

CHAPTER 1

INTRODUCTION

I. MEANING OF PROGRESSIVE TAXATION

Promotion of Equality

Genuinely progressive taxation is necessarily personal taxation. Progressive taxation may be defined as taxation which tends to promote economic equality (i.e., a more equal distribution of income, wealth, consumption, or other measure of economic status). While some indirect or *in rem* taxes may be more "progressive" than others in that they do tend to produce a slightly greater degree of economic equality than others, this effect is achieved only on the average, with wide individual fluctuations in the effects; at best the degree of equalization achievable with such taxes is limited. And though such taxes may be graduated in form (e.g., taxes on corporation income, chain stores), this graduation seldom has any close relation to differences in the economic status of the individuals who ultimately bear the burden. Really substantial effects upon economic inequality are obtainable only with taxes graduated according to some attribute of the individual taxpayer indicative of his economic status or "ability to pay." Accordingly, we are here concerned primarily with such personal taxes.

Ability to Pay

In a strict sense, "ability to pay" is not a quantity susceptible of measurement or even of unequivocal definition. More often than not, ability to pay and the equivalent terms "faculty" and "capacity to pay" have served as catch-phrases, identified by various writers through verbal legerdemain with their own pet concrete measure to the exclusion of other possible measures.

Ability to pay thus often becomes a tautological smoke screen behind which the writer conceals his own prejudices.^a

In a broader sense, any method of taxation that achieves the objective of reducing the degree of economic inequality among individuals is to that degree taxation according to ability to pay. The base used for such a tax can then be considered an index of ability to pay.

But ability to pay, however interpreted, is an attribute of individuals and not of things, nor even, in any sound sense, of the agencies of individuals as such. To be sure, in assessing a tax the ability to pay of individuals is necessarily measured or indicated by some overt fact which can be determined objectively and measured, but the index thus selected must not be identified with ability to pay as such. It must never be forgotten that it is the individual that is being taxed and not the income, wealth, property, or expenditure that happens to be the measure according to which the tax is assessed.

II. FORMS OF PROGRESSIVE TAXATION

Progressive taxes may be divided into two general types: one type of tax is based on a flow of money or goods and services during a given period of time, the other on a stock of capital or goods belonging to a taxpayer at a given point in time. The principal exemplars of the "flow" type of tax are the income tax and the spendings tax; the "stock of goods" type of tax includes property taxes, net worth taxes, capital levies, and succession taxes.

Spendings

Of the flow types of tax base, spendings is probably the easiest to define. In principle it is merely the money value of the

^a For example, Paul Haensel, in a review of Irving Fisher's book advocating a spendings tax, says: "By no stretch of logic is it possible to advocate a progressive spendings tax, since progressive rates are thinkable only as applied to general capacity to pay." [33 *American Economic Review* 164 (March, 1943).] Usually the identification of "ability to pay" with "income" or other quantity is not so deliberately oblivious of the possible claims of other indicia.

total volume of goods and services consumed by the taxpayer during a given interval of time, since what is to be measured is the current level of welfare of the taxpayer. In practice, the amount paid for items purchased for personal use is for convenience taken to measure consumption, thus disregarding the time lags between purchase and consumption. For durable consumer goods purchased in large units, an annual rental value may be preferred, as a measure of consumption, to the lump sum outlay, since in such cases the irregularities produced by a strictly cash accounting may be more objectionable than the inconvenience of the added computation. Allowance must be made in any case for consumer goods and services obtained otherwise than by purchase for money, as by gift, compensation in kind for personal services, barter, or direct personal effort. Also expenditures for personal consumption must be distinguished from business expenses and investment outlays made to procure spendable income, a distinction often requiring quite arbitrary decisions.

When a spendings tax was first suggested, it was generally believed that such a tax would prove impractical because of the necessity of deriving the tax base from an aggregation of the many small items that make up consumer outlays; this method of computing the tax would not only be tedious but would be almost impossible for the tax collector to audit effectively.¹ Modern proposals for a spendings tax contemplate arriving at the tax base indirectly from data on total receipts and on outlays for investment. On one side of the ledger would be added together various "funds available for expenditure," such as wages, dividends, gifts, insurance proceeds, withdrawals from trade or business, proceeds from the sale of assets, and bank balances and cash at the beginning of the year. From this would be deducted non-spendings uses of these funds, such as life insurance premiums, purchase of securities, gifts, etc., and bank balances and cash on hand at the end of the year. The difference, added to the non-money items mentioned above, would be the base for the spendings tax. The items involved

¹ See, e.g., A. C. Pigou, *Studies in Public Finance* (London, Macmillan & Co., Ltd., 1928), Ch. X, esp. pp. 135-144.

in such a computation would be fewer, larger, and more amenable to audit than those which would be required in a schedule of actual outlays on consumer goods and services, and with such a method of computing the base the spendings tax becomes a practical possibility.

Accrued Income

The definition of the base for an income tax is somewhat more difficult and has aroused much controversy. The only definition that is completely consistent and free from anomalies and capricious results is "accrued income," which is the amount of spendings as defined above, plus the increase (or less the decrease) in the net worth of the taxpayer during a given interval of time. The net worth of a taxpayer is the excess of the value of his assets (including durable consumer goods the purchase price of which was excluded from spendings and for which a rental figure was used instead) over his liabilities. The determination of income thus involves practically all the problems occurring in the determination of spendings, and, in addition, all the problems involved in the determination of net worth.

Exactly what method should be used in valuing the assets and liabilities that make up the net worth of the taxpayer depends to a considerable extent on the precise point of view adopted, and substantial differences can arise from the use of different principles and methods of valuation.² Quite possibly there exists no objective and theoretically correct method: if the theory is pushed hard enough the conclusion may be reached that accrued income depends, to a considerable extent, on the subjective attitudes and intentions of the taxpayer with respect to his assets. Actually, however, no tax base in use has come close enough to this theoretical definition to make of this problem anything but an academic conundrum.

In addition to the problem of valuation, there is a fundamental question as to what assets of the taxpayer should be

² For a discussion of the various possible methods of valuation and the differences that can arise from this source, see James C. Bonbright, *The Valuation of Property* (New York, McGraw-Hill Book Co., 1937), esp. Ch. I; also below, page 138.

included for the purpose of determining his net worth and hence his accrued income. For example, the value of the individual himself, considered as an asset capable of earning an income in future years, is tacitly ignored in even the most inclusive definitions of accrued income. Even when earning power is definitely enhanced through training, the enhancement is not considered an addition to net worth, nor is the expense of training considered an investment but rather an item of consumption; conversely, no amortization of this value is allowed for.^b

This definition corresponds to what is meant by R. M. Haig's definition of money income as "net accretion to economic power,"³ a definition that has become a standard quotation in the American literature on the concept of taxable income. Literally interpreted, this definition would include only savings and exclude consumption expenditures, but there is little danger of a serious misunderstanding. Henry Simons expresses the same fundamental idea when he defines personal income as the "algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period."⁴

Modifications of Accrued Income

But none of the above definitions are to be applied rigorously and without exception. The exclusion of economic power embodied in personal ability or skill has already been noted. In addition, general agreement and practical necessity dictate that changes in net worth brought about by gifts, bequests, and other gratuitous transfers shall not be considered in computing the taxable income of the individual.⁵ Simons, however, takes vigorous exception to this practice and advocates treating gifts as income to the recipient, but without permitting any deduction

^b Occasionally this factor is specifically considered. See, e.g., Kenneth E. Boulding, *The Economics of Peace* (New York, Prentice-Hall, Inc., 1945), pp. 104-108; also below, pages 123-126, 300.

³ R. M. Haig, "The Concept of Income," in *The Federal Income Tax* (New York, Columbia University Press, 1921), Ch. 1.

⁴ Henry C. Simons, *Personal Income Taxation* (Chicago, University of Chicago Press, 1938), p. 50.

⁵ See below, pages 200, 201.

to be made from the income of the donor on account of the gift.⁶ In this he appears to be almost alone, however.

Attempts have been made, notably by Irving Fisher, to define income as merely consumption.⁷ But even though consumption is in effect the money approximation of "psychic income," to attempt to extend this notion to the field of commerce and taxation is fruitful of nothing but confusion. Accrued income is certainly a definite and important concept, and even if the term "income" could successfully be appropriated to mean expenditure, another term would then have to be invented to refer to what is now called income. For example, if income is defined to mean spending, the familiar phrase "living within one's income" becomes either a meaningless tautology or a contradiction in terms. The spendings tax should stand or fall on its own merits rather than on any accident of nomenclature.

Others have attempted to define income in such a way as to exclude capital gains, but unless the ultimate result is to define income as spendings, it appears to be impossible to produce such a definition that will be internally consistent and not require hairsplitting distinctions, nor give capricious results. To be sure, the British concept of income has laid great stress on the recurrence and severance of the receipt, and on this basis profits from capital transactions have been excluded from income, except in cases where such transactions form a regular occupation of the taxpayer. But this has been done only by drawing extremely arbitrary distinctions between casual and regular trading, and at the expense of considerable avoidance.^c

^c The unsatisfactory British experience with capital gains is summarized by Haig, as quoted in Simons, *op. cit.*, p. 148. Magill quotes the Colwyn Commission as giving the following expression of the British notion of income (it could hardly be called a definition): "In the practical world income is not a mathematical abstraction . . . but that net receipt . . . which is usually regarded as income . . . not subject to any specific appropriation for the replacement of capital which is used in producing the income and which over a long period of years may waste in such use." [Roswell Magill, *Taxable Income* (New York, The Ronald Press Co., 1945), p. 120.]

⁶ Simons, *op. cit.*, pp. 125-147.

⁷ Irving Fisher, *The Nature of Capital and Income* (New York, The Macmillan Co., 1906), p. 106.

Realized Income

In practice, accrued income has never been used as a tax base, largely because of the difficulties involved in the annual determinations of the net worth of the taxpayer. In an attempt to arrive at a workable approximation of accrued income, the concept of realized income has been developed. Continual valuations of the property of the taxpayer are avoided by waiting until an increase in net worth is "realized," that is, converted into cash or some readily valued form. Criteria for determining when a realization takes place are necessarily somewhat arbitrary, but assuming that all accruals of income are sooner or later realized (at the latest, when the estate of the deceased taxpayer is appraised), realized income should differ from accrued income only with respect to the time at which the taxpayer is deemed to receive it.

The present federal income tax base may be regarded as essentially a corruption of the realized income concept. As will be seen later, the legal rules as to when income is deemed to be realized for tax purposes are not only extremely arbitrary (as to some extent they cannot help but be), but inconsistent as well, so that even after the liquidation of the assets of the taxpayer, realized income, as defined by law, fails to correspond to accrued income. And the realization criterion has even been held to require the omission of imputed rentals of owned homes from the tax base.⁸

Property

Measures of ability to pay based on stocks of goods or capital are somewhat more varied than those based on flows. One of the older of these is the property tax. In a relatively pioneer stage of economic development, when the division of labor is advanced only to a slight extent and production for home use bulks large, the measurement of consumption or income is much more difficult than at a later stage of economic development when a much larger fraction of the economic activity of the

⁸ Harley Lutz, Fairchild, Magill, Tarleau, and others (The Committee on Post-war Tax Policy), *A Tax Program for A Solvent America* (New York, The Ronald Press Co., 1945), p. 107.

individual is carried on through the market. At the same time property rights are rather simple in form, and immediate possession of tangible property may be one of the best available indices of ability to pay. The complexities of progressive rate scales are usually beyond the thinking and the administrative competence of the times, and only flat rate taxes are usually imposed, even though moderate progression based on overt possession would be relatively simple and would give rise to few inequities. But even with flat rates, since ownership of property is generally more concentrated in the upper economic strata than either consumption or income, such a tax may be fairly well in accord with ability to pay.

With the development of more complex forms of property ownership, ownership becomes divorced from possession and use, and intangible property rights and obligations increase in importance. It is then no longer possible to impose an equitably graduated property tax without requiring detailed personal returns and permitting offset of liabilities and the evaluation of equities. It is still possible to assess a flat-rate tax against the property itself, independently of its ownership; but the degree of progression obtained with such a tax no longer satisfies modern notions of equitable progressivity. Moreover, new forms of property develop, such as patent rights, capitalized good-will and organizational momentum of going concerns, monopoly positions, and the like, that cannot be evaluated by the mere addition of small tangible components, nor easily detected through piecemeal assessment of individuals by local taxing jurisdictions. The inevitable tendency to omit such forms of wealth from the base of any tax assessed against property, rather than against persons, leads to a tax that bears primarily on the more tangible forms of property. The result is a distortion of the economy and further reduction in progression. Under modern economic conditions these intangible property rights can no longer be ignored; the proper base for a progressive tax must now be the net worth of the individual rather than the direct possession of tangible property. The poor results of the homestead exemption laws illustrate the difficulties and inequities involved in an attempt to graduate

taxes based on mere possession. The flat-rate general property tax, which formerly was the most satisfactory progressive tax available, has become completely inappropriate as an element of a progressive tax structure.

Net Worth

There are two principal ways in which a tax can be levied on net worth. One is to levy a low annual tax on net worth either at a flat rate or with a graduated scale of rates. The effect of such a tax, however, is fairly similar to a tax at a corresponding higher rate on the accrued income (as defined above) derived from the property. The chief difference would be that an accrued income tax would tax unexpected capital appreciations resulting from increases in anticipated earning power, while no corresponding burden would be imposed by the annual net worth tax.^d As income is almost always easier to measure, includes this windfall gain in the tax base, is more closely related to the availability of funds with which to pay the tax, and is generally more satisfactory as a tax base, there seems to be no reason for attempting to collect any large amount of revenue by means of such a tax.

Such a tax may have an important function, however, at the extreme top of the economic scale, where it might be desired to impose taxes that would actually impinge on capital. This objective could not be achieved with an income tax alone, since a rate of 100% or more would result in the refusal of the taxpayer to collect the income, whereas a tax on net worth could

^d A property worth \$10,000 and yielding an annual net income of \$400 would be the occasion for the same tax whether levied in the form of a net worth tax of 1% or an income tax of 25%; the tax would be \$100 in either case. The same would be true if the income is not obtained separately but consists in the appreciation in value of the asset during a "ripening" period.

However, if the asset suddenly reveals increased earning power, immediately appreciating in value to \$20,000 and thereafter producing an income of \$800, an income tax of \$2,500 would be assessed on the capital gain in addition to the annual \$200 tax on the \$800 income thereafter, whereas the amount of the net worth levy would merely double and so correspond only to the \$200 income tax on the increased income.

The corresponding comparison in the case where the increase in value results from a fall in interest rates is more equivocal, but if the relation between the tax rates is changed to correspond to the new rate of interest a similar result is obtained.

not be avoided in this way. A mere reduction of income would produce a relatively small reduction in the net worth tax, and the rate with respect to capital would still be so low that it would not pay the taxpayer to destroy or divest himself of his capital. The occasion for such drastic progression seems remote, however: succession taxes would seem to be sufficient to take care of any degree of progression that is likely to be desired in the near future.

In practice annual graduated taxes on net worth have had little support in this country, owing to the difficulty of administering such taxes on a local level, the fear of interstate tax competition, and doubts as to the constitutionality of such a tax at the federal level. The homestead exemptions may be considered a crude attempt to introduce a degree of graduation into the general property tax, but this is a long way from a graduated net worth tax.

A second way of levying a tax on net worth is to assess a heavy, once-for-all "capital levy." Such a tax has been widely discussed, particularly in England,⁹ and was advocated by the Fabians and the British Labor Party as a method of liquidating the national debt after the close of the first World War, and also as a method of financing the socialization of industry. While never used in England, variants of this tax were tried in Germany with such frequency as to raise the derisive cry "wieder die 'Einmaligen,'" and have also been tried in Czechoslovakia, Austria, Hungary, and Italy, with degrees of success ranging from fair to poor. Aside from the serious practical difficulties encountered in imposing such taxes, they are by their very nature not a part of a permanent fiscal program.¹⁰

Succession Taxes

The type of progressive tax on wealth that is of greatest current importance is that based on the gratuitous transfer of

⁹ One of the principal terms of reference of the 1927 Colwyn Commission was the examination of the capital levy, and a large part of the testimony was devoted to this question.

¹⁰ A complete discussion of the theory of the capital levy and of European experience with variants of this tax will be found in J. R. Hicks, U. R. Hicks, and L. Rostas, *The Taxation of War Wealth* (Oxford University Press, 1942), beginning on p. 180.

property from one individual to another. Such taxes, in the form of estate, inheritance, and gift taxes, have achieved the widest acceptance of any form of progressive taxation and have appeared in a luxuriant variety of forms. But again, in order to increase the equity of the tax and prevent avoidance, it may be necessary to convert succession taxes to a form representing more nearly a tax on the flow of wealth from one generation to another, rather than a tax on a stock of wealth on the occasion of its transfer.¹¹

Minor Indicia of Status

Perhaps reference should be made in passing to a form of taxation that is fast becoming obsolete, that is, to taxation according to minor indicia of economic status. Among the indicia that have been used in the past are the number of windows in the taxpayer's residence, the number of fireplaces, the display of coats of arms, and the like. More recently proposals have been made for progressive taxation based on the rental value of residences. In principle a fairly progressive tax might be produced in this way, but in practice no great amount of revenue or steep progression can be obtained. Such indicia may be so chosen as to be fairly well correlated with ability to pay, but when, as often happens, they are chosen primarily to suit the convenience of the assessor, they are likely to be too unimportant in themselves to persist in the face of any really significant tax. Even if the number of indicia are multiplied greatly, attempts to raise an important amount of revenue on such a base almost always result in the rates becoming prohibitive and the point of diminishing revenues being reached before any substantial contribution to the exchequer has been made. Our modern luxury taxes may be considered the vestigial remnants of such taxes.

III. PERFECTING THE TAX BASE

Imperfections Limit Progression

Whatever the type of progressive tax, it is important that great care be taken in defining the tax base. If a tax is to be

¹¹ See Chapter 7.

highly progressive, it must be levied, at least in part, at fairly high rates on a relatively small base. The effects of any imperfections in the form of the tax are thus intensified, and the repercussions caused by such defects may even defeat the main purpose of the tax. As long as such defects persist, increased progression secured by stiffening rates is obtained only at the expense of increased waste and inefficiency in the economy at large. In extreme cases it may be actually impossible to increase real progressivity past a given point by further rate increases: available methods of tax avoidance may be such that increased rates merely drive more taxpayers to the use of these loopholes, to the detriment of the revenue; greater burdens must then be imposed upon the lower economic strata.

Perfection of the tax base is thus one of the prime prerequisites of steeply progressive taxation. It appears likely that in the United States the point has already been reached where very little if any further progression can be achieved at the top of the scale, or the inefficiencies and inequities already produced shall be long tolerated without fairly drastic overhauling of the bases upon which the chief progressive taxes are levied.

Nor does the urgency of perfecting tax bases appear likely to diminish in the future. In a world where the functions of government appear to be generally increasing, tax burdens are likely to increase correspondingly in the long run, with corresponding increases in the injustices and wastes arising from faulty taxes. That these defects have not already proved more serious under heavy wartime rates may be ascribed in part to patriotic support in the national emergency and in part to the short time which has so far elapsed, in which the taxpayer has been able to adapt his operations to these taxes. These favorable conditions cannot be expected to last, and if present defects are left as permanent features of the tax system, avoidance devices and other undesirable adaptations may be expected to develop rapidly.

Subsidiary Benefits

Perfection of the tax structure carries its benefits considerably beyond the immediate area of taxation. The costs of tax

collection and the inefficiencies induced by taxation are a part of the costs of those public projects that must be financed in whole or in part from tax revenues. Reducing these costs of raising funds will increase the area over which such projects are worth while. In particular, in a technology characterized by long-run decreasing costs and economies of scale in fields comprising a substantial portion of the economy, there are opportunities for deriving substantial benefits from financing such industries to some extent from tax revenues, thus permitting prices to be set at the marginal cost of production and improving the allocation of resources throughout the economy.¹² This procedure can of course be advantageous only if the additional costs of tax collection, and the incidental inequities and other dislocations produced by the additional taxes, are not such as to cancel the benefits of this improved allocation of resources. Thus each improvement in the tax system extends the area throughout which the allocation of resources may be so improved.

Active and Passive Defects

Tax defects may be divided into two types. We have those defects that involve a discrimination between two alternative situations between which the taxpayer is in some measure free to choose. In general such tax defects produce at least a slight pressure impelling the taxpayer to choose one alternative rather than the other. Such defects may be termed "active." Then there are those defects that involve situations which the taxpayer is powerless to alter (or can alter only at prohibitive cost). Such imperfections can therefore have no influence on the action of the taxpayer; they may accordingly be termed "passive."

For active defects, we have a very delicate and objective means of detection: the existence of any such influence by the tax on the choices of the taxpayer (other than through the mere

¹² For a fuller exposition of the theory of subsidising decreasing cost industries, see Alfred Marshall, *Principles of Political Economy*, 8th ed. (London, Macmillan & Co., Ltd., 1920), pp. 472-475; Harold Hotelling, "The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates," 6 *Econometrica* 242 (July, 1938); Abba P. Lerner, *The Economics of Control* (New York, The Macmillan Co., 1944), pp. 174-227.

reduction in his resources), which is not in line with a deliberate social policy, implies a more or less serious imperfection in the tax base and usually involves some degree of inequity, in that there is an unjustifiable differential between the tax burdens of comparably situated taxpayers. Such an imperfection is to be eliminated if possible, not only to increase the equity with which the tax burden is distributed, but even more to prevent interference with the efficient operation of the economy.

The passive type of inequity is much more difficult to deal with objectively. In fact, such inequities will frequently be found to depend on subjective notions concerning the proper distribution of the tax burden about which it may be impossible to come to an agreement. For example, it may be impossible to achieve general agreement on the proper degree and pattern of progression. While passive inequities will be discussed to some extent in what follows, it is to the active type of tax defect that this discussion is primarily directed.