceedings of the . . . National Tax Association*, 1919, pp. 426-70; "Second Report on a Plan of a Model System of State and Local Taxation: By the Committee Appointed by the Association in 1932 to Review the Plan Proposed by a Former Committee in September 1918," *Proceedings of the . . . National Tax Association*, 1933, pp. 353-420. See, by way of comment, *The Place of State Income Taxation in the Revenue Systems of the States*. Report of a Committee of the Tax Policy League (New York, 1935).

an adequate consideration of the many significant points analyzed by the committee.

A recent survey of the opinions of teachers of public finance, made by the New York State tax commission,¹³⁵ indicates in a striking manner the kinds of topics upon which disagreement is apt to be found, and the extent of the disagreement. Unfortunately, it is not possible to tell whether the disagreements arise chiefly from differences in objectives or differences in technical judgment. Out of 127 professors responding either yes, no, or no conclusive answer, 90 per cent or more responded the same way in 12 out of the 116 questions. On only 1 question was there a complete agreement in the yes and no answers: 126 voted yes on "graduated personal income tax," and 1 returned an inconclusive answer. The other 11 questions, in the exact wording as given in the printed document, were:

Should inheritances or estates be taxed by the Federal government.	Yes: 115
Should gifts, whether or not in contemplation of death, be taxed to avoid evasion of the inheritance tax.	Yes: 117
Should the death taxes be progressively graduated.	Yes: 121
Net income tax on corporations.	Yes: 120
General retail sales tax: Local.	No: 119
Producers sales tax: Local.	No: 119
Tobacco tax.	Yes: 121
Such luxury taxes as can be practically administered.	Yes: 116
[Should there be an] . . . increase in control . . . [over] suppression of crime . . . [on part of Federal government accompanied by equal decrease on part of states].	Yes: 119
Should the state supervise local assessment.	Yes: 123
Should competent board of state engineers determine taxable valuations of all difficult properties, such as railways and public utilities.	Yes: 119

In several questions the division of opinion was close. The following questions are those where the difference between the number of yes answers and number of no answers was not greater than 10:

¹³⁵ *Answers by American Professors of Public Finance to Questionnaire on Taxation with Special Reference to the Relationships of the Federal Tax System on the One Hand and of the State and Local Tax Systems on the Other* (Report as of January 1, 1936), separately printed, by New York State tax commission (1936).

	Yes	No	No definite answer
Classified property tax for intangibles	55	57	15
Minimum filing fee in Federal personal income tax law	59	53	15
Ditto, in state law	59	52	16
Personal income tax to include capital gains and losses provision	53	44	30
Gasoline tax to pay for all highway construction (Federal, state, and local)	57	51	19
Gasoline tax to pay for all highway construction and maintenance	56	55	16
Increase in financial support of education on part of Federal government accompanied by decrease for states	56	50	21
[Increase in Federal control] over merchandising	54	51	22
Should state statutes contain tax limit provisions	58	49	20
Abolition of towns with transfer of functions to county or state	47	51	29
Death tax basically Federal tax with surtaxes collected by states that care to adopt them	54	48	25
Abolition of all death taxes except Federal with distribution of part of proceeds to states	49	58	20

For another statement of opinions, see "The Taxation Problem of the United States: Report of a Special Committee of the National Economic League," *Consensus*, XX, 2 (November 1935), 1-46.

In *Tax Systems of the World* (pp. 362-63), Paul Haensel presents his idea of a model plan, complete even to rates of tax.

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