VOLUME IV
No. 10

OCTOBER
1943

THE TAX REVIEW

THE SMALL INCOME AND THE SALES TAX

THE floor under the individual income tax, that is, the amount of income to which this tax does not apply, has always been determined in accordance with expediency and revenue need rather than on the basis of some carefully computed subsistence minimum. With the growing pressure for revenue as the defense and war programs got under way, one procedure that was quickly approved was to lower the exemptions. This was called "broadening the income tax base." The result of the successive changes in this direction was to add large numbers of new taxpayers, to collect a moderate amount of tax from this group, and to impose a substantial added burden on those already subject to the tax.

For example, in 1941 the lowering of exemptions was estimated to produce $303,000,000 of additional revenue, of which $47,000,000 was to be paid by new taxpayers at the bottom. The preliminary estimate of the added revenue from the further reductions under the 1942 Act was $1.1 billion, of which new taxpayers were to contribute only about $100,000,000.

As these successive changes were made, it became increasingly apparent that the traditional method of income tax administration was no longer appropriate or defensible. That method involved postponement of tax payments until determination of tax liability with respect to the income of a given year. Its successful operation assumed the existence of a sufficient income surplus to enable taxpayers to set up, out of income as received, a tax reserve against the payments to be made after the income year had closed. The steady increase of income tax rates, the retroactive application of those increases, and the lowering of exemptions, together produced a situation in which few taxpayers were able to maintain the practice of reserving the tax out of current income.

Relief from this condition was provided by the Act of 1943, which introduced the bookkeeping change of current rather than deferred tax liability, and the administrative change of withholding at source a part of the tax on wages and salaries. Both principles were sound and much needed. As applied in the 1943 law, however, there was too great complication and the initial phase of operation indicated a degree of annoyance and burden which required prompt alleviation through simplification.[1]

While the simplification of an unnecessarily complicated procedure would no doubt allay much of the annoyance experienced by taxpayers, some adverse developments have begun to appear which raise the question whether a tax withheld at source, even if simplified, is the best method of taxing small incomes. The present arrangement is the result of carrying a particular method of taxation to its logical conclusion. Unquestioning acceptance of the doctrinal virtues of this tax has prevented frank consideration of its defects and has been responsible for the belief, now being put to the test, that a tax laid directly on incomes will operate as satisfactorily at one end of the income scale as at the other.

Among the indications that this belief regarding the universal applicability of the income tax is not well founded may be mentioned the following:

1) The dissatisfaction of taxpayers, leading to pressure for counterbalancing wage increases or for absorption of the tax by employers. The extent of such dissatisfaction cannot be ascertained, but there can be no doubt that it exists.

2) The cost of compliance to employers. For the present, this cost is being indirectly absorbed by the government, in large measure, since it is the chief customer of a great sector of business and its contract terms cover all forms of costs. With a return to free and competitive markets, the impact of this cost will be more keenly felt.

1. *Cf. The Tax Review*, July and September, 1943.

3) Compliance cost and taxpayer annoyance are both increased by the complicated withholding schedules. As the workers become more conscious of the effect of withholding on the pay check, they tend to object more vigorously to a tax method which sometimes lets them take home less income though earnings are larger. It would be most unfortunate for the maintenance of production if the workers should begin to watch too closely the effect of a higher wage bracket rate upon their pay.

The elaborate series of wage brackets and withholding rates is a product of the effort to maintain an artificial equality among taxpayers. The result, especially under the complicated conditions of existing law, is a considerable degree of uncertainty for many as to whether or not the tax withheld is sufficient to discharge their full tax liability. Adam Smith said, long ago, that a considerable degree of inequality was not near so great an evil as a very small degree of uncertainty.[1]

In view of these and other factors, it appears appropriate to suggest consideration of an alternative method of taxing small incomes. The method proposed here for that purpose is a federal retail sales tax. It would accomplish this purpose in the following manner:

1) The sales tax would be paid by all.

2) Income tax would be collected only from those persons having, say, more than $1,000 if single or $2,000 if married. A moderate allowance could be added, if desired, for dependents in establishing the income tax floor.

The customary argument against the sales tax, namely that it is regressive in relation to income, would not be a valid objection against this arrangement. Persons with incomes below the income tax floor would pay sales tax only while those with incomes above that floor would pay both sales tax and income tax.

The belief that a retail sales tax is an inflationary force is not well founded. If the tax is to be collected from the ultimate consumer, it does not enter into the cost of goods or services and there would be no occasion whatever to disturb basic ceiling prices. The tax becomes an added item, computed upon the established price and collected from the consumer at the time of sale.

There are both advantages and disadvantages in this proposal. Among the advantages are:

1) The great reduction in the number of persons subject to withholding tax. It is currently estimated that there will be some 44,000,000 income taxpayers in 1943. On the basis of data compiled by the OPA, it would appear that upwards of 20,000,000 taxpayers would be affected by this change.[2] The OPA figures may be open to some question, but there can be no doubt that a substantial number of taxpayers would be involved. All of the labor and expense of computing and deducting small amounts from each pay envelope for this number would be eliminated, and the total cost of withholding would be enormously reduced.

2) Within limits, there is an element of option in the sales tax, in that the amount of tax does depend on the volume of purchases. In this respect, the sales tax is a tax on spending. It is, in fact, a more reasonable form than any of the atrocious plans for a graduated spendings tax.

3) In so far as the tax should prove to be a deterrent to consumer purchases, it would be an aid in the struggle to hold the price ceilings against inflationary pressure. True, a decline of purchases would affect the revenue, but this adverse result would also follow from the kind of spendings tax which the Treasury has sponsored.

4) There is a definite element of certainty about the retail sales tax. No one capable of simple multiplication need ever be in any doubt as to the amount of sales tax to be paid on a given purchase.

5) The sales tax fits the requirements of convenience to the taxpayer quite as well as does the withholding tax. It is paid in an indefinite number of small installments. Certainty of amount and convenience of payment go far to offset any theoretical drawback which may be alleged on the ground of regression.

6) The sales tax would reach those who, for any reason whatever, are not effectively taxed under the income tax. It is doubtful if the withholding device is, or can ever be, fully operative with respect to all small income payments by every type of employer. Use of the sales tax as the method of taxing those with incomes below a reasonable income tax floor would be a sensible solution of this difficulty.

A federal retail sales tax would present some disadvantages:

1) Matters of definition. But many of the states have had enough experience with this tax to provide a guide to the preparation of a federal law and its regulations.

2) Cost of compliance. This cost will be transferred from employers generally to retailers. Nothing definite can be said regarding the comparative cost of collecting or auditing the two procedures, but it is evident that both methods involve a considerable burden for the business concerns that must act as collecting agents. In either case, since the government is spared a substantial part of the collection cost, a moderate basis of compensation to these unofficial agents would be proper. Such allowance will probably prove necessary when the government no longer absorbs so much of this cost indirectly, as at present.

Aside from the greater convenience and certainty of the sales tax as a method of dealing with the small incomes, the important question is the relative yield. In view of the

1. *The Wealth of Nations* (Cannan Ed.) Vol. II, p. 778.
2. *Office of Price Administration, Civilian Spending and Saving, 1941 and 1942.*

Treasury's current proposal to increase the over-all withholding rate, the plan suggested here takes on added significance for all taxpayers.

Recent estimates of retail sales in 1943 and 1944, after eliminating sales to other retailers and to governmental units, and excluding sales now subject to excise taxes, indicate a sales tax base of $54 billion. A tax of 10 per cent would produce better than $5 billion and a rate of 15 per cent would yield upwards of $8 billion. These yield estimates assume that the spending tendency would not be greatly restricted by the tax. If consumption spending were materially cut down, the inflationary pressure would be relaxed and this would help with price control and rationing even if less revenue were produced.

Two points about the sales tax are essential. First, there should be no exemptions. The class of articles most commonly suggested for exemption is food, but food sales are estimated to constitute more than 50 per cent of total retail sales in 1943 and 1944. The exemption of food would wreck the revenue possibilities of the tax. Moreover, if the sales tax is to be regarded as a substitute for the income tax, in the case of a large group with low incomes, an exemption of this magnitude would be inappropriate.

Second, the rates should be proportional. The usual line of argument for differential rates on various classes of goods is that so-called luxuries should be taxed more heavily than necessaries. A system of differential rates of sales tax is commonly, though erroneously, referred to as a system of progressive rates. In support of such rates it is urged that the higher rates on such things as jewelry, art objects, furniture and rugs would curb inflation. But the worst effects of inflation would not be manifest in the prices of art objects and jewelry. They would be felt most severely in the prices of food, clothing and other necessaries. In fact, no great harm would result from a high price on such things as jewelry and art objects.

The principal difficulty in any classification of consumer goods for the application of differential rates is the complete lack of agreement regarding a large part of the area. One man's luxury is another man's necessity. In a recent communication to the *New York Times,* the suggestion was made that the government could transfer classes of goods from one tax rate group to another. Experience with the OPA's curious shifts of ration point value, and with its whimsical handling of the "gasoline for pleasure driving" rule should be sufficient to prevent the delegation of so important a power as arbitrary determination of the rates of sales tax to any bureaucratic agency.

Against the gross revenue to be expected from a sales tax must be set the revenue loss from the suspension of withholding on the low incomes. No data are available that would supply a definite estimate of this loss. Using estimates of the income of family units and single persons compiled by the OPA, it appears that the income tax loss from the plan suggested here would be of the magnitude of $500 to $800 million. The net additional revenue from a sales tax of 10 per cent would thus be of the order of $4.3 to $4.6 billion.

The relative advantage of different tax measures must be judged by considering the large rather than the petty factors involved. This is particularly true in face of the extraordinary fiscal demands of total war. It is always possible to show that individual cases would fare worse—or better—under one tax than under another. Looking at the revenue problem in the large, these facts appear to be well established:

1) The bulk of total income payments consists of individual incomes of $10,000 or less.

2) The bulk of the taxes now being paid and of any additional taxes that must be imposed will fall upon the incomes of $10,000 or less.

3) Therefore, whether added revenue is to be sought by an increase of income tax rates or by a sales tax, much of the extra burden will be borne by the same group of persons.

The principal issue thus becomes a matter of choice between the only two methods available for obtaining a substantially greater revenue from individuals in the lower income groups. It is suggested that the sales tax alternative deserves careful consideration as a preference over the proposal to inaugurate higher rates of withholding and surtaxes. There is a strong case for a certain diversity of tax methods. Since all taxes are paid out of income (except the estate and gift taxes) there is a theoretically perfect case for abolishing all other taxes in favor of a single levy on income. But in practice such a scheme would not work nearly as well as a set of different taxes. It would focus too acutely upon one point all of the taxpayer discontent, and thus its adverse psychological effects could magnify any consequences of the real burden.

A drastic increase of income tax rates has the effect of putting all taxpayers in a vise, where all are squeezed into the same pattern. The current proposal becomes, in some measure, compulsory saving through a new scheme of postwar refunds. One basis of Treasury objection to a sales tax is the new administrative problem, yet there is no hesitation in proposing to introduce ledger accounts with 44,000,000 taxpayers in establishing a record of the postwar refunds. It should be apparent that even so much compulsion in saving as the current Treasury plan involves will be damaging to the voluntary bond purchase plans which, on the whole, have not done too badly considering the failure to recognize the importance of an adequate interest incentive in the case of the lower income groups where the propensity to spend rather than save is greatest.

A combination of sales and income tax would be like carrying a load on both shoulders instead of on one. It would give the taxpayer some sense, however small, of being able through voluntary restraint to adjust his total tax load. It would avoid the disturbance necessarily incident to a sharp advance of the withholding rate while this method of tax administration is still in the trial stages.

The introduction of a sales tax and the elevation of the income tax floor would not affect the structure of the latter tax nor would it render less necessary the steps already indicated in the direction of its simplification. A so-called "notch" provision would be required to prevent the income tax from reducing incomes that are slightly above the $1,000 or $2,000 levels, respectively, to a point below those levels. The scope of the income tax would be reduced to proportions that will more nearly admit of proper administration. It will still be possible for the entire income tax liability of a considerable number of persons to be discharged by collection at source. Tax withholding and current payment of tax liability are the most important developments that have occurred in our income tax experience. The two principles are mutually dependent. In particular, if withholding were to be eliminated by the pressure of popular antagonism, the principle of current tax payment would be in jeopardy. There is far less danger of losing these valuable procedures if it is frankly recognized that there are limits to the successful application of the income tax, and if it is as frankly recognized that the force of tax consciousness is quite as likely to be directed against the tax as against any other objective.

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