

THE UNIVERSITY OF MINNESOTA

GRADUATE SCHOOL

Report  
of  
Committee on Thesis

The undersigned, acting as a Committee of the Graduate School, have read the accompanying thesis submitted by Frank Kuehn for the degree of Master of Arts.

They approve it as a thesis meeting the requirements of the Graduate School of the University of Minnesota, and recommend that it be accepted in partial fulfillment of the requirements for the degree of Master of Arts.

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June 1920

THE UNIVERSITY OF MINNESOTA

GRADUATE SCHOOL

Report

of

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This is to certify that we the undersigned, as a committee of the Graduate School, have given Frank Kuehn final oral examination for the degree of Master of Arts . We recommend that the degree of Master of Arts be conferred upon the candidate.

Minneapolis, Minnesota

June 1920

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AN INCOME TAX FOR MINNESOTA

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A Thesis Submitted to the  
Faculty of the Graduate School of the  
University of Minnesota

by

FRANK KUEHN

In partial fulfillment of the requirements  
for the degree of  
Master of Arts

June 1

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## INTRODUCTION.

The income tax is rapidly being adopted as a means of raising revenue to meet the increased cost of government. European countries have long used this form of taxation and are now getting huge revenues from this source. England and Germany each derived over \$200,000,000<sup>1</sup> from the taxation of incomes before the war, while now they are literally raising billions by this means. In 1913 the United States constitution was amended to allow taxation of incomes without apportionment. In the same year Congress passed the Federal Income Tax Law. This has proved such an important source of revenue during the war that it will very likely become a permanent feature of our federal fiscal system.

Some sixteen states have tried income taxation, but up to 1911, it had always proved a failure.<sup>1a</sup> In that year Wisconsin passed an income tax law which, contrary to the many predictions of failure, proved a great success, both from the administrative and the revenue points of view. Massachusetts and several other states have passed income tax laws recently, and others are contemplating such action. The main reasons for the passing of income laws by these states were, in the first place, to find a remedy for the defects of the general property tax and secondarily to provide new sources of revenue.

In Minnesota the question of income taxation began to be discussed as soon as the success of Wisconsin's law became evident.

<sup>1</sup>Ilyons - Ann. Amer. Acad. March 15, p.77.

<sup>1a</sup>Seligman - The Income Tax. p. 418.

A general feeling exists among the people of the state that something is wrong with our system of taxation. Complaints about the injustice and inequality of our general property tax and especially of the personal property tax are becoming more numerous and insistent. In 1917 the Minnesota Tax Conference was organized to meet annually to discuss the state's problems of taxation and to propose remedies. The State Tax Commission has studied our system of taxation thoroughly and has been advocating the adoption of an income tax similar to the one now in force in Wisconsin.<sup>1b</sup>

It is the purpose of this paper to consider, first, whether in the light of conditions existing within the state and the experiences of other states and governments, an income tax is desirable as an adjunct to the Minnesota tax system and, second, what should be the nature of such an income tax as would insure its success.

The first two questions to be considered are:

- (1) What is the tax situation within the state?
- (2) Does it call for a change in the present system of taxation?

<sup>1b</sup>See Recommendations in Reports of 1914-18.

## CHAPTER I.

### THE GENERAL PROPERTY TAX IN MINNESOTA.

#### Introduction.

The general property tax has been the chief source of revenue since the state was founded. It is, however, becoming more and more unsatisfactory as a means of determining each man's contribution to the support of the government. It was <sup>comparatively</sup> just and equitable in the earlier history of the state when the chief values were in land and agricultural capital. Then there were few forms of personal property and each man could determine the value of his neighbor's property. But those conditions no longer exist. The industries of the state have increased greatly in size and number; business has become complex and inter-communal while personal property has taken on many new forms and increased until now its value is a large proportion of the state's wealth. Under such conditions the general property tax does not work satisfactorily. European countries cast it over-board long ago, but in the United States the property tax has maintained its foothold. Its defects are becoming so evident that people are beginning to look around either for a remedy or a substitute.

The chief defects may be treated under five heads.

#### Inequalities.

The general property tax does not affect all property equally. This is in large part due to the poor administration

of the tax. The primary assessment is made by an assessor who is elected locally and subject to local influences. The period of assessment is of 6 - 8 weeks duration and does not enable an assessor to become an expert appraiser. Remuneration is so low and the task such an unpleasant one that capable men of the community seldom care to take the office. It usually goes to some man whose only qualification is his willingness to do the work.<sup>2</sup>

Minnesota has some 2,500 assessors with about as many different standards of valuation.<sup>3</sup> The assessor is expected to make the total assessment as low as possible so the district may not have to bear a greater share of the state and county levy than other districts which are presumably also greatly undervaluing their property with the same end in view. Different pieces of property within the same districts are often valued by different standards as is well shown by the numerous and drastic changes made in the assessments by county boards of equalization. The local boards of review seldom do anything to correct these inequalities in the original assessment, although they are in a better position to do so than the county and state boards of equalization.<sup>4</sup>

Taxpayers have lost faith in the fairness of the general property tax and evade it whenever possible. Much property, especially personal property, thus never appears on the assessment rolls. If it does appear, the value given is so low that it practically escapes taxation.<sup>4.1</sup> Assessors do not remedy this for fear of losing votes or causing offense. If the assessor were backed

<sup>2</sup>Minn. Tax Comm. '18. p. 63      4.1 See MS p.5-6.

<sup>3</sup>Ibid p. 64.

<sup>4</sup>Minn. Tax Comm. '16. p. 29.

by a higher central authority, his work could be greatly improved. The fault is not so much in the assessor as in the system which sends him out unprepared and unsupported to do a piece of work requiring a skilled appraiser who can disregard local opposition. The result of this poor work by the local tax officials is that great inequalities in the tax burdens exist as between different counties; between towns and cities, town and counties, and between rich and poor. It is common talk that the personal property tax is a tax upon orphans, widows, the helpless and the honest.

The inequality caused by the general property tax is perhaps best indicated by the following statements made in the 1918 report of the Minnesota Tax Commission:

"There are 2,671 separate assessment districts in the 86 counties of the state. In 1918, percentage increases and decreases in the assessment of real estate were made in 1825 of these districts by county boards of equalization. In addition to the percentage changes in assessor's valuations, a large number of changes in the assessed value of tracts of land were made by county boards in nearly every county of the state. Mille Lacs is the only county in which no changes were made by the county board in either real or personal property..... In 9 counties it was necessary to change the assessments in every district while in 19 counties changes were made in all but three.... These changes varied in different counties, the minimum ranging from  $1\frac{1}{2}$  % to 20 % and the maximum from  $16\frac{2}{3}$  % to 800 %. The inequalities in the assessed valuation of personal property were even greater than in real estate, if we may judge by the numerous and in some

cases radical changes made in assessor's returns. The maximum increases ranged from 20% to 1500%. In 26 counties the maximum changes were above 300%; in ten, 300%; in eleven, 200%.<sup>5</sup> From the viewpoint of equality the general property tax, especially the personal property tax feature has broken down completely.

Important classes of property escape taxation.

The second great defect of the general property tax as actually administered is its failure to reach certain classes of property. It is notorious that personal property largely escaped taxation. This is especially true of intangible personal property such as bonds, stocks, notes and mortgages. The 3 mill tax on "moneys and credits" has improved matters but whereas this form of personal property bears only 3 mills, the rest of the property in Minneapolis must pay 64.4 mills this year.<sup>6</sup> In 1914 the Minnesota Tax Commission reported that only one third of the intangible personal property that should be listed under "moneys and credits" appeared on the assessment lists.<sup>7</sup> Tangible personal property also escapes to a large extent because it is impossible to value such things as household furniture, machinery and stocks in trade anywhere near their true value. The reports of assessors, tax officials and tax commissions in Minnesota and other states in the union have repeatedly called attention to the fact that personal property pays a ridiculously small proportion of the whole tax.<sup>8</sup>

<sup>5</sup>Minn. Tax Comm. '18, p. 64 ff.

<sup>6</sup>Ibid. Letter May 14, 1920. This is average rate for city; the ward

<sup>7</sup>Minn. Tax Comm. '14, p. 74. rates differ.

<sup>8</sup>Minn. Tax Comm. Report, 1918, p. 53. Nat. Tax Assoc. '07, p.477.



Another class that escapes its just share of taxation is that composed of salaried men and wage earners.<sup>9</sup> A poor man scarcely able to make both ends meet may be heavily taxed on his little home and scanty furniture while a corporation lawyer making \$25,000 a year and living at his luxurious hotel or club pays very little or no personal property tax.<sup>9</sup>

### Dishonesty Fostered.

A third great defect of the general property tax is the constant and almost irrepressible temptation to dishonesty which it places before every property owner. A man inclined to be upright is almost forced into dishonesty by the tax. He sees his neighbors escaping the tax and the rate rise on the property that is reported by the honest men. Pretty soon evasion becomes so general that the community sanctions the violation of the law while assessors and tax officials wink at the wholesale evasion on every side. Men who are known for their honesty in business dealings will think nothing of undervaluing their property when the assessors come along. Tax commissions thruout the country condemn the general property tax on this score. One calls it a tax upon "ignorance and honesty".<sup>10</sup> An Illinois commission calls it "a system debauching to the conscience and subversive to the public morals - a school for perjury promoted by law."<sup>10</sup> Our own tax commission says that "it puts a penalty on honesty and a premium upon dishonesty, especially when applied to certain forms of

<sup>9</sup>Nat. Tax Assoc. '07, p. 481.

<sup>10</sup>McPherson N. Tax Assoc. '07, p. 478.

personal property."<sup>11</sup>

Discrimination Against the Poor.

The general property tax is also defective in that it throws a heavier burden upon the small piece of property and upon the poorer classes of people. This results from the unequal assessment and the escape of personal property. It is inevitable that the assessor, who knows the value of the small houses better than that of the large expensive ones, will value the \$1,000 house of the poor man nearer its true and full value than the \$10,000 house of the rich man. The personal property in the small home is more easily checked up and valued than the luxurious and expensive furniture, rugs and bric-a-brac in the large house. The forms of intangible personal property which escapes oftenest are held largely by the well-to-do classes. In speaking of the general property tax E.R.A. Seligman says that the great inequalities come from the excessive burden placed upon the expenditure of the poor classes while the rich escape the general property tax in the state and local taxation. In the United States the burdens of taxation are becoming more and more unequally distributed and the rich classes bear a gradually smaller share of the public burden.<sup>12</sup>

Defective in Theory.

The fifth great defect of the general property is its deficiency from the point of view of theoretical justice. It is

<sup>11</sup>Minn. Tax Comm. '16, - p. 86.

<sup>12</sup>Seligman - Income Tax. p. 640.

generally admitted that justice in taxation means the levying of the tax in proportion to faculty - to the ability of the citizen to pay. And this faculty or ability is determined by the amount of the taxpayer's net income, for in the last analysis all taxes are normally paid out of income.<sup>13</sup> Judged by these firmly established principles, the general property tax is unjust in theory because large classes of persons whose incomes are derived from salaries or wages, and who are perfectly able to bear some share of the public burden, are relieved of taxation entirely. Property is a very imperfect test of ability. Much property that has value but no money income is taxed as heavily as other property that yields a large income. Durable consumer's goods such as household belongings, personal effects and objects of art are hit by the general property tax. So are investments in the struggling firms that can't pay a dividend. The general property tax hits the property of the unfortunate enterprise struggling on the verge of bankruptcy just as heavily as that of the highly successful corporation. J. H. T. McPherson in an address before the National Tax Association says: "The conclusion is inevitable that the theory of the general property tax is unsound: it assumes that property is a uniform measure of ability, which is untrue. If it were possible to carry it out to the letter in practice, it would still involve flagrant injustice."<sup>14</sup> The general property tax in its present form is condemned by publicists, administrators and students of taxation.<sup>15</sup>

<sup>13</sup>Bullock - Nat. Tax Assoc. '16, p. 374.

<sup>14</sup>Nat. Tax Assoc. 1907, p. 481

<sup>15</sup>Ibid. 1907, p. 482.

In Minnesota the property tax is putting an ever increasing burden upon real estate while personal property largely escapes.<sup>151</sup> The weak spot in Minnesota's system of taxation is the attempt to tax personal property.<sup>152</sup> The tax commission says that this tax cannot be enforced in its present form.<sup>16</sup> All attempts to improve our taxation system must thus be centered upon the personal property feature of the general property tax. The only remedy seems to be the abandonment of the attempts to tax personal property as was done in Europe long ago.

The next questions that arise are: Can the personal property tax be dropped without providing a substitute? If not, what substitutes are possible? (See Appendix B for outline of Minnesota tax system.)

Can the Personal Property Tax be Dropped Without Providing a Substitute?

Total exemption of personal property is impossible in Minnesota until the constitution is amended.<sup>161</sup> In 1906 it was amended to allow the classification of property and the application of different rates to the various classes, provided all the property in a class be taxed at a uniform rate. Personal property is placed in classes 2, 3 and 4, and is assessed respectively at 25, 33 1/3 and 40 % of its full value.<sup>17</sup> This percentage assessment together with the \$100 exemption allowed the "heads of families" makes possible a \$400 exemption of per-

<sup>151</sup>See Appendix A.

<sup>152</sup>Minn Tax Comm. Report, 1918. p. 85.

<sup>16</sup>Ibid. p. 86.

<sup>17</sup>Minn. Tax. Comm. '14, p. 13.

<sup>161</sup>See Appendix C for proposed income tax amendment.

sonal property in class 2. The people of the state are ready for a partial exemption of personal property but would not favor its|entire|abolition because they feel that many owners of personal property who are well able to bear their share of the burden of supporting the state and local governments would escape taxation entirely. The tax commission believes that total exemption of personal property will eventually come, but that the state is not yet prepared for such a radical change in the tax base unless a business or state income tax takes the place of the present personal property tax.<sup>18</sup>

Total exemption would reduce the base of taxation considerably. In 1915 the total assessed value of real and personal property subject to ad valorem taxation was \$1,730,216,000.<sup>19</sup> Of this amount, \$1,284,150,906 was real property; \$233,368,380 personal property and \$212,696,830 was "moneys and credits."<sup>19</sup> The ratio of real estate to personal property, not including "moneys and credits" was 83½ % to 16½ % of the total.<sup>19</sup> If personal property were exempted, the tax rate on real estate would have to be increased 20% to produce the present revenue. The increase in the rate on real estate in the urban districts would be 30% because the ratio is 76% real to 24% personal property.<sup>19</sup> In the country the ratio is 89% to 11% and the increase in the rate on real estate would then be but 12%.<sup>19</sup> This increase would not be distributed equally, for those with an equal amount of personal and of real property would have the increase in the real

<sup>18</sup>Minn. Tax Comm. '16, p. 86

<sup>19</sup>Minn. Tax Comm. '16, p. 113.

estate tax off-set by the exemption from the personal property tax; those having less real than personal property would pay less and those with more real than personal property would pay more than now.<sup>19</sup> Real estate owners will not permit exemption if they have to assume the burden now borne by personal property. They feel that they are already bearing far more than their share and have started movements to lighten the burden upon real estate.

If the exemption of personal property would involve too great a burden upon real estate and be unacceptable to those who fear that many wealthy people would escape taxation entirely, we must consider (1) whether our present system of taxation can in any way be improved so as to produce better results and (2) what taxes could be used as substitutes for the personal property tax.

#### Can the Present System be Improved?

The chief reason for the failure of the general property tax in our own and in other states is the lack of central control of administration. Local assessors have failed to enforce the laws properly because they were not properly trained and backed by a higher central authority. Many tax officials admit that a great many of the inequalities could be eliminated if we had better administration of the laws. The remedy for the present inefficiency in the administering of the general property tax would be the county assessor system whereby the tax commission would appoint assessors for each county and the local assessors would be eliminated.<sup>20</sup> The experience of other states seems to

<sup>20</sup>Minn. Tax Comm. '18, p. 68.

show that better results can be obtained by such a system of administration.<sup>20</sup>

It is not an easy matter, however, to bring about such a change. The idea of home rule is so firmly rooted and the distrust of central control is so great in local government circles that a radical reform of this kind cannot easily be secured. The people of the state feel that something is wrong with our tax system but they don't know just where the trouble lies. It would take a great deal of agitation to educate them to the point where they would be willing to permit a change from the local to the county assessor system. An immediate change from the local to the county assessor system is thus not to be looked for and we must seek other means of ridding our tax system of its present gross defects.

#### Possible Substitutes for the Personal Property Tax.

Some states have sought to solve the problem by abandoning the general property tax as a source of state revenue.<sup>21</sup> This solves the problem as far as the state is concerned but it does not remedy the main defect in the Minnesota tax system - the inequality caused by the personal property tax. A separation of state and local sources of revenue brings with it other evils the chief one of which is the difficulty of improving the administration of the tax laws. The local authorities need the control, backing and supervising of the central authorities and the central

<sup>20</sup>Minn. Tax Comm. '18, p. 68

<sup>21</sup>Ann. Amer. Acad. 1915, Mar. P. 135.

authority needs the local knowledge of the local authority. The ideal is not separation but joint control.<sup>22</sup> Then there is also the question of whether enough revenue could be raised for the state if the general property tax were entirely dropped as a source of revenue by the state. A member of the state tax commission says that the state could not get along without this source of revenue. The state tax system would be deprived of its elasticity if the general property tax were abandoned by the state for state purposes. The following table shows the relation of the receipts from the property taxes to that from other sources.

TABLE I.

Sources of State Receipts in 1919<sup>23</sup> (Round Numbers).

General property tax.....	\$6,362,078.09
Interest on funds, etc.....	1,060,728.59
Departmental.....	2,487,131.16
Institutions.....	2,444,678.13
Inheritance.....	683,607.51
Insurance.....	690,515.06
Railroad companies.....	7,532,181.26
Others .....	<u>547,173.01</u>
Total	\$21,808,092.81

The receipts of the state from the general property tax could not very well be distributed among the other sources without taxing them unduly. In the 1919 legislative session

<sup>22</sup>Adams. Ann. Amer. Acad. 1915, Mar. p. 133.

<sup>23</sup>Minn. Tax Com. Letter May 14, 1920.



ore the tonnage tax was discussed as a source of revenue. Estimates of probable yield are not available.<sup>271</sup> Then the tax commission also recommended an increase of the rate on the gross earnings of telephone companies.<sup>24</sup> These would not greatly increase the state's revenues. The other sources could not be taxed very much heavier than they are now, for their rates are on a par with the rates on other property.

The cost of government in the state of Minnesota has risen greatly during the last ten years and will rise even more rapidly in the future. The amounts raised by the state rose from \$7,387,000 in 1908 to \$15,157,531 in 1918.<sup>24a</sup> The net expenditures increased from \$7,626,000 in 1908 to \$19,154,748 in 1918.<sup>25</sup> (In the last two amounts the receipts and expenses of state institutions are included.) In 1919 the taxes of Minnesota according to a statement just issued by the state tax commission were 35% higher than in 1918.<sup>26</sup> These increases in the cost of government were caused by higher prices of labor and materials, increased appropriations to state institutions and greater expenditures for public education.<sup>27</sup> These three causes will make the need for revenue even greater in the future. In addition the State Legislature passed a Soldier's Bonus Bill providing for the payment of \$20,000,000 to returned soldiers.

<sup>24</sup> Minn Tax Comm. Report. 1918, p. 5-6.

<sup>24a</sup> Ibid. p. 101.

<sup>25</sup> Ibid. p. 113

<sup>26</sup> Mpls. Tribune. Feb. 21, '20.

<sup>27</sup> Minn. Tax. Comm. Report. 1918, p. 121.

<sup>271</sup> The tax commission says in this connection that the revenue from such a source would probably vary substantially from year to year depending entirely upon the net profit of the output and the rate imposed thereon. Letter May 14, 1920.

A movement is also on foot to build a state highway system <sup>of</sup> 7,000 miles. . . . The the cost of this is not to be raised by general taxation, but by taxing automobiles, it would nevertheless narrow the tax base considerably.<sup>272</sup> and other state institutions The State University will also need largely increased appropriations to carry out its building programs and to meet the need of a rapidly increasing student body. The consequent increased need for revenue serves only to make the question of reforming our tax system more acute. The more revenue is needed the greater will be the inequalities of our present personal property tax and the heavier will become the burdens on those who can't escape.

To summarize the tax situation in Minnesota: we raise most of our revenue by means of the general property tax. Conditions have changed so much that this kind of taxation no longer produces good results. It is especially weak in its personal property feature. Evasion has become so wide-spread that very gross inequalities result. The burden falls mostly upon the honest, the widows, orphans and the helpless. As the greater part of the value of personality is held by the rich, the personal property tax has fallen heaviest upon those least able to pay and lightest upon those best able to pay it. Many of the inequalities are due to the inefficiency of a decentralized administrative system. The possibilities for reforming this feature are so slight that other remedies must be found, and that quickly, for the rapidly increasing need for revenue greatly intensifies the inequalities. A survey of the possible ways of relieving the situation has disclosed no adequate rem-

<sup>272</sup> See Appendix D.

edy. It remains to examine state income taxation as a possible substitute for our defective personal property tax. ( See appendix G for taxation of Real Estate.)

Sentiment Towards Income Taxation in Minnesota.

State income taxation has been discussed favorably as an adjunct to our tax system since the success of the Wisconsin law became apparent. Within recent years this discussion has taken on a more serious turn, because our tax burden is rapidly increasing. The state tax commission has embodied the following recommendation in its last few biennial reports: "That when a civil service commission is established in this state, an income tax law similar to the one now in force in Wisconsin be adopted."<sup>28</sup> The topic of state income taxation has come up at the four annual meetings of the Minnesota Tax Conference. Samuel Lord, a member of the State Tax Commission, said in an address before the 1920 conference (Jan. 22): "Real estate feels the burden of the taxes. Real estate bears four-fifths of the tax burden, not because real estate represents four-fifths of the wealth, but the personal property is fluid and escapes its just share of taxation. Even with our very low rate of three mills on moneys and credits we are not reaching all the taxable property.

"The remedy, as I see it is largely involved in some form of income tax law."<sup>29</sup>

Next fall (1920) an income tax amendment will be submitted to the voters of Minnesota. (See Appendix C)<sup>30</sup>

<sup>28</sup>Minn. Tax Comm. '18. p. 6.

<sup>29</sup>Mpls. Journal, Jan. 22. - p. 1.

<sup>30</sup>Minn. Tax Comm. Letter May 14, 1920.

The Conference adopted the following resolution:

"Resolved, further, that after the creation of such county assessor or supervisor, and until such time, we favor the elimination of taxation on all personal property and the substitution in lieu thereof of an income tax."<sup>30</sup>

The Minneapolis Tribune says in an editorial of April 17, 1920:

"The question then arises: Are those who have no real property and very little tangible physical property of any kind faring better of the taxation score than those who do have such property? In other words, is the taxation scheme based as fully as it should be on the principle of ability to pay? Are some men with net incomes of \$3,000 or \$5,000 or more, who have no visible property to tax, paying proportionately more for public purposes than are other men with net incomes of \$2,000 to \$3,000 or more who have visible property to tax? If not, is it not the task of legislative and taxing authorities to devise ways and means by which this inequity may be eliminated?

These are serious times in terms of taxes, and it is important that Minnesota have a taxation system which shall come as near as is humanly possible in preserving the equities of every citizen in respect of what comes out of his pocket for state and community purposes. If such a system cannot be arrived at under present constitutional provisions, there is a way to remedy that situation."

## Chapter II.

### HISTORY NATURE AND OPERATION OF STATE INCOME TAXES.

#### Introduction.

The history of state income taxation may be divided into two periods with 1911 as the dividing point. Previous to 1911 the income tax was tried in sixteen states but in every case the experiment resulted in dismal failure. Administrators, publicists and students of taxation consequently concluded that the income tax was unsuited for state purposes. E.R.A. Seligman in his book, "A Study of the History, Theory, and Practice of the Income Tax at Home and Abroad." (1911) said after reviewing the experiments with state income taxation: "From the preceding survey it will be seen how utterly insignificant and unsuccessful have been the experiments with state income taxation in the United States."<sup>1</sup> D.O. Kinsman, a well-known writer on taxation, said: "The experience of the states with the income tax warrants the conclusion that the tax as employed by them has unquestionably been a failure."<sup>2</sup>

The reasons for the failure of income taxation in these sixteen states are summed up in the following statement by Mr. Kinsman:

"A careful study of the history of the tax leads one to the conclusion that the failure has been due to the administration of the laws. The causes operating to produce this failure in administration appear to have been four: the laws themselves

<sup>1</sup>Seligman - Income Tax - p. 418.

<sup>2</sup>The Income Tax in the Commonwealths of the U.S. 1903. p. 116.

have been defective in their provisions for their own administration; the officials have been lax in the enforcement of the laws, the taxpayers have been persistent in evading them; and the nature of the incomes has made them especially difficult to reach."<sup>1</sup> Seligman thinks that these reasons are only secondary and says that the main cause of the failure of state income taxation is "the impossibility of localizing income."<sup>3</sup> Income taxation as a source of revenue for the states seemed entirely out of the question at this time.

In 1911, however, the state legislature of Wisconsin, disregarded all the previous failures with state income taxation and unmindful of the dismal predictions about another attempt in this direction, passed a state income tax to apply to the net incomes from all sources.<sup>3.1</sup> The results of the first year were a great surprise. Where others had so woefully failed, Wisconsin was able to show an income tax levy of \$3,501,166.44 for the first year!<sup>4</sup> This unexpected success changed the attitude of those who had little faith in state income taxation from one of condemnation into one of watchful waiting to see whether the results would be lasting or were only a freak. Several states have followed the lead of Wisconsin and have passed income tax laws.

As the experience of other states will be of the great value in the consideration of an income tax for Minnesota, brief sketches of the nature and operation of the present income tax laws will be presented of the following states: Massachusetts, New York, Connecticut, Oklahoma, Wisconsin and the Federal in-

<sup>3</sup>Seligman - Income Tax -p. 426. 3.1 Certain kinds of income  
<sup>4</sup>Ann. Amer. Acad., Mar. '15 -. '73. are exempted (See MS. p.36.)

come tax law.

The income tax laws of these states are of three kinds: The Massachusetts law taxes only special classes of income, exempting that of real estate; Wisconsin has a general income tax law applying to all kinds of income; Connecticut and New York tax the income of corporations only, while Oklahoma has a personal income tax law.

#### The Massachusetts Income Tax.

Massachusetts has taxed income in one form or another since 1634.<sup>5</sup> In colonial days it employed a crude form of faculty tax. This gradually developed until in 1849 it was made a tax upon the income from business, trade, and professions.<sup>5</sup> In 1836 a tax had been placed upon the income from annuities.<sup>5</sup> These taxes were never of any importance as revenue producers.

The income of intangible personal property was not taxable altho it had grown greatly in amount and importance. Personal property was supposed to be subject to the local tax rate, but as the assessors could not compel a return of this or any other property, it largely escaped taxation.<sup>5</sup> The rate upon the personal property that was reported became so high that many tax payers moved to communities which had more favorable rates or sometimes they even left the state. This gradually threw the burden of taxation upon real estate and such tangible personal property as was attached to it.

The need for reform became so urgent that various com-

<sup>5</sup>Report of Tax Commission 1918 pamphlet, p. 4. "Operation of the Massachusetts Income Tax for the first year April 1918."

missions were appointed to investigate the subject and to propose remedies. The movement towards reform was hastened by the governor's inaugural address in 1911. When it was realized that a change of the constitution was necessary, the proper amendment was enacted and ratified in 1915 by an overwhelming majority.<sup>6</sup>

The present Massachusetts income tax law, which was passed in 1916, is not a general income tax law but taxes only certain kinds of income, and particularly exempts other kinds of income, to avoid double taxation. The chief exemptions apply to the large classes of income from real estate; dividends from Massachusetts corporations and interest from savings bank accounts.<sup>7</sup>

#### Income.

Income falls into four classes which are subject to different rates.

Class I. Net income from business, trade, employment, or profession.

Class II. Interest and dividends.

Class III. Gains from the sale of securities during the year. In case the securities are sold during the year, the tax is on the difference between the value on January 1, 1916 and the selling price. If bought before, the difference in value between Jan. 1, 1916 and the sale price is used as the basis.

Class IV. Income from annuities.<sup>8</sup>

<sup>6</sup>Tax Com. Report, Bul 7, Operation of Mass. Law for 1917, p. 4.

<sup>7</sup>Ibid., p. 5.

<sup>8</sup>Mass. Gen. Acts. '16, Ch. 269, Sec. 2.



### Deductions.

Class I. The deductions from this class of income comprise all those usually allowed to reach an exact figure of true net income. In addition an arbitrary deduction of 5% of the income derived from tangible property owned and used by the taxpayer in his business is allowed in order to avoid double taxation.<sup>9</sup>

Class II. The following kinds of interest are exempt from taxation: interest on deposits in the savings banks of Massachusetts and of the New England states (except Rhode Island) and New York, interest on United States government; commonwealth and municipality bonds; mortgage on real estate which is situated in Massachusetts.<sup>10</sup>

As a general rule the dividends of Massachusetts corporations are exempt.<sup>10</sup>

### Exemptions.

Exemptions under the Massachusetts income tax law are as follows: \$2,000 for a single person, \$2,500 for a married person, and an additional amount for wife and children makes possible a maximum exemption of \$3,000. It is important to note that this exemption applies only to the first class and not the other three classes of income which are taxed under the Massachusetts law. The only exemption that applies to classes II and IV is the provision that persons whose total income from every source, whether taxable or exempt, is under \$600 may

<sup>9</sup>Mass. Tax Comm. Bul. 7, p. 6.

<sup>10</sup>Mass. Income Tax director letter.

claim an exemption of \$300 from taxable interest or dividends or from taxable income derived from an annuity.<sup>11</sup>

Rates.

The rates for 1917 and 1919 are:<sup>11</sup>

Class I. (1917)  $1\frac{1}{2}$  %; (1919)  $2\frac{1}{2}$  %.

Class II. " 6 %; "  $6\frac{1}{2}$  %

Class III. " 3 %.

Class IV. "  $1\frac{1}{2}$  %.

The 3% tax upon the net gains from dealings in intangibles applies equally to the investor, the speculator, the stock broker or any other person who has purchased or sold this class of property within the year. The 6% rate applies to intangible property the taxation of which caused so much trouble under the old law.<sup>12</sup>

Penalties.

For failure to make a return within the time prescribed, a fine of five dollars for every day during which such person is in default is imposed unless the state tax commissioner sees fit to grant an abatement.<sup>13</sup> If no return or an incomplete return is made, the taxpayer is notified by the tax commissioner and given thirty days within which to make a complete return.<sup>13</sup> For failure to comply, a fine of \$100 to \$10,000, imprisonment for not more than a year or both may be imposed.<sup>13</sup> The offender

<sup>11</sup>Letter of Mass. Income Tax Director. 1920.

<sup>12</sup>Mass. Tax Comm-Bul. 4, 18, p. 5.

<sup>13</sup>Mass.Gen. Acts - '16, Ch. 269, Sec. 13.

may also be barred from public office for a period of five years.<sup>13</sup>

### Administration.

The administration is centralized under the tax commissioner, who appoints an income tax deputy and assistants, together with a district assessor and deputies in each of the eight districts of the state. These districts follow county lines, although in a few cases two or more counties are combined into a single district.<sup>14</sup>

During the first year that the law was in operation, every effort was made by the tax officials to run down delinquents. A large number of people had failed to file returns either because of ignorance of the law or, in some cases, with the deliberate design to evade. The department secured returns from 9,000 delinquents and expects to run down as many more.<sup>15</sup>

Extensive lines of investigation have been conducted in the verification of the returns. Various methods were employed, namely: (1) correspondence, (2) interviews, (3) formal examination under oath, and (4) auditing of books of accounts.<sup>15</sup> This last method has proved extremely profitable - in some cases an auditor producing in a single day's work an additional tax in excess of his own salary for the entire year.<sup>16</sup> Another line of investigation that has proved extremely lucrative is that involving the claims of non-residence. A large number of these claimants were determined to be inhabitants of the com-

<sup>14</sup>Mass. Tax Com. Bul. 7, '18, p. 6.

<sup>15</sup>Ibid., p. 9.

<sup>16</sup>Ibid., p. 10.

monwealth.<sup>17</sup> The tax commissioner in reviewing the work of his department during the first year after the passage of the new income tax law, says, "It is thus seen that expensive as the department is to maintain, its labor pays for itself. Taxes thus produced will to a great extent come in automatically for assessment in future years."<sup>18</sup> The department succeeded in collecting 97% of the taxes assessed. This record of collection compares favorably with that of any city in the commonwealth.<sup>18</sup>

#### Returns.

A return is required of all persons receiving any income taxable under the act, or whose total gross income from all sources exceeds \$2,000.<sup>19</sup> Returns are thus often required, although no tax is assessable. Income from real estate is not to be included in the return.<sup>19</sup>

#### Information at the Source.

The law requires taxpayers to report the names and addresses of persons receiving \$1,800 or more in the form of wages, salaries or other compensation during the year. The names and addresses of those receiving interest, dividends, or annuities not specially exempted by law must also be reported.<sup>20</sup> Tax collecting officials have found this information of great value in discovering delinquents. Relations have also been es-

<sup>17</sup>Mass. Tax Com.-Bul. 7, '18, p. 10.

<sup>18</sup>Ibid., p. 11.

<sup>19</sup>Letter of Mass. Income Tax Director. 1920.

<sup>20</sup>Mass. Gen. Acts. 1916, Ch. 269, Sec. 25.

tablished with the federal treasury department and much valuable information has been obtained. This has been supplemented by investigations in New York and the New England States.<sup>21</sup>

#### Application of Proceeds.

The revenue derived from the income tax is distributed to the towns and villages to compensate them for the loss of receipts from the tax on personal property. This loss is determined by subtracting the local receipts obtained from the taxation of personal property in 1917 from that received from the same source in 1915. If any money remains, it is used as an offset to the state taxes that must be paid by the localities to the state government out of the general property receipts.<sup>22</sup>

#### Results.

The yield of the Massachusetts income tax, which falls upon the income of intangible property, can roughly be compared with the yield of the old tax upon the capital value of intangibles. \$8,120,621.07 was required to reimburse cities and towns for the decrease in the total personal property assessed in 1917 from the amount so assessed in 1915. This decrease roughly represents the amount of tax which had been secured locally from intangibles at their capital value plus a smaller amount to allow for a fuller disclosure of tangible property in this year.<sup>23</sup> It is safe to assume that the old tax on capital value was

<sup>21</sup>Mass. Tax Com. Bul. 7, p. 10.

<sup>22</sup>Mass. Gen. Acts. 1916, Ch. 269, Sec. 23.

<sup>23</sup>Mass. Income Com.-Bul. 7, p. 15.

yielding not over \$9,000,000 whereas the income tax produces \$8,697,503.51.<sup>24</sup> In comparing the two figures, one must consider the fact that the new law has a narrower scope, for it exempts \$300 of interest (if the total gross income is below \$600) as well as the incomes of non-resident beneficiaries of estates and trusts.<sup>24</sup>

In 1916 the tax upon the income of business was estimated by the local assessor to have brought \$770,288; in 1917 under the new income tax law it brought \$2,577,061.56.<sup>24</sup>

The three per cent tax upon net gains from dealings in intangibles, which has no parallel under the old law, produced \$836,234.51.<sup>25</sup> The yield on annuities is estimated at \$24,211.51.<sup>25</sup>

The cost of administration for the first year was \$300,000.<sup>26</sup> This amount includes the purchase of equipment as well as other initial expenses that would not arise in subsequent years. The expense of collection is equivalent to 1.86 per cent on the total assessment of \$12,140,000.<sup>26</sup>

In speaking of the income tax during its first year in operation, the tax commissioner said in the 1917 report.

"Both from the point of revenue and the public's satisfaction, the law has proved a decided success. An equitable tax that all can afford to pay has been substituted for one that was driving wealth from the state."<sup>27</sup>

<sup>24</sup>Mass. Income Com.-Bul. 7, p. 16.

<sup>25</sup>Ibid. p. 16.

<sup>26</sup>Ibid., p. 14.

<sup>27</sup>Ibid., p. 17.

New York Income Tax.

In New York the movement towards income taxation was also caused by the breakdown of the personal property tax. Mr. Mills, president of the seventh New York State Conference on Taxation, in an address before the conference in 1917 said: "The case against the tax on personal property as a part of the general property tax has been proved conclusively and with finality.<sup>28</sup> I am inclined, in so far as New York is concerned, to favor the income tax as against the classified property tax."<sup>29</sup>

In the same year New York passed the "Franchise Tax on Manufacturing and Mercantile Corporations." This provides for a tax of three per cent upon the net income of all manufacturing and mercantile corporations organized or doing business in New York.<sup>30</sup> Steam railroads, steamboats, water works, gas lighting and gas companies are subject to another tax and so exempt from the franchise tax.<sup>31</sup> Corporations taxable under this provision are exempt from personal property and capital stock taxes.

The tax must be paid annually in advance for the year beginning November 1st, upon that part of the income of the business transacted within the state. It is computed by the state tax commission upon the basis of the net income for the calendar or fiscal year of the corporation, next preceding as shown by the return of the corporation as filed with the internal revenue

<sup>28</sup>New York State Conference on Taxation. 1917, p. 21.

<sup>29</sup>Ibid., p. 22

<sup>30</sup>Laws of New York, 1917. Ch. 726 par. 210.

<sup>31</sup>Ibid.

collector under the federal income tax law of 1916.<sup>32</sup>

Any corporation failing to file a report as required under the law is liable to a fine of not exceeding \$5,000. Any officer of a corporation who makes a fraudulent return or statement with intent to defeat or evade the payment of the tax is liable to a fine not exceeding \$1,000.<sup>33</sup> If tax is not paid by January 1st following assessment, a penalty of 10 per cent is added together with an additional one per cent for each month in default.<sup>34</sup> The unpaid taxes become a lien upon the real estate and personal property of the corporation.

The law forbids the disclosure of any reports or the contents thereof by any official.<sup>35</sup>

The manner in which the law works is not yet apparent, as it is only a year old. It is expected to work very well, however, because a similar law in Connecticut shows good results.  
(For a discussion of the recent 1919 personal income tax law see Appendix H.)

#### Connecticut Income Tax.

Connecticut has had an income tax law similar to that of New York since 1915. It applies to ordinary business corporations and imposes a two per cent tax upon the net taxable income as reported to the United States government under the federal income tax law of 1916.<sup>36</sup> As public utility corporations are subject to a gross earnings tax, they are exempt from the income tax.

The administration of the law was placed in the hands of

<sup>32</sup>New York State Laws, 1917, Ch. 726, Par. 209.

<sup>33</sup>Ibid., Par. 219 f.

<sup>34</sup>Ibid., Par. 219 ff.

<sup>35</sup>Ibid., Par. 219 i.

<sup>36</sup>Nat Tax Assoc. Proceedings '16, p. 372.



the state tax commissioner with whom the companies are required to file copies of the income returns as made to the internal revenue commissioner.<sup>36</sup> Much the same information is reported to the state. If any corrections are made in the return by the federal department, either to increase or decrease the taxable amount, such change must be reported to the tax commissioner who will compute the additional tax or refund the amount originally overpaid.

The use of the returns made by the companies to the federal department, permits the state of Connecticut to get the benefit of an income tax without building up a special income tax administrative law such as Wisconsin and Massachusetts have, requiring a special, independent, and different detailed report to be made by the corporation.<sup>37</sup> The large costs of collection that must be paid by these two states are avoided by Connecticut in using the federal returns.<sup>37</sup>

The Connecticut income tax has been more productive than was at first expected, yielding \$1,600,000 in 1916." It is a good example of cooperation between the state and the national governments in the administration of income tax laws.

#### Oklahoma.

In 1908 Oklahoma adopted an income tax law that differed from similar laws in other states in that it applied to gross income instead of net income. The law also provided that "the tax shall not be levied upon the income derived from property upon which a gross receipts or excise tax has been paid."<sup>38</sup>

<sup>37</sup>Proceedings Nat. Tax Assoc. '16, p. 421

<sup>38</sup>Proceedings Nat. Tax Assoc. '16, p. 51.

After a ten-years trial, it was found that the income tax was still of comparatively little importance as a revenue producer.<sup>38</sup>

There were several reasons for this failure. The law was glaringly unjust because it taxed gross income without regard to the cost of producing it. Then also the incomes derived from property which paid a gross receipts tax regardless of net profit secured, were exempted from income taxation.<sup>38</sup> The law was consequently very unpopular and was unenforceable. The administration was placed in the hands of the state auditor who was not, however, given adequate supervisory control over local assessment officials nor sufficient funds wherewith to meet the expenses of collection. Owing to the unjust provisions of the law and the difficulty of collection, practically no attempt was made at enforcement. The public was trained to consider the state income tax as largely a donation or free-will offering to the state.<sup>39</sup>

In 1915 the law was amended in response to a widespread demand that income should bear a larger share of the cost of government. The law now subjects the entire net income from all sources to this tax including incomes from property, business, trade, and professions.

The tax collected under this law in 1915 was \$250,000 while that for 1916 was \$500,000.<sup>39</sup> This increase is due to better enforcement resulting from the fact that the auditor was now allowed \$5,000 for meeting collection costs.<sup>39</sup> Tho the percentage increase in the amounts collected is great, the 1916 revenue

<sup>39</sup>Ibid. p. 52.

is small in comparison with that which should have been paid. The federal government in 1916 collected \$4,428,000 thru its personal income tax from Oklahoma citizens.<sup>40</sup> Applying the state rates to the federal classifications, Oklahoma should have collected from these same individuals upon these same incomes the sum of \$2,627,572.<sup>40</sup> In addition to this, millions of dollars of federal income tax were collected from incomes upon property owned and business done in Oklahoma by persons living elsewhere. These incomes are subject to the state income tax but Oklahoma collected only a few thousand dollars in income tax from persons residing outside the state.<sup>40</sup> All things considered, \$4,500,000 to \$5,000,000 is a conservative estimate of the amount of income tax due the state of Oklahoma for the year 1916. Less than ten per cent of this amount has been collected.<sup>41</sup>

The 1917 legislature reduced the income tax rates, so that the highest rate of five per cent on \$100,000 and over is now two per cent. This was done because of a feeling that the former rates were too high. The state is trying to keep rich men from moving their <sup>places of</sup> residence outside the state and ~~their assuming that~~ thereby ~~they can~~ escaping the income tax while still enjoying the profits from the property owned and the business carried on within the state.<sup>42</sup> The amount collected from citizens of the state is not more than fifteen or sixteen per cent of the amount that should have been produced in 1916.<sup>42</sup>

The 1916 income tax receipts exceed the combined collections of the other seven years, yet the revenue for that year

<sup>40</sup>Ibid., p. 53 Proceedings Nat. Tax Assoc. 1916.

<sup>41</sup>Ibid., p. 54

<sup>42</sup>Ibid., p. 54.

is not more than 1.5 per cent of the total tax collected in the state.<sup>43</sup> The total revenue levied by the state and local governments amounted to \$29,000,000. Of this \$23,000,000 was collected by means of the general property tax and \$500,000 by the income tax.<sup>44</sup> Income taxation in Oklahoma has resulted in the same unsatisfactory results as in many other states and the cause seems to be the same, namely lack of properly centralized administration.

#### The Wisconsin Income Tax.

In considering an income tax for Minnesota the experience of the neighboring state Wisconsin will be of the greatest value. The two states are very much alike as to their industries, population, and wealth. Both have a large agricultural population and in both the manufacturing industries are centered in a few large cities. Before the adoption of the state income tax, the same dissatisfaction prevailed in Wisconsin with regard to the general property tax that now exists in Minnesota.

Wisconsin in 1911, adopted the income tax as a means of raising revenue in spite of the fact that the experience with income taxation in some sixteen other states had apparently proved that form of taxation unsuitable for state purposes. In 1903 a joint resolution was introduced into the legislature to amend the state constitution so as to authorize the levy of an income tax.<sup>45</sup> It was adopted with but one dissenting vote. A defect in the notice of election held it up but in 1908 the

<sup>43</sup>Ibid., p. 55. Proceedings Nat. Tax Assoc. 1916.

<sup>44</sup>Ibid., p. 50.

amendment was submitted to the people and carried by the decisive majority of 85,696 to 37,729.<sup>45</sup>

The first draft of the income tax was presented in the legislature in 1909. A joint committee of three senators and four assemblymen was appointed to investigate the subject and to report to the legislature at the next session. Public meetings were held by the committee in all the larger cities and open discussion, suggestions and criticism were invited. When the bill was presented in the legislature in 1911, the first real opposition appeared. Some sixty different amendments were offered - many purposely designed to defeat the law.<sup>46</sup> Towards the end of the session an expert, Dr. Kineman, was engaged to redraft the bill. This he did with the aid of the tax commission.<sup>46</sup>

The law was passed in June 1911 and made to apply to all incomes received during that year.<sup>46</sup> Almost immediately test cases were brought into the courts to determine the constitutionality of the law. In sustaining the law the court said:

"By this act the legislature has, in substance, declared, that the state's system of taxation shall be changed from a system of uniform taxation of property (which so far as personal property is concerned has proven a failure) to a system which shall be a combination of two ideas, namely, taxation of persons progressively, according to ability to pay, and taxation of real property uniformly according to value."<sup>47</sup>

<sup>45</sup>Kennan - Ann. Amer. Acad. Mar. '15, p. 65.

<sup>46</sup>Ibid., p. 66

<sup>46.1</sup> See Note MS. pp.20

<sup>47</sup>Ibid., p. 66

Income.

Income is defined in the Wisconsin income tax law as including rent, dividends, interest, wages, salaries, fees, profits, royalties "and all other gains, profits or income of any kind derived from any source whatever."<sup>48</sup>

Deductions.

There are the usual deductions for "ordinary and necessary expenses," for wages and salaries, for losses, dividends, interest of indebtedness, pensions and inheritances. "Taxes paid on unproductive property are not allowable deductions" but "taxes upon the property or business from which the income is derived" are deductible.<sup>49</sup>

Exemptions

The exemptions consist of \$800 for a single person; \$1200 for husband and wife; \$200 for each child under the age of 18 and and \$200 for each dependent.<sup>50</sup>

Non-residents and corporations are not allowed any exemption but must pay the tax on their whole net income arising from sources within the state.<sup>50</sup>

Rates.

The scale of rates for individuals progresses from one to six per cent. ~~which~~ The increase in percentage of rates is

<sup>48</sup>Wis. Income Tax Law. 1919 p. 6.  
<sup>49</sup>Ibid., p. 20.  
<sup>50</sup>Ibid., p. 22.

accelerated with the progression, <sup>while</sup> the basis of taxable income to which the rate applies advances uniformly by steps of \$1,000.<sup>51</sup>

On the first \$1,000 the rate is one per cent; on the second \$1,000,  $1\frac{1}{2}$  per cent; on the third,  $1\frac{1}{2}$  per cent, and so on until on the 13th \$1,000 it is six per cent.<sup>52</sup> The rates are not as high, however, as would appear at first sight. For example, altho the rate for the 12th \$1,000 is  $5\frac{1}{2}$  per cent, the amount of tax to be paid upon \$12,000 is \$355 or only 2.9582 per cent of the sum.<sup>53</sup> The point at which the maximum rate is reached corresponds very closely to that at which it is attained in European countries - about \$14,390.<sup>54</sup> (See pp.81 for Table)

The rates for corporations are much higher, for they begin with two per cent on the first \$1,000,  $2\frac{1}{2}$  per cent on the second and reach the maximum of six per cent with the 7th \$1,000.<sup>53</sup> This scale of rates was adopted by the 1913 legislature in place of a scheme which was a part of the original law. This law attempted to adjust the rates according to the proportion which the net income bore to the assessed value of the property used in producing the income.<sup>54</sup> It was thought that this would equalize the burden of taxation between corporations of different sizes and prosperity. The plan proved impracticable and to some extent inequitable. During the year it was in force individuals paid on the average of 1.96 per cent while corporations paid 5.4 per cent.<sup>55</sup>

<sup>51</sup>Kennan, Ann. Amer. Acad. Mar. '15, p. 67.

<sup>52</sup>Wis. Income Tax Law. 1919, p. 25.

<sup>53</sup>Ibid. p. 26

<sup>54</sup>Kennan, Ann. Amer. Acad. Mar. '15, p. 68.

<sup>55</sup>Ibid.

Additional rates were added in 1919 under the Soldier Bonus Act and the Educational Bonus Act.<sup>56</sup>

### Penalties.

The penalties are severest for violation of the secrecy of returns. They include fines of not less than \$100 and not more than \$500; imprisonment in the county jail of from one to six months or in the state prison for not more than two years, in the discretion of the court.<sup>57</sup>

For failure to make returns, or for making intentionally false or fraudulent returns, the penalty is a fine of not more than \$500 or imprisonment for not more than one year or both, in the discretion of the court. In addition, the tax upon the amount of the omitted tax may be doubled.<sup>58</sup> Besides these the law provides a penalty of \$5.00 on the assessor for each question left unanswered on an income tax return.<sup>59</sup>

### Administration.

The most important feature of the Wisconsin income tax law is the prominence given to the scheme of administration. It was realized that the main reason for the failure of the income tax in the other states lay in the fact that the administration was in the hands of local officials who were very lax in their methods. Wisconsin sought to avoid this danger by providing for a higher de-

<sup>56</sup> Wisconsin Income Tax Law. 1919, p. 59 ff.

<sup>57</sup> Ibid. p. 49.

<sup>58</sup> Ibid. p. 38.

<sup>59</sup> Ibid. p. 35.



gree of centralization. To this end the administration of the law was placed in the hands of a state tax commission which in turn appointed a "supervisor of the income tax" whose duty it was to arrange all the administrative details of the new law.<sup>60</sup>

### Assessors of Income.

The commission appoints assessors of income who are selected after a rigid civil service examination, with special reference to their character, ability and capacity. They are appointed for a period of three years with salaries ranging from \$800 to \$3,600. The state is divided into 40 districts with an assessor of income located in each.<sup>61</sup> Besides being assessor of the income tax he has also been given the duties of the former supervisor of the assessment of the general property tax. (See MS. p132.

### Returns.

All returns of income by individuals and firms must be made to the assessors of income. The returns are carefully edited and the assessors make an assessment of each case. If the assessor has reason to believe that the return does not disclose the full income, he may increase the amount and notify the taxpayer.<sup>62</sup> Appeal may be made from the assessor's decision to a board of review composed of three men appointed by the tax commission for each assessment district. Final appeal may be made to the tax commission itself.<sup>63</sup>

<sup>60</sup>Kennan, Ann. of Amer. Acad. Mar. '15. p. 60.

<sup>61</sup>Wis. Income Tax. 1919, p. 27 ff.

<sup>62</sup>Ibid. p. 38.

<sup>63</sup>Ibid. p. 59.

Corporations are assessed directly by the tax commission and are given the right of appeal to the circuit court of Dane County, in which the capital of the state is located.<sup>64</sup>

Information at the Source.

The Wisconsin tax commission has organized a system of "Information at the Source", which has been found to work very efficiently and smoothly. The information obtained is classified and arranged and then furnished to the assessors of the respective districts where the recipients of the wages or dividends reside. This system has a great deterrent effect upon taxpayers and assists greatly in making people give proper returns of their income.<sup>65</sup> (Topic further discussed MS. p 142.)

Exemption of Intangibles.

The Wisconsin Income tax is not an additional tax supplemental to the general property tax but a substitute for the tax on personal property. When the income tax was first passed the general laws were amended so as to exempt <sup>property</sup> from taxation, (a) moneys, (b) stocks and bonds, (c) "All debts due from solvent debtors whether on account, note, contract, bond, mortgage or other security, or whether such debts are due or to become due."<sup>66</sup>

In order not to put the owner of tangible personal property at a disadvantage as compared with the owners of intangible property, the former may use his personal property tax receipt

<sup>64</sup>Wis. Income Tax. 1919, p.39..

<sup>65</sup>Kennan, Ann. Amer. Acad. Mar. '15, p. 71

<sup>66</sup> *ibid*, p.71.

as cash in paying the income tax. This is called "offsetting."<sup>67</sup> For example, if a person's income tax is \$50 and his personal property tax \$30 he can turn in the personal property tax receipt and \$20 as full payment of the income tax.

#### Application of proceeds.

The Wisconsin income tax is not a state income tax in the sense that it is applied only to state purposes.<sup>68</sup> The law provides that 70 % of the amount collected shall go to the local taxing unit (city, town, or village) where it was collected; 20 % to the county and the remaining 10 % to the state. This 10 % is to reimburse the state for the expenses of collection.<sup>69</sup> In practice it has been found that only 20 % of the state's share is necessary to pay the total cost of administration.<sup>70</sup>

#### Income From Interstate Commerce.

Wisconsin has attempted with some success to tax the income from interstate trade. A method of allocation is provided for by law to determine the share of the interstate income of an enterprise subject to the Wisconsin income tax. The value of the gross business of the corporation in the state plus the value of the property in the state is used as the numerator of a fraction the denominator of which is the sum of the total gross value of the business of the corporation both within and without the state, and, the full value of the entire property.

<sup>67</sup>Wis. Income Tax, 1919. p. 51

<sup>68</sup>Kennan - Ann. of Amer. Acad. Mar. '15, p. 71.

<sup>69</sup>Wis. Income Law. 1919. p. 27.

<sup>70</sup>Kennan - Ann. Amer. Acad. 1915. Mar. p. 69.

of the corporation. The fraction so obtained shall represent the proportion of the capital stock represented within the state.<sup>71</sup>

This method is somewhat complicated and arbitrary and sometimes leads to grotesque results. It has worked fairly smoothly, however.<sup>72</sup> In speaking of the interstate corporations the Wisconsin tax commission says in its report:<sup>72</sup>

"The Wisconsin income tax has, on the whole, encountered very little difficulty with this class of taxpayers.....The large foreign corporations have dealt quite as fairly with the Wisconsin income tax as any other class of taxpayers. It is just as easy to assess the big interstate corporations under the income tax as it is under the property tax."<sup>72</sup>

### Results.

As a fiscal measure the results of the Wisconsin income tax far surpassed the expectations of even its most enthusiastic supporters. During the first year many predicted that Wisconsin would fare no better with the income tax than the other states which had tried it and that the amount collected would probably not even cover the cost of collection. The supporters estimated that the yield would probably be about \$1,000,000 the first year and that many peculiar difficulties of administration would be met in the first year of operation.<sup>73</sup>

It was a great surprise to all therefore when the income tax levy of the first year amounted to the very respectable sum

<sup>71</sup>Wisconsin Income Tax - 1919. p. 8.

<sup>72</sup>Ann. Amer. Acad. Mar. '15, p. 73.

<sup>73</sup>Kennan - Ann. Amer. Acad. Mar. '15, p. 73.

of \$3,501,166.46.<sup>73</sup> In 1918 it amounted to \$11,830,142.<sup>74</sup>

This remarkable showing will perhaps be better appreciated when compared with the first year's yield of the Civil War Income Tax of 1868 which was \$2,741,858 - only 78.3 % of Wisconsin's first levy.<sup>73</sup> For the year ending December 31, 1912, the Wisconsin law levied \$2,793,605.40<sup>on</sup> corporations while the federal tax on corporations in Wisconsin amounted to only \$575,550.61.<sup>75</sup> Of the latter amount 29 % was from railroads, public utility corporations, insurance companies and national banks which were exempt from the state income tax.<sup>75</sup> During its first year, the federal income tax law of 1913 collected \$220,642 from individuals, \$497,785 from corporations, or a total of \$718,427<sup>75</sup> as against \$2,002,212 collected by the Wisconsin tax.<sup>76</sup> The difference in rates and exemptions must of course be taken into consideration. From this comparison it seems evident that the Wisconsin income tax brought to light much more corporation income than did the federal law during the same period.<sup>75</sup>

The amounts of revenue collected by the Wisconsin income tax have very much exceeded the losses occasioned by the exemptions of intangible personal property. A careful investigation by the tax commission disclosed that the exemption caused a loss in revenue of about \$700,000<sup>for</sup> one sixth of the income tax levied.<sup>75</sup> In 1912 about 37% of the whole income tax was paid by personal property tax receipts.<sup>77</sup> Thus the amount raised

<sup>74</sup>Wis. Tax Com. Report '18, p. 3.

<sup>75</sup>Ann. Amer. Acad. Mar. '15. p. 74.

<sup>76</sup>Wis. Tax Com. '16, p. 54.

<sup>77</sup>Ann. Amer. Acad. Mar. '15, p. 74.

by means of the income tax in Wisconsin is about 50% more than was raised by the personal property tax.

The total cost of administration in 1916 was approximately \$104,000. Of this amount \$54,000 went to the assessors of income as supervisors of the general property tax. The cost of administering the income tax was thus \$50,000. On the basis of actual cash collections, the income tax cost for the fiscal years of 1915 and 1916 was respectively 2.20 and 2.62 per cent. This makes the Wisconsin income tax one of the least expensive direct taxes collected in any country.<sup>78</sup>

The attitude of the average citizen is of the greatest importance in the success of any tax law. During the first year of the operation of the income tax great opposition appeared on all sides. A political campaign was fought out on the question of income tax or no income tax. But the opposition has died down and now the public opinion throughout the state is that "the income tax has come to stay" and that, however objectionable in some respects, it is a distinct improvement upon the personal property tax which it has supplanted.<sup>79</sup>

#### The Federal Income Tax Law.

One of the most important problems of state income taxation is the proper cooperation with the federal government in the taxation of incomes. It is therefore desirable that state

<sup>78</sup>Wis. Tax Com. Report. '16, p. 69.

<sup>79</sup>Ann. Amer. Acad. '15, Mar. p. 75.

Wis. Tax Comm. '16, p. 41.

income tax laws be modeled after the federal law, as far as local conditions and considerations will permit in order to facilitate the administration of the laws and to avoid undue friction between the two jurisdictions. With this point in mind, a brief description will here be given of the Federal Income Tax Law of 1918 to indicate the main provisions of that act.

### History.

Although the states imposed taxes upon incomes from the earliest colonial days, the federal government did not resort to this method of raising revenue until the time of the Civil War. In 1863 Congress passed an income tax law which with some changes remained in force until 1872.<sup>80</sup> While a fair amount of revenue was thus secured, the income tax did not work very satisfactorily being finally repealed because of the wholesale evasions.<sup>80.2</sup>

Agitation for some kind of tax upon incomes continued, however, and finally resulted in the incorporation of a provision in the Wilson Act of 1894<sup>80.2</sup> providing for an income tax. The supreme court declared this provision unconstitutional. The popular demand for an income tax increased and finally in 1913 led to the ratification of the sixteenth amendment which authorizes congress to pass laws taxing incomes.<sup>81</sup> In the same year such a law was passed and with numerous changes in succeeding years has now become a great engine for collecting revenue.

<sup>80</sup>1 The amendment gave Congress power to tax incomes without without apportionment.

<sup>80</sup> Seligman. *The Income Tax*. 1914 pp. 435 and 466  
<sup>80.2</sup> *ibid* pp 476 and 505

It will very likely remain a permanent part of our national fiscal system.

Imposition of the Tax.

The statute imposes an income tax on individuals, including a normal tax and a surtax. The tax is upon the net income after deducting from gross income the allowable deductions. *Corporations are subject to income and excess profits taxes under the Act.*

Gross Income.

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 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 and income derived from any source whatever." The gross income of a corporation is the same as in the case of an individual. (Sec. 212. Rev. Act. 1918.)

Deductions.

Among the deductions allowed from gross income are "debts ascertained to be worthless and charged off within the taxable year, and, in case of corporations, all dividends received from corporations which are taxable upon their net incomes"; "all the ordinary expenses incurred during the taxable year in car-



rying on any trade or business including salaries or other compensation for personal services actually rendered;" "all interest paid or accrued on indebtedness;" "all taxes paid or accrued within the year imposed by the United States or any state or subdivision thereof;" "losses sustained, if not compensated by insurance; a reasonable allowance for depreciation; obsolescence and amortization" and charitable contributions. (Sec. 234. Rev. Act. 1918)

Exemption.

The statute allows a personal exemption of \$1,000 to each single person; \$2,000 to the head of a family and \$200 for each person dependent upon the taxpayer. Children over 18 years are not considered dependents.

The law also permits an exemption from the normal tax of dividends received from corporations which are subject to the income tax. (Sec. 216. Rev. Act. 1918.)

Rates.

Net incomes not in excess of \$4,000 are subject to a normal tax rate of 4 % while those in excess of \$4,000 are subject to an 8% normal tax. (Sec. 210 Rev. Act. 1918.)

In addition to these normal rates the law provides for a surtax upon higher incomes. On the first \$1,000 above \$5,000 the rate is 1%; upon the \$2,000 above \$6,000, it is 2%; upon the next \$2,000 it is 3% and so on until upon the \$2,000 between \$98,000 and \$100,000 it is 48%. The rate then increases until it is 65% upon the net incomes above \$1,000,000. (Sec. 211. Rev. Act. 1918.)

Returns.

Every individual<sup>1</sup> having a net income for the taxable year of \$1,000, if single, or \$2,000, if married and living with husband or wife, is required to render a return even though such individual may not necessarily be subject to the tax. (Sec. 216 Rev. Act. 1918.)

"Returns are to be made to the collector of internal revenue for the district in which the taxpayer has his legal residence or in the district in which is located his principal place of business." (Sec. 241. Rev. Act. 1918.)

Penalties.

"For failure to file the return within the time prescribed by law, a penalty of 25% of the amount of the tax is imposed and in the case of a fraudulent return, willfully made, a penalty of 50% of the tax is to be added." (Sec. 3176. Revised Statutes. 1918) In addition a specific penalty of from \$1,000 to \$10,000 or imprisonment for not more than one year may be imposed (Sec. 253. Rev. Act 1918)

Information at the Source.

"Every person, corporation, or partnership making payments of gains, profits or income of any description which are either fixed or determinable to any other person or partnership amounting to \$1,000 or more in any year is required to make return of such information to the Commissioner of Internal Revenue, giving the amounts of such payments and the names and ad-

<sup>1</sup> State and government officials are exempted by an administrative ruling.

dresses of the recipients." (Sec. 256. Rev. Act. 1918.)

### Collection at the Source.

Withholding the tax at the source is limited in application to non-resident alien individuals and foreign corporations not having any office or place of business in the United States, except in the case of obligations containing the so-called tax-free covenant. (Sec. 221. Rev. Act. 1918.)

### Administration.

The administration of the federal income tax law is in the hands of the Commissioner of Internal Revenue who is subject to the general supervision and control of the Secretary of Treasury.<sup>2</sup> The commissioner is aided by an Assistant Deputy and five Deputy Commissioners. The income and excess profits taxes are collected through local collectors of internal revenue who have charge of the collection of all internal revenue.<sup>2</sup> These local collectors are in closest touch with the taxpayer and are responsible for the proper collection of taxes. "It is the duty of the collector to cause his deputies to proceed thru every part of the district and inquire concerning all persons therein who are liable to pay any internal revenue taxes and all persons owing or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate such objects." (Sec. 3172 Rev. Stat.) The local collectors forward all the returns to Washington where the assessments

<sup>2</sup>Montgomery, R. H. Income Tax Procedure, 1919. p. 33.

are made by the Commissioner of Internal Revenue.<sup>3</sup> A good deal of criticism has been directed against the organization of the Bureau on the ground of overcentralization.<sup>3</sup> It seems an unnecessary amount of work to send all the returns to Washington; the assessment could just as well be made at the local revenue office.

### Results.

The federal income tax has proved a very important source of revenue for the government, especially after the war began. In 1913 the tax upon the incomes of individuals and corporations was 5.2% of the total revenue collected.<sup>4</sup> In 1914 it was 8.2%; in 1915, 11.5%; in 1916, 16.3%; in 1917, 32.3% and in 1918 it was 68.1% of all the government receipts.<sup>4</sup> The federal income tax brought the tremendous sum of \$2,838,900,000 in 1918.<sup>4</sup> The taxation of income has become a permanent part of our federal fiscal system.

### Conclusion.

The foregoing survey of the nature and operation of the income tax laws of five states and of the federal government shows that:

1. State income taxation can be made to work.
2. To be successful the income tax laws must be carefully drawn up. Wisconsin put the drafting of its law in the hands of a committee and an expert who freely consulted the vari-

<sup>3</sup>Montgomery, R. H. Income Tax Procedure. 1919. p. 33.

<sup>4</sup>Blakey, R. - Amer. A. Rev. 1919. June, p. 240.

ous interests in the state and who aimed to adjust the law to conditions existing within the state.

3. The income tax can be made a valuable source of revenue for both the state and national governments.

4. The success of state income taxation depends mainly upon the provision of properly centralized administrative machinery. The success of the Wisconsin, Massachusetts, Connecticut and federal income tax laws is due to the centralization of administration. The states which had failed to make the income tax work had used the local, decentralized form of administration.

5. The income tax corrects the most serious defects of the general property tax. It is a much better tax than the personal property tax because it tends to raise the burden of taxation off the shoulders of the poor and to put it upon the rich. It also furnishes more revenue than the personal property tax and makes possible a reform of our state taxation system.

6. The adoption of income taxation in the United States is in accord with a like European movement which took place during the 19th century.

(p.52. The discussion in the original draft of the paper is here omitted and inserted elsewhere.)

<sup>5</sup>Seligman, E.R.A. - Income Tax. 1911, p.3.

## CHAPTER III.

### THEORY OF INCOME TAXATION.

The extension of government activities into many new and hitherto untouched fields necessitates the raising of more revenue to meet the increased expenditures. The old systems of taxation must be altered to meet the changed conditions. Methods of taxation that were formerly satisfactory, both from the standpoint of revenue and that of equality, are no longer adequate. Our tax systems must be changed so that they will conform more closely to the accepted principles of justice in taxation.

#### Principles of Taxation.

Adam Smith in his famous book: "The Wealth of Nations" laid down the following principles to be observed in taxation: equality, certainty, convenience, and economy.<sup>7</sup> He was one of the first writers to recognise that taxation should be guided by certain fundamental principles instead of expediency, which had till then been the guide.

Bastable, an eminent English writer on public finance, maintains that these principles are inadequate.<sup>8</sup> He says that the main principle that should guide the practical financier in taxation is that of productiveness.<sup>8</sup> He avers that the chief purpose of a tax is fiscal. If it doesn't produce revenue, it

<sup>7</sup>Adam Smith - Wealth of Nations. Bk.V, Ch.2, pt.2  
<sup>8</sup>Bastable, C. F., - Public Finance p. 376. 1898

is worthless, even if it has all the other good qualities of a tax. In the second place, a tax should be economical, that is, inexpensive in collection and of such a nature as to retard as little as possible the growth of wealth. Then, thirdly, it should be justly distributed, and, fourthly, elastic. That the tax should be elastic and convenient he regards as matters of less interest, these canons being now generally observed.<sup>8</sup> The Committee of the National Tax Association which was appointed to draw up a model plan for a system of state and local taxation, stated that "the fundamental purpose of a tax is to provide revenue, which it will be agreed, ought to be raised as equally, certainly, conveniently and economically as possible."<sup>9</sup> The income tax must be examined to determine how far it conforms to these principles and in what respects it should be changed so as to incorporate these fundamental principles as fully as possible.

As the movement towards state income taxation is due largely to dissatisfaction with the general property tax and to a demand for such improvements or such a substitute as will remove the glaring inequalities of the personal property tax, the most important point to be held in mind in the consideration of state income taxation is the degree to which it meets the requirements of equality. As C. H. Mote says in speaking about Indiana's tax problems: "The problem is not to raise more revenue but to distribute present burdens of taxation more

<sup>9</sup>Report of Model Plan Committee, 1918, p. 3. N. T. A. Pro. 1919, p. 462 ff.

equitably."<sup>9.1</sup> The same note is struck in every other state where a change of the existing tax system is discussed. Seligman says that the income tax is not needed for revenue or elasticity or as a makeweight but to redress existing inequalities and to reform the state and local tax systems.<sup>9.1</sup> (See also Appendix A.) The Benefit Theory.

Each person should contribute a just share to the support of the government. The determination of what is a just share is not an easy matter, for people differ widely in wealth, earning power, and tax paying ability. Two principles of justice are used in taxation. The first one is the benefit theory.

This doctrine holds that a man ought to contribute to the public burdens in proportion to the benefits he receives.<sup>10</sup> Special assessments for the improvement of a street are based upon the benefits supposedly derived by the adjoining property. When fees are collected for the registration of deeds and mortgages, such payments are supposed to be for the benefit that accrues to the owners. Benefit is not, however, measurable in the case of wars, health regulations, road-building and many other government activities.<sup>10</sup> A century ago the benefit theory was used more frequently, for it was held that as the state protects everyone, everybody was under the duty to pay taxes.<sup>10</sup> This conformed to the principle of universality of taxation.

At present it is generally agreed that taxes are not paid for protection or benefits but because we are a part of the state. The duty of protecting and supporting it are born with us. We cannot live without its confines if we want to enjoy the fruits of civilization.<sup>11</sup> All our actions are condi-

<sup>9.2</sup>The Income Tax 1914. p. 642.

<sup>9.1</sup>Note - Nat. Tax Assoc. 1917, p. 250.

<sup>10</sup>Seligman - The Income Tax. 1914, p. 71.

<sup>11</sup>Ibid. p. 72.



tioned by the existence of the state. It is not chosen by us but we are born into it and it is as much our duty to support it, as it is to support ourselves or our family.<sup>11</sup> The benefit theory is inadequate as a standard of justice because it is based upon the assumption that benefits can be accurately measured, that we are members of the state by choice and that we are not integral parts of the state.<sup>11</sup>

#### The Faculty or Ability-to-Pay Theory.

Although we use benefit as a standard of justice in some parts of our taxation system, students of finance are practically agreed that faculty or ability to pay furnishes the best *principle* of justice.<sup>12</sup> Ability to pay is not only the ideal basis of taxation but the goal towards which society is steadily working.<sup>13</sup> "History shows the gradual development of the principle of faculty or ability to pay - that each individual should be held to help the state in proportion to his ability to help himself."<sup>14</sup> With the general acceptance of the ability to pay standard, we must next determine an accurate measure of ability.

#### Measures of Ability to Pay.

History points out the use of several measures of ability. The first one of these was the individual or poll tax. This was fairly suitable under primitive conditions when the idea of property was not well developed but at present it is rapidly

<sup>12</sup>Rawles - Nat. Tax Assoc. Proceedings, 1916. p. 71.  
<sup>13</sup>Seligman - The Income Tax. 1914, p. 72.  
<sup>14</sup>Ibid., 1911, p. 4.

being abandoned even as a supplementary test.<sup>15</sup>

Produce or product is also used as a measure of ability. This is well illustrated in our present gross earnings taxes. The chief fault with this measure is that it doesn't take account of indebtedness nor the net produce. Two companies may have the same gross earnings but one may be unable to pay its expenses while the other may have a large net profit. In such cases gross earnings would not be a good measure of ability to pay and should therefore be restricted to public utility companies and others operating under similar conditions.<sup>16</sup>

Expenditure is used as a test of faculty in the case of direct and indirect taxes on consumption. It is defective as a measure because expenditures are a large percentage of revenue in the case of the poor man and a small percentage in the case of the rich man who has a large surplus.<sup>17</sup> It was largely because of the inadequacy of expenditure as a norm that the federal income tax was adopted.<sup>17.1</sup>

Property is at present the chief test of ability but its defects are becoming more and more apparent to all. The value of property is the capitalization of its income or product. This is true in the long run but for short periods of time there may be a gap between the value of property and of income.<sup>18</sup> The value of two adjacent farms will not be changed by the fact that the crop of

<sup>15</sup>Ibid., 1911, p. 5.  
<sup>16</sup>Ibid., p. 14.  
<sup>17</sup>Ibid., p. 12  
<sup>17.1</sup>Ibid., p. 640  
<sup>18</sup>Ibid., p. 6 - 10.

one farmer was destroyed <sup>by hail (he</sup> and received no income while the other had a bountiful crop. The property test of ability is also defective in that it does not reach labor incomes nor make allowance for indebtedness or the expenses of maintaining property.<sup>18</sup> Neither does it distinguish between consumptive and productive property, or between productive and unproductive property. Its chief fault as a test of ability has been the difficulty of reaching all property. The general opinion among students of taxation is that property is no longer satisfactory as a test of ability to the degree that it was in the past.<sup>18</sup>

#### Income as a Measure of Ability to Pay.

The rapid progress of income taxation in so many of the civilized countries of the world has been due largely to the growing conviction that income is superior to property as a test of ability to pay. Delos O. Kinsman, in writing about the experience of the states with income taxation says: "People have turned to income taxation because they believe in the theory that the individual should contribute to the support of the government according to ability and that income is the most just measure of that ability. This is the reason for the movement towards income taxation in spite of its failure in so many states."<sup>19</sup>

Income is defined by Seligman as "that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in

<sup>19</sup>A Jour. of Econ. Feb. 1909. p. 306.

consuming it, his capital remains unimpaired."<sup>20</sup> When speaking of income, we mean not gross income but net income, which is arrived at by making certain deductions from gross income.

As all taxes are normally paid out of income, it is a better test of ability than either expenditure, produce, or property.<sup>21</sup> A man's property is a rough measure of his ability to pay but the income he receives is a much better test, being the fund out of which he must normally pay all taxes whether they be consumption, property, or income taxes. One of the chief arguments advanced in favor of income taxation is the failure of the property tax to reach labor, professional, and speculative incomes. The income tax being a tax upon the richer classes is much superior to the personal property tax which falls most heavily upon those who are least able to pay, that is; widows; orphans, and the helpless; while the rich, because of their large holdings of personal property, escape their just share. Although the personal property tax failure is due to a large extent to inefficient administration, personal property has some inherent defects which make it unsatisfactory as a measure of ability. Intangible personal property, for instance, is hard to discover and tangible personal property, being composed mostly of consumption goods and productive goods which depreciate easily, is difficult to value correctly. The movements for the exemption of personal property from taxation is a recognition of its inadequacy as a test of ability.<sup>21.1</sup> Income

<sup>20</sup>Seligman - Income Tax. 1914. p. 19.

<sup>21</sup>Bullock - Nat. Tax Assoc. Proceedings, 1916. p. 374.

<sup>21.1</sup>Minn. Tax. Com. Report. 1916. Ch. VII.

is also a better measure of ability because it makes allowance for debts, losses, and the cost of maintaining property. The property tax hits a business concern with a deficit just as hard as it does a firm with a large profit. The income tax takes only from the latter. In taking the income of the whole year as a base, the income tax is superior to the property tax which takes the value of property as on a certain day such as May 1st. The taxpayer who has an occupation which does not require him to have much property on hand that day has an advantage over the man who happens to have much property on that day.

Although income is superior to property as a measure of ability, it is by no means a perfect test. The first great difficulty with income as a test is the fact that income does not represent the same ability in all cases. Income is divided into two general classes, earned and unearned. In the first class are the incomes derived from labor and personal services; in the second are those derived from property and transactions. This peculiarity of incomes is remedied in some present day income tax laws by differentiating between the kinds of income and applying different rates. The Massachusetts income tax law is a good example. (See Ch. II, p.22-27). The problem of earned and unearned increments is dealt with more fully in Chapter VI under the heading of differentiation.

Another peculiarity of income is the fact that the income of a poor man does not represent the same ability taken dollar for dollar as the income of the rich man. Our income taxes deal with this peculiarity by the devices of exemption and progression.

(See Chapter VI.) The Swiss advocates of the general property tax consider the income tax seriously defective because it exempts rich men from taxation upon luxurious consumption as evidenced by the possession of costly furniture, valuable paintings and lavishly appointed stables.<sup>22</sup> The devices of exemption and progression as used in our income tax law do not correct this defect very well, for the rich man who invests in productive enterprises is taxed the same as the one squandering his money in luxuries.

Another defect of the income tax is the taxation of the successful business enterprise which has a profit and the failure to reach the unsuccessful concern. Both concerns get the same amount of benefit from the government but the successful concern is in a way forced to pay higher taxes so that its unsuccessful competitor may escape his due share. As a result the efficient, progressive must help the inefficient, unprogressive concerns. The property tax was too harsh upon the unfortunate concern but the income tax is too lenient upon those concerns which happen to have no net profit because of misfortune or inefficiency.

The income tax is also defective in that it includes all money incomes while the large field of psychic incomes is left untouched. The federal income law taxes a man on the rent he received from his house, but if this man happens to live in his own house he did not have to pay a tax on the rent he would have received if the house had been rented. The Wisconsin income

<sup>22</sup>Bullock - N. T. A. Proceedings, 1916. p. 374.

tax law provided for the taxation of both received and enjoyed rent. In 1919 the law was amended to exempt the latter because it was impossible to administer this part of the income tax effectively.<sup>23</sup> As psychic incomes are indeterminable in most cases, income may be defined for tax purposes as being composed of money income and the occasional inclusion of such psychic incomes as are notorious and easily calculable.<sup>23.1</sup>

From the foregoing discussion it will be seen that income is not a perfectly satisfactory and ideal test of faculty. "It must be supplemented by the other tests of faculty in order to form a well rounded whole. Each of the preceding tests, while unsatisfactory in itself, possesses some advantages which can be utilized in framing a system of taxation - each in turn can be employed as a partial test of faculty to fill out certain gaps."<sup>23.2</sup> To get approximate justice in our taxation system, consumption, product, poll, property and income must be used as tests of ability to pay wherever they tend to bring the greatest equality.

The committee appointed by the National Tax Association to draw up a model system of state and local taxation realized the inadequacy of income as a sole measure of ability and therefore proposed a system of taxation composed of three separate taxes: a personal income tax; a property tax and a business tax. It said: "It is evident that the combination of taxes we have recommended will give better results than any one tax, however levied, which is made to yield the same amount of revenue.

<sup>23</sup>Wis. Income Tax Law. 1919, p. 6.

<sup>23.1</sup>Seligman - The Income Tax, 1914. Ch. I.

<sup>24</sup>Nat. Tax Assoc. 1919, p. 459 f.

With the best drawn law and the very best of administration, there will always be a certain amount of inequality in the operation of any tax. If therefore, all the revenue needed is derived from but one tax, such inequality as inevitably arises will be concentrated at a few points where it can not be mitigated. But under a system by which the same amount of revenue is collected from separate taxes levied upon income, property, and business, it is clear that such inevitable inequalities as arise in the working of any one tax may be, and to a considerable extent must be, offset or mitigated by inequalities arising under the others. By the mere law of probability it must happen that the inequalities arising under the three separate taxes will not all be concentrated at the same point, and that some of them will to a certain extent compensate for others."<sup>24</sup>

<sup>24</sup>Nat. Tax Assoc. 1919, p. 459 f.



## CHAPTER IV.

### THE PERSONAL INCOME TAX.

#### Introduction.

In drawing up the model plan for state and local government, the committee of the National Tax Association sought chiefly to eliminate the double taxation that results from the present lack of interstate cooperation in taxation. The plan does not contain any new principles of taxation but seeks to have the states apply consistently those principles which they now recognize in their tax laws, but which they misapply. The first of the three taxes proposed is a direct personal tax "which was based on the principle that each person having taxable ability should pay some sort of a direct personal tax to the government under which he is domiciled and from which he receives the personal benefits that government confers."<sup>1</sup> The second is a tax on tangible property, by whomsoever owned, "based on the principle that property should be taxed by the jurisdiction in which it is located, because it there receives protection and other governmental benefits and services."<sup>2</sup> The third is a tax on business based upon the principle that business carried on for profit in any locality should be taxed for the benefits it receives."<sup>2</sup>

As the model plan for state and local taxation was drawn up by students of taxation and by eminent tax experts and administrators who are members of the National Tax Association, an or-

<sup>1</sup>Nat. Tax Assoc. 1919, p. 430

<sup>2</sup>Ibid. p. 431.

ganization representing the best authorities on taxation, the model plan will undoubtedly stand as the first great step towards the improvement of state and local taxation the United States. Any tax reform proposed for any state should therefore be based upon this model plan.

The rest of this paper will be devoted to a consideration of state income taxation with a view to drawing up such an income tax plan for the state of Minnesota as will conform to the model plan, fit existing conditions within the state, and eliminate the glaring inequalities of the general property tax.

To make the tax system of Minnesota conform to the model plan, it should be composed of two separate taxes: a personal income tax and a business tax. The present Wisconsin income tax is composed of a personal and a corporation tax. These could easily be changed into the kind of taxes recommended in the model plan. Massachusetts has a personal tax, since it is in no case levied upon non-resident persons or interests.<sup>3</sup> It is, therefore, a proper nucleus for a personal income tax but does not fulfil the functions of the business tax.<sup>3</sup> The corporation income taxes of Connecticut, New York, West Virginia, and Montana may be classified as business taxes.<sup>3</sup> The experience of these states with the two kinds of taxes is of great value in an attempt to work out an income tax for Minnesota.

#### Kinds of Personal Taxes.

A personal tax is to be levied with the exclusive view of carrying out the principle that every person having taxable

<sup>3</sup>Model Plan Committee Preliminary Report. 1919. p. 36.

ability should pay a direct tax to the government under which he is living.<sup>4</sup> There are four kinds of personal taxes which can be used for this purpose.

The first one of these is the poll tax. This kind of tax is utterly inadequate to accomplish the object in view, and can at best be used only as a supplement to an adequate system of personal taxation.<sup>4</sup> The second kind of personal taxation is the net fortune tax.<sup>4</sup> This is used to some extent in Europe, but could hardly be recommended as a means of securing revenue because it is foreign to American ideas and of doubtful constitutionality. The third kind of personal tax is the presumptive income tax which is levied upon persons according to certain external indicia which are taken as satisfactory measures of taxable ability.<sup>5</sup> House rent is the index usually used in presumptive income taxes. Such a tax is comparatively easy to administer and would raise no difficult constitutional questions but house rent is after all a very imperfect and inadequate indication of a taxpayer's income and could not yield as favorable results as a better form of personal tax.

The fourth form of personal taxation is the personal income tax. "By this is meant a tax levied upon persons with respect to their incomes which are taxed not objectively as incomes but as elements determining the taxable ability of persons who receive them. This tax is better fitted than any other to carry out the principle that every person having taxable ability shall make a reasonable contribution to the support of the government under

<sup>4</sup>Ibid. p. 10

<sup>5</sup>Ibid. p. 11

which he lives. It is as fair in principle as any tax can be; under proper conditions, it can be well administered by an American state, as Wisconsin and Massachusetts have proved; it is a form of taxation which meets with popular favor at the present time, and therefore seems to offer the line of least resistance."<sup>6</sup>

#### What Income Includes.

The model plan provides that the personal income tax shall be levied in respect of the citizen's entire income from all sources.<sup>7</sup> This recommendation agrees <sup>in general</sup> with the present practice in income taxation. The Wisconsin Income Tax Law provides that "the tax shall be assessed, levied and collected upon all income, not hereinafter exempted, and shall include all rent, dividends, interest, wages, salaries, fees, profits, royalties and all other gains, profits or income."<sup>8</sup> The federal law provides that "there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax and a surtax."<sup>9</sup> The Massachusetts income tax differs from the foregoing in that it applies only to net income from business, trade, employment and profession; interests and dividends; gains from the sale of securities and annuities.<sup>10</sup> The only exemptions that should, and of necessity must be allowed in a state personal income tax are the interest on federal securities and the salaries of federal offices. The practice of exempting state and local bonds should be abandoned as soon as possible "for the personal obligation of

<sup>6</sup>Ibid. p. 12

<sup>7</sup>Ibid. p. 14.

<sup>8</sup>Wisconsin Income Tax Law, 1919, Sec. 1087 m-2

<sup>9</sup>Revenue Act of 1918. Sec. 210

<sup>10</sup>Mass. Commissioner of Taxation, Letter. Jan. 1920.

the citizens to contribute to the support of the government under which he lives should not be affected by the form his investments take, and to exempt any form of investment can only bring about an unequal, and therefore an unjust distribution of this tax."<sup>11</sup>

The experience of Wisconsin with income taxation indicates that in actual practice it may prove better to exempt certain kinds of income. In 1917 the Wisconsin income tax was amended so as to exempt the "estimated rental of residence property occupied by the owner."<sup>12</sup> The Tax Commission recommended this change of the law in its 1916 report alleging that it was difficult to determine the rental with any degree of accuracy, that such taxation lead to general adverse criticism of the law, that it gave rise to clashes and dissatisfaction of owners and officials and that the aggregate taxable income from that source was negligible.<sup>13</sup> Another problem that often arises is the difficulty of separating capital and income. The Wisconsin Tax Commission quotes Seligman's definition: Income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption so that in consuming it, his capital remains unimpaired.<sup>14</sup> The courts will have to be called upon to determine the exact division when doubtful cases arise. Such a decision was rendered March 8, 1920 by the U. S. Supreme court when it declared that stock dividends are capital and so not tax-

<sup>11</sup>Report of Model Plan Committee, 1919, p. 14.

<sup>12</sup>Wis. Income Tax Law, 1919, Sec. 1087 m-2. p.6 (Pamphlet).

<sup>13</sup>Ibid. 1916 p. 46.

<sup>14</sup>Wis. Tax Com.-- The Wis. Income Tax Law. 1919, p. 7.

able as income under the federal law.<sup>14.1</sup>

### Deductions.

Net income is a far better test of the individual's ability to pay than gross income which makes no allowance for expenses. The federal income tax law defines net income as gross income less the allowable deductions.<sup>15</sup> Seligman calls it the amount above all necessary expenses of acquisition and available for consumptive use.<sup>16</sup> The determination of net income is the real problem of income taxation. The problems of making deductions from gross income to obtain the net income are the most numerous and general in income taxation. They cause much irritation to the taxpayers and involve an endless amount of supervision on the part of assessors.<sup>17</sup> Since many deductions are wholly intangible, their determination is entirely dependent upon human judgment and no solution can be "absolutely right or exact."<sup>17</sup>

The difficulties of making deductions are not, however, sufficient to destroy the usefulness or to embarrass the operation of the income tax if the administration is by conscientious and industrious men.<sup>17</sup> The same kinds of problems are inherent in direct and advalorem taxes. The difficulties encountered in allowing deductions are limited by the fact that the margin of possible difference in varying estimates, while important, is restricted in range.<sup>17</sup> Then also the difficulties diminish with

<sup>14.1</sup> Wpls. Journal. Mar. 8, 1920.

<sup>15</sup> Revenue Act of 1918.

<sup>16</sup> Seligman - The Income Tax. p. 19.

<sup>17</sup> Adams - Pol. Sci. Q. 1913, Dec. p. 581.

each successive assessment. Certain natural checks on deductions such as the information at the source help to decrease the difficulties.<sup>17</sup> It is also possible to formulate general rules to cover certain cases as in the case of a machine whose life may be set at ten years and 10% of whose value may be written off each year to allow for depreciation.

The deductions allowed in existing income tax laws are "such as will bring about an exact figure of true net income."<sup>18</sup> In the model plan "net income is defined substantially as a good accountant would define it."<sup>19</sup> The deductions allowed by the Wisconsin income tax law may be taken as representative of those usually permitted in state income tax laws.

This law permits "deduction of wages and salaries paid for services rendered in producing the income reported. Compensation paid to domestic servants, chauffeurs, and family physicians cannot be allowed as deductions because such expenses are of a personal character and are presumed to be covered by the exemptions allowed."<sup>20</sup>

A deduction is also allowed for "the ordinary and necessary expenses actually paid within the year in carrying on the profession, occupation or business from which the income is derived."<sup>20</sup>

"Losses during the year and not compensated for by insurance or otherwise are deductible, provided that no loss resulting from the operation of business or the ownership of property may be allowed as a deduction unless the income which might be

<sup>18</sup>Mass. Tax. Com. Letter, Jan. 1920.      <sup>19</sup>Model Plan. p. 15.  
<sup>20</sup>Wis. Tax. Com. - The Wis. Income Tax Law. 1919, p. 17

derived from such business or property would be subject to taxation under this act."<sup>21</sup> Claims for depreciation or loss of property having no relation to the business carried on or the property employed therein are not allowable."<sup>21</sup>

"Dividends or incomes received by any person from stocks or interest in any concern or corporation, the income of which shall have been assessed under the provisions of the act "are allowable as is also "interest paid within the year on existing business" and "pensions received from the United States."<sup>22</sup>

"Taxes upon the property or business from which the income is derived" are deductible but "taxes paid on unproductive property are not allowable deductions."<sup>22</sup> Besides these the Wisconsin law allows as deductions "all inheritances, devises, bequests and gifts received during the year;" all insurance received by any person in payment of a death claim "and dividends received from banks which are subject to taxation by the state."<sup>23</sup>

The deduction of these items from gross income to obtain net income gives rise to a great many perplexing problems which must be solved as they arise. In some cases it will be necessary to call upon the courts to decide whether certain items are allowable deductions. In other cases it will be necessary to devise special methods to improve the administration. One such problem which is very important at the present time is the method of dealing with the incomes which consist of interest on tax-free Liberty Bonds. The model plan committee suggests that these in-

<sup>21</sup>Ibid. p. 18.  
<sup>22</sup>Ibid. p. 20.  
<sup>23</sup>Ibid. p. 21.



comes may be reached to a certain extent by disallowing such an amount of otherwise allowable deductions as is equal to the amount invested in tax-free government bonds.<sup>24</sup> Unless some such plan is adopted, personal income taxation will not work well, for the federal government has issued large amounts of bonds.<sup>24</sup>

### Who Should Pay an Income Tax.

The Wisconsin Income Tax Law provides that every resident is taxable upon all his income whether it be received from property located and business transacted within or without the state while non-residents are taxed only on the income received from within the state.<sup>25</sup> The Massachusetts income tax applies only to inhabitants who reside within the state at any time between January 1 and June 30.<sup>26</sup> The federal tax applies to all individuals whether residents or non-residents.<sup>27</sup> The English income tax is largely collected at the source and consequently is more upon income than upon persons.<sup>28</sup>

The model plan committee says that "since the purpose of the personal income tax is to enforce the obligation of every citizen to the government under which he is domiciled, it is obvious that this tax must be levied only upon persons and in the state in which they are domiciled. It is contrary to the theory of the tax that it should apply to the income from any business

<sup>24</sup> Report of Model Plan Committee - p. 15.

<sup>25</sup> Wisconsin Income Tax Law. 1919, sec. 1087 n-2

<sup>26</sup> Mass. Tax Com. Bul. #7. 1918. p. 6.

<sup>27</sup> Revenue Act of 1918. sec. 210 and 213.

<sup>28</sup> Seligman - The Income Tax 1914. Chapt.-British Income Tax.

as such, or apply to the income of any property as such. 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."<sup>29</sup> The objection that this limitation of the personal income tax to residents allows the income received from property and business within the state by non-residents to go tax-free is answered by the committee by saying that the personal income tax is a part of a system of three taxes. The object of this system is to eliminate double taxation by exempting from taxation the incomes going to non-residents and by applying the personal tax at the taxpayer's residence, the property tax at its situs and the business tax at the place of business. Any personal income tax that may be adopted by Minnesota should fall upon all residents who have a net income. Any other procedure would lead to the double taxation of interstate business and investments and make the solution of the problem of interstate comity more difficult than it is now.

After making the proper deductions to arrive at the net income, a further distinction must be made between incomes before they can serve as reasonably satisfactory tests of ability to pay. Present day income taxes accomplish this by distinguishing between incomes as to their amounts and as to their nature. A distinction as to their amounts is brought about by (1) exemption and (2) progression; and as to their nature, by differentiation.

<sup>29</sup>Model Plan Committee Report. p. 13.

Exemptions.

It is the established policy of the countries imposing income taxes to exempt a certain fixed sum of each individual's income from taxation. Wisconsin allows an exemption of \$800 while the federal law allows \$1,000.<sup>24</sup> The purpose of exemption is to free from taxation the amount that is necessary for an individual to maintain his working efficiency, his economic independence and his standard of living. If the law were to tax all incomes, it would in the case of small incomes be necessary to repay a part of the receipts in the form of charity. It is better for the morale of the people to relieve the smaller incomes from taxation and thus to encourage thrift and the gradual improvement and maintenance of the standard of living. Although the granting of exemption is contrary to the principle of universality - that all should contribute to the support of the government - it is justified on the ground that a relief of the income below a fixed amount is in accordance with the principle of faculty or ability to pay. A man with a large income that leaves a large surplus above the minimum of existence is better able to pay taxes than the man whose income is just sufficient to enable him to live in a decent way. As the standard of living changes, the exemptions should also be changed. A good many complaints made against the federal income tax law are on the score that the exemptions have remained fixed although living expenses have greatly increased. The Bureau of Labor Statistics estimates that the cost of living in the United States has increased 83.1 % from 1913 until October

<sup>24</sup>Wis. Income Tax Law - Sec. 1087 m.

in 1919. . 24.1 The amount exempted should fit the conditions. In the United States we should have higher exemptions than in Europe because our standard of living is much higher.<sup>25</sup>

It is always a difficult matter to decide how large an exemption should be granted. Some people advocate high exemptions; others low ones. Both have certain advantages and certain disadvantages. A high exemption impairs the amount of revenue because it frees large numbers of people from taxation. It is like cutting a slice from the bottom of a pyramid. With the exemption of large classes of people from taxation, we also run the risk of having a large non-taxpaying majority decide what the government shall do with the money collected from a small tax-paying class. The result may be abuse and extravagance. This danger would not be great in the case of a state income tax because only a small share of the state's revenue would be derived from the income tax. Aside from the injustice that would result to the small taxpaying class there would also be the danger of sectional prejudice. New York City, for instance, <sup>in 1914</sup> paid one half of the federal personal income tax<sup>26</sup> while Milwaukee County in Wisconsin paid 41% of the state income tax.<sup>27</sup> A high exemption is desirable, it is held, because a greater social utility will be realized and a greater advance in economic strength gained. It is the aim of democracies to raise and maintain the standard of living; for the better that

24.1 Monthly Labor Review. Jan., 1920, p.98.

25 Seligman - Income Tax. 1914, p. 670.

26 Nat. Tax Assoc. Proceedings 1915, p. 137.

27 Wis. Tax. Com. Report 1916. p. 55

people live, the greater will be the progress of civilization.

Low exemptions are desirable because more revenue can be secured and larger proportions of the people will be reached. As nothing makes a man watch the actions of government more closely than an attack upon his pocketbook through taxation, a low exemption is advocated because it causes more interest in government and consequently greater efficiency of democratic government. How far this argument is valid is debatable. A low exemption is undesirable because it increases the difficulties of collection by greatly increasing the number of returns that must be examined; it increases the cost of collection; irritates the taxpayer and tax officials because of obnoxious inquisitorial features; raises the danger of possible poor relief; reduces the economic power disproportionately and so affects the basis of taxation.<sup>28</sup>

A fixed amount of exemption is undesirable because it creates a certain amount of injustice and consequent inducement towards evasion. A man whose income is \$1,100 will tend to under estimate his income so that it will come within the \$1,000 exemption. The English solve this problem by a system of abatements by which a series of deductions is allowed on incomes.<sup>29</sup> The deductions decrease as the amounts of income increase. In a consideration of state income taxation the principle of abatements could not be introduced very well because of the great difficulty of administration. After state income taxation becomes more general, this device may be considered more carefully.

<sup>28</sup>Seale- Jour. of Pol. Econ. Oct. 1911, p. 657.  
<sup>29</sup>Hill, J. A. The English Income Tax.  
Seligman - The Income Tax. 1911 p. 184.

The family relationship is taken account of by allowing a higher exemption to the married man supporting a family and in addition allowing a certain exemption for each child or dependent. Wisconsin, for instance, allows \$800 to a single person, \$1,200 to the head of a family and \$200 for each dependent.<sup>30</sup> Corporations are not allowed exemptions. The reasons given for this are that they are not subject to the infirmities of natural persons and that they have no physical needs. Religious, charitable and educational institutions are exempted because they are supposed to be aiding the government by working for the public welfare. Wisconsin exempts intangible property from the property tax because the state income tax is a substitute for the personal property tax.<sup>31</sup>

The question of the exact amount to be exempted should be based upon statistics showing the amount necessary to maintain the standard of living. The Wisconsin Bureau of Labor estimated that the average wage of the work man was \$600 in 1911.<sup>32</sup> The exemption was accordingly put a little higher, at \$800 and \$1,200. As living expenses are higher now, these amounts may be a little low. The Massachusetts income tax grants exemptions of \$2,000 and \$2,500 with a maximum of \$3,000.<sup>33</sup> This seems a little too high but it must be considered that this exemption does not apply to receipts from interest, dividends, annuities and speculative gains.<sup>33</sup> (See p. 23 of MS.) The federal law allows

<sup>30</sup>Wis. Tax Law, 1919. Sec. 1087 m. Children over 18 not considered dependents.

<sup>31</sup>Haugen - Proceedings Nat. Tax Assoc. 1912, p. 327.

<sup>32</sup><sup>1</sup>bid., p. 324.

<sup>33</sup>Mass. Tax. Com. Bul. #7. p. 6.

exemptions of \$1,000 and \$2,000.<sup>34</sup> The model plan committee recommends an exemption of not more than \$600 for a single person and \$1,200 for a husband and wife.<sup>34,1</sup> The exemptions granted by European countries are much lower: England \$800; Prussia \$214; Norway \$210; Denmark \$540; Austria \$250.<sup>35</sup> A lower standard of living and longer experience with the administration of the income tax account for this. The exemptions to be allowed in any state income tax should be based upon the conditions existing therein as shown by wage, living and wealth statistics.

#### Progression.

The surplus which remains after the exemption of a certain fixed amount of net income does not represent the same ability to pay in all cases. One man may have a large surplus, another a small one. A man's ability to pay increases more rapidly than does the size of his income. Different rates must therefore be applied to the different amounts of surplus so as to put the man with the high income on the same basis as the one with a small income. As universality and uniformity are two of the most important principles of taxation, it would seem that the application of different rates to different incomes is inconsistent with justice. Uniformity does not, however, mean absolute numerical equality but equality of the burden of in-

<sup>34</sup> Rev. Act. 1918. Sec. 216.  
<sup>34,1</sup> Model Plan Committee Report, 1919. p. 15.  
<sup>35</sup> Minn. Tax Com. 1910. p. 162 ff.

dividuals.<sup>36</sup> If by uniformity we meant numerical equality, then each taxpayer would have to pay a fixed proportion regardless of the size of his income. But 6% of a large income does not represent the same burden as 6% of a small one. By uniformity we mean an equality of sacrifice. In this sense uniformity and progression are not inconsistent but compatible.

Progression is justified on the grounds of compensation and faculty. One of the chief reasons for the adoption of the federal income tax was the necessity of offsetting the consumptive taxes which fell heaviest upon the poorer classes. In state income taxation this argument would not hold true. A state income tax would, however, relieve real estate of the burden that personal property should bear under the general property tax. Large incomes have a greater faculty because of the fact that the richer a man gets, the easier it is for him to increase his wealth. As the first \$1,000 is much harder to save than any of the succeeding, it represents much more value to the man with a small income than to a rich man. An equality of sacrifice would demand that the rich man give up a larger sum of money in the form of taxes. By equality of sacrifice we here mean an equal sacrifice in producing wealth and not in paying part of the income as some of the old writers held. In popular circles progression is generally upheld on the ground that it distributes wealth.

Equality of sacrifice cannot be obtained exactly or absolutely because of the diversity of human wants and desires. We can, however, approach it better by progression than by propor-

<sup>36</sup>Seligman - The Income Tax, 1911. p. 22.



tion because a progressive tax gives rise to less injustice than a proportional tax which hits the surplus of the poor man hardest. The tendency of income taxation throughout the world is in the direction of moderate progression. England had a flat rate tax until 1907 when a surtax was added.<sup>37</sup> Most of the continental countries impose progressive taxes with the exception of Italy which imposes a flat rate of 12%. Our federal income tax law provides for a normal tax and a surtax. The same is true of the Wisconsin income tax. Massachusetts, however, imposes flat rates. The model plan committee "recommends that the rates of taxation shall be progressive, the progression depending upon the amount of the taxpayer's net income."<sup>39</sup> If Minnesota is to have a modern income tax that shall be in line with the best experience with income taxation and conform to the model system of state and local taxation, the personal income tax must incorporate the principle of progression of rates of taxation.

#### Rates of Taxation.

The two kinds of rates generally used in income taxation are the proportional and the progressive. Although the former is still used to a certain extent, it is gradually being displaced by the progressive. In some income tax systems the two are combined. This is true in the case of the federal income tax law which imposes a proportional or normal rate of 4% upon the first \$4,000 and 8% upon all incomes in excess of \$4,000.

<sup>37</sup>Seligman - Pol. Sci. Q. Sept. 1912, p. 458.

<sup>39</sup>Model Plan Committee Report, 1918. p. 16.

In addition to this normal tax, a surtax of 1% is placed upon the \$1,000 above \$5,000 and it progresses by increasing 1% on each succeeding \$2,000 until it is 65% upon the income over \$1,000,000. Income above \$1,000,000 is subject to the proportional tax of 65% and the normal 8%. The Massachusetts law imposes proportional rates of 2½, 3 and 6½ % upon as many classes of income.<sup>41</sup> The Wisconsin law provides for progressive rates as shown in the following table:<sup>42</sup>

Table II. Wisconsin Income Tax Rates.

	I Taxable Income	II Rate per cent	III Total Income Taxed	IV True rate on whole amount	V Soldier's Bonus	VI Educational Bonus
1st	1,000	1	1,000	1 %		
2nd	1,000	1½	2,000	1.125		
3rd	1,000	1¾	3,000	1.25		
4th	1,000	2	4,000	1.375	1¾ %	7/20 %
5th	1,000	2½	5,000	1.5	2	4/10
6th	1,000	2¾	6,000	1.6667	2½	5/10
7th	1,000	3	7,000	1.8571	3	6/10
8th	1,000	3½	8,000	2.0625	3½	7/10
9th	1,000	4	9,000	2.2778	4	8/10
10th	1,000	4½	10,000	2.5	4½	9/10
11th	1,000	5	11,000	2.7273	5	1
12th	1,000	5½	12,000	2.9582	5½	1 1/10
13th	1,000	6	13,000	3.1923	6	1 2/10
15th	1,000	6	15,000	3.5667	6	1 2/10
20th	1,000	6	20,000	4.175	6	1 2/10

The rates of taxation are not as high as might appear at first sight. The true rates as shown in the fourth column of the table. Although the rate is 6% upon the 13th \$1,000, the true rate on

<sup>40</sup>The Revenue Act of 1918. Sec. 211.

<sup>41</sup>Mass. Tax Com. Letter. Jan., 1920.

<sup>42</sup>Wis Income Tax Law, 1919, p. 26 and p. 584 p. 60.

the whole amount is only 3.19%. A slight amount of inequality is caused by the fact that an income just above the thousand figure pays just as high a tax as one that is close, and just below the next thousand. Smaller steps in the income basis would, however, increase the administrative problems greatly. The point at which the maximum rate of 6% is reached is \$12,000. This corresponds closely to the average point at which the maximum rate was reached in European income taxes previous to the war.<sup>42.1</sup>

The government can increase the rates of taxation on income repeatedly without being stopped by its sudden non-productiveness.<sup>43</sup> This is an advantage from the revenue point of view. The European countries and our own national government have increased the rates greatly and have obtained large revenue for the carrying on of the war. The history of the English income tax shows how the rates have been changed to meet the changing need for revenue.<sup>44</sup> The rates of the Wisconsin income tax have recently been changed to provide for the increased expenditures resulting from the war. The Soldier's Bonus Act provides for a surtax which begins with  $1\frac{1}{2}$  per cent on the 4th and imposes 6% upon the 12th \$1,000 and all above. (See table <sup>EX. 11.</sup> An Educational Bonus Act also adds to the surtax rates. (see. table) Although the ease with which the rates can be increased is a good feature from the revenue point of view, there is always the danger that the government may become extravagant and push the rates too high. In the case of excise and customs duties, excessive rates will bring a decreased revenue but in income taxation the danger line

<sup>42.1</sup> Kennan- Ann. A. Acad. War. 1915. "The Wis. Inc. Tax." p. 68.  
<sup>43</sup> Nation - Apr. 17, 1918. p. 381.  
<sup>44</sup> Seligman - The Income Tax. 1911.

of excessive taxation is not so easily discernable. Just as it has been found to be impossible to enforce a property tax which took from 30 - 40 % of the income, so an income tax becomes increasingly difficult of enforcement if the rates take more than 10% of the income in normal times.<sup>45</sup>

The model plan committee recommends "that the rates of taxation shall be progressive, and that the lowest rate should not be less than 1% and under present conditions, it would not be expedient for any state to impose a rate higher than six per cent."<sup>46</sup> Wisconsin and Massachusetts are imposing somewhat higher nominal rates at present but these are designed to meet emergencies and will very likely not be permanent. An income tax for Minnesota should impose progressive rates somewhat like those now imposed in Wisconsin. As the times change and the income tax has become a permanent part of the tax system, changes, will and ought to be made to fit the personal income tax to Minnesota's conditions.

#### Differentiation.

Some income tax laws make a distinction between incomes in regard to their nature. This is commonly known as differentiation. England, for instance, divided incomes into two classes - the earned and the unearned and imposed higher rates upon the latter.<sup>47</sup> Earned income is that resulting from personal effort;

<sup>45</sup>Bullock - Nat. Tax Assoc. Proc. 1916, p. 375.

<sup>46</sup>Model Plan Com. 1918. p. 16.

<sup>47</sup>Seligman - Pol. Sci. Q. 1912. Sept. p. 457.

unearned income comes from property. The receiver of income from permanent property is better able to pay a tax than the receiver of the same amount of income from labor because the latter must provide for unemployment, sickness, and old age while the income from the former is at the taxpayer's disposal. The income from property should therefore be taxed heavier. This involves a discrimination between incomes which can, however, be justified on the principle of equality of sacrifice as is done in the case of progression.

The differentiation of incomes involves several difficulties. It is, for instance, very difficult to draw a sharp distinction between earned and unearned incomes. The two shade into each other so that although the extremes are easily distinguishable no clear-cut separation is possible. The imposition of rates on the basis of an arbitrary line would lead to inequalities. The practice of the countries using the principle of differentiation varies considerably. Italy separates incomes into temporary, mixed and permanent.<sup>48</sup> England classifies them under five separate schedules.<sup>49</sup> Massachusetts separates incomes into the following classes:<sup>50</sup>

Class I. Income from business, trade, employment or professions. Rate 2½%.

Class II. Interest and dividends. Rate 6½%.

Class III. Profits from sale securities. Rate 3%.

Class IV. Income from annuities. Rate 2½%.

<sup>48</sup>Seligman - The Income Tax. p. 24.

<sup>49</sup>Seligman - The Income Tax, 1921 Chapt. II-III.

<sup>50</sup>Mass. Gen. Acts. 1916. Ch. 269. Sec. 2.

Although no statistics have as yet been given out summarizing the Massachusetts income tax returns, it seems that the above classification has given satisfactory results in practice.

Another serious difficulty with differentiation of income for <sup>the</sup> purpose of taxation is the fact that it interferes seriously with the application of progressive rates. The administration of the income tax would also be more complicated if a distinction were drawn between earned and unearned income. The model plan committee recommends "that the rate of the income tax shall be the same for all kinds of income, that is, that it shall not be differentiated according to the sources from which income is derived. Under this system (three taxes; personal, property, business) there will be heavier taxation of the sources from which funded incomes are derived; and there will, therefore, be little if any ground for attempting to differentiate the rates of the personal income tax."<sup>51</sup> As the income tax here proposed for Minnesota is based upon the model plan, the differentiation of incomes such as is used in Massachusetts may well be disregarded.

<sup>51</sup>Model Plan Committee. Preliminary Report. p. 16.

## CHAPTER V.

### THE BUSINESS TAX.

#### Introduction.

The second part of the proposed income tax for Minnesota is a business tax. Although this term is somewhat new in income taxation, taxes on business are as old as business organization itself.<sup>52</sup> Business taxes are to be found throughout the world and here in the United States we have hundreds of them under many different names.<sup>52</sup> There are the so-called franchise taxes, incorporation fees, corporation excess taxes, and the like. The great number and diversity of these taxes gives rise to much inequality and injustice, and calls for the formulation of an approximately consistent scheme of business taxation which may serve as the basis of reform. The plan committee has drawn up such a scheme of business taxation as a part of its scheme of state and local taxation.<sup>53</sup>

#### Justification of Business Taxation.

There seems to be an increasing disposition in recent years to question the wisdom of taxing business or of laying taxes upon the business unit.<sup>54</sup> As this questioning is more than a mere product of the irritation that accompanies tax-

<sup>52</sup>Adams, T. S. N. Tax Assoc. Proc. 1916, p. 186.

<sup>53</sup>Model Plan Com. Prelim. Report. p. 26.

<sup>54</sup>Adams, T. S., Address Nat. Tax. Assoc. 1917, p. 185, 1918 Report.

paying, it is necessary to examine arguments usually advanced and to justify the levying of a business tax such as is here proposed as a part of the income tax for Minnesota.

It is alleged that a tax upon business complicates the property and income taxes, puts a penalty on initiative and thrift, dampens industry, and penalizes the successful business concern. It has generated a brood of "franchise taxes" which are inconsistent, illogical and selfish; it gives rise to indefensible double taxation; is shifted when it was not expected to move and remains "put" when it was expected to shift, and finally, it violates the great principle of ability to pay.<sup>54</sup>

In answer to these allegations it may be said that business taxation is justifiable from the political and moral standpoints. A great part of the cost of government is due to the necessity of maintaining a suitable business environment. Business is responsible for much of the work which occupies the courts, the police, the fire department and the army and navy.<sup>55</sup> An increase in business results in the long run in an increase of public expense. Surveyed from this point of view business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.<sup>55</sup> From another point of view, a market is a valuable asset to the social group which maintains it and communities ought to charge for the use of community assets.<sup>55</sup>

<sup>55</sup>Ibid. p. 187.



A business tax is designed to express the fiscal obligations of business to the community. This obligation is not adequately met by the property tax or the personal income tax. There is no helpful relation between the value of real estate occupied and the duty which the business in question bears to the state. The same thing is true in the personal property tax.<sup>56</sup> There may be much business with little property or much property with little business.<sup>56</sup> For similar reasons the personal income tax is plainly unfitted to express this fiscal obligation. This tax is supposed to be paid where a man resides, not where he transacts business.<sup>56</sup>

The greatest objection raised against business taxation is on the ground of non-compliance with the principle of ability to pay. This criticism rests upon a shallow and narrow interpretation of the ability theory.<sup>57</sup> It tests every application by the effect upon the consumer - upon the taxpayer as one who clothes and feeds himself. Of two corporations with the same capital, business, and net income, the one may be owned by small shareholders, mechanics, and workingmen while the other may be owned by a few rich men. That a business tax would not have the same effect upon the shareholders of the two corporations, is true, but the ability principle also regards the taxpayer as a producer - not only as a consumer.<sup>57</sup> The taxpayer must be considered in his capacity as producer, as a business man in his economic and political environment, which recognizes the truth

<sup>56</sup>Ibid. p. 188 Adams; T.S. NAT. TAX. ASSOC. PROC. 1918.

<sup>57</sup>Ibid. p. 191

that the state and community stand as silent partners\* in every business enterprise.<sup>57</sup> In this capacity the state has a right to a fair share of all profits in excess of the amount required to elicit the requisite investment of capital. The state thus stands on a par with the other shareholders in the divisions of the profits. The taxation of business and real estate is based more on the principle that benefits must be paid for, whether income is large or small; while personal income taxation is based more upon the ability theory.<sup>59.1</sup> Most good business taxes combine or represent at once both the ability and the benefit principles. They are not taxes upon the individual, to be judged entirely by their effect upon him, but they are the prior claim of the state upon the private profits which arise out of the business environment created and maintained by the state.<sup>58</sup>

Taxes upon business have a great fiscal value. They are inexpensive to collect and comparatively productive in yield. A given rate upon the business unit will usually yield a very much larger revenue than the same rate of taxation laid upon the individual owners of business.

The business tax is a valuable source of revenue for many states. It is generally called a corporation or franchise tax. The Wisconsin income tax which Minnesota would do well to take as a model, is partly a business tax. The United States levies a corporation tax as do also the states of New York, Connecticut,

\* The term "silent partner" is not used in its legal sense here. The state shares in the surplus, not the obligations.

<sup>58</sup>Ibid. 192.  
<sup>59.1</sup>Ballock, Nat. Tax Assoc. 1916, p. 376.

West Virginia and Montana.<sup>59</sup>

The model plan committee recommended a business tax as a part of its plan because so many states levied what are in name or fact business taxes, upon the theory that they have a right to levy taxes upon business done within their jurisdiction.<sup>60</sup> As this is a reasonable claim, the only way in which interstate comity could be brought about and unjust double taxation be avoided, was by adopting the business tax which could be used as a model by the states to follow in the drawing up of new laws or the reforming<sup>^</sup> the old.<sup>60</sup>

A business tax is desirable as a part of a Minnesota income tax because (1) business should help pay for the government costs it gives rise to; (2) it should pay the state the share due it as a silent partner. (3) it should pay because it has tax-paying ability as a producer. A business tax is (4) inexpensive to collect, (5) comparatively productive in yield, (6) in accordance with the practice of other states and (7) helpful as a means of reforming our present defective tax system.

#### Kind of Business Tax.

The business tax should be levied upon the net income derived from business carried on within the state. A tax of a fixed amount, such as is often imposed by license taxes, is undesirable because of its inequality. Neither could gross

<sup>59</sup>Model Plan Com. Report. p. 36.

<sup>60</sup>Ibid. p. 26.

receipts, rental value of premises occupied, size of the town or city in which the establishment is located, or any other external indicia of business profits serve as well as net income.<sup>61</sup> Net income is not a perfect measure of business profits but it is better than any other test or combinations of tests.<sup>61</sup> Net income as a measure encourages the infant industry, spares every industry in lean years and fosters industrial experimentation.<sup>61</sup> It also greatly lessens the administrative difficulties that would arise by using other measures, which in the end look towards net income as a goal.<sup>61</sup> Concerns which do interstate business must determine the proportion of income derived within the state. There are practicable methods of making such a determination, so that no serious difficulty ought arise on that score.<sup>62</sup> With proper administration a business tax levied upon net income would be far superior to one levied according to any other indicia.<sup>62</sup>

Certain exceptions would have to be made to the general rule. Railroads and public service corporations could be better taxed by the use of the gross receipts method.<sup>62.1</sup> In the case of railroads it would be difficult to use both the property and business taxes because of the difficulty of keeping the two separate, and of properly apportioning the proceeds among the various jurisdictions.<sup>62.2</sup> Public service corporations owe a peculiar obligation to the public which can best be expressed by a gross receipt tax. Concerns so small as to exempt them from federal income tax might be taxed upon their gross receipts but no tax

<sup>61</sup>Adams - Nat. Tax Assoc. 1918, p. 190.

<sup>62</sup>Model Plan Com. Report. p. 29.

<sup>62.1</sup>Ibid., p. 22.

<sup>62.2</sup>Ibid., p. 29.

should be lower than say \$200<sup>62.2</sup> Care should be used so as not to make too many exceptions to the rule.

### Deductions.

The deductions allowed corporations in the determination of net income are similar to the ones allowed individuals. (See p. 69 M. S.) The Wisconsin income tax law may again be taken as a model. It allows the deduction of "payments made during the year for wages of employees and salaries of officers, if reasonable in amount, for services actually rendered..."<sup>63</sup> and also cash bonuses. "Losses actually sustained within the year and not covered by insurance" may be deducted provided the income expected from that business operation where the loss occurred would have been taxable.<sup>64</sup> This clause was added in 1919 to allay much criticism of the law. The Wisconsin law also permits the deduction of taxes,<sup>65</sup> dividends, ~~bank~~ dividends and gifts to charitable institutions.<sup>66</sup>

Numerous rules have been made by the tax commission to solve the many perplexing problems that have arisen in connection with the allowance of deductions. The problem of allowing for depreciation and obsolescence is one of the most complicated. The principle upon which deductions for the depreciation of property and the exhaustion of natural resources should be allowed is that the capital be returned tax-free by the time the property is worn out. No allowance should be made after the capital originally in-

<sup>63</sup>Wis. Income Tax Law. Pamphlet by Com. 1919, p. 11.

<sup>64</sup>Ibid. p. 13

<sup>65</sup>Ibid. p. 14

<sup>66</sup>Ibid. p. 16

vented has been returned. This involves the determination of the life of the property. The commission has drawn up the following schedule to assist people in the allowance of deductions for depreciation:

III. Annual Depreciation (in percentages.)<sup>68</sup>

Buildings	Frame and Painted %	Brick & Masonry, %
Sheds	7	
Stables	4	3
Farm dwellings	1.5	1.5
City dwellings	2.5	1.5
Stores	2.5	
Warehouses	2.5	
Factories	5	
Hotels	2.5	1.75
Machinery	3 - 10 %	
Horses	16 %	
Harness	20	
Sleighs	10	
Automobiles	20 - 25 %	

Rate of Taxation.

The rate of taxation upon business should be proportional and not progressive because neither the absolute amount of net income nor the relation it bears to the capital invested is an indication of the benefits a concern receives from the government under which it carries on its business.<sup>69</sup> A concern with a large capital and therefore a large income does not receive any more

<sup>68</sup>Wis. Tax Com. Pamphlet Wis. In. Law 1919, p. 56.  
<sup>69</sup>Model Plan Com. Report. p. 30.

benefit from the government in proportion to its size than does the small concern with the small income. The size of the income is an indication of the success of the business and not of the benefit received.<sup>69</sup> A graduation of rates would lead to many administrative difficulties which would react unfavorably upon the law and lead to absurdities which could not be remedied except by the arbitrary discretionary action of the tax officials.<sup>69</sup>

Although the model plan committee recommends a proportional rate upon the net income of business, such an eminent authority on income taxation as T. S. Adams favors a graduated tax.<sup>70</sup> He states that 14 or 15 countries have secured handsome revenues by excess profits taxes upon business.<sup>70</sup> A graduated tax on business is justified by the fact that an abnormally prosperous concern should be made to share its "supernormal" success with the state because the success measures roughly the value of the facilities, opportunities and environment offered by the community.<sup>70</sup> The excess profits tax should fall upon the net income in excess of the normal income. Although an excess profits tax has much to commend it, it seems that in a state income tax composed of a personal and a business tax, it is best to avoid complicating the tax law and to place only a proportionate tax upon business. When the income tax has become a permanent feature of the tax system, it will be possible to make changes which will lead to greater equality.

The actual rate of the tax should be moderate. A busi-

<sup>70</sup>Adams - Nat Tax Assoc. Taxation of Business 1918. p. 190.

ness with much tangible property will pay a heavy property tax and the business tax will be supplementary; a business with little tangible property would make only small demands upon the services of the government and would pay less on that account. The tax should not be lower than 1% or more than 5% unless under very exceptional conditions.<sup>71</sup> The Wisconsin tax upon corporations progresses from 1 - 6%.<sup>72</sup> Connecticut levies a 2% tax upon corporations.<sup>73</sup> New York levies a 3% tax.<sup>74</sup> A moderate rate upon business is desirable because the business tax as here proposed is a part of a system of two taxes: a personal income tax and a business tax.

#### Differentiation.

A differentiation of incomes and the application of different rates is undesirable in the scheme as here proposed because funded incomes are already taxed higher than unfunded being in most cases subject to the personal income tax and the business tax and indirectly to the property taxes. (See also M.S. p. 77 + 78.) The business tax is to replace the tax which firms now pay upon personal property.

#### The Personal Income Tax and the Business Tax Compared.

The income tax for Minnesota as here compared is composed of two distinct taxes: the personal income tax and the

<sup>71</sup>Model Plan Com. Report 1918, p. 30.

<sup>72</sup>Wis. Income Tax Law. Sec. 1087 m-6. Ch. 658.

<sup>74</sup>New York Laws, Ch. 726 Par. 200.

<sup>73</sup>Nat. Tax Assoc. Proc. 1916. p. 372.



business tax. The personal income tax is laid upon the individual in his capacity as consumer, and is paid where he resides; whereas the business tax is paid by men in their productive or commercial capacity at the place where the income is earned. The two taxes stand side by side but they reveal many sharp differences. The personal income tax is allied in nature to the group of taxes "in personam" and the business tax to those "in rem". The former is based upon the ability to pay principle; the latter more upon the benefits principle. The plan is based upon the income tax now in force in the neighboring state Wisconsin but it differs in several important respects such as the rates of taxation and the persons and concerns subject to the tax. The aim of the income tax here proposed is (1) to eliminate the gross inequalities now arising in our tax system especially the personal property tax and (2) to bring about interstate comity and less double taxation.

#### Double Taxation and Equality.

Double taxation is inherently unfair and contrary to sound principles of taxation. The fundamental laws of some of our states forbid it but there is more double taxation in the United States than in any other country.<sup>75</sup> This is due to the fact that we have two taxing sovereignties - the national and the state. Double taxation places a larger burden upon some taxpayers and forces them to seek to evade what they consider an unjust burden. G. D. Barnes, tax commissioner of Wisconsin said

<sup>75</sup>Judson - Ann. A. Acad. 1915. Mar. p. 105.

with regard to evasion and double taxation: "The objection is not because a man does not want to pay taxes but because he does not want to pay out of proportion to his neighbor's or his competitor's taxes. Corporations don't try to evade and minimize taxes to beat the state but as a mere matter of self-preservation. They have to do something in order not to have duplication upon duplication."<sup>76</sup>

One source of double taxation is the overlapping of the state and federal taxing jurisdictions. A cigar manufacturer in Wisconsin has to pay an internal revenue tax upon his tobacco; a license tax to the state; a general property tax to the local authority and besides these, both a federal and a state income tax - if his income is of sufficient size. The most serious problem of double taxation arises out of the fact that there is no agreement between states as to whether a tax shall be paid at the situs of the property or at the place of residence of the recipient of the income. The result is that in the case of a state income tax considerable embarrassment may arise out of the fact that a man resides in one state, his legal domicile is in another, his income is derived from corporation securities which are in a safe deposit vault in a third state while the corporation itself has its chief offices in a fourth state and its distributing branches in a fifth. The question arises, where and how shall this income be taxed? There are all kinds of possibilities for inequalities, from a complete escape to the taxation of the same income by many states. In Wisconsin an injust-

<sup>76</sup>Barnes - Nat. Tax Assoc. 1917, p. 139.

ice occurs to taxpayers because the income from outside the state is not taxed. The taxpayer receiving his income from outside is consequently favored.<sup>77</sup> A certain manufacturing company in the same state is taxed upon 95% of the profit it makes. It has established places of business in 29 states but pays taxes in Wisconsin because it manufactures its goods there although only 1/20 of the sales are made in that state. Other states tax the business done there with the results that this company is taxed doubly. Double taxation is one of the biggest problems to be met in state income taxation.

Massachusetts exempts the many kinds of income derived from real estate with the designed purpose of preventing double taxation.<sup>78</sup> Wisconsin, however, taxes incomes from all sources including real estate while personal property taxes are deductible from the income tax.<sup>79</sup> The result is a double burden upon the real estate owner. A certain amount of double taxation also results from taxing the income derived in the form of dividends from a corporation whose profits are taxable and in some cases, as in Wisconsin, at double rates.<sup>80</sup> To avoid the inequalities arising from double taxation in a state income tax it is necessary that the states cooperate among themselves and with the federal government so as to develop uniform rules of procedure.

The income tax as discussed in the preceding pages is designed to eliminate the double taxation arising out of the lack of interstate comity. The committee appointed by the

<sup>77</sup>Wis. Tax Com. Report, 1918. p. 8.

<sup>78</sup>Mass. Tax Com. Bul. 7, p. 5.

<sup>79</sup>Wis. Income Tax. 1919, sec. 1087 m 26. (A few kinds of income

<sup>80</sup>Zoller - Nat. Tax Assoc. 1916, p. 218. are exempted.)

National Tax Association to draw up a model plan of state and local taxation had the evil of double taxation especially in mind when it recommended a state tax system to be composed of three taxes: the business tax, the personal income tax and the personal property tax.<sup>81</sup> Double taxation will be largely eliminated if the personal income tax is levied at the domicile of the taxpayer, if the business tax is levied upon net income derived from business carried on within the state, if the property tax is levied on tangible property at its situs for the governmental services received and if the tax upon intangible property is dropped.<sup>81</sup> The personal income tax and business tax here discussed are drawn up to conform with the recommendation of the model plan committee.

<sup>81</sup>Model Plan Committee Report. 1918. p. 32 -33.

<sup>81.1</sup>Ibid p. 7 Note.

## CHAPTER VI.

### THE YIELD OF INCOME TAXES.

#### Introduction.

The committee appointed by the National Tax Association to draw up a model plan of state and local taxation stated in its preliminary report: "Whatever other purposes taxation may properly have, its fundamental purpose is to provide revenue. Until this fundamental purpose is achieved, and the American states are today very far from accomplishing it, we shall hardly find it worth while to consider what other purposes taxation may properly have."<sup>1</sup> It will be the purpose of this chapter to examine the yields of the income taxes in the states which have been most successful in the taxation of incomes.

Up to 1911 state income taxation was a miserable failure from the point of view of productiveness. Few states were able to collect much more than was necessary to pay the expenses of collection. In 1911, however, Wisconsin passed an income tax law which yielded over \$3,000,000 when even the most enthusiastic supporters of the law estimated the probable yield at about \$1,000,000. This opened a new chapter in state income taxation. England has taxed income since 1842 and derives a great deal of revenue from that source.<sup>2</sup> Germany before the war collected about \$200,000,000 from income taxation.<sup>2</sup> In all the European

<sup>1</sup>Model Plan Com. Report. p. 3.

<sup>2</sup>Lyons Ann. A. Acad. 1915. p. 77.

countries income taxes yield a good proportion of the governmental revenues.

Yield of the Federal Income Tax.

The federal government receives a very large share of its revenue from the income tax. The figures of the following table will tell the story.<sup>3</sup>

IV. Yield of the Federal Income Tax.

Source	1913	1914	1915	1916	1917	1918
Individual income tax	4.9%	3.9%	5.9%	8.8%	16.2%	
Corporation tax	.3	4.3	5.6	7.5	16.1	68.1%
Liquors						10.4
Tobacco						3.7
Misc. In.Rev.						6.3
Tariff						4.4
Misc.						7.1

In 1918 the income tax yielded the federal government over 68 % of the total revenue collected or \$ 2,838,900,000.<sup>3</sup> In 1920 it is estimated to yield \$ 3,000,000,000.<sup>4</sup>

Yield of the Massachusetts Income Tax.

In speaking of the operation of the law during the first year the Massachusetts Tax Commissioner said: "The law has been a decided success from the point of view of revenue."<sup>5</sup>Massachu-

<sup>3</sup>Blakey - Ibid. p. 1919. p. 240.

<sup>4</sup>Mpls. Journal, March 24, '20.

<sup>5</sup>Mass. Tax Com. Operation of Mass. Law. 1918. p. 17.

setts raised \$8,697,503.51 by its tax on intangibles in 1917. By the old tax on the capital value of intangibles the yield would have been \$6,867,000 if its scope were narrowed to that of the new tax which allowed certain exemptions of interest and dividends and also non-resident beneficiaries. The business tax yielded \$770,288 in 1916 and \$2,577,000 in 1917.<sup>6</sup> The tax on net gains from dealings in intangibles was \$836,000 while that on annuities was \$24,000.<sup>6</sup>

The results of the Massachusetts income tax law are not as striking as those of the federal or the Wisconsin laws but they show that a marked improvement has been brought about by subjecting intangibles to the income tax in place of the old capital value personal property tax.

The Connecticut corporations tax netted \$1,600,000 in 1916 - much more than it was expected to yield.<sup>7</sup>

The Oklahoma income tax has been a failure from the revenue point of view. In 1916 about \$500,000 was raised out of a total state revenue of \$29,000,000.<sup>9</sup> The law has been in force since 1908 but is still an unimportant revenue producer.<sup>9</sup> It was estimated that the state should have collected from \$4 - 5,000,000 but only 10% of this was actually received.<sup>9</sup> The experience of Oklahoma is a good illustration of the experience of all the states who failed to make income taxation work.

<sup>6</sup>Ibid. p. 16.

<sup>7</sup>Nat. Tax Assoc. Proc. p. 421. 1916.

<sup>8</sup>Wis. Tax Com. Rept. 1917. p. 39. 1918. p. 3.

<sup>9</sup>Nat. Tax Assoc. Proc. 1917. p. 50 - 54.

V. Yield of the Wisconsin Tax.

Income of Wisconsin Income Tax. (Round numbers.)<sup>8</sup>

I Year	II Income Tax Assessed.	III Personal property tax offset	IV Net Cash Proceeds.
1912	\$3,482,000	\$1,609,000	\$1,872,000
1913	4,084,000	1,805,000	2,279,000
1914	4,145,000	1,987,000	2,157,000
1915	3,837,000	1,825,000	2,011,000
1916	5,344,000	2,384,000	2,959,000
1917	9,482,000	3,221,000	6,161,000
1918	11,830,000	4,707,000	6,951,000

The Wisconsin tax laws permit the presentation of personal property tax receipts in part payment of the income tax. Column II of the foregoing table shows the total income tax assessed; column III the amount of the personal property tax offset and column IV the net cash remaining over and above the offset. The net cash proceeds have increased from \$1,872,000 in 1912 to \$6,161,000 in 1918. This is due in part to better administration and in part to the rise of business property. The decrease in 1915 was due to the business depression during the first part of the war. The personal property offset amounts to about 30 - 50 % of the aggregate amount assessed. The Tax Commission said with regard to it in its 1918 report:<sup>10</sup> "It is absurd to force citizens to make elaborate, complicated income tax returns and to maintain expensive assessing machinery to assess it and then to nullify the result by the presentation of personal property tax receipts." The legislature, however, refused to act upon this recommendation. The object of the retention of the personal property tax and its use as an offset was to serve as a safeguard in case the income tax failed to

<sup>10</sup>p. 7.



work. From the point of view of revenue the Wisconsin law has been the most productive of any of the state income tax laws.

To get a true idea of the usefulness of a tax, its yield must be compared with that of other taxes in the same state. The following table shows the relation of the income tax yield to the yields of other taxes in Wisconsin.<sup>11</sup>

V

VI Sources of State and Local Revenue in Wisconsin in 1917.

<u>Kind</u>	<u>Amount</u>
General Property Tax	\$ 50,135,253.00
Corporation Tax	5,381,905.00
Inheritance	559,400.00
Income	6,037,719.00
Other	<u>1,230,553.00</u>
Total	\$ 63,344,830.00

(A surtax of \$7,425,352 was levied in 1920 for soldiers' bonus and \$1,498,582 for soldiers' educational bonus.)

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The Wisconsin income tax of 1917 yield over 10 per cent of the total tax collected whereas the federal income tax yielded 16.3 per cent of the total United States revenue in the same year.

As Minnesota gets its (Continued on next page.)

<sup>11</sup> Wis. Tax Com. Report, Letter May 20, 1920.

revenues from the same sources and in about the same proportions, an income tax similar to that in Wisconsin would not cause a very marked change in the relative amounts of revenue derived from all sources. An income tax for Minnesota is proposed not <sup>only</sup> because a new source of revenue is necessary to get additional revenue but also as a means of reforming our present defective tax system. The proposed income tax is to eliminate our personal property tax which gives rise to so many inequalities. The experiences of Wisconsin and Massachusetts show that the income tax can replace the personal property tax and get more revenue from the same sources and do it without giving rise to so many inequalities. As an indication of what can be done with income taxation in Minnesota the experience of the federal government can be cited. In 1918 the federal government collected \$58,218,134<sup>12</sup> in income and excess profits from Minnesota while the state and the localities collected \$68,507,529<sup>13</sup> from all sources.

#### Elasticity of Yield.

A point that is often brought out in the discussion of income taxation is the great elasticity and flexibility that can be obtained by simply raising or lowering the rates upon incomes. Elasticity is one of the chief characteristics of the British income tax. The action of Wisconsin in 1919 by adding new rates to obtain additional revenue for soldiers and educational bonuses

<sup>12</sup>Minn. Tax Com. Report. 1918, p. 100

<sup>13</sup>Mpls. Tribune - Feb. 21, 1920.

is an illustration of the flexibility of state income taxes. (See table on p. 81 of W. S.) The income tax is not, however, needed to give flexibility to our state and local tax system, for if there is one good point about the general property tax it is precisely that of inherent elasticity. In Minnesota the county auditor figures out the tax rate by the simple process of dividing the assessed value of all property by the revenue needed. In this way the revenue can be made to equal expenditures during the coming year. The ease of changing the income tax rates gives rise to certain dangers which are discussed on p. 82 of this study.

#### Cost of Collecting Income Taxes.

The annual cost of administering the Wisconsin income tax closely approximates \$100,000, but this includes the salaries of assessors of incomes as supervisors of the assessment of the general property tax.<sup>14</sup> Under the old law they received \$54,000 so the actual cost of administering the income tax is about \$50,000.<sup>14</sup> On the basis of actual cash collections the income tax cost for the fiscal years of 1915 and 1916 was respectively 2.20 and 2.62%.<sup>14</sup> The Wisconsin tax commission says that it is one of the least expensive taxes collected in this or any other country. The entire cost of administration of the income tax comes out of the state's share which is 10%, yet the state gets about 8% net.<sup>14</sup>

The first year's cost of administering the Massachusetts income tax was \$300,000 or 1.86% of the total assessment.<sup>15</sup> The Massachusetts Tax Commissioner says in his 1918 report that the

<sup>14</sup>Wis. Tax Com. Report, 1916. p. 69

<sup>15</sup>Mass. Tax Com. Report on Cooperation of Income Tax, 1918. p. 14.

tax could be administered for less by not auditing books and verifying reports. This would soon lead to the loss of revenue through evasion and the possible repeal of the act because of inequalities.<sup>15</sup> The federal cost is 1.54% but this does not include the cost of paper.<sup>15</sup> In 1917 the federal individual income tax receipts were \$180,108,000 and the collection cost \$1,539,000. The cost of collecting the internal revenue was .95%. In 1916 it was 1.40%<sup>16</sup>

Distribution of the Proceeds.

The Wisconsin income tax is not a state income tax in that it applies to state purposes only. The proceeds are divided: 70% going to the city or village or town where collected, 20% to the county and 10% to the state for the collection expense.<sup>16</sup> This method of distribution is desirable, otherwise the cities which pay most of the income tax would have to share an undue portion of the state tax burden. The Model Plan Committee of the National Tax Association favors such a distribution and "recommends that the states retain a proportion corresponding to that which state revenues or expenditures bear to the total state and local expenditures or revenues, and that the remainder should be turned over to the taxing district in which business is carried on."<sup>17</sup>

<sup>16</sup>Wis. Income Tax Law, 658 Sec. 1087 m-23.  
<sup>17</sup>Prelim. Report Model Plan Com. 1918, p. 31.  
<sup>17</sup>U. S. Com. of Int. Rev. Rep't. 1917 p.4-5.

## CHAPTER VII.

### THE EFFECTS AND INCIDENCE OF THE INCOME TAX.

#### The Incidence of the Income Tax.

The question as to whether a tax is borne by the one who first pays it or whether it is shifted to some one else is a very complex one. It is, however, of great importance for the statesman, who frames tax systems, to know whether a tax will shift or not, for sometimes a tax will have an entirely different effect than was at first contemplated. Some taxes such as poll, inheritance and certain taxes on monopolies will not be shifted but will be borne by the original taxpayer; others such as import duties, certain excise taxes and licenses are shifted in their entirety.<sup>1</sup> Still others will shift under some conditions and remain "put" under others. These conditions may be so numerous and indeterminate that it is in many cases hard to tell just what will happen. In speaking of the practical advice that a correct theory of incidence has to offer to the legislator, E. P. Seligman says that only those taxes the result of which can be told with some degree of certainty should be used and those whose incidence is uncertain should be used only as a last resort.<sup>2</sup> He says further: "The theory of incidence has important, but by no means final, advice to offer in the elaboration of a tax system. It does not by any means render unnecessary the study of the principles of justice and equality in taxation. It is an aid, not a substitute for,

<sup>1</sup>Seligman - The Shifting and Incidence of Taxation. 1910, p. 394.  
<sup>2</sup>Ibid. p. 395.

the study of economic justice."<sup>2</sup>

The shifting and incidence of the income tax is especially complicated because income, as it is taxed in a state income tax, is composed of many different kinds of income each one of which obeys the laws of incidence of that particular kind of income.<sup>3</sup> The income subject to the tax is composed of salaries, wages, profits, rent, and interest. The general principle that determines whether a tax tends to shift or not, is, that those taxes which tend to form a part of the cost of production tend to be shifted.<sup>4</sup> These tendencies to shift to surplus, or net profits, are met by counter-tendencies of "economic friction."<sup>4</sup> In general and in so far as the income tax falls upon net income or surplus rather than on margin, the chances are that the tax will remain where it is originally placed.<sup>5</sup> The laws of incidence that apply to the different kinds of income will be discussed in connection with the effects of the income tax upon the different occupations and classes of people.

#### The Effect Upon the Distribution of Wealth.

An income tax is popularly defended on the ground that it may be employed to bring about a more equal distribution of wealth. The chief argument advanced in favor of the federal income tax was that the customs and internal revenue taxes which fall mostly upon consumption and so upon the poorer classes should be counter-balanced by a graduated income tax which would fall more heavily upon the rich. In Minnesota an income tax is desirable because

<sup>3</sup>Ibid. p. 392.  
<sup>4</sup>Ibid. p. 393.

<sup>5</sup>Ibid. p. 387.

the burden of the personal property tax falls most heavily upon those least able to pay.

The tendency in modern tax reform is to place more and more emphasis upon the social principle. This is the principle that the government in laying any particular tax should be guided by the social consequences, that is, by the results upon groups or classes rather than upon individuals.<sup>6</sup> Attention is paid not simply to the immediate results upon the individual, but also to the wider consequences that ensue from the fact that the taxpayer is a part of society. This tendency is well illustrated in the British, German and Australian tax systems which are a combination of social and fiscal considerations.<sup>7</sup> These systems attempt to solve the fiscal problem with due regard to the social aspects of the situation. The features of our income taxes which involve the social principle and which are especially designed to bring about a more equal distribution of wealth are those of graduation, exemption, and differentiation.

The income tax tends to bring about a distribution of wealth but it is another question whether this distribution is desirable or not and whether the income tax should be used as a means of social reform. T. S. Adams says: "If carefully formulated and efficiently administered, the income tax tends to equalize the distribution of wealth and it does not in an appreciable way set in motion adverse subtle economic forces of an objectionable kind."<sup>8</sup> It is a better tax, however, than an instrument of social reform, for its virtue is chiefly fiscal.<sup>8</sup> There is always

<sup>6</sup>Ibid - The Income Tax. 1910, p. 638.

<sup>7</sup>Seligman - Pol. Sci. 1913. p. 93.

<sup>8</sup>Amer. Econ. Rev. 1915. Mar. p. 243.

the danger on the other hand that the legislator will try to put into a tax law some provision intended to correct some abuse either real or imagined, which has no relation to taxation at all. When this is permitted, the taxation principle is often impaired.<sup>9</sup> The income tax, especially the state income tax, should be used primarily to get revenue, which ought to be raised as equally, certainly, conveniently and economically as possible.<sup>10</sup> The secondary effect upon the distribution of wealth should be carefully considered in order to see what the results are and whether these are desirable or not.

Closely allied with the effect upon the distribution of wealth is the question of whether private individuals or the government can make better use of the social surplus. The government is gradually increasing its expenditures to further the public welfare. Workmen's compensation and insurance, mother's pensions, boards of health, public education and many other activities of similar nature are being entered into and extended by state governments. The tendency seems to be to let the government collect larger and larger sums to be devoted to the promotion of the public welfare. This is a recognition of the growing feeling that the government can, in many instances, make better use of the surplus above the standard of living than can the private individual.

Effect of the Property and Income Taxation Upon Business.

The property tax affects business in many undesirable

<sup>9</sup>Zeller - Nat. Tax Assoc. Proc. 1916. p. 216.  
<sup>10</sup>Model Plan Com. Report. 1918. p. 3.



ways. It takes no account of whether a concern has a profit, but hits the unsuccessful business as hard as the prosperous one. The losses of modern business are enormous; the necessary hazards great; and many firms are constantly on the brink of bankruptcy. The property tax is remorseless to these marginal enterprises. The state is the preferred creditor under the property tax, but under the income tax it takes only when there is a net profit. Then it is more of a partner and profit-sharer.<sup>11</sup> The property tax falls upon property whether productive or unproductive, whether it is owned free or heavily encumbered, whether part of a desperate new business venture or part of the salvage of a dying concern. The business tax on the other hand takes little or nothing from the new, the experimental or the unfortunate business enterprise.<sup>11</sup> It helps the small business man and the large concerns in hazardous new undertakings and abstains from burdening the business enterprise in a bad year. It collects only when the concern has a net profit and is able to pay.<sup>11</sup> The property tax discourages experimentation, penalizes industrial pioneering, retards production, reduces the supply and increases prices. It is partly shifted to the consumer; reduces the amount of wealth to be divided, and adversely affects the distribution of what is produced.<sup>11</sup> A business tax upon net profits, however, cannot be shifted because profits represent the surplus above the cost of production.<sup>12</sup> A tax can be shifted only when it enters into the cost of production and thus causes a change in the price of the goods affected.<sup>12</sup> In the taxation of the net profits the con-

<sup>11</sup>Adams - Amer. E. R. 1915. Mar. p. 236.

<sup>12</sup>Seligman - Shifting and Incidence of Taxation 1910, p. 362.

sumer is unaffected, but the producer tends to bear the tax both immediately and ultimately.<sup>12</sup> The property tax has some good features and these are retained in the property tax which is to constitute the third tax of the tax system of which the business and the personal income tax are the other two. The income tax does not reduce the share from entrepreneurs but it redistributes and readjusts it sparing the small businessman and the marginal enterprise.<sup>13</sup>

The rigors of the property tax measurably stimulated the feeling that government ownership was coming. Railroads and other corporations were paying 16% of their earnings and in some states the proportion exceeded 20%. The net income principle materially enhances the chances of private ownership and operation by adjusting the tax burden more according to the ability to pay. The income tax works for the retention of private property and makes the state not a preferred creditor nor sole owner but a full-fledged and sympathetic partner in private business.

#### The Relative Effect Upon Corporations and Individuals.

In Wisconsin the corporations pay the biggest share of the income tax. Corporations paid 70.06% in 1915 while individuals and firms paid 29.96 % of the total amount of income tax collected. The income of corporations is only 46.66 % of the total income assessed while that of individuals and firms is 53.34 %.<sup>12</sup> Thus corporations with less than one half of the income pay almost three fourths of the tax. The reason for this

<sup>13</sup>Adams - A. E. R. 1915, Mar. p. 238. Supl.

is that the maximum corporation rate is arrived at earlier and oftener than the individual rate. The average corporation rate in 1915 was 5.36% and that for individuals 2.01%.<sup>12</sup> The average assessment against corporations was \$13,380 and against individuals and firms \$1,282.<sup>12</sup> These figures indicate that the income tax falls upon successful business concerns while infant and unprosperous concerns go free. The corporation tax brings much more revenue than the personal income tax. An income tax *proposed* for Minnesota would not show such a large proportion of the tax from corporations because the rate, as here proposed, would be lower. The amount collected from individuals would be higher because the Wisconsin law allows the deduction of dividends received from corporations who paid a tax.

#### The Attitude of the Business Men.

The successful business men acquiesce in the equity of a progressive income tax. They do not dread the few dollars of taxes but the atmosphere of suspicion and absence of appreciation of social service rendered by high class enterprise honestly conducted.<sup>13</sup> The charge that a state income tax will drive away business is not substantiated in Wisconsin although the income tax is an isolated and exclusive state tax.<sup>13</sup> The Wisconsin tax commission reports that corporations have dealt as fairly with the income tax as any other class of taxpayers. T. S. Adams says that an income tax devised in a spirit of equity, reasonable in rate and tactfully administered will not drive away any enterprise worth keeping.<sup>13</sup>

<sup>13</sup> Adams - A.E. Review. 1915 Mar. p. 236

<sup>12</sup> Wis. Tax Com. Report, 1916. p. 55

The Effect Upon Corporation Stockholders.

With collection at the source such as in Wisconsin the bond holders are able to shift the tax to the stockholders by charging a higher rate of interest for the investment.<sup>14</sup> Another way of shifting is for the corporation to agree to pay the tax upon the bond interest. This results in a smaller surplus and in smaller dividends to the stockholders.<sup>14</sup> The tax upon corporation income as in the Wisconsin law which imposes double rates violates the principle of equality to pay because it takes no account of the individual's circumstances. With an income tax composed of a business and personal income tax these two evils would be much lessened. The income tax should not be collected at one time but should be due in installments in order not to disturb the money markets. The experience of Wisconsin shows that the assessments and collections of income taxes are a barometer of business conditions. During years of normal business conditions there is an normal increase in the taxes collected, while during the times of business depression the opposite is true.<sup>15</sup> The experience of England with the income tax law shows that business will accommodate itself to long-continued laws and so we may infer that with the enactment of state income<sup>tax</sup> laws business will change its methods to conform with the law.<sup>16</sup> The Massachusetts tax commissioner reports "that hundreds of taxpayers—both individual and partnership—engaged in business have been forced into better bookkeeping methods, primarily for the purpose of the tax.

<sup>14</sup>Zoller - Nat Tax Assoc. 1916, p. 217.

<sup>15</sup>Wis. Tax Com. Report. 1918, p. 5.

<sup>16</sup>Seligman - The Income Tax. 1914, p. 672.

but with a result that their true condition will be more easily ascertained and their consequent success more probable, since most of the business failures are attributed to lack of proper bookkeeping.<sup>17</sup>

The income tax does not affect the various occupations in the same way. The following table shows how they are affected:

VII. Tax on Individuals By Occupations. 1916. Wisconsin.<sup>17</sup>

Occupations.	% of tax of group to total	Average tax per taxpayer.	% of group assessed.
Farmers	3.86	\$ 8.40	11.83
Laborers	.16	2.81	1.44
Mercantile	17.18	24.36	18.13
Lawyers	3.98	52.19	1.96
Manufacturing	20.30	91.25	5.72
Banking	10.05	142.41	1.82
All individuals		25.71	

See Appendix E for later figures.

The Effect Upon Industrial Occupations.

The Wisconsin income tax bears most heavily upon the manufacturing and mercantile pursuits. The former pay 20.30% of the total income tax while the latter pay 17.18%. The merchants pay on an average of \$24.36 while the manufacturers pay \$91.25 each. The percentage of merchants paying an income tax is greater than in any other group being 18.13%. The Wisconsin tax commission reports that the income tax upon the industrial pursuits varies with the business conditions.<sup>17</sup>

<sup>17</sup>Wis. Tax Com. Report. 1916, p. 62.

The Effect Upon the Professional and Salaried Men.

The professional and salaried classes are called upon to make substantial contributions under the income tax, whereas they were often exempt or nearly so under the general property tax.<sup>18</sup> As is shown in the above table lawyers average over \$50 apiece. Probably the majority of physicians, surgeons, public officials and members of the miscellaneous professions pay an income tax in Wisconsin.<sup>18</sup> The income tax is slower in reflecting the general prosperity of the state in the case of the professions than in the case of the industrial pursuits.<sup>18</sup> As the earnings of professionals are in general regulated by custom rather than by competition and are thus not dependent on the cost of production, the tax upon the incomes of professions and salaried officials cannot be shifted.<sup>19</sup>

Effect Upon the Investing Classes.

In Wisconsin the heaviest contributors are the money lenders, the retired business men and the investing classes in general.<sup>18</sup> These classes usually escape or shift the burden to the borrower under the general property tax but they cannot do so under an income tax properly framed and applied. As is shown in the above table bankers pay \$142.41 apiece and 10.05% of the total state income tax collected. In general a comparatively heavy burden is placed upon interest. It is difficult to say how far a tax on the income from investments can be shifted. The conditions entering into the problem are many and complex and it is

<sup>18</sup>Adams - A. E. Review. 1915, Mar. '15, p. 238, Supl.  
<sup>19</sup>Seligman - Shifting and Incidence of Taxation, 1910. p. 368.

hard to determine just what proportion of the tax would be shifted.<sup>20</sup>

#### The Income Tax and the Laboring Classes.

Less than  $\frac{1}{5}$  of 1% of the total income tax receipts in Wisconsin came from laborers. About 1 $\frac{1}{2}$ % of all laborers paid an income tax and the average amount paid was \$2.81. (See table VII.) The state income tax does not affect the laborer as much as do the general property tax, the customs or internal revenue duties.<sup>21</sup> Whereas in Wisconsin, the income tax is introduced as a substitute for the personal property tax, the income tax may even be a positive benefit to the laborer.

#### The Effect Upon the Farmers.

The farmers of Wisconsin paid 3.86% of the aggregate income tax with an average tax of \$8.40 apiece. These are very low figures especially if one considers that Wisconsin is an agricultural state. The income tax does not work very well when applied to farmers because it is very difficult to determine a farmer's net income. It is much easier to find out the value of his land and livestock than the income therefrom. As a result the property tax works much better in the country than in the cities where personal property is much larger relative to the real estate. Living expenses are not deductible, but the farmers are not required to list as expenses the part of the crops consumed. As

<sup>20</sup>Ibid. p. 328.

<sup>21</sup>Adams - A. E. Review. Supp. Mar. 1915. p. 237.

the income tax works better in the cities and towns and the general property tax better in the country, the two taxes counter-balance each others defects. The farmers do not necessarily pay little or nothing for the support of the state government because 70% of the income tax goes to the tax district, 20% to the county and 10% to the state.

The Income Tax, The Rent, and the Landlord.

The income tax takes a smaller share of rent and is easier on the landlord than the general property tax.<sup>21</sup> This is due to the fact that the income tax does not bear upon unproductive land as does the general property tax which rests upon the present value of anticipated rents or earnings. The income tax also tends to decrease the rate of property taxation by furnishing a part of the revenue needed. Where the income tax thus reduces the property tax or prevents the increase in rates, real estate investors are beneficiaries of the income tax.<sup>21</sup> The Minneapolis Tribune says in this connection:

"Greatest care should be taken to avoid levying a disproportionately large share of taxes on homes. The large and small cities of Minnesota have a pardonable pride in being called communities of home owners. Ownership of homes as a contribution to good citizenship has been preached long and fervently, and it is excellent civic doctrine. Have we, in Minneapolis, reached or approached near to the point in taxation that tends seriously to discourage the owning of homes? It is very much to be feared that we have."<sup>21.1</sup>

<sup>21.1</sup> April 17, 1920. p. 20.



In general, the income tax accomplishes what it is designed to do, that is, it secures a large contribution from investors, successful professional and salaried men, and from business concerns which have reached the dividend-paying stages.

The Income Tax in its Effect Upon the Rich and Poor.

The income tax is a rich man's tax. The poor classes are largely exempted from the operation of the tax. The personal property tax falls most heavily upon the poorer classes of the community, while the rich with their large holdings of intangible property escape their due share. The income tax is a good substitute for the personal property tax because its results conform more closely to the ability to pay theory. The following table shows who pays the income tax in Wisconsin.<sup>22</sup>

VIII. Income Tax in Wisconsin on Firms and Individuals.

I Group of income	II Number assessed	III % of group to total No. Asses- ed.	IV % of group Income to total Income	V % of group tax to total Tax paid.	VI Average tax.
All	62,270	100.	100.	100.	\$25.
To \$1,000	42,000	68.14	20.14	10.14	3
\$1--2,000	10,000	17.21	18.14	9.70	14.
2--3,000	3,000	6.25	11.62	6.90	28
3--4,000	2,000	3.21	8.54	5.59	44
4--5,000	973	1.56	5.41	3.92	64
5-10,000	545	2.48	12.93	12.06	125
10-15,000	345	.55	5.18	7.73	358
15-25,000	214	.34	5.00	9.91	741
25-50,000	110	.17	4.55	10.98	1598
50-75,000	37	.06	2.86	7.67	3320
75-100,000	11	.01	1.21	3.38	4918
100,000	14	.02	4.16	12.02	13,750

(See Appendix F for later figures without percentages.)

<sup>22</sup>Wis. Tax Com. 1916. p. 61.

The figures in the above table show (column III) that 68% of all income taxpayers paid an income tax of only 10.14% of the total collected and that the average tax was \$3.- (Col. V. and VI.) Over 97% of all the taxpayers received incomes of less than \$5,000, paid only 36% of the tax with an average tax of \$30.00 (Col. II and VI.) although they received over 63% of the total income assessed. These figures show that the Wisconsin income tax falls most heavily upon the wealthy and to that extent tends to bring about a fairer distribution of wealth.

The fact that the income tax falls most heavily upon the wealthy gives rise to several important considerations. In the first place the income tax is paid by one class which is a very small percentage of the total number of voters. This may lead to extravagance in government spending. The exemption should be made as low as possible in order to bring more people under the operation of the income tax. Although the income tax falls mostly upon the rich, it is nevertheless a feeble instrument with which to reduce swollen fortunes. To enforce a progressive tax, the cooperation of the majority of the taxpayers is necessary but in order to do this the tax rates must be fair and reasonable. Experience seems to show that the limit of enforceable rate is about 10%. This is insufficient to reduce swollen fortunes. If large fortunes are to be reduced, they should be arracked directly and their causes removed. The attempt to make the income tax do the work of social reform is apt to spoil it as a tax.

The Effect Upon Saving.

The income tax is often criticised on the score that it discourages thrift and saving. Every tax discourages thrift and enterprise to a certain extent but the state income tax with rates not more than 5 or 6% is not as harmful in this respect as the general property tax which often takes 20 - 50%. The knowledge that the income tax exists and that the state will share in the gains resulting from exertion and investment exercised in the long run some repressive effect upon the intensity of labor and capital, but this is negligible when the good of government expenditures is considered.<sup>24</sup> The discouragement of saving is of greater importance, however, because the rich save a larger percentage of their income than the poor and a marked decrease of their incomes by taxation will cut heavily into the wealth set aside for future production. The question is whether this decrease of the savings of the rich will be counterbalanced in some other way. Under the present property taxes the very poor pay very little in taxes, and so a higher tax upon the rich would frequently relieve a middle class of relatively thrifty habits who do much saving.<sup>25</sup> Then also the psychological and moral aspects of a wider encouragement of the poorer classes more than counterbalance the damage to the rich since hundreds of poor can now save or at least raise their standard of living.<sup>25</sup> As a large part of the annual harvest of thrift is composed of profits earned by business concerns which immediately

<sup>24</sup>Ibid. p. 236  
<sup>25</sup>Ibid. p. 239 - 40.

turn a large part of their gains back into the business or re-invest it in related kinds of productive activity, a business tax on net profits tends to act as a negative stimulus to commercial experimentation, industrial pioneering, to small business and new enterprise in general.<sup>25</sup>

In this connection it is necessary to consider what the government does with the money raised by taxation. The benefits derived from the expenditures for public works, charitable institutions, education and such a war as the late one will in the opinion of most people, outbalance the benefits derived from that same money if expended by private persons and concerns. The present tendency is towards an extension of government activities and in so far is a recognition that the government can use the money better than the individual. A state income tax with low rates such as are proposed for a Minnesota income tax would not have serious consequences on the score of decreasing the savings and the future capital wealth of the state.

#### The Distribution of the Income Tax as to Sections.

The income tax is mainly an urban tax. Milwaukee County, in which Milwaukee is situated, has 18.56% of the Wisconsin's population, but it has 41.42% of the total income and paid 44.01% of the total income tax.<sup>26</sup> On the other hand 54 rural counties with 50% of the population and 25% of the total assessed income paid less than 20% of the income tax.<sup>26</sup> The state per capita tax is \$2.29; that of Milwaukee is \$5.43 and that of the rural

<sup>26</sup> Wis. Tax Com. Report. 1916 - p. 55.

counties is \$.95.<sup>26</sup> The federal tax shows the same distribution between industrial and agricultural states. New York state <sup>in 1914</sup> paid one third of the United States income tax while New York City paid one half of all the personal income taxes collected by the federal government.<sup>27</sup> The yield of the income tax in Wisconsin is negligible in the small cities, villages and in the rural towns unless factories are present.<sup>28</sup> In the big cities the yield of the income tax is sufficient to warrant the immediate exemption of personal property. In the event that Minnesota adopts an income tax the personal property tax could be entirely eliminated and the rates on real estate reduced in such cities as Minneapolis, St. Paul and Duluth. In the farming districts of Wisconsin where the personal property is 10% of the total assessment, the income tax revenue is very small.<sup>28</sup> Here the personal property might also be exempted without raising the property tax rates very much. In the villages and smaller cities personal property is 25 to 30% of the total assessment but the yield of the income tax is small.<sup>28</sup> If the personal property tax were abolished, these municipalities would be faced by a shortage of revenue or greatly increased rates on real estate which is already heavily taxed. Under the circumstances it would be best, in case the personal property tax were to be dropped as a part of the tax system to permit localities to do away with the tax if they didn't need it, but to retain it as a local tax if they considered it necessary.<sup>28</sup> Although the large cities

<sup>27</sup>Seligman - Nat. Tax Assoc. 1915, p. 137.

<sup>28</sup>Adams - Pol. Sci. Q. 1913, Dec. p. 584.

pay most of the income tax in Wisconsin, they do not bear an undue share of the state expenditures because the income tax receipts are divided: 70% going to the local tax district, 20% to the county and 10% to the state.

In drawing up a state income tax, the legislators must carefully consider the effect the tax will have upon the distribution of wealth. The experience of other states and especially that of Wisconsin shows that the effects of the income tax are mostly desirable and that the income tax tends to place the burden upon those who are best able to pay instead of those who are least able to pay as our present personal property tax does.

## CHAPTER VIII.

### ADMINISTRATION.

#### Significance of Administration in Income Taxation.

The most important consideration in the drawing up of an income tax law such as is proposed for Minnesota is the provision of the proper administration. The chief reason for the failure of state income taxation in the past has been the improper administration of the income tax laws. D.P. Kinsman in a book entitled "Income Taxation in the Commonwealths of the United States" says: "A careful study of the history of the income tax leads one to the conclusion that the failure has been due to the administration of the laws. This conclusion is borne out by both the admissions of the advocates and the assertions of the opponents of the tax, and is corroborated by the reports of the tax commissions."<sup>1</sup> E. R.A. Seligman says: "The success of the income tax depends, perhaps more than almost any other modern institution upon the administrative machinery..... Simply to adopt the principle of income taxation and to enact a law providing for its imposition is by no means adequate. If we select the correct machinery and elaborate a scheme which is in harmony with administrative possibilities and public sentiment in any particular country, the income tax will work. If we choose the opposite course and attempt too much, the result is bound to be disastrous."<sup>2</sup>

<sup>1</sup>p. 117.

<sup>2</sup>Income Tax, 1914, p. 673.

The Problem of Administration in a Democracy.

The failure of so many state income tax laws because of improper administration is in line with the great problem of administrative efficiency that democracy has so far failed to solve. It is a trite saying that we have solved many of our constitutional problems but have scarcely begun to attack the administrative problems.<sup>3</sup> The great political campaigns of today stress the question of efficiency of government administration. But administration in a democracy is proverbially difficult. In a community where everyone considers himself as good as his neighbor, respect for expert knowledge is not likely to be so great as in an autocracy. Administrative efficiency is difficult in a democracy because of the lack of permanence of office tenure and the obnoxious spoils system which allots offices not to the best men but to the best politicians. The attitude of the citizen towards the government official is often as of superior to inferior because the latter's tenure depends upon election. The United States is suffering from anarchy of local autonomy and Sidney Webb, the great English labor authority, says that this anarchy is as bad as the centralized autocracy of Europe.<sup>4</sup>

Although the public bears the burden of taxation, it is antagonistic and generally unresponsive to suggestions of students and experts and experienced administrators to place this brand of public service on the same plane of efficiency as that of private business.<sup>5</sup> This public attitude, which is due to inertia and lack of information, leads to perpetuation of the loose and haphazard

<sup>3</sup>Income Tax, 1914, p. 649. Seligman, E.R. A.

<sup>4</sup>Ann. Amer. Acad. 1915 Mar. p. 61. This holds true in tax administration.

<sup>5</sup>Howe - Ann. Amer. Acad., 1915 Mar. p. 112.



ways of laying taxes.<sup>5</sup> The public must be educated to realize that there are at hand intelligent, able, and highminded students who are able to help solve the government problems of administrative efficiency. The problem of administration is especially important in the case of income taxation because it needs for its successful operation a far greater degree of administrative efficiency than any other source of revenue, and, it may be added, than almost any branch of government activity.<sup>6</sup>

The Relation of Administration to Property and Income Tax Laws.

The failure of the personal property tax is due chiefly to the impossibility of proper administration of the tax. The Minnesota Tax Commission says concerning it: "It has never been successfully administered in any state. In its present form it can never be successfully enforced in this state. Many of the more progressive states in the union have already abandoned it in whole or in part. That the personal property tax will be abolished in this state is altogether probable."<sup>7</sup>

With regard to the general property tax as a whole the condemnation is not quite so harsh. The attitude towards it seems to be well expressed by C. H. Mote in an address before the National Tax Association: "There is practical agreement that improved administration will not correct the defects of the general property tax as applied to all classes of property, though it will correct some of the most glaring defects of this system so far as it ought to be retained, namely, in the assessment of real estate."<sup>8</sup>

<sup>5</sup>Howe - Ann. Amer. Acad. 1915 Mar. p. 112.

<sup>6</sup>Seligman - The Income Tax. 1914, p. 652.

<sup>7</sup>Report 1916, p. 86.

<sup>8</sup>Proceedings of N. T. Com. p. 249, 1917.

Although the general property tax is so universally condemned, the taxation of income is also subject to certain inherent difficulties. The first thought that comes to one's mind upon the mention of income taxation is, How can the income of a man be determined? His property is tangible; it can be seen; but his income is intangible and apparently impossible of discovery. If property taxation with this apparent superiority is a failure, what would income taxation be? The answer is that with the same administrative machinery as the property tax, the income tax is a flat failure as was clearly shown by the experience of some sixteen states who tried it.

From the point of view of enforcibility both property and income have certain natural advantages. The income of many securities is a simpler and more definite thing to assess than is capital value. Business income is as difficult to ascertain as the value of the property invested therein.<sup>9</sup> If there are frequent transfers, the value of real estate is easier to determine than its net income.<sup>9</sup> The value of farms and livestock ~~on the other hand~~ is much easier to ascertain than the income therefrom.<sup>9</sup> It would seem that income taxation should be confined more to the first two classes of property and the property taxes more to the latter.

Opinion as to whether property or income can be assessed more easily seems to differ with experience and geographical location.<sup>10</sup> Bastable, who resides in England where they have a successful income tax, thinks that income is easier to assess.<sup>10</sup> The Swiss with a successful property tax think property is superior.<sup>10</sup> The Germans with both taxes operating successfully think the two don't differ much in this respect while we in the United States

<sup>9</sup>Bullock - Nat. Tax Assoc. Pro. 1916, p. 378.

<sup>10</sup>Ibid, p. 377.

with the unsuccessful property tax think any other tax is better.<sup>10</sup>  
The opinion of those who have had experience with the administration of state income tax laws is that they are as easy to administer as real estate taxes.<sup>11</sup> Where the income tax was introduced under proper conditions, obviously not fatal to success, it has worked better from year to year.<sup>12</sup> The fact is that neither property nor income tax operates well without the proper conditions and administration.<sup>10</sup>

#### Centralized Administration of the Tax Laws.

The turning point in state income taxation came in 1911 with the enactment of the Wisconsin income tax law, more than half of which is devoted to an elaboration of the administrative features. The framers of the law had learned a lesson from the experience of the other states and they provided for a centralized administration. The other states had left the administration of their income tax laws to the local officials and the result was lax enforcement and a very meager yield. Massachusetts followed the example of Wisconsin and placed the administration of its income tax law in the hands of state officials. The other states which have enacted income tax laws are also providing centralized administration instead of entrusting the enforcement to local officials. The success of the British income tax is due largely to the centralization of the administering machinery under the *Inland Revenue Commissioner*. The vesting of the income tax administration in the hands of a central state body is in line with the general tendency towards centralise-

<sup>11</sup> Adams - Pol. S. J. 1913 p. 574.

<sup>12</sup> Seligman - The Income Tax, 1914 p. 572.

tion in the present-day business world and in the government. It is a movement away from local autonomy and inefficiency to centralized control and supervision. In fiscal matters those states now stand at the head which have developed an efficient central control over local action. The sooner the others fall in line the greater will be the progress toward efficiency and justice.

### State Tax Commissions.

At present most states have tax commissions.<sup>12</sup> At first these commissions were merely temporary and designed to investigate the tax situations and then to report to the legislatures. The reports, however, showed that permanent commissions were desirable not only to make reports to the legislatures but to see that the tax laws are uniformly enforced throughout the state. At present there are three kinds of state tax commissions.<sup>13</sup> In the first class are those which are charged with the assessment of corporations. In the second class are those which have the above power but in addition are required to equalize assessments. The third class has both of the above powers and besides exercises a directory or supervisory control over the work of the local assessors. Minnesota's tax commission may be placed in the second class. It administers the state gross earnings tax and equalizes the assessments of the counties. It seeks to improve local assessment by training the assessors but the commission doesn't have enough control over the local assessors to create an efficient tax administration in the state. The Wisconsin tax commission has the powers of the Minnesota commission but in addition it may appoint assessors of income from a

<sup>12</sup>Lutz - State Tax Commissions. 1918. Chapt. XIX.

<sup>13</sup>Ann. Amer. Acad. 1915, Mar. p. 122.

civil service list. It is this last power which has made income taxation a success in Wisconsin. The Wisconsin commission does not have the power to appoint the local property assessors and in that respect it has been handicapped in its attempt to put tax administration in that state upon the highest possible plane of efficiency.<sup>14</sup> Massachusetts has the same kind of administration as Wisconsin except that tax commissioner takes the place of the tax commission. If the Minnesota tax administration is to be put upon the highest plane of efficiency and justice, the state tax commission's powers should include: (1) assessment of all property or business that has a state-wide rather than a local character and the assessment of all financial institutions and public utility corporations of every kind; (2) the assessment of the personal income tax and the tax on business, also the administration of inheritance taxes and any other state transfer taxes; (3) the equalization of property assessments for the purpose of state taxation and the equalization of county assessments; (4) directive and supervisory power over the assessment of property, including the power to order reassessments; (5) power of removal, after a hearing, of local assessors for inefficiency or misconduct; (6) authority to act as a board of appeal and (7) authority to investigate the entire subject of taxation and to gather and publish comprehensive statistics concerning all matters of taxation and public finance.<sup>15</sup>

#### The Local Assessor.

The locally elected assessor who is bent on conciliating the voters and on keeping his own political job is the one who has

<sup>14</sup> Wis. Tax Com. Rept. 1916. p. 90.

<sup>15</sup> Model Plan Com. Rept. 1918 p. 39. The Minnesota Tax Com. has all above powers except (2) and (5).

demoralized the American general property tax and caused the failure of so many state income taxes. The most serious defect in our tax system is the method of selecting the assessment force. The present system of local election normally results in a miscellaneous aggregation of untrained and ill-paid assessors of varying degrees of indifference and incompetency. A few good assessors are chosen, not because of this system but in spite of it. Uniform assessment is next to impossible. The Committee of the National Tax Association on the method of selecting assessors says: "The local assessor is the keystone, nay more he is the very foundation upon which the whole administration of the whole general property tax rests. Unless he is a man of good judgment, familiar with values, endowed with sufficient moral courage to be fair and diligent enough to find and place all property in his district upon the assessment rolls, his work invariably falls far short of the legal standard and usually results in the grossest injustice."<sup>16</sup> Although the assessor's work has been tolerable in the case of real estate, his assessment of personal property especially intangible personal property has been a farce. If the assessment of incomes were entrusted to him, the result would also be a farce as the experience of some sixteen states with income taxation has shown. The Minnesota Tax Commission therefore recommends the adoption of income taxation only "after the creation of a county assessor system."<sup>17</sup>

The local assessor should be replaced by a county assessor. There are four ways of selecting this county assessor.<sup>18</sup> The first and best way is to have him appointed by the state tax commission

<sup>16</sup> Wis. Tax Com. Report, 1918. p. 14.

<sup>17</sup> Minn. Tax Com. 1918. p. 94.

<sup>18</sup> Ibid. p. 71 ff.

from a list of men who have passed the proper civil service examinations. The assessor should be under the direct control and supervision of the commission and subject to removal for incompetency. With the assessor protected in this way he can better resist the local influences to which he is now subject. There is a certain fear on the part of many people that it is dangerous to give the state officials too much power. They wish to maintain home rule and self-government.<sup>19</sup> In order to overcome this prejudice the second plan is to have the county assessor chosen by the county commissioners from a list of men who have passed the civil service examinations. The third plan is to leave the choice of those who have passed the examinations to election by the people. The fourth plan provides that the county assessor be elected without being required to pass an examination. This last plan is not very much of an improvement over the old way because it does not insure the choice of capable men but leaves them subject to local politics. The second and third plans are improvements over the present one but to secure the best tax administration and to make income taxation a success the assessors should be chosen by the state tax commission.

The Wisconsin assessors of income are a good illustration of the results that can be attained by the county assessor system.<sup>20</sup> The assessors of income are selected by the tax commission for three-year periods and upon passing a civil service examination. They spend all their time as assessors; are removable for incompetency; may be moved to other districts; receive salaries ranging from

<sup>19</sup>Am. A. Acad. Mar. 1915. p. 6.

<sup>20</sup>Kennan. *ibid.* p. 69.

\$800 - \$3600, and are allowed to hire the necessary office force.<sup>20</sup> They have charge of the assessment of the income tax and supervise the assessment of the property taxes. They are required to report to the tax commission which makes rules and regulations for their guidance. As they have not sufficient power over the assessment of the property taxes, the tax commission recommends that the assessors of income be made assessors of the property taxes as well.<sup>21</sup> The commission also recommends that as the assessment districts are too small, the county should be made the unit for the administration of the property and income taxes.<sup>22</sup>

The assessors of income are the greatest find of the Wisconsin income tax. They include men of all shades of political opinion; Republicans, Democrats, Socialists and Single Taxers. The tax commission strongly supports them in their work and earnestly urges them to a thorough enforcement of the law.<sup>23</sup> The assessors of income have responded intelligently and impressed the people of the state by their tact and firmness and have convinced them that the law is to be enforced just as written.<sup>23</sup> They have often called upon experts employed by the State Railroad and Tax Commissions to assist them in their work. In the Wisconsin system the state co-operates with the local assessor but it doesn't supplant him.<sup>23</sup> In this way the dangers of excessive centralization and excessive decentralization are avoided.<sup>23</sup> The local assessor system unsupported by a central authority was open to all the dangers of decentralization which led to chaos. The federal income tax adminis-

<sup>21</sup> Wis. Tax Com. Rept. 1916. p. 90.

<sup>22</sup> Ibid. 1918. p. 13.

<sup>23</sup> Pol. Sci. Q. 1913. Dec. p. 572-5.



tration, on the other hand is too centralized, because the localities have no check upon the collectors of internal revenue.<sup>23</sup> The Wisconsin system also avoids the danger of bureaucracy which a highly centralized system such as that of the federal tax administration is subject to.

In order to make income taxation a success, the law must provide for a protected county assessor. With him all things, even the general property tax, are possible, without him everything is chaos, as is seen in the failure of the general property tax.<sup>24</sup> The chief points that should be considered in the provision for a county assessor of income are:

- I. Appointment by the Tax Commission after passing a civil service test.
- II. Control and supervision by the state tax commission.
- III. Freedom from local politics and control.
- IV. Good pay.
- V. Permanent tenure with removal for incompetency.
- VI. Power to engage experts and necessary clerical help.

#### Expert Assistants.

The present generation is one of experts. The business which does not employ expert help will soon be crowded out by those who do. One reason for the great amount of inefficiency in our state, local and federal governments is due to the failure to employ experts. This failure to employ competent help in the government is due to the fact that voters do not realize the necessity for the expert knowledge. Massachusetts in its enforcement of the income

<sup>24</sup> Adams. P.Sci.B. 28: 575.

tax is using expert accountants and auditors to examine the books and property of those who are supposed to pay income taxes.<sup>25</sup> The commissioner admits that such expert assistance is expensive but that it pays well in the end.<sup>25</sup> The federal government is employing 18,000 people to check income tax returns and to investigate doubtful cases.<sup>26</sup> The Wisconsin Tax Commission in its annual report states that "a more thoro assessment would necessitate the examination of books and property of the taxpayers by competent accountants who, however, demand a high rate of compensation. Competent men would undoubtedly return to the public treasury the cost of their service manifold. The federal government has a number of such men in Wisconsin and the state would undoubtedly profit by adopting the same course."<sup>27</sup>

#### County Board of Review.

The Wisconsin income tax law provides that "the state tax commission shall appoint three resident taxpayers of each county to serve as a county board of review."<sup>28</sup> The purpose of this board is to give the taxpayers an opportunity to appeal from the assessment of the assessor of income. This board serves as a check upon the assessor of income by subjecting his decisions to the review of local men. It is a recognition of the principle of home-rule and self-government and should help much to bring public opinion to the point where it will support a greater centralization of the tax administration in order to make for greater efficiency and equality.

<sup>25</sup>Mass. Tax Com. Bul. #7, 1918. p. 10

<sup>26</sup>Mpls. Tribune, Mar. 7, 1920.

<sup>27</sup>1918, p. 3.

<sup>28</sup>Wis. Tax Com. pamphlet, 1919, p. 39.

Returns.

Returns of all taxable income must be made by corporations to the tax commission by a certain date under the Wisconsin law. Firms and individuals make their returns to the assessors of income who carefully edit and make the assessments. In Wisconsin six kinds of return blank forms are sent out: (1) individual, (2) guardian and trustee, (3) firms and copartnerships, (4) corporation, (5) farmer and dairymen and (6) wage earners, salaried men and those getting incomes from personal services.<sup>29</sup> It is of great importance that the return blanks be as simple as possible because a great deal of criticism of the federal income tax law was caused by return forms which even bankers found difficult to understand. Irritation caused by complicated return blanks may even be serious enough to embarrass the enforcement of the law. Complicated blanks have caused much extra work for the tax officials and in Massachusetts have led to many delinquencies in spite of the fact that the department conducted a widespread campaign for the education of the taxpayers.<sup>30</sup>

A proper enforcement of the income tax laws calls for much investigation to verify returns. In Massachusetts there were about 19,000 delinquencies to 183,000 returns.<sup>30</sup> The department proceeded zealously and turned in 9,000 but it was estimated that about 10,000 were still delinquent one year after the returns were due.<sup>31</sup> The investigations were conducted along several lines: (1) correspondence, (2) interviews, (3) examinations under oath, and (4) auditing books.<sup>31</sup> The auditing of books proved very profitable, for

<sup>29</sup> Kennan- A.Amer.Acad.Mar.1915, p. 70

<sup>30</sup> Mass.Tax Com.Bul. 7. 1918 p. 8-9.

<sup>31</sup> libid.p.11.

sometimes a day's work uncovered enough income to pay the auditor's salary for a year.<sup>31</sup> A large percentage of claims of non-residence were also decided in favor of the state. <sup>seven</sup> ~~ten~~ <sup>ty</sup> of all the taxes assessed and billed were collected.<sup>31</sup> This record compares favorably with that of any city of the commonwealth. Under the new law more tangible personal property was reached than under the old law with local administration. In some quarters it is urged that publicity of the names and the amounts of income tax payable would help greatly in cutting down delinquency and evasion but it seems that this method would cause more irritation than additional income.<sup>32</sup> A more uniform system of bookkeeping would also assist greatly in the making of returns.

#### Penalties.

Closely connected with the subject of returns is that of imposing penalties for late or fraudulent returns. Penalties should be imposed with discretion. If a return is incomplete owing to ignorance of the law, the government will gain by not imposing the extreme penalty. Laxity in this respect should not be tolerated either and the negligent taxpayers and the evaders should suffer the full penalty that the law provides. The penalty should be higher than the amount of the tax for the year otherwise evasion would be encouraged. The usual penalties are fines, doubling the rates, and imprisonment. A strict enforcement of the law by punishing to the full extent of the law is absolutely necessary to prevent the income tax from becoming a farce such as our present personal property tax.

<sup>32</sup> New Republic. Aug. 12, 1916.

Secrecy of Returns.

All the income tax laws provide heavy penalties for disclosure of income tax returns. This is necessary in order to safeguard the interests of individuals and of business concerns. A business concern might suffer much inconvenience and damage by having its returns opened to the inspection of its competitors. Unless secrecy of returns were guaranteed, the temptation for evasion would be greatly increased and the problem of administration be greatly complicated.

Appeal and Review.

The Wisconsin income tax law provides that corporations may have a hearing and appeal before the tax commission to review their assessment.<sup>33</sup> From the commission's final decision, they may appeal to the district court of Dane County, in which the commission has its office.<sup>33</sup> Individuals and firms may appeal from the decision of the assessor of income to the county board of review and from this to the tax commission.<sup>33</sup> The taxpayers are thus not bound to the decisions by the tax officials. The corporations may appeal to the courts while the individuals have a chance to be heard by their own neighbors who make up the board of review.

Collection at the Source.

The method of collecting the income tax at the source was considered the chief factor, in the long-continued success of the English income tax. In the United States, however, this method is being abandoned. In the federal income tax law collection at the source is limited in application to non-resident alien individuals

<sup>33</sup> Wis. Income Tax Law. 1919. Sec. 1087 m - 13 - 19.

and foreign corporations. The Massachusetts law does not employ collection <sup>At the</sup> source but uses the method of information at the source.<sup>35</sup> The Wisconsin income tax law does not provide directly for collection at the source but taxpayers are allowed to deduct dividends received from corporations who have paid an income tax. In this way 75% of the total income tax revenue was received from corporations and partnerships.<sup>36</sup> Collection at the source is undesirable because it entails too much expense to the collecting agents such as corporations, banks and trust companies. It also leaves out of consideration the circumstances of the people receiving the dividends. A man might have a deduction from his wages even if his total earnings are below the exemption allowed by the law. To refund the amount deducted would only complicate the administration. With collection at the source it is difficult to apply that great principle of progressive rates which is the most prominent feature of modern income taxation. If the tax is collected at the source, the collecting agent will have the use of the money until taxpaying time. The taxpayer also runs the risk of the company's failing. He would then lose not only the amount deducted from his salary but would also have to pay the tax. Collection at the source is a convenience and an element of strength but not a necessity in income taxation. In the income tax such as here proposed for Minnesota, collection at the source would be undesirable because the business and personal income taxes are distinct and separate.

<sup>34</sup>Revenue Act 1918. Sec. 221 and 237.

<sup>35</sup>Mass. Tax Com. Bul. # 7 p. 7.

<sup>36</sup>Adams - Pol.Sci.Q. 1913, Dec. p. 577.

Information at the Source.

Information at the source is used in modern income taxes in place of collection at the source. The federal, the Massachusetts and the Wisconsin income taxes provide for information at the source. The Wisconsin tax commission has organized a system of information at the source that works efficiently and smoothly.<sup>37</sup> Income tax returns forms are accompanied by blanks for the names, addresses and amounts paid to persons as (1) salaries above \$700, (2) as dividends from corporations and (3) as interest on indebtedness.<sup>37</sup> This information is classified and arranged by the tax commission and furnished to the assessors of the district where the recipient of the wages, dividends or interest lives. This system is not provided for by law but has been worked out by the commission under its power to make needful regulations. It serves as a threefold check: (1) it shows whether excessive salaries are paid by the corporations; (2) it tests the correctness of corporation deductions for wages, salaries and dividends paid and (3) it has a great deterrent effect upon individual tax payers.<sup>37</sup> The experience with information at the source seems to show that better results are attained and with less friction than by the method of collection at the source.

The Attitude of the Public.

Whenever a big change such as the adoption of an income tax is contemplated, the attitude of the public must be taken into consideration. The wisdom of any material change in a system of taxation is problematical, unless backed by a strong and well-de-

<sup>37</sup> Kennan- Ann.Amer.Acad. 1915. Mar. p. 71.

fined public sentiment.<sup>38</sup> The history of the English income tax shows how the public sentiment changed from one of uncompromising hostility to one of virtual acquiescence. The criticism against the federal income tax has been directed not against the principle of income taxation but rather against the cumbrous way in which it is carried out. In Massachusetts, the commissioner reports "a general feeling of satisfaction with income taxation is expressed by all classes of people."<sup>39</sup> In Wisconsin the opposition against the income tax was violent at first but it has changed so that now "the consensus of public opinion is that the income tax has come to stay and however objectionable it still is in some respects, it is a distinct improvement upon the personal property tax."<sup>40</sup>

#### Evasion.

The personal property tax is a failure because of the whole sale evasions. The income tax laws of some sixteen states were failures because the taxpayers evaded the law. T. S. Adams, formerly State Tax Commissioner of Wisconsin, and with the treasury department of the federal government says: "As a matter of fact, the American taxpayer is honest, and his past attempts to evade taxes have arisen largely from the inequitable provisions of the tax laws themselves. If you impose an income tax with reasonable rates and with provisions that are fair both to the taxpayer and the state, and if you make it plain to the taxpayer that you have adopted general principles which you will follow both to your disadvantage as well as to your advantage; the taxpayer will

<sup>38</sup> Minn. Tax. Com. 1916, p. 119.

<sup>39</sup> Mass. Tax Com. Bul. #7, 1918, p. 17.

<sup>40</sup> Kennan- Ann. of Amer. Acad.



meet you halfway, and you will be surprised, not by the number of attempts to evade the tax, but by the astonishingly welcome and refreshing evidence of a desire to cooperate with the administrative authorities. A few people will lie. Perhaps there are two or three per cent who will lie, if you let them; the rest will tell the truth without great pressure."<sup>41</sup> Coming from a man with such wide experience practical as well as theoretical this statement carries great weight.<sup>41</sup> K. Kennan, another tax expert says in answer to the statement that the income tax makes a nation of liars: A review and test of thousands of income tax returns impresses officials with the evident truthfulness and honesty. Of 1,000 returns which were defective or erroneous one-third contained errors which had the effect of increasing the tax. Of the rest the majority were faulty because of ignorance or misunderstanding. Only five per cent show evidence of fraud."<sup>42</sup> [See also Appendix I]

It is difficult to determine just how much evasion there is. In Massachusetts during the first year 9000 delinquent returns were brought in and the commissioner estimated that 10,000 more were still out. With 183,000 returns in all, it would seem that somewhat less than ten per cent were delinquent.<sup>43</sup> The Wisconsin commission said in its 1918 report that "no doubt there were some evasions."<sup>44</sup> The U. S. Treasury department reported on Jan. 20, 1920 that \$400,000,000 was collected from income dodgers in the past year.<sup>45</sup> As \$2,838,900,000 was collected in all during 1919 the amount collected from tax dodgers is about 14%. This shows

<sup>41</sup>Montgomery - Income Tax Procedure, 1919. p. 38. Gites Adams.  
<sup>42</sup>Ann. Amer. Acad. Mar. 1915. p. 75.  
<sup>43</sup>Mass. Tax Com. Bul. #7, p. 9.  
<sup>44</sup>p. 3.  
<sup>45</sup>Mpls. Tribune.

rather unsatisfactory results in the administration of the federal income tax law. The abnormally high rates account for much of this attempted evasion. The question of evasion is difficult to investigate but the reports of the officials who administer the Wisconsin and Massachusetts income tax laws indicate that the evasions are not any higher than can be expected in the enforcement of any tax law. The evidence and the opinions indicate that evasion is not nearly as wholesale as under our present personal property tax.

Cooperation with the Federal Tax Authorities.

As both state and federal income tax laws operate upon the same income, it is desirable that the same methods be used by both taxing authorities in order to avoid useless duplication and irritation. The federal government is in a better position to tax corporations doing interstate business, while the state can furnish the federal authorities with local knowledge that is of great assistance in checking the federal returns. In the administration of the Wisconsin income tax, many of whose provisions are similar to the federal law, the practice of the federal law has been followed where applicable.<sup>46</sup> The state tax authorities use the federal rules of construction and practice so as to bring about more efficient administration and to lighten the burden upon the taxpayer.<sup>46</sup> The same return blanks are not used because the federal returns refer to all incomes from all states while the Wisconsin receipts must be distributed to the localities.<sup>46</sup> The Massachusetts commissioner reports that his income tax department has cooperated closely with the federal authorities and has been able to add a good

<sup>46</sup> Wis. Tax Com. Report. 1916 p. 42.

many returns to the federal list while at the same time much valuable information was obtained from the federal authorities.<sup>47</sup> The Connecticut and New York corporation income tax laws provide that the taxes shall be based upon the returns to the United States government. Although there is some cooperation between the tax authorities of those states and the federal government it is only a beginning. The federal law now has a provision "that the proper officers of any state imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation .....at such times and in such manner as the Secretary of Treasury may prescribe."<sup>48</sup> W. B. Crowcher says in writing about the administration of the British income tax:<sup>49</sup> "The secret of success of the British income tax lies in the system of joint control under which the local and central authorities work together, and for the most part in complete harmony."

#### Cooperation with the other States.

One of the greatest objections to state income taxes has been the fact that a lack of cooperation between the tax authorities of the various states has led to much double taxation. With a system such as here proposed (an income tax composed of a business tax and a personal income tax) this danger can be overcome.<sup>50</sup> It remains for the administration of the tax to solve the problem of allocating the incomes of interstate corporations among the states in which the business is done. There are several ways in which this can be done.

<sup>47</sup>Bul. #7, 1918, p. 10.

<sup>48</sup>U.S.Rev.Act.1918, sec. 257.

<sup>49</sup>Econ.Jour.1911, p. 287.

<sup>50</sup>Preliminary Report of Model Plan Committee. 1918.

Wisconsin is using one which seems to be giving fairly satisfactory results. (See MS.p. 4/.)

Conclusion.

The failure of income taxation in some sixteen states was due mainly to decentralized administration. Any income tax law that is left to the local assessors for enforcement as was done in these states cannot be expected to be a success. Our personal property tax is a failure because our locally-elected, untrained, and unsupported assessors are unable to carry out the law. If we left an income tax to be enforced by them, the result would also be a failure. The state income tax to be successful must be administered by a set of officials similar to the assessors of income of Wisconsin. Unless our state can secure a county assessor system backed up by the state tax commission, it is useless to pass any kind of income tax. The first essential of a state income tax is proper centralized administration. With it the state income tax will succeed; without it, the income tax will fail.

The Chief Features of the Proposed Income Tax for Minnesota.

The income tax as here proposed for the state of Minnesota consists of two separate taxes: the personal income tax and the business tax. The chief reason for keeping the two taxes separate is to avoid double taxation which arises out of the attempt to tax interstate investments and property in the same way as if they were within the state. The personal income tax is levied upon the individual's entire net income in conformity with the principle that every person having taxable ability should pay some sort of a direct personal tax to the government under which he is domiciled

and from which he receives the personal benefits that government confers. The business tax is levied upon all business carried on within the state in accordance with the principle that business carried on for profit in any locality should be taxed for the benefits received. Intangible personal property must not be taxed because that would give rise to double taxation.

The personal income tax presents the following characteristics:

- (1) The tax is payable upon all net income of all persons residing within the state.
- (2) The deductions from gross income are to be such as will result in the net income substantially as a good accountant would determine it.
- (3) The amount exempted should be between \$600 and \$1000 for single persons and \$1000 and \$1500 for married persons with \$200 for each dependent.
- (4) The rates should progress from not less than 1% to not more than 6%.
- (5) The differentiation of incomes is undesirable - being brought about by the twofold nature of the income tax.

The business tax presents these characteristics:

- (1) The tax is payable upon the net profits of all business done within the state.
- (2) The deductions are similar to those granted individuals.
- (3) The rate should be proportional and not lower than 1% nor higher than 5%.
- (4) No exemption or differentiation is to be allowed to business firms.

The administration includes the following features:

- (1) Both taxes are to be administered by the state tax commission.
  - (2) The assessment of individuals and firms is to be in the hands of county assessors.
  - (3) County assessors are appointed by the commission after passing a civil service examination and hold office during good behavior.
  - (4) County assessors are subject to the control and supervision of the state tax commission.
  - (5) The property assessments should be under the control and supervision of the county assessors to insure the efficient administration of the property taxes.
  - (6) County boards of review composed of local citizens chosen by the commission shall review the assessments of the assessors and hear appeals.
  - (7) Corporations are to report to and be assessed by the state tax commission.
  - (8) The income revenue shall be divided among state, county and local district according to expenditures of each.
- The purpose of the income tax as here proposed for Minnesota

is:

- (1) To eliminate the gross inequalities now arising from the defective general property tax especially the personal property tax feature.
- (2) To prevent double taxation arising from the taxation of interstate investments and property.
- (3) To add a new source of revenue which shall add elasticity

to the state tax system and at the same time provide the additional funds necessary to meet the rapidly increasing expenditures of the state.

- (4) To bring about incidentally a better distribution of wealth.
- (5) To assist in reforming the state tax system by introducing the county assessor feature which cannot be obtained under present conditions.

The success of the income tax as here proposed is dependent chiefly upon two requirements:

- (1) The income tax must be well drawn up, preferably by a group of income tax experts as was done in Wisconsin.
- (2) The income tax must provide for centralized state administration.

The Income Tax in the present Tax System of Minnesota.

Having drawn up a plan for an income tax, it is necessary to determine its place in the present system of taxation. The income tax is to replace the present personal property tax - both tangible and intangible - as well as the tax on "moneys and credits." The most important sources of revenue in the present tax system of Minnesota together with an estimate of the yield of each are:<sup>51</sup>

General property tax.

Real estate.	)	\$51,000,000
<u>Personal property.</u>	)	
		700,000
<u>Moneys and Credits</u>		
Gross earnings		6,200,000
Inheritance		800,000

<sup>51</sup>Minn. Tax Com. 1918 p. 104, 123; 1916 p. 68.

Insurance	600,000
Miscellaneous taxes and other sources	<u>8,400,000</u>
Total	\$67,329,000

No separate figures are given of the amounts obtained from real estate and personal property taxation. The assessments in 1916 were as follows:

<sup>52</sup> Real estate	\$1,369,000,000
Personal property	241,000,000
Moneys and credit	234,000,000

These assessment figures give a rough basis of comparison of the three taxes but the amount obtained from each cannot be ascertained, because property is classified into four classes for purposes of taxation. As Wisconsin collects about the same amounts from the same sources the figures presented in Table VZ p. 104 will be of value.

With the income tax here proposed as a part of the Minnesota tax system the chief sources of revenue would stand like this:

Real estate tax

Income Tax

Personal income

Business.

Gross earnings.

Inheritance.

Insurance.

Other miscellaneous taxes.

<sup>52</sup>Ibid. 1916 p. 70



The real estate tax is to be the chief source of revenue of the localities while the income tax receipts are to be divided between the state and local governments in the proportion their expenditures bear to the total. The administration of the income tax must be entirely in the hands of the state while the administration of the property tax should be in the hands of state-controlled county assessors. The administration of the property tax cannot be left entirely to the local authorities even if the state gets very little revenue from that source because the local authorities-unbacked and uncontrolled by the central authorities cannot put the tax administration upon an efficient basis. The central authorities would gain by the joint assessment through the local knowledge which can be secured from the local officials. The gross earnings tax should be retained because railroads and public service corporations enjoy certain privileges which should be paid for regardless of net profits. The gross earnings tax can be better administered than any other tax in the case of this class of public corporations.

The income tax as here proposed would be a great step in the direction of reforming the Minnesota tax system. Its adoption would eliminate the grossest defects of the present system and place the state well in the lead as far as reform of state and local taxation is concerned.

#### APPENDIX A.

Is an income tax for the state desired for more revenue, greater equality, or both?

Answer: The purpose of this amendment is primarily two-fold. 1st As you will observe it permits, if adopted, the substitution of a progressive and graduated tax on incomes in lieu of the present unsatisfactory tax upon certain classes of personal property. 2nd. It will undoubtedly tend to relieve the tax burden upon real and personal property, as well as providing additional revenues from sources not heretofore reached under the general property tax system.

Minnesota Tax Commission.. Letter May 14, '20.

#### APPENDIX B.

##### THE TAXING SYSTEM OF MINNESOTA.

The Minnesota tax system as now constituted consists of:

A. Gross earnings tax on the property of

1. Railroad companies,
2. Sleeping car companies,
3. Freight line companies,
4. Express companies, and,
5. Telephone companies.

These taxes are in lieu of all other taxes and assessments upon their property within the state.

B. Insurance companies pay the state annually a sum equal to 2 % of their gross premiums less return premiums, on all direct business received by them within the state.

C. A mortgage registry tax of 15 cents for each \$100 is imposed if the mortgage runs less than 5 years and 25 cents for each \$100 if it matures more than 5 years after its date.

D. "Money and credits" are subject to a 3-mill tax.

E. Grain received in or handled by elevators or warehouses is subject to a tax of one-fourth of one mill. This tax is in lieu of all other taxes on the grain handled by the elevators.

F. A vessel tonnage tax of 3 cents per net ton of registered tonnage of all vessels is imposed.

G. Telegraph companies are assessed on all their tangible and intangible property by the state tax commission at a rate not to exceed the average rate in the state.

H. The general property tax is the most important in the system. Property is classified into four classes and each class is assessed at a different percentage of true and full value.

The first class covers mined and unmined ore and is assessed at 50 percent of its true value.

The second class covers household goods and all other property used to equip the family residence and is assessed at 25 per cent of its full value.

The third class consists of the implements of farmers, the machinery of manufacturers and unplatted real estate and is assessed at 33 1/3 per cent of full value.

The fourth class covers all real estate and personal property not included in the first three classes and is assessed at 40 per cent of full value.

In its 1918 report (p.82), the Minnesota Tax Commission

says that after five years of actual trial the results obtained have been far more satisfactory than even its most ardent friends anticipated. It recommends the abolition of the distinction between platted and unplatted real estate.

I. The state subjects inheritances to rates ranging from 1-12½ %.

J. A poll tax of from one to not more than four days of road labor can be required by villages.

H. A state-wide one-mill school tax as well as a one-mill road tax are also levied.

This brief outline is taken from Chapter II of the Tax Commission's 1914 report. The reader can get a more detailed and accurate view of the Minnesota tax system by reading that chapter.

#### APPENDIX C.

What is the exact wording of the income tax amendment?

Answer: The amendment reads in part:

"and there may be exempted from taxation, household goods, wearing apparel, agricultural products in the possession of the producer thereof, tools, implements and machinery and all real and personal property owned by county agricultural societies and used for holding agricultural fairs, to such an extent and in such manner as the legislature may determine.

" Taxes may be imposed on incomes, privileges and occupations, which taxes may be graduated and progressive and the exemption of a reasonable amount of income from taxation may be provided, and such taxes may be in lieu of taxes on any class or classes of personal property as the legislature may determine."

Minn. Tax Com. Letter May 14, 1920.

APPENDIX D.

BABCOCK PLAN OF STATE TRUNK HIGHWAY SYSTEM.

This amendment will be submitted to the electors of the state at the general election next fall (1920).

Section 4 of this amendment provides (among other things) that "the legislature may provide by law for the issue and sale of bonds of the state in such amount as may be necessary to carry out the provisions of section 1 of this article..... The proceeds of the sale of such bonds shall be paid into the treasury of the state and credited to the trunk highway fund.....

"In case the trunk highway sinking fund shall not be adequate to meet the payment of the principal and interest of the bonds authorized by the legislature as hereinbefore provided, the legislature may provide by law for the taxation of all taxable property of the state in an amount sufficient to meet the deficiency, or it may, in its discretion, appropriate to such sinking fund moneys in the state treasury not otherwise appropriated."

APPENDIX E.

Table Showing Income Tax on Firms and Individuals  
Classified in Occupation Groups for the State.  
(Income of 1917 on 1918 roll)

<u>Occupation</u>	<u>Number Assessed</u>	<u>Taxable Income</u>	<u>Tax</u>	<u>Average Tax Per Taxpayer</u>
Bankers & capitalists	1,319	\$ 6,378,000	\$234,000	\$ 177.90
Manufacturers	3,174	15,056,000	507,000	159.80
Lawyers	1,285	3,447,000	76,000	59.46
Retired or unoccupied	3,294	5,721,000	149,000	45.25
Mercantile	14,123	27,577,000	544,000	38.56
Physicians	2,104	3,975,000	68,000	32.63
Professors & Teachers	2,908	2,128,000	32,000	11.24
Common Laborers	2,860	852,000	9,000	3.19
Farmers,	21,345	21,775,000	253,000	11.89
Other classes omitted.....				
<b>TOTAL</b>	<b>98,299</b>	<b>\$132,891,000</b>	<b>\$2,698,000</b>	<b>\$27.43</b>

Wisconsin Tax Com. Letter May 20, 1920

APPENDIX F.

Table Showing Income Tax on Firms and Individuals  
According to Amount Groups of Income, for the State.  
 (Income of 1917 on 1918 roll)

<u>Classified by Amount</u> <u>Groups of Income.</u>	<u>Number</u> <u>Assessed</u>	<u>Taxable</u> <u>Income</u>	<u>Tax</u>
TOTAL? ALL GROUPS	98,299	\$ 132,891,209	\$ 2,696,106
Under \$1,000	65,808	26,180,000	263,000
\$1,000--	17,371	24,350,000	262,000
2,000--	6,477	15,800,000	189,000
3,000--	3,136	10,760,000	141,000
4,000--	1,687	7,500,000	108,000
5,000--	979	5,350,000	86,000
6,000--	598	3,800,000	68,000
7,000--	415	3,800,000	62,000
8,000--	328	2,780,000	61,000
9,000--	232	2,200,000	73,000
10,000--	161	1,700,000	46,000
11,000	142	1,600,000	47,000
12,000--	124	1,500,000	47,000
13,000--	178	2,480,000	84,000
15,000--	374	7,000,000	289,000
25,000--	199	6,650,000	328,000
50,000--	53	3,160,000	172,000
75,000--	23	1,190,000	111,000
100,000-& Over	26	4,700,000	272,000

Wisconsin Tax Com. Letter May 20, 1920.

## APPENDIX G.

### The Taxation of Land Values.

When a change in a tax system is considered--such as is here proposed for Minnesota -- the question of subjecting land to a heavier tax must be carefully weighed. One reason for this is that real estate comprises a large percentage of the state's wealth. Another reason is that an old land tax is burdenless. Land is now rapidly rising in value and it would be comparatively easy to adjust the tax rates so as to take the unearned increment and use it as a permanent source of revenue. Nobody would be harmed by such a tax.

The Tax Commission has made a careful study of the tax systems of the western Canadian provinces which have taken long steps towards exempting personal property and improvements from taxation and towards shifting the burden to real estate. The Commission states: (p.109) "In conclusion it can be said that the single tax principle is still deeply rooted in the Canadian West. It has been tested under both prosperous and adverse business conditions and it has stood both tests fairly well. Nearly every system will succeed, or pass unnoticed, in prosperous times; the real test comes in times of adversity. While the Canadian system has not been uniformly successful under adverse business conditions, it is doubtful if the old system would have been any more successful under the same circumstances." After discussing the probable effect of partial and total exemption of personal property, buildings, and improvements in Minnesota, the Commission concludes: (p.119) "As already stated, we do not



Believe that the state is yet prepared for the radical change in the tax base that would result from a complete exemption of personal property. Nor do we believe it would be wise to effect entire exemption of such property at one stroke unless and concurrent with the change, we adopted a substituted tax, such as a business tax, or a state income tax." In regard to the exemption of buildings and improvements it says: (p.121) "This would result in an increase in the proportion of state taxes to be paid by rural districts and a decrease in the proportion to be paid by urban districts."

(Chapter VII in the 1918 report of the Tax Commission will give a more detailed and accurate account of this problem if the reader desires such.)

## APPENDIX H.

### The New York Income Tax.

New York State passed a personal income tax law in 1919. The law was modeled as closely as possible after the federal income tax law in order to reduce to a minimum the difficulties of the administrator and the annoyance of the tax payers. While it did not seem wise to go quite so far as to demand a duplicate of the federal return, an effort was made to use as far as possible in the state law the same language as that employed in the federal law. The definitions, the exemptions, and the deductions are virtually identical. The consequence is that to all intents and purposes the returns made by individuals for the federal tax can be utilized with significant changes for the state tax. (p.529)

One difference between the New York income tax law and the federal law is that the former includes dividends as a part of regular income while the latter allows a partial deduction for dividends of corporations. The reason for this distinction is twofold. The state income tax is to reach only the income earned within the state while the federal law taxes corporations on their entire income. In the second place the legislature proceeded on the theory that a corporate income tax should be regarded as a business tax and that there is as little reason for exempting <sup>that part of</sup> the individual's income <sup>which is</sup> received from corporations, from the income tax as <sup>exempting the income</sup> that <sup>is</sup> received from real estate which is taxed.

Other points of difference are:

1. The New York income tax rates are graduated but not so steeply

as the federal rates. The rates range from 1-3 %.

2. The administration is centralized under the office of the state comptroller. This centralization is a distinct improvement over the old system which left the administration of the tax to the local officials.

3. The yield is divided between the state and the localities each receiving one-half. (p.530)

The problem of the treatment of non-residents was one of the most knotty the law-makers had to solve. The law provides that both residents and non-residents be subject to taxes on income earned within the state. Residents are subject in addition to a tax on income from all other sources. Non-residents are freed from double taxation by a reciprocal deduction which operates similarly to free residents of New York from double taxation by a sister state. (p.536)

(The above discussion is based upon E.R.A. Seligman's article in <sup>the</sup> Political Science Quarterly: "The New York Income Tax." September 1919 p.521-)

For a discussion of the federal income tax law after which this New York law is modeled see MS. p.44.

APPENDIX I.

Tax Delinquency in Milwaukee.

May 11, 1920.

Wisconsin Tax Commission,  
Madison, Wisconsin.

Gentlemen:

The following data in respect to the collection of income taxes in the city of Milwaukee is very interesting.

.....

Personal property assessments in the city of Milwaukee in 1912 were made on about a 67.18 %, whereas the percent in 1919 was 93.93 %.

.....

The item of delinquent income taxes is interesting since large increases of income assessments and taxes within the last few years has resulted in fewer delinquents. Of the item of \$ 39,347.63, delinquents in 1919, I can account for a considerable amount which was withheld from payment due to the position taken by the Alien Property Custodian, some of which has since been ordered paid.

	<u>Delinquents.</u>	<u>Per Cent</u>
	\$ 74,000.00	5.42
1912	79,000.00	4.87
1913	77,000.00	4.49
1914	35,000.00	2.19
1915	34,000.00	1.80
1916	33,000.00	.98
1917	35,000.00	.93
1918	39,000.00	.99
1919		

Yours very truly,

(Signed) John H. Leenhouts,  
Assessor of Incomes.

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