VOLUME IV
No. 4

APRIL
1943

THE TAX REVIEW

Copyright, 1943, by Tax Foundation, New York, N. Y.

ABILITY TO PAY

MUCH of the debate, confusion and disagreement, in and out of Congress, over the issue of improving the income tax may be traced to the doctrines of income taxation that have come to be accepted as gospel. Because of these doctrines, and because of various obsessions about them which have become fixed in the minds of many people, any proposal to alter the income tax is regarded by these persons as a kind of blasphemy.

It would be difficult to find a subject in the whole field of government finance in which there has been more uncritical acceptance of dogma than in the case of the income tax. The consequences of this attitude are now apparent in the difficulty of making, or even of securing temperate and objective consideration for, a change of procedure.

It is well understood that the 16th Amendment imposes no mandate with respect to income taxation, except that it permits such taxation without apportionment of the levy among the states according to population. This specific authorization was deemed necessary on the assumption that the income tax is a direct tax. But beyond the circumvention of the "direct tax clause," the amendment neither orders nor forbids anything. It does not even require that incomes be taxed. It says nothing about the rate or rates of taxation, and it fails entirely to mention ability to pay. Consequently, Congress has always had full discretion and authority to define income (subject only to the views of the Supreme Court as to what may be income or what income may be within the federal tax jurisdiction), to determine the rate or rates, or even to decide whether or not incomes shall be taxed at all.

Under these conditions, there is no reason whatever for regarding the current theory and practice of income taxation as above criticism or improvement. It is natural that those members of Congress who have served for years on the committees initially responsible for the tax law should be a bit sensitive to criticism, although it is impossible to understand how anyone could have pride of authorship in the obscure, confused, complicated document which is known as the income tax law. While there has been much complaint about the law, this has dealt principally with specific provisions. There has been too little thoughtful consideration of the underlying theories and dogmas on which it rests.

One of these theories, namely ability to pay, has been extremely influential in the shaping of income tax policy. Yet it is far from correctly understood or accurately applied.

In its most elementary and literal sense there is no mystery about the economic concept of ability. It means the possession or control of wealth or income. So far as the ability to pay taxes is concerned, it would be measured only by such wealth or income as is received in money. Taxes must be paid in cash. Hence, those forms of real income which never materialize in cash are no part of one's ability to pay income tax, however much they may contribute to the recipient's scale of living. Illustrations of noncash income are the produce of gardens and farms consumed by the producer and his family, the shelter provided by an owner-occupied residence, and the corporate shareholder's equity in undistributed earnings.

Exclusion of these and similar items from income tax returns has often been criticized, but it is obvious that their inclusion would frequently lead to extreme hardship, to say nothing of the administrative difficulties involved.

The amount of income received is commonly regarded as the best indicator of ability. In the case of the property tax, all nonincome producing property is assessed and taxed, a policy which tends to force gradual dispersion of such holdings through liquidation, unless the owners have cash receipts from other sources sufficient to carry the taxes. Ultimately, the ownership of property which currently yields no income would tend to pass, at sacrifice figures, into the hands of those having other cash income

for tax payments. It is by no means certain that the best utilization of such property would be made by these persons.

In the case of income, it is clear that any ability which is represented thereby exists only with respect to income in hand. That is, when one has received a pay check or a dividend check, he has an ability to spend which is measured by the amount thereof. He can then proceed to pay his bills, to make purchases, or to pay taxes. When that money has been spent, he is through until more comes in, except as he may mortgage future receipts by arranging a loan with a bank or personal finance company.

At this point a singular and most unfortunate confusion of thought emerges with respect to the technique of income taxation. Income tax laws operate at least a year behind. That is, the tax is legally levied upon the income of the preceding year, notwithstanding that virtually all of this income will normally have been disposed of before the amount of the tax levy is determined, or even determinable. This is called taxation according to ability, but it is more properly to be regarded as the exact opposite. In effect, the tax law says to the individual, "You had a certain amount of income in the year 1942, and you are liable to pay a certain amount of tax on that income in 1943." The uncritical believer describes this procedure as ability taxation. Whatever income the individual may have had in 1942 or any other year indicated a certain ability to pay taxes in that year. It certainly is no clear indication of any ability whatever to pay a tax in any year subsequent to the income year.

The ability to do anything with money endures only while the money is still in hand. When the money is gone, there is no longer an ability to do anything at all with it. If it were otherwise, if the fact that in the past one had been in possession of given sums means that the ability indicated by those sums is still existent, still a valid basis for a tax levy, then there is no reason against reaching back two years or five years when more revenue is needed. So far as any bona fide ability to pay tax is concerned, it would be as sensible to go back two or five years as it is to go back one year. The income that most citizens received in 1942 is as completely gone today as the income which they received five years ago. There is no more trace or evidence of ability remaining from their 1942 incomes than there is from their 1938 incomes.

The only sensible interpretation of ability is that it is a function of current income. A portion of any income item can be taken in taxes as that income is received, or while it is in hand, or as it is spent, and a tax levy at any point from the receiving to the spending inclusive may be properly considered to be taxation according to ability. The levy of tax upon income after it is gone is a travesty upon the ability concept.

But it will be said that ignorance of the law excuses no one. The citizens should take cognizance of the fact of income taxation and they should put aside a portion of each item of receipts as a tax reserve. Thus they would carry forward into 1943 a fund, derived from the income of 1942, with which to pay the tax now due upon 1942 income.

This is a counsel of perfection, which could be realized only in a society of perfect men. Since so few men are perfect, human affairs are seldom arranged with complete foresight. In fact, the paternalistic social security program is a frank admission that many will not make and have not made provision for old age, although it is the next most certain thing, after death and taxes, to happen to all of us.

Furthermore, the provision of a tax reserve out of current income amounts to self-taxation, for the law has always delayed the entire process of income tax assessment, levy and collection until after the close of the taxable year. No income tax law has ever contained so much as a hint of how the taxpayer should prepare to meet its exactions.

Even those persons who might be endowed with sufficient prudence and foresight to have done better than the law requires or contemplates, by setting aside year after year a tax reserve out of current income, would have been confused and defeated by the recent federal policy of retroactive increases in income tax rates. A society of perfect men would have been frustrated by the bungled timing of tax legislation over the past three years. When tax laws are enacted in September or October, carrying substantial increases of tax rates on all income received since the preceding January 1, no adequate tax budgeting is possible for the great mass of the taxpayers. And yet the revenue acts of 1940, 1941 and 1942 were in turn regarded by their authors as virtually perfect applications of the ability to pay principle, despite the fact that each of them in turn imposed severe retroactive rate increases upon all income received over periods of six to nine months prior to enactment.[1]

There is one potent reason, though not thereby necessarily a good reason, for the lag in income tax levy and collection. This is the use of progressive rates. The requirement that all income items received in a stated period be added together in order to ascertain the total tax to be paid upon the whole is solely a result of the insistence upon progression. Indeed, those who regard the existing system as a perfect example of taxation according to ability invariably believe that the system has this virtue solely because of the progressive feature. In the current interpretation, ability taxation means progressive taxation, and to the question as to why progression is necessary, the innocent answer is given that it means taxing according to ability.

1. *Cf., The Tax Review*, Vol. IV, No. 3 (March, 1943), p. 9.

TABLE I

TOTAL INDIVIDUAL RETURNS, NET INCOME AND TAX, 1940, AND 1941, WITH PORTIONS THEREOF IN NET INCOMES UNDER $5,000, AND $5,000 AND OVER[1]

Net Income Classes	Number of Returns		Net Income[2] (Million)		Total Tax (Million)	
	1940	1941	1940	1941	1940	1941
Grand total of returns	14,778,159	25,618,013	$36,277	$58,571	$1,496	$3,892
Taxable returns	7,504,695	17,417,215	23,555	45,979	1,496	3,892
Returns under $5,000	6,724,904	16,484,447	14,452	34,651	189	1,245
Returns, $5,000 and over	779,791	932,768	9,103	11,328	1,307	2,647
Percentage, $5,000 and over group to:						
(a) All taxable returns	10.4%	5.4%	38.6%	24.6%	87.4%	68.0%
(b) All returns	5.3%	3.6%	25.1%	19.3%	87.4%	68.0%

1. Compiled from *Statistics of Income*, Part I, 1940, and *Preliminary Statistics of Income*, Part I, 1941.
2. There is an inflation of the 1941 total net income figures by the treatment of all income reported on Form 1040A (the short form) as net income, whereas in reality it was gross income.

Passing over the circular reasoning involved, and passing also for the present occasion the arguments that can be advanced against any tax rate progression, it is proper to ask wherein lies the peculiar virtue of an annual levy at progressive rates upon the total income of a 12-month period. Why not permit quarterly returns and tax payments? The general practice of corporations is to distribute dividends at quarterly intervals. Or why not monthly returns and payments, at progressive rates, since another large segment of the working population is paid on a monthly basis? Or why not weekly returns and payments? In fact, why not permit those who so desire to report each item of income as it is received and pay the tax on it at once? No hocus-pocus of definition or dogma can disguise or refute the fact that ability comes and goes with income, or the further fact that ability does not accumulate in arithmetical fashion. After one has received and spent the income of a whole year, the numerical record of the receipts is about all that remains, and the progressive tax is really levied upon a sum in arithmetic rather than upon income in any significant sense of that term.

The explanation for the use of an annual period is quite simple, though it has no connection with ability. It makes a few persons pay a much heavier tax than they would pay if returns were made and taxes computed more frequently and payments were made for shorter periods. The income received during twelve months is naturally larger, ordinarily, than the income received in three months or in one month. Therefore, the taxpayer is pushed into a higher surtax rate bracket by the use of an annual total of income than he would be if he were allowed to report for shorter periods or if he were allowed to report each income item separately as received. The same purpose underlies the proposal to require joint returns.

Early in its history the federal income tax was developed into an instrument for concentrating this part of the tax load upon a limited segment of the national income. Even in the year 1941, the concentration of income tax was conspicuous despite the changes made in the Act of 1941.[1] This is seen from Table I.

This table can be interpreted in two ways. The group of persons with net incomes of $5,000 and over paid 87.4 per cent of the total tax on individual incomes in 1940 and only 68 per cent of the total tax in 1941. Hence it can be said that the tax base was broader in 1941 than in 1940. The amount of income in the net income classes under $5,000 increased by $20,199 million from 1940 to 1941 and the total tax on these incomes increased by $1,056 million. On the other hand, the total net income reported in the net income classes of $5,000 and over increased from 1940 to 1941 by $2,225 million while the tax increase on these incomes was $1,340 million. In other words, the broadening of the tax base that occurred in the 1941 Act, plus the enormous increase in small incomes, resulted in a tax rise which absorbed 5 per cent of the gain in small incomes and 60 per cent of the gain in large incomes, i.e., net incomes of $5,000 and over.

It is apparent that the existing method of income taxation is wholly inappropriate for the task of collecting the amount of tax now required. Total so-called net income of taxable returns rose, from 1940 to 1941, by $22,424 million, but the total tax advanced by only $2,396 million, or 10.7 per cent of the gain in reported net income. The disposition to identify ability taxation with progressive taxation, that is, to assume that taxpaying ability exists only, or mainly, in the section of income subject to substantial surtax rates, has been and is a serious barrier to the acceptance of new concepts and new methods. Yet the facts regarding both the increase of incomes and the significance of income as an indicator of ability obviously call for a change. With an increase of reported income in a single year of the proportions stated above, it should have been possible to take by taxation much more than 10 per cent of that increase.

1. *Preliminary Statistics of Income*, Part I, 1941.

The line of improvement becomes clear, once it is recognized that ability has no meaning and no economic significance except as it is related to current income. The well-known situation with respect to the growth in the number of small incomes and in the proportion of total national income comprised in these small incomes emphasizes that the principal problem of tax revision is to devise a method of taxing income as it is received at a proportional rate. These facts emphasize also the futility of projecting a complicated system of tax rate progression into the lower income brackets.

The taxation of income as it is received, at a proportional or flat rate, can be accomplished by adaptation of the normal tax to this purpose.[1] Such adaptation would represent full compliance with a rational conception of ability, for that concept involves certainty of the amount of tax and convenience to the taxpayer. The strength of the popular demand for a current basis of tax payment indicates a sound appreciation among the people of the validity of the foregoing interpretation of ability, and keen dissatisfaction with a doctrine which requires that so vital a thing as a tax be based upon so dead a thing as last year's income.

Harley L. Lutz
Professor of Public Finance
Princeton University

[1] *Cf.*, *The Tax Review*, Vol. IV, No. 3 (March, 1943).

PUBLISHED BY
TAX FOUNDATION
Charles C. Bauer, *Executive Director*
30 Rockefeller Plaza
New York City

★

Quotation of material in this publication
is permitted when acknowledgment is made.