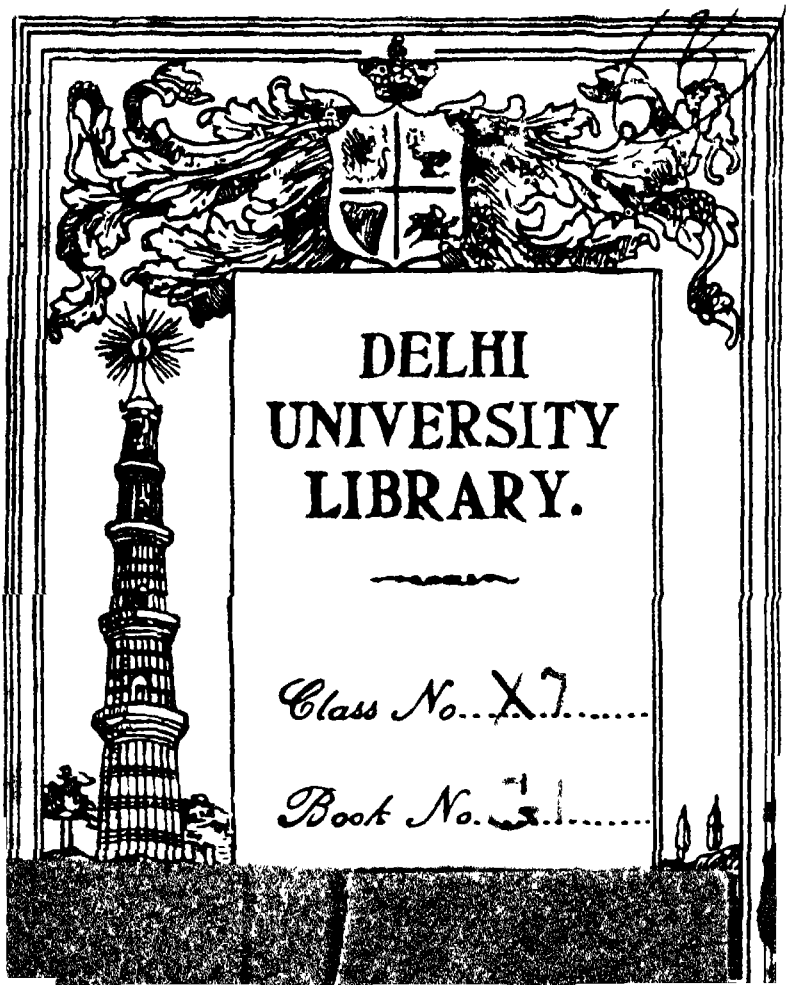
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INTRODUCTION

TO

PUBLIC FINANCE

BY

CARL C. PLEHN, PH.D., LL.D.

FLOOD PROFESSOR OF FINANCE IN THE UNIVERSITY OF CALIFORNIA

"Je n'impose rien; je ne propose même rien; j'expose"

DUNOYER

FIFTH EDITION

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PREFACE TO THE FIFTH EDITION

DURING the six years since the last revision of this book much grist has run through the tax mills. When I wrote the last edition *war taxes were at their peak.* The United States federal income tax had a 12% "normal" rate with surtaxes running up to 65%; the British income tax was 6s. in the pound, with supertaxes running up to 6s. more. There were in addition war profits and excess profits taxes, together with a mass of other war taxes hastily scrambled together. "Nuisance taxes" abounded. The burden on the taxpayer's back was not only heavy but badly packed. The "hitch" was loosening, the "cinch" was slipping and there were galling sores under the pack saddle. Since then the taxpayers have grown stronger and although the burden may not be much less in aggregate, it is relatively lighter; the whole load has been repacked and much war junk, useless in peace times, dropped. The United States Revenue Act of 1926 repealed most of the "nuisance taxes," also the capital stock tax, and reduced the income tax rates to a 5% normal with 20% maximum surtax, and the estate tax rates from a 40% maximum to a 20% maximum. The United States tariff has been revised. Vexing problems in relation to income taxes, inheritance taxes and the property taxes have been partially solved. In England, Mr. Churchill's budget presented to Parliament in April, 1926, was greeted with sighs of relief although not exactly with peans of joy.

The war with its aftermath of huge debts, of international obligations, of crippled or violently reorganised industries, of currency disorders and continuing high prices left a mass of financial problems requiring solution. These aroused a new interest in our subject on the part of the public and an unusual

output of books, periodicals and current literature followed. Constantly recurring changes in the tax laws have forced the taxpayers to intensive study of their duties and rights. In the United States we have had seven great federal revenue acts in the last thirteen years involving in each case a multitude of changes in taxation. The stream of rulings, regulations and decisions emanating from the administration, the courts and quasi judicial bodies flows on unceasing and in ever-increasing volume. Furnishing interpretations for this huge mass of law, and giving advice as to its application in specific cases, has become a profitable vocation, well nigh a profession for thousands. Accountants and lawyers as well as tax experts have to be versed in the revenue laws and their application. To be sure much of this interest is in the practical problem that confronts each citizen, namely, "how much do I have to pay?" But since that apparently simple question cannot be answered without reference to general principles a wider interest soon develops. The theory and the principles of taxation have an immediate and direct practical value.

The recent increase however in present day tax burdens is by no means all due to the war. State and local taxes in the United States, not including war costs today, take from the citizens nine times as much money as they did when the first edition of this book was written thirty years ago. They are five times as much per capita. They took a little over 4% of our national income thirty years ago and now take nearly 7%. These are startling facts. It is interesting and important to every one to know why this increase has come, and to inquire whether the corresponding expansion of government activities is sound. We spent in 1895 about $2.50 per capita of population on schools. Last year we spent over four times as much. To be sure we have more and better schools. Are they four times as good? In addition there has been a heavy increase in public debt, wholly apart from the war debts. Is this justified? The book does not contain specific answers to these questions, but aims to set forth the principles on which sound finance rests.

A still larger part of the public expenditures than in the past

now goes for "*social* betterments." But more careful consideration has been given to the methods of promoting social ends. Among the examples of this noted in the text the new British old age, health and unemployment insurance legislation is possibly the most striking.

The original plan of this book involved giving the reader and student a considerable amount of information concerning past and current government expenses, also both the history and present methods of taxation as illustrative of the principles laid down. As a consequence the text, at certain places, soon gets out of date. In this edition *all such material is brought down to date.* Under *expenditures* the latest developments of social betterment have been indicated. Under *taxation* a great many changes will be found. The more extensive ones bring the story of *customs duties, income* and *inheritance taxes* down to date. The amendments made in the United States income tax laws have necessitated a complete rewriting of many pages. The latest developments in *inheritance taxation* necessitated a complete revision of another large section. The transition from war to peace conditions has resulted in numerous minor changes of text. The recent achievements in improved budget methods have been presented.

As stated in the preface to the first edition this book was originally planned as an elementary text. Such is still its aim. It presents those principles which the future taxpayer and voting citizen should know concerning the finances of government. Controversial questions are not dogmatically answered, but the arguments on both sides are stated without intentional bias. Facts and figures from which the reader may draw his own conclusions are given in abundance. A considerable amount of historical matter is given, for in this field it seems obvious that *the lessons of history* may not be ignored. Nor may one wisely confine his knowledge to his own country's methods; comparisons are helpful. Naturally enough, considering the author's home and life-long contacts, American finance occupies the first place, but considerable space is given to British experience. It will hardly be disputed that those two nations whose institu-

tions and traditions have the same origins may profitably learn much one from the other. The financial history of France and Germany has been drawn on for pertinent illustrations, but no attempt has been made to cover those countries to the same extent as the United States and Great Britain are covered. In short outside of those two countries historical and comparative data have been selected primarily for their illustrative value.

The brief bibliography at the end of the book suggests the nucleus of a working library for supplementary reading. It has been revised to include some of the new books of general interest.

CARL C. PLEHN

BERKELEY, CALIFORNIA
October, 1926.

PREFACE TO THE FOURTH EDITION

THE world moves. When I compare the contents of this edition with those of the first edition which was printed in 1896, I am astonished by the extent and number of the changes in public finance which have occurred in the twenty-five years just passed. Although I have lived through them and had a hand in their making still their magnitude surprises me. The additions made to the book in three revisions record only the more momentous changes in governmental finance. But even so the record of new things done, and of new ways of doing things, by government, is impressive indeed. There is ever room for more improvement, but progress has been made.

The list of changes constitutes in itself a fine record of progress and achievement. In the field of taxation the following pages record as accomplished facts reforms which twenty-five years ago were dreams. In the United States the income tax has come into use, and although it is not yet fully fitted into its place in the fiscal system it is coming to be better understood and highly appreciated. The inheritance tax, which was so unimportant in 1896 as to require only a few pages, is now well-nigh full grown. The old general property tax, which in 1896 seemed so hopelessly antiquated as to be beyond reform, has been remodelled, curtailed, and adapted to the conditions of modern life. Its evils have been trimmed away and it will, unless all promises deceive, again occupy an honourable place in the esteem of the fiscal authorities. The improvements in tax administration have been as remarkable as the changes in the fiscal system itself. The business of taxation is attracting fine men and as officers they are making taxation a science. Above all and as paving the way for the better taxes and better

administration of the old taxes there has come a clearer social judgment on what constitutes justice in taxation. Official commissions and voluntary associations of taxpayers and officials are studying taxation and disseminating knowledge of correct principles. A body of trained and experienced experts in taxation now exists whose wisdom is being freely drawn upon by legislators.

The burden of taxation is light only when the money raised is well spent. Although the amount of taxes being raised to-day is far larger than in 1896 the burden thereof, except for the financial burden of the war, is less. Governments are doing many new things, most of which are good, and are doing the old things better. Educational facilities are better, more varied, and although more costly, create in each succeeding generation new sources for meeting the cost of the new methods. Prisons have changed or are changing from punitive to curative institutions, and every criminal cured is an economic asset instead of a burden. The same is true of institutions for the care of defectives. The mothers' pension system has greatly increased the chance of making good citizens of the half-orphans. Proper provision for industrial accidents has spread the burden thereof over the many who can carry it easily instead of allowing it to fall with crushing weight on the few. Old age pensions and public servants' pensions are being transformed from doles into rights. We are protected from adulterated foods and to a greater extent than before from epidemic diseases. The term "public highway" has ceased to mean the abstract privilege of passing over a streak of mud, and has a new and concrete (!) meaning. Public utilities are being made more and more public servants. When the world goes to war it does so more efficiently than ever before. In every direction the public money is being more wisely spent and our impatience with the waste of public money, which is greater than ever, is in itself proof of progress.

The book has been extensively revised throughout. Many pages of dry theoretical discussion have been omitted to make room for the presentation of the actual taxes whose operation

it is hoped demonstrates the theory in a more simple fashion. The discussion of *the income tax*, and of the *inheritance tax*, has been completely rewritten and given very much more space, as is becoming in view of their present importance. The chapter on the *shifting and incidence* of taxation, a topic of burning interest, has been entirely recast, simplified, and a new and more practical point of view has been introduced. The discussion of *public expenditure* has been recast to give room first for a statement of the guiding principles and especially for the introduction of the new objects of expenditure. The exemplification of the principles of *war finance* afforded by the World War has been examined, and the main features of the war finances of different countries recorded. The new taxes tried and proposed, especially the *increment value land taxes*, the *excess profits taxes*, and *the capital tax*, have been discussed. *Recent reforms* accomplished and proposed have been considered. Facts and figures have been brought down to date.

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK,
April, 1920.

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INTRODUCTION TO PUBLIC FINANCE

GENERAL CONSIDERATIONS

SECTION 1. **Finance and Public Finance Defined.** — Public finance deals with the raising and spending of government funds. A government needs money in much the same way as an individual does. But a government gets its money mostly by taxation, which is a power an individual may not exercise; and a government spends money primarily for the good of society — for the all of us — while an individual usually spends on himself and on his near of kin.

Finance is a broad term covering all matters relating to money and especially to monetary transactions. Thus we have bank finance, corporation finance, trust finance, private finance, individual finance, "high finance," and public or government finance. The term *financier* calls to mind bankers, syndicates, brokers, promoters, and other dealers in money and in credit, as well as Chancellors of the Exchequer and Secretaries of the Treasury. The common element is that they all deal with the funds or means of payment. Any transaction interpreted, measured, or recorded in money is a financial transaction. While the government may coin money and transact a banking business, such activities are not customarily included in Public Finance. That term has come, by accepted usage, to be confined to a study of funds raised by governments to meet the costs of government.

SEC. 2. **Age of Public Finance.** — The science of public finance, meaning thereby the orderly study and arrangement of the facts and principles belonging to this field of knowledge,

is old. The discipline as we now have it began with a group of advisors (or with the teachings of such advisors) to the ruling kings and princes of the various kingdoms, mostly in central Europe, which were formed toward the end of the Middle Ages. These writers were called the *cameralists*. The term *camera* meant chamber or cabinet, and a cameralist, strictly speaking, was one who was a member of the king's cabinet. Hence by metonymy a cameralist was one who dealt with, studied, and wrote about the duties and business of the king's cabinet officers, among which, naturally, matters financial were of the first importance. The demand for cabinet officers and the presence of many persons who were ambitious to become such afforded an opportunity for teachers of, and writers on, the cameralistic science or sciences. Hence a considerable number of such teachers arose, some of whom enjoyed high repute, and deservedly. They have been regarded as the forerunners of the political economists, and so, in a sense, public finance, which formed the greater part of their studies, is older than our modern science of economics, with which it is now so closely associated and so generally held to be a part.

In the days of the cameralists taxation was not very fully developed and much of the revenue which supported the rulers and their governments was derived from the royal or princely domains consisting of cultivated lands, rented to tenants or peasants, or directly administered, of forests and of mines; and from dues, rents, fees, and other charges not of the nature of taxes. So the studies of the cameralists had to do with many forms of revenue which have now disappeared or shrunk in importance as public revenues. They, however, did not neglect taxes, which were then steadily rising in importance.

Adam Smith on Public Finance. — Adam Smith embodied in his *Wealth of Nations* (1776) a full discussion "of the Revenue of the Sovereign or Commonwealth," covering first the "Expences" and then the revenues, and as to the last devoted by far the greater part of his attention to taxes. That he could relegate the discussion of public revenues other than from taxes to a bare dozen of pages and take four times that

space for taxes shows the change that had taken place since the days of the cameralists. Moreover, Adam Smith devoted a long chapter to the Public Debts, thus recording the beginnings of an important, then new, phase of public finance. Public debts came in with the rise of constitutional government. In the days of the cameralists it was the ruler, not the commonwealth, whose credit formed the basis of any public borrowing.

Adam Smith's treatment of public finance and his views on taxation in particular influenced greatly the course of legislation and the trend of thought on finance for many a decade after the publication of his book, and is still potent. As a sample of the character of his work, as well as because of their pre-eminent significance, we may present his famous canons of taxation here despite the fact that they logically belong in another place. They are commonly called canons although Smith called them maxims. The following is an abridgment of the canons. The full text is to be found in *The Wealth of Nations*, Book V, Chapter II, Part II.

Adam Smith's Four Maxims with Regard to Taxes in General

Equality. — " I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." By " revenue " he means: rent, profits, and wages, which he calls " the three different sources of private revenue."

Certainty. — " II. The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person."

Convenience. — " III. Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it."

Economy. — "IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state."

We also insert here, so that it may come early to the reader's attention and remain ever in his mind as he proceeds, a still greater maxim written three thousand years or more before the days of Adam Smith, by Manu the Indian sage and law-giver (between 1200 and 1500 B.C.). Manu, it should be explained, held that taxes should not be levied on the capital but on the income of the taxpayers, because otherwise taxation would check the productive use of capital and lessen production.

Manu's Maxim

Progression. — "Of the unequal partition of taxes the necessary consequence is a greater quantity of suffering than the same amount of taxes would produce, if more equally imposed, because the pain of the man who pays too much is out of all proportion greater than the pleasure of the man who pays too little. To make the burden of taxes equal, it should be made to press with equal severity upon every individual. This is not effected by a mere numerical proportion. The man who is taxed to the amount of one-tenth, and still more, the man who is taxed to the amount of one-fifth or one-half of an income of 100 rupees per annum, is taxed far more severely than the man who is taxed an equal proportion of an income of 1000 rupees, and to a prodigious bigness more severely than the man who is taxed an equal proportion of 10,000 rupees per annum." [1]

Financial Studies Down to 1892. — Since the time of Adam Smith writings on Public Finance have grown in volume.[2] In Germany there were many systematic treatises covering the whole field, public expenditures, public revenues of all kinds including taxation, public debts, and financial administration

[1] Burnell and Hopkins, *Lectures on the Laws of Manu*, p 394.

[2] An excellent brief account of this literature appears in Bullock, *Selected Readings in Economics*, Chapter I.

including the budget. Rau, Wagner, Roscher, Cohn, and Eheberg are among those who published systematic treatises. Schönberg's *Handbuch*, a collection of important monographs, has a volume entirely devoted to the discussion of financial legislation. In France and England many writers have studied taxation, notably: de Parieu, Paul Leroy Beaulieu, Leon Say, Ricardo, M'Culloch, and other economists. But the first systematic treatise on the whole field in English was Bastable's *Public Finance*, first edition, 1892.

SEC. 3. **Government Expansion.** — Financial problems are becoming ever more important, because the functions of government have grown in importance and in number. Our industrial, commercial, and social organisation has become more and more complex, and one consequence thereof is that it requires better and more government organisation to keep it running smoothly. The more government there is the more it costs. The more dense population becomes the more vital and numerous are the activities of government. Traffic police are not needed at country crossroads but in the great cities they are indispensable. Government cost rises per capita from year to year and generally speaking is highest where progress is most marked. Whether we look with favor or with misgiving on the constant expansion of government activities the fact remains that there is a constant expansion and consequently ever greater financial problems.

Recent Literature. — Possibly these facts explain the great recent increase in the interest taken in public finance which finds a record in publications. In the United States we have many writers, either of books or of essays, among whom are H. C. Adams, T. S. Adams, Bullock, Daniels, Dewey, Haig, Hollander, and Seligman, not to mention a multitude of others whose interest in systematic public finance is great but possibly secondary to some other interest. Notable, also, are the official reports of tax commissioners and other financial public officers. Of great importance are the publications of voluntary associations of taxation students and taxing officials. The published proceedings of the National Tax Association begun in

1897 contain a large amount of interesting and valuable material.

In England intensive study has been devoted to the theory of taxation, and notable results have been achieved by mathematical methods of analysis to which Marshall, Edgeworth, and others have contributed. There are also English scholars whose work is descriptive and analytical of existing taxes, like Wilson and Goschen, while the monumental work by Stamp on British Incomes and Property requires special mention.

It would take too much space to list the legal treatises on taxation in any detail. But Cooley and Judson should be named as perhaps the leading American jurists to discuss taxation.

SEC. 4. **Divisions of the Subject, Policy.** — The subject falls naturally into four parts: (1) public expenditures, (2) public revenue, (3) public debts, (4) financial administration.

Writers on public finance have hesitated to pass judgment on questions of policy as to what should be done or left undone by government. Such questions as the wisdom of embarking upon a system of governmental old age pensions, the wisdom of compulsory education, or of government operation of railroads, are not purely financial questions. They are questions largely for the statesman to determine and for students of political science or government to discuss. Our attitude on the question of prohibition of the sale of intoxicating liquors cannot be determined solely by consideration of the taxes lost. But once a policy has been determined upon and a new activity sanctioned then the cost and the best way of meeting that cost become questions of finance. In this sense Public Finance is a science dependent on other sciences, on economics, and on the science of government.

It is sometimes said that a government decides first what it will spend and then raises the money. This is sometimes taken to mean that a government regulates its income by its expenditures, a plan which it would not, ordinarily, be wise for an individual to attempt to follow. This statement can easily be taken to mean too much. In war time the first thought is,

of course, what must be done, and only afterward is the question raised: What will it cost and how shall we raise the money? But in ordinary times the cost of any proposed new or expanded activity is weighed against the advantages. The germ of truth in the statement is that public revenues and taxes can be determined somewhat at will and are not limited as individual incomes often are by conditions beyond control. It is, within limits, practically true that legislative bodies often decide first what they would like to do and then consider whether the taxpayers will be complacent with the added burden of taxes. But the resistance of the taxpayer is potent to restrain in many cases.

It is not always true that where the largest taxes, large, that is, per capita or even in proportion to wealth, are levied the burden of taxation is greatest. If the money is wisely spent by the government the tax burden may be light, even though the expenditures are large. But the burden of taxes misspent by bad government is always heavy and as hard to bear as would be tribute levied by a conquering enemy. Good order, good schools, good roads, and many other results of good government produce the sources from which taxes can be drawn.

SEC. 5. **The Classification of Expenses and Revenues.**—To the matter of classification, in particular of public charges, writers on public finance have directed much attention. A good classification is helpful in seeing the relations of things. In the present work the classification used is that suggested by Professor Cohn for all public charges, and afterwards developed in a somewhat different way by Professor Seligman.[1] The charges made by the government upon individuals are regarded as varying in character according as the special benefit conferred upon the individual is made the exact or the partial measure of, or is not allowed to affect at all, the burden imposed upon him.

[1] Cohn, *Finanzwissenschaft*, pp 104–118, esp pp. 117, 118. Seligman, *Quarterly Journal of Economics*, May, 1892 and 1895, Essays in Taxation, Chap. IX. Hints of the same classifications are found in Malchus and Hoffman. See, also, Plehn, Classification in Public Finance, *Pol Sci. Quar.*, March, 1897, and Nicholson, *Principles of Political Economy*, Vol. II, Bk. VI, Chap. IX. Especially important and illuminating is the "Appendix," beginning on page 146 in Bastable's 3d edition.

The nature of this classification may be illustrated by reference to the well-known customs of large athletic clubs. For membership, and the usual privileges of the club, each member is assessed the same sum, irrespective of the actual extent to which he uses the club, and without reference to his ability to pay, that being assumed, for this purpose, to be equal to that of every other member, and certainly without reference to any known ability to pay more. This fee is justified by the common benefit conferred. If, however, the member makes use of the dining-room, or asks for special privileges, such as the private use of the club quarters, grounds, boats, appliances, etc., he pays an additional sum, measured, generally speaking, by the special benefit conferred upon him. Again, if the club is in debt, or proposes to enlarge its facilities, not infrequently a subscription paper is passed around and each member is urged to contribute, not the same amount all others have subscribed, nor yet in proportion to the use he makes of the club, but "as much as he is able." And lastly, there are not infrequently cases where poor but promising athletes have been admitted, in order that the club may have the glory of their prowess, and have been excused from dues.

Now there is an analogy between such a club and the State in respect to the contributions demanded, the benefits conferred, and the method of operation. Generally speaking, the State endeavours, in collecting revenues, to impose an equal [1] burden upon all for the support of those functions that are regarded as conferring a common benefit, and a special burden for the support of those activities which confer a special benefit, and under certain circumstances to increase the burden imposed upon the very wealthy, who are regarded as able to bear more; and lastly, to tax all for the support of the poor. Not that the State always succeeds in its endeavour, nor that all States recognise equally the desirability of the attempt; for in public finance expediency necessarily plays a large part. But most States have come to recognise more or less clearly these ideals, and their policy can be conveniently summarised in this way.

[1] What is meant by "equal" will be discussed later.

Common and Special Benefits. — The various activities of the State can be easily classified, according to the degree of common or special benefit they are supposed, by the lawmakers, to confer upon the citizens, or taxpayers. The various groups may blend or shade into one another at their margins, but those activities belonging to the centre of each group are easily recognisable and are fundamentally different in each. Thus, it is universally admitted that the functions of the general administrative and legislative departments are of such a character as to give a common benefit, for which, ideally, every one should pay according to some scheme of supposed equality. But at the other extreme there are many things done by the State which confer so special a benefit as to justify a special charge. For example, when the State carries a passenger or a box of freight over its railroad, or carries a letter, or provides the citizens with china or tobacco, it confers a special benefit. Between these two extremes there are any number of grades, according as the predominant thought is that of common or special benefit, when both ideas are present. But there is one more consideration that must be introduced. There are a certain number of State activities which it is in the interest of the whole to have performed, but which accrue to the special benefit of certain classes, who on account of poverty are unable to pay for that benefit; and if the State is to perform these functions, it must call upon the other classes for assistance, excusing the poorer. Theoretically, the support of the poor and defective classes is an activity conferring a common benefit upon all the other members of society, and hence they are called upon to contribute accordingly. If we consider it the moral duty of society as a whole to help the weak, then the relief of the poor confers a common benefit. It is the same if we look upon poor relief from a less altruistic point of view, and consider that society is merely protecting its own interest, as, for example, in isolating the feeble-minded, so that they shall not propagate their weakness. Without going into details which will receive attention later in the book, it is now clear that this conception provides a feasible way of classifying public activities

and public revenues. It is a classification, which will, we believe, help us to get at the economic features of expenditures and reveal the justification of taxation.

It must not be understood that the assignment of any activity to a particular group is permanent. Activities that were once regarded as conferring special benefit — as, for example, a large part of the administration of justice — come in time to be regarded as of common benefit. Such changes sometimes proceed with rapidity, and the stages are not passed through synchronously by all States. There are, for example, many cities which let private individuals provide the water supply. Others provide it themselves, on precisely the same terms as individuals would, while others provide it much as they do other special privileges, regarded as conferring both special and common benefits; and very probably the time is near when some large cities will regard it quite as much a matter of common benefit to provide each and every citizen with at least a certain amount of water, paying the cost out of funds derived from the general taxes, as they now regard it a matter of common benefit to dispose of the sewage, a function which was once considered the duty of each citizen, and is still so regarded in some cities. But however mutable our classes may be, they are clearly discernible, and it is generally only by slow degrees that functions move from one end to the other of the systematic grouping.

While there seem to be general tendencies, which transfer all activities from the special benefit to the common benefit plan, there are a few exceptional cases where the movement is the other way. The support of religion is such an instance. Originally almost the sole object of State expenditure, this has now, after passing through various ups and downs, come to be regarded as of such special benefit that it is being gradually excluded from the sphere of the State, and left to private support.

PART I

PUBLIC EXPENDITURE

CHAPTER I

THE NATURE OF THE STATE AND ITS FUNCTIONS

SECTION 1. **The State an Organism.** — The STATE is the centre of public finance. The State requires money and services for the performance of its functions. The first question is, What is the nature of the State, and what are its functions? To answer this we shall have to borrow a little from political science. The best authorities on political science seem to answer the question, "What is the State?" with a more or less expanded but not essentially modified restatement of Aristotle's famous dictum: "It is manifest that the State is one of the things that exist by nature, and that man is by nature a political animal." The State is an organism into which the individual is born, and through which alone he can hope to reach his highest development. Upon its existence, and the perfection with which it performs its functions, depends the degree of social organisation possible. The State seems to be God-given to enable society to organise on a grand scale for the accomplishment of practical ends far beyond the reach of the individual, — ends upon which the welfare of the individual depends.[1]

Individualism and Socialism Reconcilable. — The two opposing theories as to the proper sphere of the State, Individualism and Socialism, stand for two grand truths. The one for the truth that the individual, if he is to accomplish his manifest destiny, must be allowed and assured room enough for the free

[1] Cf. Kidd, *Social Evolution;* for detailed analysis of the nature of important modern States see Burgess, *Political Science and Comparative Constitutional Law.*

exercise of his powers so as to develop them, and to expand. Such individual development is necessary for the advance of society. The second is that the State affords the individual the surest means of obtaining the assistance of his fellows, so necessary to his own complete manhood. The way of reconciling these two theories is pointed out in the Christian doctrine that true freedom consists in perfect obedience to the law. Anything short of perfect obedience to the highest law is failure to attain the highest freedom.

The constant intrusion of the State on fields of activity previously given to the individual is a natural result of the constant increase in the separation of employments, necessitating more extensive organisation. As the individual becomes more and more dependent for the completeness of his own life on his fellows and their faithful performance of the duties assigned to them, the organisation of the State becomes correspondingly more perfect. As regards this increasing importance of organisation, the following will fairly summarise the practice of advanced nations. It is impossible to approve on *a priori* grounds of every intrusion of the State into fields hitherto set aside for the individual. Only when such intrusion does not lessen individual power, energy, ambition, and ability to advance, is it permitted. And only when it promises definitely to increase the importance of the individual, in the long run, is it desirable. The burden of proof is, therefore, in each concrete case thrown upon the persons who would have the State advance into new fields. There is no absolute limit to, but only a general presumption against, the assumption of new functions by the State.

Sec. 2. **The Limit of State Expansion.** — If political science cannot in the nature of things give us any definite, theoretical limits to the expansion or the contraction of State functions, can such limits be found in public finance? If the common statement that " the State regulates its income by its expenditure and not its expenditure by its income " is altogether true, there can be no limit set by public finance to the possible expansion of State functions. But there are, as a matter of fact,

many important exceptions recognised.[1] Those exceptions are: (1) that statesmen in deciding as to the advisability of any new expenditure necessarily consider the amount of burden it will impose on the taxpayers. The expansion of municipal activities in the last twenty-five years has been so rapid that at present any further expansion is, in many instances, at least temporarily checked by the difficulties in the way of meeting the cost. (2) There are some instances where for political reasons income has outrun what was regarded as wise expenditure, and new ways of spending have had to be devised. This is a decidedly more unfortunate state of affairs than the other, for such forced expenditure seldom takes a wise direction. Witness the wholesale plundering of the United States treasury for pensions. (3) Expenditures may sometimes rise very rapidly, and necessarily so, at a time when it would be extremely unwise to attempt to increase the revenues. At such times the practice of nations — a practice that has proven itself wise — has been to let expenditure run beyond the income and borrow the difference.

One of the prime requisites of a good system of public revenues is that the sums taken from the people each year in the various ways shall be as steady as possible. The reason for this will be made clear under the general consideration of revenue. That fact, however, forbids our determining the annual revenues absolutely by the annual expenditures. The general practice of nations is to increase expenditure, (*a*) when it is absolutely necessary, (*b*) if not absolutely necessary, when it offers advantages which more than compensate for the increased burden on the revenues. The experience of nations has also shown that it is universally better to do the public business, if expenses are increasing rapidly, on a deficit rather than on a surplus. If expenses are for a considerable period quite uniform, the usual policy is to keep the revenues, as nearly as possible, equal to them, but not in excess of them, and when expenses can for some reason be lessened, some of the revenues may be applied to the amortisation of accumulated deficits. It would seem,

[1] Cf. Bastable, p. 42; Wagner, I, sec. 11.

then, that steadiness of revenue is treated as the more important consideration. Herein lies a limit, but not an absolutely fixed one, to the expansion of expenditure and of State functions.

To sum up: the general character of public expenditure, especially as to whether imperative or not, as well as to its particular direction, will depend primarily upon considerations which belong to political science. Its amount will depend on the revenue-yielding strength of the State, and upon the effect which such expenditure will have thereon. The danger made so much of by some writers [1] lest, revenues being obtainable by compulsion, that compulsion be exercised for the benefit of interested persons, who gain particularly by the increased spending, is in a democracy replaced by the corresponding danger lest too meagre supplies be granted by the voters who must themselves pay the larger part of the revenues, and advisable or even necessary lines of expenditure be omitted or seriously curtailed.

SEC. 3. **Public Expenditure in Early Times.** — Expenditure, like every other feature of public finance, changed radically in character and direction during the eighteenth century. Therefore, before proceeding to analyse present expenditure, we shall do well to take a brief survey of expenditure before that century. In the early stages of State life the forms of property were few, public life was identified with the family and with religious life. There was little call for definite public expenditure. The chief item was for religious observances, and for these purposes only was there a distinct public treasury. Foundations for the support of religious observances, as seen in Greece and Rome, are extremely old. The temples have their own groves, lands, mines, and flocks, receive contributions, and collect payments for their services. Materials for the study of this period are scant. Services of a public character are performed by all citizens as a matter of course. In war they are the warriors; they furnish their own arms. Their reward is in the success of their enterprise. By mutual effort, or by the slave labour of conquered peoples, they build their fortress-

[1] Roscher, sec. 109.

cities, ships, roads, and temples. The simplicity of economic life and the absence of a money economy forbid the rise of any proper system of public revenues. Taxes are levied on conquered peoples, but the free citizen is usually exempt. There is practically no division of labour in State matters which would call for a paid public service. Greece and Rome emerge from these primitive forms with a more complicated system of expenditure, but with relatively little advance in revenues.

SEC. 4. **Athenian Expenditure.** — In Athens we find a highly developed system of expenditures, almost communistic in character, and greater than that of other nations of Greece on account of the sources upon which the city treasury might draw and the peculiar circumstances in which the city was placed.[1] The expenditure for public buildings and public works was particularly large, as were the extravagances of public festivals and sacrifices, of donations to the people, compensations for attending the assemblies, and the like. Peculiar to Athens, among all the nations of that era, was the assistance rendered at the public expense to the poor and especially to the children of those fallen in war. Regular expenditures are said to have varied from 400 to 1000 talents, or from $410,400 to $1,026,000. Extraordinary expenses in time of war were relatively small on account of the rendition of voluntary services by the citizens.

Expenditure in Rome. — In Rome there was no distinct public budget in the earlier days of the republic.[2] The public wealth was not distinct from the private wealth of the citizens. With the increase of the provinces and the receipt of tribute from them came regular methods of public expenditure. The items directly borne by the State were the cost of the priesthood, of buildings and other structures and roads, of the army, of the general administration, and of the distributions of food, of grain for the city population, and donations of money, oil, and wine. The army was first paid in 406 B.C. But for a

[1] The outline in the text is necessarily very brief; for a longer account see Boeckh, *The Public Economy of the Athenians*.

[2] See Marquardt, *Römische Staatsverwaltung*, Bd II

long time afterward the remuneration amounted to little more than the reimbursement of expenses. At first the Emperor was supposed to live from his own private property, but as he had control of all the public revenues, the distinction was difficult to maintain. The later courts were extremely extravagant.

Greek, and especially Roman, expenditure had many features similar to modern expenditure. In classic civilisation, division of labour was sufficiently developed to render possible the payment of those who devoted all their time and energy to public affairs. But continuity of development is lacking. From the fall of Rome to the rise of feudalism there is a reversion to the earlier forms of public life. Public expenditure is not separable from private. The citizen serves the State without remuneration, and there are no public expenses proper.

SEC. 5. **Feudal Expenditure.** — It is the essence of feudalism that all governmental functions are placed in the hands of officials who are given the possession of lands which yield the necessary revenues for the execution of those duties. At the same time the relation between these rulers and the people is such that services can be commanded for public purposes without distinct remuneration. The undeveloped condition of commerce and industry necessitates that public contributions shall be in products and in services. The chief duties of a public character that are performed by these semi-public officials are the organisation and leadership of military operations and the crude administration of justice. Of the administrative functions in our modern sense there are scarcely any. The public funds are so entirely under the control of the prince that he comes to regard them as his own. At the same time the various subordinate lords, who were originally officers of the crown and who received lands for the purpose of supporting them in their offices, succeed in retaining possession of the lands and other rights and privileges, although neglecting the duties for which they were given. As the monarchical State emerges from feudalism there is the same complete identification of the public purse with the private purse of the monarch as there was of the State with the person of the monarch. And this, too, although

a good share of the revenues are now derived from taxation. Expenditure is for the gratification of the prince, and so far as he sees that his interest is the same as that of his people he spends for them.

Expenditures under Constitutional Government. — The advance of constitutional forms of government is everywhere characterised by successful attempts on the part of the representatives of the people, or of those who contribute to the public purse, to get control of the finances. Constitutionalism advances just as fast as it succeeds in these attempts. At present the control of the purse is entirely in the hands of the constitutional legislative bodies in almost all civilised countries, and the domains of the prince, which were originally given him by the people in order that he might be supported in proper dignity in the performance of his public duties, and were then diverted by him to his private enjoyment, have been regained in many cases by those who gave them, and are in most States once more public property. The expenditure for the support of the crown now becomes one of the chief items on the civil list. The final establishment of constitutional government has introduced a new criterion for judging public expenditure. An expenditure is no longer a justifiable one when it gratifies the whim of the ruler of the governing body, but it must result in some clear benefit to the people as a whole, or to the nation, or in a benefit that is so regarded; otherwise it will not continuously meet with the popular approval which is now necessary to sanction every governmental action.

SEC. 6. **Necessary, Desirable, or Superfluous Expenditures.** — Many attempts have been made to classify public expenditures, and often with good results. The most common are those which follow, more or less closely, the usual economic analysis of private expenditure, according as the wants satisfied are necessary, desirable, or superfluous. The use of economic terms in this way is to be commended, but as in economics, so here, the vagueness and relativity of these terms are very unsatisfactory. Different writers do not agree as to what are necessaries, even for the same State. After all, the assignment

of any particular expenditure to one or the other of these categories is merely the expression of the author's individual judgment on the expenditure in question.[1] Professor Bastable, realising this difficulty, proposes a classification based on the order of historical rise of the different functions, or perhaps it would more nearly reproduce his thought to say that he tries to establish historically a sort of natural evolution or sequence of public expenditures. Such a classification is useful, for the purpose of historical treatment, but even there it presents many difficulties. The difficulties arise from the fact that such a process merely substitutes for the author's judgment, on which the older classifications rest, the judgment of the leaders of national policy at different times and in different places on the same questions: namely, Are these expenses necessary or merely expedient? He certainly gains much by substituting the point of view of past statesmen for that of any present person or persons. But for purposes of exposition it will be a still greater gain if we can eliminate the personal element entirely and make a classification that does not depend upon the way in which the desirability or undesirability of the different functions is regarded.

Economic Classification of Civic Housekeeping. — Such an analysis as we are in search of has been suggested by Professor Cohn,[2] which he has well called the "economic analysis of civic housekeeping." There are, according to this suggestion, four groups. The first consists of those functions which confer so definite a benefit upon the individual, and are so clearly performed solely for the benefit of the individual, that he would naturally be expected to meet the cost of them. The second group consists of those functions which confer a common benefit upon all members of the State, of such a character that it cannot be parcelled out and each portion definitely assigned to the respective members. This group embraces the prime functions of the fundamental institutions of the State. These are the two extremes. Between them are two more groups. The third consists of those functions which confer a special benefit

[1] Cf. Bastable, p. 43. [2] *Finanzwissenschaft*, p. 11*.

that might be separately assigned to particular persons, but in which such assignment is wholly or partly waived, because there is also sufficient common benefit to justify making such functions a total or partial charge on the general ability. Finally, a fourth group, which consists of those functions that confer a special benefit on certain individuals more or less unable to assist in bearing the charges, and which are consequently treated as though they conferred a common benefit upon all the members of society.

Dropping, for the present, all consideration of the ways in which the benefit is measured, which will be fully discussed under the head of revenue, and rearranging the groups in the order of their importance, we have the following four classes of expenditures:

First, the largest and most important, those which confer a common benefit on all citizens.

Second, those which confer a special benefit on certain classes that is treated as a common benefit, because of the incapacity of these classes.

Third, those which confer both a special benefit on certain persons and a common benefit on all the others.

Fourth, those which confer only a special benefit on individuals.

Under the first of these come the general expenditures for the support of the constitutional agencies of the government. The support of the administrative and legislative departments, in almost all their branches, including the diplomatic corps, and everything necessary thereto, as public buildings, etc. Here, too, belong the support of defence and the maintenance of internal security and quiet. Here belong, according to modern practice, the maintenance of roads, although it was once treated as belonging to class four, and passed through a transition stage in class three. Under this class belong also the chief expenses in connection with the maintenance of the money circulation, although a part of this expenditure is in most countries to be assigned to class three.[1] The same is to be said of the expendi-

[1] The United States once charged a seigniorage of one-fifth per cent.

ture for education. Here belong the administrative control and assistance of private industry and commerce.

Under class two belongs the care of the poor and the defective. Also the support of the pensioned, unless the pensions are such that they may be regarded as wages delayed in payment, in which case they belong to the first class.

Under class three come the administration of justice, the provision for religion wherever the State has an established church, and general administration of the postal service (sometimes, however, this is in class four), the administration of special rights, like patent rights, copyrights, corporation privileges, etc.; also, the recording of titles, etc., the laying out and grading of streets, building of sewers, etc.; so, also, the water-supply in many cities, although the provision for this is rapidly undergoing a development that will eventually place it in class one.

To class four belong almost all of the great industries carried on by the State or by cities, the monopolies maintained by them for the benefit of their treasuries, etc.

As will be seen from remarks made above in connection with the assignment of certain of these services to the different classes, there has been, and still continues, a certain process of evolution which may be generally summed up as a tendency for all these expenditures to move from class four to class one. There are many instances where expenditures now regarded as naturally and unchangeably belonging to class one were regarded as belonging to class four. When a government assumes any new industrial function, as, for example, supplying water to the inhabitants of a city, that function is usually assigned at first to class four and treated as though conferring a special benefit only. But it frequently comes about that it is regarded as a function conferring a common benefit at least in part, and passes into class three. There are forces at work which seem likely to place it finally in class one. In the case of highways this transition has been completely made, and, except in the case of city streets, which still belong to class three so far as construction is concerned, but pass into class one as soon as

finished, highways are usually treated as conferring common benefit only.

In the following chapters on expenditure the order indicated above will be followed. The arrangement of the different expenditures under class one will be somewhat according to historical origin and importance.

CHAPTER II

THE GROWTH OF PUBLIC EXPENDITURES

SECTION 1. **Rapidity of Growth.** — Public expenditures have grown very rapidly, especially since 1850. They are still growing fast in all progressive countries. The growth is a striking accompaniment of the intensification of popular government. The more democratic a government becomes, the more do the people incline to spend upon government activities.

This growth shows up very large when stated in absolute figures. But, of course, it should also be considered relatively. That is, it should be stated in proportion to population and to wealth. The increase in public expenditures is more rapid than the increase in population. It is probably more rapid, also, than the increase in wealth and in private incomes, although this statement is difficult to prove statistically and possibly is true only where governments are most active or, to use a common phrase, most progressive.

The statistics of public expenditure are now being published by most governments in great detail, and on account of their multiplicity cannot be introduced here. They are very difficult to interpret. One reason for this is that no altogether satisfactory measure of the private income and private wealth of the people of different nations has yet been devised. Welfare, measured in the joy of living, as distinct from wealth, measured in money, is so often the aim of public expenditures, that it seems illogical to set up comparisons based solely on private money incomes and public money expenditures. The effect of good roads may be measured, in part, by the increased value of the farms served; but what is the money value of the

training obtained in good schools, or of the peace of mind which an old age pension system affords?

Wars which break out with ever greater violence each time leave behind them great debts, with heavy interest charges to be met each year. We think of these as extraordinary charges, and when so conceived they seem to conceal any general trend in the ordinary charges.

Another cause of confusion in the interpretation of the statistics of the increase in public expenditures is found in the changes in the purchasing power of money, in which all expenditures are necessarily measured. Even if by the method of index numbers we could arrive at an approximate basis of comparison between different years, we are still confronted by a more serious difficulty. That is, there has been an enormous change in the relative importance of the things which money will buy and in the services governments require. How can one find a basis of comparison to measure the difference between the primitive public housekeeping of, say, William of Normandy and the complex organisation of government under George V? Or between the days of Washington and those of Wilson?

Public expenditures grow because, and as, public activities increase and multiply. This increase is both extensive and intensive. Governments in every branch, central, intermediate and local, are constantly assuming new work or duties, and are constantly performing the older functions, and in turn the newer ones, also, on an ever larger scale. Public schools, for example, were long ago added to government activities. At first they included only the primary grades. Then there were added grammar grades, high schools, normal schools, and even universities. Instruction becomes more and more diversified and intensified and even research is subsidised. The end is not in sight.

Governments sometimes drop functions. The dropping or curtailment of the government's interest in and contributions to religion is the best illustration. This, however, is almost the only important illustration to be found in recent ages.

Most changes, like the abandonment of the town pump for a new waterworks system, involve only the substitution of a better service for a less complete one.

Extravagance. — When attention is directed merely to the aggregate of public expenditures the rapid increase sometimes causes alarm. Then charges of extravagance are made against the party in power. But it takes only a moment's consideration to realise that the real question is not as to the amount spent, but as to the wisdom of the expenditures. It is quite possible that to spend too little on public schools may be far worse than spending too much. If, after due and careful consideration, it has been decided that an elaborate system of highways should be built, the consequent increase in expenditures is not *per se* evidence of extravagance. If the highways serve a real need and are well built and well kept, they may be a source of many economies to the people and also to the government. It was not the size of the expenditures of the French court in the 18th century, but the non-public, non-social character of them which contributed to the French Revolution.

Of general principles or controlling laws there are few to be found in this field. The wisdom or folly of each individual expense should always be the point at issue. In 1776 the people of Pennsylvania wrote into their constitution the following piece of profound wisdom: "the purpose for which any tax is to be raised ought to appear clearly to the legislature to be of more service to the community than the money would be if not collected."

SEC. 2. **Government Business Obeys Law of Increasing Cost.** — Whether governments serve the public better or worse than private enterprise could or would, in activities in which a choice is possible, is a question on which opinions differ. Public finance has a clear teaching on one vital point. It is distinctly in the evidence that, by and large, as now conducted, government business obeys the law of diminishing returns or increasing cost per person served. The larger the population served, the greater is the *per capita* cost.[1] It has

[1] Data on this point will be found in my little book on Government Finance in the United States, esp. p 86.

sometimes been thought by careless observers that since large scale production is generally cheaper per unit, other things being equal, than is small scale production, so the cost of government ought to become cheaper *per capita* as population grows. But such is not the case in practice. Generally speaking, great cities spend more *per capita* and impose heavier tax burdens than do smaller ones. The highest government costs are generally to be found where population is densest. The fact seems to be that large, or dense, populations at once require, and afford an opportunity for, larger government activities. The post office is clearly an activity in which large scale operation should render the cost per unit less than when the business is small. But the constant demand, the insistent demand which will not down, for lower rates, more service, and new kinds of service from the post office, eats up the savings which large scale operations might have made possible. The residents of large cities might have made a saving *per capita* on street lighting as the cities grew larger, had they been content with the same grade of lighting. But instead they demanded more light and now revel at night along "great white ways" resplendent with ornate electroliers. The average cost of schools, per pupil, per annum, in the United States trebled between 1900 and 1920. The increased cost arises from providing new subjects of instruction, better trained teachers, finer school buildings, more elaborate equipment, transportation to and from school, free text books, health supervision and many other innovations. The activities of the police departments of large cities are almost the only ones which seem to be cheaper *per capita* as cities grow larger. But there is at the same time a rapid growth in analogous functions, so even this may be only an apparent advantage.

The facts of public expenditures seem to bear out President Wilson, who said: "The people of the United States do not wish to curtail the activities of their government, they wish, rather, to enlarge them; and with every enlargement, with the mere growth indeed of the country itself, there must come, of course, the inevitable increase in expenses."

CHAPTER III

EXPENDITURE MAINLY FOR THE COMMON BENEFIT

SECTION 1. **Net Expenditure.** — In this chapter we shall consider expenditure of the first class; that is, expenditure treated by the government as so clearly for the good of all that no special charge is made upon any of the individuals incidentally benefited. From one point of view expenditure of the second class, wholly for the benefit of certain persons, who are, however, exempt from any special payments, the expense being treated as involving only common benefit, is sufficiently like that of class one to come under the heading of this chapter. But it has been made a part of the next chapter in order not to lengthen this one unduly. Both of these expenditures might well be called net expenditures in distinction from those which, unlike them, develop some accompanying revenues.

Administrative Expenditures. — The first item is that for general administration. Administrative expenditure is for the support of those officers of the government who have to do with civil affairs. For convenience it is best to limit it to those officers whose functions are absolutely indispensable to the execution of the laws. The officers who will be included vary, from country to country, with the frame of the government. It has been customary for financial writers, following the lead of the cameralists, to limit their discussion of this expenditure to that for the crown and court. This is, in England, called the civil list. The peculiar character of such expenditure in monarchical countries makes it advisable to isolate it. But it must be borne in mind that in republican countries there is no corresponding expenditure. The salaries of the highest executive officials in republics are of the same character as those of

the ministerial officials in monarchies. In England the civil list provides for his Majesty's privy purse, household, charities, etc., and for the annuities paid to members of the royal family. In most monarchical countries these expenses were originally met by the revenues from the crown estates. But the revenues from the domains having been absorbed by the general treasury, it became necessary to make provision for the civil list from the general revenues. To the civil list should be added the salaries and other expenses of the ministries, their clerks, secretaries, etc. In federal governments the administrative departments of the component parts or commonwealths, as well as that of the central government, should be included. Finally, there are the administrative departments of the local governments. It is very difficult to ascertain the number of such officials and almost impossible to ascertain all such expenses.

In monarchical governments, and to a certain extent also in republican governments, traditional sentiment demands that the head of the government shall hold a social position of great prominence and perform certain merely ornamental functions, involving considerable expenditure. So that the expenditure for the services of the highest officials is often larger than the sums which would be necessary to obtain merely efficient service. This lavish expenditure may be fully justified on political grounds, but as it involves great waste, both directly and indirectly by example, it cannot be justified on economic or fiscal grounds.[1] It is a general fiscal principle, applicable as well to this part of expenditure as to any other, that the expenditure should not be larger than is necessary to secure the most efficient service. The justification of this lavishness, therefore, must be found, if anywhere, in the creation of some equal utility recognised by political science. The exceptions made in practice to the general rule of economy do not extend beyond the heads of the administrative departments. In the subordinate positions the remuneration does not generally exceed and is often below that which must be paid for similar services in private life. Indeed, there is a certain saving, in that many of

[1] Rau, *Finanzwissenschaft*, sec. 48.

the positions, especially where the tenure of office is secure for a relatively long period, can be filled at a lower cost than the same services command elsewhere, on account of the honour attaching to them. In those countries where the expenditure for the higher positions is largest much is saved by the lower pay attaching to subordinate positions.

Diplomatic and Consular Service. — In this connection mention may be made of the diplomatic and consular service, which, while partly conducive to the better performance of other functions, as, for example, defence and the regulation of commerce, is yet properly considered to be subordinate to the executive departments. Here again the traditional opinion, that the dignity of the nation can only be properly sustained by a lavish expenditure on the part of the ambassador or minister, imposes on the treasury burdens far greater than the value of the services rendered, if measured by the ordinary business standards. As the means of communication improve and the general efficiency and reliability of the news agencies of the public press grow, it becomes harder and harder to justify this extravagance even on political grounds. The custom of lavish expenditure for diplomatic services has not been carried to such extremes by the United States as by other countries. As these positions were formerly more or less of the nature of political prizes, in that country, this has probably been to the improvement of the service. In recent years the foreign relations of the United States have grown in importance. There has been a distinct effort to increase commerce with South America and to promote a better mutual understanding. Commercial attachés are being added to the more important ministries. Young men can now look forward to the consular service as a career and train for it. There has been a marked corresponding increase in cost. Meanwhile Great Britain, having always had an adequate service, has increased her expenses but little.

The Cost of Collecting the Revenues. — To the administrative department belongs the expenditure for the collection of the revenues. Although this is a part of the gross expendi-

tures only, it is properly included in the general accounts so as to render control possible.

While the cost of collecting revenue will naturally vary very much with circumstances, some generalisations are permissible. The cost of collecting customs duties should be kept within three per cent, and that of internal excise taxes within still narrower limits. But if the total amount to be raised is relatively small the cost is likely to be proportionately larger. In like manner heavy direct taxes are proportionately less costly to collect than are light ones.

SEC. 2. **The Legislative Department.** — The expenditure involved in the payment of salaries to legislative officers, when any such are paid, is not the largest part of the expenses caused by the maintenance of such bodies. There are the clerks, aides, pages, etc., in immediate attendance upon the bodies during their session, the expenses of elections, which in this case swell to considerable amounts, the costs of investigations, public hearings, etc., necessary to put the legislature in possession of the facts upon which to base their actions, and the expenses of promulgating laws, publishing speeches, reports, etc., all of which together form no inconsiderable burden on the finances of every nation enjoying legislative government. These expenses also extend from the federal government down to the municipal governments. The desirableness or undesirableness of paying legislative officers for their services is a matter for political science to determine, and depends in large measure upon the traditions of the different peoples. In England relatively little is spent in this way in any of the legislative departments of the government from Parliament down to the parish. But in that country there is a tradition of unpaid public service that gives her much help in this direction. In the United States the direct emoluments and other legitimate expenses of the federal Congress, and the direct and indirect, more or less illegal, raids by the commonwealth legislatures on the treasuries, as well as those made by the city councillors and aldermen, are very large.

Some mention should also be made of the expenses involved

in the support of local or semi-local legislative bodies. For the United States, there are the State legislatures and the city councils, and, for England, the local government board and the county and municipal councils. Of these, only the commonwealth legislatures are purely legislative in character. The others perform functions which are better described as administrative. It is so difficult to obtain a correct estimate of the particular expenses for the support of these subordinate bodies as to be an unprofitable task. These bodies, too, are so intimately concerned in the administration of the other functions that we gain little by isolating the mere expenses of their maintenance. With the commonwealth legislatures, however, the matter is different. These are purely legislative. In most commonwealths the legislatures are paid *per diem*, and they are prevented from running up too large bills by the limitation of their term. The *per diem* remuneration and mileage are fixed by law, and range from $5 to $10 a day and from five cents to ten cents per mile. A loophole for additional expense is left by the necessity of allowing the legislature to appropriate money for incidental expenses. Money is spent for the hire of personal attendants on members, stenographers, clerks, etc., for tours of inspection to various institutions, and the like. This abuse became so flagrant in California that it was eventually prohibited by a constitutional amendment limiting the expenses of the legislature. Most of this expenditure contravenes the rule of economy. England in the absence of the federal system is spared this expense.

Expense of Judiciary. — A very considerable part of the expense of maintaining the judiciary is treated as a matter of common benefit. These expenditures are sufficient to insure the continued existence of the courts, whether they have any litigation before them or not. But as some part, and often a very considerable part, of the costs of actual litigation falls on the litigants, and as the courts are, in most places, almost continuously engaged in work of that kind, it seems more consistent with our classification to treat this expenditure as one partly for private benefit, under class three.

SEC. 3. **Public Buildings.** — The construction and maintenance of public buildings for the convenience of the executive and legislative departments and for other purposes is one of the most important although not one of the largest items of expenditure. The construction of such buildings is of course necessary. That they should be imposing edifices, handsomely decorated and equipped, is a matter of national and local pride. That their construction should not be wasteful is self-evident. The extravagances and theft which have too often accompanied the construction of such buildings in the United States are too well known to need discussion. They are purely abuses and need no further words of condemnation than they have always received. The cost of construction may be regarded as a permanent investment, not yielding a money revenue, but important utilities. These expenditures are obviously subject to great fluctuations from year to year.

The exact annual value of these utilities to the government cannot be directly estimated in money. Indirectly it might be estimated as the equivalent of the interest on the sums which it would cost to replace them in the most economical manner, less the annual cost of the repairs. As, in some cases, the original expenditures were extravagant and wasteful, this method of computation would result in a smaller sum than the interest on the original cost.

SEC. 4. **Cost of Defence.** — A nation differs from individuals in that no law can be imposed upon it by any external human power. The enforcement of the rights and obligations of nations in their intercourse with one another is left to the different nations themselves. As long as international law offers no peaceful means of redressing wrongs, war is the only resource. "International law," says Woolsey, "assumes that there must be 'wars and fightings' among the nations." This assumption is universally correct. There are no signs, as yet, in spite of the peace conferences at The Hague, and the proposal of a League of Nations, that nations will cease to consider that war, or at least the actual preparation therefor, as its sole preventive, is an absolute necessity. The whole theory of the independence

and equality of sovereign States, upon which international law proceeds, throws the maintenance of national dignity, honour, and recognised national rights upon the nations themselves. The extent and character of preparation for war in each State depends upon its history, national character, and geographical situation. Thus, the warlike traditions, the mutual distrust, and contiguity of France and Germany, impelled to extensive preparation for war, and similar considerations affected other nations of Europe. On the other hand, the traditions, national character, and geographical position of the United States, until after the war with Spain in 1898, led to a feeling of security, and a preparation so insignificant, compared to European armaments, as to call forth continual warnings and protests from military authorities. As a result of the acquisition of territory in the Pacific, and in the Orient, there has been thrown upon the United States the burden of maintaining the bulwark between the white and the yellow races, on the western side of the territory occupied by the whites. The unavoidable expenses for this purpose, while they have not yet reached the magnitude of those of England and of Russia for the defence of the eastern side of their outlying possessions, are already large and are growing rapidly. The necessity and probable continuance of this burden on the finances of nations being thus predetermined, the only task for the student of finance is to ascertain how great a burden this imposes on the treasuries and what possibility there is for some return. An extended discussion of the actual expenses of war itself is given at the end of this book. In this chapter we are discussing only peace time expenditures of a military character.

There has been much discussion of the relative merits and economy of the different methods of army organisation. It is pointed out that the German system of compulsory service of all citizens without remuneration shows a much smaller cost, per man, than the English and American system of paid enlistment. But it is urged again that there are in Germany a larger number of expenses involved in the army system than those of the government, as the personal expenditures of the soldiers, the cost of the country from the disturbance of production, the

extra costs of enrolment, of free quarters during manœuvres, etc., which do not appear in the budget, but which should be counted in before any fair comparison can be made. It would seem that, in the end, the actual net expenditure for this purpose could only be as much less, per man, as the standard of living of the soldier is less in the one country than in the other. And on this ground it might be urged that the German system, which gives the soldier but little spending money to waste, and by very strenuous measures inculcates thrift and almost penurious economy, is on the whole the cheaper. How much again this lessens the efficiency, per man, and necessitates a larger number of soldiers is hard to estimate. In England the volunteer system, while adding somewhat to the cost, does not make as heavy drains on the treasury as do the German reserves; but as the expenditure by the individual members of the volunteer service is for a public purpose, it is a part of the cost of the system, and a part that is very difficult to estimate. On the whole no accurate comparison is possible.

The following figures are instructive: In the budget of 1894–95 England appropriated for the army £18,000,000, for the navy £18,700,000, together £36,700,000; for 1908–9, army £29,459,000, navy £32,329,500, together £61,788,500; in the last *pre-war* budget, army £28,885,000, navy £51,550,000, together £80,435,000. The United States appropriated in 1895, army $54,500,000, navy $31,700,000, total $86,200,000, but this included $16,000,000 for new vessels; in 1906, army $117,900,000, navy $110,500,000, together $228,400,000; in 1914, army $94,300,000, navy $140,700,000, together $243,000,000. In most countries the preparation for war is a source of rapidly growing expenditure.

Aside from maintaining the integrity and the dignity of the State, which are, of course, the greatest conceivable public benefits, the expenditures for the army and the navy yield little direct economic return. The navy protects the citizens abroad and contributes thus to the pursuit of commerce; while the army, likewise, keeps open the channels of internal trade. In those countries where the entire male population is passed through

rigid military training, the military system supplements in a very important manner the general educational system and gives valuable mental and physical training. Countries with a small standing army participate in this benefit to a much smaller degree. The existence of a strong military spirit fosters the virility of a people, and hence contributes to its manhood and efficiency in every direction, while the absence of that spirit betokens effeminateness and degeneracy. But these are benefits that cannot be measured statistically, nor in money, and must be left for the sociologists to discuss.

The Expense of War. — The expenses of actual war are not a part of the regular budget of modern nations. They are always treated as exceptional or extraordinary expenses. Besides the sums actually expended by the public treasury there are many indirect losses and expenses involved. According to the estimates of Wilson[1] the cost of wars to England from 1688 to 1882 was over £1,258,680,000. The estimated cost of the Boer War to England was over £182,000,000. The cost to the United States of the Civil War is hard to estimate. The debt incurred amounted to $1,845,900,000; $800,000,000 of revenues were spent during the war; commonwealths and cities spent a part of their current revenues and rolled up debts, and the pensions will probably amount to over $2,000,000,000; $6,000,000,000 represents approximately the actual expenditure by all the governmental agencies on the side of the North. Data on the World War will be found in a chapter at the end of this book. Every important war leaves behind it a great burden of debt; and the debt charges, including interest and repayment of principal, run on for years. It was estimated that before the World War Great Britain had liquidated only such part of her debt as was contracted prior to the revolution of her American colonies. The United States, on the other hand, has ever pursued a policy of speedy debt payment and prior to the Great War was practically out of debt. Wars have also been the occasion for granting of soldiers' pensions discussed in the next chapter.

[1] *The National Budget*, etc.

SEC. 5. **Roads.** — The building of roads illustrates very clearly the evolution of government activities. Privately built toll roads were displaced or followed by publicly owned toll roads, then by the "king's highway" for military and official use and, finally, by roads and streets completely free to all.

In the United States down to the close of the nineteenth century roads were built almost wholly by and at the cost of the local governments. A notable exception was the building of the Cumberland Road by the federal government, 1807–1838. Owing in part to the question raised by Madison as to whether Congress had the right under the Constitution to build roads, and in part to the fact that after 1830 it was clear that railroads would serve better the purposes aimed at, the federal government abandoned this activity after 1838. Eighty years later it re-entered the field of highway building by grants in aid to state highways.[1]

Road building by separate and relatively small districts is apt to lack coördination and uniformity. The "good roads" movement which began about the end of the nineteenth century received a powerful stimulus from the coming into use of automobiles. About the same time the steam shovel, the tractor, the heavy truck and other mechanical devices, far more powerful than plows and scrapers drawn by teams of horses, lent their aid in road grading. Then too, asphalt and other petroleum products, and cement became sufficiently abundant to be available as surfacing material. Wider, smoother roads with easy grades became possible. But these are enterprises of large size and wide concern. Hence almost inevitably the reconstruction of highways became an activity of the states rather than of the local governments. But branch roads are still local enterprises and maintenance even of highways has not been wholly transferred from the local districts. More recently still, that is since 1916, the demand for interstate roads has led to federal aid. No public expenditure brings so immediate and so proportionately large a return in social welfare. Together with the motor

[1] See Appendix on federal aid to roads, end of this book.

vehicle they bid fair to eliminate the distinction between city and country. They facilitate not only the transportation, but the actual production of food, and make both labour and capital more mobile.

Navigation. — The maintenance of waterways, roadsteads, harbours, rivers, canals, is also a public function. Canals, to be sure, have passed, or are passing, through the same development as roads, and in some respects harbours and rivers have also done so. In the United States the dredging and improvement of the facilities for navigation in rivers and harbours are the only important items of " internal improvement " that have been consistently held in the hands of the federal government. The " rivers and harbours " appropriation was at one time notorious on account of log-rolling and possibly of graft. In the same line is the maintenance of lighthouses, signal-stations, the weather bureau, and life-saving stations. The last-named is in some countries supported, in part, by private contributions.

SEC. 6. **The Cost of Education.** — No expenditure commends itself more than that for education. It creates the groundwork of all political institutions. No expenditure in the opinion of Geffcken is more " reproductive " than that which the State makes for the development of its future citizens. But the expenditure of the various countries for this purpose cannot very well be compared, because it is very difficult to obtain a complete statement of all the outgo under this head. The local governments generally have certain lower branches under their control and pay a part or the whole of the expense of those. In federal governments the remainder of the system is generally under the control of the component parts. The United States federal government has rendered assistance to the commonwealth and local schools by grants of land of unknown, but very large value, and by the collection and dissemination of information through a bureau of education, and in various other ways. In England the provision for education made by public authorities is generally less than in most other countries, the sole exception being the provision for technical education. Until very recently this line of public activity has been regarded

by that country as one conferring a special benefit and to be paid for in part by fees. But it is now pretty clearly the accepted policy of all modern nations to provide at least the primary education necessary for every citizen as a common benefit and to make it compulsory and free to all the recipients. In treatment, then, it is regarded as being as much a benefit to the rich childless man to have the sons of his poorer neighbour educated as that he should have the protection of the police in the enjoyment of his property, and he is made to pay on that principle. In regard to higher education as given in the secondary schools, and technical education, there is no such uniformity of practice. Education in the rudimentary mechanical arts is in fact becoming as important a need of society as elementary education in the usual branches. As the pace of industry becomes more rapid and its organisation more perfect, the possibility of giving this sort of instruction by the old apprenticeship system vanishes. There is no place for the boy in the modern factory. Private initiative cannot be depended upon to supply the opportunity for this sort of education. The State has to do so if it is done at all. In this respect many of the English cities are far ahead of any American city.[1]

Whether college and university education should be given the recipients free of charge at the common cost is, in practice, also an open question. Had not liberal private endowments been made for this purpose, it is probable that the question would long ago have been settled, and that this branch of education would have been treated as the primary was. University education, even though enjoyed by but a relatively small number of the citizens, is quite as " reproductive " and as beneficial to the State as a whole as even a widely diffused system of primary schools. It is quite as important, if not more important, to have highly trained leaders of public action and thought as it is to have a low degree of intelligence widely disseminated. The university as a centre for research alone is worth many times what it costs if properly conducted. In proportion to the benefits which it confers on the State it is,

[1] Shaw, *Municipal Government in Great Britain.*

where run at the general cost, the least expensive part of the whole system. The provision made by many of the western commonwealths of the United States for the liberal support of universities from the public funds has been without exception the most beneficial and economical expenditure they have made. In Germany, too, a large part of the expense is borne by the State. Closely related to education is the maintenance of museums, libraries, picture galleries, and scientific investigations. These comprise in most countries an important part of the provision for education.

SEC. 7. **Aid to Industry.** — Indirectly all public expenditure aids private industry and commerce. But there are many forms of direct aid that are treated and regarded as conferring a common benefit on all alike although accruing to the good of certain persons. Bounties are sometimes offered for certain products. Enterprises of various kinds receive subventions or partial and even complete exemption from taxation. The so-called protective system involves an indirect expenditure of the people's money in the same way. The expense of maintaining the currency, of building and keeping up roads, canals, harbours, and the like, is of the same character. So are many public buildings, as exchanges, markets, slaughter-houses, structures and grounds for public fairs and the like, and commissions and other organisations for collecting and disseminating knowledge concerning horticulture, agriculture, and various industries. The maintenance of a system of weights and measures also belongs here. Besides all those mentioned and some others which are generally treated as expenditures for the common benefit, there are a great many things which the State does for the benefit and assistance of industry and commerce that are regarded as conferring special benefit and treated as such.

The administrative control of private industry and commerce has become a necessity on account of the growing power of modern organisations of capital and the growing importance of the "public" functions which many of these private enterprises perform. The necessity has been widely felt of con-

trolling industrial monopolies, and we have numerous commissions for the regulation of railroads and other public-service industries. To this branch of expenditure belongs also the cost of the control exercised over the production and sale of foods for the protection of the public health. This is mainly an expenditure of the local governments, although it occasionally enters into that of central government, especially in the case of imported foods. In the United States the federal government has assumed this important function, and many of the states are supplementing its work. The cost of the enforcement of sanitary regulations of all sorts is another expenditure of the same character.

STATISTICAL APPENDIX ON COST OF SCHOOLS IN THE UNITED STATES

The cost of schools per capita of population has been: 1870, $1.64; 1880, $1.56; 1885, $1.96; 1890, $2.24; 1895, $2.55; 1900, $2.84; 1905, $3.53; 1910, $4.64; 1915, $6.03; 1920, $9.80.

Children of school age: 1900, 28.3 per hundred of population; 1920, 26.2 per hundred.

School in session: 1900, average 144.3 days per annum per pupil; 1920, 161.9 days.

Teachers' salaries have increased and classes are smaller; as a result it cost in 1920, $27,300 to teach 1000 pupils for one year against $8,800 in 1900.

SOURCES OF SCHOOL FUNDS

IN 1900	
Permanent funds and lands	$9,000,000 or 4% of total
Local taxes	149,500,000 or 68% of total
State taxes	38,000,000 or 17% of total
All other	23,000,000 or 11% of total
Total	$220,500,000
IN 1920	
Permanent funds and lands	$26,500,000 or 3% of total
Local taxes	759,000,000 or 78% of total
State taxes	134,000,000 or 14% of total
All others	50,000,000 or 5% of total
Total	$970,500,000

CHAPTER IV

EXPENDITURE MAINLY FOR THE BENEFIT OF INDIVIDUALS

SECTION 1. **Public Charities.** — In this chapter we shall consider the remaining three classes of expenditure. These are not so very closely akin, but have one point of similarity; namely, that they are all regarded as to a greater or lesser extent for the particular benefit of individuals. The first, however, is not so treated by any nation, but is treated as though it were an expenditure for the benefit of all. The relief of indigence and the protection of society against the insane and the criminal, the care of the feeble-minded and otherwise defective classes, and the care of the sick are among the most costly and most discouraging features of public expenditure. In the United States the expenditure for pensions, charities, and gratuities amounts each year to large sums. Generally, even after the State has done all that it can be induced to do, there is still room for private effort in the same direction. The expenditure by private persons and societies for exactly the same purposes is possibly larger than that of the government; so that this is one of the heaviest of all public expenditures. The relief of poverty has generally received more attention in treatises on economics than in works on public finance. But it belongs very properly to the latter science as well. It is generally a local, rather than a national, expenditure, but on account of its vast size and economic importance has often received the attention of the central authorities, and is in many cases, at least partly, under their control. There is almost no expenditure that fails so signally to accomplish anything like permanent results. As frequently administered, poor relief has aggravated the very evils it has been intended to relieve. The words of Malthus are still

true: "We have lavished enormous sums on the poor, which we have every reason to believe constantly tended to aggravate their misery." [1] Yet the expenditure is necessary, indeed imperative, and will be so as long as the present sentiments on the subject prevail, unless we can remove the causes. That this may be done by the extension of educational facilities, especially technical schools, is a frequent contention. The systematic relief of poverty in such manner as to lessen its evil has recently become the study of scholars and of able administrators, and some progress has been made. The student of finance need not enter into the question of the causes nor of the cure of poverty. Indigence there is, and the State has assumed the duty of relieving it. The modern methods of relief are fast coming to be as economical and efficient as the conditions under which they are necessarily administered admit. Like war, this is a form of expenditure that shows little tangible result that can be measured in terms of money.

The general principle applied in the granting of continued assistance to the poor is that the cause of poverty to be relieved must be such that it cannot be removed by the individual efforts of the candidates for assistance. In other cases, only temporary assistance is rendered. Those who can help themselves are desired to do so. The four agencies which really work together toward the same end are the civil, the ecclesiastical, the associated,[2] and the individual. These should all work harmoniously and should avoid duplication of work. The assisted persons should, so far as possible, be put under conditions which will enable them to help themselves to the limited extent that they are able. The repression of vagrancy and the punishment of wilful paupers, who are really able to support themselves but unwilling to do so, is left to the courts.

Mothers' Pensions. — The care of orphaned children presents special problems. Orphans neither of whose parents are living and who have no relatives who can support them are cared for either in public homes or similar institutions, or by being placed

[1] *Essay*, p. 438.

[2] Associations or leagues of charitable organisations.

under the care of families. In the first place this is always at the public cost. In the second it is sometimes at public cost, in whole or in part. Half orphans whose fathers are living are more generally left to the support of the fathers. The case of widowed mothers with minor children is, however, considered as presenting special problems. The mother cannot well care for the child or children if she goes out to work. It seems harsh and probably is not well for the children if they are separated from the mother and placed under public care. A solution has been found in giving the mother sufficient money from the public funds to support herself and the children until they grow up.

Insurance as a Means of Lessening Poverty. — Old age, sickness and unemployment are among the causes of poverty, against which provision can be made by the methods of insurance. Funds may be accumulated during the prime of life, while in good health or while employed, to be used when these afflictions arise. Furthermore since old age, sickness and unemployment do not fall on all the population at one time, although they may fall on any one, the sharing of the loss involved by all exposed thereto is not, it is argued, unfair. That is what is done voluntarily by those who take out fire or life insurance. Since a great many of those most likely to fall into poverty from these causes are not prudent or wise enough to provide for their own protection through private agencies, public insurance has been resorted to. To be effective this must be compulsory, at least for all those whose private means are likely in the event of disaster from these causes to be insufficient for support. Employers may be required to contribute part of the premiums. In some of these insurance schemes the government also meets part of the cost from tax money. In that case there are three contributors to the funds, the insured, his or her employer and the general taxpayers. The methods vary greatly.

The establishment, *de novo*, of old age, health, or out of work insurance under government control involves assuming a matured obligation for which no fund from past premiums is available. Hence to provide for those who grow old, sick or lose their jobs soon after the system begins, funds must be provided by

the government from other sources, that is either by taxation or by borrowing.

Insane and Criminal Classes. — Modern society supports the insane and criminal classes at public cost. In this way the greatest possible saving is made. Indeed, the cost need not be nearly as great as it is. To a large extent prisons can be made self-supporting. It is perfectly feasible by a proper division of the field between the different institutions to make the prisons, insane asylums, and the like entirely self-sustaining. Hard labour is frequently a part of the criminal's sentence; the less violent insane can be made to work, and something can be got, by proper supervision, from the feeble-minded and the paupers. By an exchange of products between the different institutions the necessary diversity can be obtained. There is little excuse for the too common uselessness of the labour imposed; the tread-mill and oakum picking of our older prison discipline; the digging of unneeded ditches by the insane, etc. Exchange of products, too, avoids the danger of conflicts with the labour unions, which so often arise when a prison attempts to make a product for sale in the open market. This expenditure is very closely related to the one for the maintenance of internal peace and security. The burden falls mainly upon the finances of the central government, or, in a federal State, upon those of the component commonwealths. The policy of isolating the defective classes, the insane and criminal, the deaf and dumb, the feeble-minded, and the like, is an economy for society as a whole, and if it can be made to prevent the propagation of these weaknesses, is far-sighted.

Hospitals. — Hospitals for the sick are imperative needs in the case of infectious diseases; they are great blessings and very desirable from the standpoint of expediency in all cases. The opposition occasionally manifested by selfish private medical practitioners to public hospitals is a sufficient proof of their economy. Fortunately the modern attitude of the medical profession is strongly for preventive measures and consequently favours the erection and support of hospitals. Generally this is a local expenditure. Certain branches of the government,

like the military and the naval, have generally found it necessary, on account of the large number of persons in their employ, to make provision by hospitals for the care of their own sick. The maintenance of quarantine stations for the isolation of persons coming from infected countries or districts is a national affair. Its cost may at times rise to a considerable amount. But there is no question as to its necessity and economy. In the United States there are arrangements for quarantine between the different States, partly at the cost of the federal government and partly at that of the commonwealths. Quarantine against plant and animal diseases is similar in character, and the expense is met in similar ways.

SEC. 2. **Pensions.** — Old-age pensions for officials whose lives have been spent in the public service, or for soldiers whose health has suffered, for the good of all, are but the proper recognition of those services. They may be regarded as sums reserved from the wages from year to year and paid over in this form. In that case this expenditure should be placed under class one. This is the case with most of the pensions in England, and there they are generally correctly classed under the expenditure for the departments to which the men pensioned belonged before they retired. But when this expenditure becomes, as it was in the past in too large measure in America, a means of reward for political services rendered to candidates for public office, it cannot be placed anywhere but in class two, being then an expenditure for the benefit of certain persons considered as though it were for the benefit of all. The rapid increase of expenditure for this purpose in the United States, as well as the curious features of that increase, show that it cannot all be justified by any rule of economy. In this country only soldiers are pensioned. Under general laws, which require only that there shall be sufficient proof that the applicant is entitled to a pension, all those who base their claims on inability to work or excellent services are pensioned. But many others have been pensioned by special acts of Congress. The abuse of the system ceased about 1900, although the pensions granted before that still continue. The amount of pensions increased after the

Civil War, rapidly but irregularly. The Spanish War brought new pensioners into the ranks and the decline in pension costs was checked. In 1918 the allowances were increased and the total expended in that year reached $222,000,000, the largest sum ever paid.

War Insurance. — *To avoid the notorious evils of the old* pension system a new plan was adopted at the very entry of the United States into the World War. That plan was based on the principles of compensation insurance. In brief the government undertook at its own risk and expense to insure the soldiers against death or disability arising directly from or during military service. In the event of death the widow is to receive a fixed sum each month for the remainder of her life or until remarriage, and if there are children fixed sums are allowed to them until they reach the age of eighteen. In case of total disability the soldier himself receives compensation, larger amounts being allowed if he has a family. In the case of partial disability compensation is proportioned to the reduction in earning capacity. The government undertakes to care for and medically treat all disabled with a view to their restoration to full earning capacity if possible. To be recognised as compensable death or disability must occur while in service or within one year after discharge or resignation.

In addition the government sold regular life insurance to the soldiers. Since the government itself assumed all strictly war risks and paid all administrative expenses this insurance was at relatively low premium rates.

The Proper System of Retirement Pensions for Public Servants. — It seems necessary that public servants should have means of support when they retire on account of old age or disability. Since public salaries are rarely large enough to admit of much saving some kind of retiring pensions seem appropriate. Grave practical difficulties arise in inaugurating such a system where there are a body of officers already in the service for whom no provision has been made. It means a sudden large increase in the cost of the public service. Assuming that this difficulty can be overcome the choice lies between

a so-called free pension system, and one supported by annual premiums collected from those who are in line for retirement. Probably in the long run the two are much alike. For probably even if a so-called free pension is established the salaries will be lower by reason of the pension promised. Since under either plan the officer pays for his pension in annual instalments or premiums, it is only just that he should have a definite contract personal to him. It is not just, if he leaves that service before reaching the age of retirement, that he thereby lose the value at date of resignation of the accumulated premiums, whether he has paid them in money or by accepting a lower salary. But that in turn requires that the government shall keep proper reserves, just as an insurance company which sells annuity policies would have to do. Conducted in this way, once the initial costs are met, a pension system is self-sustaining and means only a relatively small regular annual outlay. The initial cost may be regarded as restitution of moneys of which the public servants have been unjustly deprived in the past. But one danger must be held in mind. Pensions on this plan are in essence annuity insurance. The premiums or reserves have to be calculated on the basis of the ordinary mortality tables. But these involve the assumption that the number insured shall be large enough to make the law of averages a safe guide. A small city with only a few hundred school teachers and other officers cannot very well assume that the law of averages will be lived up to by its pensioners. The plan requires at least a hundred thousand in the group of pensioners, and that means that it can be conducted only by a governmental unit of large size. Provisions similar to those which are here indicated for retirement pensions may be used to cover disability as well, and both may be cared for in one general system.

SEC. 3. **Workmen's Compensation.** — Another and a different application of the insurance principle is the establishment of so-called workmen's compensation. We cannot properly discuss the whole problem, but shall discuss the government's part only. Industry exposes workmen to accidents

which may result in loss of life or in disability. If this burden is left on the individual who suffers the accident or on his family, it is often a crushing one. It has been found that neither the workmen nor the employers can safely be trusted to guard against this hazard by private insurance. Government must step in and compel the provision by insurance of compensation in case of industrial accidents. In the most successful systems the government fixes the rates of compensation. It may establish its own compensation bureau or quasi insurance company to carry the risk, collecting annual premiums to cover the losses. It may content itself with fixing compensation rates and adjudging the amounts due in each case and compel the employer to pay the compensation. This would practically force the employer to insure with some commercial company. Sometimes the government does both, and by setting up its own insurance bureau regulates by competition the conduct of this business by the commercial companies. When properly conducted such a competitive government bureau is more effective in regulating the rates of insurance than direct regulation or prescription of rates would be. Joined with compensation there is usually found the enforced use of safety appliances and other methods of preventing accidents. This whole movement is one of the greatest advances of recent years.

SEC. 4. **Bounties and Protection.** — Under this class belongs also that expenditure which is made for the development of industry by bounties and the protection of home industries against foreign competition. The latter expenditure differs from the former only in that the sums spent do not pass through the hands of the officers of the treasury. The recipients of this assistance collect it directly from the contributors in the shape of higher prices for their wares than would otherwise prevail. With the economic side of this expenditure, and the possibility or impossibility of adding permanently to the wealth of a nation by this process, public finance has nothing to do. But as many important nations practise this form of expenditure, we cannot avoid at least a statement of its character. The revenues derived by the government from taxes on the commod-

ities actually imported will be considered in Part II. But so far as any actual "protection" is afforded the home producer, it is an item of expenditure. In effect it is practically the same as if a subsidy or bounty were paid to the producers out of taxes collected from the consumers of the goods in question. This expenditure is made not so much in the hope of increasing the total wealth of the nation directly as in the hope of obtaining a greater diversity of products, so that in the end the effect will be to increase the wealth, indirectly, by allowing for a greater division of labour, and consequently for more steady and efficient production. This policy has nowhere been begun as a permanent one, but one of its results is the growth of powerful vested interests which make for permanence. Thus bounties are paid directly from the treasury, or protection is afforded to industries which it is hoped will eventually be self-supporting, but which are not so at the time. At different times circumstances have caused this policy to be supported by different arguments. Practically all the most important arguments have been used at different times in the United States, where protection has prevailed with scarcely a break from 1816 to 1909. The oldest of those arguments is known as the "infant industries argument." It is urged that new, weak industries cannot hope to live if subject to the competition of older foreign industries. At the same time it is maintained that in case of war it would be practically necessary for a country to be able to supply all its own needs. This grows directly into the argument of List, which is in the main to the effect that a nation's prosperity, in general, depends not so much upon the mass of wealth produced as upon the greatest possible diversity of its industries, so as to develop all possible phases of its national production. Just as the human body is healthier when all the muscles are uniformly developed than when a few are abnormally strong, so, it is argued, a nation is more truly prosperous when all its productive forces are moderately active than when its entire force is expended in a few lines. Later comes the patriotic or "home market" argument, which urges that the home producer has a claim on the custom of the home consumer.

Finally this argument has been developed in the United States into the famous "pauper labour" argument, and it is maintained that the home producer has been enabled to pay his workmen higher wages than the same classes of workmen receive in foreign countries, on account of protection, and that to remove that protection would be to reduce the home workmen to the standard of life of the foreigners. This latter argument is largely an appeal to class interests for votes and is not wholly tenable. The infant industries argument, it is generally admitted, is incontestable. The strongest argument in favour of the continuance of this subsidising of industries has been developed from that of List. This may be restated somewhat as follows: if the productive energy of a nation has but a few outlets, as in exploiting natural advantages, there is a great danger that the nation's economic life may become stagnant. If, however, production be diversified, even by an artificial process, it is much easier to keep the current of productive energy in motion, allowing it to be turned in whatever direction new advantages may open up.

In England, which has for many years been regarded as the "classical home of free trade," there has recently been a revival of sentiment in favour of protection. But this movement has not resulted in establishing a protective system in that country. The reasons for the revival of protectionist sentiment are the difficulty of furthering trade relations with countries practising protection and whose home markets are supplied by protected manufactures, and the desire for closer trade relations with the colonies.

While it may be admitted that there is great force in the arguments in its favour, it must be remembered that protection is very heavy expenditure, not less heavy because it is hard to estimate its amount. There is a practical limit set by the wealth of the people to the possible amount of expenditure in this direction. If this process places too heavy a burden on the nation's annual wealth increment, the burden will not be borne, and the end defeated. Again, if the "protected" infant industries finally outgrow the need of subsidies, and fix prices by

competition, the drain upon the resources of the country ceases. If they do not, the subsidising process may continue so long as the general mass of the wealth is not thereby too seriously curtailed. A nation may be able to pay for diversification of industries, just as it may be able to pay for schools, for parks, for museums, for libraries, etc. But the limit of such expenditure is set by what the nation can afford. This limit is too frequently overlooked; it is too often forgotten that all protection is public expenditure. No " protection " is afforded unless the price is raised. The difference between the price that would have prevailed and the price that does prevail is the amount the nation spends for this purpose. This is not offset by any direct gain in wealth, and can only be justified by the desirability of having a diversity of industries.

SEC. 5. **Expenditure for the Administration of Justice.** — We now come to those expenditures that are treated as conferring a benefit divided between the particular individual who pays for what he gets, and the people as a whole who pay in the general taxes for the general or common benefit. The first and oldest of these is the expenditure for the courts. The adjudication of disputes between different persons was one of the earliest functions of government. The payment of the costs was originally thrown upon the suitors. But modern governments conceive that it is in the common interest to have justice universally administered. Upon the general and accurate administration of justice depends in great measure the prosperity of business. But either as a preventive of too frequent litigations or on account of the special benefit supposed to accrue to the suitor, the costs are divided, and one part paid by the people, the other — a minor part — by the suitor. In criminal cases the whole cost practically falls on the State; in civil cases the attempt is generally made to assess the cost upon the party at fault. A large part of the local administration of justice in England is rendered without emolument by the Justices of the Peace. Besides the mere deciding of disputes and of criminal cases, the judicial departments perform other legal functions of importance, as, for example, the probating of wills, the dis-

posing of property of intestates, etc. Somewhat similar legal functions are performed for the special benefit of the individual citizens by the administrative branches of the government, as registration and legalising of deeds, mortgages, marriages, and other contracts, the granting and registration of copyrights, trade-marks, patent rights, corporation rights, etc.

In the United States the courts have developed a number of quasi-legislative and administrative functions of great importance. As the interpreters of the federal and commonwealth constitutions, they have had to meet new conditions, and indicate the bearing of the constitutions thereon. They have often been called upon to interpret the meaning of constitutional customs that have grown up outside of the written documents, and have in this way given those customs a certain degree of legal prominence. They were formerly in some of the commonwealths (following an old English custom) allowed to determine the local tax levy or apportionment. Quite recently, by the use of injunctions, they have exercised a sort of administrative control over industry, especially as affects the relations of employers and employees in industrial monopolies of public importance, as, for example, common carriers. In the control of municipal corporations, both by punishing illegal acts and compelling due compliance with discretionary duties, they have largely performed the functions exercised by the administrative departments in Europe.[1] In all this work they are considered as acting for the common benefit.

SEC. 6. **Betterment of Property, etc.** — Other functions that are similarly treated need but to be enumerated. Among them are the laying out and grading of streets, building of sewers for the benefit of all the citizens, and the special "betterment" of the property of abutting landowners. The division made here is generally that the first cost is assessed to the specially benefited persons, the subsequent costs, maintenance, etc., to the people generally. The supply of water is similarly treated in many cities. One of the best examples of this sort of expenditure is that of the post-office, as managed in the United

[1] See Goodnow, *Municipal Home Rule*.

States. This service is almost entirely treated as conferring a special benefit on the users. A part of the cost of the distribution of newspapers within the county in which they are published is treated as a public benefit. In some countries the post-office is so managed as to yield a surplus, in which case it passes into class four.

SEC. 7. **State Industry.** — Expenditures of class four are part of the gross expenditure only. When a State spends money in wages and in the purchase of a plant and raw materials for the production of porcelain and the like, it expects to get it all back again from the sale of the commodities. The same is true of a city maintaining a gas plant, of a State railroad, etc. Originally, the State made use of public lands, forests, mines, etc., as a source of income, but now there are a great many industries and enterprises which the State conducts more for a public purpose than for the gain to the public treasury. A city does not operate its street railways primarily as a source of income, but to guarantee the citizen good and cheap service. Hence the gross expenditure for this purpose is a very important item. It is growing to be more and more so as time goes on.

Some of the more important industries that the State carries on are for the purpose of supplying itself with certain commodities, as arms, ammunition, war-ships, and the like. Such industries are carried on from the highest branches of the government down to the lowest. We find, for example, many American towns supplying a part of the support of the inmates of their public institutions by cultivating the lands of the poor-farms.

Some of the most striking instances of such industrial expenditure are connected with communication and transport, and with those industries the management of which, on account of the tendency to monopoly, is frequently put into public hands. Examples of this are numerous among those already mentioned. Many industries have been at different times and places so managed as to cost more than they brought in. That is, they have resulted in a net deficit, not a net profit. They thus pass into class three.

A rather significant list of enterprises has in modern times

been entered upon by the State, which might be, but are not, managed so as to yield a revenue that offsets their cost. These are museums, libraries, parks, baths, and the like. They belong under class one.

SEC. 8. **Expenditures Directly for Human Welfare.** — Since about 1900 there has been a movement, growing in strength, to bend the activities of government more to the care of human beings directly than to the mere improvement of their environment or economic well-being. A common criticism of government expenditure has been expressed as " spending more money to secure good litters of pigs than to promote the welfare of human beings." The resultant legislation has given to government some new activities. Among them may be mentioned: increased provision for health and sanitation; pure food and drug laws including, especially, pure milk, and better enforcement of such laws; supervision and care of the physical well-being of school children; safety appliance requirements in factories and workshops, increased provision for recreation, sport, and exercise; community medical service, which as yet is only an expansion of the older hospital service, although it promises to become different and more important as various forms of social insurance increase. All of these activities trench upon the freedom of the individual in ways that sometimes become irksome. The safe middle course between the meddlesomeness of the infatuated reformer, and the genuine helpfulness of a true public service has yet to be found. The most hopeful feature of this new departure is the discovery that the public will make use of new knowledge and of new facilities freely without compulsion.

PART II

PUBLIC REVENUES

CHAPTER I

THE CHARACTER AND CLASSIFICATION OF PUBLIC REVENUES

SECTION 1. **The State Requires Services and Commodities.** — German writers on public finance generally begin the discussion of revenues with the statement that the State requires services and commodities. The services are furnished by the citizens; in primitive communities freely, by all, in virtue of membership in the State, later by particular ones who are paid for them. The commodities or wealth required may be produced by the State or taken from the citizens. In the ancient primitive community, services are rendered by the citizens as their proper contribution to the State. The commodities needed are for the most part furnished by the individuals without any recognition of a transfer of ownership to the State. The division of labour necessary for the successful administration of more complex affairs of the modern State demands a separation of the persons permanently in the service of the State from the other classes. These must then be supported from somewhere, and in classical times this is accomplished by giving the State, or what is the same thing in classic thought, its special officers, the income from certain sources, as mines or productive enterprises, and taxes upon tributary peoples, or certain inferior classes of citizens. Out of these funds the public officers were supported, and those in the service of the State who were paid for their services were maintained.

Again, in the Middle Ages, feudalism furnished a mode of support for public officers by giving them a certain control over

land and its occupants. This was a means which, without the use of money, provided services and commodities for the public needs.[1] But later as money became more plentiful, and in ordinary transactions payments in kind and in services were commuted into payments in money, the government in turn commuted services due into money payments. At the same time, lands originally conveyed to public officers in consideration of their public services, and to enable them to perform those services, passed absolutely into their control and were treated, in part at least, as their private property, and the services and commodities they yielded became the private income of those individuals and their families. But although the revenues from the domains, retained in this same way by those families which became the sovereigns, were still applied to public expenses, they soon became insufficient, as the State's functions grew, and other resources were sought. In the mad scramble for public revenues, old rights to dues and services were tenaciously retained by rulers or their officers. Especially were the claims to military and similar general services held. These claims, too, were finally commuted into money payments, which became compulsory just as the services from which they were derived had been compulsory.

Voluntary Payments. — The names used for the first revenues, which differed from the receipts from domains and the customary services, show very distinctly the voluntary character of the payments. They are called beggings, requests, gifts (*beden, petitiones, benevolences, dona*), or from the point of view of the assistance given, aids (*aide, steuer*).[2] With the gradual growth of the needs, for which these demands were made, into permanent needs, with the further centralisation and concentration of the public functions, with the neglect of public duties by the feudal lords, and by the quasi-public officers quartered on the land, and with the consequent performance of these duties by the government, the demands upon the people became permanent and compulsory.

[1] Maine, *Early Law and Custom*, p. 148.
[2] Seligman, *Essays*, pp. 6–7.

SEC. 2. **Effect of Constitutionalism.** — Since the emergence of the monarchical State from feudalism, the trend of public finance has been directed by the growth of constitutionalism, — or the representation of the people in the government. As the whole advance of this movement turned upon the success of the people in obtaining the control of the purse, it is evident that the resulting changes in the financial system must have been very important. The long history through which the different revenues have passed, the necessity of constant compromise between the different interested parties, and the various changes made necessary by the growth in the economic life of the world, all these have left modern States with a most confused jumble of revenues. Yet with all the irregularities and anomalies that can be found in the revenues of any modern State, there is still in every case a more or less clearly traceable systematic development. This growth of system is clearly due to the work of the representatives, in whose hands the development of constitutional government finally placed the control of the collection and spending of the public money. As these representatives realised the need of revenues, they naturally sought for some principles of right and justice to guide them in the choice of sources. The result has been a partial uniformity in the systems of the different countries.

It should not, however, be imagined that this uniformity is very great, nor that the systems of the different countries are alike in details. But somewhat the same fundamental ideas seem to underlie all. There are also great differences. Thus one country chooses to obtain the larger part of its revenues from a tax not used at all in another. Historical practices and differences in the frame of government necessitate modifications, even of the same principle. That bugbear of the student of public finance, practical expediency, which has ruined many a fine theory, works in the most astonishing ways to prevent the execution of approved principles.

SEC. 3. **The Justification of Taxation.** — The uniformity above noted came about as a natural result of the general search by the agents of constitutional government for some

good reason why, in each case, the particular person contributing should be called upon to do so. As the representatives of the people, they naturally had to satisfy, in some way, the reasonable desire of the people for some clearly defined method of apportionment. As it is generally hard enough to convince men of the need of contributing anything, the plea put forth must be a strong one. If we confine our attention, for the purposes of illustration, to taxes alone, which are the hardest of all revenues to justify, we can see more clearly how the necessity of thus showing good reasons led to uniformity. It is evident that if the representatives had, for instance, informed their constituents that "taxes are one-sided transfers of economic goods or services," [1] they would have had considerable difficulty in getting consent to any taxes. But when they announced, "taxes are paid in return for the benefits conferred upon you by the government," it was easier to collect them. When they proceeded to assess taxes on the basis of a more or less definite attempt to measure the benefit conferred, or where, in the nature of things, an actual measurement was impossible on some other basis of supposed equality, they clearly had a very good case to present to their constituents. It requires but the slightest knowledge of the history of constitutional legislative bodies to prove conclusively that such was the process of reasoning. And this fully accounts for the similarity of the systems of various countries.

Whenever it was perfectly clear that a certain function conferred a special benefit on an individual citizen, the charge was made on him, and those persons not so clearly benefited were wholly or partially exempt. Thus we have the practice of taking tolls from persons using the roads, of collecting fees from the suitors at court, or making a sale of some privilege or commodity to the citizens for a price, as in the case of granting a monopoly, or the sale of manufactured wares, or of lumber, or ore from the domains. But many of the more important functions do not result so clearly in a special benefit to the individual, and recourse is had to some other mode of justi-

[1] Part of the definition of taxes by Professor Ely, pp. 6, 7.

fication. At first, naturally, the older ideas are developed. The services traditionally due from the citizen to the State, of which that of military service is the most prominent example, are recalled and appealed to. It is claimed that money should be given in commutation of these services. Then the ground is shifted again and again, and many apparently different reasons are advanced. But in all these changes one thing is clear, — the shifting of argument is made in order to enable the use of some new measure of the amount of taxation, and at basis the justification remains practically the same. The citizen is asked to pay, because he shares in the benefits common to him and his fellows. But this common benefit does not suggest any particular measure.

SEC. 4. **Compulsion a Universal Feature.** — Another point of similarity between different nations must be studied historically; that is the feature of compulsion. This feature is old and universal. It is, perhaps, older than any one of the nations and began in that feudal system from which they emerged. The citizen had to be compelled to render his service to the State, whenever the special benefit to him was not clear. That feature the most advanced constitutional governments have retained. There have, to be sure, been instances where States, and especially cities, have had recourse to voluntary contributions to meet the expenses giving a special benefit. But these soon passed into compulsory contributions. A fine example of the development of a voluntary contribution into a tax is found in the English poor-rate. In the twenty-seventh year of the reign of Henry VIII, 1536, collections were made for the impotent poor (voluntary). In the first Edward VI, 1547, bishops were authorised to prosecute all who refused to contribute for this purpose (compulsion enters). In the fifth Elizabeth, 1563, the justices of the peace were made judges of what constituted a reasonable contribution (compulsion as to the amount). And from the fourteenth Elizabeth, 1572, regular compulsory contributions were levied, and so they have continued.

SEC. 5. **Classification of Revenues.** — We have already classified expenditures according to the character of the benefit

conferred.[1] Now the almost uniform practice is to collect compulsory revenues from all the citizens for those expenditures that confer a common benefit, or one that is so treated; then to collect special compulsory revenues for a part of the cost from those persons regarded as specially benefited by expenditures of class three; while the revenues for meeting the fourth class of expenditures are raised by the sale of the commodities or services.

Professor Seligman finds that there are three distinct classes of revenues, each resting on a different justification.[2] The first of these three we shall call taxes. This is a slightly narrowed use of the term. In the broadest sense an exercise of the taxing power of the State occurs whenever a compulsory contribution of wealth is taken from a person, private or corporate, under the authority of the public powers. But such a broad definition of taxes would include, also, the charges for expenditures of the third class levied to pay the cost or part of the cost of a special service. As these are certainly different from those charges levied to meet the expenditures conferring a common benefit, it is necessary to adopt the narrower definition.

Taxes Defined. — In this sense, then, taxes are general compulsory contributions of wealth levied upon persons, natural or corporate, to defray the expenses incurred in conferring a common benefit upon the residents of the State. A tax is justified, but not necessarily measured, by the common benefit conferred.

Fees Defined. — When a distinct attempt is made to levy the charge only where a traceable or assumed special benefit is conferred, and to make it cover the cost, or a part of the cost thereof, the compulsory payment is a fee. In the broadest sense fees are taxes, but they are not taxes in the narrower sense defined above. They compose a large and important class by

[1] See Part I, Chap. I, sec. 6.

[2] See Seligman, "Classification of Revenues," in the *Quarterly Journal of Economics*, April, 1893, and April, 1895; *Essays*, Chap. IX. In my opinion Professor Seligman has not improved his classification by the refinements introduced in the second article. Nor is the necessity for distinguishing between fees and special assessments clear. Special assessments are a kind of fee, even within the terms of the professor's definition of fees. Nothing is gained by raising classes logically secondary in character to first place. It is hoped that the simple general outlines of Professor Seligman's classification, as given in the text, may find general acceptance.

themselves. A fee has a different justification from a tax. A fee never exceeds the cost of the special service rendered. A charge for a special benefit that exceeds the cost is best regarded as consisting of two parts: one a fee, the other a special tax. A fee may be defined as a compulsory contribution of wealth made by a person, natural or corporate, under the authority of the public powers to defray a part or all of the expenses involved in some action of the government, which, while creating a common benefit, also confers a special benefit, or one that is arbitrarily so regarded.

Rates Defined. — The third category of revenues has been called "contractual" revenues, or, by the United States Census Bureau, "commercial" revenues. They are more specifically designated by Professor Seligman as "prices." But there are good reasons for preferring the term "rates" as the general designation of the class. They are the charges made when the government performs some service, or supplies some commodity, in substantially the same manner as that service would be performed, or the commodity supplied and sold, by private enterprise. Thus we speak of railway rates, water rates, rates for gas or electrical current, telegraph and telephone rates, etc. At the same time we speak of the "price" of Gobelin tapestry, or of Sevres ware. While common usage is not altogether consistent, the charges made by a monopoly are more often called rates than prices. The government generally establishes a monopoly whenever it takes over any industry and refuses to allow its citizens to compete with it. Industries in which it allows competition are rather unusual and exceptional. Hence the term "rate" seems preferable to "price," and will be adopted in this work.[1]

If the State has a monopoly, it may act as a private person would and take "all the traffic will bear," or it may forego a part of the possible gain, and the payment becomes or ap-

[1] The term "rate" was not used in this sense in the first edition of this book, nor has it yet received general recognition in theoretical works. But it is not infrequently so used in official documents. It should not be confused with the English designation of local taxes which are, in that country, generally spoken of as *par excellence*, "the rates."

proaches a fee. If the State has no monopoly, it must, perforce, act as an individual would, subject to competition. Every civilised country has these three categories of revenues, and combinations thereof, and no more than these. Every civilised country recognises the same justification for each contribution. Every government appeals to the same motives to induce the payment of each class. In the case of the first two classes the motive is compulsion, in the last the government withdraws and allows the interest of the individual to bring him forward and induce him to make the contribution. This class has been called voluntary. If this term meant merely the absence of compulsion, — the spontaneity, as it were, of the contribution, — it would be satisfactory. But generally there is the danger of confusion arising from the implication in the term that the contribution is without return, of the nature of a gift. Hence, in order to show the character of the payment, Professor Seligman has called it " contractual." There are serious objections to this term also, although it is of such a character as to admit of a technical application very easily. But in lieu of a better and for sake of uniformity we will adopt it. There is less objection to the term " commercial " revenues, used by the United States Census Bureau. But up to the present time the term has not been commonly adopted.

SEC. 6. **Compulsory Revenues are Derivative; Contractual are Not.** — Thus far, for sake of simplicity, and not to depart from the usage of other writers, we have considered the revenues as practically identical with the money flowing into the treasury. Services rendered without pay do not belong to our subject. But still it is not quite accurate to identify the public revenues with the money that flows into the treasury. Money is here, as in private households, but the representative of wealth. When the government compels its subjects to pay contributions of classes one and two, taxes and fees, it does so in order to obtain control of wealth which it takes from the people to consume for a public purpose. But in the case of contractual revenues the matter is quite different. Here the government simply sells, for money, wealth: material things, privileges, or ser-

vices which it has brought into existence. The transaction is a simple sale. This is partly true of some fees. The money that flows into the treasury simply takes the place of actual wealth already created or being created by the government. The important thing to note is that rates result in little or no increase in the amount of wealth in the hands of the government, unlike the other cases, but represent a mere change in the form of the wealth already owned. It is not wealth taken from the people to be consumed by the government; but wealth created by the government is turned into money so that it may be more conveniently used. Nothing is taken from the people, for they receive back the equivalent of their money in wealth, over which they then have control as owners. In the case of compulsory revenues the matter is different because they receive back nothing tangible, but simply enjoy the common or special benefits of good government. These benefits are of the same character exactly as the benefits which accrue to the individual when he consumes his own wealth. They are "reproductive," if at all, in the same sense that the consumption of bread by the worker is reproductive. That is no sense at all. Just as the aim of all production in the economic world is consumption or the satisfaction of wants, so the end and aim of the compulsory collection of revenues is consumption by the State. Sometimes, to be sure, the government turns these funds into permanent forms of wealth which are slowly consumed; as, for example, roads. Sometimes, too, the government adds to the effective power of the wealth before consuming it, or uses it to produce new wealth; but yet, so far as the individual is concerned, he has parted with his property in a way which leaves him benefited, to be sure, but in exactly the same position as when he spends the same amount for some gratification. Quite the contrary is his position when he buys a piece of china made by the government, for then he has the equivalent of his money. The government, too, is no richer than before, but has its wealth in a form which better suits it.[1] Frequently the government uses the wealth created directly without first turning it

[1] Cf. Stein, *Finanzwissenschaft*, II, 138.

into money. This wealth is as much a part of the revenues as any that is sold.

We may now change our terminology slightly, and say that there are three sources of public revenues: the first is collected from all the citizens by compulsion, on the ground that certain expenditures are necessary and confer a common benefit upon all; these are taxes. The second is collected by compulsion from certain persons on the ground that they are specially benefited by some expenditures; these are fees. And lastly, the State creates wealth for itself. The wealth thus created constitutes a part of the revenue of the government belonging to the third class. This, whether sold or not, is contractual revenue or commercial revenue, and is received in the form of rates.

SEC. 7. **Gifts, Fines, and Penalties.** — One or two minor matters have to be noticed and our classification is complete. Sometimes States receive gifts, generally for some special purpose. These are now rare and unimportant. The special purpose is usually more or less outside the general functions of the State. Sometimes the State receives property by reversion, or takes property which has no apparent owner. This, too, is an insignificant category. The State may exercise the right of eminent domain and take property for some purpose. Generally speaking, it restores an equal amount of some other kind of wealth, so this transaction results in no net revenue. The State is the recipient of not insignificant sums from fines and penalties inflicted under the penal power. These are compulsory contributions levied with an intent to injure, and differ materially from the other categories. Their nature is clear, and they will receive no further attention. All the receipts of the State come under one or the other of these categories.

CHAPTER II

THE VARIOUS KINDS OF TAXES, FEES, AND RATES; ALSO DEFINITIONS

SECTION 1. **The Measure of Taxation.** — Considerable confusion in the discussions of the different modes of taxation is due to the failure to distinguish clearly between the justification of taxation in general (*i.e.* why there should be any taxes at all) and the measure of taxation (*i.e.* what should be the basis upon which to decide how much each citizen should pay). The universally accepted justification of taxation is the common benefit conferred upon the individuals by the action of the government. But the common benefit is, strictly speaking, equal,[1] while the taxed citizens are unequal in wealth and ability to pay taxes. Therefore recourse has to be had to some other measure of taxation. It lay nearest, in the search for such a measure, to overlook the distinction between the measure and the justification and to assume that there was a difference in the benefit enjoyed by the different citizens.

The Benefit Theory. — Thus one theory assumes that protection to life, liberty, and property is the chief benefit conferred, and that this benefit, or at all events its cost, varies as the property varies, generally in exactly the same proportion. This theory has been called the benefit theory of taxation,

[1] "The protection of the subject in the free enjoyment of his life, his liberty, and his property, except as they might be declared by the judgement of his peers or the law of the land to be forfeited, was guaranteed by the twenty-ninth chapter of Magna Charta, 'which alone,' says Sir William Blackstone, 'would have merited the title that it bears of the *Great* Charter.' " Cooley, *Constitutional Limitations*, 5th edition, p. 430. "Equality of rights, privileges, and capacities unquestionably should be the aim of the law; . . ." "The State, it is to be presumed, has no favours to bestow, and designs to inflict no arbitrary deprivation of rights." *Ibid.*, pp. 486 and 487.

because it attempts to estimate by the benefit conferred the amount of tax each individual should pay.

The Faculty Theory. — The difficulties involved in measuring benefit, with sufficient accuracy to serve as a basis for taxation, led another school of thinkers to abandon that entirely. These writers feel that each citizen is necessarily a part of the organism of the State, one of the nourishing cells, as it were. And, as in all organisms of nature each organ or each cell contributes to the life of the whole, in accordance with its powers or strength, so each citizen should contribute as he is able. They claim that it is easier to measure ability than it is to measure benefit. This theory is called the faculty theory, the term "faculty" having been found in this sense in early tax laws. Generally speaking, this ability is supposed to be indicated in some way by wealth or by income. But the advocates of faculty as a measure of taxation encounter a serious difficulty in attempting to ascertain whether faculty is proportional to wealth or income or increases more rapidly as these increase in amount. A negative side of the same idea is presented when it is claimed that the tax should impose an equal sacrifice upon every citizen. In determining what constitutes equal sacrifice, we encounter the same difficulty as in determining how to measure ability.[1]

SEC. 2. **Difficulties of Classification.** — It will be noticed that the basis from which each of these measures starts is individual wealth. The first argues that benefit is indicated by wealth, the second that faculty is so indicated. If wealth is the basis, then the classification of taxes might be made to depend on that of wealth. Such a method, although tried, has been found impracticable, because the processes of shifting render it impossible to ascertain the final incidence with sufficient accuracy for classification. It has also been suggested that we might use the different specific means employed by nations to measure benefit or faculty. But here again we meet with difficulties that are almost insuperable; for in that case

[1] See Chap. III for further discussion of this point. A full and instructive discussion of these theories is to be found in Seligman's *Progressive Taxation in Theory and Practice.* See also, Professor Edgeworth's three articles on the "Pure Theory of Taxation," *Economic Journal,* Vol. VII.

the classification will depend on the theory adopted as to the correct measures. If we adopt the benefit theory, our classification will depend on the different indices of benefit chosen. If we adopt the faculty theory, then our classification will be according to the indices of faculty. But we are not at liberty to adopt one or the other of these theories exclusively, because no nations have done so in practice, and their taxes are some of them based on the one theory, or at least best explained thereby, and some on the other, while many combine both or may be interpreted in either way. At the same time many taxes that could not be justified on either basis are retained by the nations on grounds of general expediency, because they yield considerable revenue, or because they have been long in use. If, therefore, we adopt a classification presupposing either theory, we shall find many taxes that do not conform to it. Inasmuch as no consistent plan for the measurement of taxation has been adopted by any country, no uniform method of classification upon " natural " grounds can be found.

These difficulties are inherent in the matter that we are attempting to classify. The librarian generally desires to arrange his books according to the subjects treated. But encyclopædias could not be so arranged without tearing the books to pieces. We might theoretically dissect each tax, and assign its parts to the different categories according to the real nature of each part. But we gain little by this painful process. In this case classification will not help us to ascertain the real nature of the things studied.

These difficulties have not always been regarded as insuperable, and many brave attempts have been made to overcome them, but with so little uniformity as to mark the failure. There are almost as many classifications as writers.[1] The least satisfactory of all are those that attempt to find some natural arrangement. Those which have the most apparent success accept the official names used by the treasury departments of the different nations, and give them merely such limitation as is necessary to use them scientifically.

[1] See Nicholson, *Principles of Political Economy*, Vol. III, p. 291 ff.

SEC. 3. **Direct and Indirect Taxes.** — Perhaps the most common distinction is that made between direct and indirect taxes. This distinction first obtained theoretical importance in the writings of the Physiocrats. By direct taxes they meant any of those taxes which were levied immediately upon the "produit net." [1] There alone, they argued, could be the fund out of which taxes could be paid. To levy taxes anywhere else was indirect, because the burden would be shifted from one to another until it rested there. The assignment of any particular tax to one or the other of these categories was with them a mark of approval or condemnation. With the recognition that other economic processes besides those which added to the material property of the world created wealth, this peculiar theory of taxation drifted into abeyance. The same terms, however, have been widely used by officials and writers and have such prevalence that a recognition of them cannot be avoided.

Rau and Wagner have made the most elaborate attempts to define the modern usage.[2] In this they were only partly successful, because of irregularities in official usage. But despite these irregularities the terms are valuable. Wagner's distinction is practically as follows. There are two ways in which direct and indirect taxes differ. (1) In the case of direct taxes, the taxpayer is also the tax-bearer, at least in the expectation of the lawgiver; any shifting of the burden to another is not expected, not desired, and sometimes, even, forbidden, or subject to penalty. Indirect taxes are, *vice versa*, those in which the taxpayer is not permanently the tax-bearer, or is not intended to be; but a shifting of the burden to another is expected and desired, and may even be prescribed.[3]

But the element of shifting is not the only one that is essential to the idea. The second characteristic is what may be called the technical, administrative conception of direct and indirect taxes. It is based on the method of procedure. (2) Direct

[1] Cf. Higgs, *The Physiocrats*.

[2] Cf. Bullock, "Direct and Indirect Taxes," *Political Science Quarterly*, Vol. XIII.

[3] Wagner, *Finanzwissenschaft*, II, 1st ed., p. 269; 2d ed., secs. 97–100. Schönberg's *Handbuch*, 3d ed., III, p. 171.

taxes are such as are laid regularly according to some fixed fact (or one so treated, and at least somewhat fixed), something regularly recurrent, and hence previously ascertainable, — a fact as of personality, of rank, of property, of earning, etc., — and are, consequently, assessed according to some list or roll (cadastre). Indirect taxes, on the other hand, are such as are laid according to some changing, temporary, more or less accidental fact which is, consequently, not previously ascertainable, — something the result of processes, events, transactions, — and are laid and collected according to tariffs.[1]

These two methods of distinction follow quite closely the usages of theoretical writers and of official bureaux. There are important exceptions in some countries. Thus in France the customs duties are not officially classed as indirect taxes, but form a class by themselves akin to direct taxes. In the United States at the time of the Civil War the income tax was viewed by the courts as an indirect tax, or at least not as a direct tax in the sense of the Constitution.[2] This decision, however, was reversed in 1895, by a bare majority of the same court, which decided that a somewhat similar income tax was a direct tax in the meaning of the Constitution. This decision was in accord with the distinction made above.

The principal direct taxes are: the land taxes, building taxes, property taxes, poll taxes, class taxes, income taxes, industry taxes; the indirect taxes are: the custom duties (with the exception of the French), internal excise taxes, transaction taxes, most fees and licenses. The inheritance taxes, or death duties, as they are called in England, are not easy to classify. In the first sense they are direct taxes, and in the second they are indirect. This is, perhaps, the only important tax that cannot be easily classified. The inheritance tax wherever it exists is used because it is expedient and without much cost yields a large return. It is levied at a time when the persons paying it

[1] Wagner, *Finanzwissenschaft*, II, 2d ed., p. 239.

[2] Springer *v.* United States, 102 U. S. 508. See article, "The Direct Tax of 1861," *Quarterly Journal of Economics*, July, 1889; Seligman, "The Income Tax," *Forum*, 1895; Bullock, "The Origin and Effect of the Direct Tax Clause," *Political Science Quarterly*, XV, p. 470 ff.

are not in position to demand a strong justification. It is sometimes justified on the ground that it compensates for previously unpaid taxes. If this justification holds, then the inheritance tax must be classed as a direct tax.

SEC. 4. **Taxes on Persons, Property, or Income.** — A few other terms which are often used as the names of different groups of taxes and help, in a way, to classify them must be mentioned in this connection. We sometimes speak of taxes as being separable into (1) those on persons, (2) those on property, (3) those on income. These terms do not indicate the final source from which the tax is paid, but the basis upon which it is levied.

1. In the case of personal taxes the different persons who are to pay the tax are listed and assessed either (1) individually, as in the case of *per capita* taxes, or (2) as representatives of a group, as in the family or hearth taxes, or (3) according to some characteristic, as rank in life, office, employment, age, income, property, etc., supposed to be indicative of the benefit they receive from the government or their ability to pay. A complete system of such taxes might be built up, and it is possible to suppose that all the requirements of justice could be met thereby.

2. Taxes on property are those taxes which take the property owned by a person as the index either of the benefit received or of the ability to pay. These taxes may be considered as pursuing property wherever it is to be found with little or no regard for the personality of the owner. They are not, of course, in any but the most exceptional instances, paid out of property. But no particular regard is had to the real source of payment. They may be levied upon any and every kind of property. They are sometimes called real taxes from *res*, things. But this usage has no established sanction in English; in that language real taxes are taxes upon real estate.

3. Taxes on income in the broadest sense are all those taxes which make wealth in the process of acquisition the basis of assessment. These are of two principal kinds: (1) those which are levied upon the annual increment of wealth as such, irre-

spective of the person who is the recipient thereof. That is, they treat the various items of wealth increment as the basis of taxation without regard to the grouping of these increments into a whole in the income of any particular person, and consider the person paying the tax only in so far as he is an income producer through his own activities. This is the character of the British income tax. (2) Those which demand of each person, or seek to obtain concerning each person, a summary of the total income he receives. This latter tax is sometimes so treated as to make it difficult to distinguish it from a personal tax, for the different persons are listed and classed according to amount of income they receive.

By a peculiar and entirely unwarranted use of common English terms in a strange and foreign sense, property, income, and the like have been called the tax objects, and the corresponding taxes objective taxes, meaning that they are taxes on things in distinction from taxes on persons. On the other hand, the persons are called the tax subjects, and personal taxes called subjective. This usage, although it has the sanction of a great authority, in Bastable, has fortunately not been favourably received. Seligman, in a review of Bastable's book, pointed out that by the object of a tax we usually mean the purpose of the tax, and the tax subjects may be things as well as persons subjected to the tax.[1]

SEC. 5. **Taxes on Rent, Interest, Profits, and Wages, etc.** — Following the lead of Adam Smith, various attempts have been made to classify taxes according as they fall upon one or the other of the different shares in distribution, — rent, interest, profits, and wages. But, as Bastable has well shown, the sources from which the different taxes are paid are generally a combination of several of these. The wealth or income of very few persons consists of simply one of these shares. The attempts to carry out such classifications consistently have failed. Bastable's attempted compromise by calling such taxes as can be traced directly to one or the other shares in distribution primary, and all others secondary, brings us to practically the

[1] *Political Science Quarterly*, VII, p. 717.

same results that were gained by Wagner in the discussion of direct and indirect taxes. His primary taxes are those called direct taxes above, his secondary are the indirect.

One other important set of distinctions must receive our attention, because it has the sanction of two prominent authorities. Wagner suggested and Cohn accepted the classification into taxes paid out of wealth at the time of its acquisition (*Erwerb*), or while in possession (*Besitz*), or upon its consumption (*Verbrauch*). This distinction, according to the stage in which the tax finds the wealth from which it is paid, is often useful in showing the effects of certain taxes.

Another very valuable distinction is that made by the term "taxes on revenue." Taxes on revenue are those that fall or are assessed on the revenue or income yielded by different kinds of property. These are a species of taxes on acquisition.

The three sets of terms which we have used in this work are: (1) direct and indirect taxes; (2) personal, property, and income taxes; (3) taxes paid on wealth at acquisition, in possession, and at the time of consumption.

SEC. 6. **Classification of Fees.** — We now come to the important task of classifying fees. The essential consideration to be held in mind about these payments is that they cover a part of the total cost of certain governmental activities, which are performed for the benefit of all, but yet confer a real or assumed special benefit on the individual. When the payment covers the whole or a little more than the whole cost, it is a rate. Since fees are levied upon the receivers of certain benefits from the government, it follows that the only classification for fees is that which shows what activities of the government convey the benefit. We can thus classify according to the different departments of the government, for the services of which fees are collected.

1. **Judicial and Legal Fees.** — The most numerous are the judicial and legal fees, the character of which has already been made clear from the discussion of the nature of these expenditures.[1] Examples of these are the regular court costs and fees,

[1] See Part I, Chap. III, sec. 4.

probate fees, the charges for recording deeds, mortgages, contracts, marriages, etc.

2. **Administrative Fees.** — Next come the administrative fees for the special services of that department. They are: police fees, charged for the special benefits accruing or supposed to accrue to the individuals from the exercise of the police power of the State; the fees for education, when charged; a large number of industrial and commercial fees for services rendered individuals in their industrial and commercial undertakings. The industrial fees include license charges for permission to carry on certain businesses (care must be taken not to confuse these with police fees, nor with business taxes assessed on the same plan). Commercial fees include road and canal tolls, harbour dues, and a number of similar charges.

Special Assessments. — A very important class of administrative fees are those known as special assessments, or in England as "betterment" taxes, usually levied for local improvements affecting property, as streets, sewers, etc. Seligman has defined these as follows: "A special assessment is a compulsory contribution paid once and for all to defray the cost of a specific improvement to property undertaken in the public interest, and levied by the government in proportion to the special benefits accruing to the property owner." He regards them as of so much importance as to make them a class of revenues coördinate with taxes and fees. Strictly speaking, they are fees.

SEC. 7. **The Nature of Public Rates.** — The revenues derived from the rates charged for the services rendered by the industrial activities of the State, or from the production and sale of commodities, so long as these enterprises are conducted for profit, are of the same general character as the earnings of the people. Early writers on public finance devote a great deal of attention to the income of the State from the public domain, forests, and mines, which were at one time of great relative importance. These have shrunk in importance, in modern times, but in their place have come the earnings of the so-called "public service" enterprises, like the railroads and

the street railways, telegraph and telephone service, water works, and others of a similar character. As stated in another connection, these enterprises are usually monopolies. Even when they are not of such a character that they would be monopolies even under private control, the government makes them monopolies by refusing to allow any private enterprise to compete. The French tobacco monopoly affords in part an example of this. Industrial enterprises conducted by a government for profit, under competitive conditions, are rare. The general analysis of these earnings, whether monopolistic or competitive, can be found in any good treatise on Economics and need not be repeated here.

Public rates, however, differ in some respects from the charges made by similar private enterprises. The differences can be most readily shown by an illustration. Let us suppose that a certain city is supplied with water by two private companies, both of which have the right to lay pipes wherever they wish. They will then supply water, supposing that they actually compete, at rates determined mainly by the costs, which are those of management, interest on the "plant," the cost of water, and of the supplies and the general running expenses. The average rates will be considerably higher than need be by virtue of the duplication of the plant, etc. Suppose, however, before any material duplication is reached the companies unite, forming one company which has the monopoly. The charges will now be regulated by "what the traffic will bear," and provided the supply is ample will tend to conform to those rates which will yield the largest net returns. The principles by which monopoly rates are regulated are well known to students of economics. The charges in this case cannot be greater than the cost to the citizens of operating their own wells, nor even so high as to induce the citizens to economise materially in their use of water. But suppose that the townspeople are not content with the rates or with the service. They attempt regulation and fail. They may determine to buy out the plant. Once the city owns the plant it may run it in one of four ways. (1) It may run it as the company did, to make the highest

possible profits, charging all or nearly all the traffic will bear. The surplus over costs goes into the treasury and helps to defray the other expenses of government. The rules determining what the traffic will bear are rules of pure economics. There is absolutely no difference between this public business and a private business. The method of "charging what the traffic will bear" is the method in economic life of determining the value of commodities so sold. It takes the place in the sale of monopoly goods of the "free dickerings of the market" by which price of other goods is determined.[1] The private company had to pay expenses, so does the city; the private company enjoyed a surplus or made an "unearned increment," so does the city; the private company spent this surplus to the satisfaction of the wants of its stockholders; the city spends the surplus for the benefit or for the satisfaction of the general wants of the citizens, who may be regarded as its stockholders. Even if it foregoes taking quite all the surplus, the principle is the same. A private company sometimes does that in deference to public opinion. (2) The city may decide not to make money, but to charge only what the service costs and make the service as good as possible. It then foregoes taking the full price of the wealth that it has produced and allows each consumer to enjoy the surplus. Then the payment by the citizen is a fee. (3) It may charge a fee much smaller than the cost, or a fee for all water consumed over a certain amount. but provide a certain amount of water for each citizen at the common cost. (4) It may distribute the water free of charge and pay for it out of the common fund derived from taxation. Now the sums received in the last three cases only are fiscal in character.

In this connection it is important to note that there is a strong tendency for a government to abandon the economic, or profit making, method of managing such enterprises and to pass to some one of the fiscal methods. That is, the government's method of conducting a public service does not usually con-

[1] See Sidgwick, Bk. II, Chap. X; Andrews, *Institutes of Economics*, p. 122; Marshall, *Ec. of Ind.*, pp. 180 ff.; Senior, pp. 103–114; Sumner, *Essays*, p. 46; Hadley, *R. R. Trans.*, p. 100; Seligman, *Railway Tariffs*, etc., pp. 8 ff.

tinue to follow that of private management. Thus, for example, it would be natural, and perhaps proper, for a private water company to keep a "large capital account" and to carry a heavy interest or dividend charge against the earnings. But when a government has paid off in whole or in part the debt contracted when it acquired the plant, it is not uncommon to drop the interest charge and to reduce the rates in proportion to the reduced costs. The reason for making such an enterprise a government function is the recognition of some public interest or benefit, and, for the same reason, the fiscal method of administration is the more appropriate. Some writers have even gone so far as to suggest this as a sort of test as to whether any given enterprise should be taken over as a government function. They say, in substance, that if the people are not willing to see the enterprise in question conducted on fiscal principles, they should not make it a government function, for it will probably pass on into one of the three fiscal methods of management above outlined and may in time reach the last.

As Cohn has so well pointed out, it is a very different problem that we have to deal with when the management of some industry is made merely the form or means for collecting a tax from certain classes of persons. The French tobacco monopoly, for example, is not in any sense to be looked upon as an industry undertaken in the common interest, or even in the interest of a particular class. It is the aim of the French government to tax the users of tobacco. This aim is attained by other governments through different processes. The form of a monopoly has been found to be remarkably easy, expedient, and successful as a method of indirect taxation.

SEC. 8. **Definitions: The "Base."** — This section will be devoted to the definition of terms used in connection with revenues. The base of a tax is the thing, characteristic, or phenomenon by the possession of which the amount that each taxpayer shall contribute is to be measured, or it is that upon which the tax is "levied." The base is not always, although it may be, the source from which the tax is paid. Thus a tax based on property is generally paid out of the income, or rev-

enue, which flows, sometimes from the property, sometimes from other sources, while a tax on income would be, normally, paid from the same income that constitutes the base. The direct taxes are almost always called by the name of the base; indirect taxes are seldom so named. The base is often expressed in units of value; as, for example, $100 worth of property. It may, however, be expressed in terms of some other units of measurement, as yards, tons, acres, barrels; or again by mere count, as, one poll, one ox, etc.

"Ad Valorem" and "Specific" Taxes. — When the base is expressed in terms of value, the tax is sometimes called an "ad valorem" tax. When the base is expressed in terms of some unit of measurement other than value, the tax is sometimes called "specific." But neither of these terms is applied to certain kinds of taxes, such as poll taxes, income taxes, or inheritance taxes. Sometimes the unit of the base is complex and arbitrary. For example, in Vermont, the base of the general property tax is each dollar in the "Grand List." But only one per cent of the true value of the property of each taxpayer is "set in the list," while his poll is also "set in the list," at an arbitrary valuation of $100. This complexity of the base arose, originally, from the custom of fixing an arbitrary uniform value for each piece of property, as so much per acre of land, so much per head of cattle, so much per horse, irrespective of actual value. Other cases of such complex bases usually have some similar historical origin.

The "Rate." — The rate is the amount of tax that falls upon each unit of the base. The rate, whether for specific or ad valorem taxes, may be proportional or disproportional. It is proportional when it is always in the same proportion to the base, whether the amount held by a taxpayer or subject to the tax be large or small.

The important thing to observe in connection with proportional tax rates is the way in which the rate is arrived at. It often occurs that a government desires to raise a definite amount of money by a given tax, but the aggregate of the base is not known at the time this amount is fixed. It may, therefore,

direct that when the aggregate of the base is ascertained, the amount to be raised shall be divided by the aggregate of the base and the quotient, or the rate thus obtained shall be applied in turn to the amount of the base held by each taxpayer, thus determining his taxes. Or again, and this is perhaps more important, a central government may apportion among its local divisions the total amount to be raised, assigning a lump sum to each, and the local government of each division may apportion its share among its taxpayers in the manner above described. In the latter case the "rate," so far as individual taxpayers are concerned, will vary from one local division to another. When either method is followed, the rate, or even the tax itself, is often called "apportioned." This distinction is especially important in the United States, where most of the state taxes are apportioned in this manner. In many instances, however, the government fixes the rate in advance, and is content to accept the revenues, be they large or small, which the rate so fixed will yield. It is true, however, that even in these cases there is a rough sort of apportionment made before the rate is fixed, otherwise the revenue might be too large or too small. Fixed proportionate rates are sometimes laid down by some superior authority to limit the extravagance of lower governmental bodies.

Disproportionate rates are rates which in themselves vary as the amount of the base held by different taxpayers varies. These rates may be progressive or regressive.

Progressive rates are the most important general class of disproportionate rates. This term is applied when the rate is proportionately higher for a taxpayer who is taxable for a large amount of the base than for one who is taxable for a smaller amount. That is, the fraction taken is ever larger, the larger the amount of the base possessed by the individual taxpayer.

Progressive rates may be regular or irregular according as they increase by some fixed mathematical rule or increase in some more or less arbitrary manner. There are very few regular progressive tax rates in actual practice. Arithmetical or geometrical progression would give regular progression and so

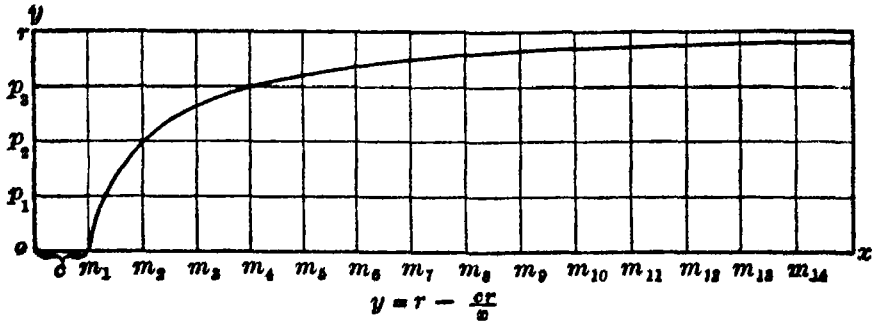
would many other mathematical formulas, notably, some of those of calculus. Of course, many forms of regular progression would, if continued long enough, reach a rate equal to one hundred per cent of the base. As this results in practical confiscation, such an extreme is seldom provided by law. Usually, after a certain relatively high point is reached, the progression is more or less arbitrarily stopped and a proportional rate is substituted. Were the progression to be continued until it resulted in confiscation the motive would not be a fiscal one, for such a policy would diminish the revenue by ultimately cutting down the aggregate of the base. In fact, as we shall see later, the motive for a progressive rate is always something other than the purely fiscal one.

One of the most common, and certainly one of the most important, forms of progression is that called "degressive." In this case the rate (as distinct from the tax) increases but by an ever decreasing increment. In perfectly regular degression the rate would be so arranged that it would constantly approach but never quite reach a given proportional rate as a limit. It would be cumbersome to accomplish this result by varying the nominal rate. But practically the same end can be reached by the simple expedient of deducting from each of the ascending amounts of the base a fixed amount, that is, technically untaxed, and applying to the remainder, in each case, a nominally proportioned rate.

Diagram *A* illustrates a theoretical form of regular degressive taxation, which may be regarded as an ideal. The diagram is

DIAGRAM A

A Typical Form of Regular Degression



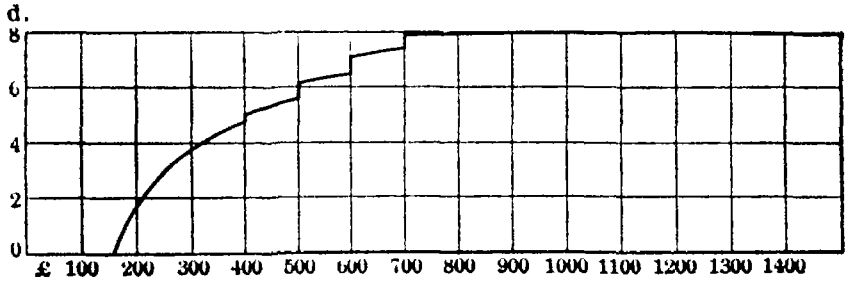
drawn on the assumption that a constant amount "C" is deducted from each and every amount of the base, be the base large or small, and that the remainder is subject to a proportional tax of "R," which thus becomes the limit, which the rate constantly approaches but never reaches.

In actual practice such regularity as is assumed in the chart is seldom found. The regularity may be broken by changing the amount of the deduction allowed at different stages, or by cutting it off altogether.

Diagram *B* represents the beginning of the schedule of rates of the British income tax, as it was under the law of 1898, when

DIAGRAM B

BRITISH INCOME TAX, FORM OF 1898. RATE, 8D. PER £. SLIGHTLY IRREGULAR DEGRESSION, ENDING IN PROPORTION



the rate was fixed at eight pence per pound. The deductions allowed were £160 up to an income of £400; then £150 up to an income of £500; then £120 to £600; £70 to £700; after which no deduction is allowed. As will be readily seen this carries fairly regular degression up to £700, after which the rate is proportional.

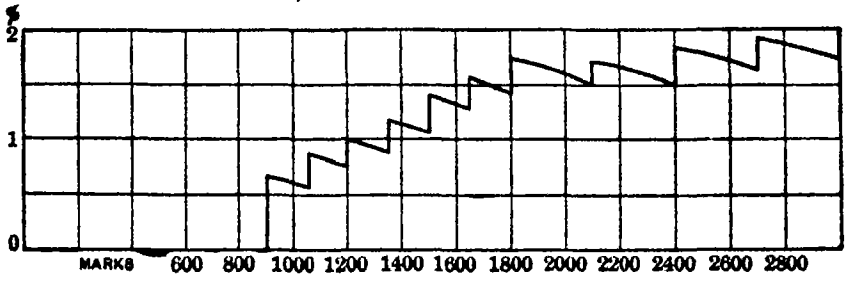
Progressive tax rates are often graduated; that is, the rate increases by grades or stages of the amounts of the base, and is either proportional or fixed within each grade. From this practice it is very common to speak of all progressive taxes as "graduated taxes." It is probably safe to say that the term "graduated" is more widely used in this connection, and perhaps better understood than the term "progressive."

Diagram *C* represents a somewhat complex form of the graduated tax. But it is a form which with modifications as to details

and rates is very frequently found and is found in connection with many important taxes. The diagram shows the first ten grades of the long series of grades in the Prussian income tax, as it was in 1891. It is a form that is intended, broadly speaking, to result in a series of rates that impose a generally degressive tax. But on account of the fixed rate within each grade, and of the change in rates from grade to grade by round numbers only, the resulting schedule is regressive within each grade, and occasionally regressive from grade to grade. If the rates were proportional within each grade, the chart would show a series of horizontal steps.

DIAGRAM C

FIRST TEN GRADES OF THE PRUSSIAN INCOME TAX, 1891. GRADUAL DEGRESSION, REGRESSION IN EACH GRADE



Many other forms of progressive rates have been devised. They are found in a great many different kinds of taxes, but are most common in income and inheritance taxes. The theory of progressive taxation is discussed in another connection.

The rate is regressive when it is the reverse of the progressive, that is, when it is higher for the taxpayer who has a small amount of the base than for one who has a large amount. This is usually regarded as an unjust mode of taxation, and when it occurs, it is usually an accidental or unintentional result. Sometimes it is brought about by the evasion or partial evasion of taxation by those who should be the heavier taxpayers. It is occasionally adopted intentionally, as when it is desired to exterminate small saloons and drinking places by a higher license tax than is imposed on the larger ones. It is safe to say that whenever regressive rates are found, they are either accidental or their purpose is distinctly non-fiscal. The regressive

rates are in practice never very regular in form, even less so than the progressive rates, but theoretically they can be quite as regular in form as the latter.

It should be noted that graduated taxes are usually regressive within each grade; that is, the tax is a larger proportion of the base for a taxpayer who is just over the lower limit than for one who is at or near the upper limit of the grade. Strictly speaking, every so-called proportional tax is graduated and consequently regressive within each grade. This is because the recognised unit of the base, be it a pound, a dollar, a penny, or a cent, constitutes a grade and necessarily takes the same rate throughout. But when the unit of the base is small, this graduation and regression is of so little importance that it is ignored.

Other Definitions. — Impost is a general term for any tax, but there is a tendency to make it synonymous with indirect taxes.

Customs duties are indirect taxes levied on the goods imported into or exported from certain territories.

Excises are indirect taxes levied on goods produced or consumed within certain territorial limits.

Toll was originally a general term for many taxes, but it has come to have a special meaning, and applies only to the charges for passage over roads, bridges, canals, etc.

A tax is said to be shifted when the taxpayer reimburses himself from some one else. The final incidence of the tax is the falling of the burden upon some person who does not shift it.

Two terms of great importance in connection with taxation are "levy" and "assessment."

The term "levy" covers all the legal processes of imposing a tax and making its payment compulsory. It is an act of the supreme authority of government. "Whatever else it may be," says Mr. John Fiske,[1] "the government is the power that taxes." Conversely no tax can be imposed except by governmental authority. In England and the United States the power to levy taxes is a jealously guarded prerogative of the

[1] *Civil Government in the United States*, p. 7.

legislative department. Two of the commonest provisions of the constitutions of the commonwealths of the United States are in effect: (1) that "the power of taxation shall never be surrendered or suspended by any grant or contract to which the State shall be a party." (2) "No tax shall be levied except in pursuance of law." Only in countries having a system of administrative law is there a seeming departure from this principle.

After the legislative or the equivalent authority has levied a tax, the next step is the "assessment." This term covers the acts and proceedings of the administrative officers in determining the amount of taxes each taxpayer is to pay. By metonymy it is often restricted, in common usage, to the most important process involved. Thus in the United States in connection with the administration of the general property tax, the term "assessment" is often used as though it were synonymous with the "valuation" of the property.

While legally and logically the levy of a tax involves fixing the rate, and while theoretically this part of the levy can no more be delegated by the legislative authority to any one else than can any other part of the levy, nevertheless, a seeming delegation of this power often occurs. Thus some executive department may be instructed to ascertain that rate which will yield a certain sum of money, and this rate, although unknown at the time the law is enacted, is declared therein to be the legal rate. This is only a seeming evasion of the fundamental principle; for the executive department on which this duty is imposed has no discretionary powers and merely makes a mathematical computation, the result of which it has no power to alter. Unquestionably illegal is the not uncommon practice of such executive boards of rounding out the rate to some whole number, or to some convenient fraction, so as to simplify the extensions on the tax bills. But this is such a trivial matter that the courts do not regard the tax levy as invalidated by such a proceeding.

The tax list or roll, which is also known by many other names, contains the record of the assessment. It is a legal

document of the first importance. It is in force and effect a warrant, compelling payment, and the basis of all legal tax proceedings. In many cases, notably on the continent of Europe, these lists are, for certain taxes, elaborate, permanent or partly permanent records, which may serve various legal purposes as well as the fiscal, as for example the record of titles, and are called " cadastres." When the same tax is used by several different departments of government, as, for example, by the cities, counties, provinces, or other divisions of local governments and also by the State or central government, the initial tax list or the original may be retained and filed in each local office or tax bureau, and a duplicate thereof sent up to the higher department or division of government. When a number of these duplicates are brought together, the combined list is designated by some distinguishing name, such as the " grand duplicate," the " grand list," or some other similar term.

" Rate," when used alone without the prefix " tax," is a term applied in England to many local taxes, as the " poor rates," or simply " the rates," and in that country often carries the distinction between local taxes and general taxes. In America local taxes for the maintenance of the water systems are not infrequently called " water rates," but the term does not carry the same meaning as in England.

CHAPTER III

THE TAX SYSTEM

SECTION 1. **Taxes are Combined into a System.** — No nation has ever found it feasible to adopt any single tax as the sole source of its income. No nation at all advanced in civilisation has attempted to conduct its government entirely from the earnings of its domains or industries. Every civilised nation of to-day combines the three sorts of revenues, those produced by its own activities and those obtained from taxation and from fees. And furthermore, no nation attempts to exist with only one of each of these kinds of revenues. These different forms are combined into a " system " or general scheme, which conforms more or less closely to the general ideal of justice which may have been adopted by the nation. To judge of the justice or expediency of any tax it should be studied in its place in the " system." We have already seen the two main theories as to the proper measure of taxation: the one, that taxation should be measured by benefit; the other, that it should be measured by faculty. A perfect system would so combine the different forms that the total burden imposed would be in accord with the ideal adopted.

The Dream of a Single Tax. — There is a constant tendency toward the simplification of tax systems, although most modern systems are still extremely complicated. It is the dream of financial theorists, and has been ever since the science began, and it is the aim of many would-be reformers, to find a single tax that will furnish all the necessary funds for the support of the government. The physiocratic *impôt unique* on the *produit net* is well known, as is also the justification therefor. It is also well known wherein this fails. Modern proposals generally

involve something more than mere tax reform. The socialistic demand for a single, exclusive income tax with a progressive rate is advanced with a hope of effecting a redistribution of the wealth of the world. Henry George's well-known scheme for a single tax on land has a similar ulterior purpose. His object is to free industry from trammels which he supposes are due to the appropriation of land values by private individuals. In form his proposition is not very unlike that of the Physiocrats. He is an extreme individualist, but he aims, like the socialists, at a new distribution of property. Of these two modern schemes for a single tax the first is perfectly feasible from the fiscal point of view. Such a tax could probably be administered and could be made to yield ample revenue. It fails, however, to answer the simplest requirements of justice. For example, it would not, unless our whole scheme of economic life were first altered, seem just that the man whose property was benefited by the grading and metalling of a street should be entirely free from a special charge for the special benefit. The scheme is inexpedient for three reasons: (1) it presupposes for its successful administration a method of distribution of wealth very different from that which the world now has; (2) it demands a perfection in the technique of administration as yet absolutely unattainable; (3) it would need, in order to be fairly administered, more honesty than men have yet shown in their dealings with the government. None of these reasons militate in the least against the incorporation of an income tax in the tax system, beside other taxes. They apply only to its use as the sole source of revenue.

Mr. Louis F. Post, official lecturer for the Single-tax League, gives the following explanation of the second most prominent form of a single tax.

"The practical form in which Henry George puts the idea of appropriating economic rent to the common use is '*To abolish all taxation save that upon land values.*' This is now generally known as 'the single tax.' Under its operation all classes of workers, whether manufacturers, merchants, bankers, professional men, clerks, mechanics, farmers, farm-hands, or other work-

ing classes, would, *as such*, be wholly exempt. It is only as men who own land that they would be taxed, the tax of each being in proportion, not to the area, but to the value of his land. And no one would be compelled to pay a higher tax than others if his land were improved or used while theirs was not, nor if his were better improved or better used than theirs. The value of its improvements would not be considered in estimating the value of a holding; site value alone would govern. If the site rose in the market, the tax would proportionately increase; if that fell, the tax would proportionately diminish." [1]

A full discussion of the economic and social effects of Henry George's single tax would carry us far beyond the scope of this book. The argument for the single tax, as a mode of taxation alone, is far from complete by itself. In so far as it can be stated separately it has been well given by Fillebrown.[2] His statement is as follows: "*a*. The site value of land is a social product. *b*. A land tax cannot be 'shifted.' *c*. The selling value of the land is an untaxed value." From *a* he would have us draw the conclusion that the ground rent should belong to the community as a whole. This, of course, involves the economic argument for the single tax. From *b* he would have us infer that the only person affected would be the landlord, and from *c* that "if all taxes are ultimately taken from rent, it follows that in the course of two or three generations taxation may cease entirely from being a burden upon any one." [3] In the first edition of this book there was a discussion of the probable sufficiency of the revenues which could be obtained from this source, and figures were presented from which the author was inclined to draw the conclusion that the entire ground rent would in most communities be less than the revenues now being spent by the government. Those figures have been questioned, and it is difficult, if not impossible, to get any that both sides to the controversy would be willing to accept. But it appears to the author on more mature consideration that the point is

[1] "The Single Tax," p. 1. Henry George, *Progress and Poverty*, Bk. VIII, Chap. II.

[2] *A. B. C. of Taxation*, p. 155. [3] *Op. cit.*, p. 163.

not quite pertinent. Because, if it were admitted on the one hand that all taxes other than those on land values were unjust, then it would become the duty of the government to keep its expenditures within the revenues available. But on the other hand some of the ablest among the modern disciples of Henry George do not lay full stress on the word "single." "It is a question of applying land values to the common use as far as they will go, or as much of them as may be needed, as the case may prove to be." [1]

Aside from any question as to the probable sufficiency or insufficiency of the revenues, the single tax presents a great many practical administrative difficulties for the solution of which no detailed suggestions have been offered. Thus we cannot easily foresee how, under the changed conditions, the assessment would be made, or how the actual ground rent would be ascertained. It is especially difficult to see how the revenues would be apportioned among the various divisions of government, or what would be the assignment of governmental functions to different divisions of government under the new régime. All these difficulties make governments hesitate to plunge into so comprehensive a change, the outcome of which it is so difficult to foresee.

If on economic grounds, or on the ground of general public policy, we deny that any such fundamental changes in the modern system of land ownership, possession, or enjoyment are desirable, or that the "private appropriation of ground rent" is in any way a wrong, or the cause of any social or economic evils, then the case against the single tax is clear. It would be fundamentally unjust because it lays an unduly heavy burden on certain classes and allows others to go free or at least to enjoy a very considerable abatement in their contributions to the common ends of society.

Increment Value Land Taxes. — An apparent application of the single-tax idea is found in the recent extension of a system of special taxes on the increment of land values, espe-

[1] Louis F. Post, *The Single Tax*, p. 86. Quoted approvingly by Fillebrown, *op. cit.*, p. 154.

cially in large cities in Germany. As these cities have grown rapidly in population there has come a corresponding increase in land values. In many cases the existing tax systems have been insufficient to reach this added tax-paying capacity in a manner that seemed adequate under the new conditions, and consequently new special methods of reaching it have been devised. The special taxes are usually based on the so-called "unearned" increment in value and not on any increase due to actual outlay or improvements made by the owner. They are usually levied at the time of a transfer, when the actual increment of value appears. The rates, while often sharply progressive according to the percentage of unearned increment over cost, are not so heavy as to take the entire increment. They accrue, as a rule, to the benefit of the cities only. These taxes are therefore unlike the "single tax" in that they do not in any event take the whole of the ground-rent, whether as an annual payment or in capitalised form.

Every tax tends to repress the development of the particular phenomenon on which it rests. A single tax of any kind will tend to defeat its own ends by repressing the existence of the phenomenon which gives the signal for its assessment. For example, in Mexico land is not taxed, but if the farmer kills a cow, or sells a crop, he is taxed. Naturally this discourages any extension of the uses of land that involve this disagreeable consequence. The experience of nations which has led them to diversify the forms of their taxation is, therefore, supported by theoretical considerations. The tax system of the United States is still, and the tax systems of all European nations have been, until recently, and are yet in great measure, mere accidental jumbles of different historical taxes, which are retained simply for the revenue that they yield and not because of any belief in their justice. It is not often that nations are rich enough to enjoy what Professor Cohn has well called the "luxury of reform for reform's sake." Their reforms have been most often undertaken for the sake of increased revenues.

To be sure, the rough edges have been somewhat worn away

by the friction of economic forces, and the process of tax shifting has in some instances removed some of the worst injustices. But examined from the standpoint of some ideal system, the tax systems of many modern nations fail woefully. It matters little which ideal be the one held up by which to test them; whether it be that of the benefit theory, or that of the faculty theory, the failure is the same.

SEC. 2. **Theories of Justice in Taxation.** — What in the opinion of nations constitutes the idea of correct or just taxation? The answer to this question is to be sought in the theories of taxation that have found favour, and are generally contained in the writings of economists and financiers. The Physiocratic answer was, we have seen, inadequate. The benefit theory would say that each citizen should pay according to the benefit he receives. What is the benefit and how is it measured? The common benefits are, clearly, the peaceful enjoyment of life, liberty, and property. The protection the State affords to life and liberty is theoretically equal for all; that to property might be considered to vary as the amount of property varies.[1] A uniform tax on each poll for the first two benefits, and a proportional tax on property, would seem to answer the requirements of this theory with sufficient accuracy. But the relatively small returns from the poll taxes and the great expense and friction of collecting them soon led to their partial abandonment. Property then remained the chief basis under this theory. The value of property seemed clearly to depend on its revenue-yielding power. It is a matter of comparative indifference which is taken. Hence the idea embodied in the famous dictum of Adam Smith: "The subjects of every State ought to contribute toward the support of the government, as nearly as possible, . . . in proportion to the revenues which they respectively enjoy under the protection of the State."[2] But here again as the industrial population separated from the soil

[1] The benefit theory has been illogically developed into a defence of progressive taxation. See Seligman, *Progressive Taxation*, 2d ed., p. 181 ff. I have not included this illogical side in the discussion.

[2] Bk. V, Chap. II, Part II. On the various interpretations of this passage, see Seligman, *op. cit.*, p. 150.

and a large body of citizens arose, who had no land and little personal property, and who could ill afford to part with any of their earnings, humanity and expediency urged the exemption of the minimum of subsistence. It cost too much and caused too much bitterness to collect taxes from those having only the bare necessities. Then came Ricardo's suggestion, "The power of paying taxes is in proportion to the net, and not in proportion to the gross revenue." The items that were to be deducted were the costs of production, among which were then counted the bread and meat for the labourers, which were regarded very much as so much fuel shovelled into the furnace of a human machine. Hence it was argued that it would be too burdensome to production to tax what was necessary to maintain the productive power of the workers. A certain amount of income, therefore, should be exempt; for if taxed, the tax would certainly be shifted. Fortunately, according to the prevalent theory of wages, the amount to be exempted would remain fixed, or nearly so, advancing, if at all, very slowly. So that all incomes over a fixed amount were to be taxed proportionally, since the benefit to such individuals as possessed incomes above the chosen minimum was supposed to be in exact proportion to the amount in excess of the minimum. Stated broadly, this theory was as follows: All taxes must be proportioned to benefit. Certain classes only are benefited, namely, those having income over a certain amount; that is, over the minimum of subsistence. They should be taxed on the amount above that minimum of subsistence. It would seem, then, that the money spent in protection of the workers who lived on the minimum of subsistence was to be treated as if of benefit to the other classes. This puts the worker in much the same category with the pauper for whom the State, from reasons of humanity, decides that it is worth while to care. With a clearer perception of the character of production and a realisation of the fact that the worker was a man, the satisfaction of whose wants, even if they did not exceed the minimum of subsistence, was yet as important as the satisfaction of the higher wants of other classes, came a realisation

of the inadequacy of this theory. It is now quite generally abandoned, except as the legal theory in America.

Perhaps the best statement of the United States legal theory of what constitutes the just measure of taxation is given by Judge Cooley.[1] "If it were practicable to do so, the taxes levied by the government ought to be apportioned among the people according to the benefit which each receives from the protection the government affords him; but this is manifestly impossible. The value of life, liberty, and of the social and family rights and privileges cannot be measured by any pecuniary standard; and by the general consent of civilised nations, income or the sources of income are almost universally made the basis upon which the ordinary taxes are estimated. This is upon the assumption, never wholly true in point of fact, but sufficiently near the truth for the practical operations of government, that the benefit received from the government bears some proportion to the property held, or the revenue enjoyed under its protection; and though this can never be arrived at with accuracy, through the operation of any general rule, and would not be wholly just if it could be, experience has given us no better standard, and it is applied in a great variety of forms, and with more or less approximation to justice and equality. But, as before stated, other considerations are always admissible; what is aimed at is, not taxes strictly just, but such taxes as will best subserve the general welfare of political society."

Benefit as a measure of taxation is therefore according to the admission of one of its strongest advocates inadequate. Only in special instances can benefit be directly measured. There, of course, it has been and will remain the basis of taxation, at least until the State shall decide that the special benefit has been merged in the common benefit.

SEC. 3. **The Faculty Theory.** — But the faculty theory, while offering some difficulties, is on the whole more satisfactory. The faculty theory is well illustrated by the history of the English poor law, to which reference has already been made. At first the attempt was made to supply the wants of the poor

[1] *Taxation*, p. 24.

by voluntary contributions. But it soon became apparent that all were not contributing "as God had prospered them." The idea that the support of the poor was a benefit to the other classes, except, perhaps, so far as almsgiving was supposed to insure a man's salvation, did not appeal to the legislators. They anxiously avoided making the contribution compulsory because it would be hard to justify such a policy by pointing to any benefit. But they felt that fairness demanded that each should contribute according to his ability. Indeed, this was their understanding of the Divine command upon which they were consciously acting. The justices of peace were, without any very definite instructions as to the mode of procedure, authorised to see that each person contributed fairly according to his ability.[1]

What then constitutes ability? The original idea seems to have been that the possession of property constituted ability. But the value of property depends upon its power to yield the owner a revenue. If we consider landed property only, we find historically the greatest uncertainty as to whether men should be assessed according to some estimate of the salable value or according to its annual yield. This uncertainty arose from the conditions of the times. The salable value of landed property was, of course, determined by the annual produce or revenue-yielding power. In the middle ages land was not salable property; hence, it was the custom to value it for purposes of taxation according to the annual produce, or the annual rental value, which was determined by the produce. The history of taxation in the American colonies is very instructive as to the method of determining what constitutes faculty or ability to pay. Here for the first time in history, or at least since the fall of Rome, was a country that enjoyed almost absolute free trade in land. When the Connecticut proprietors bought in fee simple lands in Vermont, which they had never seen, to be sold again on cash terms to settlers, whom they had never seen, often for prices which the same lands would not bring to-day, they were doing what was not possible in any European

[1] Ashley, *Economic History*, II, p. 360.

country at the time and what is only partly possible in most of them to-day, *i.e.* selling land as one sells wheat or any other commodity. The New England colonists, therefore, had the choice of two methods of assessing property in land: they could follow the older method to which they were accustomed at home, which assessed the rental value of the property, or they could take some method suggested by the fact that lands were really sold, in fee simple, for a price. In general they chose the latter, although there are numerous traces of the old method both in the tax laws and in other regulations that are of a similar character. It is unfortunate that none of the investigations into the history of this period have been specially directed toward this point. Vermont furnishes one of the best examples of the principles underlying the colonial idea of taxation. There the conditions were very simple. Taxation[1] was intended to cover all male inhabitants. Every male between 16 and 60 years of age, with a few definite exceptions, was "rated" at £6 on his person. That is, everybody was considered to be able to contribute something, whether he had property or not. Then the different items of property were "set in the list" over against the name of the owner at fixed rates. For example, each acre of improved land, 10*s.*; an ox or steer four years old, £4; three years old, £3; two years old, £2; one year old, £1; a horse three years old or over, £3; all "horse kind" two years old, £2. Money on hand, or due, was listed at £6 in the £100. Then all persons were listed "for their faculty," according to occupation and earnings: attorneys at from £50 upwards, as the value of their practice increased; all tradesmen, traders, and artificers "proportionally to their gains and returns." Other items of property were entered in the list in a similar way at fixed rates. The sum total of all the different items over against the name of each person was supposed to represent his total ability or faculty. The notable thing about all this is that only revenue-yielding property was listed. It was not a property tax purely, nor an income tax. But the thing which it sought to ascertain was how

[1] Wood, *History of Taxation in Vermont.* Columbia College Studies, IV, 3.

much ability or faculty each person had. All property that was regarded as indicative of faculty was listed, and many other things that were also indicative of faculty were included. Later, however, Vermont adopted a form more nearly in accord with the idea that property alone indicates faculty.

There are, then, two ways of ascertaining faculty. In the one the base is primarily the property irrespective of the revenue the property yields. In the other it is income from property or from other sources. There are also two ways of completing the measurement: We may assume that faculty is proportional to property or income; that is, that it increases in exactly the same ratio as property and income increase. Or we may assume that it increases more rapidly than either property or income. The choice of base and the choice of rate have given rise to long and weary discussions and hair-splitting distinctions. In regard to the first, it is sufficient to say that at present the most widely accepted view is that, from the standpoint of abstract justice, income forms a better starting-point for the determination of faculty than property. But we cannot avoid entering the discussion as to whether faculty is in proportion to income or increases more rapidly. The widespread advance of democracy, and of sympathy for those in the lower walks of life, led to the desire to justify if possible the exemption of smaller incomes, especially the minimum of subsistence, and this desire found means of fulfilment in the newer theories of value, the conception of marginal utility, and the discussion as to the relative urgency of different wants. If we classify certain wants as absolute necessities, then the conclusion is near that the possessor of the minimum of subsistence has no ability to pay taxes. The possessor of a great deal more than the minimum of subsistence can in proportion bear more taxes than one who has only enough to obtain a few comforts in addition to the necessities. That is, the test of justice is found in equality of sacrifice, and we impose a greater sacrifice if we take away from the labouring man with $1500 a year 10 per cent of his income than we impose on the capitalist with $15,000 annual income by taxing him

in the same proportion. Moreover, if we look upon faculty as identical with general economic power, then it is clear that, as the control of wealth increases, the ease of further increase is greater. Thus it is easier relatively for the millionaire to double his fortune than it is for the daily-wage earner to rise to independence.

Only slightly different in form is the so-called "leave-them-as-you-find-them" theory of justice in taxation. That is, that taxes should be so imposed that when all have paid them, each will be left in the same position, relative to his fellows, as he was before the payment.[1]

SEC. 4. **The Compensatory and Socialistic Theories.** — There are two other theories, which, independent of the idea of sacrifice or of increased economic power, attempt to justify a higher rate of taxation for higher incomes than for lower. These two theories adopt the hypothesis that the common benefit is equal, and demand that the inequalities in wealth should be removed in order to make it easily possible to tax according to this equal benefit. There are, first, those who argue that the inequalities in wealth are due in large measure to the action of the State, and hence the State is justified in abandoning the idea of equality of taxation and in taxing those who have much wealth more heavily than others, for they have gained from the State's own action. This has been called the compensatory theory. Others, again, starting from the same hypothesis, urge that taxation cannot be equal, because evil economic forces have changed the abilities of the taxpayers and that it is the duty of the State to offset these forces by readjusting wealth through taxation. This has been called the socialistic theory. Neither of these theories can justly be called scientific; they both cut loose entirely from existing conditions.

After a careful study of all the modern theories of justice in taxation we are forced to the conclusion that none of them is superior in any way to the noble maxim or canon of Manu

[1] The student will do well to read carefully the three essays by Edgeworth on the "Pure Theory of Taxation" in the 1897 volume of the *Economic Journal*.

quoted at the very beginning of this book in the unnumbered chapter entitled "General Considerations."

The Practical Application of Progression. — These theories all demand that the rich should be taxed *proportionately more heavily* than the poor. This principle is not always successfully applied, but there is no country which does not attempt to apply it. How is the attempt made? There are several ways. *First*, heavier taxes are imposed on luxuries than on necessities. There are heavier taxes on silk shirts and stockings than on cotton ones, heavier taxes on broadcloth than on blue jeans, heavier taxes on fine flavored cigars than on common plug tobacco. *Second*, a series of taxes cumulate on the rich many of which do not apply to the poor. The poor man pays his lighter indirect taxes as above, a poll tax, and, may be, a small property or income tax. The rich man pays the same or heavier indirect taxes and poll taxes and proportional property taxes and then a whole series of other taxes such as heavier (proportionately) property and income taxes, together with business taxes, inheritance taxes, capital taxes, and often still others. *Third*, a differentiation is made within each tax by levying heavier or progressive rates on the rich. Thus incomes of small amounts may be entirely exempt, incomes of moderate amounts may be taxed only a few per cent while large incomes may be taxed many more per cent.

In working out progression, under the third method, two important questions arise. One is: In what kinds of taxes may a progressive tax rate be used? The other is: How high can the progression be carried?

Progression Logically Applies to Direct Personal Taxes Only. —The answer to the first one is: progressive tax *rates* may be logically applied only to a direct personal tax so framed as to be based on some clear index of ability to pay. That progressive rates are wholly out of place in customs duties and excises is so obvious that a mere statement that it is so suffices. Whether the import be champagne or coal, the rate per case or per ton is the same for a shipload as for one case or one ton. But progressive rates are in place for income taxes, inheritance

taxes, and for property taxes when in the last case the base is a man's aggregate estate. But if the property tax is one on things ownable, regardless of the owner, progression is out of place. Ordinarily there is little difficulty in deciding whether progression is applicable, but sometimes the decision becomes difficult. A poll tax is ordinarily not progressive, despite the fact that it is personal. But sometimes the assumption has been made that some polls or heads are different from others. Then the rate may be made progressive and a Duke's or Earl's head may be taxed more heavily than a peasant's. On the other hand, while a tax on the shares of the heirs or legatees of property left by a decedent may properly be progressive, it is wholly illogical to impose progressive rates on the entire estate left by him. For that means that the privilege of inheriting $500, say from a million-dollar estate, is worth more than that of inheriting the same amount from a $1000 estate. Although the principle is clear, legislators, having, perhaps, some difficulty in grasping progression at all, often attempt ridiculous applications. They are sometimes prone to try to apply it to any new direct tax, whether personal or not. Thus it was applied to the excess profits tax in the United States with the most astonishing lack of sense.

How High May Progression Go? — The second question, how high may the rates rise? has never been answered by a definite rule. McCulloch very correctly said when we abandon proportion "we are at sea without rudder or compass." Professor Seligman, after surveying all the theories and practices in the matter of progressive rates, said: "If, therefore, we sum up the whole discussion, we see that while progressive taxation is to a certain extent defensible as an ideal, and as the expression of the theoretical demand for the shaping of taxes to the test of individual faculty, it is a matter of considerable difficulty to decide how far or in what manner the principle ought to be actually carried out in practice."[1]

The theory of marginal utility, which holds that each unit of a large supply or stock of goods available gives less satis-

[1] *Progressive Taxation*, 2d ed., p. 302 ff.

faction than each unit in a small one, gives us no measure of how much less the satisfaction is. It does, however, teach that, in general, after the somewhat uncertain point of satiety is passed, each added unit in the surplus has no more utility than any other unit in the surplus. This gives us a scientific explanation of the common practice, adopted under the dictates of common sense, of stopping progression and reverting to proportion after some assumed high level is reached.

If we are under necessity of saying where, in a given income tax, for example, progression shall stop and proportion set in, we are forced to decide by considerations quite outside of the field of pain inflicted and of strength available. The real decision will have to be made on the basis of general social welfare. A tax at rates so very progressive as to approach confiscation quite rapidly, may be justified as a war tax, but if we desire to stimulate industry and promote thrift it is essential, lest the accumulation of capital cease, to avoid any approach to confiscation. War income taxes with maximum rates above fifty per cent for large incomes are not uncommon, but in peace times a rate over ten per cent is held to be dangerously high. Practical administrators of the tax laws regard twenty-five per cent as the highest advisable rate for the inheritance tax, and while it would be hard if not impossible to state the grounds for this conclusion, the unanimity shown argues that it would be wise to be guided by it.

It would seem, then, that, in general, faculty is the ideal base of taxation; that faculty can be measured either by property or by income, but best by the latter; that faculty increases somewhat progressively and is affected by the consideration of relative conditions, as the kind of property, the source of the income, or the burdens already resting upon the individual or property. All these considerations have to be applied in determining whether the tax system of any country complies with the rules of justice. They do not apply with the same strictness to the separate taxes.[1]

[1] The recognition of the principle of progression in the recent reforms of taxation is very marked. See Seligman, *Essays*, 305 ff.

CHAPTER IV

THE DEVELOPMENT OF TAXATION BEFORE THE INDUSTRIAL REVOLUTION

SECTION 1. **Taxes Not Found under Feudalism.** — Feudalism placed a large number of economic receipts directly in the hands of the rulers. These receipts were generally sufficient for the discharge of the customary public activities. It is a mistake, therefore, to search for taxes proper in the period of the supremacy of feudalism; that is, from the capitulary of Charles the Bald, 877, to the end of the thirteenth century. Taxes begin to emerge with the transformation of feudal rights and dues, the commutation of obligatory military services, and the like into payments in kind or in money. Greek and Roman forms of taxation had even less influence on modern systems of taxation than Greek and Roman forms of expenditure on modern spending. For the study of Roman law and the traditions of the glory of the Roman Empire determined many State activities that involved the spending of public wealth. But new methods of obtaining the funds were devised. Information concerning the taxes of the period from the fall of Rome to the capitulary of Charles the Bald is rather meagre and too vague to be of much value.

Early Taxes. — The first taxes to emerge from the darkness of this period are a number of fee-like contributions of the nature of commuted feudal services, or directly connected with feudal rights, certain market dues and customs duties, tolls for protection to travellers, for the use of roads, bridges, and ferries, and two forms of property taxes, land taxes and family taxes. The land taxes of this period are just emerging from the character of rent payments and acquire only by degrees the char-

acteristics of pure taxes. Even in the case of land left to the original possessors after conquest, the payments demanded are more of the character of rents than of taxes. But the combination of these charges with hearth or family taxes leads to the formation of various mixed property and personal taxes. The fact that land is practically the only kind of revenue-yielding property and that no considerable earnings are made without the use of land, makes this tax sufficiently universal for the demands of justice.

Direct taxes are in this period, as in classical times, never paid by the freeman. They are regarded as derogatory and as the badge of a servile position. The freeman could give his services to the State, he could risk his life for it, but he would regard it as a deadly insult if he were asked to pay taxes. Indirectly, of course, he was taxed, as, for example, when he bought merchandise, for permission to sell which the trader was taxed.

As soon, however, as industry began to develop, as soon as the crafts sprang up in the cities which clustered around the market-places, and classes which had lived in part from industrial pursuits found it possible to obtain so wide a market that they could live entirely from their industry, then, there arose such a differentiation of the sources of wealth that the old forms of taxation were insufficient. Taxation had, therefore, to be extended to meet the new forms of wealth. The first methods of taxing these were dictated solely by expediency and the desire of obtaining as large revenues as possible, rather than by any definite ideas of justice, and were mainly indirect in character and partly an extension of the older market dues, excises, customs, and tolls, together with new taxes of the same kind.

Of old Roman taxes none can be strictly said to have survived the conquest. Some lasted throughout the Merovingian period in a greatly changed form. Finally they were merged into various feudal payments, and took on the nature of rents. A few relatively insignificant market dues and fees constitute the only taxes which regularly formed a part of the revenues

of the State or of the State's officers, the feudal lords. The regular feudal burdens, while economic in character and not fiscal, really fill the place of the later direct taxes. In proportion to the prosperity of the people they were certainly as heavy as any modern systems of taxes. The rapid disintegration of the German Empire into smaller territorial lordships after the sixteenth and seventeenth centuries rendered the question of imperial taxation at once less pressing and more complicated. On some eleven different occasions, according to Wagner, between 1427 and 1550, the Empire, as such, stood in need of extra revenues, for purposes so clearly of common benefit as to justify a demand for common contributions. Such an instance is that of the Hussite and Turkish wars. The tax used was the "common penny." This direct imperial tax was a mixture of poll and personal taxes with income and property taxes. We find very similar taxes in France and England. It fell upon all imperial subjects whether holding from the crown or not, provided they held property. The rate was an irregular regressive one, being smaller for all above a certain amount of property. It was very badly administered and not universally collected.[1]

In the German principalities that were formed out of the German Empire the first direct taxes were the *bedes*. These were extra payments, similar in form to the existing feudal contributions. They were made by those already paying such dues and were measured in somewhat similar ways. The basis was generally landed property. The first *bedes* were more or less voluntary, private contributions for the support of the *Vogt*, count, or lord for some recognised public purpose. By contracts entered into between the contributors and the lords, they became compulsory and formed part of the regular income of the lords, who then in extraordinary cases of need would again come forward with the demand for extra or "necessity" *bedes*. This was frequently done in times of war. Hence, these *bedes* were often called "army *bedes*." Some of these in turn became customary or fixed. With the rise of the idea of public life and

[1] Cf. Wagner, Schönberg's *Handbuch*, 3d ed., III, 184.

public needs, the *bedes* easily became compulsory public contributions, and were regarded as distinct from the feudal dues, which by virtue of longer standing and the absence of a recognised public purpose were treated as the private revenues of the prince. A peculiarity of the earlier assessments of the *bedes* was the method of apportionment to, or assumption by, the different orders or cities of a certain lump sum, which was then distributed by their own rulers among the different members, according to some measure agreed upon. Prelates, clergy, and knights were exempt from the ordinary *bedes*. They sometimes rendered similar contributions, hedging themselves in with all sorts of reserves and precautions, to prevent the payments becoming regular. These were called "donative monies."

It was in the cities that retained a large degree of political independence that the highest development of the fiscal system was to be found in the middle ages. This is owing to the fact that they were in advance of the rest of the country in their economic development. Long before the principalities were able to abandon payments in kind and services, the cities were collecting taxes in money, making some use of public credit and developing regular fiscal offices. "The art of taxation," says Wagner,[1] "the use of public credit, and the practical organisation of the financial administration in the cities had been an important part of public institutions for centuries before the territorial State had even recognised the need of such." This field has, however, not yet received the attention of historical investigators sufficiently to allow us to draw conclusions as to the generally prevailing forms.[2]

SEC. 2. **Early French Taxes.** — In France the early growth of a strong central power led to an intensification and sharp differentiation of the royal feudal dues from the other feudal charges, which gives them something the character of taxes. But inasmuch as the French State was peculiarly a proprietary State, and the territory was rather a part of the private property of the king than public property in the modern sense, these early charges

[1] Schönberg's *Handbuch*, 3d ed., III, 185.
[2] See Schönberg's *Investigations into the City of Basel.*

are not taxes proper, but rents, or, to use the more general term, feudal dues. But the rapid growth of the central power, and the high development of public needs in the kingdom, necessitated more revenues. These needs were at first met by the collection of indirect consumption and trade taxes. The tendency toward the development of indirect taxes grew apace after the seventeenth century. The mercantile theory, which was supreme for most of the time after Colbert, prompted a high development of custom duties, and these ran parallel with internal consumption taxes. In the eighteenth century there were three, or possibly four, important taxes which had grown up in various ways out of the feudal dues. These were the "*taille*" [1] (tallage), the "*vingtièmes*" (twentieths), the "*capitation*" (poll), and possibly the "*dîmes*" (tithes).[2]

The *taille* is of feudal origin. Originally it was arbitrarily assessed with extreme rigour upon the serfs by the lords, and occasionally upon the great vassals by the king with the assent of the peers. It became a permanent charge when royal power was firmly established on the ruins of feudalism. Charles VIII made it permanent at the same time with the establishment of the royal army. The *taille* was both real and personal. On the one side it was based on the revenue from landed property; on the other, it was based on the faculty of the taxpayer, measured by the revenues from his landed property, and active rents, as well as the products of his own industry. This tax, suppressed in 1790, yielded 44,737,800 livres the year before. Necker obtained 91,000,000 livres from it. Nobles and clergy were exempt.

The *vingtièmes* consisted of one or more twentieth parts of

[1] The term "*taille*," in English, tallage, also spelled *talliage*, *tailage*, and *taillage*, is from a root meaning "to cut" It is explained as derived from the general method of keeping accounts by means of notched sticks A *taille* was any sum of which account was kept, then the amount scored up (tallied) against any person. Slender sticks with notches called "tally-sticks" were used by the English exchequer for accounts, until abolished by the statute of 23 Geo. III, c. 82. Similarly, the German *Kerbe*, tally sticks. Other roots meaning "to cut" are common in the names of various taxes; viz *incisio*, *incisura*, *cise*, later *accise*, *adcisio*, Eng. excise; in these Latin roots the thought is, that a part of the taxed article is cut out for the government.

[2] See Vignes, Ed., *Traité des Impôts en France*, 1872, p. 10.

the revenues from either landed or movable property. This tax had a varied history. At first it was used with the *taille*, but when that tax was made permanent under Charles VIII, the *vingtième* disappeared. It was revived in 1710 by Louis XIV as a war tax. It remained as the occasional resource of the treasury up to the Revolution. Only the clergy were exempt. It produced 46,000,000 livres (under Necker, 55,000,000).

The *capitation*, or system of poll taxes, was the variable tax of the ancient monarchy. It dates from 1695. It was first regarded as a temporary expedient, but was continued to the Revolution. It was assessed according to a tariff of twenty-two classes. But the base was frequently changed. The clergy were exempt, the nobles were taxed on the basis of their presumptive ability, and those who paid the *taille* were taxed according to the amount of that tax they paid. In 1786 it yielded 41,500,000 livres.[1]

The *dîme*, or tithe, was an assessment paid in kind from the fruits of the soil for the benefit of the clergy. The tax was not always the tenth, but varied from one-seventh to one thirty-second. The ecclesiastical purpose of this payment has led some to refuse to call it a tax in the strict sense. Since the Church exercised a power that differed little from that of the State and the burden was a regular one maintained for a public purpose, it should probably be called a tax.

The *corvées* were more strictly taxes than the *dîmes*. These were personal services applied to the construction of the roads and other public works. They were regarded as feudal dues. They were of two kinds: the first were levied on property and rendered by the proprietor for his lands, and the second were levied on persons and rendered by all, irrespective of land-holding. The nobles and the aliens were not subject to the personal *corvées*. The clergy could commute them into money payments or have them rendered at their own cost. The land *corvées* were due from all hereditary proprietors irrespective of rank, but they were not bound to furnish them in person. Louis

[1] For further details see Parieu, *Traité des Impôts*, I, p. 144 ff

XVI suppressed the *corvées* in 1776, but they were reëstablished. They disappeared in 1793.

The most important indirect consumption taxes were leased for 166,000,000 livres, and those collected by the government were 51,500,000 livres. These together nearly equalled the revenue from direct taxes. The indirect taxes of the ancient monarchy were: first, the *aides*, which consisted of taxes on drinks, on articles of gold and silver, on iron, oil, skins, starch, bills, paper, etc., and the *octrois*, levied at the city gates on all sorts of goods when brought into the towns; second, the *gabelle*, or salt tax, which was so arranged as to amount practically to a direct tax. For the people were obliged to buy each year from the management of the monopoly an amount of salt determined in each case by the size of the family. There was a similar "salt conscription" in Germany. Thirdly, there was the tax on tobacco.

SEC. 3. **Early English Taxes.** — In England[1] we find in Anglo-Saxon times three principal taxes: (1) The ship-geld, or ship money, a tax imposed on those shires and towns along the sea-coast which were unable at time of need to furnish ships for defence, when invasion was threatened. It was levied intermittently and was used exclusively for naval purposes. The attempt of Charles I, in 1637, to impose this tax on all of England and for purposes other than the navy, was one of the contributing causes of the civil war. (2) The tribute-like "Danegeld" was levied after 991 at so much a hide (piece of land) and paid to the Danes to prevent them from raiding the coasts. After the cessation of the original cause, it was collected by the kings as private revenue. (3) The "fumage," or "tax of smoke farthings," was a tax on every hearth. This seems to have been a traditional form of tax with the Saxons. It was in effect a family tax, as the hearth stood for the family.

In Norman times, the feudal character of the government was such that it obtained revenues from the demesne, from feudal dues, and from the royal prerogatives so great that no

[1] See Dowell, *History of Taxation and Taxes in England.*

real taxes exist. The Danegeld was levied by the Conqueror as an annual tax, but disappeared after 1163.

With the reign of Henry II came a more ordered and regular system of taxation. This began with the well-known commutation of the military obligations of tenants. It was due to the continental position of the Angevin kings. The distance at which war was waged and the length of service demanded rendered the military obligations particularly burdensome, and tenants were anxious to commute them. An army of mercenaries, too, suited the king better, as easier to control than the feudal army. Hence arose the commutation of the duty to foreign service into a money payment of two marks, £1 6*s.* 8*d.*, on each fee of £20, known as the "scutage," or shield-money. Henry II collected three such scutages, and this tax did not fall into disuse until after 1322. It was practically a land tax, levied each time for a special purpose.

The "*tallage*" in England was the tax that was collected from the tenants on the royal demesne on occasions of unusual expense. Those who paid the hidage or Danegeld were generally exempt. Cities and towns not exempt in this way paid the auxilium or aid. The tenants were liable for these taxes up to one-tenth of their goods. In the city of London the tallage was treated as a "benevolence." It was superseded after Edward III by the general taxes on movables.

The taxes on movables began with the "Saladin tithe" in 1188.[1] It was one-tenth of rent and movables paid by all except crusaders. Out of this insignificant beginning grew a system of taxes on movables which finally included all the taxes so far mentioned. Richard I levied a tax on all ploughed land in 1194, known as the "carucage," from the area upon which it was levied; namely, the amount of land that could be covered

[1] The tithe, or tenth, as the rate of taxation appears in many taxes in Christian countries. It is especially common in Catholic countries. The idea of taking a tenth has its origin in Mosaic law: "And concerning the tithe of the herd, or of the flock, *even* of whatsoever passeth under the rod, the tenth shall be holy unto the Lord." Lev. 28:32. A half a tithe and other convenient fractions give rise to the rates, which otherwise appear irregular.

by one plough (*caruca*) in a season. After 1224, this was merged in the tax on movables.

The tax on rents and movables, which began, as just stated, with the Saladin tithe, was continued from 1189 to 1334. This was a grant of one-thirteenth in 1207, one-fifteenth in 1225, one-fortieth in 1232, one-thirtieth in 1237, one-fifteenth in 1275. Up to 1283, the method of obtaining the grant was by separate negotiations with each section of the country. But after that date, general grants were made by Parliament and other taxes were discontinued.

Besides these direct taxes, the crown had the privilege of taking "customary" tolls upon merchandise imported or exported. Hence our modern term, "customs duties." These tolls were of the character of licenses and protection money. Their early history is obscure. Before the Magna Charta they had become so fixed and regular as to call forth the well-known clause of that historical document: "Let all merchants have safety and security to go out of England, to come into England, and to remain in and go about through England, as well by land as by water, for the purpose of buying and selling, without the payment of any evil or unjust tolls, on the payment of the ancient and just customs" (*sine omnibus malis toltis, per antiquas et rectas consuetudines*). In 1275 these "ancient customs," slightly raised, were granted Edward I by Parliament. The chief duties were on wine imported and wool exported and a poundage on all other goods imported or exported.

From 1334 to 1453 there are a number of changes to note. The fifteenths and tenths were apportioned among the communities, cities, and boroughs, the townships and the demesne tenants, in 1334, and the assessment then made remained the basis of taxation. The tax thus became a fixed charge. It varied in rate from one-half a "*fifteenth*" and "*tenth*," to two-fifteenths and tenths, as the need for revenues changed. Sometimes no such grant was made. In 1377 Parliament granted to the king a tax of "four pence, to be taken from the goods of each person in the kingdom, men and women, over the age of fourteen years, except only real beggars." This was known as

the "*tallage of groats.*" Subsequently a classified poll tax was employed, in which an attempt was made, by the arrangement of the payers into classes and a gradation of the rates, to get a larger return by taking advantage of the greater wealth of certain classes. The rates were: for the Duke of Lancaster, who was the highest subject, £6 13*s.* 4*d.*; earls £4, barons £2, and so on down to the lowest; every one, except beggars, was to pay at least a groat or 4*d.* In 1379 this yielded £25,000, which was only slightly more than the previous tallage of groats. The clergy were included in both these taxes. After the peasant revolt, which was occasioned partly by the oppressive methods used in collecting these taxes, return was made to the fifteenths and tenths. From 1382 the landowners take the whole burden of the old "fifteenth and tenth." In 1435 this was supplemented by a graduated tax on income from lands, rents, and annuities, and offices of freehold. In the reign of Edward III the customs yielded large returns. They consisted as before of tunnage on wine, customs on wool and leather, and poundage on all other merchandise. The popularity of Edward IV enabled him to add to his other sources of revenue the "*benevolences*," demands on the rich for special contributions. These "benevolences" were not always cheerfully paid. It was more often "as though," says More, "the name of *benevolence* had signified that every man should pay not what he himself of his good will list to grant, but what the King of his good will list to take." Throughout the history of taxation in England the grant of monopolies of new industries was made a source of income to the government. The multiplication of these under Elizabeth did not yield much revenue, although it gave rise to much discontent.

There is little in the varied application of these taxes that is important as showing the line of development until the seventeenth century. At that time they proved unequal to the task of meeting the growing needs of the treasury. The chief auxiliary lay in the extension of the indirect consumption taxes. The year 1692 (revision, 1697) saw the establishment of a permanent land tax. This grew out of the apportionment of

the "fifteenths and tenths." It became a fixed charge on land, a real burden, not having, as time went on, any definite relation to the income from land. In 1798 Pitt made this redeemable by the payment of a lump sum down, after which no annual tax would be collected. This privilege has been taken advantage of to the extent of removing half the charge from the lands. In its operation the land tax became rather a rent than a tax.

The Income Tax. — The wars of the period of the French Revolution and the consequent need of revenue introduced the general income tax (1798, 1802, 1803, 1806). This tax was no departure in principle from the older taxes, although a departure in method. It has been well characterised as a combination of several taxes into a system which has for its aim the proportional taxation of all incomes, with the exemption of a certain fixed sum (degressive). The form which it took in 1803 is the best to study. Two separate acts were passed, the one taxing all incomes from holdings of real estate, rents, and public salaries at the source; that is, so far as possible the tax was deducted before the revenues passed into the hands of the recipient. The second taxed industrial earnings and interest on capital on the basis of a declaration by the taxpayer. The tax began with an income of £60 (later £50), and this amount could be deducted from all incomes below £150; after that the full rate was paid. Each person was required to declare his whole income and could claim reimbursement for any tax stopped at the source if he could show that his total income was below the minimum. This tax, set aside in 1816, was restored in 1842, as a substitute for the indirect taxes, removed in consequence of the demand for commercial freedom. The rate is changed from time to time as the needs of the government change.

SEC. 4. **The English Local Rates.** — Local taxation in England has been partly independent of royal taxation. England has not followed the continental plan of collecting revenues for local purposes in the form of additions to the national taxes. While the weight of national taxation fell upon customs duties, excises, and certain direct taxes, measured roughly by income,

local taxation was based exclusively upon revenues from real estate. The prototype of all local taxation was the poor rate. Previous to the reign of Elizabeth local activities were of such a character that they could be discharged from feudal dues. In the manorial villages and the boroughs with semi-feudal guild, and close corporation governments, which owned landed property, feudal incomes paid the few public expenses. But the removal of the monasteries, hospitals, and other charitable foundations, threw upon public charity a number of well-developed paupers; and the rapidly changing character of industry and of economic life constantly gave rise to the problem of what to do with the unemployed, who at times became very numerous. The result was the famous poor law of 1601. The principle of the tax for the support of the poor had been of slow growth. In the reign of Henry VIII the giving of alms was prohibited, and collections for the impotent poor of the parish were required to be made in each church. In 1547 the Bishops were authorised to prosecute all persons who refused to contribute for this purpose, or should dissuade others from contributing. In the fifth year of Elizabeth the justices of peace were made judges of what constituted a reasonable contribution for this purpose. After 1572 regular compulsory contributions were levied. Out of a purely voluntary contribution, then, there emerged in two-thirds of a century a compulsory tax. The basis of this tax was the annual rental value of real property. The tax was collected not from the owner but from the occupier. Most of the other taxes for local purposes which have developed in England since then are of the same general character. They are too numerous to mention here. Besides the direct taxes, there were a few indirect ones, market dues, road tolls, coal and wine duties.

SEC. 5. **Early American Taxes.** — In the American colonies we meet with entirely new conditions. Public needs were simple and few, and were mostly local in character. Customs duties were for the most part controlled by the mother country in the interests of her general colonial policy. So the colonists were driven to other forms of taxation. Practically free trade

in land existed. Land at a known selling value early formed a large part of the property of each citizen, and differed in no essential particular from his other property. There were in some colonies, to be sure, charges of a feudal nature known as quit rents, which were a recognition of the king's interest in the land. These never became of fiscal importance, and never developed into taxes. Nor do they seem to have ever seriously modified the essentially free character of landowning, since they were so irregularly and meagrely collected. They were "acknowledgments His Majesty receives of the People's Tenure and Subjection." [1] At times they developed into an apparent tax on certain lands. They seldom formed a part of the revenues of the colonial treasuries, being generally payable to the king.[2]

Just as there were three different forms of government among the colonies, so there were in the beginning three different tendencies in taxation.[3] New England began with a tax on property and faculty. The General Court of Massachusetts laid down in 1634 the following principle: "In all rates and public charges the towns shall have respect to levy every man according to his estate, and with consideration all other his abilities whatsoever, and not according to the number of his persons." [4] Later, however, poll taxes were used, and the general property tax was extended to cover property in the process of acquisition, or the earnings of labour. In all the New England colonies the resulting system was practically as follows: Each person was to contribute as he was able. Ability was measured, first, by property, real and personal; secondly, by the person himself; thirdly, in the case of wage-earners, merchants, and others, by earnings. With a few notable exceptions, as in the case of lawyers, the third measure of ability gradually fell into disuse. It has been repeatedly pointed out [5] that the New England

[1] Spottiswood Letters, quoted by Ripley, *Financial History of Virginia*.

[2] See Wood, *History of Taxation in Vermont*, p. 13. Also Schwab, *History of the New York Property Tax*.

[3] Cf. Seligman, *Essays*, p. 19 ff.

[4] Massachusetts Records, quoted by Douglas, *Financial History of Massachusetts*, p. 18.

[5] Walker, "The Bases of Taxation," *Political Science Quarterly*, Vol. III.

people had the habit of saving. All earnings were soon turned into property. So that the demands of justice were fully met by the general property tax and the poll tax. In addition to these direct taxes, there were a number of indirect taxes, "imposts," some collected in the form of licenses, and many as excises.

In the Southern colonies, of which Virginia will serve as a model, the first taxes were the poll taxes. "Personal responsibility," says Ripley, "was thus the basis of taxation at first, but as the burden of taxation became heavier this liability was partly transferred to real estate." [1] This transfer of the burden to real estate began with the practice of making the personal tax a lien upon the property of absentees, or of persons dying before the payment of the tax. The general property tax in a form like that in use in New England did not exist in Virginia before the Revolution. The grossness of the poll tax was modified by some reference to the different kinds of property owned. In consequence of the failure to develop a good system of direct taxes Virginia resorted to indirect taxes, export duties on tobacco and hides, import duties on liquors and slaves, and some general tunnage duties forming the main features.

The third or central system is fairly represented by New York. There, under the West India Company, 1621–1664, taxation first took the form of moderate indirect taxes on goods imported and exported and imposts on the consumption of beer, wine, and spirits. It was after the passage of the colony into the hands of the English that attempts were made to develop the property tax. The actual existence of this tax begins with the formation of the Assembly after 1683.[2]

In all parts of the United States after the Revolutionary War the main reliance for local revenue was the general property tax. The commonwealths, as such, had little need for revenues until after 1840. In the formation of the Union indi-

[1] *Financial History of Virginia*, p. 21.

[2] See Schwab, *Die Entwickelung der Vermögensteuer im Staate New York*, Jena, 1890. Also Schwab, *History of the New York Property Tax*, *Pub. of the Amer. Econ. Ass.*, V, 5.

rect taxes were made the prerogative of the federal government, so that the commonwealths had to resort to other means. The character of direct taxation in the United States since the formation of the Union will be treated in the next chapter. The differences in the forms of taxation in the different parts are due both to political and economic differences.

CHAPTER V

THE DEVELOPMENT OF TAX SYSTEMS FROM THE INDUSTRIAL REVOLUTION TO THE WORLD WAR

SECTION 1. **Changes in Taxation Due to the Industrial Revolution.** — The trend of the development of taxation was abruptly changed by the industrial revolution at the close of the last century. On the one hand, the development of constitutionalism, vesting, as it did, the control of the purse in the people, and especially in the taxpayers, had the inevitable effect of changing the ideas underlying the tax systems. New ideas as to the justification of taxation developed, and with them a tendency to seek new measures of taxation. On the other hand, the rapid increase in wealth, the growth of new forms of wealth, such as invested capital, the birth of new kinds of property, and of ways of holding property, as the many kinds of credits, and the rapid change in the distribution of wealth among the different classes in the community, — all of these and other similar causes led to the constant extension of taxation to the new forms. Old taxes which were well suited to certain simpler conditions of society become under new conditions unjust, and give rise to dissatisfaction, to many attempted and some accomplished reforms. These reforms in turn prove no more satisfactory in the long run, for the conditions they were intended to meet change again.

Just as the attention of economists was chiefly directed to the study of productive agencies during the first three-quarters of the century, so the general tendency of the same period in finance may be broadly characterised as an attempt to compel the different agencies of production to contribute to the

support of the government. It is claimed that economists have, during recent years, turned their attention more to the consideration of questions of distribution, and it is certainly true that the most recent tax reforms have been in the direction of securing a better division of the burden among the sharers of the new wealth rather than among the producers thereof. Subordinate to this tendency are various proposals and attempts to alter the distribution of wealth by the use of the taxing power.

The demands upon the revenues increased vastly during and immediately after the period of war which followed the French Revolution. Large debts had been accumulated; great armies and navies claimed support even in times of peace. New functions were being thrust upon the governments. Moreover, the new economic era demanded the payment of all charges upon the State in money and necessitated the collection of revenues in money. The old feudal receipts and services became more and more inadequate; new industrial receipts were, in general, not calculated to be much larger than the sums necessary to support the service or institution which furnished them. Consequently, taxation on an ever increasing scale becomes the basis of all State finances. Taxation is no longer regarded as a temporary expedient to meet passing and extraordinary needs. It is admittedly a necessary and permanent policy.

The doctrine of political equality when generally accepted leads to a demand for universality and equality of taxation. The difficulties that arise are no longer as to the justification of taxation in general, but as to the justice of certain forms and measures of taxation. The main question is, what is equality, and what the best method of attaining it. The methods and direction of reform were necessarily prescribed by the constitutions of the various countries and differ much from land to land. Different economic and social conditions have also an inevitable effect. Among the constitutional features that determine the direction of taxation the following may be mentioned. First, federal governments have generally been

excluded from the field of direct taxation. The central governments of the German Empire, Switzerland, and the United States depended for revenues from taxation on customs duties and internal excises. The sense of personal loyalty to the central government is inferior to that to the commonwealth governments so far as willingness to contribute directly to its support is concerned. Those who pay a direct tax wish to see the money expended near at hand and under their own eyes. The partial concealment or at least lack of prominence of the indirect contribution permits of its collection without calling the attention of the contributors forcibly to the fact that they are taxed by a new authority. Just that advantage of partial concealment in this tax which appealed so strongly to the monarchies, before the birth of political consciousness on the part of the people, appeals to the federal governments. At the same time the practical necessity of uniform rates over the whole country, which arises from the fact that these taxes disturb the economic balance of industry and commerce, and the greater ease of administration with a larger territory and a single boundary, make it advisable to put all of them in the hands of the central organ. It was the latter considerations in regard to custom duties that led to the establishment of the Zollverein and eventually of the German Empire.[1]

On the other hand, the different States of which the federal governments are composed have shown themselves inclined to restrict their taxation to the direct taxes, leaving all but a few of the indirect ones to the central governments.

But this separation of the assessment of direct and indirect taxes between different authorities has been productive of great difficulties. For it is impossible to assess any tax justly and equally without reference to the other burdens already imposed on the contributors. It would seem that the demands of justice which dictate that the whole system of taxation should work toward a definite and single purpose, will necessitate either the

[1] See Bowring's Report on the Prussian Commercial Union, *Parliamentary Documents*, 1840, Vol. XXI, pp. 1–17. Reprinted in Rand, *Economic History*, p. 170. Also Legoyt's *La France et l'Étranger*, Vol. I, pp. 250–255; *ibid.*

coördination of these forms or the placing of both of them in the hands of the same authorities. The proper coördination of all taxes is hard to accomplish when the taxing power is in different hands. This is one of the hardest problems of American taxation.

The development of direct taxation will now be traced in detail by reference to some of the more important countries. Indirect taxes cannot properly be said to have undergone any process of development. Many changes have, indeed, been made, dictated by different economic theories and purposes. But it has been simply a flux backward and forward. Sometimes ulterior aims, as protection, have been abandoned and strict fiscal principles allowed sway. In those cases we find a simplification and a decrease in the number of articles taxed. But no general principles have been developed.

SEC. 2. **Reforms of Taxation in Different Countries.** — Probably the most thorough attempts to reform taxation in accord with clearly recognized principles of theoretical justice have been in Prussia. That country has taken advantage from time to time of the advice of men of science. It has been doubly happy (1) in having a goodly number of unpartisan financial scientists to draw upon; (2) in being able to draw upon them for advice, either by counting their pupils among its fiscal officers or placing the scientists themselves on its tax boards and commissions. It has been able to make changes with a broad conservatism that looked toward the gradual realisation of accepted ideals. With characteristic visionary eagerness, France has several times started out to obtain at a single bound some new ideal, but has each time fallen upon forms and methods but little better than those in vogue before. In England, special difficulties and objections have been met with little reference to any general plan. The result has been a steady approach to a better state of affairs, with only an occasional intensification of existing evils, due to the attempt to cure symptoms rather than to seek the underlying causes of the trouble. In the United States there have been spasmodic and ill-directed attempts at the removal of a few clearly recognised

abuses; and without any consistent attempt to change the system, the result has been a decided modification. The general failure of the property tax to reach personal property gave rise at first to vigorous efforts to extend and sharpen the methods of assessment. These attempts failing, other methods of reaching the mass of personal property were devised, which have resulted in a partial change of system wherever they have been successful.

SEC. 3. **Tax Reforms in Prussia.** — The most instructive country to study is Prussia. The line between the old and the new may be drawn at the reforms of Stein and Hardenburg in the forms of land tenure. These reforms may be regarded as having been accomplished in 1811. Briefly stated, their result was to abolish personal serfdom, dissolve the feudal partnership between tenants and proprietors, and establish free trade in land.[1] Although these reforms had to do mainly with land, and although the accompanying edict of 1810 promised speedy reform of the land tax on the basis of a new survey, or *cadastre*, nothing material was accomplished in the reorganisation of this tax until 1861. In that year the land tax was rearranged for the entire kingdom on the basis of a new and rapidly executed survey. Some twenty different provincial land taxes, with upwards of one hundred minor variations, which had existed before that time, were merged into an apportioned tax upon the net product of each piece of land as given in the *cadastre*. This tax recently yielded about 40,000,000 M. annually.

The reforms which preceded this were those of the indirect consumption taxes, out of which finally emerged the personal class tax. The edict of 1810, which was referred to above as promising a reform of the land tax, seriously attempted to remove inequalities by destroying many feudal exemptions and privileges, and removing local differences. A general scheme of consumption taxes on necessaries, of which the excise on meal is a type, was planned for city and country alike. It was,

[1] Seeley's *Life and Times of Stein*, Vol. I, pp. 178–297. Morier, "The Agrarian Legislation of Prussia during the Present Century," in Probyn [Editor], *Systems of Land Tenure in Various Countries*, pp. 306–316. See Selections in Rand.

however, immediately found that the meal tax was hard to collect in rural parts. As early as 1811, therefore, a poll tax of one-half thaler from every person over twelve years of age was substituted for the meal tax in all places except the larger towns. In 1820 this tax, still applying to the same places, developed into a classified poll tax; *i.e.* all persons were grouped according to rank, profession, and general prosperity, into a few classes, which were then taxed *per capita* at different rates for each class. Somewhat modified the next year, so as to make twelve classes, in groups of three each, and with rates which ranged from one-half thaler to 144 thalers, and covering all persons over fourteen years old, this tax endured thirty years. As before, this tax did not extend to the large cities, where the excise on meal and meat was regarded as placing the same burden on the people. Such a remarkably clear perception of the fact that indirect taxes are practically the equivalent of direct taxes in the individual burden they impose is not often met with in fiscal history.

The Income Tax. — In 1851, this tax was changed in order to make room for the introduction of an income tax on all persons having an income of over 1000 thalers. Those persons whose incomes were below this amount were taxed in the large cities by the meal and meat tax; in the country and in small towns, by a class tax, like the old one, with rates ranging from one-half thaler to 24 thalers, according to the supposed income. Persons living in large cities who paid the income tax were allowed to deduct 20 thalers from their income as compensation for the meal and meat tax they were supposed to have paid. Later reforms removed these gate excises except for local purposes. As the income tax forms a special topic in a later chapter, we will not at present follow the details of its development and reform. It is sufficient to say that it was a progressive tax on the income of every person.[1]

When the land tax was reformed in 1861, the building tax was separated from it, having been until that time a part of it; and all old taxes of a similar sort were merged in the new one.

[1] See Chap. IX.

This tax is assessed in the cities according to the rental of the buildings, and in the country according to the size of the lands connected with the houses, and other characteristics.

One of the reforms that were made after the peace of Tilsit to strengthen the weakened economic resources of the country was the establishment of general industrial freedom. Naturally, such a change would have been regarded as a failure from the standpoint of the statesmen of the times, if it could not be made to yield a revenue to the treasury; so the new industries were burdened with a new tax. This tax, which was very weak, and which, wisely, perhaps, failed to meet all the new forms of industry which came into existence, was subjected to a thoroughgoing reform in 1891. But it was at that time transferred to the local governments. Capital invested and some of the permanent features of each business form the basis of this tax.

The Prussian system, as it existed before the great reforms of 1893, may now be seen as a whole. It consisted of two parts: (1) There was a group of three complementary taxes upon the produce of property and capital, — the land tax, the building tax, and the industry tax; (2) there was a system of personal taxes culminating in an income tax. The former group, true to the economic tenets of the first three-quarters of the century, taxed the productive agencies. The latter, although it originated as a consumption tax, aimed at taxing the shares in distribution. Thus the older consumption taxes, which were originally assessed without any very clear idea of what the justification was, but were used because productive of large revenues, yielded to new taxes supposed to be more fairly in accord with the modern system of distribution.

The Great Reforms of 1893. — We are now in position to see the significance of the great reforms of 1893 (all of which went into effect in 1895), made under the leadership of *Finanzminister* Dr. Miquel. These reforms place Prussia far in advance of all other countries in the theoretical perfection of her tax system.[1] The income tax, which has long been correctly regarded as the

[1] See Seligman, *Essays*, pp. 330–339. References to larger and more detailed statements are given there.

foundation of the Prussian tax system, was subjected to a thorough reform in 1891.[1] It was strongly urged at that time that income from property represented a far higher faculty, per unit, than income from labour and personal exertion, and, therefore, that a perfect system should contain two kinds of progression: one that taxed larger incomes more heavily than smaller ones; another that taxed incomes from property more heavily in proportion than incomes from labour. It was felt that the existing produce taxes (*Ertragsteuern*), the land, building, and industry taxes, failed to accomplish this end. Hence one of the reforms of 1893 was the surrender of these taxes to the communes, and the initiation of a general property tax as supplementary to the income tax. This tax, which can be properly understood only when its supplementary character is held in mind, is arranged as follows:

The tax is one-half per mill on the lower limit of the class within which the property falls. The classes go by stages of 2000 M. from 6000 M. to 40,000 M., of 4000 M. up to 60,000 M., of 10,000 M. up to 200,000 M., and above that of 20,000 M. each.

Thus:

Property			Tax
	Up to 6,000 M.	. . .	exempt.
From	6,000 " 8,000 "	. . .	3 M.
	8,000 " 10,000 "	. . .	4 "
	10,000 " 12,000 "	. . .	5 "
	20,000 " 22,000 "	. . .	10 "
	40,000 " 44,000 "	. . .	20 "
	60,000 " 70,000 "	. . .	30 " etc.

Above 200,000 M. the stages are 20,000 M. each, and the tax increases 10 M. in each stage.

This tax being supplementary to the income tax accomplishes the result of imposing a differential rate on funded income as against unfunded income.

The abandonment by the State of the three old taxes on land, buildings, and industry rendered the reform of local taxation

[1] See Chap. IX.

possible. As has already been said, the proper coördination of all tax burdens is one of the chief problems of modern tax reform. With the exception of the beer taxes, and the meat and meal taxes still used by some of the cities, local taxation in Prussia is mainly direct. Most of it, until 1895, took the form of percentages additional to the rates of the royal taxes. In some cities there were important special local taxes, like the house rent tax in Berlin. Prussia, also, grants subsidies from the royal treasury to the local bodies for special purposes. But the symmetry of the national system was somewhat destroyed by these additional rates. Such additions to the income tax were especially intolerable. Real estate is, moreover, a particularly good basis for local assessment. It cannot evade the tax, and it is the recipient of particular benefits from good local government. The same is true of businesses of a local character, although it is not safe to let the rate vary from place to place. Hence these three taxes were handed over to the local bodies. At the same time the attempt was made to regulate all other sources of local revenues.

After the revolution the income tax was made an imperial tax, and to offset their loss of revenue the component states have been subsidized and given other revenues. In 1924 another sweeping tax reform was inaugurated which is not yet fully consummated. The heavy post war burden of the income tax on a father of a family "rich in children but poor in worldly goods" has been somewhat reduced. A man with a wife and three children has an exemption of 2160 M ($540), and the rates in the grades immediately above the exemption are moderate.

SEC. 4. **Development in France.** — In France indirect taxation has probably found a higher development than anywhere else. Indirect taxes yielded in 1908 over 2,000,000,000 francs, against 560,000,000 francs from direct taxes. Some of the main taxes are on the consumption of wine, spirits, beer, sugar, salt, tobacco, etc.; there are also the *octrois* or gate duties collected by some of the cities as a means of contributing their share of some of the direct taxes to the general treasury. There are also the taxes on acts and transfers, which will be treated

under fees, since they assume a private benefit, and the customs duties. Not peculiar to France, but receiving a high development there, is the mode of collecting a tax on consumption by a monopoly of the manufacture of tobacco in the hands of the government. The imperative necessity under which France laboured all through the XIXth century of continually increasing her revenues, and the danger of making the burden unbearable if thrown upon the existing direct taxes, as well as the desire on the part of the legislators of concealing so far as possible the actual burden, lest an impatient constituency rebel, accounts well for the relatively high development of indirect taxation. The preference for indirect taxes as the main reliance of the public revenues argues, however, a low stage of political ethics. The more highly developed the consciousness of citizenship and membership in the State, the easier it is to make direct taxation effective.

Direct taxation in France dates in its present form from the Revolution. All the taxes of the ancient monarchy were abolished at that time and a fixed scheme of taxes on revenue-yielding property substituted. This system of direct taxes has four chief members: (1) the tax on real estate, known as the "*impôt foncier*"; (2) the apportioned tax on polls and rents of dwellings, "*cote personnelle et mobilière*"; (3) the tax on doors and windows, "*impôt sur les portes et fenêtres*"; (4) the tax on business, "*impôt des patentes.*"[1] Supplementary to these taxes are a number of taxes classed as "assimilated to the direct taxes." These, so far as they flow into the central treasury, are: (1) the mining dues, or the royalties from the mining rights, "*redevances des mines*"; (2) the fees for the certification ("*vérification*") of weights and measures; (3) the tax on property held in mortmain, that is, property held in perpetuity by the *communes*, hospitals, churches, seminaries, charitable

[1] "*Patentes*" is translated by Leroy Beaulieu by "licenses," *Science des Finances*, Vol. I, p. 395. There is no exact English equivalent. The "license" in this case is little more than evidence of the payment of the tax. The term "patent" does not seem to imply, as the term "license" does, the granting of a special privilege. The term "license" is, however, not infrequently used in English to indicate a tax on business.

institutions, and the like, "*taxes des biens de la main morte*"; (4) the taxes on horses and carriages, "*impôt sur les chevaux et les voitures*"; (5) a number of miscellaneous fees and charges of which the charges for the inspection of pharmacists, grocers, druggists, and herbists are examples.

The real estate tax, the poll and rents of dwellings tax, and the door and window tax are, in most part, apportioned taxes. The real estate tax, "*impôt foncier*," was, down to 1890, a combined tax on agrarian lands and on land with buildings. It was apportioned on the basis of a very elaborate survey and valuation completed in 1850 and carefully kept up to date. These taxes, like the other apportioned taxes, were apportioned in successive steps, first to the *départements*, then to the *arrondissements*, and then to the *communes*, by the several legislative bodies, and finally divided among the individuals in each of the *communes* by a "*conseil de répartition*." In 1890 the tax on dwellings, that is, the tax on land with buildings on it (*propriété bâtie*), was separated from the agrarian land tax and the amount levied on the land was somewhat reduced. In 1897 further relief was granted to small landed properties. In 1908 the *impôt foncier* yielded 200,000,000 francs. The land tax is still an apportioned tax, but that on dwellings, or on *propriété bâtie*, is now proportioned, and the uniform rate is about 3.2 per cent.

The tax on polls and rents of dwellings is peculiar to France, the same combination not being found in the tax systems of other countries, although the elements thereof are not uncommon. This tax, the *personnel-mobilier*, as it is called, is two taxes in one, a tax on polls and a tax bearing the somewhat misleading designation "*mobilier*." This latter tax was originally designed to cover personal property, hence its name, and thus to supplement the *impôt foncier*. The personal or poll tax element of this tax is due from every citizen of France and from every resident enjoying civil rights, except paupers, married women living with their husbands, and children, whether of age or not, living with their parents or guardians, and not enjoying an independent income. It is the same in rate for all the inhabitants of a given locality and the rate is fixed at three

days' wages. The rate at which the wages shall be assessed is determined each year by the general council of each *département*. It may, however, not be fixed at less than one-half franc, nor at more than one franc and a half. Thus the minimum tax is one franc and a half and the maximum four francs and a half. The other element of this tax, the *mobilier*, is assessed according to the rental value of inhabited houses. It is in this part of this two-headed tax that the apportionment is worked out. The poll tax falls short of raising the commune's share of the combined taxes, and the balance of the quota is assessed upon the rentals of dwellings (*loyer de habitation*). Some of the large cities, Paris, Lyons, Marseilles, and a few others, raise a part or even the whole of their quota by means of duties on goods brought into the cities, *i.e. octrois*, and do not levy on rentals.

The door and window tax is an apportioned tax rated according to the number of windows and doors in the houses. It was intended to supplement the personal and dwelling tax, but it is really an addition to the real estate tax. It is paid by the owner and he is allowed to shift it if he can to the tenant.

The business tax is an old one. Established in 1791, remodelled in 1844, it is now enforced under a law that was adopted in 1880. Unlike the other direct taxes it is regarded, not as an apportioned, but as a proportioned or rated tax. The "*impôt des patentes*" is imposed on every person, native or alien, who carries on any trade or profession in France, except agriculture and a few others that are especially exempted. The aim is to tax the profits of industry or of a profession, as nearly as may be proportionately. The methods of determining the rates for the different occupations or industries are extremely complex, so much so that only the most general outline can be attempted here. The objects of this complex system of rates are to avoid on the one hand any inquisitorial prying into the affairs of the individual taxpayers, and on the other hand to shun the danger of receiving false declarations as to the amount of the profits. This is done by seizing upon certain concrete, external signs, or natural and obvious characteristics, as evidence of the size

of the profits. In general the rates fall into two parts. The first is called the fixed duty (*taxe determinée*). This is the same for each occupation of the same sort, and is largely independent of any of those conditions which make one occupation more profitable than another of the same kind. The second is the proportional rate, based on certain characteristics that are assumed to indicate that a given industry is more or, as the case may be, less profitable than another of the same kind. The fixed duty, however, is not the same in all towns, for it is assumed, for example, that a druggist in a large town makes larger profits than one in a small place. For the fixed duty occupations are grouped in three classes and fall under schedules A, B, and C of the law. Class A includes the general run of merchants and artisans. Merchants are again divided into three classes, according as they sell entirely at wholesale, partly at wholesale and partly at retail, or entirely at retail. In this class the fixed rate is based on two considerations, (1) the nature of the business and (2) the size (population) of the place in which the business is conducted. Thus occupations are divided into eight general classes according to their nature, and for each of these there are nine ratings according to the size of the place in which they are located. Class B contains a number of businesses in connection with which it seems necessary to consider the size of the enterprise as well as the size of the place and the nature of the business. So a third set of characteristics is introduced supposed to show the size of the enterprise. In this class are bankers, department stores, water works, hack and omnibus companies. Class C includes the smaller industrial pursuits, handicrafts, and the like. In this class the size of the place is not taken into consideration, but some concrete index of the size of the establishment is taken in connection with the nature of the business. Such indices are the number of appliances, or machines used, the number of workmen employed, and the like. The proportional part of the rate is based mainly on the rental of the place of business and the rental of the home the proprietor occupies. It varies for each of the main classes and also within the classes

These rates are for class A from two to five per cent of the rental, for those in class B ten per cent, in class C from one and two-thirds to ten per cent. The "liberal" professions, such as those of lawyers, doctors, and the like, pay only the proportional rates.

During the Great War France found her tax system too inelastic. An income tax was introduced in 1916.

SEC. 5. **English Tax Reforms.** — The English system of taxation can be very briefly treated here, because the principal component parts will be discussed in detail in later chapters. What is necessary here is to give an outline of the system as a whole. The greatest change in the British scheme of taxation within this period was the elimination of the protective principle from the customs duties, — and indirectly from the excises also, — brought about in the period from 1840–1850, by the abolition of the corn laws and the agitation leading thereto. The consequent simplification of both the import duties and the excises rendered it possible to manage them purely as a source of revenue with a view to obtaining relatively larger sums. The customs duties, the entire tariff of which, 1912, contained only 40 rates, and the somewhat more numerous excises and stamp duties, paid one-half the total annual revenue. The property and income tax, which was restored in 1842 and has since been the variable or elastic element in the system, will also receive special attention in another chapter. Inasmuch as this famous property and income tax is a system, in itself, of five taxes which are calculated to fall upon the chief sources of wealth, it complies, in a way, with the requirements of universality. Its rate is degressive, so that it attempts to comply with the requirements of justice. It may be looked upon as the complete system of direct taxation. Outside of the system there are two remnants of older taxes which are anomalies and destroy, somewhat, the logic of the system. This lack of any logical reason for retaining them does not necessarily form any good reason for abolishing them. They give rise to no serious complaint, they are old and have been in the main capitalised, so that they form no real burden at present. They are the land

tax of the eighteenth century, which is now a redeemable rent charge, and the house duty. This latter developed out of the hearth tax of 1662. In 1688 it had been replaced by a window tax. In 1778 a tax on the annual rental was added to the window tax, and finally after 1851 this tax on the rental value was left to stand alone.

There is still another tax which supplements the property and income tax, and that is the inheritance tax. The most recent changes in these inheritance taxes, — "death duties," — which have existed in England since 1694, will receive attention under another heading. The important thing to note in this connection is that these taxes have introduced the principle of progression very extensively into the tax system of England.

The English system as it now stands consists (1) of the customs and excise duties; (2) of the so-called property and income tax, a degressive tax upon five kinds of income; (3) two older taxes, the land tax and the house tax; (4) a graduated inheritance tax; and (5) a number of stamp taxes on deeds, receipts, and so forth.[1]

The different authorities that have had the power to levy local rates in England are very numerous. The whole system is very complex. The different rates, each going by the name of the authority that levies it, or the purpose for which it is collected, are mostly upon the same base; namely, the annual rental of the various tenements. They are generally levied upon occupiers. In the case of tenements of less than £10 annual value, the difficulty of collecting from the occupier is so great that the plan of making the landlord advance the tax has been adopted. He then shifts it to the occupier. The recent reforms of county and municipal government in England have resulted in a simplification of local rates.

SEC. 6. **American Tax Chaos.** — Like the English, the American system can be but briefly treated here, since many of the taxes will receive our attention in subsequent chapters. The principal federal taxes have been customs duties and excises.

[1] Williams' *The King's Revenue* contains a fine outline of the revenue system of England. It is one of the best books of its kind ever compiled.

The states, or commonwealths, have confined themselves rather closely to direct taxes, as have also the minor civil divisions. Down to 1840, commonwealth taxation was very meagre. Many of the states attempted to get along without recourse to taxation at all, depending for revenues upon the sale of lands, fees, and other sources.

The evolution of taxation in this country during the XIXth century resulted in little advance. Indeed it had been to make confusion thrice confounded. Not only was difficulty found in adjusting the spheres of the different taxing authorities, but no sound principle, indeed scarcely any principle at all, had been followed. Before the Revolutionary War the general property tax, whose origin we have already seen, answered the requirements of justice and equality fairly well. As has been frequently remarked, the American people were a saving race. As fast as they created wealth they turned it into property. The forms of property were, even when not immovable, tangible and unconcealable. Real estate formed the mass of it. Movable property consisted of furniture, farm utensils, and cattle. There were few stocks or bonds, or other forms of credit in which to invest wealth. Among such a people a tax levied on property that was easily ascertainable answered all the requirements.

But as intangible personal property increased, as opportunities for investment multiplied, it became impossible to make the property tax "general." It became a tax on real estate except for the few conscientious persons who declared their personal property. Until about 1900 the commonwealth legislatures made but half-hearted attempts to sharpen the procedure of assessment. Since that date a number of the states have introduced a plan of central control of the local assessors by a strong central commission. Wherever adopted this has resulted in marked improvement in the direction of greater equality. Prompted at first by a wave of popular excitement, which took the form of a feeling of bitterness toward certain classes of capitalists, the legislatures have, from time to time, attempted to reach personality by taxing the corporations in which the untaxed funds were invested. The resulting cor-

poration taxes worked some improvement. They supplement the general property tax very effectively. Within the past twenty years a number of states have been remodelling their tax systems, by selecting certain sources of revenue for the use of the state or central governments only, leaving the general property tax to the minor civil divisions. One general result of this movement has been the taking over of the taxation of corporations by the state, with corresponding increase in efficiency of administration. Sometimes the legislatures have attempted to tax mortgages, as if they were a part of the property on which they rest. As mortgages have to be recorded in order to be legal, it is possible to get at the full value. In some commonwealths, then, the mortgagee is taxed on his interest in the property and the owner is exempt to that extent. In California, where this plan has been most extensively tried, the result has not been at all what was desired. The only effect has been to raise the rate of interest on mortgages by the amount of the tax plus from one-fourth to one per cent. That is, the mortgagees have succeeded in shifting the burden of the tax to the real owners with a handsome addition for their trouble. Such a shifting is always possible when any one form of capital is taxed, leaving other forms untaxed, either because they are exempt or because they escape the tax. A recent development in some states has been the exemption of mortgages from taxation as property under the general property tax and the substitution of a tax at a low rate, known as a recording tax. But in general and in most of the commonwealths the American system remains what it has been since 1840, — a regressive tax on real estate, supplemented in part by corporation taxes in some commonwealths, and by an ever increasing number of inheritance taxes. It is a system condemned by every scientific writer and impartial statesman, but retained as the only source of revenue.

The difficulties which have prevented persistent attempts at reform remain, and it is hard to see how they can be overcome. No one commonwealth can afford to pursue personal property with so much vigour as to actually impose a tax on all of it.

Only concerted action could accomplish this. Capital is sufficiently mobile to move easily from commonwealth to commonwealth, and if compelled to bear its fair share of the burden in one and not in another, it will surely migrate. Legislators are extremely desirous of attracting capital and very wary of repelling it. The owners of capital cannot be taxed personally. They change their residence from city to suburb and even to unfrequented rural parts on the slightest increase of local taxation and move from commonwealth to commonwealth with equal facility. Residence, too, is a matter of intention, and it is easy if personal taxes are proposed to plead residence in another commonwealth. Concerted action being practically impossible, the tax-dodger is safe.

But while the present system is very bad, it has been tolerated in the past, and arouses less discontent at present than might be expected because it falls mainly on the receivers of economic rent. The value of land in many parts of the United States has increased very rapidly and is still increasing steadily; so that in those parts, while the taxed owner feels the burden severely, he consoles himself with the thought that he is largely or wholly reimbursed by the increased price which he hopes to get for his land. The general practice, too, of assessing real estate at a fraction of its value, even though so universal as to work no actual lessening of the burden in any individual case, tends to stifle murmurs of discontent. For the owner secretly congratulates himself on not having to pay on all of it, — an illogical basis for self-congratulation, to be sure, but still not infrequently effective. The same person, too, is not infrequently the owner of taxable personal property which he conceals, and he is less uneasy about the tax on real estate so long as he is able to save the other.

Another reason for the absence of a concerted movement of real estate owners to lessen the burden arises from the fact that the real estate tax is a real burden on the property, and shifts itself by the process of capitalisation. For the new purchaser gets his property at a lower price than he would have to pay if the tax had not been imposed. The frequency and ease with

which real estate changes hands gives constant occasion for this capitalisation of the tax. Every real tax, when not a part of a well-organised system which taxes every kind of property or all receivers of wealth, can be shifted in this way. It becomes a rent charge on the property to which it is thus attached. A dim perception of this, and a possible realisation of the fact that a reform of the tax system might transform this tax into an actual burden again, may lie at the bottom of the indifference with which the average landowner views proposed reforms.

All of this selfish indifference is, of course, mistaken. It defeats its own ends. The burden of taxation is light only when properly adjusted to all the shoulders. The serious effects of an unjust, unequal, and ill-arranged system of taxes upon the economic forces of the country have been treated elsewhere. The property tax forms the subject of a special chapter.

We have spoken merely by courtesy of an American *system*. As a matter of fact there is none that is worthy of the name. Federal authorities tax with no reference to commonwealths and municipalities; commonwealths and municipalities, without reference to federal action. Municipal taxes are, however, generally adjusted to the existing commonwealth taxes, but only in such a way as not to make the resulting burden appear too large. Their efforts in this direction have only served to intensify the existing inequalities.

SEC. 7. **The National Tax Association's Model Tax System.** — A movement in the direction both of a better system or coördination of different taxes within each state and of better relations between the taxes of different states has resulted from the preparation by the National Tax Association of a plan for "A Model System of State and Local Taxation." [1] This report has been justly characterized by Professor T. S. Adams as "one of the wisest and most helpful statements ever published concerning the proper structure of the tax system of the American State." The report proposes:

(1) A personal income tax. "Every person having taxable

[1] Proceedings of the Twelfth Annual Conference on Taxation, Chicago, June 17–19, 1919, pp. 426–470.

ability should pay a direct tax to the government under which he is domiciled." "The tax should be levied upon persons in respect of their entire net incomes, and should be collected only from persons and at places where they are domiciled. It should not be collected from business concerns, either incorporated or unincorporated, since such action would defeat the very purpose of the tax." Non-residents earning income in or receiving income from sources in a state should not be taxed.

(2) There should be "a tax upon tangible property, levied exclusively at the place where such property is located" and "intangible property of all descriptions be exempt from taxation as property." The tax-paying ability represented by such property can be reached in other ways.

(3) That the methods of taxation applied to public service corporations be improved so as to impose an equitable burden upon such companies, but no one method was recommended.

(4) A business tax "levied upon the net income derived from business carried on within the state levying the tax."

(5) Improved administration involving (*a*) assessment districts large enough to justify the employment of a permanent full time official; (*b*) a term of office long enough to develop efficiency, at least four years; (*c*) power of removal of assessors by the state tax commission; (*d*) a permanent central state tax commission, with broad powers over the entire tax system, state and local.

The plan is sufficiently broad and flexible to be adapted to the needs and conditions of any state.

CHAPTER VI

EXCISES[1]

SECTION 1. **Comparison of Excises and Customs.** — Generally speaking, indirect taxes are older than direct taxes. They are suitable to a more primitive organisation of society. Hence, it will not be amiss to treat them before we analyse the direct taxes. By far the larger part of the indirect taxes are on consumption (*Aufwandsteuern*). Most of the taxes on consumption fall under one or the other of two heads: they are either excises or customs duties. In the United States the excises are called internal revenue taxes. Excises may be defined as all those taxes levied within a country on commodities destined for consumption. Customs duties fall on commodities as they enter or leave the country. In their effect on the economic condition of the country and on the tax-bearer they are practically the same. In both cases the persons who first advance the taxes are generally supposed to reimburse themselves from the persons to whom the wares are sold. In both cases, although less often in the case of excises, it may be true that only a part of the funds taken from the tax-bearer flows into the treasury. For both of them enable producers who escape, or whom it is not intended to tax (as the home producer in the case of a tax on imported commodities), to collect on each piece of goods sold a bounty or a tax in the form of a price higher than he could otherwise obtain, the amount of which goes into his own pocket. Sometimes this subsidising of certain producers is intentional, sometimes only accidental. In any case the ultimate effects

[1] The discussion here is confined to normal, or peace times, conditions, in order to give the reader a view of the more permanent principles. War taxation, treated elsewhere, is distinctly abnormal.

which will result from such an interference with the ordinary currents of trade cannot be fully traced. It is comparatively seldom that excises have been intentionally used to change the movement of economic life. But customs duties have regularly been used for that purpose. Excises have, to be sure, been used to influence social life, to lessen the consumption of certain commodities the use of which is regarded as injurious to the individual or dangerous to society, but the object, in that case, is social, not economic.

Direct Consumption Taxes. — There used to be a large number of the so-called direct consumption taxes. A few of these still survive. They are direct in the first sense of that term, but not in the second. These direct taxes on consumption are either remnants of the older taxes on movables, or arose from the attempt to frown on the use of luxuries. They differ from excises in that they are levied directly on the consumer and not on the person or persons who supply him with the commodities. They are to-day few in number and of little fiscal importance. The chief instances in modern times and the most universal are the dog taxes. There are, in England, similar taxes on guns, carriages, armorial bearings, and men servants. In the United States watches, clocks, and firearms have been made contributory in this way. Plate, houses, clocks, hair powder, and a great many other articles have been taxed. It is regarded as just and proper to make articles of luxury the subjects of taxation because their use is supposed to be evidence of ability to pay. The tendency now is to leave the administration of direct consumption taxes to the local bodies. They are sometimes combined with police regulative laws and are assessed as a means of enforcing those ordinances. This is the case with the dog tax in America.

SEC. 2. **Some Excises Have the Same Purpose as Sumptuary Laws.** — It is the excise tax in all its forms that has displaced the direct consumption taxes. The distinguishing feature of this tax is that some resident seller of an article, whether produced in the country or abroad, or the manufacturer of such an article, advances the tax either during the

process of its production or at some time before it reaches the consumer. The main purpose of the excise is to obtain revenue, but the ideas underlying the sumptuary laws, and the desire to use taxation as a means of social and moral reform, have dictated some of these taxes or at least the selection of the commodities to be taxed. The fact that the consumption of certain articles like spirituous liquors, tobacco, and playing cards is condemned in itself, and that such articles are regarded as unnecessary luxuries, has led governments to disregard, or, indeed, to favour, the repressive tendency of the tax upon the use of them. It is felt that in case the tax should lessen the consumption, the gain to the community in moral and social well-being would more than offset the loss to the treasury in revenue. Moreover the consumption of such articles is not, it has been found, liable to serious diminution on account of the tax, unless, as in the case of the French tax on tobacco, it is very high.

A System of Excise Taxes. — In the seventeenth century there was a marked tendency to multiply excise taxes. So strong did this tendency become that not a few able writers advocated a general excise as the most just form of tax.[1] Many of the recent suggestions for the reform of taxation in France are in the same direction. This tendency can be easily explained by the rapid multiplication of taxable commodities. It was urged that the ease with which such taxes were shifted insured in the end perfect justice. It was also often urged that consumption is more or less voluntary, and any one who finds the tax too heavy can avoid it or lessen it by curtailing his consumption of the taxed article. Thus if the taxed articles are not important necessities, the contributor has a certain control over his share of the tax and can suit it to his means. If the tax is on a luxury, he has presumably absolute control over his contribution. But modern investigations into the character of distribution and consumption would seem to indicate that these views are erroneous. There is no doubt that consumption is a very poor criterion of taxpaying ability. What a man spends is no indication of his tax faculty. There

[1] Cf. Cohn, p. 336; Seligman, *Shifting and Incidence*, p. 12 ff.

are, also, some important administrative difficulties. The yield of these taxes is beyond the control of the fiscal officers. If more revenues are needed, it is not always possible to obtain them by raising the rates, since a rise in the rate may, in fact, lessen the revenues by lessening the demand for the articles. Therefore, they are not variable at the pleasure of the treasury. It follows, further, that a system of excises alone would be extremely inelastic. But as parts of a system, the elasticity of which is provided for by other elements, they have proved very valuable on account of the relative ease of collection, and the large returns which they can be made to yield. In England, Russia, and France the returns of the excises and customs duties were one-half or more of the national revenues. In Germany the constitution conferred upon the imperial legislature the power to regulate the customs and excises upon domestic productions of salt, tobacco, spirituous liquors, beer, sugar, and syrup.[1] The commonwealths of the Empire did not levy excises on the articles above mentioned except Bavaria, Wurttemberg, and Baden. The Empire could not tax any other articles. In the United States the federal government derived nearly half its revenues from excises and an almost equal amount from customs.

Principles of Excise Taxation. — The following principles have been developed as governing the returns obtainable from excises: (1) Articles which are regarded as necessaries, and which naturally have or can have a wide consumption, are very suitable under this tax for obtaining large revenues. In this case the operation of the tax is like that of a poll tax. The old French *gabelle*, a tax on salt, is an example. The effect of these taxes, if high, is possibly to curtail consumption and possibly to cause a substitution of other similar articles not taxed. Possibly, too, they may curtail the consumption of other articles by lessening the money available for their purchase. But even with a low rate, these taxes are extremely productive of revenue, on account of the large number of contributors. The objection to burdening necessaries and rendering the existence of the

[1] Burgess, *Political Science*, II. p. 174.

poor harder, leads, however, sooner or later, to their abolition or to a reduction in their rates. These, like the poll taxes, recognise to too small an extent differences in ability. They are, however, good sources of revenue in cases of extreme need. (2) Luxuries and comforts may be taxed heavily. This applies especially to luxuries the use of which has become a fixed habit with large masses of people. The general principle is to select those luxuries of the widest consumption as the objects of the heaviest taxes. Thus alcoholic liquors and tobacco are universally taxed in this way. In the United States they formed almost the sole objects. In times of special need it is customary to press the semi-luxuries or comforts into service. Here again, the choice is made of articles of widest consumption; such as coffee, sugar, silks, chocolate, etc. In most modern excise systems, the heaviest burden falls upon luxuries. In England, where the receipts from excises were nearly one-fourth of the total revenues, the chief burden fell upon spirits (1908, £22,830,000) and beer (1908, £13,550,000). In France, aside from the *octroi*, the chief excises are on beer, wine, spirits, and tobacco, then on sugar, salt, and playing cards. In Germany, apart from the city gate taxes, they fall upon alcoholic drinks, tobacco, and sugar. Modern excises are, then, mainly taxes on alcoholic drinks and tobacco with the addition of a few other duties upon playing cards, etc., and in cases of great need, upon a few articles of large consumption.

SEC. 3. **Methods of Assessment.** — By far the most interesting features of the excises are the methods of assessment and collection. These are practically of three kinds, which may be variously combined: (1) A tax on the producer or seller so levied that the failure to pay it deprives the person of the right to sell, and renders him liable to penalty. That is, a so-called license [1] is sold. (2) An impost on each unit of the article. This demands the registration of the dealers therein; and sometimes they are required to give bonds as surety for the payment

[1] For the distinction between a license and a permit see the United States Census Bureau definitions, Wealth, Debt and Taxation, 1907, Classification of Revenues. A license to conduct some business illegal in itself differs from a license required merely to compel the payment of a tax.

of the tax. Wherever it is possible, this impost is collected by means of the sale of stamps purchased of the government to be affixed to each package, hogshead, etc., or by means of brands, or other marks affixed by officials who thus receipt for the payment. The stamp or brand serves as evidence that the tax has been paid. Goods not bearing these would, if taxable, become contraband and liable to seizure. (3) By the retention of the monopoly of manufacture and sale by the government.

England and America use a combination of (1) and (2). Thus in England every barrel of beer is taxed 7*s.* 9*d.* (1908) and every dealer and brewer pays a license besides.[1]

[1] The following applies to 1908

BEER DUTY, EXCISE

	£	*s.*	*d.*
Beer of specific gravity of 1055 degrees, per 36 gal.	0	7	9

ANNUAL LICENSES

Brewers of beer for sale	1	0	0
Other brewers			
Brewing solely for their own domestic use, exempt from beer duty, if the annual value of the house occupied does not exceed £8	(exempt)		
Same, if annual value of house exceeds £8, but does not exceed £10	0	4	0
Same, if annual value £10 to £15	0	9	0
Same, but liable also to beer duty, over £15	0	4	0
Same, or for consumption by farm labourers, if annual value of house does not exceed £10, exempt from beer duty	0	4	0
Same as last, if over £10, liable also to the beer duty	0	4	1
Beer dealers	3	6	0
Beer dealers, additional to retail, off the premises	1	5	0
Beer retailers, on the premises	3	10	0
Beer retailers "on," occasional (license per day)	0	1	0
Beer retailers, grocers, "off," Scotland, to £10	2	10	0
Beer retailers, grocers, "off," Scotland, £10 and upward	4	4	0
Beer retailers, grocers, "off," England	1	5	0
With varying and additional licenses for combination of sale of beer with wine, spirits, etc.			

Spirits are taxed in a similar way and so are the dealers therein. In the case of tobacco the import duty forms the tax on the commodity, and the manufacturer pays a license graded according to the size of his business.

Tobacco manufacturers:

	£	*s.*	*d.*
Under 20,000 lb.	5	5	0
20,000 to 40,000 "	10	10	0
40,000 " 60,000 "	15	15	0
60,000 " 80,000 "	21	0	0
80,000 " 100,000 "	26	5	0
100,000	31	10	0

In the United States all internal revenue taxes are payable by stamps. These stamps are pasted upon the packages containing the taxed commodities in such a way as to be necessarily broken when the package is opened. Or else they are pasted up or exposed in the places of business. The table below illustrates the whole system.

Schedule of articles and occupations subject to tax under the internal revenue laws of the United States in force August 28, 1894, as amended to 1908.

SPECIAL TAXES

	Rate of Tax
Rectifiers of less than 500 bbl. a year	$100.00
Rectifiers of 500 bbl. a year, or more	200.00
Retail liquor dealers	25.00
Wholesale liquor dealers	100 00
Retail dealers in malt liquors	20.00
Wholesale dealers in malt liquors	50.00
Manufacturers of stills	50.00
And for stills or worms, manufactured, each	20.00
Brewers, annual manufacture less than 500 bbl.	50.00
Brewers, annual manufacture 500 bbl., or more	100.00
Manufacturers of oleomargarine	600.00
Retail dealers in oleomargarine	48.00
Wholesale dealers in oleomargarine	480.00

DISTILLED SPIRITS, ETC.

Distilled spirits per gallon	$1.10
Wines, liquors, or compounds known or denominated as wines, and made in imitation of sparkling wine or champagne, but not made from grapes grown in the United States, and liquors, not made from grapes, currants, rhubarb, or berries grown in the United States, but produced by being rectified or mixed with distilled spirits, or by the infusion of any matter in spirits to be sold as wine, or as a substitute for wine, in bottles containing not more than one pint, per bottle or package	.10
Same, in bottles containing more than one pint, and not more than one quart, per bottle or package	.20
And at the same rate for any larger quantity of such merchandise, however put up, or whatever may be the package.	
Stamps for distilled spirits intended for export, for expense	.10

TOBACCO AND SNUFF

Tobacco and snuff, however prepared, manufactured, and sold, or removed for consumption or sale, per pound 12 cents, or with discount of 20 per cent	$ .09⅗ net

CIGARS AND CIGARETTES

Cigars of all descriptions made of tobacco or any substitute therefor, and weighing more than 3 lb. per thousand, per thousand	$3.00
The same, weighing not over 3 lb. per thousand, per thousand	.54
Cigarettes, weighing not more than 3 lb. per thousand and of a wholesale value or price of more than $2 per thousand, 36 cents per pound, or per thousand	1.08
The same of a wholesale value or price of not more than $2 per thousand, 18 cents per pound, or per thousand	.54
Cigarettes, weighing more than 3 lb. per thousand, per thousand	3.60

FERMENTED LIQUORS

Fermented liquors, per barrel, containing not more than 31 gal.	$1.06
More than 1 bbl. and not more than 1 hogshead, 63 gal., in one package	3.20

OLEOMARGARINE

Domestic, per pound	$ .02
Imported, per pound	.15

OPIUM

Prepared smoking opium, per pound	$10.00

PLAYING CARDS

Playing cards, per pack, containing not more than 54 cards	$ .02

SEC. 4. **Types of Excises.** — We may now look at a few typical excises. The taxation of salt by means of an excise, collected in the form of a tax on producers, a tax on sellers, the sale of a monopoly to a private company, or state manufacture, is one of the oldest forms of taxation. On account of the nature of the commodity, a necessity for which there is no substitute, and of which poor and rich consume about the same amount, this tax acts practically as a poll tax. With the modern tendency to abolish or at least to lower poll taxes, as unequal and unjust, the salt tax has been largely abolished, or its rates have been so lowered as to practically nullify the returns. France in 1908 received about 10,000,000 francs from the salt excises. The English salt tax yielded at the time of its abolition only £380,000. The United States war excise upon salt yielded only $300,000 (1899).

The best, but not by any means the sole, example of the tobacco monopoly is in France. This interesting tax scheme began in 1674 under Colbert. It continued with slight interruptions for over a century as one of the most productive parts of the revenue system. It was leased to a *ferme générale*, who paid the government, at the time of Necker, 32,000,000 francs annually. At the time of the Revolution the monopoly was abolished, and an attempt was made to introduce a series of taxes on tobacco. But the monopoly was restored in 1810 by Napoleon I, and has continued ever since. Under the present law the culture of the plant is forbidden outside of certain localities. Each year the estimated amount required by the department is apportioned among the different applicants within the district where it is permitted to raise tobacco. Several thorough official inspections of the fields and crops are made and even the number of plants and leaves is counted to insure obedience with the regulation which demands the delivery of the whole crop to the government. Tobacco raised for export is similarly watched to see that none of it escapes into the channels of the French trade. The price for each quality is determined by a commission of officials and experts. A part, about one-half, of the supply is imported. The manufacture is carried on in public factories, which employ about 20,000 workmen. The sale is in the hands of some 40,000 petty officials, who receive a percentage of their sales and whose appointment is a part of the party spoils system. The revenues obtained in this way are enormous:

1815	40,000,000	francs.
1869	197,000,000	"
1872	218,700,000	"
1876	262,300,000	"
1880	284,000,000	"
1885	300,000,000	"
1890	373,000,000	"
1895	381,000,000	"
1900	415,000,000	"
1904	447,000,000	"
1908 with matches	516,000,000	"

The prices charged for tobacco are high compared with the prices prevalent in other countries, so high that the consumption is apparently checked thereby, it being per capita less than one-half that of Germany. Austria and Italy have very similar state tobacco monopolies. France added a monopoly on matches in 1890.

SEC. 5. **The Proper Field for Excises.** — On account of the large returns obtainable from an excise on luxuries, and in view of the fact that any repressive effect of such excises is not felt to be harmful, but is often desired, it is probable that these taxes will be long retained. They are applicable to any luxury the consumption of which is large and of which the production is sufficiently simple or concentrated to allow of supervision. But in general, excises as taxes on expenditure or consumption are unfair. What a man spends is no indication of his ability to pay taxes, and what a man spends on a certain limited list of commodities is less so. When these taxes are made a subordinate part of a system and due allowance is made in the other taxes for the existing burdens, there is less objection to them.

CHAPTER VII

CUSTOMS DUTIES

SECTION 1. **Customs Duties Defined.** — Customs duties are taxes levied upon commodities when they cross the national boundary line, or are admitted within a customs territory, consisting of a combination of countries or of definitely limited parts of countries. Unless a city or town forms an independent sovereignty, taxes levied on goods entering a city are not called customs duties, but *octrois* or imposts, and partake of the nature of excises. Duties upon goods passing from province to province in the same country are likewise not customs duties; neither are tolls or transit duties charged upon goods passing through the country. Such charges are fees for the ostensible or real service of the government in keeping up roads and bridges, maintaining peace, and allowing transit.[1] Customs duties are indirect consumption taxes of practically the same character as excises. Their treatment in a separate chapter is not on account of any actual difference in nature but because of their historical and fiscal importance.

SEC. 2. **Old Customs Duties Covered Both Imports and Exports.** — The old forms of customs duties were on exports and imports alike. They arose by analogy from the transit tolls which were customary in the Middle Ages. Once in use their fiscal importance was recognised, and it was easy from the standpoint of feudal politics to justify their continuance. Feudalism regarded every act of the vassal as the concern of the lord. If any vassal, or later any subject, found a new means of gain, feudalism imposed on him the duty of con-

[1] Cf. Bastable, p. 552, for contrary view. Bastable does not recognise fees as a separate class. Hence his identification of transit duties with customs duties.

tributing a part thereof to the lord or the king. If a subject sold a commodity to a foreigner it seemed to the men of the Middle Ages that the king's goods were being alienated and the privilege of so doing one to be paid for. Export duties were sometimes substituted for old time prohibitions of exportation. In recent times export duties have been generally abandoned, apparently because it is felt that they make it more difficult for the home producer to market his goods abroad. Sometimes export duties are used as a convenient means of taxing industries not so easily taxed by other methods. The goods so taxed are often those in which the country has a monopoly or else a decided advantage in production over the foreigner. The old export duties in the Philippines, which however were removed in 1912, fell on sugar, hemp and tobacco, three staple products; in one of these Manila hemp or abaca, the Islands have very nearly a monopoly. In India as late as the fiscal year 1925–26, the export duties yielded a considerable revenue, the amount being one-fifth as much as that of the import duties. In some cases, illustrated by the British duty on coal exported, which was imposed in 1901 and repealed in 1906, such duties are defended not alone as revenue measures but as helping to conserve some natural resource from depletion. Germany abolished export duties in 1873, France in 1881. Export duties reappeared among the miscellaneous war and post-war taxes and served in some cases to regulate or control the movement of goods for war purposes, or to give domestic users an advantage. We may anticipate that they will not continue very long.

Import duties are exceeding common, numerous and onerous. No country is without some. Their yield is large. At one time half the revenues of the Empire of Germany and half those of the United States federal government came from import duties. English customs have often run to nearly a fourth of the receipts of the United Kingdom.

SEC. 3. **The Purposes of Customs Duties.** — Although the fiscal interests are great, yet in every important country except England the receipts from this source are not regarded as of any greater importance than the effects upon the industries of the

country. There are then two sides from which these taxes must be studied: (1) from the side of the revenue-yielding capacity; (2) from the side of the "protection" afforded the industries of the country which levies them. While it would be undesirable to introduce a full discussion of the far-reaching economic effects of protective duties upon industries and commerce in a treatise on finance, yet a brief statement of these effects and of the main reasons which have led great nations to adopt these taxes is essential to an understanding of their nature. It is as essential to know how and why protective duties are intended to alter the existing economic conditions, as it is to know how and why the income tax, for example, is supposed to leave them unaltered.

SEC. 4. **Protective Tariff Defined.** — What is the distinction between a protective tariff and a tariff for revenue? It may be briefly stated as follows: a protective tariff is a scale of duties so arranged as to prevent importation, wholly or in part, and to raise the price of commodities from abroad, the production of which within the country it is intended to encourage. The scale of duties is, therefore, arranged with a view to the supposed needs of the industries which it is intended to develop. A tariff for revenue, on the other hand, aims to avoid any effect upon industries within the country, and the duties are laid according to principles similar to those of the excise upon articles of large consumption and great tax-bearing capacity. The term "a tariff for revenue *only*," so current in the United States, is the expression of an unattainable hope. A moment's consideration of the law of international exchange,[1] namely, that the interchange of commodities between distant places is determined by differences in their possible cost of production in the same place, and not by their absolute cost of production in the separated interchanging places, will reveal the fact that even a very small duty upon a single commodity affects the demand of the country from which that commodity comes for other things, and indirectly affects every commodity manufactured in the country laying the tax. The same is true of an excise.

[1] See Mill, *Prin.*, Bk. III, Chap. XVII.

In fact, any consumption tax has far-reaching effects. Strictly speaking, there can be no such thing as a tariff for revenue *only*. What is meant by that phrase is that the tariff shall be so arranged as to yield the needed revenue with the least possible effect on the trade and industry of the country.

It must be noticed that every tariff, even though it contains many protective features, also necessarily contains many duties which are mainly for revenue. Thus in the United States, even with high protective duties, the main revenues were obtained from the taxes upon a few commodities. The receipts in 1888, for example, were: from duties on sugar and the like, $52,000,000; from wool and woollens, $37,000,000; from iron and steel, $21,000,000; these three together being more than half the entire receipts from customs duties.

SEC. 5. **Protection as a National Policy.** — The protective principle is widely applied in every important existing tariff of customs outside of England, Holland, Norway, Belgium, Switzerland, and Denmark. This policy is clearly the outcome of national selfishness. The attempt to direct industry into certain lines by artificial means cannot find support in any system of political economy that regards the largest possible world's product as the proper aim.[1] The object is rather the greatest possible diversity of home products. In so far as this purpose is attained, it is by the process of shutting out competition and allowing the home producer to collect from home consumers a certain amount of support, greater or less, according to the supposed needs of the producer in question. In so far, then, the actual protection afforded is an item of public expenditure. Revenues collected by means of higher prices authorised by law are spent in developing the industry protected. It is in every respect the same as if a subsidy were paid to the manufacturer

[1] See the article by Professor Folwell on "Protective Tariffs as a Question of National Economy," in *The National Revenues*, a collection of papers by American economists, edited by Albert Shaw, Chicago, 1888. Contrary to the popular opinion as to the views of economists, none of the writers who have contributed to this symposium finds it possible to attack protection on *a priori* grounds. On the free-trade side see Report of the Proceedings of the International Free-trade Congress, London, August, 1908. Cobden Club, Caxton House, Westminster, S. S., London, 1908.

or other producer, except that the money goes directly to him without first passing through the treasury.[1]

SEC. 6. **A High Protective Tariff Yields Little Revenue.** — We turn now to a treatment of the fiscal character of protective duties: (1) In the first place, it is clear that the more "protection" the duty gives, the less will be the revenues afforded to the government, and the greater the possible revenues to the subsidised producer. Absolute protection means the exclusion of the foreign commodity and no revenue to the government The subsidy that the producer can obtain is determined by the conditions of production; it varies from nothing to the whole amount of the tax according as the cost of production varies above what the cost of the imported commodity would be without the duty. (2) Above a certain point high duties tend to diminish the revenues to the government, and increase the subsidy to the producer, by diminishing the amount of the commodity imported. The point beyond which the total revenues diminish is ascertainable by a principle similar to that of charging what the traffic will bear. In practice that point can be ascertained by gradually increasing the duty until it is found that the importation begins to diminish, and stopping the increase of the duty when it is found that the added duty checks more of the importation than the increased duty compensates for. A tariff of customs duties arranged throughout on this principle would be a revenue tariff, and if universal, would yield enormous sums. It would, also, contain many protective features. The burden of such a tax would be insufferable. No such general tariff has ever been enforced. (3) Protection is given only when the price is raised. The subsidy paid to the producer is paid by the consumers within the country. This part of the tax is never shifted to foreigners and generally remains on the consumer. (4) But that part of the tax which flows into the treasury of the government is not always, although generally, paid by the consumer, whether protection is afforded thereby or not. There are a few rare instances in which the tax that forms a part of the government's

[1] See above on expenditure for protection of industry.

revenue is shifted either to the foreigner, *i.e.* the producer, or the speculator, *i.e.* the importer. These instructive instances may be summed up as follows: The consumer escapes that part of the tax which flows into the treasury on purchases of commodities actually imported: (*a*) When the amount of the commodity produced in the country laying the tax is sufficient in quality to entirely supply the home market and to fix the price very close to the cost of production, while the foreigner has at the same time so large a supply that he must enter that market to dispose of it. In this case, if any revenue at all accrues to the government, it is clear that it is paid by the foreigner, who is burdened by the whole tax and may lose more, — more, that is, if his entrance into the market still further depresses the price. The home producer gets no subsidy. A commonly cited example of this is the case of rye in Germany in good years when the outside crop is also good. (*b*) When a new tax is laid on goods produced by the aid of a large fixed plant for a limited market which would be lost if the price were raised. As long as the producer is unable to change the nature of the plant, he must pay the tax. An example was found in the iron products from the Rhine districts prepared for the trade as "Sheffield" cutlery. England could in this case tax the foreigner until such time as he could change the character of his product. (*c*) In the case of commodities that are used only as the substitutes for something else because cheaper, and which would not, if the price rose higher than that of the commodity for which they are used, be consumed at all. In this case the foreigner pays a part or the whole of the tax when the alternate commodity is cheap. For example, rye in Germany when wheat is cheap, especially if at the same time the crop of rye is short. (*d*) In the case of commodities a large part of whose total consumption is produced in the country, but not enough to absolutely fix the price, which is still above the cost of production. The foreigner in that case may pay part of the tax, since his arrival depresses the price. (*e*) The speculator regularly pays the tax in those frequently recurring instances when the commodity is massed in warehouses on the

border ready for importation on a rise in the price and on being imported, at the order of various speculators, in large masses depresses prices again. It is a pretty well-established fact, from the investigations of Cohn and Kandtorowicz, that the speculators on the Exchange as a whole lose more than they gain. This loss is in part the consumer's gain through the relief from taxation.[1]

SEC. 7. **Specific and Ad Valorem Duties.** — Customs duties regarded merely as a source of revenue depend upon the same principles exactly as those which underlie excises used for that purpose. The greater revenue is obtained with the least expense from a few simple duties upon important commodities.

Technically, customs duties are of two kinds, according as they are levied upon goods in bulk irrespective of their value, or the contrary. This technical distinction is of great importance in determining the incidence of these taxes. Duties levied according to the value of the imported commodities are known as *ad valorem;* those according to weight, bulk, or other unit of measurement are known as *specific.* The latter usually fall most heavily upon the coarser or cheaper grades of commodities. Such a tariff is, therefore, regressive and contrary to the spirit of many consumption tax systems, which usually tax luxuries more heavily than other commodities. But the great saving in expense, and the great ease of collecting and administering specific duties, go a long way in recommending them. *Ad valorem* duties demand more machinery of administration, as, for example, the certification of the consul in the place where the goods come from to the correctness of the invoice, a corps of appraisers, and a careful examination or inspection of all incoming goods. Little of this is necessary in the case of specific duties. Specific duties are now retained mainly for simple commodities of uniform value per unit, or for rough groups of articles, whose value is easily ascertained.

[1] See the masterly treatment of the whole of this intricate subject by **Lexis**, "Handel," in *Schönberg's Handbuch*, 2d ed., Vol. III, XXI, sec. 77; also Conrad, in his *Jahrbuch*, XXXVII; Cohn, "Zeitgeschäfte und Differenzgeschäfte," in *Hildebrand's Jahrbuch*, VII, p. 388; brought down to date in 1890 by Kandtorowicz.

Smuggling. — The watching of the frontier and the prevention of smuggling is one of the primary difficulties that have to be overcome in the administration of customs duties. Goods of high value and easily portable are not very well adapted to pay such duties, unless they can be obtained only from distant countries and are thus easy of identification. Whenever there is a heavy excise on any commodity there is generally a correspondingly heavy customs duty as well. Sometimes the imported commodity pays both the duty and the excise or a part of the excise.

The political or protective element in customs duties has been gradually retreating in importance, and the fiscal has correspondingly advanced. Stein [1] makes this the sole law in the history of customs duties. It would be best characterized as an advance of the fiscal interest, leaving the political or protective interests the same as before. The pressing wants of nations, and the fact that federal governments have been well-nigh confined to these taxes, have necessitated this advance.

SEC. 8. **History of Customs Duties in England.** — We may now look at some examples of customs duties. Those of England are particularly instructive.[2] The term "*consuetudines*," or customs, applied to the duties levied upon imported and exported commodities even before the Magna Charta, bespeaks their antiquity. In the time of the Norman kings, however, trade was insignificant and the duties not very productive. The original duty on wine was one cask from every cargo of between ten and twenty casks, two from twenty or more. What the original duty on wool was is not known. Finally the system settled down to a 5 per cent tax on all imports and exports. Down to 1700 these duties were entirely for revenue purposes and had no intentional protective features. At one time their yield was nearly £1,500,000. The eighteenth century saw a changed policy. Special protective and prohibitive duties were established. This was the policy of the entire century, except during the "long peace" of Walpole, 1722–1739. By

[1] Vol. II, Part II, p. 377.

[2] See Hall, *History of the Customs Revenue*, and Dowell, *History of Taxation*.

1759 the general charges were 25 per cent, while many commodities, like tea, coffee, sugar, wines, and spirits, paid even more. The expenses of the wars which marked the turn of the century led to a general increase of charges on revenue-yielding commodities. Yet with all the many increases in the tax charges there was not a corresponding increase in revenues. In some cases the high duties of the war period exceeded the limit of what the goods would bear. For example, sugar paid duties ranging from 20*s*. to 39*s*. per hundredweight during the first fifteen years of the nineteenth century. But the annual income was least when the duties were highest. Consumption fell off half a million hundredweight under the higher price. It must be noted that this result was obtained in the case of a commodity not produced in the country itself. Salt, also, bore a heavy duty in this period to the lessening of the consumption. Tea, coffee, tobacco, wine, and other foreign products were also subject to revenue duties so high as to be close to, if not beyond, the limit of greatest productivity.

Interesting and instructive is the experience of England with protective duties. Export duties on raw material, or the prohibition of the exportation thereof, as in the case of wool, was originally one of the most prominent features of the English system. From the middle of the seventeenth century down to 1825 the exportation of home-grown wool was forbidden. Until 1802, however, the importation of wool was free. Then the import duty rose rapidly from 5*s*. 3*d*. per hundredweight, in 1802, to 56*s*. per hundredweight in 1819. To encourage the production of raw silk, heavy duties were placed upon that commodity in 1765, and not lessened until 1825. Linen manufacture was encouraged by bounties.

The chief battles over the customs duties in England were waged around the "corn-law."[1] Two things among others of minor importance seem to have contributed mainly to the establishment of protective duties on bread-stuffs.[2] The

[1] The American student must bear in mind that in England "corn" means wheat, or, in general, bread-stuffs.

[2] See McCulloch, *Taxation*, p. 206; Wilson, *National Budget*, p. 62 ff.; Levy, *History of British Commerce*, 2d ed., Part II, Chap. 7; Rand, p. 207 ff.

first was the existence of heavy public burdens upon land, and the desire to compensate land owners and land users therefor. The other was the desire to make England as independent as possible of all foreign nations for her food supply, and to keep even the poorer lands in cultivation. According to the advocates of this policy, protection was needed to enable the proprietors and tenants to buy manufactured products. It was the political power of the proprietors that enabled the policy to be maintained. The various tariffs that prevailed may be conveniently summarised as intended generally to maintain a chosen price, which it was assumed would enable the producer to live, and would not place too heavy a burden on the consumer. Hence the frequent recourse to a sliding scale by which a higher duty was imposed as the price fell. The best example is the scale adopted by Sir Robert Peel (5 and 6 Vict. c. 14), by which the duty was to be 20*s*. per quarter when the price was 50*s*. and 51*s*., and decreased 1*s*. per quarter for every rise of 1*s*. in price; so that the duty would only be 1*s*. per quarter when the price rose to 70*s*. and over. The idea was, clearly, to maintain, if possible, a price of at least 70*s*. A similar purpose underlay the earlier prohibition of importation, until the price rose above 80*s*. per quarter.

Popular agitation, headed by the Anti-Corn Law League, was based upon the hope of cheaper food supplies. It was supported by the rapidly growing manufacturing interests in the expectation that cheaper food would result in a fall in wages. After years of effort it brought about the repeal of the corn laws in 1846. The sympathy aroused by the Irish famine of the same year contributed to this end. Just before the repeal of the corn laws Peel had, in 1842, simplified the whole tariff by eliminating many of the protective features, especially by removing duties on raw material and freeing a number of small articles. As a substitute source of revenue the income tax was restored. Gladstone, in 1860, completed the removal of protective features. Since that time it has been true, in the words of Bastable, that " the English customs system is remarkable for its vigorous adherence to the principle of purely financial

duties. All traces of a political aim in the imposition of customs duties have now disappeared." The corn duty was, however, restored as a revenue measure at the time of the Boer War. It lasted but a short time, namely, from April 15, 1902, to July 1, 1903, and during that time yielded £2,448,000.[1]

During the fiscal year 1907–1908 the customs yielded £32,500,000 as follows: tobacco, £13,739,000; tea, £5,807,000; coffee, £184,000; cocoa, etc., £287,000; chicory, £47,000; currants, raisins, and other dried fruits, £456,000; sugar, £6,708,000; beer, £23,000; spirits, £4,133,000; wine, £1,177,000. The Great War brought many changes in English customs duties. They may not be permanent. Mention of them will be found in the chapter on War Finance.

SEC. 9. **The German Customs Union.** — The difficulty of administering customs duties in the small and scattered areas of the different States of Germany led to the formation of the German customs union (*Zollverein*) in 1833. This union, which at first embraced a population of 25,000,000 and a territory of 80,600 square miles, grew in size and in permanence with the renewal, from time to time, of the treaties which bound together the States composing it, and with the entrance of new States, so that in 1854 it embraced 98,000 square miles and 35,000,000 inhabitants. It was the core of the recent German Empire. At the beginning the moderate, mainly revenue, duties of Prussia were adopted. In the tariff of 1865 the rates were lowered and many removed. Duties on grain and on almost all raw materials were removed, and the duties on manufactured goods reduced. The free-trade tendency which accomplished this change lasted until long after the formation of the Empire, indeed down to 1877.

The constitution of the Empire conferred upon the imperial legislature the exclusive power to regulate customs. It might levy taxes to any amount upon all articles exported or imported, for revenue purposes or for protection or for both. But the imperial legislature could not tax anything else. Further

[1] The so-called "registration" duty, 1869–1870, yielded £1,000,000 during the entire period of its existence.

revenues, if needed, could be raised in the form of an apportioned requisition upon the commonwealths of the Empire. The growing need of the Empire for revenues was accompanied by a wave of protectionist sentiment, so that the increased duties were more and more protective in character. It is true, however, that the revenue features were increased at the same time.

Particularly interesting was the duty on grain, introduced in 1879, and raised several times afterward. The rate became 5 M. per 100 kilograms for wheat and rye, 4 M. for oats, $2\frac{1}{4}$ M. for barley. These duties were in some measure protective in ordinary seasons. It was frequently found that a part of the revenue which flowed into the treasury from this source, especially in extraordinary years, was paid by others than the consumer.[1] Generally, however, the consumers paid the home producers a goodly sum in the shape of higher prices. The operation of these grain duties has been materially modified in recent years by the conclusion of commercial treaties with some of the grain-producing countries. The main revenues from customs duties in the Empire came from coffee, tobacco, wine, and grain.

SEC. 10. **History of the French Tariff.** — France has a highly developed system of customs duties. By the edict of 1664 Colbert attempted to reduce to a single uniform scheme all the confused and multifarious customs charges that had come down from feudal times and were in the hands of many different authorities. The tariff thus established was protective in character and was dictated mainly by the mercantile doctrine. But many provincial duties were left, and as time went on confusion increased. The Revolution swept all the old taxes away, and in 1791 the system which is the basis of the present one was established.

The development since then has been gradual. Prohibitions of imports and exports, so numerous in the tariffs of the ancient monarchy, have now all been removed. Since 1863 the only exceptions to this statement are books that infringe the copyright law and munitions of war. To insure the proper

[1] See example cited above; also Cohn, p. 565 ff.

registration, for statistical research, of all traffic, there used to be an import charge on all goods of 15 centimes per 100 francs' worth or 50 centimes per 100 kilograms, and an export charge of 25 centimes per 100 kilograms. These have been removed.[1]

During the period subsequent to the Revolution, and down to 1814, war measures left no opportunity to test the tariff of 1791. The Restoration established a highly protective system at the instigation of the Chambers. The Second Republic continued the same policy. Napoleon III, finding himself unable to persuade the deputies to change the tariff, removed many of the prohibitive duties by treaties. The first of these treaties, with England in 1860, fixed the maximum *ad valorem* duty on English goods at 30 per cent for the first four years and 25 per cent after that. Other treaties followed, extending similar privileges to other countries. In the spirit of these treaties the tariff itself underwent many amendments, raw products were admitted free, duties on foods were removed or lowered, and the duties protecting the stronger manufactures were lowered. By 1873, that is, after the struggle with Germany was over, and after the revenue system had been rearranged to meet the tremendous burden which was the consequence of the war, France had two distinct tariffs. First, the general tariff built upon the law of 1791 amended many times. Second, a conventional tariff based upon treaties. Since these treaties generally contained the clause granting each nation the same privileges as the most favoured, this tariff was more uniform than the method of construction would lead one to expect. In 1881 the general tariff was pretty thoroughly revised so as to approach the treaty tariff. Manufactures were slightly protected. With this as a starting-point new treaties were made.

One of the most remarkable reforms that any tariff has ever undergone was accomplished in 1892. This was the passage of two tariffs in a single law. There was first a general tariff or maximum which was to be levied on goods from all countries

[1] On the whole subject see Levasseur, "Recent Commercial Policy of France," *Journal of Political Economy*, Vol. 1, No. 1, December, 1892.

not obtaining special privileges by treaties. Second, a minimum tariff marking the lower limit to which the concessions might go. The latter was to be applied to the native products of those countries which grant French products reciprocal privileges. Both of these tariffs were protective. There are over 700 items in the maximum tariff, but the number on which concessions could be made was considerably less.

SEC. 11. **The United States.** — The tariff history of the United States has been written many times.[1] Its effects have been explained in many different ways. Not one of the many histories is clearer and more impartial than the short statement by Professors Seligman and R. Mayo Smith, printed (in English) in the publications of the *Verein für Socialpolitik*, 1892 (Vol. XLIX, Part 1). Nothing but the barest outlines can be attempted here.

The colonial policy of England prohibited the exportation of the more important commodities, the "enumerated" articles, to any country but England. Importation was to take place only from British ships. As was seen in the chapter on protective expenditure, bounties were paid to encourage agricultural products. The only import duty in the colonies was that imposed in 1773 on rum, molasses, and sugar from other than British colonies.

After the War of Independence there was a movement to protect the new industries which had sprung up. As Congress did not, until the adoption of the new constitution in 1789, have the power to collect duties, the commonwealths tried to afford the desired protection. There is naught but confusion in these efforts, all of which, however, came to an end when the commonwealths were forbidden to levy customs duties.

The tariff was the sole source of tax revenue which the new federal government had. It was, consequently, largely utilised from the first. Down to the close of the War of 1812 the tariffs were, in effect, if not in intention, revenue and not protective tariffs. The rates were generally low, except on purely

[1] Sumner, *History of Protection in the United States;* Taussig, *Tariff History of the United States.*

revenue articles like sugar, tea, coffee, and wine. The Orders in Council, the Berlin and Milan decrees, on the east side of the Atlantic, and the Embargo and Non-Intercourse acts, on the west side, followed by the War of 1812, gave absolute protection to American industries and seriously lessened the growth of the customs revenue of the government for a period of seven years. It is not surprising, therefore, to find the new industries which had been forced into existence during that time calling loudly for protection after the peace. A strong protectionist sentiment arose which initiated a policy that had scarcely more than a temporary setback from 1816 to 1895. That policy was to combine high protective duties with important revenue duties. The main arguments advanced for and against the policy of protection have been stated under Expenditure. The industries protected were the textiles, cotton and wool, and iron. Among the revenue duties may be named those on tea, coffee, and wine, and perhaps those on sugar and tobacco. The first period of the protective policy passed the highwater mark in 1828.

The only important setback which the policy sustained before the recent tariffs was in the so-called free-trade period from 1846 to 1860. The act of 1846 was heralded as a tariff for revenue only, but it was still highly protective. The duties on the classified commodities ranged from 5 per cent to 100 per cent; the last on spirits. Some purely revenue duties were removed entirely, as, for example, the duty on tea and coffee. The protective textile industries retained their duties for the most part; woollens 20 to 30 per cent, cottons the same, iron 30 per cent. All the duties were made *ad valorem*, a change which involved an increase in the cost of administration. A more substantial reduction was made in 1857.

The crisis of 1857 resulted in a serious decline in the revenues, and just before the Civil War broke out, Congress passed the so-called Morrill tariff, March 2, 1861. This tariff increased the protective duties, especially on iron and woollens. From the technical side this act made two changes of note. First, specific duties were again restored; second, the system of so-called compensating duties was initiated. This second feature, which

afterwards received a very broad application, can best be made clear by an illustration. The Morrill tariff increased the duty on raw wool. To compensate the manufacturers for this, a specific duty, supposed to represent the duty on raw materials, was placed on manufactures of wool, together with an *ad valorem* duty for protection.

Immediately after the passage of the Morrill act the war broke out. Under the pressure of the need for revenues Congress passed a long series of acts increasing the duties on purely revenue articles, putting duties upon articles hitherto free, and raising as compensation the protective duties. The idea of giving compensatory duties was extended to cover the burden of internal taxes also. Thus the manufacturers were, in 1864, given special compensatory duties to offset the heavy internal taxes. This remarkable protectionist measure, embodied in the act of 1864, was rushed through Congress with only one day's discussion in each house. It represents the highest limit ever reached. Nearly 1500 articles were enumerated; the average rate was close to 50 per cent. It shows the effect of three different forces: there was (1) the desire to increase the revenues, (2) the feeling that the manufacturer had a good claim for compensation for the high taxes in general, (3) the mad scramble to gain all that could be gained from this class of legislation.

This act afterward received a number of amendments to meet the changes made in the other parts of the revenue system, but the character of the tariff was not materially changed until 1883. One of the most interesting changes, technically, was the fixing, in 1866, of the method of ascertaining the value upon which the duty was laid. It was provided that the value should be determined by adding to the value, at the place of shipment, the cost of transportation, packing, commission, warehousing, and other charges which fell upon the goods before their arrival.

The protection policy thus extended gave strength to vested interests which thereafter supported that policy. The only changes of note down to 1894 are the attempted reforms of 1870, 1873, and 1883, and the McKinley tariff of 1890, which

reduced the income by removing the duties on purely revenue articles and on very strong, self-sustaining industries, but increased the protective features.

In 1894 came a change that at first appeared to be very important. The McKinley bill of 1890 had become practically the platform of the Republican party, and the Democratic party went into power pledged to the reduction of protection. They proceeded slowly to the fulfilment of these pledges. The famous Wilson bill was reported December 19, 1893, and became a law August 27, 1894, without the approval of the Democratic President. It failed of his approval because of the objectionable features introduced in the Senate. Two things prevented the change from being sweeping. The first was the power of the vested interests in the protected industries. Every sort of pressure, short of illegal, was brought to bear in favor of the existing system. The second was the patent danger of too sudden a decrease. Sweeping reform would ruin industries and create a depression.

The reduced tariff was not destined to remain long in force. Within three years, that is, in 1897, there was a deficit in the treasury, which gave an excuse for new tariff legislation. By this time the protectionists had rallied and were again in power. Congress was called together in special session and passed the so-called Dingley tariff, as a strict party measure. This tariff restored most of the protective features that had been removed in 1894. Protection was again granted to wool as a raw material, and compensatory duties were placed on manufactures of wool. In some respects the wool and woollen schedule was made higher than ever before. Hides, which had been on the free list ever since 1872, were given a protective duty of 15 per cent *ad valorem*, while, to quiet the protests of the shoemakers, manufacturers of leather received a compensatory duty that fully made up for the increased cost of the raw material. On cotton goods, however, the duties were slightly reduced, although not all along the line. Silk and linen received a rather substantial advance. The iron schedule was not materially changed from the condition in which it was left by the McKinley

bill. The greatest struggle was waged around the sugar tariff. The duty placed on raw sugar in the Wilson bill was retained and slightly increased, while the refiners received a differential that afforded them very handsome protection. On the whole the Dingley tariff raised the protective wall higher than ever.

Having reached this stage, the protective system rested for twelve years. During this time there developed, very slowly, a sentiment for tariff reform. The protectionists yielded a little to this sentiment, and won the privilege of having the tariff "revised by its friends." In April, 1909, Congress was again assembled in special session to "provide revenues to meet a deficit" and to consider a bill known as the Payne bill, which had been prepared by a committee of Republicans with a view to propitiating the sentiment in favour of tariff reduction. The Senate, in which the protectionists were strongly entrenched, prevented as great a reduction as the House was willing to make. The resulting act of August 5, 1909, known as the Payne-Aldrich tariff, increased the duties on luxuries for revenue purposes, raised a few of the protective duties, and made a considerable number of decreases. One feature of this bill was the retaliatory provision, whereby duties considerably higher than the normal or regular rates might be imposed on goods coming from those countries which did not accord American goods the same treatment accorded by those countries to the most favoured nation with which they traded.

Four years later, in 1913, the Democrats being in power, the Underwood-Simmons tariff was enacted. This act was described as "not free trade, but tariff for revenue." It was also called a "competitive tariff," meaning one that would put the American producer on an equal footing with the foreigner. Many protective duties were reduced. An important feature of this act was the creation of a permanent Tariff Commission to study the effects of the tariff continuously, and to provide Congress with information whenever needed. It was not authorized to recommend policies nor to suggest rates. The commission was bipartisan, and for a time included in its membership some eminent economists. Its reports are extensive, carefully prepared and

full of valuable information. How far the findings of this commission have influenced or can influence tariff making is a matter on which opinions differ. Dr. Thomas W. Page, one time chairman of the commission said, after his retirement from membership: "The Tariff Commission had little influence in determining the duties in the present (1922) law."[1] Yet it is possible to believe that the information assembled and published may have somewhat shaped public opinion.

The World War threw all foreign trade into a chaotic condition, and tariff revision with increased protection was vigorously demanded. The resulting tariff, known as the Fordney-McCumber Act was passed in September, 1922. The announced purpose of this act was "to establish rates to offset the difference in the cost of production here and abroad." This is a formula difficult of application, at any time, particularly so in an era when production costs were so extremely uncertain and variable. The rates were revised upward in many cases. The opposition has characterised this action as setting up a new tariff wall which makes it more difficult than it would have been under the old law to rehabilitate foreign trade. In particular the increase in protection at this time was criticised as imposing a burden on those nations to which we lent money for the prosecution of the war by taxing the goods they might send us in payment of their debts. This act contained a provision for changes in the rates to be made by executive order of the President to the end that the duty shall "equalise" the difference between foreign and domestic costs of production.[2]

[1] Page, T. W., Making the Tariff in the United States, 1924, p. 29.

[2] Few changes have been made under this provision An interesting one is the increase of the duty on wheat from 30 cents to 42 cents per bushel. Wheat was free under the Payne-Aldrich tariff.

CHAPTER VIII

PROPERTY TAXES

PART I. *The General Property Tax, with Special Reference to United States*

SECTION 1. **The American General Property Tax.** — The general property tax may be defined as a tax in which the base is the entire amount of the property, real and personal, owned by the taxpayer. This tax is old and is a favourite tax for local purposes. The general property tax can be studied to the best advantage in the United States, where it is used more extensively, perhaps, than in any other country, and where it is the main source of revenue for very important parts of the government. It is also used in Switzerland as the main source of revenue for some of the component parts of the federal State. In Prussia, Holland, and some other countries it is used to supplement other taxes, but when so used, it takes on a different character. The federal government in the United States does not levy any tax on property in general. If under the constitutional provision, which requires that direct taxes shall be apportioned among the states in proportion to population, the federal government should levy a tax, that tax would presumably be apportioned among the people by most of the states in accord with their own laws, and collected as their own state taxes are collected.

We need to see first the relation in which this tax stands to the other taxes in the system of state and local taxation.

The individual states, the cities, and the other local divisions of government in the United States derive their revenues from a considerable number of sources. They each use some or all of

the following taxes: (1) the general property tax; (2) the poll tax, payable either in money or in services, or in both; (3) taxes on selected kinds of business; (4) taxes on certain ways of conducting business, as the corporate form; (5) inheritance taxes, and (6), in a few instances, income taxes. They also use license taxes or fees for permits which are distinguished from taxes proper by the fact that regulation rather than revenue is the more important consideration. They also receive other fees of many sorts, mostly small, for special services to individuals, recording of documents, and the like. Streets, sewers, and other similar public improvements are mostly constructed from the proceeds of special assessments on the property immediately benefited. The cities, especially, not all, but many of them, and to a very small extent the states also, receive revenue from water works, gas and electric works, street railways, canals, and other public service enterprises and to a very small extent from industrial and commercial enterprises. A few of the states receive revenue from the sale or use of public lands. There are in addition a number of fines and penalties for various infractions of law.

Among all of these sources of revenue the general property tax stands preëminent. It is the structural iron which holds the building together. It is the largest single source of revenue and is universally regarded as preëminently *the tax* for all purposes. There is no state in the Union in which this tax does not exist at least as a tax for local purposes, although there are six states in which it is not used to supply revenue for the state or central government. Without a single important exception, it is used in every city, in every town or its counterpart in local government, in every district, be it a road district, school district, drainage or irrigation district, or a district organised for some other purpose. The few exceptions are insignificant, and are in each case due to conditions clearly peculiar.

The general property tax of the United States was, in its original conception, a *direct personal tax* for local purposes. It was a tax on persons, natural or corporate, in proportion to all their property. The only exemptions were originally per-

sons, usually corporate, like municipal corporations, schools, colleges, and churches which were regarded as performing some public or quasi-public functions. Sometimes natural persons, like ministers of the gospel, paupers, invalids, or veterans of war, were exempt from pious, religious, charitable, or patriotic motives. The present statutes still show marked traces of the personal character of this tax as originally conceived. As an illustration of the older conception we may cite Vermont, where every person was "rated" or "listed" for his poll, his property, and all his "faculties." In all the older laws the "person" came first, and his estate was the attribute by which the amount of his tax was measured.

It was a *local tax* intended primarily for the apportionment of neighbourhood charges among neighbours. The functions of government were at first exercised mainly by the local divisions. Even as late as 1840, when the functions and activities of the state or central governments had reached the first stage in their development, this tax was used to a very limited extent only, for supplying revenue for other than strictly local purposes. By slow degrees the larger unit of government, the commonwealth, began to draw upon this source by way of rates additional to the local taxes. Strangely enough, these added rates rarely, if ever, took the form of a surtax so common, for example, in Spanish taxation, nor did the surtax conception enter American financial thought anywhere until after 1890. Yet the effect of these additional tax rates is distinctly the same as that of the surtax.

By degrees, also, the strictly personal conception of the tax has been modified, and it has steadily become more and more of an objective tax, or a tax on things ownable regardless of the owner. This change has come about first through customs operating with the force of law, and is not even now so apparent in the statutes as it is in the actual administration. With several notable exceptions, of which New York is a conspicuous example, the personal declaration of the taxpayer may still be required and is more or less regularly exacted. But even where this form is still retained, property, even real estate, may be

taxed in the name of "unknown owners." As commonly conceived by legislator, administrator, and taxpayer alike, the general property tax, as it stands to-day, is a tax on all property, irrespective of ownership, within the territory of the taxing authority, except such as may be expressly exempted on account of its use for a public or quasi-public purpose or out of consideration for what is regarded as a desirable public policy. As an illustration of this, we may quote the phrase most widely used as the introductory sentence of the revenue laws of the various states: "All property, real and personal, within this state, not specially exempt, shall be taxed in proportion to its value." Yet traces of the older conception of a personal tax remain, often inconsistent and illogical, and giving rise to confusion of thought and practice.

SEC. 2. **Types of the Property Tax.** — Although this venerable tax, which dates from soon after the establishment of the various colonies on the continent of America, has been developed in each of the several states from a common origin as to principles and ideas and by very similar social, political, and economic forces, yet there are variations from state to state, and from one part of the country to another, which are by no means insignificant. Some of them are, in fact, so important that a failure to recognise them leads to a serious confusion of thought. It is this divergence, in one state or another, from the general type which makes it so difficult to explain briefly the nature of American tax problems. These differences concern in some degree the kinds and classes of property subject to the tax. But they concern in far greater measure the forms and methods of administration, and as it is on the administrative side that the greatest evils have been apparent, these may be considered as the more important.

Although, as just suggested, the constitutional provisions, the statutes, the ordinances, and the equally potent controlling practices, customs, and traditions vary from state to state, and although no two of them are exactly alike, it would nevertheless be an exaggeration to say that there are fifty-one different varieties of the general property tax in the United States.

Such a statement would lay too much emphasis on minor details. There are, however, several more or less distinct types. Some of the differentiating characteristics of these types are the result of the differences in the framework of the government,[1] others arise from differences in the social and industrial development.

In attempting to describe these types in a brief space we inevitably incur all the dangers of any broad generalisation. It should be understood that in many cases the types interblend; also, that for clearness' sake we shall select examples of the extreme forms of each type.[2]

The New England Type. — Among the oldest types is that which we may call the New England. This extends wherever the New England township form of local government extends, and even where the township system is modified by a superimposed county system. That is, in all the territory north of the Ohio River and of its line extended as far westward as the Rocky Mountains. It is that type of the general property tax which is the historical outgrowth of the well-known and famous "township" system of local government. It differs from the other types not so much by reason of any difference in the underlying conception of who and what is taxable, as it does in its administrative features. In general, the administrative or tax district is small, very small. In the "West" it is a township, six miles square; in older settled states it may be even smaller, it may be a city ward. Sometimes this district contains only a few hundred inhabitants, rarely over five thousand, and the number of taxpayers is, of course, very much less, perhaps a fifth or an eighth of the population. Consequently there may be considerable common knowledge of each other's affairs among the taxpayers, at least outside the cities, and the assessors may be assumed to have some knowledge of the property which

[1] Any reader not familiar with the various forms of local government in the United States will find enlightenment in Fiske, *Civil Government in the United States*; Bryce, *American Commonwealth*; and Hinsdale, *American Government*.

[2] The reader who wishes to delve into the multitudinous details and variations is referred to the present writer's contribution to the Census Volume on Wealth, Debt, and Taxation. Special Report, 12th Census, 1907.

they are to assess and of the value thereof. The assessors, for there are often several in one township, are elected for short terms, one year or two years, and in some cases perform their official functions without interrupting their ordinary vocations. Their work can usually be performed in a few weeks. In short, the administration is democratic, springing from the taxpayers themselves and ever under their control.

There are many variations of this type. There are some in which there is no central control at all, or so little that it has no influence, and others in which the administration is quite highly centralised. Between these two extremes are many degrees. We have space for only two examples, one at each extreme, Rhode Island and Indiana. Rhode Island's old system prior to 1910 will serve to illustrate a highly decentralised system. Rhode Island, as has often been pointed out, is, as a state, a sort of federation of small towns, each retaining a degree of autonomy and independence greater than such units enjoy anywhere else in the country. Here the state had very few functions to perform, and the "county" was a mere grouping of towns into court districts, a geographical rather than a political conception. The tax for state and county purposes, the county expenses being met from the state levy, was less than 10 per cent of the total amount raised by means of the general property tax. Consequently there was no fiscal reason, or at least not a strong one, for central supervision. The state levy was until very recently apportioned roughly among the towns at long and irregular intervals, of about sixteen years each, by a sort of contractual agreement between the towns made through their representatives in the legislature and taking the form of law. The administration of the tax was, therefore, almost purely a matter of local concern, although provided for by a general statute. Each of the towns, many of which contain less than two thousand inhabitants, elects each year in town meeting not less than three nor more than seven assessors, also a tax collector. The assessors were all-powerful, their action nearly final. There was no provision for review or for equalisation between individuals.

The only recourse an aggrieved taxpayer had was to take the matter into the courts. Not even the date when the assessment was to be made and to which it applied was fixed for the state at large, each town selecting these to suit itself. Such is the extreme of the democratic or New England type of the general property tax.

Equalisation. — In most of the other states having the same general type of this tax there are local boards of review, usually consisting of the local council, " trustees," with power to revise the assessments made by the assessor. In still others, owing primarily to the greater importance of the central or state functions, and the consequently larger proportional amount of state taxes to be apportioned, there is more central control. The cruder form of this central control is a state board of equalisation with limited power to review the work of the local assessors. Such boards do not, as a rule, change individual assessments, but by making a nominal valuation for each township or tax district as a whole determine the amount which each town shall pay to the state. But that amount is apportioned among the individual taxpayers on the basis of the original assessment. Such boards as these are virtually apportioning boards only. A fine example of this is afforded by Michigan, where an apportionment of state taxes is made only once in five years, and each town adds to its tax rate enough to raise its quota of the state tax. There is thus no general state tax rate.

Central Tax Commission. — From this crude form of centralisation, which scarcely affects the local or decentralised character of the tax administration, we pass, from state to state, through varying degrees of centralisation until we come to those like Indiana. That state has the old general property tax almost pure and undefiled in principle and theory, and yet has a very powerful central controlling board. The original assessment is still made by a multitude of local assessors elected and acting in the small townships. But these assessors are supervised and directed by county assessors, one for each county, who are assisted by other officers and act as the agents

or representatives of the central or state board. By conferences, instruction, and sharp supervision, backed by the right to discharge assessors, the central board exercises a very effective control reaching down into each township.

There are two controlling reasons for this development of central supervision. The first is that the proportionate amount of state and county taxes to be apportioned is greater. Thus in Rhode Island, as we have seen, the state tax, which includes county taxes, is less than ten per cent of the total tax, while in Indiana the state and county taxes amount to nearly half of the total taxes on property. Clearly, then, any inequalities in the valuations between the different towns become at once of great importance. If, for example, a given town that has property which at the average rate of valuation for the state would be assessed at $200,000 and would usually pay, say, $2000 in town taxes and $2000 in state taxes, should make its valuation only $100,000 it would pay in town taxes still $2000, but would pay in state taxes only $1000, throwing $1000 unjustly on other towns. The other controlling reason for greater centralisation is the existence of railroads and other great public service corporations whose property lies in many townships. The local assessor may know all about the value of farm lands in his little town, and how much a cow or a hog is worth, but he cannot possibly know how much six miles of railway track, part, perhaps, of a great transcontinental railway system, are worth. Such properties can only be valued as part of a whole. Hence, the application of the so-called " unit rule " necessitates a state board. This reason for the centralisation of the administration of the general property tax exists, also, in states not having the New England type of this tax, but it is far more potent in states where that type exists because of the extreme smallness of the assessment district.

The Southern Type. — A second type of the general property tax is found in the Southern states, and may, for that reason, be called the Southern type. In general, it is found in the territory south of the Ohio River and as far west as Louisiana. It is almost everywhere accompanied by an extensive system

of business license taxes which fill in certain gaps in the general property tax, and hence modify the classes of property to be included. On its administrative side it has been determined by the county system of local government which exists in those states where it is in force. The county being a very much larger unit of local government than the township, both in population and territorial area, its government is necessarily more representative and the type of property tax developed is less democratic. The county performs all the functions of local government, outside of the cities which are usually separately incorporated. The county revenues collected from the property tax are in most cases equalled or exceeded by those collected for the state, a condition almost the reverse of that in New England. From the beginning the state or central government loomed larger and had more functions to perform in the South than in the North. Ignoring, for purposes of brevity, the differences between individual states, we may venture to generalise as follows: Under the general supervision of the county court, which has administrative as well as purely judicial functions, the assessor or a small board of assessors makes the valuation of property. As this officer cannot, in the nature of things, know many of the taxpayers whose property he is to value, nor much about values in portions of the county remote from his home, his duties are far more difficult than those of the town assessors in the North and very different in character. Personal declaration by the taxpayer is required, at least by law, and, in general, more respect is assumed to be paid to the values declared by him. Penalties for failure to make a declaration are more severe and more often enforced. The diligence of the assessor is stimulated by commissions, it being customary to compensate him by a percentage of the taxes levied. Nevertheless considerable property escapes and it is not uncommon to find so-called " back tax commissions " or other officers authorised to assess property not placed on the rolls by the assessors. These commissions are more nearly a part of the regular machinery of government and quite unlike the guerilla or private " inquisitors " of Ohio, to which, as an anomaly,

much attention has been devoted.[1] There is also a more pronounced tendency in these states to use the general machinery of government for the levy and collection of this tax, and not to create a special and entirely separate set of officers. Thus the sheriff or the treasurer is often *ex-officio* tax collector. State supervisory boards are usually composed of *ex-officio* officers of the state, such as the governor, the auditor, and the treasurer, or the attorney-general, and property of a general character like the railroads is assessed by them. Everywhere else in the country the rate is always determined by apportionment, but in many Southern states a proportional (percentage) rate is fixed by statute and changed only at comparatively long intervals.

The Pacific Coast Type. — The third and last type is the Pacific coast type. This prevails in the states on and west of the Rocky Mountains, and in a modified form in Texas. Although, like the other types, it takes on various forms, yet it is rather more uniform than the other two, and this in spite of the tendency of the people of this part of the country to experiment with weird, fantastic, and evanescent theories. This type resembles the Southern type more than the New England type. In fact, the state of Missouri was one of the acknowledged sources from which this type was drawn. It differs from the Southern type more in spirit and traditions than in outward form. The county is here an administrative district of the state government. But the county has less autonomy than in the South, most of its activities being directed by general statutes under the supervision of state officers or bureaus. In New England and in the South authority flows to a certain extent from the local units to the state, in the far West it flows only from the state down to the local units. The state's share of the general property tax is usually about one-third of the whole, including what the state raises for the purpose of equalising the expense of maintaining the school system, which is paid over to the counties for expending, but under general laws. The assessment is made by a county assessor elected for a long

[1] Carver, *Tax Inquisitors in Ohio.*

term, usually of four years. He is assisted, usually, by many deputies and may assign them districts. Personal declarations by the taxpayers are required by law, but very irregularly enforced. The county administrative board acts as a board of review or "equalisation" as between individuals. There is always, in this type, a state board of equalisation whose functions, however, differ from those exercised by boards of a similar name in the states of the East and of the Middle West. As has been stated above, those Eastern boards usually make a nominal valuation for the purpose of apportioning the state taxes, and the "state tax rate" resulting may differ in every town, because each town in assuming its allotted quota of state taxes again apportions it on the basis of its own valuations. That is, in the New England type the valuations placed against individual properties are not changed by state board action. In the Western type, if the state board of equalisation decides that it is necessary to raise the valuation in a given county, say, 10 per cent, that 10 per cent is added to each individual assessment on the rolls, and the state rate is the same for every county and every taxpayer. The county "rate" might, consequently, be reduced by such action. Property of a general character like railroads is assessed by a central or state board, usually by the state board of equalisation.

The Three Types Nowhere Pure. — In thus marking out and attempting to describe briefly the three main types of the general property tax on its administrative side in the United States the writer is fully aware that he is treading on new ground. He is also keenly conscious that his broad generalisations are dangerous. It may well be that he should have made a fourth group of states like Michigan, Minnesota, Wisconsin, and Ohio, which present many peculiarities. It may be possible that the differences noted are not the most distinctive that might have been selected. His purpose was, however, to point out that there is not "a" general property tax in the United States, but fifty-one different property taxes, which fall into three or four general groups. Since it is the administrative side of this tax which breaks down and, as we have seen,

since there are many different types of this tax, it follows that there is no universal remedy for the existing evils.

SEC. 3. **The Property Subject to This Tax.** — Passing now from the administrative features, let us turn to the content, the property subject to the tax. The statutes quite generally define the locus of the taxable property, the time at which its value and amount shall be taken, and the kinds and character of the property to be included. There has been no particular difficulty so far as real estate is concerned with the place concept, it is real estate within the town, or the county, or the state that is taxable irrespective of the residence of the owner. But when it comes to personal property, especially to intangible personal property, there has been and still is much trouble, and no clear principle of interstate comity has yet emerged. The original theory was, as we have seen, that this tax was a personal tax, and that theory very naturally adopted the legal theory that personal property takes the situs of its owner. But, in general, the practice now is to tax personal property where found, if found at all, and the residence of the owner has little significance. A notable example of the uncertainty of ideas on this subject was afforded when, a few years ago, the state of Vermont expressly exempted all personal property outside the state belonging to residents. Although it was generally assumed that this was done from the alleged unworthy motive of tempting rich New Yorkers to take up a nominal residence in Vermont and thus evade taxation in New York, whose laws make the situs of personalty follow the owner, yet this action merely legalised what has become a very general practice.

The difficulty of determining the situs of personal property is the reason why the attempt to tax stocks and bonds to the owner has been practically abandoned, and in its place it has become customary to tax the property represented by such securities to the corporations, and to ignore the stockholder.

Many anomalies have arisen from this conflict of the theory that the property tax is a personal tax with the fact and practice that it has become a real tax. A very pretty illustration of this is afforded in the case of national banks. It will be recalled

that the national banks were established at the time of the Civil War to aid in the sale of the federal bonds, and that to induce the national banks to hold these bonds, those banks were allowed to issue notes secured by the bonds. These national bank-notes came into competition with notes issued by banks chartered by the states. To drive the state bank-notes out of the way and to thus make room for the national bank-notes, Congress imposed a tax of 10 per cent on all bank-notes except those of national banks. It had long before been decided by the courts that the states could not tax a federal bank except by express grant of Congress. It was feared that the states, if allowed to tax national banks at all, might retaliate by prohibitive or discriminating taxes. Hence Congress did not, in the first act, convey to the states the power to tax these banks. Later, however, it relented and prescribed a method, and one method only, by which the states should tax national banks. In this federal statute permitting the taxation of national banks we find embodied the prevailing theory and practice of the property tax of that period. The statute says, in substance, that the shares of stock in national banks must be assessed to the stockholder, not to the bank, although the bank may be the agent of the stockholder in paying the tax, also that the shares must not be taxed at a higher rate than is imposed on any other like moneyed capital. Then to prevent double taxation which might have arisen where the stockholder resided in a different state or town from that in which the bank was located, Congress defined the situs of the stock as in the place where the bank was located.

It is hard to trace the origin of a practice which may have sprung spontaneously in many different places from similar conditions which had to be met. But one cannot but be impressed by a reading of the statutes, and by the frequency with which the phraseology of the federal law is repeated therein, with the idea that this law has had a great deal to do with destroying the theory of personal situs. On the other hand, it has certainly not checked in the least (except so far as the banks alone are concerned) the very general tendency to regard

a corporation as an artificial person and to levy the taxes on its property without reference to the stockholders.

Assessment Day. — The time element, the date to which the assessment refers, is usually defined so as to work the practical exemption of the current products of land. Thus for the most part the assessment is made as of some day in the winter or spring, before the crops of the year have been planted and long after the crops of the year previous have been sold and taken to market, at a time, that is, when barns and warehouses are empty. This strikingly illustrates the prevailing American conception that the property tax is a tax on capital, not on income or revenue. With a sort of grim humour "All Fools' Day" is often chosen as tax day. Even in those states, mostly among those having the Southern type of this tax, which make the day to which the assessment refers fall in the autumn, the crops and produce of the year are usually expressly exempted by law.

Definitions. — The property included in the base of this tax is most commonly defined as "all property, real and personal, in the state not specifically exempt." The exemptions will be discussed below. The terms "real and personal property" are most commonly taken in their ordinary common law meaning. But this is by no means the universal rule. In many cases certain items are arbitrarily defined "for purposes of taxation" as real or as personal property. Ordinarily, land and the legally immovable physical improvements thereon are real estate. Certain rights, however, attaching to land, mortgages secured on land, and franchises over lands are arbitrarily called real estate or personal property for purposes of taxation, irrespective of their common law character. As these arbitrary definitions are not uniform from state to state, they give rise to considerable confusion. Sometimes even the following of the common law principle makes curious shifting. One of the most striking illustrations of this is the classification of possessory claims to government land and of the improvements upon it as the personal property of the settler thereon during the five years that he is acquiring his title, and before the government

patent has been issued. The census of 1890 published tables and charts which made it appear that the then "new" state of Montana had a remarkably high proportion of personal property and comparatively little real estate. This was due in large part to the above classification. The arbitrary nature of these definitions vitiates almost all direct comparisons of the statistics of assessments between different states.

It occasionally happens that for tax administrative reasons or to avoid special difficulties arising from some peculiarity of the law, very illogically arbitrary definitions are made. Thus telegraph poles and lines are defined in one state as personal property, a device intended merely to give the assessor an extra commission; again, in New York special franchises or the right to use the public streets is defined as real estate. The reason for this latter definition is that in that state each taxpayer is allowed to deduct the amount of his debts from the entire amount of his personal property, and under that law, if franchises were defined as personal property, the corporations owning them would deduct their bonded indebtedness, leaving nothing taxable on the franchise.

Occasionally certain items of income are defined as property for purposes of taxation. These instances are usually of receipts, like those from ships plying in foreign water, or insurance premiums, or brokers' commissions, which are not represented by any taxable capital in the state. This is a survival of the old personal theory of the property tax.

The classes of personal property taxable and actually taxed, at least to a limited extent, are usually household and office furnishings, stocks of goods in shops and warehouses, farm tools, machinery, and live stock. Other forms of personal property generally taxable according to law, but rarely taxed, are money and credits. The moot questions in regard to the taxation of the latter will be discussed below.

Sec. 4. **Exemptions.** — Property exempt from taxation comprises in the first place all public property, also greenbacks and federal bonds exempt by federal law. The only exception here is that in a few states public property may be included

when the apportionment of state taxes is made to towns or other assessment districts. Next in general extent come exemptions granted from religious, pious, charitable, or benevolent reasons, such as churches, cemeteries, asylums, and homes for the aged, the infirm, and widows. The breadth and extent of these exemptions varies considerably from state to state, but even in the most meagre cases includes all church buildings and cemeteries. An interesting extension of this idea is the exemption in many states of the secret societies, like the Masons and Odd Fellows, on the ground of their charities. Another very general class of exemptions comprises those for educational purposes, such as schools, colleges, and the like, usually only those endowed, also public libraries, and literary, scientific, and philosophical societies. A smaller group is composed of associations like agricultural societies, volunteer fire companies, and others doing some work assumed to be of a public character. Lastly, there are many miscellaneous exemptions granted for social or economic reasons or for reasons relating to the fiscal administration; among these are limited amounts of certain classes of personal property, as a few hundred dollars' worth of household furniture, tools of mechanics and farmers, a limited amount of land, machinery, etc., for promoting new industries for a limited period of time. But there is little uniformity among the various states with reference to this group of exemptions.

In general it may be said of the exemptions granted that, while they have, of course, been granted only to those who had sufficient political influence to secure them, they do not in any but a very few exceptional cases represent an abuse of political power. The motives were in general altruistic or for the public weal. It is, furthermore, a thoroughly well-established principle of fiscal law that, whenever, and in so far as, any such property yields any private profit, it loses its exemption.

SEC. 5. **The Assessment Roll.**—The list of taxpayers with their taxable property is usually made up annually and does not assume the form of a fixed *cadastre* in any of the states, although in some states it approaches that form slightly. The original conception of the tax, as a personal tax, is the chief

reason why the roll usually begins with the taxpayer and not with the property, and the consequent frequency of assessment prevents the roll from attaining a permanent form. In the case of real estate, however, there is here and there a provision which contains the possible germ of a *cadastral* system. In a few states real estate is revalued only once in four years, but alterations and new improvements are assessed annually. In some states the county surveyor provides maps and block books which the assessor uses as the basis of his work. But even in those states there is little permanence imparted to the roll by this practice. Two reasons for the absence of a *cadastral* system, especially in the more recently settled states and in those parts of the country which are growing rapidly in population, is the constant and frequent change in ownership of land and the rapid fluctuation in land values.

Valuation. — The criterion of value for purposes of taxation is always the selling value, and rarely the rental value.[1] The reader should remember that there is practically no tenant class in the United States, that agricultural land is for the most part cultivated by its owners, or by tenants who expect to become land owners. The annual value of the use of land is a conception rarely used in business. It is the capital value or selling value that is almost always referred to and used. Lands change hands with considerable frequency, and with great ease and freedom. How much land is worth per acre in the country and per square, or per front, foot in the cities at purchase is usually a better-known fact than rental values. While admittedly the value of land depends on the product, yet rental values, when determined, are usually computed on the basis of a percentage of the capital values rather than of the product. Assessors in making up their rolls depend upon prices paid when transfers are made, or upon appraisements, for determining the value of land, and rarely, if ever, seek any information as to rentals. This is equally true of city real estate and of farm lands. In the same way boards of equalisation in at-

[1] Delaware and New Jersey and parts of Maryland and Pennsylvania offer the necessary exceptions to prove the rule. In these old states rentals are considered.

tempting to check up the work of assessors investigate selling prices, and not rentals. In fact, the leasing of land is so rare, and usually occurs under such peculiar circumstances, that rentals never afford a satisfactory basis of valuation. According to the United States Census Bureau, only 35 per cent of the farms of the country are cultivated by tenants, but among these rented "farms" are many truck farms, dairies, nursery gardens, and florists' gardens in the vicinity of cities, which are more often rented than is agricultural land proper. Another reason why rental values are not used for taxation purposes is that in many states there are large tracts of land not under cultivation. Less than 50 per cent of all land in the United States is "improved"; that is, under cultivation, and less than three-fourths of that actually in farms is "improved." Yet the unimproved, unused land has a selling value in the market, and is taxable. In the same category fall the unimproved city lots, held for speculation.

The use of the selling value, or a capital concept, instead of the rental value, introduces an element of uncertainty into the assessment or valuation of land for purposes of taxation. A great deal is left to the discretion of the assessors; they have no mathematical rule which they can follow. In the British property and income tax, *Schedule A* is the most sure and certain group, on account of the prevalence of a universal system of leasing, and in the German states the values in the *cadastre* can be fixed with a high degree of certainty and accuracy on the basis of annual rental value or known annual produce. Nothing of that sort is possible in the United States. What is usually meant by the terms "full cash value," or "true value," is perhaps best defined as, in the terms of the California statute, "the amount at which property would be taken in payment of a just debt from a solvent debtor." It is not what would be paid by the highest bidder, nor what the property might bring at a forced sale, but more nearly what it would be appraised at in the settlement of an estate for division among the heirs. This conception is at best vague, and leaves much to the discretion of the officers. Hence it is, that in order not to err by ex-

cessive valuations, the assessors, in practice, universally fall below the true value as defined by law. In states where a heavy state tax is apportioned on the basis of local assessments, there is a further motive for undervaluation; namely, the endeavour on the part of the assessor to save money for his constituents by evading part of the state tax. The prevailing practice of undervaluation has been recognised by law in some states. Thus in Illinois only one-fifth of the true value is to be entered in the roll. But, nevertheless, undervaluation goes on just the same and the 20 per cent is computed on less than 100 per cent of the true value.

Inequalities in Valuation. — Far worse than the general undervaluations which create inequalities between districts are special or individual undervaluations. These are in rare instances the result of corruption or conscious favouritism; more often they arise from the natural inertia of the officials who do not make the roll keep pace with the changes in property and its value. Various devices have been resorted to, to obviate or lessen these inequalities. The official boards of review usually become mere umpires to decide disputes between assessors and dissatisfied taxpayers. Somewhat more successful in cities has been the introduction of a graduated scale of values in each block, the inner lots being valued according to their distance from the corner. In the West it is quite common to find a provision to the effect that unimproved land must not be valued at less than improved land of the same quality and similarly situated. This is doubtless a provision suggested by Henry George's theory.

A rather important provision, as tending to stimulate the assessor to take greater pains in his work, is that which requires that land and the improvements thereon shall be valued and assessed separately. This seems to have originated in California. It has recently been rediscovered by New York, and adopted there with great enthusiasm.

Personalty. — The assessment of personal property presents the greatest difficulties. The main difficulty is to find it. Some kinds of tangible personal property, such as cattle and animals

on farms, wagons, machinery, tools, etc., are not difficult to find, and as easily valued. In states where there are large herds of cattle, as in Nevada, it is the custom for assessors to agree upon a uniform value per head. Household furniture can as easily be found, but difficulty at once arises over values. In every state, except New York, the taxpayer is by law required to fill out a minute inventory of all his furniture and other personal property. But he frequently ignores the law, and the assessor proceeds by a sort of doomage process, which amounts usually to a guess based on the general character of the house the taxpayer lives in, his household equipment, and his general financial standing. In New York, where no statement is required, the taxpayer is allowed to appear on "grievance day" and "swear off his taxes," if he feels that the guess made by the assessors is too high. The enforcement of the statement and the reliance placed upon it vary from state to state, and even from locality to locality within each state, to such an extent that no generalisation can be made with safety. It is certainly the intention of the law that every taxpayer should file a statement of his entire property, and the penalties for failure to do so are severe. But it is equally true that this provision is not uniformly enforced, and that the vast majority of the statements filed are incorrect and incomplete. These statements usually have to be sworn to when filed, and the widespread perjury and consequent contempt of law constitute a sad and a menacing feature of the political life of the country.

SEC. 6. **The Taxation of Mortgages.** — One of the moot questions in the United States is whether credits and money should be considered property for purposes of taxation. The debate on this question has been especially lengthy in connection with mortgages, because they are usually of record, or will be reported by the borrower, so that they are more easily discovered than other credits. If we include the evanescent forms of discussion, it is safe to say that there has been far more literature on the taxation of mortgages than on all other subjects relating to taxation in the United States.

In most states a note secured by a mortgage is taxable as

property of the mortgagee, and the property which secures the mortgage is taxable to the mortgagor without deduction for the mortgage. It is obvious that this procedure rests on the old conception of the general property tax as a personal tax. The thought of the legislator is that the lender is able to pay a tax by virtue of the interest income he receives. That in most cases the lender will reimburse himself by shifting the tax to the borrower in the form of higher interest does not, in the opinion of the legislator, present any good reason why an attempt, at least, should not be made to reach the lender. The most recent departure from this rule is to impose a special tax on the mortgage of the nature of a registration tax at a rate considerably lower than would be the result of taxing it as property. The property by which the mortgage is secured is then taxed in full to the borrower. This is in substance the outcome of the long struggle in New York State. This method assumes that the holding of the mortgage represents taxpaying ability of some sort vested in the lender. It is not unlike the conception underlying the Prussian law which imposes an additional tax on funded income in the form of a property tax, even though the income from the property has already been taxed as part of the taxpayer's income. Another solution of the problem is to treat the mortgage as an interest in the property and to try to divide the burden between the two parties. This in any case avoids double taxation. In California the attempt was made to compel the lender to pay the tax by at least making him advance it. It became evident, however, that he shifted the tax to the borrower, whose last state was worse than his first, because he had to pay not only the tax but the cost of shifting as well. In Massachusetts a similar compromise was made in that the mortgage and the surplus of the property over the mortgage were assessed separately, one to the lender and one to the borrower, but these two parties were allowed to agree as to who should pay the mortgage tax. Generally the borrower assumed the whole burden with corresponding reduction in interest. This is obviously a roundabout way of accomplishing a very simple thing, hence some few states simply

ignore the mortgage entirely. Thus the statutes of Washington provide "that mortgages and all credits for the purchase of real estate shall not be considered as property for the purpose of taxation." Recently that state has extended the same principle to all credits. This latter provision simply legalises a prevailing practice, for credits other than mortgages were rarely found by the assessor.

Money and Credits. — It is the law in most of the states (Washington by recent enactment is one of the exceptions), and it is prevailing public sentiment, that money on hand, or on deposit, and credits are taxable property. But it is only in rare instances that they are taxed. Of the more usual attempts to uncover personal property of this class through the machinery of oaths, affidavits, and the like, Professor Daniels, in his work on Public Finance, says: "The effectiveness of such laws is inconsiderable. If Jove laughs at lovers' vows, he probably guffaws at taxpayers' oaths. Even the Psalmist's hasty allegation of universal mendacity needs little qualification in this province of finance. Where the taxpayer's conscience is tender, he finds (as one puts it) that virtue is perforce its own reward. This phase of the system is described in one tax report as 'a tax upon ignorance and honesty,' and in another report we are told that 'the payment of the tax on personalty is almost as voluntary and is considered in pretty much the same light as donations to the neighbourhood church or Sunday school.'"

There are two consequences of this almost universal evasion. The first is that when money is loaned under circumstances which make it at all likely that it will be found by the assessor, the rate of interest is raised above what it would otherwise be by an amount sufficient to cover the tax, together with another extra charge for the cost of shifting and attendant risk. The second is that any "ignorant and honest taxpayers" who may report this class of property are unduly taxed. It seems, then, to be futile to try to tax this class of property, and the underlying reason for the failure to reach it, and for the objection which people in general have to paying it, *is probably to be found*

in the fundamental fact that it should not be taxed at all. Although credits may be included within the term "property," from the point of view of law, they are not property in any true economic sense. Like money, credits are representative wealth.

The following citation from the report of the California Commission on the reform of the revenue system of that state explains this point: "If we take the view that the property tax should be a real tax, based upon things or property without respect to who may own them, then it is illogical to regard a credit as property. A credit is merely a right on the part of the creditor to receive and to enforce payment of the obligation due from some other person. The notes, bonds, or other documents embodying the credits merely stand as evidence of the existing contract. The very existence of the documentary proof and the phraseology in which many of these documents are couched demonstrate very clearly that the creditor himself is not in possession of the money, or lands, or the goods which secure the loan, and the transfer of which to the debtor brought the credit into existence. The creditor has only the right to receive these things, or similar things, back at some future time. If the United States government borrows $100,000,000 upon bonds, — which are merely its promise to pay, — there is a transfer of $100,000,000 in gold from the buyers of the bonds, or the creditors, to the United States treasury. The creditors who hold the bonds feel themselves no poorer than before, but no one would seriously contend that by this simple transaction the property or wealth of the country has been increased a particle. There is only $100,000,000 of real wealth involved, which has passed into the possession of Uncle Sam from that of his creditors, and which will be returned when the bonds are paid. Nor would any one seriously contend that the payment by the United States of some of its indebtedness and the cancellation of the bonds destroyed any wealth. Standing against every credit there is an equal amount of indebtedness, and the maturing of this indebtedness destroys no material wealth, nor does its creation add anything to the material wealth of the world or to the substantial property which has to bear the

burden of taxation. To consider that credits are property as well as the goods and other property by which they are secured is like adding together two sides of an account — the assets and the liabilities. To treat credits as property, and also the lands, goods, and other forms of wealth in the hands of the community, would result in an obvious duplication of values, and if taxes were levied upon that basis would result in double taxation, unless the debtor were allowed to deduct the amount of his debts in the same way that we permit him to do in the case of mortgages. But the existing laws do not usually permit that, save and except that the debtor may deduct his debts from the amount of his credits. Illustrations of the way in which the taxation of credits works objectionable double taxation might be multiplied and the argument extended indefinitely, but the above illustrations ought to be sufficient to make clear the fundamental principles involved."

SEC. 7. **Taxation of Corporation Franchises.** — As has been stated above, corporations, when subject to the general property tax, are generally regarded as legal persons and are taxed in the same manner as any other persons. A special difficulty is involved in the taxation of the so-called intangible personal property of the corporations. This class of property, sometimes called " the franchise," sometimes " the corporate excess," and often simply " the intangible property " is the capitalised value of that part of the net earnings that is in excess of a reasonable return on the amount invested in the real estate, machinery, and other tangible property of the corporations. Its value for purposes of taxation is usually obtained by ascertaining, first, the value of the real estate and other tangible property; second, the aggregate market value of the stock, bonds, and other funds representing the property; and third, by deducting the first from the second. The remainder is assumed to be the value of the intangible property. When the market value of the securities cannot be ascertained, the net earnings are capitalised in order to ascertain the aggregate value of the property. This whole process presents great difficulties and leaves much to the discretion of the assessing officials.

The legal theory is that this excess value is the value of a class of property called the franchises, conferred upon corporations by governmental authority. The courts have defined franchises as: "special privileges conferred by government on individuals and which do not belong to the citizens of the country generally by common right."[1] As these franchises are legally property, they are included in the taxable property. It is generally recognised that there are three, or possibly four, different kinds of franchises that enter into and contribute to the corporate excess. But the attempt to assess or value them separately is rarely made, and in the nature of things is not successful. Their value merges in one mass with other elements analogous to "good-will," and the only practical method of valuation is to treat them as a unit.

The first of the franchises recognised by the courts is the right "to be" a corporation, a privilege accorded to any three or more persons who associate together in the manner prescribed by law for the formation of private corporations. This franchise conveys the right to use the corporate name, to have a corporate seal, to sue and be sued, and in general to enjoy the privileges ordinarily permitted to corporations. While this franchise is theoretically included with the others in the corporate excess, it is also subject to a fee at the time it is granted and may also, together with the second, be subject to an annual fee-like tax, in addition to the taxes imposed upon it as part of the property. These charges may be uniform or they may be graduated. The second sort of taxable franchise is called the franchise "to do and to act." This is inevitably conferred at the same time as the first mentioned and is but slightly different in character. Third, the revenue laws, as interpreted by the courts, seem to recognise two other kinds of franchises, which we may call, for convenience, special and general, but they are so closely analogous as to be exceedingly difficult to distinguish one from another. These are both subject to taxation as property, and are included in the assessment of the property

[1] Such franchises are not to be confused with the right to exercise the electoral power.

of the corporations. One of these franchises requires a special grant; the other is acquired automatically under the enjoyment of the powers conferred by the general law for incorporation, and is, as will be explained below, very closely akin to "good-will." These two classes of franchises are here grouped together and treated as one class, simply because they are to be valued for purposes of taxation in practically the same manner.

The first of all to be recognised as taxable franchises were the special franchises enjoyed by public-service corporations, such as water companies, gas companies, street railway companies, and the like, which use the public streets, under some special permission. These are "special" in the sense that they have to be specifically described in each case and cannot be conveyed by general statute, and they virtually convey the right to use some public property. They are often very valuable, and that they were so was early recognised.

From the practice of assessing these special franchises there grew up the practice, which has frequently been sanctioned by the courts, of assuming that every class of corporations enjoys a sort of general franchise that is distinct from the mere right to be a corporation, or to act as a corporation. Thus banks have been taxed for their "franchises" and their value ascertained in the manner described above. While these two classes of franchises, which for convenience we have called the special and the general, are apparently, in the opinion of the courts, almost precisely alike and are treated in the same manner for the purposes of taxation, they are, from the economic point of view, fundamentally different.

The franchise of a bank, in this sense, is closely analogous to that kind of property known as "good-will." This is a class of property which presumably might be taxed as property, but which as a rule is never taxed except in those cases in which it is enjoyed by corporations, and then it is taxed as a franchise. It is a question, open for serious consideration, whether the taxation of such a franchise, tantamount to the taxation of the good-will, against corporations, while similar items of property, if this be property, are not assessed against individuals and

firms, does not constitute an unjust discrimination against corporations.

SEC. 8. **Objections to This Tax.**—The general property tax has been subjected to severe criticisms and has frequently been condemned. We may now examine the grounds on which this condemnation rests. Among many there are two of great importance. (1) It is urged that the tax is unjust because property forms no criterion of taxpaying ability. It is maintained that income is a far better basis. (2) It is urged that the general property tax is inexpedient because so difficult to administer justly, especially in the matter of the discovery and assessment of personal property and because of its effect on the movement of capital and forms of investment. Against these serious objections it is urged that when there is a tolerably just system of income taxation already in existence, a property tax in addition thereto fulfils the requirements of justice because it imposes a heavier burden on "funded" income, which is regarded as indicative of more faculty, since it is less precarious. It also supplements the income tax by making property in enjoyment, the use of which is an indication of tax faculty, a part of the base, as, for example, picture galleries. And, lastly, the comparative steadiness of the return from the property tax is a great recommendation from the fiscal standpoint. It would seem, then, that the objections to the general property tax as the main part of a system may still stand, but that there may be room for such a tax as a subordinate part of a larger system, the demands of justice being met by the proper relation between the different parts of the system. In Switzerland and Prussia the general property tax is part of a more elaborate system. In the United States it stands almost alone for commonwealth purposes, supplemented in some states by other taxes intended to reach certain forms of revenue-yielding property. The universal condemnation of the American commonwealth general property tax is therefore not due to the defects in the tax itself, but mainly to the fact that it is not properly supplemented by other taxes.

The first question that arises when the general property

tax stands alone, and a question which, although not so prominent, also arises in other cases, is: Can the method of assessment be made sufficiently effective to reach uniformly and equitably all forms of property, especially personal property? The answer to this question that has been given by the experience of the United States is emphatically in the negative. This is especially true when the administration of the assessment is left to officials popularly elected for a short term, in small districts, and by the taxpayers whose property they are to assess. It is also in the negative, but somewhat less unanimously so, when the assessment is under the control of an impartial bureaucracy appointed by some higher authority and not beholden to a local constituency. In the one case the assessor is apt to be too friendly to the assessed, in the other too ignorant of local conditions.

SEC. 9. **Scientific Judgment of the General Property Tax.**— The property tax as the sole or chief form of direct taxation has few supporters among scientific writers. So universal and unanimous has been the condemnation heaped upon this tax that we must consider in detail some of the objections that have been raised.

Professor Seligman sums up his interesting discussion of this tax in words to the following general import:

The general property tax is a failure as the main source of revenue from the triple standpoint of history, theory, and practice.

1. Historically, it was once well-nigh universal. In a community mainly agricultural it was not altogether unsuited to the conditions. But as soon as industry and commerce became important, it failed to extend so as to comply with the requirements of justice. It became, in fact, even where not so considered, a tax on real property. Everywhere but in America it has been (*a*) divided into a number of subordinate property taxes, (*b*) allowed to become a subordinate member of another system, or (*c*) entirely abandoned. Sooner or later it will have to be abandoned in America.

2. Theoretically the general property tax is deficient in two

respects. First, it assumes that there is an ascertainable general property. But since property is a composite of inseparable but widely differentiated elements, this assumption is contrary to the fact. "The general mass of property has disappeared, and with it vanishes the foundation of the general property tax." Secondly, "property is no longer a criterion of faculty or of taxpaying ability." Two equal masses of property may be unequally productive, because used by men of differing talents, and thus differently joined with the personal element, or because the possession of them may give rise to fortuitous gains, or because the owner of one mass of property may be labouring under peculiar economic disadvantages.

It is the income which property yields that is the best index of the taxpaying power which the property represents.

3. Practically, "*the general property tax as actually administered to-day is beyond all peradventure the worst tax known in the civilised world.*" As at present administered, it fails entirely to reach intangible property. It debases public morals by putting a premium on dishonesty. It is regressive and presses hardest upon those relatively least able to pay.[1]

This is strong language, — even stronger has been used.

Recent Regeneration of the Property Tax. — Against this condemnation we may set the following important considerations. As this tax becomes more a tax on things ownable than a tax on persons in proportion to their property or estates it becomes much more manageable. Thus if instead of trying to include mortgages, *choses in action*, stocks and bonds we tax the property they stand for and represent, one ground for criticism of the tax is removed in no small part. There is a very proper place in the general system of taxation for a tax, mainly local, on real estate and tangible personal property including the property of corporations as well as of individuals. If other taxes reach the signs of ability which the old general property aimed at but missed many objections disappear. Again in recent years the administration of the tax has improved. In the great cities, especially, trained assessors,

[1] Seligman, *Essays*, pp. 23–61

equipped with proper maps, and using well-nigh scientifically accurate methods have reduced the inequalities to a negligible minimum. While rural assessments are not so well administered as urban, considered by and large, yet there are whole states where under competent supervision of state tax commissions excellent assessments at approximate equality are being made. As we now see it the redemption of a large part of the general property tax is possible and in its proper place as a property tax, if not a general property tax, it may be useful for years to come.

PART 2. *Special Property Taxes*

SEC. 10. **Forms of the Land Tax.**—The *land tax* is one of the oldest contributions. It has three forms: (1) it may be based upon each unit of area, sometimes with an attempt to classify the different units as to fertility; (2) it may be based upon the estimated value of the land or upon an estimated average annual yield or surplus; (3) it may be based upon the actual yearly yield, and be as it were a share in the product. The tax was common in the latter part of the Middle Ages as a recognition of the monarch's right of proprietorship in the soil. A good example of this, among many others, is afforded by the so-called quit-rents in the American colonies.[1] In their first form these payments are not strictly taxes. They are acknowledgments of the people's tenure. But they frequently grow into taxes. In France, as we have seen, the *taille* developed from feudal dues. The *impôt foncier* now yields 200,000,000 francs. In England the old land tax has been converted into a redeemable rent charge, but the revenue from land is still taxed in the general income tax and yields £1,500,000 annually. Local taxation in most countries falls largely on land. In Prussia the land tax was in 1895 transferred entirely to the local bodies.

Economic rent as the surplus of revenues from land, after all expenses have been deducted, has always been regarded as a legitimate object of taxation. It has been strongly argued that this tax cannot be shifted. But as the land tax is not always

[1] See Ripley and Wood.

confined to rent-bearing land, being generally imposed upon all land, even the poorest in cultivation, and as modern economic theory does not regard rent as an inevitable surplus, this old argument needs thorough revision. (See Chap. X.)

It is in the assessment of this tax that the *cadastre* has been most widely used. The principles upon which the best *cadastres* have been built are the following: (1) A careful measurement of the land is made and recorded. In the older ones the land is entered in rough historical units: the "yoke," the "hide," the "seed." Sometimes the *cadastre* is intended to serve other purposes, as that of a record of titles. In any case the names of the owners or occupiers are entered with each piece. (2) A record is made of the yield of each unit of area, and from that is estimated either the gross revenue or the net revenue,—more frequently the latter. As a rule the *cadastral* revenue is less than the actual net revenue. Another method is that of recording the market value.

The *cadastre*, when finished, is subject to more or less frequent revision. A partial revision which involves the recording of changes of title, etc., is generally made currently. An entire revision is only undertaken after periods of considerable length. The making of a complete *cadastre* is a matter of considerable expense and takes no little time. In many cases more than the mere land is recorded, buildings and other improvements being frequently entered in the same *cadastre*.

It is generally urged in justification of the retention of the land tax, even in countries where there are other taxes that fall upon the revenue from land, that the income accruing from land is constantly increasing in every growing community, and that the expenditure of the government accrues largely to the benefit of the land-holders, and appears in the form of an increased value or rental. The same reasons are urged in support of a higher rate for the land tax.

On the basis of a *cadastre* the land tax is generally apportioned; less frequently it is proportioned. In general, the tax lends itself better than most others to the apportionment method. With a fixed valuation as a basis which varies comparatively little

from year to year, it seems perfectly natural and easiest to apportion the amount that it is desired to raise among the different pieces or units.

SEC. 11. **The Building Tax.** — The older forms of the land tax often included the *building tax*, with which it was closely connected in character. At present, this contribution generally forms an independent tax on the revenue from the site and the building. It is, like the land tax, a tax on a fixed source of income. Its incidence will receive special attention elsewhere.

The buildings taxed may be classified according to value, or according to the uses to which they are put, or according to their location, whether urban or rural. There are two very different forms of the building tax: one is intended to fall on the income derived by the owner from the building; the other simply taxes the occupier according to the rent, taken as the index of a certain amount of tax faculty on his part. The second is very much like a consumption tax. The first regards the revenue derived as a source from which the tax may be paid. But even this first form, when paid by an owner who is also an occupier, is very much like a consumption tax.

The building tax, wherever in use, is one of a number of other similar taxes; it never stands alone. In ease of assessment it has many advantages. The valuation is simple and inexpensive. Alterations affecting the base can be easily and accurately ascertained. Unlike the land tax, the building tax is regularly assessed each year. Hence this tax is more often proportioned than apportioned. The building tax may be extended into a sort of industry tax, as when it is assessed with higher rates upon buildings used for industrial or commercial purposes. An example of this method of assessing the business tax is that of France cited above.

SEC. 12. **Increment Value Land Tax.** — Mention was made above of the introduction in German cities of a tax on the increase in the value of lands resulting from the growth of population. Such a tax has also been used by central governments. A notable example is the tax of Great Britain, a description of which will serve to show the nature of all these taxes. The

history of that tax throws some light upon its purpose. The old land tax of 1692 was made a redeemable rent charge in 1798 and most of the more valuable land had been redeemed in the course of the next century. Most land was, therefore, by virtue of the agreement of redemption made in 1798 supposedly free from taxation in England, save and except (and the exception is important) that the rent of land might be included in taxable income, and the local rates were levied on the basis of rent paid. But there was no tax being levied on the capital value of land in 1909 when the increment value land tax was proposed. In 1909 England was in need of larger revenues, and in casting about for them Lloyd George hit upon the scheme of a tax on land. He argued that the redemption of the old land tax applied only to the value as it was in 1798 when the rent charge which might be redeemed by payment of its capital value was fixed, and that any increase in value since then was beyond the scope of the old contract of exemption. However, he proposed to tax not the increment since 1798 but only that which might accrue from time to time after 1909. His plan aroused intense opposition in the House of Lords where the land-holders were represented and led to a political conflict between the Lords and the Commons over the right of the Lords to refuse their assent to a finance bill. An appeal to the people resulted in sustaining the measure and also in what would in the United States be considered as an amendment to the constitution, although in Great Britain there is no written constitution to amend. For the Lords lost the right to veto a finance bill.

The increment value land duty was one of four taxes levied at the same time. The others were: First, a "reversion value duty," which is a tax on the increase which may be found to have occurred in the value of a piece of property which has been leased, when, on expiration of the lease, it reverts to the original owner. Second, an "undeveloped land duty," an annual tax on land lying practically idle or not used and developed as it might be. The tax was light but developed some revenue. Third, a "mineral rights duty" falling upon the annual rental value of mining rights. We shall confine our

attention to the increment value land duty alone, since the others are self-explanatory, or at least will be so when the former is understood.

The increment value duty is a tax on the increase in the value of land since April 30, 1909. It is levied on the occasion of a sale, or of a transfer occasioned by death. The base is the increase in value ascertained on the "occasion" between (1) the value as of April 30, 1909, or (2) on the second and subsequent sales or transfers each giving rise to a new "occasion" and the next preceding "occasion." To fix the value from which subsequent increases should be computed a new Doomsday Book, based on a survey and valuation of all the lands in Great Britain, was to be made. This was a gigantic and costly undertaking, as there was no such valuation of land on a capital basis in existence. The tax was to apply only on the increment in the *site value*, which was the value of the land considered as stripped of all that had been done by man to enhance its value. As nearly as may be site value is the present value of the original and indestructible characteristics of the land. Agricultural lands were exempt, partly because it was at that time believed that they were not increasing in value, but more because the tax was conceived of as aimed at land which was passing from the agricultural state to industrial or urban uses. The theory of the tax seems to be that the site value of land is due to the growth of population rather than to any economic activity of the owners and is hence peculiarly indicative of ability to pay taxes. Elaborate rules were set up for arriving at the site value too intricate to be reproduced here.

The rate was 20 per cent on the excess of the increment in value over 10 per cent of the original value. An example will show the tax more clearly than can be done by description. The site value of a piece of land was fixed in the Doomsday Book at £1000, five years later it was sold and the site value reascertained was found to be £1500. The tax would be 20 per cent of £1000 plus 10 per cent thereof, or £1100, subtracted from £1500, or 20 per cent of £400, and amounts to £80. Another period of years passes by and the land is sold again. It is

now the increase over £1500 with due allowance of 10 per cent which becomes the subject of the tax. So much of the land of England is leased and sublet that leasehold interests are often sold or inherited and so part interests or leasehold interests were subjected to the tax, as well as the interest held by the owner of the fee.

A study made of the incidence of this tax and a comparison of it with the general property tax of the United States shows that under parallel conditions the general property tax, which draws the increment value under taxation each year as long as it exists, would be many times heavier than is the increment value tax.[1] The reason for this is that the property tax is regularly recurrent each year, while the increment value tax occurs only occasionally, the owner meanwhile having the use of the full property undiminished by the tax.

This tax must not be confused with Henry George's single tax. It falls on the so-called unearned increment and was devised by a man named George, but there the resemblance ceases. The single tax would have to be on the annual value and could not be on the capital value. The single tax would have to be an annual tax and not one on "occasion."

This tax came to an untimely end. The Doomsday Book, a very costly book to write, was not completed when the war broke out. Moreover during the intervening period the revenues from this tax were grievously disappointing. The British government during the war had no time to spend on an unremunerative tax which was so costly to administer, and its collection was suspended. We are informed that in 1920 the repeal of the tax is under contemplation.

SEC. 13. **Taxation of Capital.** — The taxes we have already considered cover most fixed capital. Circulating capital also, in all of its many forms, has been subjected to separate taxes. This is as true of those countries which have the general property tax as of those which attempt to accomplish the desired results by the taxation of the various elements of revenue. How to

[1] See Plehn, "A Study of the Incidence of an Increment Value Land Tax," *Quarterly Journal of Economics*, May, 1918.

reach this kind of revenue and to make the faculty which it represents bear its share of the public burden is one of the most difficult practical problems of taxation. The chief difficulties arise from the elusive nature of circulating capital and the intimate way in which it is connected with many of the processes of industrial life. Justice and equality demand its taxation. But various pleas of expediency are against it. Capital is hard to reach, and if it is not fairly taxed, the result may be injurious to trade. There are two forms in which this tax has been applied with some effectiveness. One is that of a tax on mortgages, the other that of a tax or taxes on corporations and banks. Some results have also been attained by the attempt to tax stocks and bonds. Public stocks are especially easy of assessment. But there is an objection to taxing them when the other forms of investment escape, because of the bad effect on public credit. If it is distinctly declared beforehand that the bonds are to be taxed, their selling price is lowered. If it is not so declared, at the time of issue, and the tax is subsequently assessed, the process is regarded by the holders as equivalent to a partial repudiation of the debt, and subsequent loans are looked upon askance. When, however, all forms of revenue-yielding capital are, nominally at least, subject to taxation, this objection to taxing public securities disappears. If the tax is not to have the effect of reducing the capital value of the stock, bond, or other security, it must fall upon every form of capital. But so great are the difficulties of making it thus universal that, as a general rule, such a tax affects the rate of interest on all new investments in the taxed form. The foregoing applies only to a tax on bonds as property or capital and not to the inclusion of the interest thereon as part of taxable income in general.

Taxation of Mortgages. — Where there is a complete system of public records for deeds, mortgages, and contracts, necessary to their validity, it is comparatively easy to tax these recorded securities. Thus it is that mortgages are generally easily taxable. This, however, results in inequality if the tax is not extended beyond the recorded contracts. When the mortgage

is upon property already taxed, as, for example, by the building tax or a general property tax, the question arises whether both the borrower and the lender should be taxed, or only one, and if so, which one. An able writer says on this point, "Tax the mortgagee on the amount of the mortgage, and the mortgagor on the value of the property minus the mortgage. That is the only rational system." [1] Indeed, it would be, if every other form of capital were taxed; but when that is not the case, the result is in every respect the same as though the owner were taxed alone. Generally he pays more.

Stoppage at the Source. — Taxation at the source has been warmly recommended for reaching interest on capital; *i.e.* to have the debtor advance the tax and shift it if he can to the lender or share it with him. In the case of corporations, this method is applied to the dividends. As Bastable [2] has well shown, such a tax is a combined tax on interest and on profits, and is therefore partly outside our present purpose. The taxation of corporations is not always the taxation of circulating capital merely. Corporations often own other taxable property, — land, buildings, etc. But in the United States, one of the main objects of the introduction of taxes on corporations was to reach forms of personal property that generally escaped. The other object was, of course, to extend the general property tax to cover all property. We find that the basis of the corporation tax is, in many instances, the capital stock at its par value, or at its market value; and in a good many instances, the bonded indebtedness is also included. When the nature of the business is such that the capital stock and bonds do not represent all the capital concentrated in the hands of the corporation, as, for example, in the case of banks and insurance companies, then the business transacted, the gross earnings, the dividends, or the net earnings become the basis. But no clear line is drawn between the taxation of interest and profits, so that corporation taxes often approach, in character and operation, business taxes.[3]

[1] *Political Science Quarterly*, V, 35. [2] P. 422.
[3] See Seligman, *Essays*, Chaps. VI, VII and VIII.

SEC. 14. **Post-war Capital Levies.** — In countries where an income tax has been long established, suggestions are sometimes made for an additional tax on capital. When these proposals take on a definite form they look very much like the property tax as used in the commonwealths of the United States. After a great war when the government is confronted with the problem how to dispose of or carry a great debt, it is natural to canvass the possibility of an immediate discharge of the debt by making one great effort or sacrifice, and thus gain freedom from subsequent, heavy annual debt charges. This idea is old, and was entertained by Ricardo. On the whole, but with some notable exceptions, economists find the objections to a heavy capital levy or property tax very strong, the main one being that the regular tax system is or should be designed to place an adequate and equitable tax on all classes, or to reach in due measure every form of ability to pay. If it does this there seems to be no justice in singling out one class, the property owners, for an additional and heavy contribution. Yet the proposal draws strength politically from the very fact that it is discriminatory, and is class legislation. The situation is that during the war the heavy tax burden is distinctly felt by all classes, and the more numerous small taxpayers are naturally much incensed by the fortunes made by " war profiteers " some of which are very conspicuous. The labour party, when there is one, finds in such fortunes glaring evidence of inequality. That the smaller and even the large older fortunes have been greatly diminished by war taxes and war sacrifices is not so conspicuous a fact as the extravagance of the *nouveaux riches*. But quite aside from the passions of classes and the interplay of political forces, there are questions of expediency and " immediate necessity " which have led to serious consideration of heavy, one time, capital levies. Thus in Germany when the paper mark collapsed and funds for the support of the new tenor, the *rentenmark*, were needed the capital levy seemed the most expedient way out.

The forms which the proposals for a post-war capital levy took were numerous and varied, though few were enacted. But the theory of these proposals brings out so clearly some of

the principles of taxation that it is well worth while to consider them. We shall not consider those which were in the main a recommendation for one or two years of extremely heavy taxation, raising for a time only every tax to a very high limit and adding, where such a tax did not exist before, a tax on capital assets not fully taxed by the existing system. Such and any other heroic measures have obviously much to recommend than if the community is willing to stand the strain. But the chief interest is in the proposals to levy a tax of say twenty-five per cent for a single year on all property. The first question is how can such a tax be paid. Since invested capital yields on the average not much over a 5% annual return, such a tax would equal five years income or be the equivalent of a 100% tax on income for a period of five years. It couldn't therefore be paid out of income. If the afflicted taxpayer resorted to borrowing he would have to negotiate a loan which would absorb one-fourth of the income of his property in perpetuity. If however he sold one-fourth of his property at the time of the levy, he would be forced to sell at a sacrifice because many others would be selling also to meet the tax, and buyers themselves probably liable to a tax, would be few compared with the sellers. Hence we find suggestions that the government take stocks and other properties in lieu of money in payment of the tax and sell them as opportunity offered. In early days in the New England colonies taxpayers were allowed to pay taxes in cattle and corn. This turned out badly because the cow the tax-collector got was often lean, dry and old and the corn mouldy. Possibly the property taken in under the capital tax levy would be of poor quality. The most practical suggestion was to levy the tax in one year and spread its payment over several. The government in a measure thus furnishes part of the credits which the transaction involves.

What many of the advocates of the capital levy overlooked is the tremendous difficulty of assessment and valuation. In the United States we have had some two hundred years of experience with the valuation of property for purposes of taxation. We have a large staff of trained assessors some of whom have had long service and experience, and full office equipment of

maps and records acquired at no small cost. Back of each valuation made this year lies, for most pieces of property, a number of years of tested values to go by. How then could a country which had none of the means of assessment create them in a single year?

The experience of Germany gives us some light on capital levies so-called. To raise a fund to support the new currency, and to pay the reparations Germany passed in 1924 an emergency tax law of the most drastic sort; included was a tax of 1% quarterly of the value of all land holdings, or a 4% real estate tax of presumably short duration. As we find in the United States that the property taxes average about 1.8% per annum permanently, a 4% tax for one, two or three years only does not appear unmanageable. No new assessment or valuation was made but some old valuations for another purpose were accepted temporarily. The understanding was that when time permitted a new valuation would be made. A temporary expedient was resorted to similarly to tax industrial and mercantile capital; but here instead of a valuation, the difference between turnover and cost, or gross receipts less wages and other operating expenses was used as the base. The aim was 2% per quarter of that net income which supported the capital investment or 8% of the net income of the year. In wholesale trade and other businesses where the margin of profit was not fairly represented by the difference between turnover and wages plus maintenance, the rates were reduced in some cases as low as to one-tenth of 1%. Again the understanding was that a revaluation or adjustment would be made later. Unfortunately for the taxpayers when the time came round at which adjustment had been promised the government decided that the payments made would have to be regarded as a final settlement. Those who may have paid too much had to accept the situation and regard the payment as a patriotic contribution. It will be observed that these rates are moderate compared with the 25% levy advocated in England. But the yield was larger than the advance estimates and the experiment has been regarded as wonderfully successful from the government point of view, if not from the taxpayers'. The whole

proceeding has some of the aspects of the ancient *beden* or *aides* (see page 55).

Inheritance Taxes

Sec. 15. **The Nature of Death Duties.** — The group of taxes levied on the occasion of the death of a property owner are commonly called inheritance taxes or death duties. They have become of great importance during the last half century.

Inheritance taxes are revenue measures and as such rest on the same principles as do any other taxes. But it is generally felt that they have also another basis. This basis was well stated by Mr. Justice McKenna of the United States Supreme Court in 1897 when he said: "The right to take property by devise or descent is a creature of the law, and not a natural right — a privilege, and therefore the authority which confers it may impose conditions upon it." [1] Similarly Sir William Harcourt said, in Parliament, when he introduced a bill revising the British death duties in 1894, "Nature gives a man no power over his earthly goods beyond the term of his life; what power he possesses to prolong his will beyond his life — the right of the dead hand to dispose of property — is a pure creation of the law, and the State has the right to prescribe the conditions and the limitations under which that power shall be exercised."

It does not, however, follow from this that the "limitations" or "conditions" which may be imposed should wholly or largely destroy the privilege of succession. The right of inheritance as it stands in most countries today serves the following purposes. It encourages thrift and the accumulation of capital. It enables provision to be made for dependents, the wife, children and others. It serves to establish continuity in business. Without it, so it is thought, saving would be discouraged, many more persons would become a public charge, and society would suffer an interruption of business after every death greater than the unavoidable interruption resulting from death.

Sec. 16. **Arguments in Favor of Death Duties.** — A conference held in Washington, D.C. in February 1925, of delegates

[1] Magoun v. Illinois Trust and Savings Bank, 170 U. S. 283, p. 288.

appointed by the governors of the several states to consider certain conflicts of laws in this field of taxation in the United States characterised inheritance taxation in one of its resolutions as "this fundamentally sound form of taxation." Among the arguments by which such an opinion may be supported are the following: (1) The legal, social-political arguments, which have been stated above in the language of the United States Supreme Court and of a distinguished British Statesman; (2) On the purely fiscal side, these taxes yield a large revenue. They can be and are collected with small expense. An inheritance, while not in all cases an unexpected windfall, is evidence of a sudden accretion of ability to contribute to the support of the state. Furthermore, this ability comes into being at a time when, owing to the unavoidable circumstances attendant upon the transfer of the property to the heir or legatee, some at least of the property is likely to be put into liquid form. Hence, provided always the rates are moderate, the tax falls on an occasion when it is relatively easy to pay it.

Counter Arguments. — Against the social-political argument, answer has been made that inheritance and even bequest is a sacred or natural right, not to be interfered with or limited at all. It is again argued that the tax discourages thrift and accumulation and hence is socially destructive. It has also been argued that the tax is paid out of capital and then, being spent by the government as if it were income, just so much capital is dissipated and the country becomes that much poorer.

Whether inheritance is a natural right or a "creature of the law" is a matter of opinion. But a moderate tax does not destroy the right or the privilege. The force of the argument as to the dissipation of capital depends largely on what is meant by capital. Whether the individual heir or legatee pays the tax out of his capital, that is by sale of assets, or out of income, he is obviously worse off than if he had no tax to pay. But if he pays it out of income his assets will continue to bear fruit. Even if he sells a piece of land to pay the tax, the land is still a productive agency for society although in other hands. This is again, from the practical standpoint, a matter of rates and mode of

collection. It is true that where the rates have been excessive, and the mode of collection so harsh as to force into liquidation business concerns which would have survived under reasonable treatment, both an individual and a social loss is inflicted. Finally, unless the funds obtained are wasted by the government, which surely is not always the case, they are spent for the benefit of all of us including the heirs, and sometimes to great social advantage.

The weight of these counter arguments is heavy only when these taxes are too heavy according to the recognized principles of sound taxation.

SEC. 17. **The Base and the Rate Structure.** — Some of the earliest of these taxes were an outgrowth of the fees and charges for probate procedure, or for the legal authority to take and succeed to the property. There are still many fees collected by the probate courts for their services. But in most countries today the death duties proper are pure taxes.

There are two ways in which the base is defined. In one case the base is the entire corpus of the estate of the decedent. In this case the tax is appropriately called an estate tax. In the other case the base is each share taken by the heirs or legatees out of the original estate. Such a tax is appropriately called a successions tax. The distinction is of considerable importance.

The Estate Tax vs. the Successions Tax. — To illustrate the difference between the two fundamental forms of death taxes we may imagine the case of a man who dies leaving property worth a million dollars. He leaves, let us suppose, one hundred thousand each to two children, another one hundred thousand each to a nephew, to an old friend and to a charity, and the remainder to his widow. If the tax is of the form of an estate tax, the amount of it is computed on the million dollars' worth of the property regardless of who is to receive it. If the tax is 15% then assuming that each of the specified $100,000 bequests is paid in full the widow gets only $350,000 and in effect bears the whole tax. If, however, he has foreseen this possibility and so arranged in his will that each bequest shall be a specified fraction of what is left after the taxes are paid each would receive his or her share

of the $850,000 in the proportions provided, or in the example $85,000 would go to each of the five named beneficiaries and $425,000 to the widow. The rate might, of course, be progressive with the size of the entire property. That we shall consider below.

If however the tax were a successions tax, we would find in the law possibly some such provisions as these. First, the widow and children would be allowed a so-called exemption of, say, $25,000 to the widow and $10,000 to each minor child, the nephew, an exemption of perhaps $2,000 and the friend and the charity no exemption at all. The rates might be 1% on the excess over their exemptions for the widow and children, 5% on the excess over his exemption for the nephew and 20% on the other two. There would probably be found also a progression in the rates according to the size of the shares. But that we may omit here as it will be taken up under rates below. The point is that under the successions tax, the tax is made lighter or heavier for the different class of heirs or beneficiaries. Under the estate tax, unless it be partly a successions tax as well, the law makes no distinction between the classes of heirs.

At first sight it appears rather reasonable, in fact quite attractive, to use the successions tax, and levy low rates with large exemptions on those near and dear to the deceased, with high rates on collateral heirs and still higher rates on strangers to the blood. In fact many an inheritance tax began with a tax on collateral heirs and strangers only, letting all direct heirs go scot free. Admittedly the theory of the successions tax is sound because it permits of an adjustment of the rates to fit the theoretical aims or intent of the institution of inheritance and bequest. A large number of modern death duties are successions taxes.

But practically the distinction is of no great significance, and since as we shall see in a moment the successions tax involves many complexities of administration and of law, the estate tax form is more satisfactory. In the first place a man who consults the inheritance tax law, especially if he takes expert advice thereon, will naturally in either case figure out how much the

taxes are going to be in the aggregate, and make such provision in his will as to result in carrying out his wishes as to the disposition of his property less the taxes so as to give to each beneficiary what he wishes each to have, not what perhaps the lawmaker imagined, in his elaborate scale each class should have. Thus the classification of heirs in a successions tax law works as intended only in the case of intestate estates or where a will has been drawn without consideration of the death duties. Since these two cases however include a very considerable number of estates and especially include those who are unable, or unwilling, to take care of their affairs properly, there is still some reason for looking with favour on the successions tax. This reason is however largely offset by some other practical difficulties, not involved in the estate tax.

Some of these other difficulties may be shown by an example. Let us go back to the man in our previous illustration who left a million dollar estate. He might, not unnaturally, leave the bulk of his estate to his widow for her lifetime in trust for the children, giving them only small amounts to begin with. Then under the successions law each of the children is held to receive at once in addition to his or her immediate share "an estate in expectancy," and the mother's share is less in value by a like amount inasmuch as she has only a "life interest." He might also, not unnaturally, bethink himself that one or both of the children may die before their mother does and wish in that event to pass some of the property to a nephew or to a niece or some other relative. But since he could not know which of several might be living when the time should come, if it ever did, he would be very likely to give his wife "a power of appointment" to select which nephew or other of several relatives he has in mind should succeed to the fortune. This "power of appointment" obviously carries another "estate in expectancy," namely that of the heir to be appointed, vesting temporarily in the widow. These various interests, shares, or estates whose names are in quotation marks above and some others not mentioned may take on a multitude of forms. The calculation of their values is often a matter requiring the assistance of trained

actuaries. Hence to direct the tax administration the law necessarily goes into a multitude of details and becomes filled with legal phraseology understood only by the legal profession. Indeed such is the ingenuity of testators that some contingent or future estates are created, the present or taxable value of which defies calculation.

It was in view of these complexities and obscurities and the practical difficulties to which they gave rise that the "National Committee on Inheritance Taxation" of 1925 recommended that the estate tax with liberal exemptions to dependents should be substituted for the successions tax. The Committee said:

"In the first place there is an obvious advantage of simplicity in the estate tax. In administering it no questions need be raised as regards the situation of the several beneficiaries. The schedule of rates is greatly simplified. The tax may be immediately computed as soon as the amount of the net taxable estate is determined. This means usually a material saving in time and expense both to the estate and to the government. Under the estate tax it is relatively easy for the testator to determine in advance the total tax burden upon the estate and so to carry out precisely his intentions as to the net amount which the several beneficiaries are to receive." It added: "If liberal exemptions are made in behalf of direct heirs and dependents, a fairly high rate of tax above the exemptions will not seriously interfere with the testator's plan to make suitable provision for those dependent on him."

The spread of community property laws, such as those in which the wife possesses a full title to one-half of all the property acquired by the family during marriage necessarily affects the revenue the government will obtain from the inheritance taxes. This is true not only because only half the joint estate is taxable on the occasion of the death of the husband or wife, but also because the tax rates are usually progressive so that half of an estate is taxable at lower rates than the whole would be. Thus if in the example at the end of this chapter, we assume that the $1,125,000 of which Ann Smith's husband had the disposition was only one-half of the community property, the total estate

of both man and wife would have been $2,250,000 and the total tax, assuming no community property and that she took by bequest an additional $1,125,000, would have been $168,750 more than shown.

The Rates. — These taxes are usually progressive. Where they are based on the distributive shares, as in the successions tax, they are progressive in two ways, once with the size of the share or the amount passing to a given beneficiary, and again with the remoteness of the relationship of the beneficiary to the deceased. Estate taxes can, of course, be progressive in one way only, that is by the size of the estate left by the deceased. If as is suggested above an exemption be granted in an estate tax to the direct heirs and dependents, a sort of two-fold progression is set up in fact but the rate schedule *per se* is still simple. Progression based on relationship is justified first by the fact that a man does not ordinarily cherish the privilege of bequeathing his property to a stranger to the blood as highly as he does that of leaving it to his wife, his son or some dependent. Secondly, looking at the matter from the point of view of the heir or recipient, a bequest from a distant relative or from a stranger to the blood is more of a windfall than is a direct inheritance, and one feels the tax less in consequence. Again, the direct heirs have in many cases been living on the property and in expectancy thereof and the accretion of ability to pay is less than in the case of a collateral heir or a stranger to the blood.

The forms taken by the rate schedules of the successions taxes are numerous. The main features only can be presented. The heirs or legatees are divided broadly into three main classes: (1) Direct heirs, including the spouse. They may be in the ascending line as father, grandfather, or in the descending line as son, grandson. Adopted children are usually included. Other dependents are not, so far as I am aware, recognized. But the achievement of a workable definition for them in the income tax law makes it possible to do so. (2) Collateral heirs, to all degrees of relationship. (3) Strangers to the blood. Brothers and sisters, with nephews and nieces, are often placed in a preferred class among the collaterals, sometimes more degrees of relation-

ship are mentioned. But usually collaterals beyond the degree of second cousins are rated as are strangers to the blood. The widow is again usually put in a preferred class among the direct heirs as are also the minor children, not so often by lower rates as by a larger free or exempt estate or by larger abatements. Thus the widow may receive a deduction of $25,000, while the son or daughter gets only a $10,000 deduction and other direct heirs still less. The exemptions or deductions granted to the other classes are usually less and diminish as the relationship to the deceased grows more distant. At the end of this chapter there will be found a table, based on the California inheritance tax law, a typical successions tax, showing possibly better than could be done otherwise how the double progression is worked out; and to make the illustration doubly clear an example of a hypothetical case is set forth showing just how much the taxes would be, and how they are arrived at.

Evasion and Avoidance. — There are many ways in which an inheritance tax might be evaded or even legally avoided. If a man gives away his property during his lifetime he may avoid the tax. He may by various tricks and devices, taking on perhaps falsely the aspect of a sale, or perhaps even a loss, so place his property that his heirs may take possession without probate proceedings. To prevent avoidance the law usually provides that gifts *inter-vivos* made "in contemplation of death" are taxable just as they would be if made by a will and consummated after death. Whether a gift is made "in contemplation of death" is hard to determine. So the law sometimes provides that any gift made within a given period prior to death shall be construed to be taxable. A form of avoidance permissable under most inheritance tax laws is to carry insurance in favor of and in the name of the beneficiaries. Unless the law specifies to the contrary such policies are not part of the taxable estate, being technically property of the beneficiary.

The Frequency of the Occasion. — Inheritance taxes are levied "on occasion," that is when death occurs. If several deaths in one family occur in quick succession the recurrent taxes may make a serious inroad into a fortune. Some tax laws recognize

this and provide that the same property shall not be taxed more than once in three or five years.

Life Insurance to Pay the Inheritance Tax. — Where an estate or successions tax has been long established and there is no prospect of its repeal, well-to-do men sometimes provide for the payment of the tax by carrying life insurance. The chief advantage of this is that it provides cash with which to pay the tax and makes it unnecessary to sell, possibly at a sacrifice, any of the assets of the estate. In England such use of insurance is said to be more common than it is in the United States although growing in favor in the latter country.

SEC. 18. **British Death Duties.** — In 1894 Parliament made a fairly complete revision of the British death duties. The older ones were fees for probate and for gifts *inter-vivos* in both cases large enough practically to constitute taxes and a legacy duty on bequests of personal property only. There was also a "settlement estate duty" where the devolution of property was "settled" or determined by agreement or trust for possibly many generations to come. The change made in 1894 was to establish a tax known as the "estate duty." This is levied on the entire estate, real or personal, settled or unsettled passing on the death of its owner.[1] The law, especially as to the rates, has been revised several times. In the law of 1894 the rates progressed from 1% on estates between £100 and £500 to 8% on estates over £1,000,000. In the revision of 1919, the 8%, the old maximum, was reached on estates between £25,000 and £30,000 and the schedule rose to 40% on estates over £2,500,000. These high rates were the result of the war.

Consideration of consanguinity is given by an additional tax known as the "legacy and succession duty." This may be described as a tax on the beneficiaries. The "legacy" duty is levied on all movable property not "settled"; the "succession duty," on "settled" movables wherever situated if under British

[1] British property law, including the laws relating to "settled estates" seem very complicated to one not to the manner born They have been recently reformed. A good reference on the "estate duty" is J Webster-Brown *The Finance Acts 1894–1919*, so far as they relate to the estate duty and to other death duties, 4 ed. London, 1921.

control, and on all unmovable property in Great Britain. The rates are for husband or wife, lineal descendants or lineal ancestors 1%, brothers or sisters and their lineal descendants 5%, all others 15%. A relief or exemption of £15,000 is allowed those who are subject to the 1% rate, if the property is subject to the estate duty. The yield of these various duties amounted in 1924–25 to £56,000,000.

SEC. 19. **Inheritance Taxes in the United States.** — 1. **The Federal Taxes.** — The federal government in the United States has resorted to death duties on several occasions. From 1789 to 1802 there was a stamp tax on inventories of estates, receipts of legacies, and on probates of wills and letters of administration. From 1862 to 1870 there was a "legacy tax" and a "successions tax" together with stamp taxes on probate documents. The legacy tax was on personal property and was graduated according to kinship. The successions tax, imposed in 1864, covered real estate. In 1898 an inheritance tax was imposed which lasted only until 1902. Finally we have had since 1916 a federal estate tax which during and just after the war was a large source of revenue, the rates having been raised to a very high point.

The federal inheritance tax of 1898 gave rise to much discussion both as to the advisability and purposes of such a tax and as to its constitutionality if a federal tax. This tax was at first administratively interpreted to be an estate tax, the phraseology of the law not being as clear as need be on that point. But in the famous case of Knowlton vs. Moore (178 U. S., 41) the court held it to be a successions tax, and constitutional. By implication the court's argument seemed to make an estate tax unconstitutional.

The constitutional question involved was this. Under the federal constitution all laws relating to property rights and in regard to the devolution of property are among the powers reserved for the states. Congress may not deprive the states of the power to establish property rights, the mode of succession thereto, and of bequest, nor can it limit or abridge those powers. The power to tax is the power to destroy. If by taxation, so it has been argued, Congress takes away a part or all of the value of

the property left by a decedent it takes the kernel of the state's power and leaves the shell only. Moreover, when a man dies his property passes for a time into the custody of the state in its probate courts, and from there goes by decree of the state to the rightful heirs. The argument in Knowlton vs. Moore was that the tax was an excise tax on the transfer or right to receive the property, after the state by the exercise of its powers had established the right. Now an estate tax may be conceived of as falling on the entire estate at the moment of death, or while in custody of the state. It seems to have no reference to the taking of shares by the heirs or legatees and hence is not on the transfer. Perhaps it is a fine distinction that is here involved. But the present federal estate tax was a war measure involving large sums which it would obviously hurt the government to refund, and the constitutional question has not been before the court in a manner to call for an emphatic decision.

Whether or no the estate tax is technically constitutional, the argument that this whole field of taxation should be reserved for the states has had wide influence. The spirit if not the strict letter of the constitution seems to be violated. Moreover the states need this revenue, the inheritance tax fits into their revenue system, and there are other taxes which the federal government can use to better advantage and administer more easily. The imposition of both a federal estate tax and a state succession tax often makes the death duties very heavy.

2. **State Inheritance Taxes.** — The description of a successions tax as given above fits fairly well the inheritance taxes of the various states in the United States. There are a few states[1] which levy an estate tax, and a few which have no inheritance tax at all.[2] The rates are moderate for direct heirs, but run up to 40% in a few cases in the upper brackets for strangers to the blood.

Several sets of difficulties have arisen: (1) from the failure of the states to arrive at a proper recognition of interstate comity, and from the attempt to include in the taxable property all that

[1] In 1925, Mississippi, New Mexico, Oregon and Utah.
[2] In 1925, Alabama, Florida and Nevada.

by any construction of the law might come within the jurisdiction of the state; and, (2) from the complexities of administration. Double and treble taxation of the same property by different states has been common and in some instances as many as twelve states have taxed the same estate. Proceedings to clear the estate even when no tax is payable are often required.

Residence is often difficult to determine. Two or more states may claim the decedent as a resident. The old principle of law that *mobilia sequuntur personam*, movables follow the person, has been appealed to, to give personal property a situs for taxation at the domicile of the owner. Yet many states while asserting this principle on the one hand have attempted to give movables a physical situs as well. Recently the courts have done something toward abolishing these conflicts of jurisdiction. The following rules now prevail, with exceptions as noted.

First. Real estate is under a decision of the Supreme Court taxable only in the state where it is situated whether the deceased owner resided there or not. This is as it should be. But some states have tried to assert a principle of "equitable conversion" and said in effect that when real estate belonging to one of their residents located in another state was sold or converted into property of the heirs, the value of the real estate came under the tax law of the decedent's home state. This practice is generally regarded as bad if not illegal, and will probably not continue.

Second. Tangible personal property located in another state was often taxed by both states. But in the case of Frick *vs.* the Commonwealth of Pennsylvania decided June 1, 1925 it was held that tangible movables, in this case mainly works of art, were taxable only in the state in which they were physically present. This probably eliminates double taxation as to such property.

Third. Intangibles, notably shares of stock and bonds, have been subject to several great abuses. We may illustrate by shares of stock. The state in which the decedent dies, claims of course full taxability of the shares of stock owned by him. But the state in which the corporation was chartered usually claims a tax also, because the shares cannot be transferred save under its laws. Finally some other states in which the corporation

does business claim a tax also. To illustrate by a *reductio ad absurdum*, suppose every state had all these rules. Then if a resident of Maine died owning Pullman car company stock, his heirs might have to pay inheritance taxes on that account as follows: (1) In Maine on the entire holding; (2) in Illinois where the head office of the company is, on the entire stock held; (3) in each and every state in the Union, on that part of the entire stock holding which the cars operated in each state bears to the whole number of cars operated. Of course the situation actually is not so extreme. But in some cases estates have had to be cleared of inheritance tax liability, either by paying the tax or showing that none was due in as many as twenty-two states. More annoying possibly than the taxes themselves which were often small or even nil, was the necessity of instituting proceedings in many states. In some cases the law provided that an attorney must be employed to secure the release even though no tax were due.

In a very recent decision the United States Supreme Court has held that merely doing business in a state or having property therein by a corporation is not sufficient ground for an inheritance tax on the stock of a foreign corporation owned by a non-resident.

By a sort of treaty or mutual understanding in interstate comity several states have agreed to a reciprocity provision of law, to the effect that they will impose only a small tax on shares of stock in their own corporations held by decedents in such other states as have a like provision and what is perhaps more important will give speedy release of tax liability.[1]

SEC. 20. **The Ideal System for the United States.** — Several principles as to inheritance taxes seem fairly clear.

First. These taxes should be substantially uniform wherever the flag flies. There is no good reason why the estate of a person dying in one state should be exempt or lightly taxed and that of one dying in another state be heavily taxed. This suggests, in con-

[1] In 1925 the states having these reciprocity arrangements were Connecticut, Massachusetts, New York and Pennsylvania. New Hampshire and California have a flat rate without reciprocity.

nection with what has gone before, that federal control looking toward uniformity might be desirable. Some careful thinkers, like Professor Seligman, have urged that the federal government levy and collect all inheritance taxes and distribute the revenue among the states on some rule of apportionment. State jealousies as well as the absence of a clearly equitable method of apportionment have prevented thus far the realisation of such an ideal. In the 1926 federal estate law a rebate on the tax due the federal government is made to each estate of the total amount of the state inheritance taxes paid up to 80% of the federal tax. Hope has been expressed that the states will so limit their taxes that they will come within this limit, in which case the federal tax would be the maximum in all cases. If this effect follows uniformity may result, and may continue if as may be hoped the federal tax is ultimately repealed.

Second. The rates of these taxes should be stable, seldom changed and moderate. These taxes cannot be used as the variable element in the tax system for equalising revenues and expenditures for they vary with the deaths and size of the estates. There is no reason why an estate falling in this year should be taxed at a different rate from one next year. It is highly desirable that a man can forsee the tax his estate will have to bear.

What constitutes moderation in rates is hard to determine. But the following points seem clear: (1) The tax should never reduce the amount passing to the family and dependents below what is necessary to prevent them from becoming a public charge. (2) The rates should not be so high as to stimulate avoidance and evasion. (3) The rates should not be so high as to cause forced sales of assets, or liquidation of going concerns. (4) The tax should trench as little as possible on capital. It has been suggested that the maximum tax should not exceed three years income, or if we consider 5% a fair annual return the maximum would be 15%. With exemptions to the widow of, say, $30,000, to children and other dependents of $10,000 each, and rates on the excess over the exemptions beginning at 1% and rising gradually to 15% or 20% on, say, all over $15,000,000 it

would require a very large estate to reach a total for all brackets combined which would exceed 15%.

Third. On account of its simplicity an estate tax with either a flat exemption which would cover the amount necessary for dependents, or with exemptions of fixed amounts for each of the members of the family, is preferable to the complicated successions taxes now used.

Fourth. Multiple taxation of the same property by several states, and all unseemly rivalry either to grasp all the taxes in sight, or to lure settlers by exemptions or privileges which have no other foundation than to gain an advantage over other members of the brotherhood of states, should cease. The aim should be interstate comity, uniformity, and equity.

SEC. 21. **Administration.** — There are a few other features of the inheritance taxes which may be briefly mentioned. These taxes are strictly taxes "on occasion," and the occasion is beyond administrative control. The yield is irregular and cannot be entered in a budget preëstimate save by guess.

Owing to the necessity for legal sanction for the passing of property, the administration of the tax is largely bound up with the courts, and becomes a part of probate procedure. But the probate judges are not ordinarily versed in taxation. For protection of the revenues the tax administrative authorities have to enter in and especially to take part in the fixing of valuations. A valuation sufficiently accurate to satisfy the court that each heir or legatee receives his due share is often woefully inadequate to protect the revenue of the government. A probate court is not necessarily concerned at all with the *value* of the property which passes to the residuary legatee. But the tax administration is. Hence inheritance tax appraisers are required, working under the supervision of the regular tax department.

It will serve to clarify the description above if we give a concrete example. The following tables give the California classes and rates and an illustration of their application.

The following example will indicate the proper method of computing the tax, under the above schedule of rates.

CALIFORNIA INHERITANCE TAX LAW, 1915

Rates and Exemptions

Classification or Indication of Relationship	Property Exemption	Application of Rates to Value of Inheritance or Bequests						
		On excess after deduction of exemption from $25,000	$25,000 to $50 000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $500,000	$500,000 to $1,000,000	In excess of $1,000,000
		Per Cent	*Per Cent*	*Per Cent*	*Per Cent*	*Per Cent*	*Per Cent*	*Per Cent*
Husband, wife, lineal issue, lineal ancestor, adopted or mutually acknowledged child.	Widow or minor child, $24,000. Others, $10,000.	1	2	4	7	10	12	15
Brother, sister, or descendant of either, wife or widow of a son, husband of a daughter.	$2000	3	6	9	12	15	20	25
Uncle, aunt, or descendant of either.	$1000	4	8	10	15	20	25	30
Other degree of collateral consanguinity, stranger in blood, body politic or corporate.	$500	5	10	15	20	25	30	30

EXAMPLE

Name and Relationship	Inheritance or Transfer	Computation	Tax	
Ann Smith, widow	$1,074,000.00			
		$24,000 exempt		
		1,000 at 1%	$ 10	
		25,000 at 2%	500	
		50,000 at 4%	2,000	
		100,000 at 7%	7,000	
		300,000 at 10%	30,000	
		500,000 at 12%	60,000	
		74,000 at 15%	11,100	
				$110,610.00
Henry Smith, adult son	30,000.00			
		$10,000 exempt		
		15,000 at 1%	$150	
		5,000 at 2%	100	
				250.00
Janet Smith, sister	10,500 00			
		$2,000 exempt		
		8,500 at 3%		255.00
William Smith, uncle	8,000.00			
		$1,000 exempt		
		7,000 at 4%		280.00
Ernest Harmon, stranger	2,500 00			
		$ 500 exempt		
		2,000 at 5%		100.00
Value of estate	$1,125,000 00	Total tax		$111,495.00

CHAPTER IX

PERSONAL TAXES: THE POLL TAX AND THE INCOME TAX

SECTION 1. **Poll or Capitation Taxes.** — The simplest form of personal taxation is the collection of an equal contribution from each subject by a poll or capitation tax. Such a tax cannot be large, because if it were it would impose a burden beyond the ability of the poor to carry. A poll tax by itself can rarely be made to yield sufficient revenue for the support of the government. A uniform *per capita* tax standing alone is not just unless all wealth is equally distributed, and only in very primitive communities is such equality of wealth found. Hence it is that the poll tax now possesses little more than an historical interest.

In the United States the poll tax has been extensively used in the past. It is now being slowly but steadily abandoned. Only ten years ago it was found in some form in nearly every state in the Union. To-day, 1926, its use is actually prohibited by constitutional law in some states. It began as a distinct commutation for personal services which were originally required of the citizen, such as work on the roads, service in the militia, or special services for schools.

Its use as a road tax is interestingly illustrative of the thought underlying its adoption. In the beginning work on the roads was considered to be a duty in which every one should share. So every able-bodied man was expected to turn out with pick and shovel, or to bring his team, and to work. But of course there were some who wanted to be excused, or whose soft hands or weak backs were not effective. These were allowed to pay for substitutes. If on the average it took, say, two days' work

by each able-bodied man in the community each year to keep up the roads, then two days' pay of common labor would be equivalent in money, as commutation of work. In some such way were the rates fixed. As time passed better roads were needed, and work on the roads like every other kind of work became specialized. The roads required continuous care. Working on the roads ceased to be demanded as a common duty. Meanwhile some citizens had grown wealthy and it seemed fair that they should pay more than others. So while the old tax remained, the large new costs were met from the general taxes.

Again, in the days when the "school marm boarded round" first with one family, then with another, it seemed quite natural to collect a poll tax to raise money for her meagre cash salary This tax was aimed primarily at those who did not contribute in other ways as by board to keeping the schools going. Hence the school poll tax. When, again, voluntary service in the militia was the "proper thing," it seemed quite natural to say to those who stayed at home and would not drill, You shall pay something in commutation of this public service. Then we had the military poll tax.

But the commutation idea was not the sole origin of the poll tax. Quite frequently the poll tax was aimed broadly at those who having no taxable property "ought to pay something anyway." So it became in the end a widely accepted doctrine in democratic communities that every one should pay a uniform poll tax to start with and more if some other test showed he could do so. On some such theory also rested the poll taxes directed specifically at certain classes of aliens.

Still another type of poll tax had its origin in a sort of fee. This may be illustrated by the typical instance of the California hospital poll tax. During the gold rush many men arrived in San Francisco ill with diseases contracted during the long voyage. A hospital was needed. What more natural than to charge every passenger a hospital fee or poll tax? To insure collection the steamship had to pay it, but it was, of course, collected by the steamer as part of the fare. But sick men with

no friends to care for them turned up in every county and soon there was a "hospital poll tax" collected in every county annually to support the county hospital, which for a time served as poorhouse as well. In this class we might include the voter's registration fee or poll tax. Yet this is possibly better explained as the converse of the slogan "no taxation without representation," that is, "no representation without taxation," a dogma not so popular as it once was.

The poll tax was usually levied on adult males in the prime of life; that is, on males between twenty or twenty-one years of age and not over forty-five or sixty years. Wives and dependents were excluded. This selection is largely due to the commutation idea. In some of the older commonwealths, dating from colonial times, the poll tax was made more universal and was combined with the property tax. Thus every taxable person was rated for his poll as though it were property at a sum which multiplied by the tax rate on property would result in a uniform poll tax. When so used it would normally reach women who had independent property as well as males, but was not otherwise applied to women.

In many countries the poll tax evolved into a tax which took cognizance of differing ability to pay. One such tax changed from a simple poll tax to one in which the rates differed for different social classes, the nobles of different ranks, the clergy, the bourgeoisie, the artisans, and the peasants; then, later, it was made to vary also with real differences in income. Finally it became an income tax. This is the accepted history of the Prussian income tax. But in the United States the poll tax did not evolve at all. Rather, it stagnated and decayed. To change the figure of speech, the poll tax, where it survives to-day, stands as a decaying monument set up in the past; and like the gravestones in old cemeteries these remaining poll taxes are moss-grown and leaning, passing memorials to dead democratic institutions of the past.

Inequality of Poll Taxes. — Practically the returns of the poll tax are insignificant. The expense of collection is relatively large. Its administration encounters friction and causes opposi-

tion. Popular thought, not realising that justice and equality in taxation can be tested only by the whole complex of taxes, seizes on the inequality which might be a good ground for objection if the tax stood alone, and holds it to be unjust. It is being repealed just as fast as the revenues it yields can be spared. Too often the repeal is not accompanied by any new taxes reaching the same sort of ability.

SEC. 2. **Personal Income Tax.** — The most advanced form of personal taxation is a personal income tax. Most income taxes are personal in intent. Yet it is possible to frame an income tax which is non-personal in effect, a tax on income without special reference to its recipient.

When, however, the "great merits" or the "justice and equality" of an income tax are extolled it is generally a personal income tax that is meant. A tax on income "from property," on income in process of payment, on income where you can catch it without bothering the income recipient, might be regarded as a complex of taxes rather than as an income tax proper.

The taxation of income is old. It antedates the Christian era in many countries. How old it is we do not know. There are records of it in the history of India and we find the fundamental concept of income taxation recorded in many places in the Bible.[1] The Jewish tithe was a simple and very natural form of the income tax.[2]

In primitive communities the concept of income was simple. It included the yield of the fields and the increase in flocks and herds. The intricate concept of net income did not, in those days, arise to plague taxpayers and tax-collectors. All there was to do was to measure the grain on the threshing floor and count the lambs, calves, or colts. No certified public accountant or expert government inspector was needed.

[1] See citation from Laws of Manu, p. 4. Deuteronomy 18:4; 26:12. In Deuteronomy 26 5–11 we find the ancient form of taxpayer's oath, which sounds as though it might be more effective than the modern one taken before a notary. See also Lev. 28:32.

[2] The ancient taxes were originally pure income taxes in underlying concept. But they were attached to income from land, which was in early days the sole or the most conspicuous form of income. When other taxes arose the old tax on the produce of the soil and on flocks and herds was gradually transformed into a land tax.

Modern Concept of Income Intricate. — In modern times, despite the fact that most people think about income as a very simple thing, the concept is really one of the most intricate in the whole field of business and of economics. The ancient farmer regarded the grain on the threshing floor as all income. The modern farmer has to find out first what he can sell his grain for in money. Then he finds out the money cost of seed, fertiliser, labour, tools, machinery, depreciation of barns, and many other expenses. Taking the latter from the former he has net profit or income. The books of accounts of a great corporation contain thousands of entries; the proper placing of each one as outgo or receipt is a matter of nice judgment and often presents problems which only experts are supposed to be competent to solve. Tax laws and especially the tax regulations contain lengthy and intricate rules for determining income. Income for purposes of taxation is, as we shall see, more or less arbitrarily defined and measured. It has to be so defined for clearness and accuracy, and in some items is arbitrarily defined to reach or attain some ideal of uniformity or to standardise practice.

For purposes of taxation we deal solely with private income, whether individual or corporate. This is because our main purpose is to make comparisons of one person with another as to ability to pay taxes. Society's income, national income as a whole, is quite a different concept. The net increment of community wealth is quite a different thing from the sum total of all individual or private incomes. For taxation purposes what we try to ascertain is *my* income, *your* income, and every other taxpayer's income.

Tentative Definition. — We may tentatively define income as *receipts during a given period of time.* But a full definition requires a definition of these terms. The above definition is given only as something to build upon.

Receipts. — Theoretically the receipts may be in goods, in services, in enjoyments, or they may be in money. Practically, and especially for purposes of taxation, goods, services, and enjoyments *per se*, unless they are of a kind customarily valued in

money, are not considered as income. Thus the goods and services that the housewife creates and renders, in cooking and housekeeping, or the mother, in the care of the children, are not accounted income, despite the obvious fact that they add to the family well-being and save outgo. But the enjoyments and benefits one receives from living in one's own house are in some countries considered income at a valuation equivalent to the rental one would receive if he leased the house to another. One cannot forecast, but it seems possible that if it should become customary to pay the wife and mother for her services in cooking, housekeeping, and nursing these items might sometime come to be thought of as income, even when not paid for. Total taxable income may increase without any increase in well-being. Farm produce of the kind ordinarily sold according to the custom of the locality is often considered income even when not so sold, but used or consumed by the farmer and his family. Yet fish caught by the farmer in the brook down in the meadow, game, flowers from the farm garden, and sleigh-rides behind the farm horses in winter are never counted as income. The money test is quite arbitrary and the results are ofttimes very whimsical. The story of the impoverished villagers who got rich by taking in each other's washing is very much in point. Their books of accounts might show incomes, offset, of course, by equal expenses. But the expenses being personal spending would not be deductible for income tax purposes and so although just as poor as before the villagers might be taxed on their income. To avoid income tax each family in the village of the story would have to do its own not its neighbour's washing. Yet we may say that under an income tax law the receipts that are taxable income are *receipts in money* or *in money's worth.*

More definite and distinctly characteristic is the fact that in stating income some lapse of time, as a day, a week, a year, *must be named.* No other form of statement is possible. "During a period of time" is absolutely essential to the idea of income. Ordinarily the period of time used is a year, so that unless it is otherwise specified we mean *annual* receipts in all

that follows. The importance of the time element cannot be overstated.[1]

Transfers of Capital are Not Income. — Care was taken in the first tentative definition not to say *all* receipts during a given period of time. That was done, not merely to exclude the kinds of goods, services, and enjoyments not ordinarily valued in money but also to exclude from an individual's income transfers to him of capital or property.

Capital and Income Distinguished. — In business, in accounting, and by economists capital is ever set over and against income and income distinguished from capital. The same distinction rules in taxation. The chief difference between a property tax and an income tax is that the base of the property tax is capital value, the base of the income tax is income value. The distinction is very vital to an understanding of the income tax.

What is the fundamental concept of capital has been the subject of voluminous discussions.[2] For our present purpose we are fortunate in being able to narrow our study to one phase only of this discussion. That phase identifies capital with property. With capital regarded as the means of production, that is, as consisting of all these things interposed between the bare hand and the satisfaction of a want, we are not directly concerned. Nor have we to decide whether we shall include consumer's goods in capital. Taxation falls in the field of distribution; that is, all taxes in last analysis are taken from the shares of the product, wages, interest, rent, and, if you are pleased to distinguish a fourth category, profits. Again, it is important to note that we are concerned only with the *value* of capital, a concept determined in the field of exchange. There is a difference between land and property rights to land. Improved land may be *productive capital*, its ownership is *private capital* or *property*, its *value* is *taxable capital* or *property value.*

[1] Failure to specify any time element in the legal definition of income in the tax law of the United States, which law says simply "income," is a logical weakness that has led to serious controversy. It has become apparent that it is not sufficient to leave the essential element — time — unspecified, see below.

[2] The whole subject is interestingly discussed by Professor Irving Fisher in *The Nature of Capital and Income.*

We are not, in taxation, so much concerned with how the loaf came to be, whence came the flour or how the baking was done, but far more with who get the slices when it is cut. We assume that a man's ability to pay is based upon the value of his property and the amount of his earnings and both are of course measured by exchange value. In taxation we deal only with values or measured wealth, and solely with private wealth. When we consider the taxation of a railway we are not looking upon it as a great complicated tool, or complex of machinery, but as property. We inquire who owns it and what ability to pay taxes that ownership represents, not how it carries goods or enhances social well-being.

In taxation, moreover, we are dealing with persons and *their* property or *their* income. The more personal a tax is the more the emphasis falls on the ownership and value of wealth, that is, on income or property and its value. The ownership of a piece of fertile land which yields an income and makes a man "rich" is the index of ability to pay taxes. What causes the fertility or how that fertility is brought to fruition by labour are important questions, but beyond the immediate issue.

For present purposes it seems best to regard capital or property value as derived from income. *Capital may be the source of income, but its ownership is significant only as the right to receive income and its value is fixed by the income.*

An assured income, not dependent solely on the labour of its recipient (which, of course, is not absolutely "assured"), usually has a property or capital value. Conversely, with certain partial exceptions or modifications, *all property values are the capitalized values of assured series of annual receipts.* The series may be long or it may be short, regular or irregular. This condensed statement is of the first importance and requires careful study and some amplification.

Income is a Series of Receipts. — Professor Fisher has picturesquely described income "as a flow through a period of time and not, like capital, as a *fund* at an instant of time." The metaphor is excellent for bringing out the contrast. But unfortunately we cannot mentally handle, nor in language

other than figurative describe, a flow without stopping it or dividing it into a series, as it were, of drops. Pay day comes but once a week, or month. Wages do not flow, they come in drops. The only way in which we can become conscious of the passage of time is to note the sunrise and sunset, or to count the ticks of the clock, or by reference to some other series of events. Obviously this mentally divides or stops the flow. Sometimes income is likened to the flow of a stream of water. When, however, we wish to measure the flow of a stream we have to stop it, or to divide the stream mentally if not physically into measurable parts. Thus the miner or the irrigationist measures water by the miner's inch, a cubic quantity accumulated at the end of a space of time. So too the actuary, who in problems of insurance is busied in computing the amount of capital corresponding to a given income, or the income corresponding to a given amount of capital, never deals with a continuous flow, but always with a *series* of incoming or outgoing payments each at a given point of time. If we know the amount and date of each of a series of receipts, we can compute the present or capital value thereof; and conversely if we know the present or capital value, we can compute the series of receipts which justifies it. This we can do whether the series is regular or irregular, immediate or future, long or short. Capital and income are then two connected ideas. There can be no such thing as capital without income, present or future, in goods or services if not in money. In this case the two terms describe each a different side of the same shield. But curiously enough there can be income without capital. The wages of labour are income but have no capital value.

Receipts in Uses and in Money. — We have to recognise different kinds of capital or property whose value arises from different kinds of receipts. (1) Some kinds of property, like tools, furniture, books, pictures, clothing, and utensils yield from time to time, when used directly by their owners, a series of satisfactions or advantages which we may call revenue or income by use. Property of this kind has a selling or present value because of the uses to which it may be put, the series of satisfac-

tions or helps which it affords. The owner may, however, lend the property to others for a series of receipts in money. This carries the property into class (2) below. The money then measures, roughly it may be, the value of the uses or enjoyments afforded. The measurement is often rough, because depreciation, replacement cost, sentimental considerations, or the inertia of the owner and the imperfections of the loan market for such things as these prevent arrival at a sure and certain value. The main point just here is that such property has a value dependent on use whether rented or not. (2) Other kinds of property, including rights in or to the property of others, when lasting or durable in character, yielding definite returns according to use or by contract, like land, or real estate generally, mortgages, bonds, and sometimes stocks, have a present or capital value which can be definitely ascertained from the yield or receipts owned. The connection here between the capital and the income is so definite in many cases that the one can be accurately computed from the other, and contracts based on the computation can be made and enforced. Unlike the first case we have here a case in which the money equivalents of capital to income and income to capital are sometimes very definite. There is nothing more definite and certain in the whole field of economic measurements than the relation between the value of a government bond and the interest it pays. The value depends on the interest.

There is a third class of receipts to which we shall come in the discussion below, which have no corresponding capital value and which are always and strictly income, and nothing but income.

Use Receipts Not Taxable. — Receipts through use or satisfaction from use, not by lending and not commonly measured in money, connected with property of the sort discussed under (1) above are not considered income for income tax purposes, except rarely when the property in question is of such a character that the use values can by analogy to rental or money values be readily determined. But income in money received by the owner of such property, as for example when it is rented,

is always included. This distinction corresponds to the common concept of income. Thus, no income tax law requires the owner of a fine painting to list as part of his taxable income the satisfaction he gets from looking at it or from proudly displaying it to admiring friends. There is no practical way of measuring such satisfaction. But every income tax law does require the furniture dealer who rents out furniture, pianos, or paintings, to pay a tax on the money income he receives. It should be observed, however, that property whose value depends on use income solely may be taxed as property, despite the fact that only with great difficulty can it be taxed through its income. Thus my arm-chair by the fireplace may be taxed as property, but I cannot well be expected to list as income the joy of sitting in it.

Income connected with property of the sort described under (2) above is almost always taxable income under an income tax. Sometimes there is a difficulty in deciding whether the receipts and the property should be classed under (1) or under (2). Thus when an owner occupies and uses his own home, the income in use may be taxable at a value per annum determined by analogy to homes that are rented. In countries where the home is generally rented the exceptional owner who occupies his own home would consider its rental value as a part of his income and it would be natural for the income tax law to do the same. But in other countries where the reverse is the case it is more natural to class the home as use property, not as income property, then it is taxed as property, not as income.

Capital and Income are Intimately Related. — It is important to bear in mind that property value, or capital, and income value are, so far as the cases under (2) are concerned, two intimately related things. While the writer holds the view explained above that the income value is the cause or source of the capital value, it is not necessary to establish that point. The two may be regarded as simply two different ways of looking at the same thing, or as suggested, two sides as it were of the shield. Thus we may say, as is the custom in America,

that a given building is worth $100,000, meaning that it should sell for that; or we may say, as is quite common in England, that the same building is worth $5000 (or £1000) per annum. The two statements describe the same facts. The British property and income tax law specifies the "annual value" of land as taxable; the British increment value duty falls on the capital value of land.

The prevailing market rate of interest, with due allowance for risk, depreciation, and other factors, is commonly used in measuring the relation between capital values and income values, under (2). Thus the bonds of a strong and solvent government in times of peace may sell on "a three per cent basis." Thirty dollars a year in perpetuity is thereby established as the equivalent of $1000 payable now.

Capital so considered is not necessarily regarded as a stock. It is a fund in the sense that it is the present value of an income, or an expected series of future receipts. That my capital may at any given moment contain, in addition to those kinds of property, which are the right to receive incomes, some cash or liquid items, not tied to income, does not require a different analysis; for the value of a cash item depends on the prospect of investment, that is, of the purchase of income, which it holds in itself. Capital so considered is not like the waters of a stream accumulated in a reservoir into which it flows. It is rather a comprehensive aspect of the stream itself.

Future Income Has a Present Capital Value. — This brings us to the last point that we need to consider in connection with capital of class (2). That is, that the income, or a series of payments, is not necessarily derivable in the immediate future. It is the expected future income no matter how remote that gives value to a vacant, unused lot of land. The income may not begin for twenty years or more, but unless it is expected to begin sometime and to continue for a while it would be folly to buy the land. Since the income tax can deal only with the income measurable, that is, income already received, such a tax is not applicable when the income is remote and therefore somewhat uncertain. The only available basis

of taxation in such a case is the property value. It is doubtless because, in the United States, there is so much property having a present value dependent on incomes expected to arise only after many years, so much property without present income, that the property tax is, in this country, so strongly entrenched.

It should now be clear that so far as property and income of group (2) is concerned the tax may be placed either (*a*) on the property value or (*b*) on the income, if the property be now income bearing, and that substantially the same effect may be reached by one method as by the other. A new permanent tax on income will diminish the corresponding property value, and a new permanent tax on the property, by diminishing the income, will likewise diminish the property value. Without going into refinements it may be said that if interest stands at 5 per cent a tax on property at 1 per cent is roughly the equivalent of a tax on income at 20 per cent. But this of course applies only in class (2).[1]

Incomes Which Have No Corresponding Property Value. — So far we have considered only two kinds of receipts, one in uses, satisfactions, or enjoyments which are not taxable income, the other owned or contractual and classed as income. But there are other receipts which are always counted as income and which, in a sense, are the simplest and most common kinds of income. These are the earnings of personal exertion, such as wages, salaries, fees, and the profits of trading. The striking thing about these is that there is no way to tax them directly save as income. There is no corresponding capital or property value. It is not necessary to discuss the refinements sometimes entered into as to whether this sort of income may be considered as related to human capital of brain or of brawn, that is, to accumulated knowledge, developed skill, or strength and acquired cunning. The simple fact is that where personal liberty prevails we never in the business world capitalise a wage or a salary nor the earnings of vocations of any sort.

[1] Further consideration of this interesting point will be found under Incidence, Chapter X.

The Two Kinds of Income: Funded and Unfunded. — From the point of view of taxation, then, there are two main kinds of income, (1) income to which there is a corresponding capital value, and (2) income from exertion. These are properly distinguished as funded and unfunded, but are more often sentimentally called earned and unearned incomes. Almost instinctively the legislator recognises a difference between these two and accords to each a different treatment. Usually earned incomes are treated more tenderly than are the unearned and are taxed more lightly. It has just been said that this distinction is accorded almost instinctively. It is rare that one hears any discussion in legislative halls of the reasons for making the distinction. It seems to be assumed without argument that it should be so. Thus Gladstone called funded or unearned incomes "lazy incomes" and by that phrase carried through Parliament a measure imposing heavier taxes on them than on earned incomes. Yet when it is remembered that the funded income may be the result of years of toil and privation spent to accumulate something to live on in old age, the reflection cast by the term "lazy incomes" seems ill-deserved in some cases. Many funded incomes may have been earned by hard and deserving labour.

While income earned by the sweat of one's brow does seem a thing more dear than income which comes in periodically without present effort, there are better reasons than this sentimental one for a different treatment of the two for taxation purposes. One reason is that by tradition, and perhaps in its very nature, the state is a partner in the ownership of all property. It has been called a silent partner, but the state's existence is so essential to the existence of property and to its security, that the partnership is very real. The right of property and the validity of contracts are subject to such restrictions, beneficial to the owners in the aggregate, as the state may in its wisdom impose. Taxation of property, or of income that has a capital or property value, is one way the state has of asserting its community or property-partnership interest. Another reason is that out of earned income should come savings. The

number of persons who have earnings but have little property is very great. Social welfare, from many considerations, requires that these persons should save. One such consideration is that he who has little or no income other than from his earnings is in duty bound to provide, by savings, a fund for the future both of himself and of his dependents. His income is therefore far less free income than is that of the man of property, however small the property may be, who has met that obligation. But these reasons, while justifying lower rates on earned than on unearned incomes, do not by any means justify the entire exemption of earned incomes, nor do they justify hostile and confiscatory taxes on unearned incomes.

The difference in treatment of the two kinds of income is sometimes worked out in the income tax itself and sometimes is brought about by the addition of other taxes on the capital value of unearned income. In the United States the state and local taxes on property impose a heavy burden on the capital value of unearned incomes and have the effect when conjoined with the income taxes of imposing a heavier burden on the unearned incomes.

Taxation of Income Not Simple. — There seems to be a decided inclination for theorists to regard the income tax as a particularly ideal tax. Some socialists have proposed a single income tax as the acme of perfection. It does, indeed, seem to be capable of being made to conform very fully to all requirements of the faculty or ability theory. But in practice there are quite as many difficulties in the equitable working out of the income tax as are to be found in other taxes. We have not by any means completely solved the problem of just taxation by placing an income tax law on the statute books. There are difficulties of legislation and difficulties of administration to be met.

The difficulties of definition of income are so great that legislators often decline, or fail, to attempt it. The result is that the statutes sometimes say, in effect, "income is income." Thus the United States income tax law says that "gross income" includes "gains, profits, and *income*." The British in-

come tax law is better in verbal form in that it says that taxable income is either "the annual value" of property, or the "annual amount of profits," yet it is equally unexplanatory. It defines by synonym. The matter is thus left largely to administrative determination.[1]

Is an Increment in Property Value Income? — Aside from difficulties in phraseology we encounter at the very start inherent difficulties. One of these is very important and may be used as an illustration. Is an increment in property value income? Let us take the case of a man who owns an office building site with an adequate building on it. It may be that as time goes on the demand for offices in his building increases and the rents go up. The rentals are, of course, income. But in consequence of the increase in rentals the property value increases. The lot and building will sell for more. Is the increment in value income? Probably many people with the specific illustration before them would say no. The rentals are income and so is their increase, but the increment is not, they would say. A bookkeeper would not ordinarily include the increment in his annual income account, although he might from time to time "write up" the value of the proprietorship to cover the increment. If the property were sold the increment would be put down as a profit but still with careful distinction from annual income. The essential feature of income, namely receipts during a period of time, is lacking when we are confronted with a single profit on some one occasion. Another reason for this common attitude is apparently a more or less well-founded opinion that while the owner of such a building may properly spend the annual receipts he ought not to spend the increase in the value of his property. For in so doing, although his original investment value might remain the same, he is in a sense "impairing his capital." Possibly the practical

[1] It is remarkable, however, how vital the phraseology of a definition becomes. The inclusion of the word "annual" in the British definition and its omission in the American make a vast difference in the frame of mind. The question of the taxability of "stock dividends" and other items of increment in capital value which vexes Congress and the Courts might not have arisen had the constitution said "annual income" instead of just "income." In Great Britain there is no such controversy.

consideration that he would have to sell the property before he could lay hands on the increment to spend it has something to do with this view. There seems to be in the popular mind a clear idea that income is something spendable without impairing one's future, even when that future is growing brighter every year. Spending is associated with the satisfaction of our wants. Our wants are regularly recurrent. That is, we grow hungry once in so often and with striking regularity. From the connection between income and spending comes the thought that income is something regular and recurrent at definite times. The more certain and regular an income is the more desirable it is. Increments in property values do not appear to be either regular, recurrent, or certain. Yet the whole notion is vague and depends upon what one ought to do if he be wise. Hence there is a real difficulty.

It is possible that increments in property values would not have given the lawmaker or the administrator much trouble if they were all of the character of the one in the illustration. The government might very well be content with the growing taxes on the growing rentals and let the increment go; or if such increments be regarded as special evidence of ability to pay the government might impose on them another and a different sort of tax. But all cases are not so clear. Dealers in land and buildings make an income not only by bringing buyers and sellers together, but sometimes by buying and holding real estate for the increment. A part of their profits comes from the increment accruing while they hold the property. When this is incidental to their regular business they always consider the entire profits as income. There may be a similar increment in the value of the dry goods a merchant buys and sells. The gains of a regular trader in grain from a rise in prices even though they are irregular in time and in amount, are nevertheless income. The same principle is involved in the question of the taxability or non-taxability of "stock dividends" when they are made for the purpose of adjusting the par value of the capital stock of a corporation to the actual value of the corporation as a going concern, to the

value, that is, based on the earnings. Such stock dividends are distributions of capital increment. Stock dividends made to cover an investment of earnings in the business are somewhat different. The difficulty arises because there is a difference in degree as well as in kind.

Decrease in Property Values. — The question is all the more troublesome from the fact that the converse, a decrease in property value, is often treated the other way. That is, such a decrease is often treated as a loss deductible from income. Taxpayers are very insistent that depreciation and obsolescence shall be treated as losses. That places decreases in property values on the income side, not on the capital side of accounts. But one can differentiate such losses from negative increments. To keep productive agents in condition and to maintain the income is a cost. A true negative increment, such as the decrease in land value where population moves away, cannot be restored or made good, at that spot, and is not a cost, although it may be socially wise to allow for it so that other land may be developed.

How Tax Laws Treat Increment Values. — The tax laws generally treat this puzzle as a Gordian knot, to be cut, not to be untied. They cut it in one of two ways. They either disregard the increment altogether when it comes unaccompanied by active dealing, as in our first illustration; or they tax it in every form *when realised*. That is when the increment is reduced to a clear money valuation on the occasion of a sale or other transfer, as by inheritance, resulting in an appraisal of the property. Inasmuch as legislators, tax administrators, and the courts have not yet solved the problem, we may perhaps be excused from attempting a rigid solution. The logic of our position (stated above) as to the relation of income to capital would incline us to the view that since the increment is due to the increase in present or future income, it is not itself income. A thing that is the effect of a cause cannot at the same time be of the cause.

Annuities. — Difficulty is encountered in the case of annuities and pensions payable for a fixed term of years or, it may be,

for life. Annuities are bought in order to have a regular income to spend and pensions are for the pensioner to live on usually in old age. Hence to most people they look remarkably like income and income of an exceptionally desirable sort. But annuities are computed by actuaries with keen minds who are skilled in argument and they have not failed to call the attention of lawmakers and tax administrators to the mode of computation of annuities. They maintain that each annual payment in an annuity of a flat or fixed sum each year is composed of two parts, one of which is by nature interest and hence undeniably income, and the other a repayment of or using up of capital. Even a pension paid on retirement after long service is properly regarded as the result of the accumulation of withheld wages into a capital sum which put at interest is paid back, interest and capital together, in each instalment during the inactive or retirement period and up to death. Income tax lawmakers sometimes yield to the argument and allow a deduction for part of the annuity as a capital transfer, or as in the case of the Massachusetts law, compromise and impose a lower tax rate on annuities than on other incomes. Sometimes, however, so-called annuities are perpetual, in which case they are generally the income of a life estate in some property, which life estate passes to the next heir, and as such they are pure income. The British law with some exceptions taxes purchased terminable annuities in full as income. In his work on British Property and Income, Stamp reports (p. 190) that the amounts are not large. But the main difficulty is that a purchased life annuity is computed on the theory of " the expectation of life," a theory true of a large group of men, but not necessarily individually true even for any one man in the group, while the income tax must apply to each man by himself. Thus if the law allows a deduction for principal used up after the manner calculated in actuaries' tables, one-half the annuitants will get too much, the other half too little, allowance. The difficulty is practically beyond solution, because one man's life cannot be assumed to be sure to equal the average life of many. Since, however, life annuitants and pensioners are usually old or dis-

abled, we might consider that as an additional and sufficient reason for a lower rate on the entire annuity or pension and thus achieve average equity as well as the halo of mercy. Since pensions are growing in favour as a means of providing for disability and old age and are likely to become very common, the proper solution of the problem is pressing.

If annuities are taxable in their entirety as income, there would be little gained in buying one for a definite term, as ten or twenty years, for a man would save money by investing his capital and spending the interest plus a part of his principal each year. But the case would be different with a life annuity, as he could not forecast how long he might live.[1]

Mining Dividends Like Annuities. — The analogous case of a mine often receives a different consideration and treatment. Many people buy mining stock and spend the entire dividends as income, regardless of the fact that the ore bodies are exhaustible and when the ore deposits are gone the original capital or investment is gone. No income tax law would allow an individual stockholder to set aside out of his dividends, as nontaxable, the amount necessary in the end to restore his capital or original investment. Yet, when this very thing is done by the company, in the guise of a depletion fund, so that the dividends are in fact less each year in consideration of the ultimate repayment of the investment as capital, the income tax law is complacent.

[1] The theory of the federal income tax in the United States as applied to purchased annuities requires the deduction of the principal or premiums and the return for taxation of the interest portions of an annuity only. The regulations (Articles 57 and 58 Regulation 45 Act of 1918) to date are couched in language difficult of interpretation. The annuitant is told that he may consider as "proceeds of insurance" and hence as no part of his gross income, "during his life only so much of the amount received by an insurer under life, endowment or annuity contracts as represents a return, without interest, of premiums" (Art. 72). In another place "where an insurer receives under life insurance, endowment or annuity contracts sums in excess of the premiums paid therefor, such excess is income for the year of its receipt" (Art. 47). Since the actuarially computed part of the annuity which is capital would seldom or never correspond to the actual in a life annuity or pension the general principle that a receipt is not a receipt until reduced to possession would lead us to infer that the regulation means that the annuitant pays no tax until the annual payments received sum up to the amount paid in premiums. We are informed that this is the practice. Hence most annuitants will not be taxed for many years, and some who die early never.

Allowable Expenses. — Not all the difficulties in regard to income turn on the distinction between capital and income. There are difficulties as to what are properly allowable expenses. There are great difficulties in the measurement of the value or amount of the income, especially in estimating incomes not wholly in money. There are times when valuation enters here almost as importantly as it does in the assessment of property.

Types of Income Taxes. — Income taxes are not all alike. The differences are often more than superficial. Thus the British tax includes the annual value of certain kinds of property, whether realised in money or not, that is, it includes value in use, and excludes from income a great part of the increment in property values even when realised in money. Per contra the American tax is almost strictly a tax on "*realised money income.*" Unlike the British, it excludes nearly all value in use and includes capital increment value when realised. There is great significance in the title of the British tax, which is a tax on property and income. A tax, that is, on the annual value of property and on the annual amount of profits. The British tax makes a sharp distinction between different kinds of income — the American does not. One result of this is that the British tax is, as to some of its important schedules, distinctly an assessed tax. One of the most surprising things about the American tax is that there is no regular official assessment at all. This feature will be commented upon below. The American tax is very nearly completely dependent on the taxpayer's own declaration. The British tax depends on declaration in only one of the five schedules and for the super-taxes. The British tax gives the taxpayer a jury of his neighbours to which he can present his grievances. The American taxpayer has a legal, but for a poor man otherwise visionary, right to appeal to an official in Washington, sometimes more than three thousand miles away, but no other appeal short of the courts.

Another difference often made much of between different income taxes is connected with the mode of collection. Some income taxes make large use of "stoppage at the source";

others collect directly from the taxpayer. Stoppage at the source means, for example, that the tenant pays the tax on his landlord's rent, deducting from the rent the amount of the tax he has paid; or again, that a banker or other agent transmitting interest or other income pays the tax for his client; and similarly that employers may be required to pay or advance the tax on salaries of their employees. Since the income tax is usually progressive or graduated and since there are usually abatements or exemptions for small incomes, it is obvious that stoppage at the source necessitates a method of repayment by the government of any excess stopped at the source. There is also involved a declaration by the taxpayer to determine the amount of tax he should pay if his income is large enough to carry him into the higher grade rates. Stoppage at the source seems to work to the apparent satisfaction of the Englishman. Yet a similar system in America failed. Perhaps its failure was due to the imperfection and half-heartedness of the administrative plans. The absence of any adequate repayment scheme for overcharges added to the dissatisfaction. But the fact that the British tax is largely an assessed tax, while the American is not, had very much to do with it. The substitution in the United States of "information at the source" has not been a happy thought. It is a sort of informer system, making folks "tattletales," and involves administrative difficulties far more costly in the long run than any returns it will bring in.

Fitting the Tax to Custom. — An income tax, possibly more than any other, but certainly quite as much, must, if it is to work smoothly, be skilfully fitted to the economic organisation and customs of the country in which it is to be used. It would be useless, for example, to provide that each owner residing in his own home should pay a tax on the rental value of the home, if all homes were owned and none rented. For it would then be practically impossible to ascertain administratively the rental value. Tenancy has to be the normal thing before such a rule will work. In countries where interest payments are universally made through banking houses and trust companies the tax thereon can be stopped at the source. But what of the

village grocer who has a sheaf of farmers' notes in a tin box on a shelf in a cupboard? What use would it be to include farm produce consumed on the farm as income, in neighbourhoods where there is no regular market and no known local price for eggs, chickens, butter, milk, garden truck, pork and beef, and other things on which the farmer lives?

So, too, must the setting of the income tax in the system of other taxes be carefully considered. There are persons who advocate a different rate for earned and unearned incomes in the United States federal income tax, after the model of England. They seem to forget that the recipients of funded or unearned incomes pay nearly all of the local and state taxes, which make a very heavy additional burden.

Net Income. — Income taxes are levied on *net* income. Income tax laws, and administrative regulations generally, begin with a definition or statement of what constitutes gross income, and then specify the deductions which may be made therefrom in order to arrive at net or taxable income.

Gross income broadly speaking includes all receipts except of pure capital assets, as by inheritance, or bequest, gift or purchase, or life insurance, or return of loans or compensation for damages of a capital nature. But receipts from property insurance are often technically treated as gross income, there being allowed, however, an offset of the loss incurred, which in most cases would wipe out the receipt. While life insurance in lump sum is considered as a capital payment, annuities are not wholly so considered. The dividing line between transfers of capital assets sole, and those which are not capital but income, is often so indistinct that both the laws and the regulations are very specific as to what receipts may be considered as excluded from income.

Exempt Income. — From gross income are also excluded all forms of income that for any reason may be exempt, except, however, those so-called exemptions which as we shall see are in effect a part of the system of rates. People are sometimes surprised to find that they have income which they spend, but which under the tax law is not regarded as income at all, but

is treated legally as if it never existed. To illustrate, in the United States it is considered unconstitutional for the federal government to tax salaries paid by the states and by the local governments which derive their powers from the states. This includes the great body of school teachers' salaries. Such salaries are therefore no part of gross income, but are treated as if they did not exist at all.

Abatements Which Are Often Called Exemptions. — In most income taxes there is a small amount of income upon which no tax is computed, only the incomes larger than this or the excess over this being taxable. In general the abatement so allowed is supposed to be equal to the minimum of subsistence, but it may be less or more than the true minimum. It is also common to allow more to a married man than to a single man and to grant still more to one having children or dependents to support. Although properly called abatements these allowances are frequently spoken of as exemptions.

Deductible Expenses, etc. — The deductions allowed in arriving at net income from gross may be grouped as: (1) expenses, including interest paid out and certain taxes; (2) losses; and (3) depreciation of capital assets.

To be deductible the expenses must be strictly business expenses. That is, they exclude personal spending and exclude investment of savings. Personal, living, or family expenses are never deductible. Neither are sums paid for new property, for betterments, sums put in the bank, or premiums paid for life insurance. Sometimes, however, the latter are deductible, not because they are not regarded as savings, but with the intent to foster this sort of thrift. Included are sums paid for labour, rentals for the use of business property, interest on borrowed capital and certain taxes. These deductions do not seem to need comment except the taxes. There are some taxes which are obviously incidental to doing business and to getting an income. Thus an importer must pay duties and, though he may reimburse himself when he sells the goods, these are a cost. Personal taxes, taxes on one's home, and other non-business taxes should not be deducted any more than any other persona

expenses. But income tax laws are not always so logical as they might be as to these, perhaps because of the frequent intermingling of personal and of business taxes. But they are logical in not allowing the income tax itself as a deduction. This is primarily because it is a personal tax and not so easily confused with business taxes. There is a curious and interesting arithmetical result which would come from deducting the income tax of last year from the income of this year. This can be shown strikingly if we take an exaggerated case. Suppose a man has a taxable income of $10,000 a year, something for living expenses being exempted, and that war necessities require a tax of 100 per cent. If allowed to deduct the income tax of this year from his next year's net taxable income of $10,000 he would have next year no tax to pay. But the third year he would again pay a big tax. With lower rates the result would not be so striking but would be there in a degree. Consequently, the government's revenue would go up and down each succeeding year.

That business losses should be deducted is always regarded as proper. But the propriety of deducting other losses is not so clear. This is especially true of capital losses, as was discussed above. In general, losses may not be deducted until fully realised, or like bad debts "written off." Upon this the regulations must obviously be very strict. A difficulty, usually resolved in favour of the revenue, arises when a loss exceeds the income of the year in which it is to be deducted. The excess may not ordinarily be carried forward.

There are great administrative difficulties in the allowances for losses and there are still greater ones in the allowances for depreciation, obsolescence, and depletion. Repairs to property, especially to property used in business, are obviously necessary to keep the property efficient and the income flowing. But the line between a repair and a betterment is vague. Obsolescence is still more vague, at least as to measurement. The main difficulty here is that obsolescence is considered as proceeding with the passage of time and at the end of a period, often many years, results in a loss. But the taxpayer is not content to

wait until the loss is realised and measurable, but wants it allowed periodically. Accountants have, very properly, been trying to train the business world to a conservative estimate of assets and to the exercise of care in the preservation of capital. In this they often run counter to an equally commendable desire on the part of the tax officials to conserve the government's revenues. The controversy leads into technicalities too intricate for this text.

Depletion of exhaustible and limited resources, as of the content of a mining property or standing timber, gives unending practical troubles. If a man has a stock of leather which he is using up to make shoes, or of cotton to make sheeting, it is clear that the cost of materials is a part of the cost of manufacture. By analogy, if he has a stock of coal underground which he is mining and turning into merchantable coal he claims the right to deduct the original cost of the coal underground. So far the matter seems simple enough. But coal underground is not bought by the ton, it is bought sight unseen, quantity but indefinitely known. Moreover, costly shafts, tunnels, and other works are necessary to reach it, and such works become useless and valueless as soon as the mineral they reached is gone. The practical problem this presents is very difficult of solution and too intricate for an elementary text. Rulings and regulations are usually wholly arbitrary and hence an unending source of friction.

Often certain gifts or contributions to charities, to churches, and to schools are allowed as deductions from income. These deductions rest on considerations quite apart from and foreign to taxation principles and are usually limited to certain fractions of the income.

After these deductions have been made we arrive at net income. Sometimes there is still another step to arrive at net taxable income, as by the deduction of the credits. But this is rather an incident to the application of the rates than to the determination of the income.

Rates are Degressive. — Income tax rates are usually progressive and the form of progression is usually degressive.

Sometimes, as in the Prussian income tax, there is a complete scale or schedule of rates set forth for different grades of incomes. In other cases there is a flat or normal rate, as it is called, applicable to all incomes, and then a series of surtaxes applicable to the higher incomes. Degression is usually achieved by the simple device of deducting a fixed amount from the income before the rate is applied, the rate on the remainder being proportional. So far as the surtaxes are concerned they too may be given a degressive effect by applying each one only to the "excess over" certain amounts. This abstract statement must suffice here. The subsequent discussion of actual laws will afford ample illustrations of the way in which this result is achieved.

The universal allowance of a credit or so-called exemption from all incomes not only brings about the progression that is desired but works the exemption of the small incomes. Thus in the United States a man without family or dependents whose income is less than $1500 pays personally or directly no tax at all. The arguments upon which this exemption rests are: (1) that the minimum of existence can pay no tax, and (2) that there are other taxes, especially the taxes on consumption, which impose a sufficient burden on those whose incomes are small. Where the line is drawn is, of course, purely arbitrary and a matter of opinion in each country. Countries which make large use of consumption taxes should, it would appear, grant a higher exemption than those which levy no consumption taxes.

Application of Income Tax to Corporations. — Logically the income tax if it is intended to be personal in character should be levied on individuals only. In fact any other system leads to cross purposes, double taxation, and many sorts of unpleasant inequalities. This is especially the case if the tax is to be progressive and the trouble becomes worse as the progression is intensified. The whole theory of progression rests on personal ability to pay. But there are many practical considerations which lead to the levy of a tax on artificial persons or corporations. Ease of assessment, the collection of large sums

at one time, and, by going directly to the sources, the prevention of evasion, are among the obvious advantages. The tax on corporation incomes is usually at a flat rate. If any so-called exemption or deduction from the net income is allowed corporations, as $3000 or $5000, the deduction is to be regarded more as an allowance for error than as an effort to graduate the rate. Progression is wholly out of place here.

Tax on Dividends May Work Inequality. — While it is relatively easy to allow the taxpayer a credit for the tax paid on his dividends by the company, if he has other income equal to or in excess of his personal exemption, it is not so easy to adjust the burden when his income is all dividends, or largely so. Thus if there be a tax on the earnings of corporations amounting to, say, 5 per cent, and the personal income tax with the same tax rate allows an exemption of $1000, then a man whose income is all from dividends would not benefit by the personal exemption at all. His neighbour whose income comes from some other source would get his exemption and would receive his income clear of tax on the first $1000. The only way in which this can be remedied is to arrange a system of rebates such as was mentioned above in connection with stoppage at the source.

SEC. 3. **The Place of the Tax in the System.** — The form of the income tax will be determined by the place given it in the system of taxation. If it were possible to administer a single tax of any sort in accord with the demands of justice, the income tax would be, theoretically, the one to be chosen. But the objections to any single tax, already stated, bear upon this as well as upon any other. Theoretically, it is best to make the income tax the central one of the system, the gaps of which are filled in by other taxes. If this be the intention, then the income tax can be arranged in the form in which it is most easy to administer. Thus the very small incomes can be exempt from the income tax, being covered by direct and indirect consumption taxes. In this way one source of difficulty and friction is avoided. Then no distinction need be made in the assessment of income from different sources. For if it be decided to tax

income from funded investments at a higher rate than other forms of income, this additional tax can be laid on in the form of a property tax. How far the exemption of smaller incomes should go, or to what extent funded incomes should be more heavily burdened, depends upon the concrete facts in each case. An abatement of the burden in cases where there are already more than the usual claims on the income, as of a large family, is also sometimes given.

SEC. 4. **Prussian Income Tax.** — As an example of an income tax, not, perhaps, ideally perfect, but still laid down in accord with the general principles enunciated above, we will study somewhat in detail the Prussian pre-war income tax.[1] In order to have in mind the main features of the development already outlined above, Chap. V, we quote from Mr. Hill the successive stages in the growth of personal taxation in Prussia:

"1. A uniform poll tax, 1811.

"2. A class tax, collecting somewhat more from the prosperous, and not less from the poor, 1820–1821.

"3. To supplement the class tax, an income tax with comparatively few classes, a uniform rate, and a maximum limit, 1851.

"4. Classification made finer, the maximum limit removed, and the class tax below made practically an income tax with a progressive rate, and the exemption of incomes up to 420 M., 1873.

"5. Exemption of incomes up to 900 M., reduction of the remaining rates of the class tax, and of the two lowest rates of the income tax, 1881–1883.

"6. Principle of progression extended to all incomes under 100,000 M., incomes under 10,000 M. taxed less than before, and higher incomes more; a declaration of income by the taxpayer required, and a finer classification adopted, 1891."

To make the new tax still more clear, we quote the rates from the law itself:

[1] For history see Hill, *Quarterly Journal of Economics*, VI, 207; Wagner, "Die Reform der directen Staatsbesteuerung in Preussen im Jahre 1891," *Schans' Finans Archiv.*, VIII Jahrgang, II Band. A full statement of the law is there appended.

TARIFF OF RATES

Incomes		Rate	Incomes		Rate
From M.	To (inclusive) M	M.	From M	To (inclusive) M.	M.
900	1,050	6	3,900	4,200	92
1,050	1,200	9	4,200	4,500	104
1,200	1,350	12	4,500	5,000	118
1,350	1,500	16	5,000	5,500	132
1,500	1,650	21	5,500	6,000	146
1,650	1,800	26	6,000	6,500	160
1,800	2,100	31	6,500	7,000	176
2,100	2,400	36	7,000	7,500	192
2,400	2,700	44	7,500	8,000	212
2,700	3,000	52	8,000	8,500	232
3,000	3,300	60	8,500	9,000	252
3,300	3,600	70	9,000	9,500	276
3,600	3,900	80	9,500	10,500	300

The rate increases

From M.	To M	In Stages of M	By M.
10,500	30,500	1,000	30
30,500	32,000	1,500	60
32,000	78,000	2,000	80
78,000	100,000	2,000	100

In the case of incomes from 100,000 M. to 105,000 M. the tax is 4000 M. And from that point on the proportional rate of 4 per cent is assessed upon the lower limits of stages of 5000 M. each.

This rate is progressive from about two-thirds of 1 per cent at 900 M. to 3 per cent at 10,000 M. Then the rate is nearly proportional at 3 per cent up to 30,000 M. Then progressive again, until at 100,000 M. 4 per cent is reached, after which it is proportional again. Each taxpayer having an income of over 3000 M. is required to " declare " it. He has to fill out a blank calling for a statement of income from each of four sources: (1) from capital invested, interest, and dividends; (2) from

landed property and houses, including all crops, whether consumed in the house or not, but deducting the cost of cultivation; (3) from trade, industry, or mining, deducting the cost of maintenance; (4) from any employment, wages, salaries, fees, and including pensions and every source of income not covered by (1), (2), and (3). Deductions are allowed (1) for interest on debts, except that on business debts; (2) for permanent legal burdens (example, maintenance of reserves); (3) contributions to sick funds; (4) life-insurance premiums. This division of the income into different parts is for the sake of accuracy of declaration, not for the sake of assessing different rates on the different kinds of income.

Persons with large dependent families or labouring under any special economic conditions seriously affecting their faculty are allowed an abatement of not more than three grades, provided their incomes are not over 9500 M. Persons having less than 3000 M. deduct 50 M. for each child under fourteen years of age, and if there are three such children, a reduction of one grade is made.

Corporations and stock companies pay the income tax on all dividends over 3½ per cent. This makes double taxation of this income, which is regarded as particularly "capable." In other ways the attempt is made to tax funded income more heavily. The exemption of incomes below 900 M. ($225) and the lower rate for smaller incomes is justified on the ground that the consumption taxes already impose a burden on these persons.

The assessment of the tax is not perfect. It is said to be considerably better, however, than the assessment of property in America. Large incomes escape in part. It has, however, an advantage in that the evasion of the tax does not in Prussia, as it does in America, intensify existing differences and inequalities. Other parts of the system tend to offset the failure in this case.

SEC. 5. **British Property and Income Tax.** — The British income tax, correctly called "the property and income tax," may serve as another illustration, but it differs very much from the Prussian. We follow the pre-war form of the tax as obviously better for illustrative purposes than the abnormal war

tax. In the first place, as has already been stated, it is rather a system of taxes on revenue than a tax on the aggregate income of each person. It is a system of modified property taxes, with a wage and salary tax appended. In Prussia the intention is to make the total income the base irrespective of the source, and reference to the sources is called for in the declaration merely as a means of getting at the total with greater accuracy. In England the different sources are kept strictly apart, and there is a difference made in the treatment of each kind of income, the tax being in some cases "stopped at the source." The total income is with some exceptions called into use only in estimating the exemptions and abatements. The taxpayer has the right by summing up his whole income to show that he has been taxed too much, or is entitled to exemption. In that case he is reimbursed. In 1907–1908 the abatements proper amounted to £885,670; exemptions on account of small incomes amounted to £886,134. The total abatements of all sorts, £2,798,289. So separate are the different parts of this tax that Mr. Wilson says of it:[1] "To the bulk of the people it is known in its most obnoxious (?) form as a tax upon ordinary incomes, salaries, professional earning, profits of trading, etc." Bastable (p. 449) says: "Inequalities are, however, removed by the comprehensiveness of the tax."

The various revenues are taxed in five "schedules," known as *Schedules A* to *E*.

The following outline of these schedules from the Acts of 1842 and 1853, with subsequent amendments, is taken mainly from Williams' *The King's Revenue*, a most admirable compilation, which should be frequently consulted by every student of British finance.

"*Schedule A.*—For and in respect of the property in all lands, tenements, hereditaments, and heritages in the United Kingdom, and to be charged for every twenty shillings[2] of the annual value thereof:

[1] P. 115, *National Budget*. Cf. Stamp, *British Incomes and Property*.

[2] See below for "deductions" allowed. Under *B* only one-third the annual value is now charged. The text gives the old law.

"*Schedule B.* — For and in respect of the occupation of all such lands, tenements, hereditaments, and heritages, as aforesaid, and to be charged for every twenty shillings [1] of the annual value thereof:

"*Schedule C.* — For and in respect of all profits arising from interest, annuities, dividends, and shares of annuities payable to any person, body politic or corporate, company or society, whether corporate or not corporate, out of any public revenue, and to be charged for every twenty shillings of the annual amount thereof:

"*Schedule D.* — For and in respect of the annual profits or gains arising or accruing to any person residing in the United Kingdom from any kind of property whatever, whether situate in the United Kingdom or elsewhere, and for and in respect of the annual profits or gains arising or accruing to any person residing in the United Kingdom from any profession, trade, employment, or vocation,[2] whether the same shall be respectively carried on in the United Kingdom or elsewhere, and to be charged for every twenty shillings of the annual amount of such profits and gains:

"And for and in respect of the annual profits or gains arising or accruing to any person whatever, and whether a subject of His Majesty or not, although not resident within the United Kingdom, from any property whatever in the United Kingdom, or any profession, trade, employment, or vocation, exercised within the United Kingdom, and to be charged for every twenty shillings of the annual amount of such profits and gains:

"And for and in respect of all interest of money, annuities, and other annual profits and gains not charged by virtue of any of the other schedules contained in this Act, and to be charged for every twenty shillings of the annual amount thereof:

"*Schedule E.* — For and in respect of every public office or employment of profit, and upon every annuity, pension, or stipend payable by His Majesty or out of the public revenue

[1] See footnote, page 251.
[2] See lower rates for "earned" incomes, explained below.

of the United Kingdom, except annuities charged to the duties under the said *Schedule C*, and to be charged for every twenty shillings of the annual amount thereof."

All incomes not exceeding £160 are exempt. The following "abatements" are allowed on all classes of income: £160 on all incomes exceeding £160 and not exceeding £400; £150 on incomes exceeding £400 and not exceeding £500; £120 on all incomes exceeding £500 and not exceeding £600; £70 on all incomes exceeding £600 and not exceeding £700.[1]

The following "deductions" (not called abatements) are allowed under *Schedule A*, namely, one-eighth in respect of lands, and one-sixth in respect of houses for repairs, etc. That is, income from lands is charged at 17*s.* 6*d.* for each pound, and that from buildings at 16*s.* 8*d.* per pound.

"Relief," in the form of a reduced rate, is given by an act passed in 1907 to "earned" incomes, in addition to all other exemptions, abatements, or deductions. "Earned" income means —

(*a*) "any income arising in respect of any office or employment of profit held by the individual, or in respect of any pension, superannuation, or other allowance, deferred pay, or compensation for loss of office given in respect of the past services of the individual or of the husband or parent of the individual, in any office or employment of profit . . .; and

(*b*) "any income from any property which is attached to or forms part of the emoluments of any office or employment of profit held by the individual; and

(*c*) "any income which is charged under *Schedule B* or *D*, and is immediately derived by the individual from the carrying on or exercise by him of his profession, trade, or vocation, either as an individual, or, in the case of a partnership, as a partner acting therein."

This "relief" extends only to earned incomes up to £2000.

The reader should note the careful distinction made in the law between "persons" and "individuals." The former includes legal persons, such as joint stock companies and cor-

[1] All pre-war.

porations other than governmental. This is especially important under *Schedule D*.

"The annual value of lands, etc., charged under *Schedule A*, is understood to be the rent by the year at which the same are let at rack-rent, if the amount of such rent shall have been fixed by agreement commencing within the period of seven years preceding the fifth day of April next before the time of making the assessment, but if the same are not so let at rack-rent, then at the rack-rent at which the same are worth to be let by the year." This rule does not apply to tithes, quarries, mines, etc., but does apply to lands, etc., capable of actual occupation, no matter how enjoyed.

"Only one-third of the annual value is charged under *Schedule B;* nurseries and gardens are charged under *Schedule D.*" Mortgages are taxed under *Schedule A*, owners being allowed to deduct what they advance in taxes from the interest they pay. Owners in occupation pay under *Schedule B*. Clergymen or ministers of religion are allowed a deduction of one-eighth on the value of any dwelling-house for which they pay rent, in respect of the portion of it which they may use for official purposes.

The greatest difficulties of assessment arise under *Schedule D*, and in 1907 the assessors were empowered to require an employer to give particulars of name, residence, and pay of any employees, and every person is made liable to be called upon to make a full return of his or her income. Normally the income taxable is the average of the profits or gains for the past three years,[1] but if the taxpayer so elect, he may be assessed on the actual amount of profits and gains for the year. Commissioners are empowered to make deductions in respect of "wear and tear" of machinery or plant used, and, generally speaking, the assessable profits are what are left after deduction of all outgoings attributable to the expenses of materials, labour, etc. Individuals are allowed to deduct life insurance premiums paid.

Many of the terms used in the schedules as quoted above will probably be unintelligible to American readers, as some of

[1] The three-year average was abolished in 1926.

the forms of income to which they apply are not found in the United States, or at least are not commonly recognised as distinct classes. On that account the following exhibit of the amount of income " brought under review " by the department administering this tax will probably prove instructive. The details of gross income are for the fiscal year 1905–1906 and the whole table is from Williams' *The King's Revenue.*

Schedule A. Profits from the ownership of:		
Lands	£52,151,543	
Houses	205,486,455	
Other Property	1,310,673	
		£258,948,671
Schedule B. Profits from the occupation of lands (farmers' profits mainly)		17,460,062
Schedule C. Profits from British, Indian, colonial, and foreign *government* securities		46,925,674
Schedule D. Profits from businesses, concerns, professions, employments (except the last of a public nature, see *Schedule E*) and certain interest:		
I. Businesses, professions, etc. (including salaries of employees), other than those enumerated below	£367,814,155	
II. Railways in the United Kingdom	41,241,692	
III. Mines	19,999,972	
IV. Gas works	7,413,611	
V. Iron works	2,683,637	
VI. Water works	5,816,300	
VII. Canals, etc.	3,847,201	
VIII. Quarries	1,695,799	
IX. Markets, tolls, etc.	869,635	
X. Fishings in the United Kingdom and sporting rights in Ireland	203,304[1]	
XI. Cemeteries	183,612	
XII. Salt springs or works and alum works	150,573	
XIII. Indian, colonial, and foreign securities (*other* than government)	14,794,821	
XIV. Coupons	12,061,156	
XV. Railways out of the United Kingdom	16,111,221	
Carried forward		£323,334,407

[1] Some sporting rights are under *Schedule A.*

	Brought forward		£323,334,407
XVI.	Loans secured on the public rates	£6,687,134	
XVII.	Other interest	4,677,654	
XVIII.	Other profits	2,399,047	
XIX.	Profits from the occupation of lands, the occupiers of which have elected to be assessed under *Schedule D* .	13,821	
			508,664,345
Schedule E.	Salaries of government, corporation, and public company officials		93,185,804
	Total gross income brought under review 1905–1906 .		£925,184,556
	Less deductions, abatements, etc. . . .		293,159,810
	Taxed income		£632,024,746

HYPOTHETICAL CASE OF A COMPOSITE INCOME

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Reference Number	Schedule	Item	Amount
1	A	Profits from the ownership of lands, houses, etc.	£500
2	B	Profits from the occupation of lands at one-third the annual value	200
3	C	Profits from government securities	200
4	D	Profits as an author	100
5	D	Profits as a solicitor (partner in a firm — total profits, £5000)	2500
6	D	Profits from investments in a public company (total profits, £55,000)	500
7	D	Profits from investments in municipal stock	100
8	D	Profits from investments in foreign bonds payable by coupons cashed in the United Kingdom	100
9	D	Salary as a land agent	500
10	E	Salary as a borough auditor	300
		Total	£5000

The income taxes are, whenever possible, "stopped at the source," that is, they are paid to the government before the income (the rents, interest, salaries, etc.) is paid over to the recipient. This has long been considered the characteristic feature of the British income tax. Williams estimates that

two-thirds of the taxes are thus indirectly collected. Stoppage at the source applies to practically all of *Schedule A* and to all of *Schedules C* and *E*. On account of the definiteness of incomes under *Schedule B* the collection is equally certain. Even under *Schedule D* many items can be stopped at the source.

The hypothetical case of a composite income of £5000 per annum by Williams given on page 256 will illustrate some of the more puzzling points.

The methods of taxing items 1, 2, and 3 are simple and require no explanation.

Item 4 is income as an individual and, although not over £160, is not exempt because this individual's total income is over £160. It is, however, "earned" income and would be entitled to "relief" but for the fact that the total of this individual's income is over £2000.

Item 5 requires no explanation.

Item 6 is income on which the tax would be paid by the company, as a "person" having income beyond the limits of any abatements, that is, £55,000, the highest sum entitled to abatement being £700. If the hypothetical individual in this case had less than £700, instead of £5000 income, he would receive abatement on this item. Technically this tax is collected directly and not "stopped at the source," but so far as the individual is concerned, the effect is much the same. This is the only item "net," less the tax appearing in the list.

The taxes on all the remaining items, 7 to 10 inclusive, are "stopped at the source," that on 8 being withheld by the banker or broker when he cashes the coupons.

The income tax is the variable element in British finance, and the rate is fixed each year with reference to the needs of the government. From 1896 to 1900 the rate was 8*d*. in the pound; 1900–1901, 1*s*.; 1901–1902, 1*s*. 2*d*.; 1902–1903, 1*s*. 3*d*.; 1903–1904, 11*d*.; 1904–1908, 1*s*.

The rates of the British income tax are very difficult to state. But if one bears in mind the history of the rates he has a clew to what is otherwise something of a labyrinth. That history we shall try to state.

History of British Income Tax Rates. — There was originally but one rate, a flat rate. Graduation, or degression in the effect of the rate after the fashion illustrated in our chart in Section 8 of Chapter II of Part II in this book, was achieved by deducting a series of "abatements" from the net income, larger abatements being allowed for smaller incomes and all abatement stopping at a moderately large income, formerly £700. The old abatements are given just above. This flat rate expressed originally as so and so many pence in the pound, and lately, as it rose, in shillings and pence in the pound, was called "the income tax," or the "standard rate." This is the rate "stopped at the source." While this rate is to-day only a point of departure, there being lower and higher rates as well, it is still thought of as *the* income tax. When it was decided to make a difference in the treatment of earned incomes, from that accorded unearned incomes, nothing other was at first disturbed in the old law, but the result desired was attained by granting a "relief" to the earned incomes. A "relief" differed from an "abatement" in that it was a reduced rate, while an abatement was a deduction from income. In 1909 a supertax of 6*d*. in the pound on the excess over £3000 for all incomes which exceeded £5000 was imposed. So far the matter was comparatively simple. Nor does it especially complicate matters that there are personal exemptions granted married persons of £25 and to all persons of £25 for each dependent.

But further changes came in as *the* income tax rate was raised. Among them were ultimately: (1) a graduation of the "relief," (2) the imposition of a supertax on large incomes, (3) the graduation of the supertax, and (4) a relief to small unearned incomes. Including only these features the rates could be stated in two series, one a low series for earned and another higher series, up to a certain point, for unearned incomes. At a comparatively high point the two series merged. But that very doubling of the series and merging brought another complication. Many incomes are partly earned and partly unearned. So adjustment of abatements and reliefs came in.

The ultimate resulting complex is distinctly appalling. It is comforting to note that even British officials have difficulty with it. They resort to so-called "effective rates" or percentages computed, with due allowance for all the modifying "allowances," "reliefs," graduations and supertax and thus show what the actual rate to be paid is at each point. The one thing to cling to, however, is the notion that there is a sort of theoretical belt-line to which *the* income tax applies and that all other rates start downward or upward from there. Yet in fact only unearned incomes between £2000 and £2500 used to pay exactly the standard rate and no more, no less. There is finally one more complication and that is that the rates at certain points "kick back" or recoil like an old-fashioned muzzle-loading musket. Thus, for example, an income of £130 was for the war tax exempt. But one of £131 did not receive an abatement of £130 as might perhaps be expected, but of only £120, and was taxable on £11, at, of course, the lowest rate of its class be it earned or unearned. In like manner an income of £3000 paid at one time no supertax. But an income of a little over £3000 paid the supertax not only on the excess over £3000, but on £500 above £2500 as well. The same feature occurs at many other points in the scale. To mitigate the harshness of this kick-back the taxpayer is allowed to make a present to the government of the margin by which his income exceeds a certain limit and would thus carry him into a higher effective tax rate, and then to calculate his tax as though his income were within the limit. So the amount paid on £131, which as a tax would figure out, literally, 24*s.* and 9*d.*, is reduced to £1. That is, the taxpayer gives the government the extra £1 over £130 and then claims exemption. At £701 this reduces the tax from £87 12*s.* 6*d.* to £75 12*s.* 6*d.* plus the £1 donated to the government or in all to £76 12*s.* 6*d.*, which is a considerable reduction. At £712 or £713 it becomes a matter of indifference which calculation is used.

With the foregoing as a clew we may now enter the labyrinth. In 1914 the annual budget, adopted just before the war broke out, fixed the income tax at 1*s.* 3*d.* in the pound and the super-

tax which had before that been simply 6*d.* in the pound on incomes over £5000, but computed on all over £3000, was graduated for all incomes over £3000. The "abatements" were £160, if the total income did not exceed £400; £150 on incomes between £400 and £500; £120 on incomes between £500 and £600; and £70 on incomes between £600 and £700. Earned incomes received relief as follows: If under £1000 they paid only 9*d.*; if between £1500 and £2000, 1*s.*; if between £2000 and £2500, 1*s.* 2*d.*, and above that came under the full rate, and when the income exceeded £3000 the supertaxes applied. The rates of the supertax were graduated from 5*d.* in the pound on the first £500 below £3000; 7*d.* on each pound over £3000 up to £4000; 9*d.* between £4000 and £5000 and so on, reaching finally a maximum supertax equal to *the* income tax rate plus a penny on all income over £7000. But after the war broke out, in November, 1914, *the* income tax was doubled and so were the relief rates and the supertax rates.

The War Income Tax Rate. — As war needs increased the rates rose, finally reaching 6*s.* in the pound as *the* income tax, and a graduated supertax reaching 4*s.* 6*d.* on the excess over £10,000. Earned incomes beginning at £131 with abatement of £120 paid 2*s.* 3*d.* up to £500, the other abatements dropping to £100 between £400 and £600 and to £70 between £600 and £700; then the relief rates rose to 3*s.* 0*d.* between £500 and £1000; 3*s.* 9*d* from £1000 to £1500; 4*s.* 6*d.* from £1500 to £2000; 5*s.* 3*d.* from £2000 to £2500, after which *the* income tax of 6*s.* came in, while the supertax began at £3000, striking back on the first £500. At the same time relief was also accorded to small unearned incomes, namely, at 3*s.* up to £500; 3*s.* 9*d.* between £500 and £1000; 4*s.* 6*d.* between £1000 and £1500; 5*s.* 3*d.* between £1500 and £2000; after which *the* income tax of 6*s.* applied, and also the supertaxes as per the scale above. It should be understood that each higher rate applies only to the excess over the amount to which the previous rate applied; also that mixed incomes received only proportionate abatements and reliefs. The war taxes reached down to workers receiving as low as two pounds ten shillings a week,

and took from them two and a half days' wages each year. The supertax began with 1*s.* on £500 in every income of £2500 or more, and 1*s.* 6*d.* in £500 on every income of £3000 and rose by 6*d.* for each additional £1000 up to £10,000, so that it was 4*s.* 6*d.* on the excess over £10,000. The highest rate was therefore 6*s.* plus 4*s.* 6*d.* or 10*s.* 6*d.* less the effect of the abatements and reliefs.

The result of all this was a slightly irregular degressive rate rising very sharply below the 6*s.* line, and approaching as an ultimate, but never quite attainable, limit 10*s.* 6*d.* in the pound or 52½ per cent. From this maximum the rates have been decreased, and are presumably liable to still further decreases. In 1923–4 the income tax was 4*s.* 6*d.* and the supertaxes, beginning at £2000, were rearranged so that the rates were 1*s.* 6*d.* on the first £500 over £2000 and reached a maximum of 6*s.* on the excess over £30,000.

Before leaving the British income tax there is one point which may be mentioned. Since the British tax in many of its schedules is imposed on the *annual value* of property, all questions as to the increment value of property are thereby automatically settled. Only when an increment value becomes part of the "annual profits and gains" under *Schedule D*, and then usually only as to persons whose income is made by regular trading in stocks, bonds, lands, and other capital investments, would an increment in capital value be likely to come under the income tax.

The Administration of British Income Tax. — The administration of the income tax ensures the taxpayer an opportunity for a hearing. The assessment is under the direction of local boards known as the Commissioners of Income Tax or Commissioners-General. Selection is made by the old land tax commissioners and "naming" in Parliament. There is a board in each of a considerable number of districts and large cities so that the convenience of the taxpayers is safeguarded. A property qualification once existing has recently been removed. The actual work of assessment is done by assessors appointed by the commissioners. The assessors report back to

the commissioners, whose clerk writes up the assessment roll. But their work is confined primarily to assessments of income under *Schedules A*, *B*, *D*, and *E*, not presenting special difficulties and for which there is stoppage at the source. Special commissioners assess railroads, insurance companies, and other matters not local, and especially the supertax. Assessments under *Schedule C* are made by the "Commissioners for Public Offices." But there are Surveyors or Inspectors appointed directly by the Treasury or by the Board, that is, the Commissioners of Inland Revenue, who also make many assessments which the local commissioners cannot well manage, and who in particular unify and systematise all the work of the assessors and of the local and special commissioners. There are special arrangements for cities and many other details we may not enter into. An appeal lies to the general commissioners, that is, to the local Commissioners of Income Tax, but in most cases appeal matters are actually handled and settled by a Surveyor and reported to the Commissioners. Final appeal lies to the Board. Collectors appointed by the general commissioners receive taxes stopped at the source and collect all others, subject, however, to extensive supervision and control by the central Board. As stated above, much of the tax, 70 per cent during recent years, is stopped at the source. This necessitates that every taxpayer who is entitled to an abatement or a relief will, and all subject to the supertax must, file a statement or return of his entire income. Repayment of any excess collected at the source, in cash or by allowance against the tax on other income, which is the most common case, is promptly made. This method gives what the American tax lacks: (1) final and conclusive assessment before the tax is paid; (2) an easy, speedy, and inexpensive appeal before local officers; and (3) as complete an audit as is ever possible.

SEC. 6. **History of Income Taxes in United States.** — The federal government of the United States made use of an income tax during and for a few years after the Civil War; that is, from 1862 to 1871, a period of ten years. Another income tax law was enacted in 1894. But this one was promptly held to be

unconstitutional so that the law never took effect. Thereafter, the constitution was amended, in 1913, and Congress was expressly empowered to levy an income tax. This Congress soon did, and the tax levied under the new provision of the constitution became one of the main sources of war revenue. It is still, 1920, in force.

Constitutionality. — In the United States the question of the constitutionality of an income tax is of great historical interest, not merely as related to taxation, but as related to greater political and social questions. Incidentally the controversy throws light on the distinction, never too clear, between a direct and an indirect tax. For both these reasons a brief statement of the old controversy, although now settled, must be included here.

The constitution originally provided:

"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons." Article I, Section 2, Paragraph third.

"The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States, but all Duties, Imposts and Excises shall be uniform throughout the United States;" Article I, Section 8, Paragraph first. (It should be noted that the word *taxes* is not repeated in the uniformity clause.)

"No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration hereinbefore directed to be taken." Article I, Section 9, Paragraph fourth.

Under these provisions it would appear that in the case of a direct tax the procedure would be, first, to fix the total amount to be raised, then divide that by the total population and multiply the result by the population of each state in order to arrive at the share of each. These shares would then be raised in each state on the further basis of apportionment selected by the state authorities. If that basis were polls, the matter would, of course, be simple in form. But even if that were the

basis, it would obviously disregard any differences in ability between the people of different states, as well as between people in the same state. If any other basis, such as property or income, were selected the differences between states and the consequent inequalities would stand out quite as clearly. The average *per capita* wealth or income now varies greatly from state to state and any *per capita* apportionment would necessarily be sadly unequal. Even the technical omission of the word *taxes* from the uniformity clause could scarcely be urged as a defence against such inequality.

It thus becomes of some importance to find out what the framers of the constitution meant by the term direct taxes, other than the one they named, to wit, a capitation tax. Historical research by Bullock and Seligman shows clearly that by "other direct taxes" the framers had in mind only the sort of taxes, land and building taxes, with which they were familiar, and which the Congress had undertaken to apportion during the Revolutionary War. Among these there was no income tax. Moreover, an income tax was, in that day and generation, a novelty, and it would not have been in the least likely that a personal income tax would have occurred to the minds of the framers of the constitution as even a possibility.

Down to 1895 the Supreme Court uniformly held that the phrase "direct taxes" as used in the constitution meant only capitation and land and building taxes. When face to face with an income tax the court held that it was not a direct tax within the meaning of the constitution, but fell among the duties, imposts, and excises which must be uniform and need not be apportioned.

The income tax law of 1894 was enacted for two reasons. One was for the purpose of meeting any deficit which might arise from a downward revision of the tariff made by the Democratic party then in power. The other was to satisfy a mild radical movement directed against the growth of large fortunes and demanding heavier taxation of the rich. The forces of conservatism at once arrayed themselves against the tax and sent an army of the most eminent attorneys into court to plead

the case against the tax. From a controversy over a fine technical point of law, the contest soon grew into a legal, political, and social struggle of mass against class. Justice Field in deciding the case seems to have recognised that it involved far more than the comparatively light tax before the court. He said: "The present assault upon capital is but the beginning. It will be but the stepping-stone to others larger and more sweeping till our political condition will become a war of the poor against the rich; a war constantly growing in intensity and bitterness." The decision was that the tax was unconstitutional. It rested in part on minor technicalities in the law itself, but in the main on the ground that the income tax is a direct tax, even within the meaning of the constitution. Thus all previous rulings were reversed.

The Sixteenth Amendment. — This decision intensified the very movement which it was, perhaps, designed to check. It failed signally to stem the rising tide of radicalism. So far as the income tax was concerned it led to the sixteenth amendment to the federal constitution, finally ratified February 28, 1913, which reads:

> "Congress shall have power to lay and collect taxes on income from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

This amendment ended the controversy over the powers of Congress with respect to the income tax. It is sufficiently self-explanatory, except as to one phrase, which still (1926) requires judicial interpretation. Does the phrase "from whatever source derived" merely remove a minor point of difficulty raised in the decision of the court in the case of the income tax of 1894, namely, that a tax on income *derived from property* is a tax on the property, and hence a direct tax which must be apportioned, or was it inserted as a sweeping investment of Congress with power to tax the hitherto exempt salaries of state officers, local officers, and school teachers, and the interest on state and local bonds? These items of income have been held to be exempt from a federal income tax on grounds origi-

nating in the famous dictum of Chief Justice Marshall in M'Culloch *vs.* Maryland, 1819, that "the power to tax is the power to destroy," and since Congress may not destroy the states it cannot tax any agencies or means necessary to their existence, or to the performance of their reserved functions. So far (to 1926) Congress has not seen fit to impose the tax on incomes of these classes and the question has not been raised in court. Whatever we may hold as to the expediency of taxing interest on public bonds, it is hard to believe that a uniform income tax on all persons including state officials would destroy the necessary agencies of the states. The dictum would clearly forbid a discriminating tax on such officials, but would scarcely apply to a uniform one. Yet, conversely, a state income tax on a federal salary does seem an impossibility.

The Civil War income tax and the attempted one of 1894 gave us many of the ideas now to be found in the federal income tax law and on that account, as well as for their own interest, are worth study.

The First Civil War Income Tax Law. — The resort to an income tax early in the Civil War was suggested by the obvious inequalities of a direct tax on real estate but apportioned to the states on the basis of population. A bill was passed in 1861 providing for a tax of 3 per cent on the excess over $800 of "the annual income of every person residing in the United States." Income was not specially defined but was declared taxable whether "derived from any kind of property or from any profession, trade, employment, or vocation." It seems to have been thought of as a tax in lieu of any tax on personal property. It was called the "income duty," and not a tax, to keep within the verbal requirements of the constitution as it then read. The duty imposed by this law was never collected, for before the date set when it should be collected Congress reassembled and passed another income tax law superseding the first. But this law gave us two ideas. One was the foundation of the degressive progression of the rates, embodied in the phrase "on the excess over," and the other that the tax is on all residents, whether citizens or not.

The Law of 1862. — The new bill was introduced in Congress in 1862 with many misgivings, being regarded as objectionable, inquisitorial, and "of all taxes least defensible," and was adopted as a necessary evil. It was attempted to mitigate it by making it a part of a comprehensive system of taxes. These included, among others, taxes on corporations, some of them based on gross receipts, others on bond interest and dividends. Salaries of federal officials were taxable at 3 per cent on the excess over $600 and this tax was withheld at the source. For other persons the tax was also 3 per cent on the excess over $600. Income was defined as the "annual gains, profits, or income of any person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment, or vocation, carried on in the United States or elsewhere, or from any source whatever." Here we find some more of the phrases still used in the income tax law. Incomes exceeding $10,000 were taxable at 5 per cent with a deduction of $600, but without benefit of the 3 per cent rate up to $10,000. Provision was made to avoid taxing as personal incomes receipts already taxed as income of corporations or in other special ways. While every one was required to make a declaration the assessor or assistant assessor made the assessment. An interval of sixty days was allowed for making the assessment. These assessment provisions were excellent in intent. It is unfortunate that they have not been carried into the present law. Unfortunately, also, they were better on paper than in practice. They broke down, not because they were not inherently good, but from the weakness of the civil service at the time. The assistant assessors were underpaid political appointees, with much authority and little skill. The personnel of the corps was constantly changing, and selections were made on the basis of the old spoils system.

One interesting feature of the law was that, with the intent to equalise between the man who lived in his own home, or on his own farm, and tenants, the latter were allowed to deduct the amount they paid in rent from taxable income. This is

perhaps the only feasible way of equalising between owners and tenants in a country where ownership of the home is so widespread, tenancy less common, and the difficulty of valuing the rent so great.

The Invention of the American Form of Degressive Rate. — In 1864 the progression was intensified. To many this seemed objectionable. The principle of progression was unfamiliar. One legislator said of it: "It seems to me it is a strange thing to punish men because they are rich." After a long debate and the consideration of many counter proposals Congress adopted a system of rates involving degression. The form was the one which is still characteristic of the United States income tax and is peculiar to that country. The new rates were 5 per cent on *the excess over* $600 up to $5000, 7½ per cent on *the excess over* $5000 up to $10,000, and 10 per cent on *the excess over* $10,000. It will be observed that, since each new rate applies only to the excess over the highest sum to which the lower rate applies, the effective rate, that is, the ratio to the entire income, never changes abruptly.[1]

This law was, however, again amended before it went into effect, and the 7½ per cent rate was cut out, the 10 per cent rate being applied on the excess over $5000. In 1867 the progressive feature was modified and a flat rate was applied to the excess over $1000. It is interesting that the principle of progression adopted, but abandoned, was revived in the later laws. It should be noted in passing that the increase in the exemption was more apparent than real as the constant fall in the purchasing power of money during the Civil War made $1000 far less effective than the original $600.

Assessment and Assessors. — While every taxpayer was required to make a written declaration there was large dependence on assessment and some degree of publicity. In his report of 1864 the Commissioner of Internal Revenue says: "the assessors . . . have become more thoroughly ac-

[1] For more details concerning this law and the whole of the Civil War income tax see: Seligman, *Income Tax*, pp 44 ff.; Kennan, *Income Taxation*, pp 237–256; Howe, *Taxation in the United States under the Internal Revenue System*, Chap. III; Von Hock, *Finanzen der Vereinigten Staaten von Amerika*, p 296 *et seq*

quainted with their obligations under the law than at any prior period."

Yield of the Tax. — The income tax of the Civil War was slow to bring in revenue at first, owing to its novelty and the lack of trained assessors. During the period when patriotic feeling ran high its yield was large. After that, evasion by false declaration became prevalent and the revenue fell off. With the general removal of the war taxes in 1870 the income tax was repealed, as to incomes received after 1871. Back taxes continued to come in for some time thereafter.

Income Tax Law of 1894. — The income tax law of 1894 carried over the old definition practically unchanged. The tax was to be a very light one, being only 2 per cent on the excess over $4000. It was to be accompanied by a tax at the same rate on the entire net profits of corporations. Dividends were not to be taxed again as individual income. Profits from real estate sold were not to be taxable unless the real estate had been acquired within two years prior to the sale thereof. This is a somewhat novel method of solving the problem of the taxation of the increment in property values. A sworn statement was to be required from all persons whose income was over $3500. All formal assessment was omitted, and there was no provision for an assessment roll. The administration was placed in the hands of the collectors of internal revenue and their deputies. This consolidation of assessment and collection with virtually no deliberate assessment at all is a very vicious feature of the law which has unfortunately been inherited by our later laws. Secrecy as to the returns was to rule. As the law was never enforced it is of interest only as a carrier-over of ideas.

The Corporation Tax of 1909. — In 1909, before the sixteenth amendment to the constitution was ratified, Congress adopted a tax on the net profits of corporations. This tax is often considered as the forerunner of the present income tax. It was known as a special excise tax and as such was upheld by the Supreme Court. It is now closely correlated with the personal income tax.

All Incomes Accruing after March 1, 1913, Taxable. — Immediately upon the ratification of the sixteenth amendment Congress began the preparation of an income tax law. This law, approved October 3, 1913, took effect as to all incomes accruing after March 1, 1913. This last-mentioned date is important. It is assumed that no income received prior to that date is taxable. Property values as of that date are the starting point in reckoning all increments of value or profits made from the sale of property. This date also enters into the measurement of capital for various purposes connected with the excess profits tax, a tax conjoined, in a way, with the income tax.

The Several Income Tax Acts. — The income tax law of 1913 was followed in quick succession by six more. The last one dated February 26, 1926 is an accumulation of all the preceding ones. Administrative and judicial interpretation has also been accumulated. The body of law which one must consult to understand fully the present and future federal income tax is already very large. It still grows apace.

The rates in 1913 were moderate. A so-called normal tax of 1% on all income over $3,000 for a single person, or $4,000 for a married person, was supplemented by a series of surtaxes beginning at $20,000 with 1% and rising to 6% on the excess over $500,000. During the war and just after it the rates rose rapidly to a 12% normal in the Act of 1918 with surtaxes rising to 65%. In the three acts since 1918 the rates have been reduced each time and in the last act, 1926, there is a 5% normal with subnormal rates of 1½% and 3% on the first and second $4,000, while the maximum surtax is 20%.[1]

Income as Defined for Federal Income Tax. — No concise definition of "income" is given. But the statute sets up a method for computing "net income." In this computation the starting point is "gross income," which is elaborately described

[1] What follows is an outline of the characteristic features of the American income tax, not a "tax-payers' guide." Montgomery, Holmes, Nelson, Black and innumerable others publish elaborate guides. Most banks furnish a text on the law. There are several "services" designed to give their subscribers currently all the new rulings as they are made. The government furnishes bulletins, including "regulations," and several series of rulings. References below are to the law of 1926 unless otherwise stated.

by an enumeration of its contents. From that certain general deductions for expenses and losses are allowed, also certain "credits" to individuals. The result is taxable income. The credits include income already taxed and the so-called personal exemptions.

Gross income "includes gains, profits and income derived from salaries, wages or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit or gains or profits and income derived from any source whatever." There seem here to be three general classes of income: (1) salaries, wages and other personal earnings; (2) business or trading profits, (3) income from investments.

Excluded from "gross income" are: (1) receipts of the nature of capital, such as amounts received from life insurance, gifts, bequests and inheritances, also, returned capital of liquidating corporations; (2) amounts received through accident or health insurance or under workmen's compensation laws; (3) interest on state, county and municipal bonds which Congress has no power to tax, and on federal bonds which carry a tax-free covenant; (4) stock dividends; (5) income of foreign governments, and of domestic governments from public utilities or "any essential government function."

All salaries or other compensations received by the officers and regular employees of a state or of any political subdivision of a state, such as a county, a municipality, a school or other district, are non-taxable. This is not mentioned in the act but rests on decisions of the Supreme Court to the effect that since the power to tax is the power to destroy, and since Congress may not destroy or limit state governments it may not tax any of the necessary instrumentalities of those governments.

Capital Gains and Earned Income. — The Act of 1921 established as a special class of income subject to special treatment, "capital gain," defined in 1926 as the gain from the sale or ex-

change of capital assets held for more than two years. This is subject to a maximum tax of 12½% but with restrictions as to the effect of this on the taxpayer's total tax.

The Act of 1924 set up another class in "earned income," defined as "wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered." A lower tax rate is imposed on this class of income.

The reasons for special treatment of these classes of income are interesting and important. Capital assets, according to the mathematical theory of investment values, increase in selling value: (1) as the income, of which the capital value is only the present worth, increases; or (2) as the march of time brings a realisable income nearer. Hence any increment in capital value is merely a reflection of future income which will be taxed if the income tax continues, and to tax both the increment and the income which causes it is a sort of double taxation.

Income earned possibly by the sweat of one's brow comes harder, so it is argued, than income from investments in property and it hurts more to part with it. Moreover labor, exertion to an economic end, is to be encouraged for social advancement. That investment income, "unearned" as it has sometimes been called, should bear a heavier tax than "earned" income is a widely accepted tenet. The only objection to granting this favour to earned incomes in the federal tax is that under the tax system of the states and cities property, and hence investment income, bears the entire burden already. As the local taxes are heavy possibly they constitute a sufficient added burden on such incomes. Since it is in many cases difficult to distinguish what part of a mixed income is earned and what not, the law arbitrarily states that all incomes under $5,000 shall be considered earned, and if more than $5,000 not over $20,000 may be claimed as earned. The tax on earned incomes is reduced by 25%.

Income in Kind. — In general the law is understood to confine the idea of income to "realised money income." Thus the use or enjoyment of one's own property, as for example, a home, is not considered taxable income although in some other countries it is so regarded. But income received in the form of

property, shares of stock, notes or goods easily reducible to cash is included. When personal services are compensated for by living quarters, subsistence and the like, these items are considered as taxable at the equivalent of their money value. Per contra food products raised by a farmer and consumed by his own family are not income. Practically the amount of income in kind that is taxed is insignificant.

Realised Incomes and Realised Losses. — Unlike the practice in Great Britain where under the *property* and income tax a theoretical annual value *may* be assessed whether income is actually received or not, the United States follows the general rule that income is not taxable until realised, that is reduced to possession. It is taxable in the year in which it is realised. The same rule applies to expenses, losses and bad debts which are deductible when realised. Consequently we have a general rule that each year stands on its own bottom. In the earlier years this rule was rather harshly adhered to. The result was sometimes great hardship. An undertaking running over several years might result in a profit, realised at the end, in a year when only small expenses had been incurred and no deduction was allowed for the heavy expenses of the preceding years, during which no income against which they could stand had been realised. This was modified first in the case of farmers who were allowed to charge the expenses of raising a crop against the receipts from the sale of that crop even though the sale occurred one or more years after the raising. With suitable safeguards it is now permitted to allocate even losses to the one or more year's business to which they properly appertain.

Gross Income Not Gross Receipts. — Gross income, the item with which the computation is to begin, is not the same as gross receipts as will be seen from the definition given above. But since it seems necessary to follow the usual forms of sound accounting practice, the forms provided by executive order require all taxpayers engaged in business, to show their gross receipts first. From this there are deducted the cost of materials used and of goods bought before the gross income as defined by law is reached. After that the deductions specified in the law are taken.

Deductions from Gross Income. — To arrive at net income, which with due allowance for the credits to which particular individuals are entitled is the basis of the tax, the following deductions from gross income are made: (1) business expenses, wages, and rentals; (2) interest paid on indebtedness; (3) taxes, except income taxes; (4) losses and bad debts; (5) exhaustion, wear and tear on property used, and a reasonable allowance for obsolescence. There are special provisions for ascertaining the depletion of capital assets in the case of mines, oil and gas wells, other natural deposits, and timber. In the series of acts passed during the war and just after, there were special provisions for deduction of an allowance for the amortisation of plant and equipment installed for the production of war materials or for war service, and which plant, etc., became useless after the war demand ceased.

Volumes have been written as to the proper interpretation of these deductions and the body of official rulings thereon is very large. But the questions involved are of interest primarily to the accountant. In the successive laws and in their interpretation there has been a marked tendency to liberality in the granting of deductions. Thus originally the only losses allowed as deductions were such as were incurred in one's regular business. A grocer for example might speculate in sugar, buying at six cents a pound and selling at five, and deduct the loss. But if he speculated in mining stock on the side and made a loss he could not claim a deduction. Since 1918 all losses are deductible to the extent they are not covered by insurance.

Peculiar to the American income tax law are the extremely liberal allowances for depreciation, depletion and obsolescence. The British law by contrast originally allowed only renewal and repair of utensils, and after 1878 "wear and tear on plant and machinery." In discussing a proposal to follow the American practice and make more liberal allowances for these items or for "wasting assets" a Royal Commission argued that all sources of income are subject to wastage. Even human beings waste away. A lawyer, surgeon or working man might with equal force claim an allowance for the exhaustion of his initial capital,

that is of his investment in education and in training, as might a mine owner for the exhaustion of the minerals in the earth. Theoretically if these allowances are made the tax rates must be correspondingly higher, so if all capital assets wasted at the same rate it would make no difference in the tax whether wastage were allowed or not. The useful purpose then that these allowances serve is equalisation between different taxpayers, where capital assets are being wasted or depreciate at different rates.

The deduction allowed for taxes is extremely liberal. For reasons explained above, in the general outline of an income tax (page 244), the federal income tax itself is not deductible. But all other taxes paid are deductible. The deduction of business taxes is fairly logical. But the deduction of personal taxes, since no other personal expenses are deductible, can be defended only as a kindness, a charity or in mitigation of the severity of the income tax. Yet the federal law allows every tax paid to be deducted. Thus the taxes on one's home if owned, are deductible even though they are clearly personal expenses and the rental or use value is not taxed. So too the taxes on a pleasure automobile and the gasoline it uses are deductible. This deduction includes all state and local taxes on property or business, all excise taxes, customs duties, even taxes on luxuries and amusements, and what seems perhaps most incongruous, inheritance taxes, whether estate or successions taxes. Special assessments for local benefits are not considered taxes and are not deductible.

Personal Expenses. — Since the main purpose of income is to meet living expenses or save when possible, personal or living expenses are not deductible, nor are savings or investment outlays, or betterments to property. Despite the argument that it would be well to encourage thrift by the deduction from income of life insurance premiums, at least up to a certain amount, both these and fire insurance premiums and the like when not clearly business expenses are not deductible.

Credits. — For purposes which will be more fully explained below in connection with rates there is a sort of distinction to be made between net income and net taxable income for the normal tax, but not for the surtaxes. Net taxable income in

this sense is net income less certain "credits." The amounts covered by the credits are treated as tax paid, for this limited purpose only. The credits are: first, income which is regarded as having been taxed at the source; second, the so-called personal exemptions. The first allowance now consists solely of "dividends" on the shares of stock of those corporations which are taxed on their net earnings, as will be explained more fully below. Under the earlier laws similar credits were established for other items of income the tax upon which was collected by stoppage at the source, namely interest, certain salaries, rent payments, and other items.[1] The second credits or exemptions have been changed from time to time. The original so-called personal exemption under the law of 1913 was of $3000 for all persons, and $1000 more if the taxpayer were a married person living with the spouse. These personal exemptions continued down to and including the law of 1917. In that year an additional "war income tax" was imposed, and for computing that additional tax the exemption credits were $1000 for single persons and $2000 for married. In 1916 there was a further allowance made to the head of a family of $200 for each dependent. A dependent was at that time defined as a child or defective supported by the taxpayer. In 1918 the credit for dependents was extended, being allowed to any person whether head of family or not, and was to be allowed on account of any dependent defined as a person "receiving his chief support from the taxpayer, if such person is under eighteen years of age or is incapable of self-support because mentally or physically defective." In 1918, too, the additional income tax known as the war income tax was added to or merged into the regular income tax, so that there is now but one tax. The personal exemptions have been frequently changed. In effect they are part of the rate schedule. In the 1926 law they stood for single persons $1,500, head of a family $3,500, for each dependent $400. None of these are allowed in computing the surtaxes.

The Rates. — The rates are such as to establish degressive progression (see page 78). There are two kinds of rates, the

[1] See law of September 8, 1916.

"normal" and "surtax" rates. The normal was originally a single flat rate applied to the excess over the personal credits. In 1918 when the "normal" rate went to 12% a "subnormal rate," as it may well be called although not so-called by law, of 6% was introduced, which was applied only to the first $4,000 above the credits. The regular normal applied beyond that sum. Finally in 1926 we find a "normal" of 5% applicable to all income over the personal credits plus $8,000, and two sub-normals, namely 1½% on the first $4,000 above the credits, and 3% on the second $4,000. Also there is a discount of 25% on earned income and a fixed limit for the tax on capital gains. All taxpayers, big and little, the clerk as well as his millionaire employer, enjoy the "personal exemptions," the benefits of the sub-normal rates, and the 25% discount of the tax on earned income. Thus we have for a married man with $100,000 net income, no dividends, no dependents, and disregarding the allowance for earned income, the following: $3,500 exempt, 1½% on $4,000 equals $60, 3% on $4,000 equals $120, 5% on the difference between $100,000 less $3,500 plus $4,000 and $4,000, or on $88,500 equals $4,425, or a total "normal" tax of $4,605, or an effective rate equalling a trifle over 4.6% for his "normal" tax. His clerk, if married, but without dependents having $10,000 income, no dividends, pays 1½% on $4,000 or $60, 3% on $2,500 or $75, a total of $135, or 1.35% of his income, or less if he has dependents and enjoys a discount of 25% on whatever part of his tax falls on earned income.

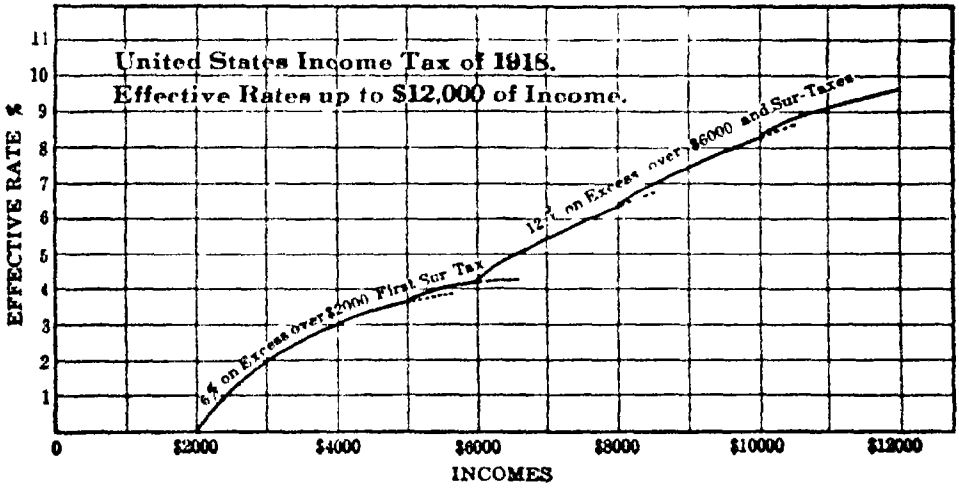
But there is a further complication arising from the fact that any taxpayer receiving dividends has a credit so far as the normal tax is concerned of the amount of those dividends. The reason for this is that these have been taxed as part of the income of the corporation by which they are paid. Thus if the clerk above taken as an illustration had $5,000 salary and $5,000 from dividends, his personal credits would be $5,000 more and his tax only 1½% on $1,500, less 25% or $16.87. Of course his dividends having been taxed at the source are less than they might have been, so he has in effect been taxed on them, and as we shall see, heavily taxed.

The Surtaxes. — The surtaxes have been frequently changed. The war surtaxes ran up to 65% on the excess over $1,000,000 and with the then normal tax of 12% made a total of 77% on that part of all incomes over that sum. We shall use for illustrative purposes the lower rates of 1926. The law should be consulted for the details. The surtaxes apply on the net income without benefit of any personal credits and are in addition to the "normal" tax. They begin at $10,000 and the first rate is 1% on the excess over $10,000 up to $14,000; the second is 2% on the excess over $14,000 up to $16,000, and so on, each successive rate applying to the amount between stated limits, or in each "bracket." There are twenty brackets and the rate increases by 1% in each. But the amount of the income in each bracket varies. After the first, which is $4,000, there follow five of $2,000 each, then ten of $4,000, then one of $6,000, one of $10,000, one of $20,000, and one unlimited. The tax in each bracket is added to those in each preceding bracket. The highest rate is thus 20% on the excess over $100,000. For an income of $100,000 the surtaxes amount to $11,660, which added to the normal taxes shown above of $4,605 makes a total tax of $16,265 or about 16¼%.

The effect of these combined rates can best be seen by reducing the total tax in each grade to a percentage of the whole income up to the end of the grade. The series of rates approaches 20% plus 5% or 25% as a limit. But it never reaches the limit. For no matter how large the income there is always the personal exemption to be deducted, and always the benefits of the subnormal rates, and so far as the surtaxes are concerned a further benefit of the $10,000 of income to which they do not apply. For example, the total tax on an income of one hundred millions received by a married man, no dependents, and ignoring dividends, works out $24,991,265, which is $8,735 less than 25%.[1]

[1] The computation of the surtax, which for large sums is tedious, if not assisted, is simplified by the use of a table printed in the official form for the return, showing the cumulative surtax at the *end* of each grade The taxpayer takes from the table the total surtax up to the grade next preceding that in which his income falls, and adds to that the percentage called for of the amount by which his income enters the last grade. Complicated as the rates may seem, their application in any one case is simple and taxpayers will find little use for the tables, charts and ingenious formulæ which enterprising mathematicians have published The real problem is "What is my income?" If a taxpayer can answer that question the rest is easy.

To see what these rates really mean and to study the progression, one may compute for a number of different incomes in series the ratio of tax to total income, assuming, as was done above, simple and uniform conditions. The results may be advantageously plotted on a curve as is done on the graph below. Owing to the continuous carrying of the exemptions and to the fact that each higher rate in the surtaxes applies only to the "excess over" what preceded, the change in the direction of the curve is never abrupt. Compare also graphs on pages 78, 79 and 80.



Theoretically there is an elbow, or bird's wing joint, in the curve at each change in the rate. But even when drawn on a very large scale the change in the direction of the curve is barely perceptible except for the first few increases. The symmetry is spoiled by the sudden change from the subnormal to the normal rate, which is coincident as well with the incidence of the first two surtaxes. The accompanying graph shows the curve up to $12,000 of income at the rates on 1918 incomes. From the point where the graph stops the curve continues in very smooth degression toward but never reaching 77 per cent. In order to aid the eye in catching the effect of the increase in rates the lines are prolonged to show where they would have gone had a new rate not been injected.

The progression under the more recent laws is far less, and the points of deflection quite different. But the curve is of the same type. The interesting approximation to a smooth curve

is the result of the American scheme of applying rates to the "excess over" fixed amounts. Few other income taxes, and of those most are acknowledged copies, have such regular progression.

Classes of Taxpayers. — The taxpayers may be roughly grouped in three classes. There are: first, citizens, whether resident or not, who are theoretically taxable on their entire income whether it be earned or gained in the United States or outside. Then, second, there are residents who may not be citizens, who are likewise taxable on their whole income, regardless of its source. Lastly, third, there are non-resident aliens receiving income from sources within the United States. The tax is therefore personal so far as residents and citizens are concerned, non-personal or falling on income *per se* as to non-resident aliens. This is on the plan of getting all that can be got. There are obvious inconsistencies in mixing the two ideas of a personal and a non-personal income tax, and the confusion in logic leads to many practical difficulties. These are even more apparent in the New York state income tax, so a discussion thereof will be postponed until we come to that tax below. It is hardly to be hoped that non-resident citizens will report all income not coming into or earned in the United States, or that resident aliens will report income that does not come into the United States. Sometimes it is said that there is another classification of taxpayers into individuals and corporations. But this is rather a classification relating to the mode of reporting and for purposes of collection, and not one of taxpayers in the sense of tax-bearers. Technically or administratively there is also a class of taxpayers, called fiduciaries, that is, guardians, trustees, executors, administrators, receivers, and conservators who handle the incomes of others.

Another way of classifying taxpayers is suggested by the application of the personal exemptions. This gives us single persons, some with and some without dependents, heads of families, and lastly husbands and wives. The law seems to contemplate that married persons may make a separate return each and be taxed separately if they have separate incomes, or they may if

they so elect make a joint return. The regulations favour the making of separate returns despite the fact that it reduces the revenue. Since the parts are necessarily less than the whole, the likelihood of running into the higher surtax rates is lessened by separate returns. If separate returns are made, only one credit of $3500 for the personal exemption is allowed. The exemption may all be taken by one alone or may be divided between husband and wife in any proportion they may desire. It is however usually only when the aggregate income exceeds the personal exemptions plus $4,000, at which point the rate rises, that there is any saving in separate returns.

The laws, varying from state to state, relating to community property of man and wife, introduce complexities into the tax liabilities of each too technical to be considered here. They are very important to many taxpayers.

Returns. — The technical name for the declaration, or statement of income filed by the taxpayer, is the "return." Returns are required of individuals if their net income equals or exceeds their personal exemptions without allowance for dependents whether any tax be due or not; also in order to have a check on the facts, if the gross income exceeds an arbitrarily fixed amount, in 1926, $5,000. Returns are also required from all corporations not specifically exempt[1]; from partnerships; and fiduciaries for their wards. The return is an important document; making it constitutes self-assessment, or if the authorities are not satisfied

[1] The exempt classes are: 1. Labor, agricultural, or horticultural organisations; 2. Mutual savings banks not having a capital stock represented by shares; 3. Fraternal beneficiary societies, orders, or associations, (*a*) operating under the lodge system or for the benefit of members of the fraternity, and (*b*) providing for the payment of life, sick, accident, or other benefits to the members or their dependents; 4. Domestic building and loan associations and coöperative banks without capital stock, organised and operated for mutual purposes, 5. Cemetery companies; 6. Religious, charitable, scientific, or educational corporations, and societies for the prevention of cruelty to children or animals, with limitations; 7. Business leagues, chambers of commerce, boards of trade; 8 Civic leagues; 9. Clubs; 10 Farmers', or other, mutual hail, cyclone, or fire insurance companies, mutual ditch and irrigation companies, mutual telephone companies, and like organisations; 11. Farmers' coöperative selling associations; 12. Corporations organised for the exclusive purpose of holding property and distributing the income; 13. Federal land banks and national farm loan associations.

All exemptions are strictly construed and are subject to limitations omitted above, but which can be found, if desired, in the law.

with the assessment, the return becomes the basis of an official assessment.

The Taxation of Corporate Income. — As has been stated, corporations were subjected to a tax on net income as early as 1909. With the coming of the personal income tax in 1913, the tax on corporations was adjusted to and practically incorporated in the general income tax. Under the earlier laws the corporations made a return of their net income and paid a tax thereon at the same rate as the normal tax on individuals, and the individual was credited, as we have seen, and as he still is, with the dividends as tax free. So far the system amounted simply to "stoppage at the source." Although unlike the British tax an individual could claim no rebate on any part of his dividends covered by his personal exemptions. The resulting discrimination is discussed below.

But since 1919 the rate on corporate earnings has been higher than the normal rate for individuals, Congress thus reverting to the former notion that corporations are peculiarly liable to a tax. Corporations now pay 13% on their net income, except that corporations whose income is not over $25,000 have a credit of $2,000 of income tax free. For net incomes but a little above $25,000, the added tax due to dropping the credit may not exceed the amount of the income over $25,000. Thus in effect a corporation whose income is $25,100 donates $100 to the government and computes the remainder of its tax on $25,000 less $2,000. The dividing line is about $25,260. Corporations were relieved in 1926 of the capital stock tax and their income tax rate advanced from 12½% to 13%.

"Withholding" under Law of 1916. — In the law of 1916 there were a number of provisions for the collection or stoppage of the tax at the source, called "withholding." The system was, however, by no means so extensive as in the British tax. Withholding the normal tax and remittance thereof to the government was made the duty of all who paid over or transferred to others: (1) interest on corporation bonds, (2) income paid out in a fiduciary capacity, (3) interest, and dividends coming from abroad, or going to foreign parts, (4) "any fixed or deter-

minable annual gains, profits and income, such as salaries, wages, interest, rent, etc. . . ."

To make such a system acceptable there must be, as is explained elsewhere, an easily accessible and expeditious means of promptly repaying to those entitled to a refund or abatement by reason of small incomes, or otherwise, all excess taxes stopped at the source. No such system was devised, or at least there was no refunding system provided in which any taxpayer had confidence. In its place it was arranged that any recipient of the items of income listed above could file with the withholder, or banking agent transferring such income, a certificate to the effect that he claimed exemption. These certificates, appropriately printed on yellow paper, could then be turned over to the government in lieu of withheld taxes. These yellow certificates at once became the "yellow dog" of the income tax. The system was unpopular, it put banks and others to a considerable expense, making them unpaid tax collectors, to their own disgust as well as to that of their customers.

Information at the Source. — In the present law there is withholding at the source only as to income going to non-resident aliens. In place of the old system we have "information at the source." This means that every person making a payment to another of "interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of $1500 or more" (formerly $800) in any year must make "return" of such payment to the government. This system is better than the other in so far as it does not involve so many persons, but worse than the other in its moral degradation. It tries to make some persons spies and tattle-tales and for that reason largely fails of its purpose.

Secrecy of the Returns. — Secrecy of the returns and of the assessments and taxes levied has been and still is a very prominent feature of the income tax. Practically nobody but officials, under bond and subject to severe penalties if they reveal the content of the returns, ever lays eyes on a taxpayer's report. The few exceptions made are safeguarded in every way. The

only publicity given is of the names and post office addresses of persons paying a tax. An exception to this rule which, however, lasted but a short time, was made in the law of 1924 when it was provided that the amount of the taxes paid should be added to the posted list of names. So much protest arose over this and the information given out was so little understandable without data as to the basis of assessment, that the provision was repealed in 1926. One incidental consequence of this secrecy is that any statistical compilations of the facts and figures concerning the incomes of the people must be so made that by no chance can the income or tax of any person or corporation be even guessed at. Statistics so compiled have obvious weaknesses.

This strong sentiment in favor of secrecy stands in the way of the creation of local boards of review, and hampers the desirable possibility of an assessment of any formal deliberative sort before collection. In place of an assessment checked, reviewed and officially recorded we have in the main self-assessment, checked only by inspectors, and revenue agents who proceed on much the same theory and by much the same methods as do detectives of crimes.

There is of course no good reason for giving publicity to a taxpayer's return, but an official assessment of taxes should obviously be an open public record. The real difficulty is not the secrecy of the returns but the absence of a formal assessment roll. To people unaccustomed to an income tax it may seem that one's income is a very intimate, personal and private affair and there is a natural dread of letting one's business rivals, or possibly one's creditors, know too much about one's affairs. But when one considers that the property tax assessment rolls contain the fullest possible record of one's assets, and that although those rolls have always been open to inspection by any one concerned there is almost no examination of them out of sheer curiosity or for purposes of gossip, the objection to a public assessment roll seems ill founded. It is usually true that one's business rival has better information than he could glean from the assessment roll. The reasons for an open roll are strong. From time immemorial the Anglo-Saxon has found in such a roll

protection from possible abuse of power by the taxing officials and some assurance that his own assessment is fair as compared with that of his neighbour. While there is no suspicion that our income tax officials have intentionally abused their great powers, there is a widespread feeling that in excess of zeal they have resolved many a doubt in favour of the revenue. Finally one may not overlook the fact that the assessment roll formally made is the best basis yet discovered for a full and complete audit of the collections, and the best safeguard against fraud and collusion.

Scanty Assessment Procedure. — The assessment procedure is scant, weak and slipshod. The taxpayer files his return with the nearest collector of internal revenue. There are none too many of these and they have offices only in the largest cities. One-fourth of the taxes shown in the return is due at once. The first official step is an office audit. In the case of small returns this is made by the local collectors. Field deputies temporarily located in smaller centers advise taxpayers in making their returns and do a large part of the office audit. But all large returns are sent to Washington, where a more expert audit is made. Inspectors may be sent to examine the taxpayer's books. The commissioner has three years to determine finally what the tax should be. There are no local boards of review. The commissioner in Washington is the sole authority for a review. Since he is legally the assessor this means that he merely reviews his own or his deputy's action. The only approximation to an assessment is the signing by the commissioner of a list to be sent to collectors. But this list is not necessarily all-embracing, for the commissioner has three years in which to complete any one assessment. Assessment is therefore a secret proceeding, with no notice to the taxpayer other than the bill sent by the collector after the so-called assessment has been signed.

The law of 1924 established a Board of Tax Appeals to which the taxpayer may have recourse against a proposed increase in his assessment. This board " rides circuit " and holds hearings in different parts of the country. It may be regarded as an excellent beginning of a proper system of review. It is useful for the larger taxpayers who can stand the expense of an appeal.

But it is not by any means a satisfactory substitute for an orderly and complete official assessment before any tax is due with adequate opportunity for even the smallest taxpayer to have his case reviewed.

Defects in the Law. — As was suggested above, the assessment procedure is very defective. It is a well-established tradition in American taxation, based on the soundest principles of law and practice, that a direct tax may not be collected save on the basis of a full and formal warrant embodied in a carefully prepared and legally attested assessment roll. Self-assessment is not found in any other tax, direct or indirect. But even if self-assessment is to be adopted the assessments should be made final and conclusive before collection.

Briefly stated, the only proper procedure is: *first*, the taxpayer files a return with a local assessor. (This office does not now exist. There is an extra-legal office of advisor, but the advisor is not an assessor.) *Second*, the assessor assesses the income and enters the assessment on an official roll. *Third*, the roll is examined by a local board of review, and to that board the taxpayer may appeal if dissatisfied with the assessment as made by the assessor. The board should have the power to revise any assessment, on its own initiative or on appeal. Its approval should be necessary to the validity of the roll. Such boards do not exist at present. Appeal now lies first to the commissioner in Washington, then to the Board of Tax Appeals. By reason of distance and expense such appeals are not very practical unless the amount of tax involved is large. *Fourth*, the roll, duly corrected and approved, should become, upon a fixed date, final and conclusive as to the taxes of the year in question. On it the proper auditing officers would extend the taxes, charging them to the collector. The roll should be the sole warrant for collection and ultimately the official record of reference for taxes paid or still due.

Another defect in the law results from the collection of taxes on corporate earnings and the method of credits to recipients of dividends. A person who receives dividends and whose income from other sources does not equal or exceed his personal exemp-

tion loses the whole or part of the benefit of the personal exemption, which accrues to his neighbour who receives no income from dividends. In like manner the benefit of the subnormal tax is withheld from dividend receivers of less than $8000 of other income. This is a very serious discrimination. It can be remedied only by a system of refunds. A refunding system, prompt and readily accessible and in which taxpayers have confidence, is badly needed, not only to correct this but other inequalities as well.

The rates of the surtaxes are extremely high, rising to a point not justifiable on any sound theory of progressive taxation, or of equal sacrifice. They are so high as to restrict accumulation and to retard production. They are nearly war rates, and if continued under peace conditions will ultimately result in decreased revenues. Unfortunately this question has become one of politics.[1]

A much discussed issue is the heavier taxation of unearned incomes. Possibly the higher rates on corporation net incomes for 1919 and subsequent years than are to be imposed on other incomes is to be regarded as looking in this direction. In reaching any decision due regard should be had of the fact that property that is the source of unearned income bears all the burden of state and local taxation.

SEC. 7. **State Income Taxes in the United States.** — While there have been at various times among the American commonwealths some taxes called income taxes, there were none worthy of that name before 1911. The older ones amounted to little more than a half-hearted attempt to include with property some few items of income, or to reach by way of taxing income some sources of vested income which could not very well be taxed on a property basis. As time passed it became more and more apparent that intangible personal property could not be made tributable under the general property tax. There seemed, however, to be a distinct kind of taxpaying ability, which had been in part aimed at by the old personal property tax and which was not being reached.

[1] See discussion of the limit of progression, p 97.

In 1911 Wisconsin proposed to kill two birds with one stone (1) to reach in part at least that sort of taxpaying ability which an income tax alone can reach; and (2) ultimately to drop the vain effort to get at personal property. So an income tax was imposed on all incomes, individual or corporate, earned in or derived from sources within the state. Money and credits, farm machinery, household furniture, and personal adornments were exempted from the old property tax and any tax paid on personal property could be deducted from the amount of tax assessed on income. At the same time the administration of the entire tax system was centralised under the supervision of the state tax commission, whose officers entered directly into local assessment work. Owing largely to the excellence of its administration and frequent adaptation of the law to meet the difficulties which arose, the new tax became a marked success. The tax was graduated, the rates rising from 1 per cent on the first taxable $1000, up to 2 per cent for the fifth $1000, then by ½ per cent per thousand, up to 6 per cent on the excess over the twelfth $1000. The exemptions were $1200 for husband and wife, $200 for dependent children, and $800 for single persons. Curiously enough the rate on corporations was also graduated. Individuals were not again taxable on dividends or interest received from corporations. The proceeds were distributed 70 per cent to the local government where the taxed income had its origin, 20 per cent to the county, and 10 per cent to the state. The tax was so successful that it gave prestige to the idea of a state income tax.

A summary of the income tax laws of all the states which have such laws would lead us into a multitude of details, and since they are frequently changed the summary would soon be out of date. The following states have a tax on personal incomes: Delaware, Massachusetts, Mississippi, Missouri, New York, North Carolina, North Dakota, Oklahoma, South Carolina, Virginia, and Wisconsin, eleven in all. This list may change frequently. Some of these laws aim merely at productive sources of income within the state where the income goes to non-residents. Connecticut and West Virginia tax corporations on the

basis of income. In general the rates are progressive and several of these income taxes are copies of the federal income tax. In view of the rapidly growing public expenses and the difficulty of reaching intangible personal property it seems highly probable that state income taxes will be more and more resorted to.

The New York Income Tax. — The most general income tax law is that of New York, which took effect in 1920 on incomes of 1919. A franchise tax on corporations measured by net income had been imposed in 1917. The tax follows rather closely the federal income tax law with divergences too detailed for an elementary text, and besides, is very frequently brought under amendment in the legislature. The rates are graduated, being 1 per cent on net income not exceeding $10,000, 2 per cent from $10,000 to $50,000, and 3 per cent over $50,000. This law opens up in full one of the difficulties which state income tax laws will have to meet and solve. That is the question of interstate income. If this tax had taken the form of a tax on residents based on personal income from whatever sources derived, as recommended in the National Tax Association's model tax system, no trouble would have arisen. But New York, especially the city, is surrounded by states whose residents work in New York, do business there, or derive income from sources in New York. Among these are the commuters, who go back and forth daily. The New Yorker did not contemplate with serenity paying a tax on his income which a non-resident working beside him or doing business in competition with him did not have to pay. So the tax was extended to cover income earned in or derived from New York. That this was not merely "grabbing everything in sight" but an attempt at making the tax equal as between a New Yorker and a commuter is shown by a provision, appearing to mean that if a non-resident has to pay an income tax in his own state he shall be allowed credit therefor to such an extent that his total tax shall equal what a New Yorker would pay on like income.[1] But since none of the neighbouring states yet levy a personal income tax this provision is inoperative.

[1] Failure of the law to make proper allowance of the personal exemption to a non-resident was corrected by the federal court, which regarded that as discrimination.

The argument that the tax on the non-resident is merely to equalise burden has, however, its weakness. For, theoretically at least, the non-resident pays, at his residence, in some form, all the taxes required to support government there; and if the New York taxes had remained on the old property basis, the New Yorker would never have thought of asking the non-resident to help out in meeting the increase in the property tax necessary to raise the amount now to be raised by the income tax. The whole thing shows a failure to appreciate that it is the entire system or complex of taxes that must be considered in determining questions of justice, not merely one tax by itself.

CHAPTER X

WAR PROFITS AND EXCESS PROFITS TAXES

SECTION 1. **A New Tax.** — So much ingenuity has been expended in the past by many generations of tax-gatherers in devising ways and means for mulcting the taxpayer that the invention or discovery of a new tax is a natural cause for surprise. Yet the Great War has apparently given the world a new tax, the excess profits tax. During past wars the sources of revenue which the new tax attempts to tap have, to be sure, been drawn upon. But they have been reached by means of the other forms of taxation, by some of the taxes upon property, upon income, and by consumption taxes.

This tax is new in the sense that it singles out a form of profits — war or excess profits — never heretofore separately distinguished as a tax base; and it is new, also, as to the social justification upon which it rests. The tax is levied on something conceived of as abnormal, and in addition to the fiscal justification ever present in all taxes, there is a more or less distinct intent to give the public a share in the gains of "profiteering" as something transitory and abnormal as well as undesirable. Every other tax is based on something regarded as normal and permanent, or at least recurrent, and even where there is a regulative intent the regulation is designed and thought of as permanent and not transitory.

Analogies with Other Taxes Partial Only. — While we have no desire to overstress the newness of this tax, it is, perhaps, of interest to consider whether the analogies to older taxes which have been suggested will hold. It has been suggested that the excess profits tax is analogous to the inheritance tax. Inheritance may be regarded as something unexpected and of

the nature of a windfall, but certainly not as something abnormal. So this analogy goes but a little way. Again, it has been suggested that there is an analogy to a special assessment for benefits accruing to some individual by reason of government action. But war was not declared for the purpose of creating profiteers or their profits, and the private benefits which occasion special assessments are not regarded as abnormal, but as more or less designed. Again the analogy goes but a little way. Finally, the tax is sometimes thought of as analogous to "unearned increment value" taxes. The analogy here is closer. But it is valid only in so far as "unearned" is interpreted to mean undeserved or abnormal, which is generally a strained meaning. An increment in the value of land is a normal phenomenon. The tax has been called a variant of the income tax. But its sole relation to the income tax is that it uses a form of income as its base. There is otherwise not even a superficial resemblance.

SEC. 2. **What are Normal Profits?** — The base of the tax is the excess of profit over an assumed normal profit. While the social mind had been prepared for the concept of this new tax base, by the subtle interpretation of unearned, in the term "unearned increment," as meaning undeserved, there has never been before such a complete, widespread, and almost unquestioning acceptance of the idea of unmerited profits as is involved in this tax. Astronomers and biologists for a long time past, and, more lately, social statisticians have used for scientific analysis that form of average called the mode, but that idea has never been very clear or distinct in the popular mind. Yet here we have a legislatively expressed conviction supported by general assent of the people that there is a modal or normal profit to which the business man is fairly entitled, and that abnormal profit ought to be trimmed away as if it were a noxious growth, or at least made wholesome by a public use.

As a source of revenue in times of peace, even in "piping times of peace," the excess profits tax is a tax that is difficult to justify or defend. But as a war tax it has a few distinct merits. They are merits of expediency, not of justice. It is

effective in getting revenue. It garners for government some of the results of war inflation of prices.

Lloyd George Justifies Excess Profits Tax. — In his first war budget speech in November, 1914, Mr. Lloyd George epitomised war taxation in the following remarkable statement: "During the war and during the period of reconstruction . . . I think we can look forward to something like four or five years when the industries of this country will have the artificial stimulus which comes from these abnormal conditions. . . . I want to impress upon the Committee with all the earnestness at my command, that it is desirable that the nation, during this period of inflation, should raise as much money out of taxation as it can be induced to contribute. It is easier to raise taxes in a period of war and to lower them in a period of peace than it would be to raise even lower taxes in a period of peace. War is the time for sacrifice, and that makes a difference. It is a time when men know that they are expected to give up comforts, possessions, health, limb, life — all that the State requires in order to carry it through the hour of its trial. It is a time of danger, when men part willingly with anything in order to avert evils impending on the country they love. Every twenty millions raised annually by taxation during this period means four or five millions taken off the permanent burdens thereafter imposed on the country."

Evils of Inflation. — Inflation is a nasty by-product of war, a result of war spending, and of the errors of war finance. Inflation spreads its influence unevenly from class to class and from man to man, enriching some and impoverishing others. It is undoubtedly less disturbing, at a time when the least possible disturbance of industry is highly essential, to gather some of the needed extra revenues from those who profit by the irregular rise in prices, than it would be to increase the general taxes. Those who get rich from war inflation can certainly well afford to pay war taxes. To use the phrase of the street, "a good way to get money for the government is to take it from those who have it." The defect of the tax is that it has so little equality.

SEC. 3. **Origin and Spread of the Tax.** — The war profits tax, which soon evolved into the excess profits tax, was first proposed in 1915 in Denmark and Sweden. It was the large and extraordinary profits made by traders, especially by exporters, in supplying the needs of Germany which attracted attention and caught the ever greedy eye of the tax-gatherer. These traders had exceptional opportunities for profit, since their trade routes were intact while almost all other trade routes into Germany were cut off. Much of this rich trade was in foodstuffs and it was at first suggested that the tax be called the "goulash" or stew tax, implying that it was aimed at the German stew-pot. From here the tax spread with incredible rapidity to all parts of the world. Like the Spanish influenza it speedily infected all the belligerent countries on both sides of the fighting lines and also most neutral countries. Writing as early as March, 1917, J. C. Stamp was able to list thirteen countries which had been invaded by this tax (*Economic Journal*, March, 1917).

When first devised the tax was aimed only at those unusual or abnormal profits which were distinctly traceable to war conditions as a cause, or to "trading on the world's misery." So its very first victims were naturally the manufacturers of munitions. But other profits soared at the same time and the line of demarcation between "war profits" and other unusual profits proved exceedingly hard to draw. So *post hoc* easily became *propter hoc* and all profits were drawn into the net. While the war profits idea, and with it the abnormal profits concept, stuck fast, all *large* profits, even though they might be quite normal, came under suspicion. Although *large* profits were fully covered by the income tax with its surtaxes, excess profits were often identified with large profits or gains. Two examples will show how the idea ran away from its own logic. Gold mining was at first included, although with a partial return to common sense it was later excluded. Now, gold has a fixed price, which was not changed by the war. But all the expenses of mining, the cost of labour and of materials, went up. By no possibility could a gold mine make a war *profit;* quite the

contrary, all gold miners suffered inevitably a war *loss*. Yet a rich "strike" was to be considered an "excess profit." Again, one of the early American excess profits tax laws undertook to cover individuals, partnerships, and corporations and included as taxable excess profits personal earnings in excess of $6000, much to the surprise and indignation of many lawyers and other professional men, many of whom earned less rather than more during the war. By what reasoning $6000 was hit upon as "normal" earnings is hard to see, the more so as the income tax surtaxes would have covered the same "excess" earnings. Exceptions there were of many industries. Thus agriculture was in many countries exempt, and in the United States the tax was finally confined to corporations.

So long as the emphasis lay on war profits, as the object of the tax, normal profits, the base from which the computation starts, was identified with a pre-war profit. The comparison was at first a direct one in absolute figures. If a given firm was making, before the war, $100,000 a year and in a year during the war made $150,000, then $50,000 was considered the war profit. Obviously this assumes that trade is along old lines, that there is no new plant and equipment and no change in products. But these assumptions were rarely true to life. How should one proceed if there were new capital investment? The answer was, allow the new capital the same *rate* of return as was earned before the war on the old capital, and tax only the excess over that amount. But suppose again it were an entirely new concern which was not in business before the war. What then? Here the answer was: allow an arbitrary rate of return on capital, arbitrarily declaring that rate to be the normal profit rate, and tax all over that as excess or war profits. In arriving at the arbitrary rate to be allowed the thought that there is a basic rate, a generally accepted "due return" on capital, which ought to be allowed, comes up at once. So any specific reference to pre-war actualities fell away and an *a priori* normal rate came in. Different countries fixed different rates. But even after this due return rate had been satisfactorily, if arbitrarily, fixed differences in risk rose up to perplex.

A company with rapidly wasting assets cannot live on six, seven, or eight per cent annual profits. Capital will not go into highly speculative enterprises (motion pictures is the stock example) unless it has a chance at big profits to offset possible big losses. Some flexibility was necessary. America adopted the idea, in part at least, of the going rate in like concerns or like lines of business. Great Britain gave the administration power to allow additional rates for risk or other peculiar reasons in selected exceptional businesses. Thus aircraft manufacture was allowed 9 per cent in addition to the general normal rate, which was 6 per cent, making 15 per cent the normal for this business. But more important than this, the ideas of depreciation, obsolescence, and depletion of capital were greatly extended, so that any excess profit or return on capital over the rigid normal assumed for all capital which might be assumed to be due to the special conditions of a given industry were thus eliminated from profits and treated as expenses.

So kaleidoscopic and rapid were the changes in the forms of these taxes in different countries that an attempt to describe them, save at undue length, would be confusing in the extreme. We can only touch on some of the main features in the taxes of Great Britain and of the United States and shall confine our attention mainly to their final form, reached just after the armistice.

SEC. 4. **The British Excess Profits Duty.** — The "excess profits duty" of Great Britain was fixed in 1918 at 80 per cent of the amount by which the profits of the taxable year exceeded the "pre-war standard of profits." This "pre-war standard" had by this time settled down to mean one of two things. It was either the average profit of any two of the last three years prior to the war, or a statutory percentage of the capital at the end of the *last pre-war year*.[1] The taxpayer might use whichever basis was the larger. Obviously the larger the *normal* the smaller the *excess* would be. New capital and new concerns

[1] By applying the statutory rate to the pre-war capital, as the normal, Great Britain preserved the idea of a pre-war profit. The American idea, as we shall see, was of a pre-war normal *rate* of profit.

received the statutory allowance together with 3 per cent additional to cover the general risk of investment in a war period. It will be observed that the pre-war normal idea was preserved as far as possible, although of course the arbitrary fixing of the statutory rate cut loose somewhat from actual pre-war facts. The statutory rate was fixed at 6 per cent for companies and at first at 7 per cent, then finally 8 per cent for other forms of organisation. Mention has already been made of the special allowances which the referees might make for lines of business with peculiar risk or other conditions. It is obvious that the determination of invested capital takes on great significance. To avoid repetition this will be discussed under the American tax only. Although the general rules of income tax accounting prevailed, "profits" were by no means identical with "income." The subject of this tax was the proprietors' trading profit only.[1] Hence interest, annuities, and all proceeds of investment are excluded from the computation. It should be noted that the application of the statutory rate being to pre-war capital, the tax is essentially a war profits tax, whether the constructive statutory or the actual pre-war profits are used as the normal. One grave difficulty of clinging so tenaciously to the pre-war basis was that as time passed and changes came, that basis became more and more antiquated and out of proper comparison with present facts.

SEC. 5. **The History of the War and Excess Profits Tax Laws.** — In the United States the "war profits and excess profits tax" reached its most highly developed form as applied to net income made during the year 1918. This tax had a forerunner in a tax of 12½ per cent on the profits of manufacturers of munitions levied under the Act of 1916. A general war profits tax was imposed by the act of March, 1917, to be replaced by the excess profits tax in the act of October, 1917, both reappearing in new and consolidated form in the revenue law of 1918. An interesting feature, fortunately for one year only, has been already referred to. That was the extension of the tax to cover the excess of personal earnings not necessarily

[1] In this the British tax was unlike the American and was distinctly more logical.

profits when over $6000. This part of the tax of 1917 caused much discontent and was barely endured even as a war measure. Profits earned in 1919 and thereafter are taxable only under the excess profits tax, the so-called war profits provisions coming to an end in January, 1920. At the same time the rates of the excess profits tax were reduced.

The "war profits and excess profits tax" (Act of 1918) applied only to corporations organised for profit.[1] As its name implies it was a combination of two taxes and was theoretically separable into two parts. One was the excess profits tax proper, the other was the so-called war profits tax. The first was theoretically on the excess of profits over pre-war average earnings. The two taxes were interwoven and interlaced. Unlike the British these taxes were based on net income from every source, as returned for income tax, and not on profits only.

The Tax as Enforced. — The two normals, which when increased by an arbitrary allowance of $3000 for each were called "credits" and were deducted from profits in order to get the taxable item, differed in the following respects. The excess profits normal was 8 per cent of the capital used in the business for the taxable year.[2] The tax fell on the difference between the actual profit and this normal profit plus an arbitrary allowance of $3000. The war profits normal was the average profits of the three pre-war years 1911, 1912, and 1913, plus or minus, as the case might be, 10 per cent of the increase or decrease in the invested capital of the taxable year over the average invested capital of the same three pre-war years. Of course, if there were no pre-war business or capital, it was 10 per cent of the capital used in the taxable year, although to this administrative exceptions were permitted. To this normal an arbitrary allowance of $3000 was added to make the technical pre-war

[1] Gold mining was specifically exempt. We omit provisions exempting very small profits, those giving abatements to incomes under $30,000, and the special provisions for profits on government contracts and for railroads and other utilities taken over by the government during the war, and some other minor adjustments.

[2] Note that unlike the British tax this cuts entirely loose from the pre-war concept; we have here a pure normal profit concept.

credit or deduction. To repeat, the excess profits tax assumed that an 8 per cent return on capital is normal under all conditions. The war profits tax assumed that pre-war actual earnings were normal and when that was not ascertainable that 10 per cent on capital is a fair estimate in view of the high tax rate to be applied to the war profit.

The excess profits tax was graduated not by size of the excess but by degree of excessivity measured in terms of rate of profits to capital. Thus on that part of the taxable excess which did not exceed 20 per cent of the capital the rate was 30 per cent, on all over 20 per cent of the capital the rate was 65 per cent. Up to 20 per cent, then, the excess was considered mild, above that it became more intense. The war profits tax was a straight 80 per cent of the excess of net income over the war profits credit.[1]

But the two taxes were not to be levied on any one company. In effect only that one was paid which was the larger of the two. The interweaving of the two taxes was, however, preserved. The excess profits tax was computed first. Then the war profits tax was computed. If the first exceeded the second it stood as the tax and the second was dropped or forgotten. But if the second exceeded the first the first was not simply dropped, but was considered as being included in the second. It seems to have been the purpose of this provision to facilitate the repeal or dropping of the war profits tax without disturbing those parts of the law relating to the excess profits tax. The law reads as though the two were one tax with three grades each having a different rate.[2]

[1] The American war profits tax, although the rate was nominally the same, was heavier than the British in so far as it applied to all net income and not merely to profits. It was lighter in so far as the 10 per cent allowance exceeded the British 6 per cent allowance. In practice the heavy depreciation allowed probably made the American tax the lighter one.

[2] At some time in the discussions over this tax and over the income tax some one hit upon the term bracket — apparently taken from printers' brackets [ ] — to describe the items entering into, and the calculations to be made in any one distinct part of the computation of the tax. The same term is used in connection with the income tax to describe parts of the income reported for a fiscal year, which parts, because the fiscal year did not correspond with the calendar year, were each subject to a different tax rate. Once understood the term is useful, for abbreviated expression, much as slang is sometimes useful.

Beginning in 1920 and applying to the net income earned in 1919 the rates of the tax are to be 20 per cent for the excess up to 20 per cent of the invested capital and 40 per cent on the rest.

Finally it crept into the law which provided for 1918 net income "a tax (the "war profits and excess profits *tax*," not taxes) equal to the sum of the following:

"First Bracket

"30 per centum of the amount of the net income in excess of the excess profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

"Second Bracket

"65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

"Third Bracket

"The sum, if any, by which 80 per centum of the amount of the net income in excess of the war profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets."

It will readily be seen that if 80 per cent of the amount of net income in excess of the war profits credit exceeded the amount of the tax computed under the first and second brackets, then whatever the 80 per cent amounted to was the total tax. For after taking away from that 80 per cent the entries found in the first two brackets, to get the amount to be entered in the third bracket, one then adds all three together again to get the total tax. What all this sliding down hill and then running up again amounted to was merely to bring clearly before the eye the increase in the tax by reason of the war profits tax, and yet to preserve the fiction that there was only one tax. The fiction was useful only to facilitate the change in the succeeding year, to a single excess profits tax by the simple expedient of dropping out the third bracket. It is a triumph in the art of law writing worthy of the high repute for sagacity attributed by tradition to the Philadelphia lawyer.

Numerical Example:

Data from books:		
Pre-war invested capital (average three years)		$50,000
Pre-war net income		10,000
Invested capital 1918		100,000
Net income 1918		40,000
Computed items:		
Excess profits credit:		
Specific	$3,000	
8% of $100,000	8,000	11,000
War profits credit:		
Specific	$3,000	
Pre-war net income	10,000	
10% of increase of capital	5,000	$18,000

First Bracket

20% of 1918 capital is	$20,000	
Deduct excess profits credit	11,000	
	$ 9,000	
(1) Tax at 30%		$ 2,700

Difficulties. — Two great logical difficulties of economic and legal interpretation of this tax at once presented themselves. These in turn gave rise to grave practical difficulties. Had it not been that patriotic fervor prevented any one from questioning these taxes they would doubtless have gone into court at once and have been tied up in an unending snarl of litigation. These two difficulties were: (1) what is invested capital and how can it be measured; (2) since the assumed universal normal of 8 per cent or 10 per cent could not, in the nature of things, recognise equally normal departures in special cases from the arbitrary general normal, what allowances for risk, depreciation, obsolescence, and depletion should be made, if any, to reach the proper normal in the special cases? The answers to these questions made to fit the peculiar concept of the excess profits have unfortunately been reflected in the interpretation and administration of the income tax with results that bid fair to be disastrous in that tax. The two questions may be considered together as essentially one.

The *value* of invested capital necessarily depends on the earnings. This is true of all businesses. But the difficulty is best seen in speculative businesses. No matter how costly a mine shaft and tunnels may have been they are as worthless as gopher holes if they tap no ore. Yet in this excess profits

SECOND BRACKET

1918 income exceeded 20% of 1918 capital by . .	$20,000	
(2) Tax at 65%		$13,000
Total tax (1) and (2)		$15,700

THIRD BRACKET

Total net income	$40,000	
Deduct war profits credit	18,000	
Basis of computation at 80% $22,000.		
80% of $22,000 is		$17,600
Deduct sum of (1) and (2)		15,700
(3) Tax in third bracket		1,900
Total tax (1), (2), and (3)		$17,600
Note the company also paid an income tax of 12% on $40,000 less: $2000 specific allowance plus the above taxes credited of $17,600, in all $19,700.		
That is 12% of $20,300, or		2,436
Total of all taxes		$20,036

Other numerical examples abound in the text-books and other references.

tax it is required to fix the value of invested capital independently of income or earnings because that value is going to be used in turn to compute the normal income. In short one has to fix the shadow in the absence of the body which casts the shadow. The thing cannot be done and in trying to do it the government has given an exhibition of how fast a puppy can turn round when he's trying to catch his own tail. The result was that invested capital came to be defined in substance as the amount paid in by the stockholders, whether originally or out of profits, in money or in property. Obviously this is approximately identical with the *value* of the capital in the case of a bank and of some similar staid and steady enterprises. But in all other cases it amounts to counting your chickens before they are hatched. Who can say what a dollar put into a street railway ten years ago is worth to-day?

The difficulties became acute in the case of mining and oil industries. A partial solution has been reached as a working basis. That solution was to take where possible the market value of the property as of March 1st, 1913, as a starting point, add at cost subsequent capital expenditures, and deduct ordinary wear and tear on machinery, etc., and a cost allowance estimated on the basis of what the ore body or sands contain per ton of ore or barrel of oil extracted. Market value was, of course, originally based on future earnings, but since market value was a knowable fact prior to the present time logic is not quite broken although badly strained by using this method. Estimates of what is under the ground are sheer guesses. The whole subject is full of trouble.

It is of course to the interest of the taxpayer to get as high a valuation of invested capital as possible, for then the depreciation and depletion allowances and, also, the normal profit allowances are larger. The excess profits tax is so heavy that the taxpayers strain themselves to get these items up. The result will be a permanent diminution of the income tax which might otherwise never have taken place.

The *A-priori* Normal. — It was remarked at the beginning of our discussion of this tax that astronomers and statisticians

have developed a very definite scientific meaning for the concept of the normal or modal average. By the formal method of least squares and the less rigid short cut application of the theory of probability a scientific mode or measure of the normal can be arrived at for any set of homogeneous items. It should be clear, however, that so far as this tax is concerned no scientific accuracy of method has been applied nor can one well be applied because the data are not homogeneous. What has been done has been to fix by statute what it is believed ought to be the normal. This congressional " ought " and the actual " is " do not agree, save in a few instances.

SEC. 6. **Yield of Tax Depends on Inflation.** — It has been remarked above that as a war tax the excess profits tax is not without some merit because it appropriates some of the profits of inflation. As a matter of fact its yield depends very largely on inflation, on paper profits reckoned in depreciated money, not necessarily corresponding to any real profits. This we may show most easily by an illustration.

Let us assume there was a small cross-roads grocery store, incorporated, doing business at the same place before and during the war. We will assume further that it served in all years from 1911 to 1919 substantially the same old customers, with the same quantity (physical quantity) of groceries, from the same old shop with the same old equipment, and all the time with the same old clerks. In short what we aim to assume is that there has been no change save in the prices of the goods bought and sold. In 1918 the store pays, let us say, twice as much money for the goods bought and sells at twice the old retail prices, paying also double the old wages to its clerks. It cost, of course, two dollars in 1918 to stock a shelf which in 1911 could be filled for one dollar. We will assume that the entire stock turns over three times each year on a 10 per cent profit margin between cost and retail selling price. For simplicity we will assume that clerk hire and all general expenses are covered in merchandise cost, so that the 10 per cent is net income or profit. The concern does not borrow but the additional turn-over capital (in dollars) is advanced by the stockholders

out of other private resources. We will assume that the premises cost $10,000 and have not been written up because tangible property is slow to respond to inflation, and that the stock of goods carried represented in 1911 an average investment of $50,000. By the assumption then the profits before the war were $15,000 per annum. In 1918 the stocks of goods represent an average of $100,000 and the profits for the year are therefore $30,000. There will be an excess profits tax to pay of $8260, but no war profits tax. We ignore the income tax of $2368.80.

Analysing the figures we have: profits before the war, $15,000 or 25 per cent on a capital of $60,000; profits 1918, $30,000 less tax of $8260 or $21,740, which is a little less than 19 per cent on a capital of $110,000. The stockholders, despite the fact that they have put $50,000 more into the business, receive in dividends (out of which there is the income tax to pay) only $21,740, which has a purchasing power of only $10,870 as compared with their $15,000 before the war. By our assumption the stockholders would have been no better off in 1918 had they kept the whole $30,000 than they were in 1911, with dividends of $15,000, the changes being merely those necessary to make the figures correspond to the actual fall in the purchasing power of money. Yet they are assumed to be making an "excess of profits" and are taxed accordingly very heavily. It may be urged against this contention of ours that the 25 per cent profit assumed in the example was always too high, and it is of course true that if the standard profit basis assumed were reduced to 8 per cent and a little over there would have been no tax. But that very contention shows the nature of the tax. It is a tax on an assumed excessivity, not as so often alleged one on profiteering during the inflation period.

Does This Tax Raise the Cost of Living? — It is commonly asserted that the tax increases the cost of living and that it enters into prices, carrying them high enough to give the trader his old rate of profit even after he has paid the new taxes.[1] If

[1] We may overlook the fact that the tax was sprung as a surprise and not enacted until the books were closed for the year.

this be true our corner grocery company would have had to be able to raise their prices, not merely 100 per cent as assumed, but enough more so that after paying the tax they would have had full $30,000 clear. Could they do it? This is a difficult question of shifting and incidence, the general principles of which are discussed in another place. The specific answer here turns largely on business psychology and will depend a good deal on the nature of the competition the business encountered. If its immediate competitors were partnerships or individuals who did not have this tax to pay the situation would not be favorable for shifting the tax. New competition would, however, not be likely to arise. Competition acts slowly and it is distinctly not safe to assume that fear of competition would enter into the problem while prices were so violently fluctuating. It would have done the stockholders little or no good to have borrowed the additional capital needed even if they could have gotten it as low as 8 per cent, despite the fact that their added capital of $50,000 earned 13 per cent, for the borrowed money would not enter into the " invested capital " and the tax would have been much higher, enough so to more than wipe out the profit they might otherwise make by use of the borrowed funds. If the original conditions were such as to warrant 25 per cent profits those conditions would, new competition being barred by the uncertainty and stress of war times, probably persist. Hence it seems highly probable that the company would feel forced to raise retail prices more than in proportion to the rise in wholesale prices. This it could do in part by raising the retail price of goods already in stock, whenever a rise in wholesale prices occurred, and in part by increasing the margin of profit used in marking its goods up. If, as is certainly likely to be the case, the rapid rise in prices curtailed purchases and lessened the volume of business in physical, not in money, measure it might be possible for the company to shift the tax in part if not wholly to the consumer. Among the store's customers there would be some living on fixed incomes who would have to curtail purchases or buy only lower grades, so the physical volume of business would naturally fall off. Our conclusion must be,

therefore, that while the tax is often a very real burden on the seller or manufacturer it also raises prices to the consumers, who furthermore suffer from being obliged to get along with less or poorer supplies. It is important to note that the period of inflation during which this tax has been in force is one in which the rate of business mortality, as measured by the liabilities of concerns which failed, has been remarkably low, compared even with prosperous pre-war years. This can hardly be explained on any other ground than that the heavy taxes, together with the ordinary wasteful costs which must be assumed to exist at all times in a fairly uniform ratio, have both been absorbed by rising prices.

Inequality of the Tax. — One feature of the tax often commented on is its extreme inequality. If our corner grocery company had promptly disincorporated as early as 1917 it would have saved the whole tax. A partnership in the same business and of the same size of business on an opposite corner would not pay this tax. If the stockholders had not been in a position to put up the additional capital but had borrowed it the tax would have jumped from $8260 to $10,160, or nearly $2000 more. That is, one of two concerns doing the same business may pay more than the other, the difference depending solely on the method of financing, which may or may not mean higher profits to the stockholders.

SEC. 7. **Discouragement of Business by This Tax.** — The extent to which business is discouraged by heavy and unequal taxation is often quite out of proportion to the burden or inequality of the taxation. It is a generally accepted truism that every tax tends to discourage the occurrence of the phenomenon on which it falls. If, as in Mexico at one time, the *sale* of cattle involved a heavy tax, cattle would not be *sold* if they could be otherwise used to advantage. This tendency never wholly absent is reduced to a minimum when the tax is regular and is expected to occur each year, and is operative at its maximum when the tax is regarded as temporary only. If a tax of 100 per cent is imposed on all buildings constructed this year, and it is known that there will be no tax next year, most

new buildings would be built next year. The excess profits tax was understood to be a war tax and it was confidently expected that it would be repealed as soon after the war as possible, being reduced or scaled down as fast as possible. This common understanding was confirmed in the federal revenue act of 1918 by actually setting forth the high rates for 1919 and the lower rates for 1920 and each year thereafter. This was a most egregious blunder — an attempt by one party "to put one over" on the party coming into power, which instead "put one over" on the taxpayers and consumers. No concealment of the programme was made. But no course more calculated to discourage production could have been devised. He who had standing timber did not cut enough to bring his profits into the excess class, even though by such restraint he could raise his price on the small amount cut far into the profiteering scale. So it was with him who had coal or oil in the ground or land for sale. By waiting a year an oil company could reduce its tax on the oil by a very considerable amount, more than enough to carry the oil in the ground. He who had leather for sale thought he might well leave it in the warehouse another year until taxes came down. So it was with every industry where postponement was possible. Only where production processes could be stopped only at a loss greater than the taxes, or where the profits would not run into the taxable excess class, or where it was feared prices might fall and the profits be forever lost, or where the consumer could clearly be made to bear the whole tax, did production continue, and in still less cases did it make its normal expansion. This was disastrous from the point of view of general social welfare. The great post-war need was rapid restoration of production, and a rapid increase therein too.

A lumber company reasoned this way. If we stop cutting there is some loss, possibly offset in part by new growth; but if we cut this year a large part of our profits ranging up to a maximum of 75 per cent will go for taxes; if we wait a year the cumulative demand will hold prices up, and next year the taxes will be at least one-third less; if we wait two years perhaps

there will be no taxes. The company then makes a computation as to just how much it can cut and sell to best advantage this year and next year in view of the tax. It is a foregone conclusion that the amount will be much less than the tempting prices would otherwise have brought forth. If it decides to cut enough to run into the excess profits it will be sure first that it will get a price large enough to cover the tax in its entirety. This explains how and why it is that the excess profits tax restrains production, enhances the high cost of living, and in general hampers industrial reconstruction. The interesting feature is that it is continuance of the tax in face of the anticipated removal of the tax quite as much as the high rate of the tax which causes this discouragement of industry.

This brings us to another interesting consideration. The tax has been extolled as giving the government a share in the plunder of the profiteers and thus restoring to the people some of that which they had lost. In so far as the tax was unexpected and retroactive, being suddenly imposed, say in 1917, on the profits of 1916, this result is achieved. But after that as we have seen it can be largely shifted or evaded. Moreover, as it falls only on profits that are at once large as well as excessive, it misses a very considerable amount of profiteering. There may be relatively very excessive profits on a small output, capital charges running over to later years' production, say of oil, and yet no tax will be paid unless the body of production be large enough to carry into the technical excess of the tax law.

Tax Condemned by Secretary of Treasury. — The Secretary of the Treasury, the Hon. Carter Glass, reporting to Congress in December, 1919, said: " . . . . The Treasury's objections to the excess profits tax even as a war expedient (in contradistinction to a war profits tax) have been repeatedly voiced before the Committees of the Congress. Still more objectionable is the operation of the excess profits tax in peace times. It encourages wasteful expenditure, puts a premium on over-capitalization and a penalty on brains, energy and enterprise, discourages new ventures, and confirms old ventures in their

monopolies. In many instances it acts as a consumption tax, is added to the cost of production upon which profits are figured in determining prices and has been, and will, so long as it is maintained upon the statute books, continue to be, a material factor in the increased cost of living."

CHAPTER XI

THE INCIDENCE AND EFFECTS OF TAXATION

SECTION 1. **Definitions.** — The most difficult problems in taxation come under the heading of this chapter. Many of them are too intricate for an elementary treatise, so little more will be attempted than to state the nature of the problems and to suggest a mode of approach.

We begin with definitions. An endeavour will be made to confine the term *shifting* to the transference of the tax from the person who first pays it to some other person who reimburses the first payer, or to its passage from one to another in a series of persons. In like manner we shall try to confine the term *incidence* or *final incidence* to the coming home of the tax to its final resting place with some person who cannot shift it any further. So far as it is possible to do so, both terms will be confined to the shifting of the burden of the tax *actually* collected by the government. The problem involved is: out of whose pocket did the money come which went into the public treasury; or, conversely, in whose pocket would that money have remained if it had not been taken by the government?

These terms, shifting and incidence, are often used much more broadly. For there are burdensome effects of the imposition of a tax which are almost inseparable in thought from the incidence of the tax *per se*. Thus a tax on liquor dealers may be so high that prices must be raised, custom falls off, and bartenders are discharged or their wages are reduced. Passing over for the moment the question whether the taxes actually paid come out of the pockets of the dealers or out of those of their customers, can we say that any of it came out of the wages of the bartenders? If we do so say, what would be our con-

clusion if the tax were so high as to kill the trade? Bartenders would receive no wages and yet could not be said to bear any tax for no tax was paid. A very severe burden has fallen on dealers, customers, and employees, yet no tax is paid. Wherever it is possible we shall refer to such incidental burdens as these as *effects* of the tax and regard them as something more or less separable from the questions of shifting and incidence. We may not succeed in this any better than have many other writers who have attacked the same problem. The difficulty is that the *effects* mingle with the *incidence* and the incidence with the effects. Every tax has a repressive effect, separable in thought but not always in computation from the money burden it involves.

We may use a simple illustration to convey the three ideas: shifting, incidence, and effects. An American bookseller, in a college town, imports some books from England, subject to a customs duty, and sells them to the college students. He pays the duty at the custom house. But he adds it to the price he charges the students. That is, he shifts the tax. The students who buy the books clearly cannot avoid the tax. So we may say that the final incidence is on them. But, by reason of the tax, fewer books are bought. The publishers' profits are less, so are the booksellers' profits, and, there being just that much less demand for printers and booksellers' clerks, their wages are depressed. Moreover some students are unable to buy the books who might have done so had there been no tax. These are all effects of the tax which do not add to the revenues of the government, and are not traceable in the money collected. If the tax is high these effects may be more serious than the tax revenue warrants.

SEC. 2. **Some Taxes are Intended to be Shifted.** — Many taxes are levied on persons who are expected to shift them. This is almost universally true of the indirect taxes. It is the deliberate intent of the legislature that they shall be shifted. It is the convenience of collecting from the few, that is, from the importers, dealers, or the manufacturers, rather than from the many scattered consumers, which determines the procedure.

These taxes present no special difficulties. It should be observed, however, that a tax is, as it were, a sticky substance, and like pitch or shoemaker's wax, some of it may adhere to every hand or thread that touches it. Thus it is clear that an importer can succeed in shifting the customs duties which he pays only if he sells the taxed goods to advantage. He may obviously be left with some tax-paid goods unsold, or be obliged to sell them at a sacrifice. He uses every endeavour to avoid this, but occasionally it does happen.

Some Taxes are Expected to Stay Where First Imposed. — In sharp contrast to the indirect taxes stand a number of direct taxes which are commonly thought of as non-shiftable. The legislature aims the tax at some person who is expected to be both payer and bearer. We may choose as an example a poll tax. It is generally considered as non-shiftable. But are there no circumstances under which a poll tax can be shifted? Perhaps there are some. Let us first suppose that the poll tax is not universal, but is aimed at a single class or confined to one district. There have been poll taxes aimed at "foreign miners" and there have been others, like a county road poll tax, imposed in a single district. In the first case the employer may have to assume the tax or, what is the same thing, pay that much more in wages if he wants to employ foreign miners. In the second case workers will not go into the county and be taxed unless they can get wages enough higher than they would get outside to cover the poll tax. A possibility, at least, of shifting seems then to exist. But, of course, the industries involved may not be so prosperous as to stand the added cost, especially if the tax is very high. In that case we may have serious effects, but no shifting because no tax is paid.

But what if the poll tax is universal, payable everywhere and by everybody? Assume for a moment that most of the people are workers who earn only a bare subsistence in wages. If the employers do not assume the taxes the workers cannot live, so it is argued. But the employers will not be able to pay the taxes unless the market price of the products will cover them, which in turn may mean restriction of output and lower wages. We may

not thus lightly assume that the tax is shifted to the consumer. Then, too, the workers are consumers and it would help them not at all if they shifted the tax on to one another. This line of reasoning leads us, we find, into a vague theory of diffusion, and weird confusion of thought. The trouble probably lies in the fact that a false assumption was made in the hypothesis that the workers themselves cannot carry the burden. This is an assumption never wholly true of all the workers and seldom true of any large group of them. Some of the Spanish rulers in the Philippines had a cynical theory that it was good for the Indians (*i.e.* the natives) to be compelled to pay taxes. For, so the theory ran, if they did not have to pay taxes they would not work, and if they had to pay taxes under penalty of confinement they would work at least long enough to earn the money to pay the taxes with, which was better than being idle all the time. This may seem a harsh doctrine. But perhaps it points to a trait in human nature. The fact probably is that a universal poll tax is not shifted nor diffused. The men who pay it work more or work harder than they would if not taxed and so earn or produce enough to live on and to pay the tax as well. The same is probably true of all taxation to a far larger extent than is realised.

This refutation of the diffusion theory does not seem complete by itself. But the position that a general direct tax cannot be diffused is strengthened if the use made of the taxes by the government is beneficial and promotes production. Good roads, for example, may increase production by more than enough to pay these costs. Good schools may make labour more productive and so may other activities of government. May it not be that good government creates the sources of its own revenues in a very real sense?

The foregoing illustration seems to suggest that a universal tax is not shiftable, while a limited or restricted one may be shifted.

SEC. 3. **Taxes on Rent, Interest, and Wages.** — There was a time when the shares in distribution, rent, interest, profits, and wages seemed to be so intimately and directly dependent on the agents or factors in production, land, capital, and labour,

that a tax on land was thought of as necessarily a tax on rent, a tax on capital or business as a tax on profit, and a tax on labour as a tax on wages. So it became the custom to discuss the incidence of taxation under the captions: taxes on rent (or land), taxes on profits (or capital), and taxes on wages (or labourers). The practice was never wholly successful because no actual taxes among the many levied were specifically aimed exclusively at any one share or source. An exception was perhaps to be found in some of the old land taxes. But in modern times it is certainly not safe to assume that any of the prevailing taxes can be traced even in the first instance exclusively to any one share in distribution or to any one source.

Taxes as They Are. — It seems far more practical to study the incidence of: (*a*) taxes on property, (*b*) taxes on persons and income, (*c*) taxes on production, and (*d*) taxes on consumption. The advantages of this are that we shall be dealing with actual taxes, and not trying to subdivide them artificially.

SEC. 4. **Incidence of a Permanent Tax on Property.** — A permanent tax on property is equivalent to an appropriation by the government of a part of the income of the property. In the chapter on the income tax we discussed the relation between income on the one hand and property value on the other. It was there shown that the *value* of any piece of property depends upon the income. It follows then that the appropriation by the government of a part of the income will lessen proportionately the capital value of the property to the owner, provided all other things remain equal. Among the other things which must remain equal are the beneficial activities of government surrounding the property. These must be neither increased nor decreased. If other things remain equal, the permanent removal of the tax should raise the selling value of the property. But if the removal of the tax means a breakdown of government, no such result is to be anticipated.

Capitalisation and Amortisation. — This theory that the tax affects the value of the property has been called the capitalisation theory or, looked at from another point of view, the amortisation theory. It is called capitalisation when we are think-

ing of the tax as vesting in the government a theoretical or constructive interest in the property. It is called amortisation when we regard the tax as involving a writing off by the taxed property owner of a part of the value of his property in proportion as the tax is to the total income, or as decreasing the selling value of the property.

The clearest illustration is found in a permanent tax unexpectedly levied on some one piece or class of property. Thus if certain securities which it was expected would always be tax free are suddenly subjected to a tax, it is obvious that they would sell thereafter for less than before. He who was the owner at the time of the imposition of the tax will have to write off or amortise the capitalised value of the tax. He who buys thereafter obtains them at a price which is based on the income less the tax. In a sense he holds them tax free. As Professor Seligman has well shown, it is the *exclusive* non-general character of the tax which makes this case so clear. Another feature contributing to the clearness is the *unexpectedness* of the tax. For if it had been foreseen, the tax would have been discounted from the very first.

There is an alluring simplicity about this theory which has tempted many to overlook some of the grave practical difficulties of its application. Thus we seem to arrive at the conclusion that the imposition of the tax involves a confiscation of property and a loss falling on one generation to the exemption of all subsequent generations. But the hard-headed business man cannot easily be convinced that the tax he pays on his land or building is no burden on him, but merely represents a loss having been borne for him by the previous owners. A *burdenless tax* seems to involve a contradiction in terms. Possibly the difficulty lies in the fact that other things will not remain equal, and that the assumption that they do remain equal is essential to the truth of the theorem. We must beware that we do not assume that the loss occasioned by the imposition of the tax is other than theoretical. It may be merely a loss of something which would never have been had but for the grace of government and the good use of tax revenues.

Another way of stating this important theory is that a permanent tax makes the government a partner in the property. The larger the government's partnership interest becomes, the smaller, so runs the theory, is that of the owner. There are two dangers in this analogy. One is that it may be understood to imply that the government is a non-contributing partner seizing but not creating a value, reaping where it has not sown. The other is that it may lead one to think of the government's interest as being salable capital, similar in kind to that of the owner. Such it distinctly is not.

It is not necessary to go so far as to consider what would happen to the value of the owners' capital if, because of the removal of the tax, government disappeared entirely. For in such a case the taxpayer would not have any salable property, the very law on which property rights rest disappearing. But let us assume that the non-collection of the tax meant no more than poorer government, such as less order, worse streets, or poorer schools. Would the selling value of the property rise by removal of the tax under such circumstances? Certainly not. It seems then that the government is usually a contributing partner and not a confiscatory agency at all. It is a silent partner as to the inside management of the property, but an active partner as concerns the outside management and environment and a partner often bringing into the firm a very goodly contribution indeed.

Again the government's partnership interest is quite unlike the owner's in kind, in that it is not a salable interest. The government has no way of realising its interest save as revenue through the annual tax. It cannot treat it as capital at all. We can speak of it as a capitalisable interest only constructively and for purposes of computation merely.

The kind of tax we have here under consideration is one attaching distinctly to the property. It must be a tax on the property as such, or it may be on the income from the property specifically as property income. A general income tax does not satisfy the requirement even when funded or property income is included.

In discussions of the capitalisation theory we often find the tax spoken of as a permanent rent charge. So conceived it is easy to show that the larger the rent charge the smaller the remaining interest of the taxed owner. There is, however, an important difference between a rental and a tax. A rental collected by government implies that the property is in the first degree public or communal property and however highly developed the private rights in the property may be they are secondary in character. A tax implies that the property is primarily private property subject, however, to the tax levy. Sometimes it is hard to draw the line. The so-called land taxes in Bengal are computed and fixed much as rentals would be. The actual cultivators, the *ryots*, are proprietary tenants under the classes of superior proprietors, the *talukdars* and the *zamindars*. But the superior proprietors are in turn tenants of the State rather than taxed owners. When an old land tax is turned into a redeemable rent charge, as was the old British land tax, it seems almost to lose its tax character. In such cases as an exception to the rule the government is in point of fact selling its old tax interest as capital.

Very different indeed from those ancient charges are modern taxes like the American property tax or that part of the British property and income tax which falls specifically on property incomes, in so far as that part of the tax is separable from the general income tax.

SEC. 5. **Incidence of the American General Property Tax.** — It is interesting and instructive to apply this theory to the American property tax. From the beginning all property owners, or would-be property owners, have known that there would be a tax on the selling value of the property. They knew that as property advanced in value the increment would be drawn in and become taxable as well as any original value. They have probably assumed that the tax *rate* would remain the same or would advance very slowly. To make a simple numerical illustration let us assume that the anticipated tax was at the rate of 1¼ per cent of the selling value of the property and that 5 per cent or twenty years' purchase is to be used in capitalising

income. These two assumptions amount to this. Out of every $500 of net income (tax not deducted) $100 goes to the government and $400 is retained by the owner. The owner's share, his salable property, is worth $80 for every $4.00 of his income and the government has a constructive interest worth $20 for every dollar of tax. We need not be disturbed by the fact that the income which determines these values may not be present income. For the present value of the property is less the more remote the income is in time. The ratios remain substantially the same, subject only to slight modifications arising from the fact that the tax is paid every year even though there be no present income.

An office building from which the owner clears $5000 a year before payment of the tax would represent a total capitalised value of $100,000 divided by our assumption into two parts or interests. One is that of the owner and is worth for sale $80,000; the other is the interest of the government constructively worth $20,000. He who bought or built the building for $80,000 gets his 5 per cent clear on $80,000 and pays a tax of 1¼ per cent on that value. The government gets its $1000 a year in taxes representing constructively a capital value of $20,000. Assume that in the course of time the rental income rises to $10,000 (before payment of the tax). The two interests double. One, the owner's, is now $160,000, the other, the government's, is $40,000. If the tax had remained at $1000, that is, if the *rate* had fallen the two shares would have been $180,000 and $20,000. Can we say that by reason of the tax *not* falling in rate the owner has lost $20,000 of his increment? Hardly, for he never was entitled to expect the rate to fall, or to expect the tax to stay at $1000. He cannot be said to have lost that which he never had nor ever anticipated having. Moreover, it is very doubtful if government had not kept pace in its development with the general growth whether the rents would have advanced so that he would have had the increase of $80,000 in capital worth.

But suppose, now, that the government plunges into reckless spending of no direct economic value to the community or to

the property owners and doubles the tax *rate* permanently. At 2½ per cent tax the owner's share drops in selling value to $133,333 and the government's share rises in constructive value to $66,666. The net income of $10,000 divides $6666 to the owner and $3333 to the government. Since the tax rate is based on the owner's share, which falls in value, a doubling of the rate does not double the government's revenue. Here we see capitalisation working in full force, $26,666 being transferred from one partner to the other. But it is important to note that the case rests on the assumption of uneconomic spending of the tax money. For otherwise the whole value, capital and rental, would go up.

The foregoing explains why property taxpayers resent and oppose any increase in the tax rate, especially a sudden one, or a transfer to the property tax of some burden heretofore carried by other taxes. It also helps us to understand why property taxpayers so seldom oppose bond issues for public improvements, even though such issues raise the tax rate. For in this case they hope that the improvement will not only add enough to their income to enable them to pay the added tax, but leave, perhaps, something over for themselves as well. That is, the owner of the building used in our illustration might approve a new water system if he hoped it would raise his rental income enough to pay the added taxes.

Within proper limits and with the reservations above set forth, the capitalisation or amortisation theory seems applicable to a tax on any kind of property. Some writers have confined it to land, others to monopoly property, still others hold it true only when the tax is not universal. It certainly affords an important approach to the study of any new exclusive tax like the British increment value land tax, which, as shown elsewhere, was recognised as causing an immediate drop in the value of the lands affected.

The notion that by reason of amortisation old taxes on property become burdenless is extremely mischievous for it leads to a light regard of extravagance in public spending. It is only wise spending by a good government that makes any

taxes easy to bear. A change from good to bad government may change a tax once easily borne into grievous confiscation.

SEC. 6. **Personal Income Tax Not Shiftable.** — We considered the incidence of a poll tax at sufficient length in the introductory section. Among the other personal taxes the income tax is clearly of most importance. Many income taxes can be broken up into taxes on the component parts of income, and thus in part reduced to taxes on property computed by the income. But a universal personal income tax graduated by the size of the income and not determined by the kind or source of the income, seems to present little basis for shifting. A differential rate on funded income constitutes a tax on property, and may be capitalised as shown above. So far as the income tax includes the increment value of property it is likewise analogous to a special property tax. So far as an income tax falls on wages and other analogous personal earnings, it can be shifted only when it creates some fundamental change in the conditions of employment, that is, the market for personal services. It is obvious that such a change will be brought about only by a tax that is not uniform. It must, to be shifted, be a tax that pulls some up and pushes others down. In a universal income tax properly adjusted there is little chance of any such change and we may conclude that for the most part the tax stays where it is put. All things considered, the income tax more nearly than any other absorbs for government the equivalent of that gain which accrues to the individual from good government.

SEC. 7. **Taxes on Producers and Dealers.** — The taxes discussed above are for the most part designed with some care and some consideration of their final incidence. They are aimed either at a distinct type of ability or at ability in general, and in the main they reach their goal.

Much more difficult are the problems of the incidence of those taxes which have no such distinct intent as to incidence. Taxes levied or falling at random on producers, on dealers, and on commercial and industrial enterprises, generally, are assessed and levied with the primary consideration of getting revenue.

Their final incidence is left to be worked out by the interaction of the various economic forces affected. Thus customs duties and excises are presumptively borne by the consumers as we have seen above. The operation of customs is in the main so simple as to present few difficulties.

Taxes Cannot be Shifted at Will. — There is, however, a naïve assumption often made by business men and the public, that any tax levied in the first instance on a producer, on a dealer, on a commercial or on an industrial enterprise will be shifted along to the ultimate consumer in just the same manner as a customs duty, for example, is shifted. The thought is that costs must be met, and accountants put taxes down with the costs, hence all the producer has to do is joyfully to add the tax to the price and *presto change* he gets it back. Generally no distinction is made between taxes. The landlord, as we are informed by the newspapers, passes all his taxes to the tenants, the farmer adds his school and road tax to the price of wheat, the grocer raises the price of butter and eggs, tea, coffee, and spices in order to get back his income tax, and above all, the railroads, public utilities, and all monopolies, so people say, pass on their taxes to the long-suffering public with unerring certainty. The theory is simplicity itself. Its adherents seldom stop to inquire what good it does the farmer to shift his tax as a producer if as a consumer he receives a share of every other producer's taxes. Above all these theorists fail to consider that if the farmer could raise the price of wheat just because his road or school tax has gone up, there could have been nothing to prevent him from raising the price of wheat before that new tax was levied. Nor do they seem to realise that if a landlord can raise his rents because he pays a tax, he would be a fool and a bad citizen as well, though, perhaps, a "good fellow," not to do so, tax or no tax.

The fact is there is only a half truth in this naïve but popular theory. It is true that many a tax levied on a producer or dealer raises prices, rarely by the whole tax, usually by a large part, occasionally by a small part only. But the great fallacy in the popular theory lies in the assumption that the whole

matter lies within the power of the sellers alone to determine. There are always two parties to a sale, a buyer as well as a seller. If the buyer is unwilling or unable to pay a price high enough to cover the tax as well as the costs, or can get the commodity somewhere else for less, the seller cannot raise the price. He has, then, the option of paying the tax himself, or quitting production and seeking to make a living somehow else. As taxes are now very nearly universal he will be hard put to it to find a way of making a living without paying a tax. The price of wheat is fixed in the world markets for wheat, and the Dakota wheat farmer may strive as hard as he pleases to pass on the last new Dakota tax levy, but he will not cause even a tiny ripple in the " wheat pit." Nor is it quite conceivable that a Dakota wheat grower would accept less than the market because his taxes happened to be less than he had expected. If office buildings are scarce relative to the demand office rents will be high, and, as the world goes, probably the taxes on office buildings will be high too, but if a lot of new office buildings are put up rents will come down and there is not therein any definite assurance that taxes will come down too. In fact, as things generally go, taxes under those circumstances are a little more likely to go up. We are not quarrelling so much with the conclusions reached by these naïve theorists, although they are mostly wrong, as we are with the line of reasoning by which the conclusion is reached. That line of reasoning proves too much, as the very important exceptions noted show.

SEC. 8. **The Tax Can be Shifted Only if Market Conditions Change.** — The fact is that the tax will be shifted only when its imposition alters the conditions of the market for the commodity in question. It must first actually lessen the supply before the price can be raised. If the tax does that, it may be shifted; if not, it cannot be shifted. The Dakota farmer, as was suggested above, cannot add his taxes to his price just because he wants to. But if the Dakota taxes are so high that wheat raising does not pay enough to cover them as well as the costs of production, wheat raising may stop in Dakota and the consequent reduction in the world supply of wheat may

put the price up. If, encouraged by the subsequent rise in wheat prices, Dakota farmers return to producing wheat and the new supply brings down prices again, some of them may find that they bear the whole tax. If taxes on wheat raisers were absolutely uniform in proportion to net profits all over the world, an equilibrium would presumably be struck at some level of prices which would leave, after taxes were paid, approximately the same profit (or just a little more) to the wheat growers as they could get in any other industry. A certain degree of shifting or diffusion of the taxes would have taken place. But if the taxes vary greatly from one wheat-growing community to another it is idle to contend that all would be shifted. For it is so obvious that he who runs may read, that a tax in one locality may easily be high enough to kill the industry there. If, again, the taxes were uniform all over the world per ton of wheat produced, they would bear heavily on those whose costs per ton were high and be negligible for those whose costs per ton were very low.

While the considerations discussed immediately above bear on all types of taxes, there is a more present interest in taxes levied on production or on products, such as a tax on gross sales, gross receipts, and taxes at so much per unit of output. It is difficult indeed to trace the incidence of these taxes fully. But we can approximate an answer to the questions: (1) whether they will cause prices to rise, and (2) whether, if they do so, the producer or the consumer suffers more. Of course if prices do not rise, both the incidence and the effect are wholly on the producer.

A Tax on Candy. — Let us take, for example, the tax on candy levied in the United States during the war. The tax was 5 per cent of the manufacturer's sales. We may assume what is probably the case (1) that the business is competitive, (2) that the demand for candy is elastic, and (3) that there is not much difference in the cost per pound whether produced on a large scale or on a small scale. Probably at first, after the tax is imposed, the price would be raised by the full amount of the tax. Then the effect of decreased demand would be felt

and prices would fall a little. This would force out the weaker manufacturers, those who before were only just meeting their costs. Then a new equilibrium of prices would be reached at a price which practically throws all the tax paid on the consumer. But production is less, the aggregate profits of the manufacturer are less, and the manufacturers and their employees are not quite so well off. The verification of this theory by the facts since our tax went on is rendered impossible by the disturbed condition of prices in general during and after the war.

A Tax on Milk. — Taxes levied on goods produced under competition and at increasing cost per unit of output, the demand for which is inelastic, are very rare. By their very nature such industries are carried on in relatively small units, that being the cheapest way to conduct them. That is probably one reason why they are seldom taxed on the basis of product or output. But again it may be that they do not seem to be proper subjects of taxation because they are mostly goods which rank as necessities. Only in the field of food and other necessities will men continue the unequal fight against the law of diminishing returns. When such taxes are levied they are inevitably shifted *in toto* to the consumer. A tax on milk is scarcely a political possibility. Yet the recent regulations requiring pasteurising and other sanitary measures impose in effect a tax on milk. The entire cost of these is shifted, as any tax would be, entirely to the consumer, for any part borne by the producers means at once bankruptcy of the marginal producers and lowered supply followed by higher prices. It is, moreover, practically certain that the consumer in such cases as this will suffer more than by the mere imposition upon him of the total tax. He will certainly have to pay the cost of shifting it as well. And, furthermore, as the tax involves the use by the producer of added capital and also subjects him to greater risk, the consumer must pay for all that.

A Tax on Street Railway Gross Receipts. — The case of a tax imposed on an industry obeying the law of increasing returns is very different. By their very nature these become monopolistic, for they necessarily produce more cheaply on a large

scale than on a small scale, and the small unit cannot survive in competition with larger ones. Moreover, the demand in these industries is usually elastic, at least within the range of prices likely to be set. A street railway may serve as an illustration and a 10 per cent tax on gross receipts will be assumed. Such a tax on a street railway (leaving out of consideration for the moment regulation of its rates by law) will raise fares a little, but not nearly enough to reimburse the company for the tax, and will very materially reduce its profits. Raising fares means loss of passengers, and lowering fares, within any probable range, will increase travel. The expenses of a street railway fall into two parts, fixed expenses which run on whether the company carries few or many passengers, and variable expenses which increase or decrease in exactly the same ratio as the number of passengers. The following table shows, very roughly, the effect of all these combined elements on the profits of a company:

Rate of fare	Average number of passengers carried per day	Gross receipts	Fixed expenses	Variable expenses, 2c per passenger	Total expenses	Net profits before tax	Tax 10% of gross	Net profits after tax
cents								
5	150,000	$7500	$3500	$3000	$6500	$1000	$750	$250
6	122,500	7350	3500	2450	5950	1400	735	665
7	100,000	7000	3500	2000	5500	1500	700	800
8	82,000	6500	3500	1640	5140	1420	656	764
9	67,500	6075	3500	1350	4850	1225	607	618
10	55,000	5500	3500	1100	4600	900	550	350

It is obvious that if there were no tax, and the company could fix the rate of fare where it pleased, it would probably fix the rate at seven cents, for at that rate it makes a profit of $1500 per day, which is larger than it would get at any other rate. Closer inspection of the table shows that if it were possible to collect fares in fractions of a cent, the company might prefer to fix the rate at about 7.05 cents, for it will be observed that the profits fall away a little faster below seven cents than they do above seven cents, indicating that there is a maximum profit at a rate somewhere between seven cents and eight cents

greater than at exactly seven cents. But as the difference between $1400 at six cents and $1420 at eight cents is small, it would be but a trifle over seven cents.

At first glance it might be inferred that the company would also make the largest possible profit after paying the tax, if it charged seven cents as before rather than any other rate. For if it went up to eight cents it would make only $764 as against $800 at seven cents. But again one must carefully observe the figures above and below the seven-cent line. The drop from $800 at seven cents to $665 at six cents is a drop of $135, while the drop from $800 at seven cents to $764 at eight cents is only $36. This is a greater proportional difference than before the tax and is too great a difference to be neglected. It indicates that there is a maximum profit greater than $800 to be had somewhere between seven cents and eight cents. A separate calculation, which it scarcely seems necessary to introduce here, shows that at seven and one-quarter cents the net profits after paying the tax would be about $812 and that is the maximum profit it could obtain at any rate of fare. The interesting and vitally important thing is that this *after-the-tax maximum profit* always corresponds to a *higher rate of fare* than does the *before-the-tax maximum*. It is never much higher but always higher. With the particular figures used in our illustration it was 7.25 cents as against 7.05 cents, approximately.

No public utility commission can restore to the company its lost profits or reimburse the whole tax. Humpty-dumpty profits made his fall when the tax was imposed and can't be put together again as long as the tax continues. If before the tax went on, the legal rate in the illustration were five cents (which, everything considered, was far too low) and the profits were, as in the table, $1000, and if after the tax the company were permitted to raise the rate to seven cents, it would still be $200 shy on former profits.

To sum up, then, the effects of the tax are: (1) a slight raise in rates (if permitted), (2) if rates are raised a goodly number of people walk or stay at home or ride in automobiles who would otherwise ride on the cars, (3) the profits of the com-

pany are inevitably lessened, whether rates are raised or not, (4) new capital is consequently harder to get, and (5) if rates are raised fewer platform men and other workers find employment.

SEC. 9. **A Tax on Gross Sales.** — Among recent suggestions for post-war taxes is one for a tax on gross sales. Generally this is understood to mean a tax say of 1 per cent or 2 per cent on the gross amount for which any goods are sold. What would be the probable incidence of such a tax? Would it all be passed on to the consumer? If the foregoing considerations are correct its shifting and incidence would be most unequal. In some cases it would be passed on, in others it would be absorbed by the producers. If the demand were very stubborn the consumer would bear the tax and more. If the demand were very elastic the producer or seller might have to absorb it. If the cost of producing or selling were constant per unit of output the effect would be different from a case where it was a diminishing or an increasing cost.

CHAPTER XII

FEES AND INDUSTRIAL EARNINGS[1]

SECTION 1. **The Connection between Fees and Industrial Earnings.** — There is the closest sort of connection between fees and the industrial and commercial earnings of the State. In the case of the sale of goods or services by a State the private persons pay the price of the wealth which they obtain. The price is fixed by economic conditions. It cannot exceed a certain sum, for if it does, the citizen will not buy. But in most cases considerations of a public character induce the State to enter upon the industry or commercial enterprise, and these very considerations are inducements to a lowering of the charges. As the public element comes to be more clearly recognised, a part of the economic forces fail to act. The State sacrifices part or all of the gain, but makes no loss. As the public element presses still more to the front, the State pays, at the general cost, a part of the expense, and charges the particular persons specially benefited merely a fee for the service. Many modern public institutions have gone through a process of development from one stage to the other, and the different stages are found contemporaneously in different countries. But while this is the order of progression in new functions, it is not the historical order of the rise of these two forms of payment for public services. Fees are the older of the two.

Fees and the Consciousness of "Public" Life. — Fees are not to be found in the ancient civilisations, because of the intimate relation between the individual and the State. Only when there is a distinct consciousness of "public" functions

[1] For definitions and classification, see Chap. II.

can we have fees. Payments in the Middle Ages for the services of the courts, of the church, of the schools, etc., were mainly of the nature of private remuneration. As soon, however, as any function comes to be recognised as public in character, fees arise. At first contributions are more or less freely and willingly rendered for the use of markets, roads, bridges, protection, and the like. Frequently there is an arbitrary assumption made that a special benefit is conferred and a fee is charged. As the State emerges from feudalism, the growth of public consciousness is marked by a rapid multiplication of these fees, which form a system of public revenues without taxes. After that the line of development is in the direction of the curtailment of the fee system and the growth of the tax system. Fees mark the transition stage in the division of labour in the public service. There is a growth of the conception of common benefits as distinct from special private benefits, and a corresponding removal of functions from one to the other category. At the same time new functions arise which are supported by fees, until finally the recognition of public interest outweighs that of the individual interest. Some fees, however, become fixed in character and are not subject to these transforming tendencies; but the public interest is recognised in this case by limiting the fees to a very small part of the total cost. Thus many court fees are retained, but the larger part of the rapidly growing expenditure for the support of justice is now met from taxes. Those functions in connection with which there are fees are regarded as conferring a divided benefit. The individual pays for what he receives, the State for what the public gains thereby.

SEC. 2. **Judicial and Legal Fees.** — The extension of the fee system by the courts to cover a very large part of the cost of the judicial system, even to such a degree as to make litigation impossible to all but the rich, was a transition stage in the development from the Middle Ages to the present. Nowhere was the fee system for court costs more abused than in England. Later practice, while placing more of the burden on the general treasury, has retained an extensive tariff of such "costs." Moreover, in not a few instances, the assessment of the "costs"

upon the party responsible for the litigation, as shown by the fact that he loses his suit, makes these fees approach in character punitive fines. This is the characteristic of American practice. In many cases the special benefit conferred is not very clear, but is arbitrarily assumed to exist, and the fee levied as though it were for such benefit.

Since the middle of the seventeenth century, a large part of many of the legal fees have been collected by means of stamps or stamped paper, the latter being necessary to legalise the transaction; the officer who furnished or cancelled the stamp being supposed to investigate and vouch for the propriety of the transaction. A notary's fee in most of the American commonwealths is of this character, the fee being receipted for by a stamp embossed upon the paper. Similar fees or taxes on acts and transfers are very common in France. Other such fees are collected in the form of the sale of a license to perform certain acts which would not be legal without such a permit; and then there is a charge for recording the act after it has been performed in accord with the permit. Of this character are the fees for marriage licenses and recording of marriages. The act itself is, also, often subject to the payment of a tax. The general character of the legal fee is seen from the following list: fees for passports and similar papers of identification, fees for recording and legally recognising births, deaths, marriages, and divorces, changes of residence or legal standing, for papers in evidence of honours, degrees, orders, titles, offices, etc., for patent rights and copyrights, for consular services in vouching for invoices, etc.

SEC. 3. **Administrative Fees.** — Many of the acts of the various administrative departments are of such a character as sometimes to confer a special benefit upon individuals for which a fee is charged. The police may render extraordinary services as in the protection of property on special occasions, in the control of masses of people, preventing intrusion, etc. Examples of these special services are very frequent. The same is true of the special services of detectives for private persons.

Educational Fees. — Fees for public education are gradually falling into disuse. They were originally charged for all grades

of instruction from the lowest up to the university. The importance of primary education to the general welfare of the people and to the prosperity of the State, when governed by popular franchise, led to the abolition of fees for that grade of instruction at a very early date. In England, owing to the prevalence of an extreme *laissez-faire* view upon this subject, fees for education were continued longer than in most countries, having only very recently been entirely abolished. In the higher grades, wherever such were in charge of the State, fees were retained much longer than elsewhere. The great universities of the American commonwealths have set the example of free tuition for their thousands of students, although they still retain a number of small fees for registration, diplomas, and certain incidental expenses connected with laboratory and similar instruction. European State universities still generally retain the fee system for most of the lecture courses. Schools intermediate between those giving rudimentary education and the universities are generally managed without fees, like the lower grades. Educational functions of governments seem to have been going through the same transformation which roads have gone through. Already the larger part of the cost is met from general taxes and but a small part from fees. Finally the remaining fees will fall away.

Church Fees.—In those countries in which the State supports the churches, or churches of a certain denomination, there are a number of fees connected therewith, such as those for the use of churches and churchyards, for baptisms, christenings, marriages, burials, confirmations, and communion. The means for meeting the rest of the expenses are drawn from two sources. A part is sometimes taken from the general taxes or from special taxes collected for the purpose, and the remainder from voluntary contributions by the attendants, or from the sale of sittings and the like. This is the only important remnant of voluntary contributions in any part of the financial system. In most instances the voluntary contributions are for special purposes, organised charity, missions, etc., which are, perhaps, not properly considered of a public character.

Commercial Fees. — The fees rendered by individuals in connection with their industrial and commercial enterprises are very numerous. The oldest and simplest are charges for the use of market-places, later for the use of public exchanges, etc.; then come the charges for statistics collected by public officers, and the charges for the use of bridges, roads, quays, etc. The modern substitutes for roads — railroads, canals, street railroads, omnibuses — are already passing from private into public hands, and the period of transition is marked by a more and more extended use of the fee system. Other means of communication — the post, the telegraph, and the telephone — are of the same character. Fees for coinage are also for services to commerce. They are in use by every country in some form or other. In the United States the charge for coinage was one-fifth of one per cent. England allows the Bank of England to make a similar charge when advancing notes upon bullion, and to set the price in notes for gold coin and gold bars. These fees must not be confused with the charges known as seigniorage, the latter being a tax upon commerce.

SEC. 4. **Special Assessments.** — One of the most important classes of fees is formed by special assessments. They are for some benefit to real property. A special assessment is a fee paid to cover the cost, less that of supervision by a salaried public officer, of a specified improvement to property undertaken in the public interest. In his excellent study on this subject Mr. Rosewater[1] tries to establish a difference between fees and special assessments. He admits the similarity, but points out that special assessments are restricted in purpose and in place, are apportioned among the members of a class, are assessed once and for all and for benefits to real property only. Professor Seligman makes the same distinction. But it is certainly not defensible on purely theoretical grounds, for the differences are not essential, but accidental. We might as well set up a separate class of taxes on marriages, for they are restricted in purpose, are assessed upon members of a class, once and for all, and are for benefits to the family only. Like

[1] *Columbia College Studies*, Vol. II, 2.

all other fees, special assessments are imposed by the taxing power, cover both public and private benefits, and do not exceed the costs.

The simplest case of a special assessment is when a street is to be built, with necessary sewers and water-pipes. The costs of this have to be met. There is a public interest in the street as a thoroughfare. Private enterprise cannot be trusted to properly protect the public interest. The city, therefore, must step in. It could pay the cost from general taxes or from tolls, of both of which the specially benefited persons would pay their share. But in that case, temporarily at least, the abutting land owners would reap an unearned harvest at the expense of their fellow-citizens. It appeals to our sense of justice that they should pay for it. They can always afford to do so, as they gain by the improvement. This system has received large currency in the United States, and has, according to Mr. Rosewater's extensive investigations, given general satisfaction.

Another method has been used to some extent in England. It is similar to that used by private speculators in America, when they open up a new city, or suburb. The city condemns and buys up enough of the land to be improved to furnish, when sold after the improvements, the funds needed. This method has a very limited application.

Special assessments are not frequent in Europe, but do occur. Mr. Rosewater finds them in varied form in France and Germany; and they are proposed in England under the name of the "betterment" tax. In the last-named country they were early applied to "walls, ditches, gutters, sewers, bridges, etc., damaged by the sea." But not until lately has the principle of measuring the tax by the particular benefit been applied or proposed, and even now the principle is not quite clear. In England the assessment is to cover the cost of the removal of injury rather than the cost of conferring a benefit. In England the cost of improvements is assessed in general taxes from which certain unbenefited districts are exempt. Strictly speaking, the principle is not regularly applied in England at all.

In the United States this fee finds almost universal acceptance.

It is, indeed, remarkably well suited to the economic conditions of a new country, and renders rapid improvement possible. In some parts of the country there are harmful results that arise from the desire to give property owners full control over the improvements for which such assessments are to be made. Thus, in some commonwealths, street improvements are only made with the consent of the owners of a majority of the property concerned. The result is that streets are opened irregularly, and some of the main streets are untouched, while side streets are improved. But this is an evil of expenditure rather than necessarily connected with this mode of collecting the revenue. The abuses of special assessments are few, and, on the whole, it is a part of the tax system of which America can be justly proud. Professor Bastable's criticism (p. 377) of these fees rests upon a misconception of the method of handling the assessments. They are assessed according to the cost of the improvements; the special benefit is the justification of the contribution, not its measure. There is seldom any difficulty in apportioning the cost fairly. No charge need be made for any additional benefit beyond the cost, and the contributor has, usually, a voice in deciding whether the proposed improvement shall be undertaken or not.

In view of the fact that the prevailing theory of taxation in this country is that which we have designated as the benefit theory, it is natural that Americans should have been the ones to have made the application of the theory in this particular case. The special assessment is applied in just those cases in which it is easiest to measure the special benefit. And although the principle cannot be given a wider application with any degree of satisfaction, it does, in this instance, comply with the demands of justice and equality. It would, moreover, be rather hard to find under the faculty theory any better justification.

SEC. 5. **Postal Fees.** — The post was included above among those functions for which fees were charged. Whether that be quite correct or not, depends upon the way in which the postal system is run. If it is run so as to yield the largest possible

revenue over and above expenses, it is of exactly the same character as any other industrial enterprise upon which the State enters. The State sells postal services for the highest price it can get, or rather, for the largest net return. Its profits, the post-office being a monopoly, are regulated by the principle of charging what the traffic will bear. But no post-office is run on this principle. The importance of the public service rendered has led to the recognition of a large element of common benefit. This recognition has not resulted in the entire abandonment of charges for the service except in a few instances; for example, the free carriage of newspapers in the county in which they are published. But it has led to the attempt to run the service in such a way that expenses shall be met, and only a small surplus, if any, shall accrue to the benefit of the treasury. Whenever the surplus tends to grow, the rates are lowered or the service improved. Of all the powers, Great Britain is the sole exception to this rule, about one-third of her postal receipts being profits. (1895, receipts £10,760,000, expenses £6,869,000. But the allied telegraph service ran behind: receipts £2,580,000, expenses £2,674,000.) The postal rates in Great Britain are as low as in other countries, but the surplus is accounted for by the extremely small size of the territory covered by the land service, the concentration of population, and the cheapness of water transportation, all of which makes it particularly easy to do a large and profitable business at low rates.

There are some writers who regard any surplus acquired in this way as practically the result of taxation, and class any charge for the public service, above the cost thereof, as a special tax. This classification presupposes that the service is, by nature, of a public character, an assumption contrary to the fact, for no function except that of governing itself, in the narrowest possible sense, is *by nature* of a public character, nor, on the other hand, *by nature* of a private character. On this consideration, therefore, it is better to class these gains, not as taxes, but as the earnings of a public industry.

SEC. 6. **Public Industries not Primarily for Revenue.** — In modern times public industries can be quite as properly con-

sidered under the head of expenditure as under that of revenue. Historically, State industries, like public or princely domains, lands, forests, and mines, were mainly sources of revenue. But a railroad is placed in the hands of the State primarily because of the public interests involved, and the expenditure for that purpose is more significant than the moderate surpluses that accrue, in some cases, to the government. For that reason we called attention to these activities under the head of expenditure. We have now to consider them as productive of so much total wealth, a part of which is immediately spent for the purpose which led the State into this activity, and a part, generally a very small part, saved to assist in the accomplishment of other purposes.

Public Lands. — The oldest form of public property is land. The public land originally embraced all the territory of the State. Gradually parts of it were alienated to a private purpose subject only to the law of eminent domain; but considerable portions even to the present day belong to the State, or, what is the same thing, to the local governments. In the monarchies of Europe such lands were once considered the property of the prince. These lands were the main reliance for public revenues in the feudal State. As the people gained a voice in the government, they laid claim to these sources of revenue for public purposes. From that time on, the public domain diminished both absolutely, by sale or alienation, and relatively as the wealth of the people swelled. Some countries adopted a very conservative policy in this respect, and retained their domains in land and forests, while others adopted the plan of steadily disposing of them. German states are examples of the former policy, while England, France, and the United States have been examples of the latter. England receives only £520,000 annually of "Woods, Forests, and Land Revenues of the crown." In the United States it was the possession of vast tracts of land by the federal government, acquired by gift from the commonwealths, and by purchase, which gave that government an independent territory over which its control was absolute, and formed one of its strongest supports, contribut-

ing most materially to the growth of federal influence. But the public lands have not been a source of revenue to the government. The money received from settlers has amounted to little more than fees for the registration of titles, and except for the ten years from 1830 to 1840 the lands have not yielded a clear revenue. The extensive surveys which the government carried out have been a large expense attributable to this source. Under constitutional government there is little danger of the failure of taxation as a permanent and regular source of revenue. So that public lands are not regarded as necessary for the integrity of the government. The retention of public lands in Germany and Austria is not explainable by any danger of the failure of taxation, but by the greater tenacity of the older communistic idea. Democratically governed cities and towns cling to their lands as strongly as the royal governments.

Forests. — Except when in charge of a highly trained body of expert officials, as in Germany, the public lands do not form a satisfactory source of revenue. They are not as a rule as well managed as similar lands in private hands. Forests form an important exception to this statement. A private owner cannot afford to wait long enough for economical use of timber land. The destruction of forests at private hands is a serious danger. Only a permanent, long-lived institution like the government can take proper care of forests.

Mines. — Closely allied with the public ownership of lands and forests is the public ownership of mines. This is one of the oldest State industries, which is of late falling into disuse. The working of mines by the government is being replaced in Europe by a system which allows of private operation, but guarantees the public interest by the collection of royalties, or mining taxes. In the older countries, where the idea of public territorial ownership is stronger, the old system still prevails, and, even where it is partially surrendered, the revenues derived from royalties and taxes are proportionately large. But in the new countries of the American continent and Australia private ownership generally prevails, and no more revenue is derived from this source than from any other taxed industry. The

feudal idea of territorial ownership, a remnant of which still survives in those countries of Europe which retain their interests in the mines, is very different from that of private ownership in fee simple as in America. This accounts for the difference in the revenues from this source.

SEC. 7. **Other Industries.** — But while the modern State has surrendered the extractive industries, a great many others have been undertaken, not so much as sources of revenue as because of the importance of the public interests involved. Before the nineteenth century the most striking instances are of the production of some commodity needed for the public service or of articles of an artistic and costly character. Examples of the latter are the Gobelin tapestries and the Sevres ware. In supplying arms, forts, vessels, public buildings, and the like there is no uniformity of practice among the nations. In only a few cases is the method regularly that of government production. There is a similar absence of uniformity in practice in regard to all those industries which involve large public interests for the conservation of which there is under private management no good guarantee. In some cases, as the water-supply, there is a general tendency in the direction of public ownership. Whenever, as in this case, a public interest is absolutely paramount to every other consideration, there is little attempt to make the industry a source of revenue beyond what is necessary to maintain the service. These industries, therefore, tend rapidly to be supported by fees or taxes. Inasmuch as it is generally the importance of the public interest that led to the assumption of the industry by the government, this tendency is universal. Roads, canals, the water-supply, the post-office, telegraph, telephone, and the railroads all pass more or less rapidly through these stages according to the importance ascribed to the public interest in them. As already seen, the post-office is now primarily supported by fees. The funds for the support of water works are generally collected from the users, as fees, or from certain classes of persons as special taxes, but seldom as prices for the service. The experience of nations with State-owned railroads is too recent and too varied to be

very instructive. States have been led into the ownership and operation of railroads: first, because the roads needed the support of public credit; second, because of military interests; third, because of the failure of private companies to protect public interests. Railroads have more often been a source of public expenditure than of public revenue. In Prussia alone have the financial results been such as to add materially to the income of the treasury. The question of government ownership of railroads is one involving considerations broader than merely fiscal ones, and does not properly belong to our subject. In no case is it at all likely that merely fiscal considerations will have more than a deterrent effect upon the solution of the problem of the government's action in regard to the management of the railroads.

While the industrial, commercial, or other economic functions of the State are of continually growing importance, they are not likely to be largely a source of net revenue. Nowhere do we find principles that would lead us to anticipate that revenues of this character will ever supply the place of taxes. Indeed, if the usual evolution continues, these functions may be performed by the State without a special charge upon the benefited persons, and, while the liberties of the people in respect to the enjoyment of these facilities will be greater, the burden thrown upon general taxation will be equally so. If a city now supplies a sewer system to citizens free of special charge except for first construction, it may with the same logic supply water. If a State furnishes roads at common cost, it may certainly so far modify the management of railroads as to apply the fee system and forego the collection of any surplus, though in this case, as in that of the post-office, there would seem to be as yet no sign of any tendency to go beyond the fee system.

PART III

PUBLIC INDEBTEDNESS

CHAPTER I

THE GROWTH AND NATURE OF PUBLIC CREDIT

SECTION 1. **Size of Public Debts.** — The national governments of the civilised world owed in 1908–1909 more than thirty-six and one-half thousand millions of dollars, or seven and one-half thousand million pounds sterling. With the addition of the debts owed by the local governments this sum will exceed forty thousand millions of dollars, or eight thousand million pounds. The nearest available figures are:

National debt of all countries, 1890	$27,524,976,915[1]
National debt of all countries, 1908	36,548,455 489

According to the best available authorities the national indebtedness of the world increased fourfold between 1848 and 1890, and by 1908 it was fivefold.

YEARS	AGGREGATE DEBT	INCREASE	PER CENT OF INCREASE
1848	$ 7,627,692,215		
1860	10,399,341,688	$ 2,771 649,473	36.34
1870	17,117 640 428	6,718,298,740	64.60
1880	27,421,937,643	10,303,397,215	60 19
1890	27,524,976,915	103,939,272	.38
1908	36,548 455,489	9,023,478,574	32.80

[From best available sources.]

[1] Bastable, in his edition of 1903, says that the total of national debts can hardly have been less than £7,000,000,000 at the close of the nineteenth century (p. 626).

The increase of national indebtedness between 1880 and 1890 was comparatively slight. But this was partly due to the payment of a large part of the national debt of the United States. The increase since 1890 is largely attributable to the Boer War in England and to the Spanish-American War. Other countries have continued the process of debt-making — although less rapidly, owing to the continuance of peace. The above figures do not include pensions, which are really debts in the form of annuities.[1]

REPORTED NATIONAL DEBT OF SPECIFIED NATIONS FOR THE FISCAL YEAR, 1904–1905

COUNTRY	POPULATION	TOTAL DEBT	PER CAPITA DEBT
Austria	26,150,710	$ 785,243,792	$ 30
Hungary	19,254,560	1,069,067,854	56
Austria-Hungary	45 405,270	1,095,606,825	24
Belgium	7,074,910	606,762,617	86
Bulgaria	3,744,280	66,162,890	18
Denmark	2,464,770	65,269,644	26
France	38,961,950	5,929,395,672	152
Germany	60,605,180	823,290,138	14
Greece	2,433,800	164,001,050	67
Italy	33,476,120	2,424,448,935	72
Netherlands	5,509,660	464,246,824	84
Norway	2,240,100	71,657,217	32
Portugal	5,423,130	855,114,614	158
Roumania	6,400,000	264,723,487	41
Russia	129,309,300	3,738,394,688	29
Servia	2,676,990	89,736,313	34
Spain	18,618,100	1,858,191,268	100
Sweden	5,260,810	103,803,418	20
Switzerland	3,425,380	19,798,382	6
Turkey	24,028,900	537,767,716	22
United Kingdom	43,218,000	3,877,318,133	90
United States	81,511,815	989,866,772	12
China	407,253,000	587,654,208	1
Japan	46,732,200	483,942,912	10

For later figures see appendix to this chapter.

[1] If these were included and capitalised at ten years' purchase, which would, perhaps, be a fair average, they would add to the debt of the United States at least $1,500,000,000.

The table on the preceding page compiled from the Statesman's Year Book for 1906 gives the details of the population, indebtedness, and *per capita* debt on the account of the national governments only, of twenty-four of the most important nations. The totals for the British Empire were: population 325,540,000, total indebtedness $7,190,748,566 (£1,440,000,000), *per capita* $22 (£4 10*s*.).

While the absolute amount of the debt has increased, the burden has materially decreased since 1880, owing to the increase in population and wealth. In 1880, the national indebtedness of countries other than the United States amounted to $35.64 *per capita*, while in 1890 it was $32.90 *per capita*. During the same period the national debt of the United States was reduced absolutely by over a billion dollars, and relatively from $38.33 *per capita* to $14.24 *per capita*. The *per capita* debt for the world at large on the national accounts only was in 1909 about $26, that of the United States in the same year about $10. Of course statistics of this sort are neither perfectly accurate nor easy to interpret. The only proper comparison between different countries would be that of the ratio of the interest charge to the annual income of the people. But the annual income is very difficult to ascertain, and the errors would, probably, be so great as to destroy the significance of the result. But the foregoing figures, while not absolutely correct, are sufficiently so to indicate that the policy of borrowing has become a most vital part of the system of public finance. The cause of the national debts is almost exclusively war and the preparation for war. If the expenses of war and its preparation had been excluded from their finances and the treasury relieved of the subsequent burden of interest, civilised nations would have been easily able to meet their current expenses. In England the annual public-debt charges for interest and debt payments consume nearly one-fourth of the annual revenues from every source. The policy pursued by England is to fix a permanent debt charge against the annual revenues and to use all that can be saved therefrom over and above the interest charges for the payment of the principal. This so-called sinking fund

system is suspended in time of war. The funded debt of France, the largest ever contracted by any country, imposed an interest charge of about 1,250,000,000 francs upon a total revenue of about 3,500,000,000 francs. If we include certain annuities and pensions, over one-third of the revenues of France were consumed in this way, before the Great War.

Cash Reserves. — Germany is the only country of importance that did not rely entirely upon the possibility of borrowing money in case of war. That country maintained a special cash reserve of many millions in gold, available for immediate application to war purposes, should it be needed. Although the German Empire began in 1871 without debt, it had in 1908 a debt of 1,588,000,000 marks. This was largely due to armament. So that, although Germany held a cash reserve for military purposes, it was practically a borrowed one, and she was making her preparation for war on borrowed money. This policy does not differ essentially from that of other countries. In the Middle Ages, however, as in classical times, it was the practice of nations to accumulate a treasure for war purposes in advance, by collecting more revenue each year than was needed. This practice is now obsolete and is also indefensible as too costly.[1]

Deficit Financiering. — Modern nations, then, practise a method of deficit financiering. They make provision in their annual revenues for the current, regular, or "ordinary" expenditures only, and rely for funds at other times upon their ability to borrow. What then constitutes this ability to borrow upon which so much reliance is placed that even the very existence of the nation is allowed to depend upon it? Since when, and how is it, that nations have been able to rely so absolutely upon public credit? The answer to both these questions is contained in the analysis of public credit.

SEC. 2. **Public Credit a Form of General Credit.** — Public credit is only one form of general credit, and it is comparatively easy to point out wherein the former differs from the latter. But credit in itself is by no means easy to define. Scarcely any two of the able writers who have treated the subject are agreed

[1] See Bastable, p. 567.

as to its most important features. It has, moreover, as a term in common use, suffered so many subtle changes in meaning in the course of its history as to leave its modern significance full of dangerous variations. The ordinary business man uses the word daily to convey half a dozen or more different ideas without recognising the differences. Scientific writers have waged long and bitter controversies concerning its proper definition.[1] Without going too deeply into the controversy, we may say that there are practically three opposing views as to the real nature of credit. First, there are those writers who, like Nebenius and Rau, start from the etymological meaning of the term and maintain that the confidence, or trust, reposed by the creditor in the ability of the debtor to fulfil an agreement in the future is the chief element in credit.[2] Second, there is a class of writers who, like Knies, regard this element of confidence, a mere psychical condition, as too intangible, too immaterial, to be of any value for a scientific definition. They proceed entirely from observation of those transactions which are said to involve the use of credit, and find in all such transactions one feature which is never present in transactions not designated as credit transactions. That feature is that the completion of the transaction is regarded as being postponed to a future time. This element of time, this postponement, must then, they argue, be the essence of credit. Credit is, in their eyes, merely a means of transferring ownership temporarily, a means of paying for present goods with a greater quantity of future ones. Third, there is still another school, who, like McLeod, regard credit as analogous to money, money being regarded as representing claims on the wealth of the whole community, while a credit is a similar claim on the wealth of some particular individual. McLeod even goes so far as to identify the claim, the order, the promise to pay, or the right to demand with "the credit." "A credit," says McLeod, "in Law, Commerce, and Economics, is the Right which one Person,

[1] A good idea of the extent of the controversy and of the conflicting views can be gained from Knies, *Der Kredit*, Berlin, 1876.

[2] Nebenius, *Der öffentliche Credit*, Carlsruhe und Baden, 2d ed., 1829; Rau, *Finanzwissenschaft*, 3d ed., Heidelberg, 1851; II Abt., p. 248.

the Creditor, has to compel another Person, the Debtor, to Pay or Do something." [1]

SEC. 3. **Reconciliation of These Views.** — These definitions, apparently so contradictory, are not altogether irreconcilable. They represent different points of view rather than real differences in meaning. Certainly nothing but credit is described by any one of the three definitions, and certainly there are shades of the meaning of the term that are aptly described by each of them. As is so often the case when a word in common use is defined for scientific purposes in several ways, we find that one definition fits certain classes of things covered by the term better than others. There are certain debts, for example, in which the element of trust is paramount, others in which that of time is more important, and again some in which the element of claim or demand is the distinguishing thing. But it is also true that there are no cases of the existence of credit where all three of these features do not appear, the one or the other varying in importance as the case may be. To fully understand a thing so many-sided as credit, it is necessary to examine it from several points of view.

If we start from the etymological meaning of the term, we cannot avoid the conclusion that one of the chief elements of credit is trust. Certainly without that intangible, unmeasurable feeling or frame of mind known as confidence, trust, or faith, on which Knies pours so much scorn, no debts would have come into existence. As Professor Cohn well says, "Credit rests on the development of opinions and institutions which arise with the general advance of civilisation." [2] Modern usage has not yet eliminated this original meaning from the term. It

[1] *Theory of Credit*, Vol. I, p. 315. In a very scholarly article published in the *Quarterly Journal of Economics*, January, 1894, Professor Sherwood discusses the nature and mechanism of credit in a way to throw a great deal of new light upon the subject. I do not believe that his analysis can be improved upon. He distinguishes particularly the credit basis of money, as generic or universal credit (which he calls "customary credits"), from that of the commonly so-called credit transactions, which he calls "formal credits." It is with the latter only that we are concerned here. They are legally enforcible. They rest in the economic sense "on a psychological trait of faith in the uniformity and reasonableness of other men's voluntary acts."

[2] *Grundlegung*, p. 553.

cannot be altogether incorrect to make this a part of the definition. It is customary enough to conceive that credit or faith is reposed by the creditor in the debtor, and that it varies in amount, although never exactly measurable. But there are many credit transactions in which the element of trust shrinks into insignificance. An advance on a warehouse receipt, a Lombard loan, a pawnbroker's advance, all of these and many like them are credit transactions, but the element of personal confidence plays little part in these. The creditor in these cases never has to consider the character of the debtor nor his ability or willingness to pay. After he has satisfied himself as to the value of the security, all that he has to consider is the time the debt has to run. It must be admitted, then, that there are a number of cases of credit transactions in which the paramount element is that of time. The first two of the above-stated views of the nature of credit are, therefore, reconcilable in this way. They may be regarded as essentially the same with a difference in the emphasis, and it is correct to change the emphasis when different kinds of debts are considered. Both of them may be covered by one definition, which may for two reasons be called the subjective definition: (1) because it takes into consideration feelings, opinions, *i.e.* trust, confidence, belief; (2) because it looks at credit from the natural point of view of the creditor who entertains that trust.

Subjective Definition. — From the subjective standpoint credit is the confidence or trust reposed by one person in the ability of some other person to fulfil a promise at some future time. The emphasis will fall upon the feature of trust or upon that of time according to the nature of the particular debt in point.

But that is not all: we have yet to dispose of that view which identifies credit with the claim which the creditor has on the debtor. In one aspect this view seems absolutely contradictory to that which we have adopted. So much so that Knies ridicules it, considering it quite as absurd as the reasoning of John Law. He says it makes the debtor give credit: *i.e.* he gives the claim, and the claim is credit. But McLeod's reasoning is not so easily disposed of. He has taken what may be

well called the objective view. He has sought out embodied credit. His, too, is the natural point of view of the debtor. The opposition, therefore, between the two views is more apparent than real, and arises from the fact that each is from a different point of view. There are two sides to the shield. The debtor sells a claim (a chose in action) which is a more or less tangible thing having a present value, just as many another right has; as, for example, a patent right or a copyright. The debtor is concerned only with the value of that claim. The creditor, however, looks beyond the claim and desires to know whether he can trust in the ability of the debtor to make the claim good. By a very natural analogy, too, the language of business says that the debtor enjoys good or bad credit, as though the trust reposed in him by others, in whose minds it exists, really became an attribute of him. There is still more ground for McLeod's view, for, as has already been remarked, it is often the nature of the claim created that adds to, or detracts from, the credit. Any man, in ordinary times, can obtain credit, if he comes prepared with collateral security and is ready to create a claim that is good on that in case his other resources fail him. It is clear, then, that the view of McLeod is important, and also that it is supplementary to that already adopted. It reveals many phases of credit that cannot be seen at all from the subjective point of view. The two views taken together make a complete explanation.

Objective Definition. — From the objective standpoint, credit is embodied in claims which are accepted by the creditor in payment. These objective claims have a value like every other exchangeable commodity, and are recorded in the various "instruments of credit."

Public Credit and Private Credit Differ. — If these two definitions are accepted, we can proceed to point out wherein public credit differs from ordinary or private credit. The peculiar conditions which distinguish public credit from ordinary credit arise from the fact that the debtor is the State. The State, being above the law, cannot be compelled, as the private individual can, to pay its debts. Public credit is therefore subjectively

defined as the confidence or trust reposed in the ability and willingness of the debtor (the State) to fulfil its promises at some future time. Objectively the claim (in this case the bond) shrinks to the character of an unsupported although generally accepted promise. There are, to be sure, some important cases in which the claim is apparently supported by something more definite than the mere promise of the debtor; as, for example, when the revenues from certain productive enterprises are pledged for the support of the debt charges. But even in these cases, the creditor has no real resource against intentional bad faith. In general the subjective standpoint gives a better view of public credit than the objective, because the claims cannot be enforced.

The fact that the debtor is the State has other important consequences. (1) The State has sovereign power and can compel its subjects to lend to it; or, on the other hand, the creditor may make advances on rather poorer terms than he would otherwise accept, from motives of patriotism. (2) The debtor State lives forever, and hence can make perpetual debts. (3) Its affairs are all open to inspection, and the would-be creditor has full opportunity to know its ability to pay. (4) Public credit may be divided into various parts, according as it is the credit of the central government or of some subordinate department that is being considered. The consideration of the relations of the different parts of the government in this respect belongs to the field of public law rather than to that of public finance.

SEC. 4. **The Late Development of Public Credit.** — Public credit was necessarily later in development than private credit. General habits of lending on a large scale had to be established before nations could borrow. The bankers and brokers of the world had to develop the machinery for handling evidences of debt before large public loans could be placed. Then, too, inasmuch as the objective evidences of debt in the case of the government were nothing but the unsupported promises of the government, confidence that these promises would be kept had to grow. At first the assurance rested on the honour of the monarch, or upon some pledge or security given by him, such

as the crown jewels, crown lands, a lease of the revenues, and the like. But later, as Bastable so ably shows,[1] the development of public credit goes hand in hand with the development of constitutional government. It would seem that the control of the purse by the very persons who were to pay the taxes gave a steadiness and security to the financial administration that aroused the confidence of money owners.

SEC. 5. **Economic Effect of Debt.** — Much attention has been given by different authors to the economic effects of public borrowing. It is now pretty well agreed that public borrowing does not, as was once taught,[2] create new wealth except indirectly, through the use made of the capital taken when it is used productively. Nor, on the other hand, does public borrowing in itself directly destroy wealth. The money borrowed may be devoted to some form of rapid consumption, as in war. In this case the destruction of wealth is determined by the line of expenditure decided upon, not by the borrowing merely. But the feasibility of obtaining large sums in this way is said to lead to more extravagant expenditure than would otherwise be indulged in, since taxation for such purposes would be difficult. The consumed wealth is replaced by claims upon future wealth which are not of such a character as to be available as productive capital. But the loss incurred is distributed over many years instead of being concentrated in a few. As in the case of a spendthrift who mortgages his patrimony for wasteful extravagance, so in the case of a nation which borrows for war, the evil that arises is from the waste of war, not from the borrowing. For a State to borrow for a productive purpose has no other economic effect than for a private corporation to do the same.

SEC. 6. **Foreign *vs.* Domestic Loans.** — There has also been some discussion of the relative merits of domestic and foreign loans and their differing economic effects. Sometimes it has been claimed that foreign loans involve less disturbance of domestic industry. The intimate relation existing between modern nations in their commercial and industrial enterprises

[1] P. 579. [2] "The public funds a mine of gold."

destroys to-day almost all the significance that might formerly have attached to such a discussion. The payment of the French indemnity of 5,000,000,000 francs to Germany after the war of 1870 was carried out in twenty-seven months, and not one single serious difficulty or disorder in the financial centres was produced by it.[1] So great is the mobility of modern capital and so vast are the current transactions, that all of this money could be easily turned into the same stream without disturbing its placid surface. The only point of importance is that a home debt is under the taxing power of the nation, while a foreign debt is less so. This makes possible an easier adjustment without the full stigma of repudiation.

The Frailty of Public Credit. — Public credit is a plant of slow growth; more than that, it is a delicate plant. It may be injured beyond recovery by a single case of failure to fulfil the promise in which it found expression. Many of the commonwealths of the United States have repudiated their debts, and have since then recovered their power to borrow but slowly, and in some instances scarcely at all.[2] Weak nations which may be or have been coerced by stronger and wealthier nations in the interest of citizens of the latter who were creditors of the former, generally borrow more easily than stronger independent nations, or parts of strong confederations, which have failed to meet their obligations and cannot be coerced.

The credit of local governing bodies depends in great measure upon their powers and duties in public law. Generally speaking, a "municipal corporation," when acting legally within the sphere prescribed to it, is like a private company, — its obligations can be enforced by legal or judicial procedure. Unlike the sovereign State, a municipality can be sued without its consent. Only with the positive sanction of the sovereign State can a municipality default and escape punishment therefor.

[1] *Blackwood's Edinburgh Magazine*, February, 1875, pp. 172–187.

[2] Under the Eleventh Amendment to the federal Constitution, a state cannot be sued in a federal court. This is contrary to the original intention of the Constitution. See my monograph, *Das Kreditwesen der Staaten und Städte der Nordamerikanischen Union in seiner historischen Entwickelung*, Jena, 1891. Egypt is a good example of foreign coercion to enforce debt payment.

APPENDIX TO CHAPTER I, PART III

PUBLIC DEBT AND THE WORLD WAR

The following tables are from a pamphlet by Louis Ross Gottlieb, on the Financial Status of Belligerents, published by the Bankers Trust Company, New York, 1920.

SUMMARY OF PUBLIC DEBTS OF PRINCIPAL BELLIGERENTS

(Million dollars)

A. *Allied Powers*

Country	Before Entering the War					
	Population[1] (thousands)	Date	Debt	Annual debt charges	Debt per capita (dollars)	Debt charges per capita (dollars)
United States	106,653	Mar 31, 1917	1,208	23	11.33	0.22
Great Britain	46,089	Aug 1, 1914	3,458	119	75 03	2.58
Canada	8,361	Mar 31, 1914	336	13	40.19	1 55
Australia	4,971	June 30, 1914	93	5	18 71	0 60
New Zealand	1,162	Mar 31, 1914	446	13	383 82	11.19
France	39,700	July 31, 1914	6,598	252	166 20	6.35
Italy	36,717	June 30, 1914	3,031	103	82 55	2 81
Japan	57,998	July 31, 1914	1,261	54	21.74	0.93
Russia	182,183	Jan. 1, 1914	5,092	218	27 95	1.20
Belgium	7,658	Jan 1, 1914	722	25	94 28	3.26
Greece	4,950	Dec 31, 1913	188	8	37 98	1 62
Total	496,442	. . . .	22,433	831	45 19	1.67

B. *Central Powers*

Germany	67,812	Oct. 1, 1913	1,105	42	17 18	0.62
Austria	30,958	Aug 1, 1914	2,631	101	84.99	3.26
Hungary	21,410	Aug 1, 1914	1,002	53	74.82	2.48
Turkey	21,274	Mar. 31, 1914	667	45	31.35	2.12
Bulgaria	5,518	July 1914	171	8	30.99	1.45
Total	146,972	. .	6,236	249	42.43	1.69
Grand Total	643,414	. . . . .	28,669	1,080	44.56	1.68

SUMMARY OF PUBLIC DEBTS OF PRINCIPAL BELLIGERENTS

(Million dollars)

A. *Allied Powers*

Country	At Most Recent Date				
	Date	Debt	Annual debt charges	Debt per capita (dollars)	Debt charges per capita (dollars)
United States	Aug. 31, 1919	26,597	894	249 38	8 38
Great Britain	July 26, 1919	37,657	1,421	817 04	30 83
Canada	Mar 31, 1919	1,584	115	189 45	13 75
Australia	Dec 31, 1918	1,619	50	325 69	10 06
New Zealand	Mar 31, 1918	734	22	631 67	18 93
France	Mar 31, 1919	30,494	1,930	768 11	48 61
Italy	May 30, 1919	15,009	577	408 78	15 71
Japan	Mar 31, 1919	1,284	52	22 14	0 90
Russia	Aug 31, 1919	54,402	766	298 01	4 20
Belgium	April 1, 1919	1,889	85	246 67	11 10
Greece	Mar. 31, 1919	521	18	105 25	3 64
Total	. . .	171,790	5,930	346 04	11 95

B. *Central Powers*

Germany	Sept 30, 1919	40,007	2,201	589 97	32 46
Austria	Oct 31, 1918	17,071	622	551 42	20 09
Hungary	Oct. 31, 1918	8,909	347	416 11	16 21
Turkey	Aug. 31, 1918	2,002	88	94 11	4 14
Bulgaria	Mar 1919	1,158	109	209 86	19 75
Total	.	69,147	3,367	470 48	22 91
Grand Total	. . . . .	240,937	9,297	374 47	14 45

CHAPTER II

FORMS OF PUBLIC DEBTS

SECTION 1. **Forms Many.** — Government borrowing takes on many forms. Among the more common are: (1) circulating notes or paper money not bearing interest; (2) unpaid accounts, most often represented by warrants, which are orders upon the treasurer to pay money and which do not ordinarily, but may, bear interest; (3) short time notes, bearing interest; (4) long time notes, bonds or annuities, sometimes called generically stocks (British) or *rentes* (French), but in the United States always called bonds.

Paper Money. — Circulating notes issued by governments to pay their obligations may be, on their face, redeemable or irredeemable. When not specifically redeemable there is still an understanding, or at least a hope, that when the difficulties which caused their issue are overcome they will be redeemed. On the other hand notes technically redeemable may never be redeemed. Irredeemable notes are usually issued only as a desperate resort in times of great stress. Redeemable circulating notes are, however, often issued in the regular course of business, especially when the government is regularly in the banking business, or they may be issued as were the United States gold and silver certificates, in part, to meet the convenience of the people, and as a regular part of the circulating medium.

Warrants. — Governments like individuals carry open book accounts showing that they owe money to certain firms, companies, or individuals. In so far as these are current and are settled at regular intervals or as soon as they can be closed and paid, these are not ordinarily regarded as debts. Still more

important are accruing salaries; for government expenses are very largely salaries. When a "claim," as it is usually called in the United States, matures under any running or other open account, or a salary payment becomes due, it is usual for the proper disbursing officer to issue a warrant directing the treasurer to pay the amount of the approved claim or salary. Such a warrant is presumed to be a settlement of the claim or to be a payment of salary, and must usually *per force* be accepted as such by the claimant. If there are funds in the treasury the warrant is practically a check or draft and is treated by the banks, and hence in all other business circles, exactly as a check or draft would be treated. But if the treasury is empty, temporarily or for a considerable time, the warrant becomes distinctly an outstanding evidence of debt. As funds flow into the treasury outstanding warrants will be accepted and paid presumably in order of presentation, although sometimes certain classes of warrants are given precedence. Thus salary warrants may be given precedence. The value of a warrant depends upon the length of time that will probably elapse before it will be paid. That is, unless the treasury is in position to pay it at once on presentation, a warrant is subject to discount. Sometimes the government itself assumes this discount or loss and in that case the warrant would be stamped, or indorsed "interest payable until redeemed." Such interest-bearing warrants become virtually notes.

The use of warrants to meet claims largely in excess of funds on hand is a loose, and undignified, way of doing government business. It betokens a dangerous condition of perennial deficit. Furthermore many claimants unaccustomed to the use of warrants are loath to accept them. Where purchases are to be made in the open market sellers may not come forward at all unless they are offered cash. In other words, warrants cannot be used to pay bills unless the claimant is willing or can be compelled to accept them. Ordinarily an officer or employee of the government has little choice in the matter once he has taken office or employment. So too in time of war, quartermasters, commissary officers, and some others take what goods

an army needs and pay for them in requisitions or orders which are to all intents and purposes much like warrants. But still cash is also needed to facilitate business for which the warrant, requisition, or order is not adapted. Even an army may obtain goods for cash which it would never discover by search and seizure. Hence governments issue or sell notes, or promises to pay, in the open market to get the cash they need.

Treasury Bills. — Taxes do not always come into the treasury in a regular stream, but often at fixed times once or twice a year; and if the government is not in position to carry a cash balance it may desire to raise money temporarily to tide over the intervals. In time of war, also, or in other times of stress money may be needed for covering expenses in the intervals between tax receipts or returns from sale of bonds. The usual device for meeting this situation is the treasury bill or exchequer bill. The name implies that this is a promissory note or an obligation of the treasurer or of the treasury department and the government is not *ex nomine* obligated thereby. But, of course, the government stands behind and will uphold the treasurer or the exchequer. The officer technically responsible for the note or bill cannot legally become so without authority and acts strictly in an official capacity. In times of peace these notes are for a short time only, and may bear a very low rate of interest. They may even be one-day notes or payable on demand and the treasury may depend upon its ability to sell new ones at any time, to meet those which may be presented, or, which is often the case, pays just enough interest to insure that the holder will find it to his advantage to hold them, or, if he must realise on them, can sell them to some one else for more, a trifle more is enough, than he could get from the treasury. A not uncommon procedure is to discount such notes in series so that only a certain amount falls due on any one-day. Where there is a bank, or a system of banks, closely related to the government the handling of such notes is greatly facilitated. The secret of the facility with which such notes are handled in ordinary times is found in the existence of large private funds or many small ones seeking temporary investment. A business

man or firm often has cash on hand preparatory perhaps to reinvestment, or funds accumulating for some definite purpose and not needed at once. It is an advantage to put these funds into treasury notes because of the interest paid even though the interest be not high, for the notes are very readily turned back into cash, by sale in the market even if not due.

Treasury Bills in Time of War. — In time of war the treasury note often becomes of great importance as a means of raising cash quickly even in large amounts. But since an unforeseen demand for immediate payment on demand of large sums on any one day might be especially embarrassing, these bills in war times are often issued for a set term, and for one longer than the usual peace time term. Care is often taken so to date them that no overwhelming mass shall fall due on any one day. In war times, too, it is sometimes desirable to reach other possible purchasers than the banks and men of finance. So the treasury note may be made attractive to the general public. While the war time treasury note is much the same in nature as the peace time one, it is just enough different in detail as to make it desirable to use a different name for it. So in the United States the term treasury certificate is used. France used the term *bons de la défense nationale* for some of hers during the war, and for another series *obligationes de la défense nationale*. England used a variety of terms, among them "war expenditure certificates." Analogous to the war treasury certificates are savings stamps and savings stamps certificates, which are a variation of the treasury bill devised to reach small savings.

SEC. 2. **Floating and Funded Debts.** — Practically all of the above forms of public debts are included under the loose general term floating debt to distinguish that part of the debt from the so-called funded debt, which consists of long-time obligations, in the many forms explained below. It is advisable at this point to find out if we can what is meant by floating and by funded debt. Unfortunately the distinction is not any too clear as the terms are used to-day, yet they are very common terms.

Originally, this distinction was very simple, and correspond-

ingly useful. In the words of Adam Smith: "Nations, like private men, have generally begun to borrow upon what may be called personal credit, without assigning or mortgaging any particular fund for the payment of the debt; and when this resource has failed them, they have gone on to borrow upon assignments or mortgages of particular funds." The first of these is the unfunded debt, the other is the funded debt.[1] But although these terms are still in common use, the meaning attributed to them has so entirely changed that to-day the so-called floating or unfunded debt consists, in large part, of outstanding claims upon very definite revenues, while it is often the case that no particular fund or source of revenue is directly pledged for the payment of the so-called funded debt. Hence it is that Professor Cohn treats Smith's grounds of distinction as antiquated, and says that the real distinction is found in the fact that the funded debts are those of longer duration, and the floating debts those of shorter duration, "although," he adds, "different causes and purposes of credit lie behind the difference in duration."[2] The most elaborate attempt to explain the modern use of these terms is that of Wagner. As it is so complete, it is well worth summarising here. Funded and floating debts can be distinguished by the following characteristics, which are more or less clearly recognisable in the different cases: (1) the purpose of the loan — floating debts are generally for rapidly passing needs, especially for the payment of the current dues of the treasury: funded debts are to supply the capital for permanent needs of the civic household; (2) continuance of the debt — together with the former characteristic, relatively shorter continuance of floating debts, at least in intention; longer continuance of funded; (3) the legal conditions of repayment — in the case of floating debts, the different items are repayable at sight or within a comparatively short period; in that of the funded, the creditor has a more limited control over the principal, the debtor (the State) being bound to repayment according to a fixed plan for

[1] *Wealth of Nations*, Bk. V, Chap. III.
[2] *Finanzwissenschaft*, p. 757.

amortisation, or making no agreement as to the repayment of the principal. This last is regarded as the essential test.[1]

The difficulty found in drawing a sharp line between these two classes arises from the fact that the distinction is at best purely an arbitrary one. It may differ from state to state, or from time to time in the same state, according to the temporary whim of the public official or statistician. The terms are relative ones. By a floating debt is generally meant one that is regarded by the person using the term as a temporary one. One official will call any debt temporary, or a floating debt, which has three, five, or even ten years to run; while another will refuse the term to any debt that is to run longer than six months or a year. Strictly speaking, the term "floating debt" ought never to be applied to any debt that is, on the face of it, to run beyond the end of the fiscal year next succeeding that in which it is created. But there is no established custom for such a limitation. In trying to draw a sharp line between these two classes, we meet with the same difficulty that we met in attempting to distinguish between direct and indirect taxes. But we have even less to go upon. Official, statutory, and scientific usage varies so much that nothing is gained by attempting to collate all the meanings. Even for the most general scientific purposes, therefore, these terms are of little value, and for the purposes of classification the distinction is absolutely useless.

SEC. 3. **Funded Debts, Bonds.** — Passing now to the funded debts we find great variety. Perhaps the simplest form is a series of notes or bonds each promising to repay a set principal or sum of money at the end of a term of years and to pay interest at stated intervals. As an example, a city may issue bonds for $1000 each payable 40 years from date of issue with interest at 4 per cent per annum payable semi-annually. There are many ways of varying the term. One of the most common is for the government to reserve the right to redeem the bond after

[1] Most writers make use of these terms; few have defined them so accurately as Wagner. For example, Adams, *Public Debts*, p. 147, concedes the term "floating debt" only to those in which the government retains the right to investigate each particular claim. This necessitates a new class of "temporary debts," consisting of treasurer's notes, bills of exchequer, and the like.

the lapse of a certain time and also to bind itself to do so after the lapse of a longer time. Thus we find a bond payable or callable after 10 years and to be paid in 20 years. A common way of referring to such a bond is to call it a ten-twenty. This means a bond which will be paid in twenty years but is callable in ten years. The object of such an arrangement is to insure the lender a fixed term during which his investment will not be disturbed, and at the same time to give the government a chance at the end of that term to pay off the obligation and relieve itself of the burden. Such provisions are of great advantage to the government in refunding operations. Thus if the government, owing to war conditions, has to pay a high rate of interest, but hopes after peace to be able to borrow money more cheaply, the right to call in its war bonds enables it to sell new bonds at low rates and with the money to pay off the old high rate bonds, or what is the same thing to exchange or convert the old bonds into new ones. Sometimes the bonds are callable at a date prior to maturity in part of the whole issue only. The ones which may be called are so designated when issued, or the selection may be made by lot. When a government foresees its revenues it may arrange from the start for serial redemption. Sometimes a government will agree that if it calls the bonds before maturity it will pay a premium to compensate the holder for the inconvenience.

"Perpetual" Debts. — There is, however, no necessary reason why a government should fix a date of redemption or name *any* sum as the principal sum. The government lives forever, and its promise to pay a fixed sum each year forever ought to be good. The contract is eventually an annuity. Such a promise is salable in the money markets at any time. A certain number of them will usually be offered for sale at all times and the government can always step in and buy them and by so doing reduce its debt. If the government is in a position to pay a little bit over market prices it can almost certainly buy as many as it wishes to buy. The advantage of not naming a sum at which the government will or may redeem an outstanding debt is that the price always represents the present value of a long

series of annual payments, uncomplicated by the computation necessary to correct a premium or a discount on the principal payable at some fixed date. In this way the obligation becomes a public stock (English) or a *rente* (French) where the attention centers in the annual payment and not on the capital investment. This does not necessarily mean that the security or the document may not have a par value entered or printed upon it. For there is a convenience in having a face value mentioned, slight though the convenience may be. It facilitates the expression of the rate and comparison of notes or bonds of different sizes. Thus a 3½ per cent *rente perpétuelle* may be issued in denominations of 100 francs, 500 francs, 1000 francs and larger, and may be sold at 98 francs per hundred. One statement of price and rates of interest describes the whole series sufficiently if the *rente* certificate bears a par value. If not, one would presumably have to quote the securities as selling at so and so many years' purchase, which requires an awkward computation. Thus 98 as par for a 3½ per cent *rente perpétuelle* happens to be 28 years' purchase, but other fractions are more difficult. But the point is that unlike a bond (American) the par value of a "consol"[1] or any annuity is not necessarily the sum which is to be paid back under a special promise.

Bonds Used in the United States. — In the United States perpetual annuities, although used in our early history, are now quite uncommon, and public bonds almost invariably promise to pay back the principal at some fixed time. This arises from the practice, commented on several times, of expressing the value of investment properties on the basis of capital value. The European, unlike the American, thinks almost habitually in terms of annual value, a concept quite troublesome to an American. Whether this way of writing public bonds leads to prompt liquidation of debt is an interesting problem in political psychology. One thing is certain and that is that American governments have paid their debts off faster than European governments have done so. It may well be that the promise to

[1] "Consol" is an abbreviation for "consolidated debt," and stands for the securities issued after various conversions resulting in one standard series of securities.

redeem at a definite date has, by focussing attention on that as a goal, contributed to prompt payment.

Multiplicity of Forms of Debts. — It will readily be perceived that there is an almost unlimited possibility of combinations of the elementary forms described above, and an almost infinite variety of public stocks and bonds possible. While infinity is a large number, the observer of bond issues and other public borrowings during the Great War might well be excused if, bewildered by the large number of different kinds issued, he concluded they were nearly infinite. The purpose of issuing many different kinds is to meet the tastes and needs of different investors. It is, however, a matter of question whether the resulting complexity is not a serious mistake. Two or three of the simpler sorts ought to be enough. In five different loans the United States rolled up a very considerable number of different bonds. Had she started with a straight 5 per cent bond and stuck to that, selling at market or at an assumed market, varying only the time of maturity, the simplification would have been enjoyable.

Life Annuities. — A favorite variant of the annuity is a life annuity. This of course must be sold on life insurance principles. But after the initial difficulty of fixing the payments is overcome, there is an advantage to the government arising from the fact that as the annuitants die the annual debt charge is automatically decreased. The charge is higher at first but gradually declines. Annuities for a fixed term of years only, afford a similar means of putting pressure on the government to reduce its debts by annual payments toward the principal.

Lottery Loans. — Another variant is introduced by the so-called lottery loans. These appeal to the universal love of gambling and may be used to give the government a profit, or save some money, much as the "bank" in any gambling game takes its percentage through the favorable arrangement of the chances. The forms of lottery loans are legion. Prizes may be awarded out of interest or out of principal, may take the form of premiums in money, or of some more preferable type of bond.

SEC. 4. **Should Public Bonds Be Taxable.** — The exemption of interest on public bonds, state and federal, from the federal income tax is a much discussed question. It is held that by investing his money in these bonds a rich man may avoid income tax in part or possibly wholly. The situation arose in this way. *First,* Congress has no power to tax in any way state bonds, nor bonds issued by the political subdivisions of the state, the counties, school and other districts and cities, because it has no power to interfere with the essential functions of the states. *Second,* as to federal bonds, these were made tax exempt in order to sell them more readily and at higher prices or, what is the same thing, lower interest rates or cost to the government. Those that are outstanding embody, as to the tax free feature, contracts that cannot be voided. It is therefore proposed: first, to amend the constitution so that in the future the interest on any new state and local bonds issued may be taxed as income of the holders; second, that all future issues of federal bonds be made subject to income tax.

Let us examine how this would work. Any bond the interest on which is subject to the income tax would have to carry enough more interest to offset the liability to tax; that is, the government would pay out in increased interest certain monies which it *might* get back in taxes. But some bonds would be bought by persons who pay no taxes, some will be hidden, and if income tax rates came down interest on bonds issued before that would be too high. It would be a losing proposition for the government. Similarly the states and cities would have to pay higher interest rates. But it would be the federal government not the states which would get the tax, so far as any was collected. In short, Uncle Sam would force up local taxes by more than he could collect. Local taxpayers would surely have a right to feel injured. In most states their own bonds and those of their subdivision are exempt from the property tax and the consequent saving in interest to the states and cities is many times more than they could hope to get by trying to tax them.

The amount of tax avoidance by these investments has been grossly exaggerated, especially when one considers that the

investor gets only the very lowest interest return. One important feature of the tax free public bond is that it competes for buyers with taxable corporate securities. That may however be an advantage to which government is entitled.

SEC. 5. **Special Provision to Enhance Credit.** — Of special ways of enhancing credit only three need be mentioned. Countries weak financially often pledge certain revenues to the payment of their debts. Thus the customs duties are often so pledged. This even goes so far as to place the collection of the duties in the hands of the creditors or of their governments, or of some outside party. Countries whose currency is uncertain often agree to pay interest and principal in some other country or in some financial centre in the money of some country whose currency is stable. Very rarely loans may be supported by collateral. This form of loan was used by France and England during the Great War not so much to support the loan, although it had that effect, as for the purpose of moving funds or credits to the point where heavy payments were to be made. Owing to the breakdown of the exchanges and the one-way flow of trade, there were no regular trade bills to be had by which payments from Europe to the United States, for example, could be made. When trade is normal it is usually large enough so that the ordinary exchanges would carry the credits. Normally, too, a country which has collateral is not in need of borrowing.

SEC. 6. **Fixing the Rate of Interest.** — In all of these forms of debt-making the chief problem of the practical financier is to fix the rate of interest as near as possible to the market rate. It is best that it should not be below the market rate, for in that case the bonds will sell for less than par, and the government will have to pay back a larger sum than it receives. This addition is accumulated and compounded interest, which it is presumably easier to pay in annual instalments than at one time. The amount of the discount at which such bonds will sell depends, in part, on the length of time that they have to run.

When the market rate of interest falls, as it generally does in

time of peace, below that at which the debt was contracted, it is generally desirable to reduce the rate of interest on the debt. If, therefore, the government can call in its bonds, it goes through the process of refunding; that is, it issues new bonds at the new rate of interest, and pays off the old ones with the proceeds. This advantage is peculiar to the perpetual bonds, and is consequently made use of whenever the rate of interest falls, which fact can be ascertained from the quotations of the bonds on the stock market.

SEC. 7. **Productive Loans.** — Borrowing to secure the means for entering upon some productive enterprise is the chief cause of the debts of the several States comprising federal States and of local governments. Cities borrow to build waterworks, to construct street railroads, to establish a gas or lighting plant, etc. In the United States the different commonwealths have borrowed to aid in the construction of railroads or to establish banks. The enterprise in which the funds thus acquired are invested furnishes an additional security for the loan, and enhances the credit of the local body, because it is supposed that the enterprise itself will yield the interest and other debt charges. There are two ways of managing such enterprises. One is by selling the commodity or service produced; the other is by the assessment of a fee upon the users. So far as the debt is concerned there is little difference in these two methods. The former, however, introduces a speculative element, while the latter is more regular in its returns. Sometimes such enterprises fail, and the interest has to be paid out of the revenue from taxation. Not infrequently debts of this same kind are made to render assistance to private companies, and the expectation is that the companies will meet the interest charges. The bulk of local debts the world over are of this general character.

National "Invested" Debts. — National governments, too, have sometimes contracted debts of this sort. Thus Prussia's debt was almost all incurred for the purchase of railroads, which pay the interest and provide for the sinking fund. Other countries of Europe have similar "invested" debts. The

United States has given aid to railroads, but on terms that give no real surety that the debt charges will ever be met by the roads. The wisdom of such loans depends solely on the wisdom of entering upon such enterprises. It may even be wise under certain circumstances to advance money borrowed in this way to private companies which promise to provide some much-needed facilities, even without any hope that the interest and debt charges will be met in any other way than by taxation. That such debts when contracted should be treated in the same manner as any other debts, and paid as soon as possible, is a matter of good business management. The failure of the assisted private enterprise to make good the sums expended is no reason for the refusal of the government to meet the obligations thus incurred, and refusal under such circumstances is as destructive of credit as would be the failure to meet any other obligation.

These different forms of debts are all in constant use, and the indebtedness of any nation will show almost all of them. The experience of the most advanced nation shows that there is as much need of a systematic arrangement of the different forms of debts as there is of the different forms of taxes. The various kinds of stocks are adapted to the differing needs of the treasury and the tastes of the lenders. The former must be consulted, perforce; the latter, if it is desired to obtain the most favourable terms; hence the scope for the exercise of good judgment on the part of the fiscal officers in the choice of forms.

CHAPTER III

NEGOTIATION, PAYMENT OF INTEREST, CONVERSION, AND REDEMPTION OF DEBT

SECTION 1. **Two Methods of Negotiating a Loan.** — There are practically two methods for the negotiation of a public loan. One is to prepare the bonds or other evidences of debt for sale, fixing all the conditions and offering them to all comers who will accept those conditions. The other is to determine the amount to be raised, and then to negotiate with bankers or capitalists or other persons in order to ascertain on what terms the sum can be raised. There are, of course, many variations of these plans, but these are the principal ones. In the first case the State loses in a measure the advantage of competition between the lenders. One of the best examples of this method is the so-called " popular subscription." For example, a State decides to issue a certain number of bonds at a fixed rate of interest, selling them to all comers at a stated price. Certain places are designated for the reception of subscriptions. If the terms offered are too low, *i.e.* offer too little advantage to the purchasers, it may be that only a part of the loan will be taken up. If they are too high, the State, of course, suffers a loss. In this case everything depends on the ability of the fiscal officers to gauge the market. This task is comparatively easy if the State already has a large number of stocks outstanding, the market price of which will roughly indicate the possible rate of interest that will be accepted on a public loan. But the extent to which the new loan will probably depress the market will have to be considered. This method with the added feature of the " drive " became a favourite method during the World War. The drive consists in organizing a vast number

of volunteer salesmen, holding public meetings to stimulate enthusiasm and arouse confidence, advertising, and in general agitation, all with a view to reaching every possible subscriber. The assignment of a " quota " to each town or district as a goal to work to is another feature.

If the second method be the one chosen, the State lets it be known that bids for a certain sum are desired. The bankers and capitalists, and sometimes the public at large, then compete for the privilege of taking either the whole issue or a part of it. The different bankers offer to provide the whole or a part of the money needed at a certain rate of interest, or if the face of the bonds and the rate of interest have been fixed, offer to buy the stocks at a certain rate, generally quoted as so much per hundred. The most favourable terms offered by reliable bidders are then accepted, and they deliver the money in mass or in instalments to the treasury, in such form as may have been agreed upon, receiving in return the securities, which they are then at liberty to dispose of as they see fit. If the market price rises, the gain goes to the capitalists; if it falls, they lose. Of course the sums needed often exceed the wealth of any one person or group of persons, and each purchaser has to depend on his ability to dispose of the securities to raise the money to meet his agreement.

In both of these cases various secondary considerations as to the form of the loan, the length of time it has to run, etc., affect the result. Sometimes it has been deemed wise to combine the two methods. That is, to negotiate with the bankers for terms on a part of the debt, and then to offer another part on similar terms to popular subscription, or even to allow of more general competition as to the terms.

SEC. 2. **Place of Payment of Interest, and Minor Considerations.** — The amount of the interest or the rate is the chief factor in the negotiation of a debt; but the place and times of payment and the kind of money in which payment will be made are minor considerations of considerable weight. So, also, is the size of the bonds. In the case of popular loans which are intended to be subscribed for by the mass of the

people, the bonds must be for small amounts; in other cases the units may be larger. There is no uniformity in this matter. The larger the bonds can be made, the easier it is for the treasury to manage the debt. Of some importance, too, is the choice between bonds that are payable to the holder, or to certain persons by name, and those payable to persons registered on the books of the State. If the bonds are payable to the holder, there is no need of a record of the holders by the government. The government is also spared the trouble and expense of recording changes in ownership. But there is an advantage of greater safety to the holders in the case of the recorded bonds, which are thus insured against loss or theft.

It is in general customary to determine the place at which the interest, etc., will be paid. This is frequently some important commercial centre, sometimes the treasury of the State. If in the country issuing the bonds there be in circulation a debased, redundant, or depreciating currency, it is often agreed to pay the interest in some foreign commercial centre, or in foreign money, in order to secure payment in a stable currency. Thus many of the commonwealths of the United States which contracted debts between 1830 and 1850 agreed to pay the interest in London in order to insure the payment in gold, and to guard their creditors against loss from the depreciated currency then in circulation. When the states appealed to Congress for assistance in the payment of their debts in 1842,[1] this was alleged as a feature involving special hardship. A large part of Russia's debt is payable in Holland and England, and in all of it the kind of money is specified. The same is true of the debts of many other countries.

SEC. 3. **Conversion of the Debt.** — While it is often necessary, in order to obtain the required funds on the best terms, to offer many different forms of public securities, yet in a time of absence of pressure it may become desirable to simplify these forms and to consolidate the debt. This involves the calling

[1] See Johnson, *Report on the Relief of the States*, 27th Con., 3d Sess., House, No. 296; a perfect mine of information on the history of public debts in the United States up to 1842.

in of the outstanding paper and its conversion into another form. Conversion is generally undertaken when a fall in the rate of interest offers the State an opportunity to gain by the process. The reduction of the rate of interest is possible whenever the State enjoys the privilege of repayment. It can then offer the creditor the choice of payment (for which it could obtain the money by the sale of new bonds at the new rate of interest) or of new securities at the lower rate. This mode of conversion or reduction of interest is, of course, perfectly legitimate. The reduction of the rate arbitrarily without the consent of the creditors is as much repudiation as the refusal to pay altogether. It is by numerous conversions and consolidations that the rate of interest on the bulk of the debt of Great Britain has been reduced as low as $2\frac{3}{4}$ per cent.

SEC. 4. **Debts Must Be Paid.** — The best justification of debt-making is that it distributes the burden of some heavy expenses upon a later period. The cost of this postponement is the payment of the annual interest. In order to fulfil the intention of the loan and to get rid of the cost of the process, it is necessary to pay the debt. If these two reasons were not sufficient, the danger of the recurrence of similar extraordinary needs and new appeals to credit, and the eventual danger of bankruptcy, point in the same direction. As we have already seen, some of the forms of debts contain within themselves the provision for payment. Life and terminable annuities involve the payment of the principal in annual instalments. Other forms call for payment in larger instalments or at the end of a term, for which provision must be made by the collection of funds beforehand. If, however, the expiration of the period finds the debtor State not in the possession of the funds needed, it may have to borrow again to fulfil its agreements. In the case of most perpetual debts it would be obviously unfair to call upon certain holders for the surrender of their bonds and to allow other holders of the same sort of bonds to retain theirs, especially if the rate of redemption is below the market rate. The whole of any issue of bonds, therefore, must be treated as a unit. This involves the gradual accumulation of a fund for

the payment of all of the debt of the same kind and issue. There is, however, another alternative. The government may enter the market with this fund, before it is large enough to pay all the debt, and purchase such of its securities as are offered for sale. Care must be exercised in the application of this method not to raise the price of the securities. In some cases arrangements are made in advance for calling a portion of the outstanding bonds by lot. This depreciates the whole issue, because each bond is liable to be called.

The Sinking Fund. — Provision made for the accumulation of a fund for the redemption of the debt is called the sinking fund.[1] The sinking fund may be defined in two ways; either it is an annual fund, *i.e.* a portion of the annual income, or it is the accumulated capital from this and other sources applicable to the payment of the debt. Not strictly the earliest, but the first important, attempt at the arrangement of a regular sinking fund is that of England in 1786 under Pitt. This was a remarkable scheme. It is said to have been suggested by Price, a clergyman, who in 1772 wrote An Appeal to the Public on the Subject of the National Debt. His argument was based on the productiveness of compound interest. He urged that a fixed sum, however small, should be set aside every year for the purchase of public stock, and that the interest on the stock thus purchased should continue and should be applied to further purchases. There would then be two sources from which the debt would be cancelled: one, the payment of the annual amount; the other, the ever increasing interest fund. The effect of such a scheme in eventually discharging any debt was regarded as almost magical.[2] It was not perceived that the real efficacy of the scheme lay in the fact that the nation continued to bear the whole burden of the initial interest charge until the debt was paid, and that the real source of payment was the excess of taxation over expenditure. In accord with this idea Pitt appointed a " Board of Commissioners of the Sinking

[1] See Ross, "Sinking Funds," *Pub. Amer. Economic Assoc.*, Vol. VII, p. 445.

[2] As an illustration, compute the sum which a penny placed at interest in the time of Christ would amount to at compound interest.

Fund," who were to receive a fixed sum each year, with which to purchase public stocks, at or below par. Interest on the stocks thus purchased was to be paid to the commissioners, and quarterly applied to new purchases. This much-admired scheme amounted to adding £1,000,000 annually to the taxes needed for other purposes, and continuing the entire burden of taxation until the debt was paid. It is clear that what was really used for debt payment was the surplus revenue. The £1,000,000 was clearly that, and the interest on the stocks purchased therewith need not have been paid but for the sinking fund. There is, indeed, no source from which the debt can be paid but taxation or similar net revenue. So great was the faith of the government in this scheme that it continued the payments to the sinking fund even while borrowing for the war of 1793 and after. The fallacy of Dr. Price's arguments was pointed out by Professor Robert Hamilton of Aberdeen in 1813. Shortly after that, it was estimated that, as a result of the sinking fund system kept up during a period of borrowing, the government had, between 1785 to 1829, borrowed £330,000,000 at 5 per cent to pay a debt of the same size at 4½ per cent. The scheme was then abandoned, never to be resumed. From this time on only genuine surpluses were applied to the payment of the debt. This abandonment of the idea of Price and Pitt, however, had a rather disastrous result, in that it largely suspended debt payment in favour of tax remission. Since 1875 England has tried a new plan. Without committing herself to a policy which would involve paying debts with one hand and borrowing with the other, and without relying upon mere chance surpluses, she decided to appropriate a fixed sum from the consolidated fund for the national debt services, to be continued as long as there were no extraordinary calls upon the funds. In 1895 £25,000,000 was the fixed charge for the national debt services, of which £1,718,263 3*s.* 7*d.* went into the new sinking fund; whereas in 1875 the sum was fixed at £28,000,000, and a larger amount went into the sinking fund. During the Boer War and for a time thereafter the sinking fund was suspended. Thus in 1901–1902 the "national debt ser-

vices" stood as follows: the "fixed charge" was £23,000,000, less £4,640,000, "sinking fund suspended," leaving £18,360,000, denominated as "inside the fixed charge"; in addition to this there was £3,250,000 interest on the war debt, which was "outside the fixed charge." In addition to this England has been converting her debt into terminable annuities, resulting in a mechanical method of debt payment which may in time of pressure work as the old sinking fund did.

SEC. 5. **American Sinking Funds.** — The American system of debt-paying began in 1790 with the application of a surplus from tunnage fees and imports to the purchase of public bonds in order partly to improve the market price of the bonds and by thus improving the country's credit to facilitate conversion. In 1792 the bonds thus purchased were made the basis of a sinking fund, it being determined that the interest on them should continue and be paid to a commission for the further purchase of public bonds. In 1795 the sinking fund commissioners were made the recipients of certain revenues to be applied to the payment of definite portions of the debt. Ross thus summarises this fund: "The sinking fund was now enlarged by the following additional appropriations: (1) so much of the permanent duties as, with existing income, should enable the commissioners to pay, in 1796 and thereafter, a yearly 2 per cent of the 6 per cent stock; (2) the surplus dividends on the government's $2,000,000 of United States Bank stock after deducting the interest accruing on the remnant of the bank loan; (3) so much of the permanent duties as, with the surplus dividends, should suffice to pay a yearly $200,000 on the bank loan, till 1802, and then begin the redemption of the deferred stock; (4) the proceeds of the sale of public lands; (5) the proceeds of debts inherited from the old governments; (6) all revenue surpluses of any year remaining unappropriated during the next session of Congress."[1] This fund was not very efficient on account of the excess of expenditures. It served one very important purpose, however, that of regulating the credit of the United States by showing the intention to pay. In 1802

[1] *Sinking Funds*, p. 49.

Gallatin organised another plan, which was continued for some time. It was to increase the revenues beyond the current expenditures and apply the surpluses to the debt payment. The results of the two plans have been compared as follows: "The inherited debt and accrued interest amounted in 1791, when funded, to $76,781,953.14. The Federalists in ten years reduced this to $72,733,599, but added $7,193,400 of new stock mostly at 8 per cent, thus bequeathing a burden of $79,926,999 to their successors. Of this, Gallatin's sinking fund extinguished $46,022,810 between 1801 and 1811. The purchase of Louisiana, however, added $11,250,000 to the principal, so that on January 1, 1812, the public debt was $45,154,189, over thirty-one millions less than the original Revolutionary debt." [1] This comparison is not altogether fair to Hamilton, the author of the older plan, for his fund enabled important conversions to be successfully made which reduced the debt charges. During the War of 1812 the payments to the sinking fund were suspended. After the war the debt stood:

Old debt remaining	$39,905,183.66
Funded war debt	49,780,322.13
Treasury notes	18,452,800.00
Temporary loans	550,900.00
Total burden on the sinking fund	$108,689,205.79

The sinking fund was at that time composed of

Interest on stock held by com.	$1,969,577.64
Receipts from public lands	800,000.00
From duties	5,230,422.36
Sinking fund	$8,000,000.00 [2]

The policy of protection, inaugurated after the War of 1812, separated income from expenditure. The ultimate purpose of most of the taxation, namely protection, was considered so paramount that a high rate of taxation was continued for that reason. The available surpluses were, therefore, large, and were from time to time applied to the debt. Down to 1824, when all the debt contracted up to that time was practically

[1] Ross, p. 67. [2] Ross, p. 69, from *Finance*, Vol. II, p. 916.

paid, the sinking fund was managed by a special commission, but since then the Secretary of the Treasury has had charge of it. The Civil War debt was by the act of February 25, 1862, supposedly placed on a secure basis. "The coin paid for duties on imports was to be applied first to the payment of interest on the bonds and notes of the United States. It was then to be applied 'to the purchase or payment of 1 per cent of the entire debt . . . to be made within each fiscal year, which is to be set apart as a sinking fund, and the interest of which shall in like manner be applied.' . . . The residue of customs receipts was to be paid into the treasury." [1] While no such regularity as was contemplated by this act was realised, yet the debt has been paid from surpluses more rapidly than was anticipated, until the reduction of the revenues in 1895, due to a change in the policy in regard to the protective duties, together with a redundancy in the monetary circulation, which resulted in a foreign drain upon the gold reserves held for the redemption of notes outstanding, made new borrowing necessary. The war with Spain involved a new increase of indebtedness, which, however, was contracted on terms remarkably favourable to the government. The same general policy of debt reduction has continued, and the debt, which amounted to $1,108,000,000 in 1900, was by 1908 reduced to $938,000,000.

The commonwealth constitutions of the United States very generally imposed upon the legislatures the duty of providing a sinking fund. Many of them, besides limiting the amount of debt that may be created, either by naming a fixed sum or a fixed proportion of the revenues that may be used for interest payment, also provide that whenever a debt shall be contracted, a tax shall at the same time be levied sufficiently large to pay the interest charge and provide a sinking fund. The general distrust of the legislatures is emphasised in the constitutions by making such laws irrepealable until the debt is paid. The commonwealths are thus permanently committed to the policy of debt payment, not so much on account of any deep-seated belief in the efficacy of the particular methods laid down, which

[1] Ross, p. 79.

may necessitate the continuance of debt payment even at a time of borrowing, but on account of the widespread distrust of the prudence of the legislatures. The same distrust has destroyed the danger of the system, by almost entirely forbidding debt-making by the commonwealths.[1]

SEC. 6. **Summary.** — In conclusion, it would seem that the experience of great nations shows: that debts must be paid; that they can be paid only by increased taxation; and that the possible weight of taxation for this purpose is determined by a consideration (1) of the length of time it is thought desirable that the debt shall run, (2) of the existing burden of taxation, (3) of the general conditions of the people. When the debt has been contracted for some productive purpose, it seems fitting that the surplus earnings of such an enterprise should go to debt payment, as this eventually enables a permanent lowering of the cost of such services to the people.

[1] For a full account of the debt policy of the American commonwealths see my monograph, *Das Kreditwesen der Staaten und Städte der Nordamerkanischen Union in seiner historischen Entwickelung*, Jena, 1891.

PART IV

FINANCIAL ADMINISTRATION

CHAPTER I

THE BUDGET; ADMINISTRATION OF EXPENDITURE; CONTROL AND AUDIT

SECTION 1. **Matters of Form.** — To the fourth and last part of our subject belong the formal arrangements of the public finances, — the preparation and ratification of the budget, the care and preservation of the public funds, the administration and control of expenditures, and the collection of the revenues. It was this side of the subject that first attracted attention and which occupied a large part of the writings of the cameralists. Lorenz von Stein gives a very considerable portion of his monumental work to these subjects, and the able French writer, Stourm, has devoted to financial legislation a volume entitled *Le Budget*. English and American economists have generally left this field to the jurists and publicists, but Bastable devotes the last three chapters of his book to some of these topics.

In every well-regulated household and every business concern the keeping of accurate accounts, the distribution of the funds among different persons, and the control of expenses have an importance second only to the broader questions of policy. Equally important in the greater housekeeping of the State are the formal arrangements for the enactment of fiscal laws, for the keeping of accounts, and for insuring compliance with the laws.

The general frame of the fiscal administration, the relation between the various departments, the assignment of particular

powers and duties to the different officials or bodies, depends entirely upon the general political organisation. How these features differ from country to country it is the province of political science to describe. But the frame of administration has an effect on the finances; and there are certain principles demanded by sound finance which are followed by every country, no matter what its frame of government.

SEC. 2. **History of Fiscal Administration.** — Of necessity the methods of accounting and control do not assume a public character until there is a pretty clearly recognised popular interest in the affairs of the State. At one time the Roman treasury under the control of the *Censors* and in charge of the *Quæstors* exhibited the features of public economy. But under the Empire the public treasury and the private treasury of the Cæsars gradually merged into a single one, and the methods of accounting became that of private rather than of civic housekeeping.

The Middle Ages were essentially unpolitical, and in that period no system of public treasuries proper was developed, except in the free cities. As we have already seen, there were no revenues collected in the monarchies for a distinctly public purpose until the fifteenth and sixteenth centuries, and consequently there could be no public accounts or public control over the funds.

Conflict Develops Legislative Control. — The constant struggle between the representatives of the people and the officers of the older absolute governments for the control of the purse led to the development of distinct methods of accounting and control. The most striking feature of the modern systems in European countries is the establishment of the budget, and of the right of the popular representatives to vote taxes and appropriations. In America the right of the legislatures to control the finances was clearly established at a very early date, and little or no advance has been made beyond the crude methods first developed. Most European countries have advanced more rapidly and perfected far better systems. This higher development of the budget in European constitutional governments

is explained by the constant conflict between the branches of the government having interests which are theoretically opposed. The modern budget is an outgrowth of the gradual assumption of power by the legislatures, and the corresponding loss of power by the executives. The latter have had to ask for funds, and the former in granting them have insisted upon knowing what they are to be used for, and upon having assurance that they will not be applied in any other way. In the United States, however, both the federal and the commonwealth legislatures suggest, or initiate, financial legislation as well as grant funds. Both of these functions of initiation and of grant being in the same hands, there is no conflict of interests such as has developed the systems of financial statements and legislative control in Europe. The only care in this country is to see that the funds are not appropriated to private purposes, while in Europe there is the desire to prevent the application of the funds to other public purposes than the ones specified.

SEC. 3. **The English Budget.** — It has been claimed that the English system served as a model for the other European countries. However that may be, and it is true only in part, the English system will serve as a good illustration of the European methods. The fiscal year begins April 1 and ends March 31. Each department of the administration prepares a careful statement, known as the "estimates," for the coming year. These "estimates," each of which comprises a good-sized quarto volume, are tediously exact and minute in the statement of what it is expected will be needed for the forthcoming year. They are called the "army estimates," the "navy estimates," the "civil service estimates," etc. The Chancellor of the Exchequer, in turn, bases his estimate of all that will be needed upon these statements, and calculates the receipts from each source on the basis of the revenues of the previous year. He then presents all the documents to Parliament with a brief, clear statement of what the expenditure will be, what it is expected the revenues will be, what new taxes, if any, are needed, or what taxes may be remitted or changed, in order to make the revenues equal the expenditure. This statement is called the budget.

"Usually, but by no means always, the proposals of the Chancellor of the Exchequer are accepted by the Commons, and even when they are not in detail, it is seldom that the items of expenditure are objected to. The House is supposed to go through the 'estimates' in detail; it forms itself into a 'committee of supply,' and sanctions every item in the three bulky volumes, but its members have not, as a rule, knowledge enough of the details to offer effective criticism, and the utmost the committee can be said to do, on the average, is to render flagrant abuses impossible. On the average, perhaps that is enough." [1] Parliament cannot directly or indirectly increase the appropriations asked by the ministry in the name of the Crown, nor add new appropriations. The estimates both of revenues and expenditure are made with such great care that there is seldom either a surplus or a deficit of any large amount at the end of the year. According to Bastable the estimates of expenditure in England for the three years April 1, 1889, to March 31, 1892, as compared with the results, show an error of only £137,000 in a total of £264,000,000, or a little over 1*s.* per £100, or $1 in $2000. All credits of disbursing officers expire, and their accounts close, March 31. All appropriations lapse at that time, except those apportioned for the consolidated fund. It requires a special act of Parliament to spend any more money on last year's account, even though the original appropriation may not have been exhausted.

SEC. 4. **English Control and Audit.** — When the budget has been prepared and voted, the next step is to see that the expenditure is carried out as authorised and to prevent any misappropriation of the funds. In England the funds are deposited with the Bank of England, subject to the order of the comptroller and auditor-general only. This officer's duties are a combination of those of the old board of audit created by Pitt in 1785 with those of the Exchequer, and date from 1866. No payment is made without (1) an act of Parliament, (2) a requisition by the treasury issued to the comptroller-general, (3) a grant of credit for the amount authorised by the act good for one year,

[1] Wilson, *The National Budget*, p. 147.

(4) a treasury order directing the transfer of the money to the paymaster-general of the service.[1] As the estimates have been closely scrutinised, there is little opportunity for the misapplication of funds. There is none whatever for overdraft. Again, after the expenditure has been made, the accounts with vouchers are passed through the comptroller's office for his approval, or audit. The report of that officer is subjected to the final revision of the parliamentary committee of public accounts. Thus the whole process begins and ends with Parliament. It will be seen that there are really two parts to the process. First, the control over the " issues " to the disbursing officers, that is, over the placing of the public moneys in their hands. Secondly, the audit of the accounts after the expenditures have been made.

SEC. 5. **History of Control and Audit in the United States.** — In the United States[2] the direct control of the money is in the hands of the executive officers, subject to the statutes of Congress. The safeguards consist in making the processes of expenditure complicated and subjecting each item to the scrutiny of several sets of executive officers. The idea of the original plan in the United States was not to allow of issues to the regular disbursing officers, but to control expenditure by a careful scrutiny of the accounts or claims rendered. The treasury was to be reached only after the claims had been cut down to the lowest possible figure. Claims against the government were first passed upon by an auditor, then by a comptroller, either of whom might reject them. Then the secretary drew a warrant upon the treasurer, and that warrant was recorded by the register and countersigned by the comptroller. Hamilton found it necessary, for the sake of economy, to pay cash for many things needed by the government, and hence this original plan broke down. Issues were made to disbursing officers, and the necessary warrants were drawn for each particular item of expenditure, afterward, in order to legalise the transaction.

[1] Cf. Bastable, p. 705.

[2] See Renick and Thompson, *Political Science Quarterly*, Vol. VI, pp. 248–281, and Vol. VII, pp. 468–482

For many years the United States had a very complicated system of audit, control, and record. There were six auditors, so called, and the "commissioner of the general land office," who was auditor for the lands account. Then there were three comptrollers, known as the first and second comptrollers, and the commissioner of the customs. Lastly there was the register. All of these were assisted by a large body of clerks. These officers were organised into four coördinate branches, with separate jurisdiction. Accounts were first examined and passed upon by an auditor, then reëxamined by a comptroller. Claims disallowed by these officers could be pushed in the Court of Claims and appealed from there to the Supreme Court. The assignment of accounts to the different auditors and comptrollers was almost arbitrary and with little system. The first auditor looked over the general income and expense accounts of the treasury, the special accounts of the customs receipts, the expenditures for the legislative and executive departments, special accounts of the treasury department, — as of the interstate commerce commission, of the public debt, of engraving and printing, of the coast and geodetic survey, of the life-saving service, of the lighthouse establishment, of the public buildings, of the government of territories, of the District of Columbia, of the central administrative departments of war, navy, the interior, etc., of the departments of labour and of agriculture, and all the expenditure for the judiciary. The second auditor had the accounts from the Indian service and the army. The third auditor had the pension account. The fourth had the accounts of the navy. The fifth looked over the accounts of the collector of the internal revenues. The sixth was for the postal accounts. The first comptroller then revised the accounts that were assigned to the first and fifth auditors, except the customs account, for which the commissioner of the customs was comptroller, and those of the commissioner of the general land office. The second comptroller had the accounts of the second, third, and fourth auditors.

All of this was changed by "the act of July 31, 1894, making appropriations for the legislative, executive, and judicial ex-

penses of the government for the fiscal year ending June 30, 1895. This act altered the accounting offices of the treasury and changed materially the system of accounting. The detail revision of accounts heretofore made by the first comptroller, as well as by the second comptroller and the commissioner of customs, was abolished, as were the offices of the second comptroller and the commissioner of customs, the first comptroller being made the sole comptroller of the treasury. A revision of accounts under the new system was only made when either the head of a department or the claimant was dissatisfied with the settlement of an account by an auditor, or when the comptroller himself had reason to believe that any particular account ought to be subjected to a second revision. Much labour was saved by this system, and the adjustment of accounts greatly expedited. It was originally one of the duties of the first comptroller to 'countersign all warrants drawn by the Secretary of the Treasury which shall be warranted by law.' This duty was continued with the comptroller of the treasury under the new system. As the Secretary of the Treasury has the duty devolved upon him of originating warrants and as all such warrants must be countersigned by the comptroller, no warrant finally became effective without their concurrent action." [1]

New Federal Auditing System. — In 1921 an act creating a budget bureau was passed which also reorganized the federal auditing system. There were previous to that six auditors, and the accounts were distributed in an illogical fashion, the outcome of the accidental historical growth of the departments.[2] There is now an independent General Accounting Office under a Comptroller-General. The old organization for audit in the Treasury Department is transferred to the new office which does all the auditing and exercises all the control formerly exercised by the old six auditors, except that there is a comptroller for the accounts of the Post Office. The functions of the Comptroller-General combine with those of a government auditor duties analogous to those performed by a certified public accountant for a corporation.

[1] *Finance Report*, 1894, pp. 836, 837. [2] See Wilson, *The State*, pp. 567–570.

Congressional and Legislative Financiering. — In the United States there is no such connection between the executive and the legislative departments of government as there is in England and in many other European countries. In England the "government" is representative of and chosen from and by the majority in Parliament. When it ceases to be supported, it ceases to be the government. Hence its budget must be the will of Parliament. But *per contra* in the United States a man may be president or governor without substantial support or even with strong opposition in congress or in the legislature. In such case a budget prepared by the executive might have little support in legislative halls. When both the executive and a majority of the legislature are of the same party, however, an agreement can usually be reached. Until quite recently there was no budget system of any kind in the United States, either federal or state. Appropriations originating in the House of Representatives were supposedly referred to the Committee on Appropriations of the House, and revenue measures likewise originating in the House were referred to another, namely the Committee on Ways and Means of the House, both were considered in the Finance Committee of the Senate. The balancing of expenditures and revenues was reached if at all by conferences, compromises and open debate on the floor. Amendment on the floor was very common. Ultimately a conference committee of House and Senate might reconcile differences between the two houses. But from start to finish there was no regular procedure which created a balanced statement of receipts and expenditures. Even when the general appropriation bill had passed and the taxes had been levied, any member might bring in a bill for additional appropriations and new taxes, or the repeal of old taxes, and such a bill might pass without any necessary consideration of its effect on the general budget. Other committees might initiate legislation involving expenses. That the results were not more chaotic than they were, was due to the prevalence of compromise and common sense. In the state governments practically the same conditions prevailed.

Ever since the protective tariff policy was fully established

when customs duties became one of the main sources of revenue, the federal government had revenues which varied with the state of trade, not necessarily with the needs of government. So that except in war times the consideration of revenue bills was complicated by considerations other than fiscal. There were many years in which Congress was more concerned to fit the expenditures to the predetermined revenues than to determine by the necessary or advisable expenditures how much should be raised by taxation. In this respect state finances were on a better basis, since the taxes were adjusted about every two years.

But the result on federal finance was not so bad as might have been expected; (1), because of the influence of the committees, especially of the Finance Committee of the Senate; (2), because, of course, some attempt was made on the floor to correlate income and outgo; (3), because the tax system was not so extremely variable, and yielded a fairly regular and usually a gradually increasing revenue. But systematic oversight and planning of the finances as a whole was lacking. For a long time many of the credits to spending officers did not expire at any set time, as at the end of the fiscal year, but continued until the sum appropriated was exhausted or the object accomplished. That advantage of control which comes from having to show cause for continuance or renewal of an appropriation was lost. One slight advantage inhered in the old American system, namely, that the sponsor of a new appropriation or a new tax had to make a good case and his item stood out alone for criticism or approval. This however was offset by "log rolling," several members trading their votes to secure passage of each others' bills.

SEC. 6. **Recent Budget Movement in the United States.** — Within recent years a strong public sentiment for better budgeting of public money has developed in the United States. As long as we retain the jealously guarded independence of the executive and legislative arms, there are only three possible ways of preparing a systematic budget which promise any degree of practical success: (1) Let the president or the governor make a budget and submit it to Congress or the legislature; (2) Set up a

board or department betwixt and between the two which shall prepare a budget; (3) Have a committee of Congress or the legislature do the work. The last is probably the least practical, for the members of the committee might not return at the next session. The first is feasible and is the most common, but contains this difficulty that it works smoothly only when the executive has a working majority of his supporters in Congress or in the legislature. When that fails, as experience has shown in state government, the legislature undertakes to show either that the governor is extravagant and cuts his recommended appropriations or that he is unsympathetic with popular demands and endeavors to raise his recommendations. In either case a deadlock may ensue. The second works fairly well whenever the budget board is kept a bit aloof from current political issues, has extensive control and supervision over all money-spending departments and institutions so as to really know and understand what is being spent and why, and when its findings and the budget it presents are given wide publicity. No such board can be wholly independent. Usually it is made to advise the executive who transmits its recommendations to the legislature. On the larger questions of policy the final decision must be legislative. Its success depends, as perhaps is the case in all other matters of government, on the force and character of the members of the board.

Modern Federal Budget Procedure. — In 1921 Congress passed a budget and accounting law. Part of this law established a budget bureau which is to prepare an executive budget to be transmitted by the President to Congress. The bureau is under the immediate direction of the President. Each department has a liaison officer between it and the bureau to present its requirements. The bureau has power to study the organization of government and recommend ways of securing greater economy and efficiency. The budget so created is technically an executive or presidential budget. The plan however is such that it may work out to be a budget system more like the second possibility above. Only time will show how it may evolve. The bureau stands now between the great spending departments on the one

hand and the President and Congress on the other. For the departments are now forbidden to go directly to Congress or its committees. So far the new budget system has not faced a situation where the President has had a strong majority against him. In such a case it seems not improbable that the budget bureau might have a well-nigh deciding voice, at least on all matters outside any great political issues in dispute. That any budget bureau or even the President himself will ever obtain the power to settle the more momentous questions such as are settled in the budget of Great Britain is wholly impossible. The law provides for a balanced budget with all the information as to both expenditures and revenues which Congress may need, or the President deem desirable. It seems to ensure that clarity necessary to effective publicity.

Modern State and Local Budget Procedure. — The states are moving in the direction of budget control. More than half now have formal budget procedure. Constitutional amendments have created executive budgets, and boards of control with budget making powers, many of which are very effective in curtailing waste, limiting the excessive demands of departments and increasing efficiency. When it comes to larger questions of policy these boards are powerless. The now frequent use of the referendum and of the initiative powers of the people tends to fix expenditures and sometimes taxation in such a manner that the budget becomes largely a bookkeeping statement of facts. A single example will suffice to make this clear. In one state the people enacted an initiative law appropriating to the schools from state funds $30 per pupil in average daily attendance, and another $30 from county funds; and also made continuing appropriations for highways. Both appropriations are continuing and grow automatically in size from year to year. Even if these grants are excessive or should become unnecessary no legislature will vote their repeal. All the governor or budget board can do is to enter them as recurring expenses.

CHAPTER II

COLLECTION OF THE REVENUES, CUSTODY OF THE FUNDS, AND THE PUBLIC ACCOUNTS

SECTION 1. **Early Methods of Collecting Revenues.** — Under the early methods of collecting revenues, the tribute due, the economic receipts, and the voluntary contributions were delivered directly to the chief or leader. Many of the early direct taxes were similarly treated. Indirect taxes upon commodities and transactions could not be managed in this way. The first crude method of dealing with these taxes was that of the tax-farmer, the Roman publican. He purchased, for a price, the privilege of collecting all of certain kinds of taxes that he could obtain. The same method was extended to other taxes where there was no similar necessity for it. This farming of taxes was used through the imperial era of ancient Rome, and, copied by France, it was extended into modern times. The various direct contributions of the Middle Ages, which were apportioned among the different cities or "estates," were frequently delivered directly to the prince or his treasurer. All of these crude methods were abandoned as soon as there was a distinct recognition of the authority of the taxing power over all the different parts of the country and over each contributor individually. The apportionment system, as originally used, was a more or less distinct recognition of the autonomy, and possibly of the partial political independence, of the taxpayers, be they provinces, cities, or classes of individuals.

SEC. 2. **Collection of Customs Duties.** — The collection of the taxes is usually the duty of the regular fiscal officers of the general administration, but industrial and commercial receipts are frequently collected by special boards in charge of them,

who turn the money over to the treasury. Assessment and collection are so closely connected that they can be studied together. In the collection of customs duties there are two things for the officials to care for. (1) They must look out for the arrival of all the taxable commodities and prevent smuggling. (2) They must ascertain the value of the goods if the taxes are *ad valorem*, and the number and size of the pieces if specific. The invoices, supported by the usual certificates, oaths, etc., are of the nature of a declaration by the owner, or importer. They are then subjected to the scrutiny of official appraisers, whose knowledge of the nature and value of the goods is very accurate. The tax is then paid to the collector at the place of importation or when it reaches the recipient in the interior, but before it is delivered to him. In case the goods are to be admitted into the interior of the country, or of the customs district, before the tax is paid, as is the case when the person to whom the goods are sent resides in the interior, the package is sealed up, or "bonded," and the seals can only be broken by an authorised collector after the payment of the tax. In countries where there are no general tax-collectors in the interior, this method is not feasible, and the goods are held in the customhouse on the boundary until the tax is paid. With a few exceptions this is the practice of the United States. But in Germany, where there are regular fiscal officers of the central government in almost every hamlet, goods are regularly shipped to the consignee, and the tax paid in the interior.

Collection of Excises. — In the case of excises, the factories, breweries, fields, and other places where the taxed goods are produced are subject to regular inspections, and are more or less under the constant supervision of the officials. The tax is collected directly from the producer or by the sale of stamps and licenses.

SEC. 3. **Assessment of Direct Taxes.** — In the case of direct taxes, it is the assessment that is the most difficult part of the process. The methods of assessing some of the taxes have already been suggested. The work consists of two parts. (1) It is necessary to ascertain the base — the persons, the

property, or the revenues subject to taxation. (2) It is then necessary to fix upon the valuation, or the rating of the base in each particular case. The latter part of the process is "making the assessment." In this the contributor may be called upon to assist, or the officers of the government may proceed entirely alone. Generally a declaration is requested, or may be required, from the taxpayer, and the officials then investigate the truth of that declaration. In Europe it is customary to form assessment commissions consisting of representatives of the taxpayers in the district, who are acquainted with the local conditions and act with the officers of the government. These commissions help the regular officers of the fiscus to make the assessment, or sit as a sort of court to hear appeals from the assessment made, or both. The final assessment, however, is made by the fiscal officers.

In the American commonwealths the assessment of the general property tax is usually made by a board of locally elected assessors or an assessor. The assessor calls for declarations from the different contributors. The law in most states imposes severe penalties for failure to comply with the requirement of declaration or for false declaration. But, nevertheless, there is, for the most part, the utmost laxity in enforcing the law concerning declarations. Only the unusually conscientious, who voluntarily come forward with complete statements, are reached in this way. So general is the habit of neglecting this duty that it is practically impossible for the assessor, no matter how anxious he may be to have the law complied with, to prosecute all the persons whom he knows are evading assessment. The general practice is to default the declaration and allow the assessor to find out, if he can, what taxable property the contributor has. If this were done by only a few persons, they could easily be brought to terms under the existing laws, but when nine-tenths of the population refuse to comply, the assessor is helpless, and the only effect that follows from the declaration by the few is to make the existing inequalities of the general property tax worse than ever. Real estate and other visible property is easily assessed. The officer has at his

command the records of titles, of deeds, etc., which he can investigate, and he ascertains the value of each piece from his own personal observation of prevailing prices. As we have seen, personal, intangible property escapes almost entirely. It would seem that this difficulty of administration is insuperable. No merely severe methods of assessment will ever cure the evil.

Equalisation. — Above the assessor in the United States there are generally two boards of equalisation, though sometimes only one. The first board is local, covering the same district as the assessor. This hears appeals from the taxpayers in regard to their assessment. It equalises between individuals. The second board is for the whole commonwealth, and is known as the state board of equalisation. This board is to adjust the burden of state taxation equally between the different districts. As has already been explained, a local assessor may make the assessment in his district lower than that in the other districts. This will not affect the burden of local taxation, for all that is needed is to raise the rate. But it lessens, if the assessment stands, the burden which the state taxes impose. These central boards are of three kinds: (1) those with power to add to or subtract from the assessment of each district, but in such a way as not to change the total amount; (2) those with power to change the assessment of any district, and which may and generally do change the total assessment of the state; and (3) those with power to change the valuation not only of districts as a whole, *but* of classes of property, or even of individuals within any district. As these boards seldom have sufficient powers, and never sufficient information as to the local conditions, the effect of their action is not all that could be desired. The only possible solution of this difficulty is the separation of local taxation from that of the commonwealths, so that the assessment can be made independently for each.

SEC. 4. **Convenience of the Contributor to Be Consulted in Collection.** — After the assessment has been completed, it is comparatively easy to make the collection. All that is needed is a collecting agent of the treasury conveniently located, to

whom the taxpayers may go, or a collector who goes to the taxpayers. The burden of taxation may be seriously increased if the convenience of the taxpayers is not consulted in this matter. The size of the district over which a collector has supervision will depend upon the density of the population. If the collector is to be sought out by the contributors, it is best that his office should be located in some business centre frequently visited by the contributors. According to the principle of "certainty and convenience," the taxes assessed upon the same person should all be entered in a single bill and all be payable to the same collector. The taxpayer should be informed as early as possible of the total amount of taxes that he has to pay, of the number of instalments in which they are payable, and of the conditions of delinquency and its penalty. Some of the American commonwealths disregard this rule entirely. They add grievously to the burden of taxation, especially in the country districts, where taxes are already entirely out of proportion to the ability of the people, and increase the irritation felt by the contributors, by inconvenient location of the collector's office, and by requiring the payment of state and county taxes to one set of collectors, while the town and other municipal taxes are paid to a different set and upon separate bills. The most economical and least irritating process is to have all the taxes collected by the same person.[1]

SEC. 5. **Moving Public Funds.** — The transfer of the public funds from one part of the country to another is, in modern times, attended with little risk. It is most conveniently done by means of the banks or the post-office. If the country is sparsely populated and insecure, the collector's office should be at or near the bank or vault in which the money is to be stored. In large countries, as, for example, the United States, it is convenient to have a number of branch treasuries scattered about the country, at which collections can be made, and

[1] The writer knows of an instance where a farmer has to travel fifty miles to pay his state and county taxes, while the local taxes are collected within two miles of his home. This is not an extreme case.

through which money for expenditure can be distributed to the disbursing officers.[1]

Safe-keeping. — The storage or safe-keeping of the funds is accomplished in one of three ways. (1) As in England a great State bank is made custodian of the funds which are sent to it from the various collectors who deposit with its branches. (2) As in France and the United States the treasury and the subtreasuries are the chief custodians of the funds.[2] (3) As in the commonwealths of the United States, where, except in a few states, private or other banks are made the depositories of the public moneys. When protected by proper safeguards, such as the giving of personal bonds and collateral, the bank depository system has proved itself far safer and more economical than the independent treasury, which is only to be defended on political grounds, if at all. The experience of the United States federal government in the early days with "pet banks" points to the political difficulties of the bank depository system. The bank deposit system prevents the periodic disturbance of the circulation by the withdrawal or storage of money. If the independent treasury system were used by all the departments of government, this disturbance would possibly be serious enough to affect prices.[3]

SEC. 6. **Bookkeeping.** — The mere mechanical details of the methods of bookkeeping and public accounts cannot be described here. About all that can be done is to make such explanation as will enable the student to easily comprehend the published accounts and statistics in their main features.

The revenue account is generally very simple. It contains items named according to the sources from which they come. Care must be taken in studying the reports of the fiscal officers on the revenues to distinguish the receipts that represent income from the receipts that are merely formal transfers and

[1] Subtreasuries are at Baltimore, Boston, Chicago, Cincinnati, New Orleans, New York, Philadelphia, St. Louis, and San Francisco.

[2] According to law, the treasurer and disbursing officers of the United States may make deposits in the national banks.

[3] Cf. Kinley's "Independent Treasury," and Buckley's "Custody of State Funds," *Annals of the American Academy*, Vol. VI, 3, November, 1895.

bookkeeping expedients. For example, the English finance account of the United Kingdom for the year ending March 31, 1895, contains the following: Receipts — I. Balance in Exchequer, April 1, 1894, £5,977,118 18*s.* 9*d.*; II. Revenues received into the Exchequer, viz. customs, excises, etc., £94,683,762 10*s.* 2*d.*; total, £100,660,881 8*s.* 11*d.* This was what England had to draw on. But following that appear a number of other "Exchequer receipts," among which are repayments of advances; as, (1) by the mint for the purchase of bullion for coinage, £700,000, representing merely a return to the Exchequer of money temporarily passed to the mint. The same year the Exchequer advanced to the mint £615,000, which will appear in 1896 as a receipt increased by the seigniorage. (2) The Exchequer borrows money temporarily in anticipation of the revenues. This appears, of course, as a receipt of £13,700,000, but is not revenue. (3) It renewed a number of outstanding bills and bonds amounting to £14,123,400. These appear as receipts, offset, of course, by an equal expenditure. But (4) it created an additional debt of £760,000, for barracks and telegraph. This sum may fairly be called revenue. So that the total amount of money that came as actual income to the treasury was £101,420,881 8*s.* 11*d.* But the total receipts *foot up* £130,217,647 13*s.* 8*d.*

On the expenditure side the issues or credits to disbursing officials are first, the consolidated fund "services"; that is, the payments for (1) the "national debt services," (2) the "other consolidated fund services," which consist of the civil list, annuities and pensions, salaries and allowances, courts of justice, miscellaneous "services," the Exchequer contributions to Ireland, and the annuity under the Indian army pension deficiency act of 1885. After the consolidated fund "services," which foot up to £26,500,000, come the supply "services" for the army, ordnance factories, navy, and miscellaneous civil "services," for the collection of customs and inland revenue, post-office, telegraph, and postal packet "services." These two items, the consolidated fund and supply "services," contain all that is strictly chargeable to the revenue. They

amounted in 1895 to £93,918,420 18*s.* 4*d.* In addition there were special expenditures of £810,000, making a total of £94,728,420 18*s.* 4*d.* But there were a large number of additional issues: (1) bills and bonds paid off by receipts from new bills, (2) temporary advances repaid, a part of which were for deficiencies in the consolidated fund. These and one or two other minor items, with a balance of £6,300,826 15*s.* 4*d.*, brought the "issues" up to the receipts.

Public Accounts, United States. — In studying the accounts published by the treasury department of the United States, we have different difficulties to meet. There is generally a clear statement, free from repetitions, or transfers, of the revenues according to the sources, and of expenditures according to departments, or objects. The only difficulties arise from the peculiar and arbitrary grouping of the expenditures. This comes from the illogical distribution of duties among the different departments already referred to. Some of the peculiarities are that the expenditure for the "civil establishment" includes foreign intercourse, public buildings, collecting the revenues, deficiency in postal revenues, rebate of tax on tobacco, refunding of direct taxes, French spoliation claims, District of Columbia, and similarly incongruous items. Those for the military establishment included rivers and harbours, forts, arsenals, and sea-coast defences; for the naval establishment included construction of new vessels, machinery, armament, equipment, and improvement of navy yards. Expenses not otherwise classified are generally listed as expenses of the treasury department.

SEC. 7. **The "Funds."** — An interesting phase of public bookkeeping is the separation of accounts into funds.[1] When Parliament voted a tax, it was formerly for a definite purpose, and the plan was to reserve the whole of it for the proposed purpose. But the receipts and expenditures of these funds never exactly balanced, and simplicity finally required that all should be turned into the consolidated fund. This method of

[1] A "fund" in this sense is practically an appropriation for a specified purpose or group of purposes.

bookkeeping is best exhibited to-day by the accounts of the commonwealths in the United States, although also used in national and municipal accounts to some extent. All the receipts are distributed among various so-called "funds," or accounts, according to some prearranged plan. A separate account is kept of all receipts and expenditures belonging to each fund. With the exception of a few trust funds arranged to keep certain sums inviolate, these funds are, in effect, mere bookkeeping contrivances. With the exception of the general fund, which receives all the money not otherwise appropriated to special funds, each of these accounts generally bears the name of the expenditure met thereby, sometimes of the revenues supplying them. In some commonwealths the number of these funds is very large.[1] The accounts are sometimes complicated by transfers from one fund to another, in which case they appear twice in the account, and frequently swell the apparent receipts enormously.

Local Accounts. — Local budgets are necessarily determined by the frame of local government and the number of functions performed by each. Thus in England the public function to be performed constitutes the basis of local organisation, and until the recent reforms each local governing body had only one or two duties; hence only one or two general accounts of expenditures, and one or two sources of income. But in America each local governing body generally has charge of all the local functions affecting a certain area, and may have as many expenditures and revenues as a commonwealth, or even more. Here methods of accounting defy classification and frequently defy sensible interpretation, even by the officials in charge. There is a crying need for reform here in the direction of uniformity.[2]

[1] See Seligman, "Finance Statistics of the American Commonwealths," *Pub. Amer. Statistical Assoc.*, December, 1889

[2] See in this connection a form suggested for published reports of municipalities by Professor H. B. Gardner, in the *Pub of the Amer. Statistical Assoc.*, June, 1889, and adopted, in part, by the Eleventh Census of the United States, as the basis of schedules and inquiries sent to the municipalities The studies of local and commonwealth accounting made by the United States Census Bureau and published in the volume on Wealth, Debt, and Taxation, 1907, are especially valuable.

CHAPTER III

FINANCIAL ADMINISTRATION OF WAR

SECTION 1. **"Extra-ordinary" Expenses.** — A serious war usually imposes a sudden, new burden upon the treasury, the exact, or even the approximate, size of which it is not possible to estimate at the outset. Many of the expenses of war belong to that class which financiers call "extra-ordinary" to distinguish them from the usual or current expenses of the government. The amount by which the ordinary expenses are increased in time of war depends upon many circumstances. Obviously, the chief factor is the size of the forces engaged and the duration of the struggle. Naturally, the chastisement of a few dozen hostile Indian braves in the immediate vicinity of the regular army posts involves practically no "extra-ordinary" expenses. Allowance is usually made in the ordinary budget for the expenses a war of that kind would occasion. But many circumstances less obvious than the size of the forces engaged enter into the determination of the amount of the "extra-ordinary" expenditures. Thus, for example, a naval war, unless it happens to become the occasion for the purchase of new ships, involves comparatively little addition to the ordinary expenses of maintaining the navy. A country which has a large standing army incurs relatively less "extra-ordinary" expense when engaging in war than a country which, like the United States, has only a small regular army.

The ordinary expenses being provided for by the regular budget, the financier's chief concern in time of war is the provision of the "extra-ordinary" funds. If the operations of the war are likely to interfere with the ordinary revenues, he must furthermore be prepared to treat a part of the ordinary expenses as "extra-ordinary," at least to the extent of fur-

nishing new means to meet them. It is not often possible, and still less often expedient, to curtail the ordinary expenditures in any way for the purpose of saving money to meet the new expenses. How to increase the receipts of the treasury by an amount sufficient to insure the efficient conduct of the war, without too serious disturbance of the industries and commerce of the people, upon which all the revenues depend, is the problem for the finance minister to solve. The "extra-ordinary" demands come thick and fast, especially at the beginning of the war, and they must be met, and met at once. The amount which may be needed at any given time is not ascertainable. But in spite of that, sufficient funds must always be on hand. Upon this more than upon any other one thing depends the fate of war. The war financier can never plead that he has no funds, nor can he ask for time in which to collect. He must have the money when it is wanted and in the amounts required. No degree of skill on the part of officers or bravery on the part of the men, no degree of self-sacrifice at the front, can compensate for failure on the part of the financier to provide the ways and means. His powers are, therefore, of the greatest and most unusual.

SEC. 2. **Increased Rates for Old Taxes.** — Possibly the most natural source to turn to in time of war for the increased revenues needed is the existing system of taxes. At first thought it might seem proper to attempt to obtain new income by raising the rates of the old taxes. To some extent this is possible. In every well-arranged tax system there should be some taxes which can be made to yield an increased revenue by simply raising the rates. One of the chief reasons for the establishment and the retention of the British "property and income tax," for example, is found in the elasticity of the returns. But not all taxes can be treated in this way. Sometimes an increase in the rate of taxation will disturb industry and commerce and do a greater injury to the welfare of the people than is received from the damages of war. Again, an increase in the rates of certain taxes will diminish the revenue or even destroy it entirely. In not a few taxes the only way

to increase the revenue is to lower the rates. This is the case with most protective duties. Any change in the rate of such taxes is bound to affect industry and commerce, and to affect them unfavourably in the first instance, whatever the subsequent effect may be. A war brings perplexities enough to business without the creation of artificial ones, and the financier should not interfere with these taxes. It added not a little to the perplexities and dangers of the Civil War in the United States that the industry and commerce of the people were repeatedly disturbed during the war by changes in the tariff as well as by the military and naval operations themselves. There are, therefore, but a limited number of old taxes from which any aid can be sought.

SEC. 3. **New Taxes.** — The next resource, naturally, is new taxes. But the establishment of new taxes, or even the restoration of old taxes not in use at the time of the war, is a matter requiring considerable time. Even if it were an easy matter to decide upon the best form of taxation and to get the necessary authority from the legislative branch of the government, the organisation of the new administrative forces for the collection of the taxes is a matter requiring time. No new system of taxation reaches its normal revenue-yielding powers within many months of its enactment. If the taxes are entirely new, the time required is longer. But even if they are more or less familiar to the people from use on some previous occasion, a considerable lapse of time must intervene between the beginning of war and the receipt of sufficient new revenues to meet any considerable part of its expenses. Furthermore, the expenses of war are now so enormous that any system of taxation which raised, or attempted to raise, the entire amount needed during the probable duration of the war would be so burdensome as to crush the people. It is, therefore, extremely unwise, and practically impossible, to attempt to raise the entire cost of the war by immediate taxation. The only other resource is borrowing.

SEC. 4. **The Use of Credit in Time of War.** — The use of the public credit in time of war is attended by many special diffi-

culties. The outcome of war is always more or less uncertain. Even if defeat would not entirely cripple the nation's resources and render the repayment of the loan uncertain, or affect the payment of interest, yet there are many considerations which make the lender hesitate. The fact that the duration of the war, the extent to which other nations may become involved, and many similar considerations affecting the size of the total demand upon the public credit are unknown, vastly increases the difficulty of placing a loan on favourable terms. But on that very account it is particularly necessary for the successful administration of the war that everything should be done to strengthen and preserve the nation's credit. There may come a time in the progress of the war when the only source from which any funds can be had is the money market. If, therefore, the financier has done anything to weaken the nation's credit at the beginning of the war, he is apt to be helpless at the close. Credit tends to weaken as debt increases.

It is for this reason that resort is frequently had in early war-borrowings to the simplest and most primitive method of debt-making; namely, that which provides revenues for the payment of the interest and the repayment of the principal at the very time the debt is contracted. The creditor sees in the new funds flowing into the treasury the security for his advances and the guarantee of good faith on the part of the government. So long as every new loan is accompanied by new taxes from which its cost can be met, the public credit is practically secure. But if, on the other hand, the government neglect this precaution during the first stages of the war, any attempt to resort to it at a later stage is apt to be regarded as the desperate device of unsound financial management and the presage of coming bankruptcy.

Public credit is a plant of slow growth and extremely tender. It withers in a day before a breath of doubt.

Inasmuch as a successful outcome cannot be hoped for in modern warfare without the funds obtainable solely by public borrowing, and the necessity for loans increases the longer the war continues, it behooves the modern war financier to guard the

nation's credit as his most precious treasure. No sacrifice is too great which will strengthen it and preserve it intact for the later stages of the war.

SEC. 5. **During the World War.** — The foregoing condensed statement of principles received full confirmation in the financial policies and practices of the different nations in the World War, as we shall proceed to show. But before passing to the history of government finances in the Great War there are several questions largely of theory to be discussed. One is a question raised by a number of economists chiefly in America which requires special consideration.

Can War Be Financed by Taxation without Loans? — Just before the United States entered the war, and just after that, a very considerable number of able economists argued strongly that it would be possible and was desirable to finance even a great war entirely by taxation during the progress of the war itself, and only to resort to borrowing to tide over the interval between the receipts of taxes. The purpose of these suggestions was to prevent, or counteract as nearly as might be, the inflation of the circulating medium which has been an ever present accompaniment of great wars in the past and was so severe in this one. Inflation, which causes a rapid rise in prices, an embarrassing advance in the cost of living, and of the cost of waging war, is, in the opinion of these economists, largely attributable to the use of credit by governments to finance the war. There is no doubt that if a government finances a war by the direct issue of fiat paper money which passes at once into circulation inflation will result. It is, also, a generally accepted view that other forms of credit used by government, such as short-time notes and even long-time bonds, pass in one way or another more or less fully into circulation and thus cause inflation. This may be seen by following the course of such credits. The government sells its bonds to the people. The money so received it spends, usually by first depositing it in the banks, then drawing checks against it and in that way passing the credit at the bank to some contractor or other person who sells something to the government. The contractor or other

person uses it in turn to pay his bills and so it passes from hand to hand and serves most of the purposes of money. In so doing it acts much as any other increase in money would, although it may be better to think of it as increased purchasing power, rather than as strictly money. The increased purchasing power thus put into circulation continues to pass from hand to hand, the amount circulating diminishing slowly as the various holders take out their profits on the transactions in which it is used, and invest these profits in some form of non-circulating capital, perhaps in part in the bonds themselves, handled as strictly permanent investments. But this is not the whole story of the inflation which the notes and bonds cause. Many of the lenders to the government use these notes and bonds as collateral for advances from the banks and thus put them indirectly into circulation, while a few of the bonds and more of the notes will actually pass from hand to hand as does money. The only difference between bonds and notes so used and fiat money is that the latter circulates more easily. Upon the point that government credit used during war causes inflation there is no material difference of opinion.

The Evils of Inflation. — Nor is there any difference of opinion upon the point that inflation is an evil. The new purchasing power passes unevenly into circulation. Prices rise irregularly, wages lag behind, salaries lag still more behind, while interest contracts, which are of course contracts for the payment of dollars, pounds, or other units of money, are unchanged and never affected by the fact that the dollars, etc., command less of other things, especially of commodities and labor. So some are impoverished, while others appear to grow rich and some actually do grow richer. Profiteering arises. Profiteering is objectionable because it seems to measure how much some get rich without giving a corresponding return — undeservedly as we feel. Inflation also tends to waste of economic resources, the conservation of which is essential to the conduct of war. For those who get rich quickly, or who for the first time perhaps in their lives receive high wages, steady employment, and large earnings are prone to be lavish

spenders and high livers. The coal miner who bought a dozen pairs of silk stockings for his wife, explaining, "My wife's going to walk in silk while the walking's good," expressed a common human sentiment.

Heavy taxation tends of course to restrict consumption. Upon that point there is no dispute. If the increased purchasing power which flows forth in time of war is largely taken away from the people again in the form of taxes they certainly cannot spend it. But we must not forget that at the same time heavy taxation will cut down production. For if by taxation the spending power of the people is curtailed, so is demand curtailed, and it is of no use to produce things which will not be sold. Those who advocate "all taxes, no bonds" as a mode of war finance sometimes answer this point as to curtailment of production by saying that the labor so set free can be turned into the making of war supplies or absorbed in the army. In so far as the army is concerned this is true whether the army be recruited by conscription or by universal volunteering, for there a direct war service is rendered for considerations into which the pay does not enter. But unless conscription of labor for industry is resorted to the lure of high wages is the only effective method available for getting war materials made. Moreover, we may not forget that a large part of the lure of high wages lies in the fact that they will buy something desired. Our coal miner may have earned the money used to bedeck his wife in silk stockings by hard work, or overtime, for high wages. Would he have been as keen to work hard if the shops contained only the coarse cotton stockings she had been accustomed to? This is one very essential point on which we must differ with our friends of "all taxes, no bonds." We are prepared to admit that much might be said for conscription for industry. For it does seem but right that he who stays home and avoids the hardships and dangers of the trenches should work as hard as he can without special reward. But the essential thing is to get the work done, and quickly, and we know that high wages with power to spend and enjoy them are a powerful lure to work. Moreover, the other plan is an experiment and

war time is a poor time to be experimenting, when failure in the experiment would spell disaster. The method we actually use in war time is to let wages and prices go up, and so lure some men into war industries while others get busy providing the lures. The well-intentioned efforts to distinguish between essential and non-essential industries and to prohibit or frown down upon the non-essential came to disaster not merely because of the inherent difficulty of seeing how silk stockings for a coal miner's wife could "help win the war." It failed because it diverted a goodly amount of intelligence and energy from actual production into blundering efforts which only hampered production. The meddlesome mischief makers who have no business of their own save tending other folks' business often flourish in time of war.

This is, however, no argument for deliberately creating inflation. Inflation is an evil which nobody can deny. Some of it is attendant upon every war. It is the large spending by government for purposes non-economic which creates inflation. Some inflation will come even under an all taxes system were such a system possible. The point is that an all taxes system would so hamper industry as practically to check it. It would put brakes on the wheels of industry and dry up the sources of capital, just at the time when all the power the machinery of production can develop is needed to carry the heavy load of war. Nor would it necessarily check high prices for it would cause scarcity of goods. Of the two evils, dear but abundant goods and dear and scarce goods, the former is clearly the lesser. Inflation, while an evil, has some merit in that it does help make men work.

"All Taxes, No Bonds" Impractical. — But the arguments for "all taxes, no bonds" appealed not at all either to the practical statesman or to the practical business man. No country tried the experiment. As we shall see all used bonds and other modes of borrowing and limited taxation to what was thought to be a wise amount. It was vain for the theorist to argue that present production is the only possible source of present expenditure, that the army cannot shoot a shell to-day

which is to be made ten years hence, that borrowing postponed no burden but merely shifted the burden about among the people, mortgaging the future of some to the service of others. The business man still felt sure that he could pay the costs of the war more easily in instalments spread over many years than he could in one lump sum down, and the statesmen and parliaments agreed with him. Somehow the proposal did not seem practical. When a theory is not practical it probably is unsound.

Borrowing Does Draw upon the Future. — The fallacy upon which the "all taxes, no bonds" theory rests is the denial of the possibility of counting upon the future. We cannot of course eat wheat in January that is not to be harvested until the next fall. But we can and do every January sell wheat not even sown. That is, we sell wheat to be grown, and sell it at a time when the land on which it is to be grown is still frozen solid and covered with snow. With the proceeds of that sale we can put men to work, or buy other goods for the wheat. This is the reason for and the nature of credit, namely, that it brings down to us out of the future the *value* of future products, although not the products themselves. If this is unreal, if credit is not real, all business is a mere dream, a figment of the brain. For there is no transaction and no economic process that does not involve some passage of time. If the interval between delivery and payment is short, we call the transaction a cash transaction, if longer, a time transaction. But so long as the sun rises and sets, so long as time must elapse between the sowing of seed and the harvest, so long as men eat three times daily throughout life and not once only for a whole lifetime, so long will there be a need for credit, and so long will credit be something real and be the powerful reality that it is. As applied in the "all taxes, no bonds" arguments for war finance the claim that we can use only present goods to wage a present war assumes that we drop all production, use our present stock of food and the like, and busy ourselves solely with fighting. Instead of that some stay behind and "keep the home fires burning," while the others fight. Nor can we draw

very deeply on accumulated capital. Capital is continually wasting and continually being replaced. Its upkeep is essential for continued production and to keep an army fed and armed.

It is useless to deny that we can mortgage the future, make the future pay for current war costs, for we do it, and have done it repeatedly. It is useless to say "the future is not *here* to bear burdens," that "the surplus of current (sic) income must be the source (sole source) of funds for financing a *present* war, and hence that borrowing "postpones no burden to the future." The future is ours to use as we please, it will all too soon be "*here*"; "*current* income" is of no importance save as "current" means "future," even a "*present*" war runs on for a time, and since we can bear no burden that is past, we can bear no burdens at all save in the future. The whole argument reduces to a play on words. It is astonishing that it had such currency and for a time bewildered so many people.

Dependence on Taxation Dangerous. — Taxation so excessive as to discourage production by leaving the producers no profits and the labourers no wages, or very small profits, and less than a living wage, will lose a war very quickly, unless some other incentives to industry are devised than profits and wages. The other incentives would have to be found outside of the field of finance. No one is able to deny that they can be found, but no one has yet found them, so it is idle to discuss the possibility.

Practically then, and theoretically as well, it would be the supreme height of folly to wage war depending solely on taxation. When we have at hand so powerful a resource as credit we should use it to make speed with the war. Relying on available taxes only means slow war work. If your enemy follows the other policy he may win. If one has a tractor he does not use a horse to plow with. Credit is too powerful a war weapon to be idly cast aside.

SEC. 6. **Proportion of Taxes and Loans.** — Upon the question of how much of the cost of war should be borne by taxation and how much by borrowing the sentiments and policy of different countries differ. Germany says: none from taxation. Great Britain *aims* at half and half. The United States has a theory

of raising enough by new taxation to insure absolutely the payment of interest on the new borrowing and thus to sustain its credit. While poor France, whose wars have been mainly on her own soil, with one great and glorious exception, has been without theory because without choice, and has been hard put to it to get enough money from both sources without regard to proportions. These theories are, however, vague, except that of Germany, because any fraction of an unknown quantity is itself unknown, and who can forecast the cost of war even as of to-morrow? Whether Germany's theory rest on overconfidence in winning and hence on expectation of plunder and indemnities, or on the idea that war itself places strain and burden enough on industry without the added burden of taxes, it seems nevertheless unsound, or at least too full of risk. For the confidence of the lender in the credit of the nation must be insured and conserved, and that is best done by showing him a stream of revenues coming into the treasury out of which interest and principal as it falls due can be paid.

SEC. 7. **The Marginal Lender Fixes the Credit of a Nation.** — The ultimate or marginal lender whose confidence must be retained to the end, come what may, may be, perhaps, a servant girl with a few hundreds in the bank, a small merchant who can spare something from his funds, — little people by the way who can contribute in the aggregate much to loans but who would be left out altogether on an " all taxes, no bonds " program, — and others to whom safety of the loan is the prime consideration. If they lose faith, savings banks, insurance companies, and trust companies which handle other people's investments cannot move, and in turn others, bankers and capitalists, lose faith and the whole structure of government credit collapses, or goes up as if in smoke. To this end a continuous flow in taxes must be assured. It can be assured only by boosting taxes as fast as possible during the early stages of the war, for when the strain of war grows too heavy it is hard to get more taxes.

Popular Loans by " Drives." — This suggests the value of the popular loan or subscription drive. If the government can

go over the heads of the wholesalers and middlemen of finance and reach down to the ultimate investors, the real savers, it may at one and the same time unlock vast stores of loanable funds, which recent experience has shown to be far larger than was ever dreamed of, and create credit where little or none existed before. Many a working man who in ordinary times finds it hard to borrow money, even for perfectly commendable purposes, discovered that if he had confidence enough in a government bond to buy it out of his earnings there were plenty of bankers and financiers who would help him to do so. He had credit which he could use to aid his government. As a matter of fact, and a very important fact too, the confidence of the working man in the bonds of his government gave the banker confidence, which otherwise the banker would never have had. For the banker argued: "Here are hundreds of people who buy bonds. Even if some of these I am helping to buy them fail to pay back my advances I am safe because some one else will buy them. Since all these people believe they are good I certainly need not worry." The extent to which credit can be developed in this way was strikingly exhibited in all countries during the war. In Germany, even without the buttress of new taxes, succeeding popular loans brought out more subscribers and more money than preceding ones, and the facilities of banking intermediate between the ordinary small investor and the government developed correspondingly. It was the same in other countries. It amounted to mobilizing everybody's credit.

Two lessons about popular loans stand out in the experience of the recent war. One is that there is danger of overdoing the "drive," in depending too much on the patriotic fervor of volunteer salesmen who in far too many instances through excess of zeal used intimidation and duress to bring "our town" up to its quota. As much harm can be done to the credit of to-morrow by duress in selling a bond to-day as would result from failure to sell. The other lesson is that too low interest rates are false economy. The government financier naturally prides himself on getting his money cheap. There is danger

in getting it too cheap. A discount or low market price on the last issue hurts a new issue. Germany began its popular loans at rather high interest rates. English financiers, who began too low, gloated for a while. But Germany placed its second, third, and fourth loans each at lower rates of interest — that is more advantageously than the one before — while in England the rate of interest had to go up. The United States played " penny wise, pound foolish " right through the whole series of bond sales, with the result that the subscriber saw bonds for which he had not finished paying his instalments fall in market price. Only the early close of the war saved the United States from embarrassment. One thing to be aimed at in popular loans is to put the bonds into the hands of investors who will keep them, and by so doing keep them out of the money markets and from being used as collateral, causing inflation. But when the bonds are forced by intimidation and duress into weak hands and when the interest rate is too low to make them attractive investments for " the widow and the fatherless " they are sure to come back on the market, and to fall in price. All that not only adds to inflation but weakens confidence, lessening credit for future loans. It is so easy to refund after war is over, if the government's credit is still good, and maintaining high credit is so vital to winning the war, that the saving of a relatively small amount of interest at the cost of credit is distinctly folly.

SEC. 8. **Aggregate War Costs.** — The total of war expenditures during the Great War ran into enormous figures. The estimated cost to date (1920), not including pensions and similar unsettled items, is placed at $200,000,000,000, taking the inflated and discounted currencies at the old parity with dollars. It has left the belligerents with nominal debts amounting to $240,000,000,000 against pre-war debts of $29,000,000,000. The accounts are still in some confusion and the basis of conversion cannot as yet be forecast owing to the instability of the currencies, and in some countries, notably Russia, of the government. It is impossible as yet to give statistical proof as to the actual burden of these debts, but it appears to be true

that great as their debts now are both England and the United States have in past generations borne a heavier burden of debt than they are now carrying. The British debt at the beginning of the nineteenth century was certainly a much heavier burden than is her present debt, and so was that of the United States after the Revolutionary War and after the Civil War. England was enabled to carry her debt easily in the nineteenth century by reason of the great increase in productive power following the great inventions which caused the "industrial revolution." The United States was relieved of her Revolutionary War debt by the same forces but more materially by the development of new lands and other natural resources, and carried her Civil War debt with comparative ease by reason again of the opening of new lands and ever richer natural resources. Whether the great World War is to be followed by a correspondingly great increase in production, facilitated by recent inventions, and the exploitation of the resources of the less mechanically equipped countries remains to be seen. The full effects of the explosion engine, giving us trackless vehicles, and aëroplanes, lighter fuel, and, also, the greater use of water power, the new foods, better organisation of agricultural production and other advances in the technique of production and transportation cannot yet be foreseen. But in face of all this and judging by the past it does not appear that the war debts, enormous as they are, will prove at all an unbearable burden.

We are, however, more directly interested in the technique of war finance during the war itself and in discovering, if we may, what principles guided. We shall confine our attention to England, France, Germany, and the United States. The opening of the war threw the whole mechanism of finance out of gear. Panics, closure of the stock exchanges, moratoria, violent fluctuations in the exchange rates or of foreign bills, money shortage, and every other feature of financial chaos prevailed, both among the belligerents and neutrals. The strain on the banking and monetary organisation of the world was relieved by drastic measures. Liquidations were postponed, redemption of notes in gold suspended, government

guarantees of private bills were granted, paper money issues were resorted to, and the banks were combined all in the effort to create new means of settlement and in belligerent countries to provide the governments with the means of payment.

England

SEC. 9. **The Last Pre-war Budget.** — England's fiscal year ends March 31st, and the budget for the next year is usually settled shortly thereafter. In 1914 the budget for the year was approved in June, about a month before the war broke out. That budget had provided for some new taxes. But a new budget was introduced in the middle of November and for several years England had a budget every six months. The usual orderly procedure of "estimates" presented and "votes" granted had to be abandoned in fact, though the form was preserved and "dummy" estimates presented. During 1914, until the second budget was approved, England financed the war on votes of credit to the government, which then obtained the funds granted by the discount through the banks of Exchequer Bills. By various devices including the issue of what was practically fiat money, by guarantee of bills of exchange and the other measures the government made mobile the reserves of the banks upon which it had to draw.

The First War Budget. — In November came the first war budget and the income tax rates were doubled, and new duties were imposed on beer and tea. Not until November was there a funded loan. This consisted of £350,000,000, authorised public stocks and bonds payable 1925–1928 and sold on practically a 4 per cent basis. A guarantee by the Bank of England to lend on them up to 95 at any time within the next three years helped the sale of what was thought of as a popular loan, although not placed by the "drive" method. About the same time five-year Exchequer bonds were resorted to and heavy advances were obtained from the Bank of England.

The First Great Loans. — In 1915–16 the expenses mounted fast. The second war budget adopted in May was preceded and followed by irregular "votes of credit." Resort was had

to the continuous sale of Exchequer bills. But by June, 1915, it became necessary to fund the great and growing mass of floating debt. The interest rate on this loan was raised as compared with that of the prior loan, but exemption from income tax, which the first loan enjoyed, was not granted subscribers to this loan. The loan had no fixed limit as to amount. It was popularised by offering small denominations, by sales through post-offices and through trades unions of small vouchers redeemable in bonds. Holders of previous issues including pre-war issues were allowed to exchange their holdings for these bonds and there was a promise that if any subsequent issues have a higher rate of interest, conversion would be permitted. The bonds were callable in ten years and payable in thirty years. The issue was a fair success although it did not reach the great mass of possible small subscribers and so failed to disclose in full the borrowing power and credit of the government. Again the mass of Exchequer bills rolled up. The failure of the government to go right down to the bottom and place this loan with the ultimate subscriber hampered its next effort, which was to borrow in the United States by issuing a loan on the joint credit of England and France. An offering of $1,000,000,000 found no market, and after some negotiations one of half that amount was underwritten in New York consisting of 5 per cent bonds due in five years at 98.

Even though backed by two great countries, and paying a very high rate, the bonds had in large part to be used to pay munition firms furnishing supplies. It seems probable that had the strength of England's credit with her own people been better shown in the preceding loan far better terms and an easier sale of the New York loans would have been achieved.

New Taxation. — In September, 1915, new taxation was resorted to with vigor. Mr. McKenna, at once the firmest and boldest chancellor the British Exchequer ever has had, presented a budget which the London *Economist* described as: "A plain unvarnished statement of unparalleled revenues, an inconceivable expenditure, and an unimaginable deficit, followed by a list of fresh taxation which imposed an unprece-

dented burden on the country." This fresh taxation redeemed the waning credit and followed by similar drastic measures put British war finance on a stable basis, until May, 1917, when the whirl of politics threw the Exchequer into the hands of Mr. Bonar Law and disorder and weakness set in. The normal income tax went to 3*s.* 6*d.*, or 17.5 per cent, the abatements were reduced, the supertax was raised. A war or excess profits tax was introduced with a 50 per cent rate. The customs and excise duties were increased. Tea, cocoa, coffee, chiccory, dried fruits, tobacco, and sugar, motor spirits and patent medicines, cinema films, watches, musical instruments, and imported motor cars were the chief contributors. The postal and telegraph rates were raised. The Chancellor set himself firmly against a multitude of small taxes which would raise more trouble than revenue and struck hard at things of wide consumption, selecting those on which the cumulating expense of frequent shifting would probably be the least. Despite all this the debt rolled up, for the war expenses still grew apace. Full three-fourths of the entire expenditures was being met by loans.

Still Heavier Taxation. — In 1916–17 the taxing chancellor, Mr. McKenna, brought in a new budget in April. Once more the income tax was raised, this time to 5*s.*, and the lower reaches were also strengthened. The lowest rate was £1 per annum, which fell on earned incomes of £131 per annum. Again taxation was driven downward to the great masses who, as Bismarck once remarked, "bring in the revenue." The result exceeded estimates. The excess profits tax was raised to 60 per cent. Again were the customs and excises raised. New taxes fell on table waters and other beverages. Amusements were made to contribute.

Varied Assortment of Loans. — Still the debt rolled up. Exchequer bonds were invented to supplement exchequer bills, public stocks, and bonds. The market became so glutted that interest went to 6 per cent. Never was the investor offered such a varied assortment of public notes and securities. The Bank of England was again drawn upon. So many purchases were being made in the United States that difficulty was en-

countered in getting credits over into the United States in quantities sufficient to make payments. The exports of Great Britain were not sufficient to carry the flood of purchase money needed. Negotiations were then entered into with English holders of American securities to pass them over to the government, by loan if not by sale. These securities were then either sold in the United States or used as collateral for loans, and the proceeds of both methods of handling them, turned into credits in the United States, were used to pay the government's bill with.[1] To force the holders to surrender their American securities a penalty, called a tax, of 10 per cent on the income therefrom was placed on holders. This device facilitated loans in the United States, although the demonstration of England's credit with her own people at home, which had come since the first expedition to the New York money market, also helped. A third great funded war loan came in January, 1917. This time a tax-free bond at 4 per cent sold at par, and a bond the interest on which was subject to the income tax, but paying 5 per cent and sold at 95, were offered side by side. The people bought the taxable bond. Whether this is evidence of the falseness of the theory that the tax-free bond is used for tax dodging, or whether the spread in price was too great, one cannot say. About a billion pounds of this loan was sold to nearly 5,300,000 subscribers. It was a clear victory for the theory that a fair rate of interest is potent.

The Darkest Days. — The last two years of the war, 1917–19, may be covered together. Under the administration of Mr. Bonar Law the government lost control of the finances. It settled down to a policy of merely meeting its most urgent obligations as they arose, drifted rudderless from one loan to another, in short, it lived strictly from hand to mouth with no thought or provision for the morrow. It was the darkest period financially in the entire history of England. Two unfortunate expressions of incompetence damaged England's

[1] This brief statement is correct only as to the principles followed. The details varied so often that a full statement would take too much space As to the 10 per cent penalty tax mentioned in the next sentence we have no real information or understanding. As bald fact it seems to be correct, although mysterious.

credit. One was to the effect that the government did not want to be bothered with new taxes, it had not a force large enough to collect them as it was; and the other was that England would have to depend upon advances from the United States as her own resources were exhausted. In May, 1917, an increase was made in the tax on tobacco and the excess profits tax was raised to 80 per cent. The next year the government, forced by popular clamour, raised the income tax to 6*s.* and the supertax to 4*s.* 6*d.*, again raised the taxes on tobacco (to 8*s.* 2*d.* a pound), on sugar (to 25*s.* 8*d.* per cental), doubled the tax on spirits, beer, and matches, put a stamp duty on checks, and raised postal rates, and finally established a complicated luxury tax, a scheme of very uncertain value.

The Errors of British Finance. — Looking back we may say that England started her tax policy too slowly, that by too heavy leaning on the banks and failure to reach down to the ultimate lender at an early stage of the war she hurt her credit. She recovered and reached a sound condition under the bold, firm hand of Mr. McKenna; and the collapse during the last two years was due not to anything in the difficulties of a military character, for they were actually costing less, but to the failure to observe the principles of steadily increasing taxation, and of steadily drawing more and ever more from popular loans. The taxpaying power of a great nation grows as its day of need grows, and its lending power is inexhaustible, so long as confidence is not abused, and the people are permitted direct access to the loan bureau. The over-dependence on short notes financed through the banks caused unnecessary inflation, and an expense to the government itself through that inflation far in excess of the interest which was saved by the low rates of interest on bonds before the last years. The greatest menace to the establishment and continuance of sound finance is that most natural hope and expectation that the war will soon be over, an expectation that discourages vigorous measures. Surely it must be clear that *too much* taxation, *too strong* credit, are impossibilities in face of a continued war and easily remedied if need be when the war stops.

France

SEC. 10. **France Had Past Deficits to Meet.** — For many years before the war France had been running behind financially. Budget after budget resulted in a deficit. Just before the war broke out France was engaged in floating a large loan to adjust and fund the accumulated deficit. This loan, consisting of 3½ per cent twenty-five year bonds offered at 91, was not going very well. The deep underlying reason for the lack of interest in this loan was the tax system of France, which was composed largely of customs and other indirect taxes and some antiquated direct taxes which tied the central revenues to the local revenues, and the reluctance to levy new taxes. After years of debate France had decided to levy an income tax, and such a tax had been adopted in 1914, to take effect in 1915. It was hoped that it would support the new loan and ultimately do away with the ever recurring deficits. The new tax was, however, a very little one, with a 2 per cent rate and liberal exemptions. For reasons difficult to understand France did not take advantage of this new tax to obtain war revenues, at first. Instead she postponed the levy from 1915 to 1916, and not until 1917 did she raise the rates.

The War Caused Loss of Revenues. — The revenue situation was also complicated and badly hampered by the operations of the war itself. Trade was very seriously cut off. This reduced the customs revenues, one of the mainstays of the government. Some of the richest territory was invaded, and that halted the direct taxes. In 1916 and 1917 taxation was taken seriously in hand, and some reforms were made. Meanwhile the revenues fell off. If we may take 1913 as normal, the following figures show the run of revenues in millions of francs: 1913, 5000; 1914, 4000; 1915, 3800; 1916, 4800; 1917, 6300; 1918, 6500.

New Taxation. — Beginning in 1916 new taxation was imposed, increasing in severity each year. We list the new taxes without reference to years. The most important were an excess profits tax, and an increase in the rates of the income tax. Then there were: a special tax on males of military age

not called to the colours; double rates on mines and on "conspicuous waste" in the form of clubs, carriages, horses, etc.; heavier taxes on amusements and beverages, securities, and imports; increased rates for postal, telegraph, and telephone service; a general tax on business profits and on gross receipts of retail sales; and many others including a tax on luxury. The last-named tax is peculiar. Luxuries were defined as consisting either of certain commodities, considered luxuries *per se*, or of any commodity if regarded as high-priced. Thus jewelry is defined as a luxury *per se*, and imitation jewelry was a luxury when any item cost over ten francs. This tax proved very burdensome, annoying, and unpopular, but was retained in 1919 after amendments. One cannot fail to be impressed with the large intermixture of sentiment with sense in the new French taxes. Thus, while the luxury tax serves better as an outlet for feelings than an inlet of revenue, the income tax was kept within the bounds of revenue rates, without the ornamental high rates which other countries indulged in.

Inflation. — In raising her war funds France was distinctly unsuccessful in avoiding those measures which lead directly to inflation. She depended at first almost entirely on advances from the Bank of France and even to the end drew largely on this source. As the French people do not use a check system, these advances were in circulating bank notes and the bank was from time to time authorised to raise the limit of such issues until at the close of the war the limit reached 40,000,000,000 francs. Two other devices were *bons de la défense nationale* and *obligations de la défense nationale*. The *bons* were interest-bearing treasury notes for short terms, the *obligations* much the same, but for longer terms. Both were made very attractive to small investors, interest was paid in advance, and they were in part non-taxable. As some of these were used for direct payments to liquidate government debts, they came dangerously near being circulating money.

The First Defence Loan. — The pre-war 3½ per cent loan dragged along into the first part of the war and hampered the floating of any new funded debt at higher rates. Finally as

new funded debts became unavoidable to meet the rapidly growing floating obligations, this old debt was allowed to be converted into new issues, a proceeding which greatly clarified the atmosphere. In November, 1915, nearly a year and a half after the war began, came the first "National defence loan." This was a 5 per cent *rente perpétuelle* sold at 88. This meant nearly 6 per cent interest with a possible profit on a rise in price after the war. It was so attractive that the loan was a great success. In this, as in subsequent funded loans, there was much difficulty in getting in any new money, for there were so many outstanding *bons*, *obligations*, and other convertible issues which could be turned in. A second war loan of the *perpétuelle* type came in 1916. In 1917 a twenty-five year *rente* was used. But in 1918 the government returned to a *perpétuelle rente*. These four loans were all the funded loans that were issued while the war continued.

The Anglo-French Loan and Collateral Loans in the United States. — France participated in the Anglo-French loan floated in New York and described above. France, like England, made vast purchases of supplies in the United States. Since there was no counter current of exports from France to the United States, difficulty was experienced in getting hold of credits in the United States in which to pay these bills. So the government endeavoured to gather up securities which could be sent over as collateral for loans. In gathering these from her own people France pursued a different policy from that of England. Instead of taxing them unless they were lent to the government, France tried to lure them in by paying 25 per cent extra on the income they yielded. The effort resulted in some degree of success and some loans were secured in this way. Finally France received advances from the governments of Great Britain and of the United States.

Debt Charges Exceed Revenues. — Toward the end of the war the interest charges on the debt rolled up so fast and became so large that they equalled the sum of all revenues. This was a condition fraught with great danger and one very embarrassing in straightening out the finances after the war.

GERMANY

SEC. 11. The Gold "War-Chest" and Other Financial Preparedness. — From the days of Frederick the Great, Germany has always had a "war-chest," consisting of a sum of gold stored in the Julius Tower at Spandau. She has also had a far greater "war-chest" in the form of carefully prearranged plans for borrowing in the event of war. These plans include arrangements for speedily mobilising all the financial resources of the banks and of the people, reaching all the way down to the peasants and the workers, who are provided means to pledge any property or resources they may have if it be necessary so that they may subscribe to the public loans. Finally, while not ordinarily intending to increase her taxes during the war, but to depend on loans primarily, Germany has sustained at all times under the Prussian rule so large a military establishment that "war taxes" were in fact always in force. In 1913 a special "*Wehrbeitrag*," or defence contribution, had been levied, which may also be looked upon as a part of the "war-chest." These measures, as part of her preparedness for war, explain in large measure why she could be so apparently indifferent to increased taxation during war. Whereas other countries had to stop and create the financial machinery of war, Germany had it all ready and had so had it in large part always. Furthermore, as part of "preparedness" Germany had plans whereby at the outbreak of war the so-called "civil budget" was at once contracted, thus setting free funds for war purposes. It is difficult to say how much of this contraction in the civil budget is bookkeeping and how much is actual economy. For some of the saving is probably achieved by switching certain salaries and other expenses from the civil to the war establishment.

The Loan Bureaus. — This prepared programme worked with great smoothness. The banks, which are also included in the prearranged system, made the first advances. These advances were supported by their large gold reserves and by the transfer of so much of the gold in the Julius Tower as was not at once

spent, and by other measures increasing their lending ability. Then "loan bureaus" opened up all over the country. These operated under laws originating in 1848 and improved from time to time. They made advances to the people, who in turn lent the money to the government, upon securities, merchandise, and later other collateral not ordinarily available for loans. These loan bureaus freed the Reichsbank and other banks under it from a large part of the strain of financing the people's offerings, although of course the big banks had to support the "loan bureaus." But their advances were secured. The Reichsbank was thus in good shape to discount treasury notes and furnished the government its early needs.

The Popular Loans. — The first funded loan came in September, 1914, and others followed at intervals of six months. It was thrown open to popular subscription. The rate of interest was high, 5 per cent on bonds sold at 97½, and the notes and bonds were available in small denominations, as low as 100 marks. There were five-year notes and ten-year bonds. The loan was a success. The short-term obligations then outstanding were cleaned up, and there was nothing in the way of embarrassing immediate claims arising for nearly six months. In this first loan there was no insistence upon reaching the ultimate subscriber and the banks and other financial institutions took part directly as well as the people. We may now summarise the subsequent funded issues. They were like the first, but with dates of maturity strung along so as to avoid embarrassing accumulations in any one year. The high interest rate was maintained and there was no fall in the price of issue. In fact, several of the loans brought a better price even than the first. The number of subscribers increased, although with considerable up and down fluctuation, being somewhat affected by the situation of the banks and their ability to take large sums. The March, 1917, loan, the sixth in order, reached 7,000,000 subscribers, which was the maximum; the eighth, in March, 1918, reached 6,500,000. The ninth, in September, 1918, however, fell off heavily, both in number of subscribers and in amount.

Financial Pyramiding. — This success with popular loans was achieved by the *Reichsbank-Darlehnskassen* or loan bureaus. The workings of this system are described by Bogart, quoting from a German newspaper, as follows:

"If you hold securities you will find it easier still to raise money. It is not necessary to sell them; you simply borrow money against them at any Reichsbank-Darlehnskasse or at any large bank, and as you will receive almost as much interest on the war loan stock, or even more interest than you pay to the lending bank, you will be nothing out of pocket. You must, however, hand over to the bank the securities against which the money is advanced to you, and the bank will return them when the loan is paid. No loss can ensue from the above mentioned procedure, or at the most, it could only be $\frac{1}{4}$ per cent per annum in the interest, if as is the case with the 'Reichs-Darlehnskassen' you pay $5\frac{1}{4}$ per cent interest on the borrowed money whilst you receive 5 per cent on the war loan stock; and even this possible loss will subsequently be made good in view of the fact that you pay only 99 marks for each 100 marks of war loan stock, which 100 marks will be repaid in full.

"If you have already subscribed to the first or second war loan and paid in full for the same, you can at once participate in the present issue. All you need to do is to take your stock — or, if you have not yet received the stock, the receipt for the amount paid — to a bank, which will advance you 75 per cent of the nominal value, so that, if you have M400 ($100) old war loan, you can subscribe M300 in the new issue without paying a single pfennig, you can even subscribe four times this amount, *i.e.* M1600 ($400) if you will also leave with the bank the stock that you take in the new loan, in which case you will have given the bank as security M400 of the old war loan and M1200 of the new war loan, together M1600 against a loan of M1200."

This system involves a sort of pyramiding by turning government credit back into private credit. Germany floated one small loan of $10,000,000 in the United States. Being debarred from purchasing abroad, she was under less necessity

than were France and England of establishing credits in the United States.

New Taxation. — But the German pre-war plan to depend upon pre-war taxes was departed from. In 1916 Germany could not resist the seductive war profits tax, and increased some of her other taxes as well. In 1917 the colossal costs made still further new taxes necessary. But the new taxes were slow to yield a return. Still further taxation was imposed in 1918, by which time the imperial revenues were nearly double those of 1916–17. Toward the end of the war the interest charges were just about equal to the entire revenues.

United States

Sec. 12. **The Unpreparedness.** — Despite the fact that war had been going on three and three-fourths years before she was drawn into it, the United States had made no deliberate financial preparation for war. Accident, not foresight, had placed in the hands of the federal government an income tax. From 1913 to 1916 this tax had remained a mere toy, a slight thorn in the flesh to a few rich men, but as for revenue, negligible. There had been no adequate machinery of assessment provided for the tax, and few of the moot points of law involved had been settled. In the absence of imports the customs system could be relied upon for little help, except in so far as it might be made the basis of consumption taxes, not protective in form. A fairly well-developed excise tax system was all that the country had in decent working order for revenues. Accident again, not foresight, a chance turn of the political whirligig, had led to an increase in the rates of the income tax in 1916 and to the introduction of an estate tax. These series of accidents should strengthen our belief in Divine Providence.

United States Finance Followed Correct Theory. — Yet once she was in the war the United States lived up to her best theory. (1) She borrowed at once on long-time bonds, (2) raised taxation to such a level that there could be no question of her ability to meet debt charges, and (3) used treasury certificates only to fill in the gaps between the receipts of new taxes and the pro-

ceeds of new funded loans. Mistakes there were and many, but none of them were fatal. It was a mistake to borrow at too low rates, as shown by the fact that after the close of the war her bonds are heavily discounted, and subscribers who had not finished paying their instalments saw bonds on which they were still paying par salable only at a loss. That mistake necessitated the use of duress in selling bonds and placed them in hands too weak to hold them. It was a mistake to place or endeavour to place the great body of taxation on the rich and moderately well to do and practically to exclude the great mass of the people from participation in war taxes. It was a harmless, but expensive, mistake to waste time and energy on frivolous taxes aimed at conspicuous waste when what was so urgently needed was only real revenue-producing taxes. It was a mistake to place treasury certificates on the market in such ways as were certain to increase inflation.

The Effects of Inflation. — Owing to war spending in the United States by the belligerent governments, to the issue by European governments of paper money and other forms of circulating credit, to the flood of gold poured into the United States, and to the decrease in the world's production, creating great scarcity of commodities, the level of prices, when the United States entered the war, was exceedingly high. This worked both to the advantage and disadvantage of the government in financing for war. It worked to the disadvantage of the government in that it had to pay inordinate prices for everything it bought. It worked to its advantage because there were profits, some real, some on paper, which could be taxed. Industrial activity was great, employment good, and there was a flood of free funds in the hands of the people which could be taxed or borrowed into the treasury. There was a general fluidity of resources which helped exceedingly to finance the war.

The Advantages of Having the Federal Reserve System. — One great advantage which the United States had was the recently organised Federal Reserve system which served in two ways: first, as an agency for the placing of treasury

certificates, and second, as the basis of mobilising all the banks not only in support of general financial measures, but for the great bond sale drives. Through the federal reserve system the treasury redeposited its funds in the banks, where, by reason of the deposit credit system, they largely remained, although passing from the government's account to those of contractors and others to whom they were paid by the government.

New Taxation. — In view of what has been presented elsewhere in this book, all we need do now is to present a summary of the revenue measures and borrowings. A pre-war munitions tax grew into the war and excess profits tax. The income tax was steadily increased and the upper ranges of rates became abnormally high. The old excise taxes were vastly increased, especially on liquors and tobacco. Stamp taxes came in. Transportation and communication was taxed, new excises in the form of taxes on what was assumed to be "conspicuous waste," or luxury spending, taxes on amusement and a miscellaneous lot of others. Strikingly absent were any new excise taxes on articles of wide consumption, which would fall on the great masses of the people.

Summary. — The Secretary of the Treasury in his report for the fiscal year ending June 30, 1919, gives the revenue receipts as follows: April 6, 1917 to June 30, 1917, $567,000,000; fiscal year ending June 30, 1918, $3,664,000,000; fiscal year ending June 30, 1919, $5,152,000,000; June 30 to October 31, 1919, $1,895,000,000; total of foregoing, $11,280,000,000. But all these figures are subject to revision, and reallotment. The disbursements of the corresponding periods were: April 6, 1917 to June 30, 1917, $1,216,000,000; fiscal year ending June 30, 1918, $12,697,000,000; fiscal year ending June 30, 1919, $18,515,000,000; July 1 to October 31, 1919, $2,985,000,000, total of foregoing, $35,413,000,000. These figures include $9,406,000,000 advanced to foreign governments, leaving expenditures by the United States during this period, $36,000,000,000.

The summary of debt outstanding October 31, 1919, was as follows:

Old debt interest and non-interest bearing	$1,120,000,000
First Liberty Loan	1,985,000,000
Second Liberty Loan	3,526,000,000
Third Liberty Loan	3,904,000,000
Fourth Liberty Loan	6,614,000,000
Victory Loan	4,414,000,000
Treasury certificates	3,736,000,000
War savings certificates (ex interest)	911,000,000
	$26,210,000,000

Adjusting for cash on hand and other factors the net increase in debt was $24,133,000,000, revenue receipts during the war were $11,280,000,000, so that the total war disbursements were $35,413,000,000.

SEC. 13. **Post-War Financing.** — What will be done after the war to reorganize finances is an interesting subject of speculation. The situation at first glance is appalling. The peace time financial system lies in ruins which appear to be as complete as those of a bombarded village. Debt charges are in excess of revenues in some countries; new current expenses as well as heavy debt charges are found in all countries. The situation looks hopeless to the eyes of a people worn and torn by war. We may, however, have confidence that the structure will be restored, and perhaps, like burned-down cities which, rid of their slums and antiquated buildings, rise more beautiful from the ruins, so too the financial system is likely to be purged of its dross and refined.

At first wild schemes will be suggested. Repudiation of debt, confiscatory taxes, capital levies, and other extremes have already been proposed. But eventually calmer councils will prevail. The debts will be consolidated and converted until the interest charge is reduced to a reasonable minimum. Taxes will be found to increase in yield as the extraordinary rates are reduced and as industry strikes its new stride. Since high prices will prevail for a long time, the monetary expression of taxes like that of wages and prices will be high, and by comparison the debt charges will be less formidable. The sheer weight of taxation will compel to greater effort in industry and greater economy in spending. Peoples who created in all

during five years war goods and services amounting to $200,000,000,000 can do it over again if they will to do so in another five years. There is little that is extraordinary or necessarily surprising in the "great rapidity with which countries recover from a state of devastation," says John Stuart Mill, "the disappearance, in a short time, of all traces of the mischief done by earthquakes, floods, hurricanes, and the ravages of war. An enemy lays waste a country by fire and sword, and destroys or carries away nearly all the movable wealth existing in it; all the inhabitants are ruined, and yet, in a few years after, everything is much as it was before. . . . With the same skill and knowledge which they had before, with their land and its permanent improvements undestroyed, . . . they have nearly all the requisites for their former amount of production. . . . They will in a short time have raised as great a produce, and acquired collectively as great wealth and as great a capital, as before; by the mere continuance of that ordinary amount of exertion which they are accustomed to employ in their occupations." [1]

SEC. 14. **Financing a Small War.** — The World War, as we have seen, forced some departures from principle. A small war may be financed more strictly according to rule. No better illustration of the application of this can be found in history than is afforded by the operation of the United States treasury during the war with Spain. That history is worth study in all its details.

The situation, as it confronted Secretary Gage when the news of the destruction of the *Maine* reached Washington, may be summarised somewhat as follows: The treasury had a balance on hand of about $225,000,000. But, as we shall see below, only about $25,000,000 of this was really available for immediate use in the prosecution of the war. The ordinary expenditures of the government, outside of those for the postal system, which was nearly self-supporting, amounted in round

[1] *Principles*, Bk. I, Chap. V, sec. 7. Of the "damn'dest finest ruins in the world," of which San Francisco boasted in 1906, there was in three years scarce a scar remaining.

numbers to $350,000,000 per annum. For the first time in many months these expenses were being nearly met by the revenues. Indeed, it was estimated that at the ordinary rate of expenditures there might be a slight surplus at the end of the year. The tariff was expected to yield about $200,000,000, the internal revenue taxes about $165,000,000, and there were about $25,000,000 to be expected from miscellaneous sources.

The Tariff Could Not Be Changed. — The larger part of the income, however, came from taxes which could not well be tampered with. The tariff had been so long a subject of controversy that there was little desire to alter its recent settlement. For reasons already made clear, there were many parts of the tariff which could not well be changed. Except in a very few instances, the income to be obtained from it would not be increased by raising the rates. In the great majority of instances, to raise the rates would have been to lessen the receipts, while to lower those rates for the purpose of increasing the income by allowing larger importations would have been to remove the protection afforded by them. This was contrary to the avowed policy of the administration. It would, moreover, have served to disturb industry and to perplex its leaders at a time already sufficiently disquieting, and might have proved but an aggravation of the disturbance caused by the war. The great body of the customs rates, of which there are thousands on the tariff schedules, are not productive of much revenue and are not intended to be. They are there to restrict importations. These certainly could not well be changed. Of the bare dozen or so of articles of importation which do yield a revenue, sugar, one of the most important, was likely to be interfered with by the war. At the existing rates, sugar imported should yield a revenue of about $80,000,000 a year, but at least half of the importation was jeopardised by the war itself, and it would have been highly impolitic to have changed the rate at this time. Iron, which was once a source of considerable revenue, was, in consequence of the changes which have taken place in that industry and of the protective features of the customs law, not available to provide new revenues, as the importa-

tions are at best small. Cotton goods, the tax upon which yields considerable revenue, were protected; so were manufactures of hemp, flax, and jute, of leather and of wool. Drugs, medicines, and chemicals were already taxed up to the limit of productiveness, from a revenue point of view. In short, there were but four important articles imported which might be used to yield additional revenue. These were hides and skins, raw silk, tea, and coffee. To tax hides and skins or raw silk would, probably, under the prevailing theory of "compensatory" duties, have involved an increase in the rates on the products manufactured from them, to maintain the same degree of protection that those products now enjoy. That would have reopened the whole tariff controversy, and have rendered the outcome of the war revenue measure extremely doubtful. Clearly it were wisest, considering how recently the tariff issue had been temporarily settled, to leave them alone. As a matter of fact, then, there are only two articles in the whole list of importations which might be considered by the Secretary of the Treasury in his search for new income. These were tea and coffee, which might, perhaps, have been made to yield together nearly $80,000,000 additional revenue. That was approximately all that could be expected from the tariff.

The Tax on Tea. — In the war revenue bill, as presented to the House of Representatives by the committee on ways and means, of which Mr. Dingley was chairman, there was no suggestion of using the tariff in any way for obtaining additional revenue. It was not until the very end of the long discussion of the measure in the Senate that it was proposed to put a duty of ten cents a pound on tea. That measure passed the Senate and was accepted by the conference between the two Houses and by the House of Representatives without any public discussion as to its merits. The reason for this duty, as for the omission of coffee from the list, is therefore not clear. The tax on tea was an important matter. The yield would have been over $10,000,000 per annum. A similar tax on coffee, which would have been at the rate of 8.5 cents per pound, would have yielded about $70,000,000 more. It is, therefore, some-

what surprising that it should have attracted so little attention from the members of Congress.

Internal Taxes. — Since the revenue from the tariff was not to be increased, the only resource available was internal taxes. That these internal taxes should have taken the same general form as the taxes used during the Civil War, and consequently more or less familiar to people and officers, was but natural. Under the stress of war it is unwise to attempt to organise entirely new taxes, such, for example, as an income tax. Though an income tax had been used during the Civil War, that form of taxation was under the shadow of an adverse decision from the Supreme Court. Even if an income tax law which would have been constitutional, according to the recent decision of the court, could have been drawn, it is doubtful whether it could have been made productive within any reasonable period of time. Recourse might have been had to direct taxes, apportioned among the states according to population. These taxes could then have been raised in any manner which the state authorities chose. But there are two fatal objections to this plan. The apportionment of taxes according to population is fundamentally unjust and unequal. What it amounts to practically is a graduated poll-tax. The different commonwealths vary so in wealth *per capita* that any *per capita* tax, however raised, would be unfair. Although the census estimate of wealth in 1890 was anything but satisfactory, yet the method used in that estimate was uniform throughout the country; and such differences as that between South Carolina, with about $350 *per capita*, and Nevada, with $4000 *per capita*, show how utterly inadequate the constitutional method of raising direct taxes has become. Then, again, the method of taxation by which most of the states raise their revenues, and which they would probably follow in raising their share of any apportioned taxes, is the worst in use in any civilised country, and the injustice of the apportionment would have been enormously increased by the injustice in collection. The second objection to this method of raising direct taxes prescribed by the Constitution is that it takes an inordinate length of time,

and war taxes should begin to yield a revenue as early as possible.

Description of the New Taxes. — The only available plan was, therefore, to seek additional revenue from the existing, indirect, internal taxes, the excises, or, as they are called in the United States, the "internal revenue" taxes, and to supplement these still further by new taxes of the same sort. Briefly summarised, the revenue bill nearly doubled the existing rate of taxation upon beer and other similar fermented liquors; it imposed special taxes on bankers, brokers, pawnbrokers, theatres, circuses and other shows, bowling-alleys, and billiard rooms; it raised the rates on tobacco of all kinds; and it placed stamp taxes on stocks and bonds, commercial papers, legal documents, checks and drafts, proprietary medicines, toilet articles, bills of lading, insurance policies, and a number of other things. Special direct taxes were imposed on the oil trust and the sugar trust, and on legacies and distributive shares of personal property.

Yield of New Taxes. — As the war revenue bill passed the House, its probable yield was variously estimated at from $90,000,000 to $105,000,000 per annum, the former being the better estimate. As amended in the Senate and finally adopted, it promised to yield at least $150,000,000 per annum. The actual yield in addition to the regular revenue during the first month was about $13,000,000.[1] But the expenses of war during the first few months, if not for a long time after that, would be, it was estimated, at least double that sum and possibly more. Therefore, unless the treasury had a considerable balance on hand, there would have been no possibility of conducting the war at all without immediate loans. The balance in the treasury at the outbreak of the war was $225,000,000. Upon this were a number of claims, some of which, however, were not immediate. $100,000,000, known as the gold reserve, had to be held for

[1] It is not possible, and probably never will be possible, to state exactly how much the new taxes increased the revenues. In the first place the reports do not segregate the income obtained from the new taxes from that obtained from the old; and in the second place, the changes in the rates and the existence of new taxes have changed the yield of the older parts of the system by an amount which cannot even be estimated. The total increase in the revenues for the fiscal year 1899 over 1898 was about $115,000,000.

the preservation of the parity of all parts of the circulation and the avoidance of general financial ruin. Then there were $13,000,000 of fractional silver and minor coins, a large part of which was worn and unavailable, while the rest was needed for currency purposes throughout the country. $14,000,000 had been received from the sale of the Pacific railroads; but although this sum was temporarily available, it would, if it were spent, be necessary to raise an equivalent amount before January 1 to meet the Pacific Railroad bonds which came due at that time. $33,000,000 were held in trust for the redemption of the notes of national banks which had failed or which were redeeming their circulation. A part of this was temporarily available, but it would be necessary to replenish that fund at an early date if much were drawn from it. There were, then, out of the $225,000,000, $160,000,000, of which a small part only was available, and that but for a short time. Anything drawn upon that would have to be replaced by January 1 at latest. Of the $65,000,000 remaining, $40,000,000 were necessary as the cash on hand for the ordinary operations of the government. That amount corresponds to the cash on hand which a merchant keeps in the till to make change or to meet small bills. This left but $25,000,000 for the initial expenses of the war, which in the state of unpreparedness would naturally be above the average. This $25,000,000 was all the unincumbered money in the treasury to meet the appropriation of $50,000,000 made by Congress before war was declared. It was clear that the Secretary of the Treasury could not provide the sinews of war without the power to borrow, both for a short time, to anticipate the revenues expected from the new taxes, and for a long time, to enable him to support any naval and military operations which might become necessary, however extensive.

Authority to Borrow Granted. — After much discussion and more or less unnecessary and dangerous delay, especially in the Senate, Congress authorised the borrowing, at the discretion of the administration, of not more than $100,000,000 at one time on treasury certificates and of an amount not to exceed $400,000,000, on 10—20 bonds at 3 per cent. Nominally,

therefore, the Secretary of the Treasury had in his hands for the necessities of war during the first six months of its duration:

Surplus on hand	$ 25,000,000
War revenues	75,000,000
Temporary loans	100,000,000
Bonds	400,000,000
Total	$600,000,000

Practically, he was limited by the fact that all of this money had not been appropriated, and it would have been folly to raise more than he had authority to spend. Including the $50,000,000, appropriated before the war broke out, the total war appropriations made by Congress before it adjourned amounted in all to $361,788,095.11. This sum covered the most generous estimates of the probable cost of the war. But the secretary did not deem it necessary to raise at once a sum equal to the total appropriations. It was estimated that the expenses for the first six months would not exceed $175,000,000, or about one-half of the appropriations. The new taxes would probably yield about $75,000,000 toward these necessities, and a loan of $100,000,000 would possibly have sufficed to meet all the demands. But the treasury raised $200,000,000 by the sale of 3 per cent 10—20 bonds, obtaining a total of $275,000,000, or nearly $100,000,000 in excess of the probable actual expenditure. The accumulation of this surplus was not in any sense an extravagant or useless piece of financiering. As has already been explained, the treasury must be prepared to meet any demand that may arise, instantly and amply. That is the imperative necessity. As the early close of the war could not have been foreseen, the fiscal preparations were necessarily liberal. Indeed, the amplitude of the funds available was one of the most potent causes of the success of the war. The excess raised was no larger than was necessary to insure the instant readiness of the treasury to meet all possible demands. Had the war continued and the demands equalled the appropriations, the treasury would have been obliged to use its power of borrowing which the fortunate termination of the war rendered unnecessary.

SEC. 15. **The Use of Credit.** — It now remains to see how the credit of the nation was protected and how it stood the strain. At the end of April, 1898, the interest-bearing debt of the United States amounted in round numbers to $847,000,000. $100,000,000 of this bore interest nominally at 5 per cent, the balance at 4 per cent. The 4 per cent bonds, payable in 1925, were quoted when the plans were being made for placing the new loan at 117¼. At that rate they would yield the investor 3¼ per cent interest. There was, therefore, some surprise when it was proposed to place the new loan at 3 per cent. It was urged that nobody would buy the new bond at 3 per cent when he could buy one of the old ones and get 3¼ per cent. Yet the outcome showed the wisdom of the move. The bonds were subscribed to seven times over, and in a short time rose to a premium of 103 and 105. In fact, the entire loan was easily placed on far better terms than any nation has ever before been able to obtain in time of war. This remarkable result was attained partly by reason of the fact that the loan was offered for popular subscriptions and the bonds were for small amounts, thus creating and reaching a new market among investors of small means. In part, too, it was due to the fact that the new bonds at par really formed a better basis for the national bank-note circulation than the old bonds at 117¼, and very much better than the old bonds at 123¼, the price which was reached before the new issue was completed. An investment by a national bank of $100,000 in the old bonds at 117¼ would yield a profit of $736.70 on the circulation, if interest is at 6 per cent; while an investment of the same amount in the new bonds at par would yield a profit on the circulation of $1302.02. The difference in favour of the new bonds was $565.32, or over half of 1 per cent. The advantage was still greater when the old 4's reached 127½, as they did before the close of the war. None of these influences, however, would have had any weight had it not been that new revenues sufficient to meet all debt charges and part of the war expenses had been provided.

A "Popular" Loan. — Much interest centres around the successful attempt to make this a popular loan, and as this was one

of the features which contributed to strengthen the credit of the country at this time, we may examine it somewhat in detail. Congress, after much discussion, finally provided that these 3 per cent bonds, "redeemable in coin at the pleasure of the United States after ten years from the date of their issue, and payable twenty years from that date," should "be first offered at par as a popular loan under such regulations, prescribed by the Secretary of the Treasury, as will give opportunity to the citizens of the United States to participate in the subscriptions to such loan, and in allotting such bonds the several subscriptions of individuals shall be first accepted, and the subscriptions for the lowest amounts shall be first allotted." Before the bill was finally passed, offers had been made by various banking houses to take the whole issue at a slight premium. Both Congress and the administration, however, favoured the experiment of interesting a large number of small property owners in the loan, even at a loss to the government. It was thought that such a measure would strengthen the national credit by giving expression to the faith of our own people in the integrity of the government. Other considerations of a political character also entered in, but with them we are not concerned. As a financial measure for the strengthening and support of the public credit it proved a phenomenal success.

The bonds were issued in denominations as low as $20. Subscriptions were received through the post-office, and every *bona-fide* subscription under $500 was immediately accepted. More than half of the entire issue was taken by 230,000 of these small subscriptions, and no subscription of more than $4500 was accepted. In all 320,000 persons offered or made subscriptions, and the total amount tendered the government was $1,400,000,000. This rush for the new bonds was not merely a matter of patriotism or sentiment. During the progress of the subscriptions the price of the bonds advanced first to 102 and finally to 105⅛. They soon stood at about 110. The lucky individuals whose subscriptions were accepted made from 3 per cent to 5 per cent in a few days. The popularity of these bonds was greatly enhanced by the standing offers

obtained by Secretary Gage from two syndicates to take the entire loan or any part of it that was not covered by the popular subscriptions.

This method of floating the loan cost the government a considerable sum of money. In the first place a possible premium was lost. How much that premium would have been cannot be estimated because the bonds were sold in a broader market than would have otherwise existed. But it would have been at least 2 per cent, for even at a higher rate the bonds offer a favourable basis for national bank-note circulation. That is, at least $4,000,000 was lost at the beginning. Then the cost of handling the loan, paying the interest, etc., is increased considerably by the small size of the bonds and the large number of holders. It is just as much trouble to pay the 15-cent coupon of a $20 bond as it is to pay the $75 coupon of a $10,000 bond. Yet in spite of all this, the placing of the $200,000,000 loan of 1898 was one of the most successful pieces of financiering ever accomplished by the government. It demonstrated the perfect solvency of the government; it gave the country a financial prestige which went a long way toward hastening the end of the war; and it so strengthened credit of the government that, had the war unfortunately continued, it would have been able to obtain funds to almost any amount on the most favourable terms imaginable. With a 3 per cent bond selling at 105 during the actual continuance of military operations, a nation may safely regard its credit as unimpaired.

The final test of the success of the financial administration of a war is the preservation of the public credit.

APPENDIX

FEDERAL AID IN HIGHWAY CONSTRUCTION

Beginning in 1916 Congress inaugurated a new policy as to highways. It was that of federal aid to the states and local governments in the building and rebuilding of roads. The first act, approved July 11, 1916, stated the purpose to be "to coöperate with the States . . . . in the construction of rural post roads." This brought the action under the power of Congress "to establish post offices and post roads," and avoided, in words at least, the old constitutional question raised by Madison and Monroe. (See p. 35.) "Post roads" were defined as any roads over which the mails were carried. But the act expressly excluded city streets. "Construction" included "reconstruction and improvement."

At that date, as explained in the text, page 35, the states were fairly embarked on the policy of "good roads." The automobile commanded what the horse and the mule could not. Many states had begun to build extensive state highways financed from the state treasury and supervised by a state bureau or highway commission. In the others the county and local authorities were active coöperatively in new construction and in extensive reconstruction.

The general idea of the act as to federal aid appears to have been that within the limits of the funds available and appropriated, and upon sound projects approved by the newly established Bureau of Public Roads under the Secretary of Agriculture, Uncle Sam would match every dollar expended by the states.

The first act carried appropriations for each of five subsequent years, commencing with five million dollars in 1917 and rising by five millions more each year to twenty-five millions in 1921. But long before the act expired additional appropriations were made and liberal appropriations still continue.

The funds made available were apportioned among the states: one-third in proportion to population, one-third in proportion to area, and one-third in proportion to the mileage of "rural delivery and star routes." Administrative expenses are, however, deducted before the apportionment is made. The later act, that of 1921, changed the method of apportionment as will be explained below.

For a state to obtain the federal aid the following steps were, and most of them are still, necessary. First, the legislature must assent. Second, the state highway commission or other appropriate body must submit a "project" to, and obtain its approval from, the Secretary of Agriculture. Third, the work when done must be approved by the Secretary.

In 1920 the aid was further supplemented by the distribution to the states of left-over war material and equipment, such as trucks and tractors, suitable for use in road work. This seems to be a modern form of "beating the sword into a plowshare."

The original act carried appropriations for five years which, as stated above, were increased subsequently. When the five years were up a new act, approved November 9, 1921, continued and enlarged the scope of federal aid. No one seemed to wish to press the constitutional question, so the camouflage of aid to "rural post roads" was abandoned. The aid is now extended technically under the commerce clause and frankly to "highways" of two classes, "primary or interstate," and "secondary or intercounty." The classification obviously includes every road of the slightest importance. City streets, as before, are excluded. A new limit appears in this law, namely, that the federal aid is available only for new projects within a selected and designated 7% of the mileage existing at the time of the passage of the act, and preference up to 60% of the aid allotted must be given to primary highways.

In both laws the duty to maintain the roads built with federal aid and the cost of maintenance falls on the state or local governments. Failure to maintain involves suspension of aid in further new work, and the diversion of that aid to maintenance under federal control. Only after reimbursement of the funds so diverted can the state come back into good standing and again receive aid.

Through his powers of approval of "projects" and acceptance of work the Secretary of Agriculture has exercised a very marked control over the road policies of the states. The desire to obtain the full amount of federal money available has stimulated road building possibly to an even greater extent than it would have gone under the pressure of economic advantage and the urge of the automobilists.

Even more completely does the federal government control the construction of roads in the national forests. Provision for such roads was incorporated in the series of acts providing for federal aid to highways which are briefly summarized above. Here, however,

the theoretical ground on which the building of the roads stands is distinctly different. The justification is not the establishment of post roads, nor aid to interstate commerce by interstate highways, but is found in the fact that the forests as federal property are exempt from taxation, so that communities "within or adjacent to the national forests" would be without resources to build the roads on which they must of necessity be dependent. There is an interesting provision of the law looking to the ultimate reimbursement of the treasury for the money spent on forest roads out of the proceeds of the sale of timber and other earnings of the forest lands. This meets, in a way, the objections raised by states in which there are no forest lands that they should not be taxed for the benefit of states which have the forests.

In 1924 the Bureau of Public Roads reported that the total mileage of certified roads in the country was 2,866,000 miles; of which 7% would be about 200,000 miles. Of these 200,000 miles about 112,000 miles were in approved projects, and federal aid had been used on over 35,000 miles, at a total outlay of over $600,000,000, to which the federal government's contribution had been $262,000,000. It is expected to complete the approved projects by 1933. The Bureau asserts that, "When the system is completed, one will be able to travel from any town of 5,000 population or greater to any other town of the same size without leaving an improved road."

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