

A History of Income Tax Legislation in the United States and a Comparison  
of This Legislation With That in Great Britain from 1929-1939

By

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## INTRODUCTION

The principle of taxation based on income is not new, in fact, it dates back before the Christian era. The use of this principle in actual taxation was unimportant before the end of the eighteenth century. During the nineteenth century, such taxes had a rather prominent place in the fiscal systems of European countries, but not until 1862 was the income tax a part of the federal tax system in the United States. The first appearance of the income tax system in the United States was the outgrowth of the urgent demands for revenue arising from the Civil War.

The British income tax, which has long been a national institution, was first introduced in 1798 when the military operations of the Napoleonic Wars made additional revenues imperative.

Income tax is based on the ability to pay. "At a time when the income of the nation was not very unequally distributed, the poll tax had a certain amount of jurisdiction."<sup>1</sup> As the poll tax gradually increased complaints became numerous and a certain graduation according to social classes had to be made. Nobles and other prosperous persons were required therefore to pay a higher poll than the people in general. Although the modification was unsatisfactory and short-lived, it is of interest as being an early recognition of the principle of graduation.

The poll tax was supplemented by taxes on property. This basis proved to be a fairer distribution of the burden and also proved more remunerative.

There is no necessary connection between the ownership of property and the ability to pay because some forms of property are used productively;

<sup>1</sup> Seligman, E. R. A., Essays in Taxation, N. Y., 1925, p. 11.

others yield no return. Further, a tax on property alone misses those incomes that are due to personal services. "Let us recognize the fact then, once and for all, that a system of property taxation, except in so far as certain forms of real estate are concerned is unsuited to modern economic conditions as the ordinary and principal source of revenue."<sup>1</sup> "Thus it is that in recent decades the tendency has arisen to substitute personal taxes for the older real taxes, and to assess the individual rather than the thing. . . . From the modern point of view, it is the duty of the citizen to support the government according to his capacity to support himself."<sup>2</sup>

It may also be noted that Adam Smith says:

"It is not very unreasonable that the rich should contribute to the public expense not only in proportion to their revenue but something more than that proportion."<sup>3</sup>

In modern times economists approve not only of the income tax but of the imposition of progressive rates. The basis for its justification is found in the fact that it is adjusted more or less accurately to the ability to pay, a principle which tends to prevent it from working any undue hardship upon the taxpayer.

<sup>1</sup> Seligman, E. R. A., "Address," National Tax Association Proceedings, vol. IX, 1915, p. 134.

<sup>2</sup> Seligman, E. R. A., Essays in Taxation, N. Y., 1925, p. 11.

<sup>3</sup> Wealth of Nations, vol. 2, Chapter V.

## HISTORY OF INCOME TAX LEGISLATION IN THE UNITED STATES AND GREAT BRITAIN

### Great Britain

The income tax is the most recent form of taxation, and in its most modern aspect had its beginning in Great Britain. It was originally adopted as a temporary resource, and it has now been assessed for over fifty years without interruption. Although still, in form, a temporary tax, requiring for its continuance an annual renewal by act of Parliament, it is, in all probability, as firmly established and as permanent as any part of the revenue system. It was introduced by William Pitt in 1798. The Pitt act was amended by the acts of 1803 and 1806 as a war measure and was temporarily repealed in 1816. Another famous English statesman and economist, Sir Robert Peel, was responsible for putting the income tax back on the statute books in 1842. It was based both upon the content and experience of the old act, "but with the especial purpose of carrying out a free-trade policy, with a tariff on imported articles for revenue only and making the income tax take the place of other taxes on commodities and license taxes which were repealed."<sup>1</sup>

In 1859 Gladstone found it a ready means of raising more revenue by the simple expedient of increasing rates. In 1910, under the sponsorship of Lloyd-George, Great Britain introduced the system of progressively increasing rates by means of graded surtaxes.

The tax has undergone hardly any changes of importance since it was first introduced. In its main features it is the same today as it was in 1842. The income tax has become the cornerstone of the British system.

<sup>1</sup>Green, W. R., The Theory and Practice of Modern Taxation, 1938, p. 37.

## United States

The first general tax law in the American colonies, with the exception of the early poll tax in Virginia, was the law of 1634 in Massachusetts Bay. This provided for the assessment of each man "according to his estate and with consideration of all other his abilities whatsoever."

It was not until seven years later that "ability" was defined to include something more than mere property. In 1649 a law was enacted, which introduced the taxation of profits of laborers, tradespeople, and others. Except as to rates, this form of law continued unchanged till 1777. The law enacted in this year gives a fuller interpretation of income than any hitherto. Taxpayers are assessed "on the amount of their income from a profession, faculty, handicraft, trade, or employment; and also on the amount of all incomes and profits gained by trading by sea and on shore and by means of advantages arising from the war and the necessities of the community."

The first suggestion of a federal income tax was made in January 1815, by Secretary Dallas. However, the income tax was first used in the United States during the Civil War; it was purely a war measure. After protracted debates involving social, economic, geographical, and constitutional questions the first Civil War revenue acts, the Act of August 5, 1861 became a law by a very close vote.

## Revenue Acts of 1861 and 1862

The act provided for a levy of 3 per cent on the annual income of every person residing within the United States who had a net income from all sources in excess of \$300. The rate was 5 percent upon income "accruing upon any property, securities or stock owned in the United States"

by citizens residing outside the United States. The rate on Treasury notes and other government securities was fixed at  $1\frac{1}{2}$  per cent. The principle of rate differentiation was introduced in the Act of 1862; the rate applicable to the income of citizens and residents in excess of \$10,000 was 5 per cent. with a \$600 exemption allowed. A provision for withholding at the source was also introduced in this act. This act was to go into effect on December 1, 1862, and to be in force for four years. No tax was actually levied until 1863.

#### Revenue Act of 1864

This act was enacted because of the increased necessity for war revenue. It differs from the Act of 1862 in that it provided for a rate of 5 per cent on incomes in excess of \$600 up to \$5,000,  $7\frac{1}{2}$  per cent on the excess between \$5,000 and \$10,000 and 10 per cent on the entire excess over \$10,000. The discrimination against citizens residing abroad did not appear in this act.

The Civil War Acts were remarkably successful from the point of view of revenue raised. It contributed to the Treasury about one-fourth of the total internal revenue collected. Administrative shortcomings were in evidence. The Civil War revenue acts were "defective not alone in theory, but also in administration."<sup>1</sup> "A thoroughly competent administrative force, adequate in size to the task it must perform, would diminish immeasurably the present burdens involved in complying with the law."<sup>2</sup>

<sup>1</sup> Seligman, E. R. A., The Income Tax, p. 479.

<sup>2</sup> Montgomery, R. H., Income Tax Procedure, 1923, p. 5.

### Revenue Act of 1894

"The lowering of the tariff rates in redemption of the Democratic Party platform pledges and the consequent reduction of Government revenues necessitated recourse to another source of revenue."<sup>1</sup> Thus, the Revenue Act of 1894 became a law on August 28, 1894 without the signature of the President. The rate was 2 per cent on the excess over \$4,000. It was levied upon all "gains, profits, and incomes derived from any kind of property, rents, interest, trade, employment, or vocation." However, this act was declared unconstitutional by the United States Supreme Court in the famous case of Pollock v. The Farmers' Loan and Trust Company, May 20, 1895.<sup>2</sup> The Court ruled that the income tax was a direct tax and could be levied only by the states under the requirements of the Constitution. Congress had the power to tax income from "professions, trades, employment, or vocations" in the nature of an excise tax, but had no power to tax the income from real estate or invested property even in the guise of an excise tax.

### Corporation Excise Act of 1909

The decision in the case of Pollock v. The Farmers' Loan and Trust Company was convincing evidence that no income tax measure could be levied without a constitutional amendment. In order to avoid the "constitutional snag", a tax on corporate incomes was proposed to be paid by corporations for the privilege of exercising their franchise rights. The Corporation Excise Act of 1909, enacted August 5, 1909, imposed a tax of 1 per cent on the net income of corporations, above an exemption of \$5,000. This act

<sup>1</sup> Klein, Joseph J., Federal Income Taxation, p. 5.

<sup>2</sup> 157 U. S., 429; 158 U. S. 601.

was declared to be an excise tax and not an income tax in the case of Flint v. Stone-Tracy Co.,<sup>1</sup> and therefore constitutional. This act may properly be regarded as the forerunner of the true income tax measures which were to follow.

### Revenue Act of 1913

The Sixteenth Amendment, ratified by the states February 25, 1913, made constitutional the imposition of a federal income tax without apportionment. This amendment reads as follows:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any censur or enumeration."

On October 3, 1913, President Wilson signed the Revenue Act of 1913, which became effective March 1, 1913. This act was the first of the present series of income tax measures. The act imposed a normal and a graded tax (surtax) on individuals and a flat tax on corporations. The exemption of \$5,000 allowed corporations under the Act of 1909 was discontinued, but the tax rate of 1 per cent remained unchanged. An individual was allowed an exemption of \$3,000, an amount which increased to \$4,000 for a married person living with spouse. Subject to these exemptions, a tax of 1 per cent was levied upon the net income for each calendar year of citizens of the United States. This was called the normal income tax. In addition graduated taxes called surtaxes were levied beginning with 1 per cent on the amount of income exceeding \$20,000, with a maximum of 6 per cent on the amount of such excess above \$500,000.

<sup>1</sup>220 U. S. 107

### Revenue Act of 1916

The primary purpose of the Act of 1916 was to provide larger revenues than those collected under the 1913 Act. For the first time nonresident aliens were specifically mentioned as subject to tax. The deduction privileges of the 1913 Act were extended by a provision for the deduction of losses by the taxpayer. The normal rate for individuals and corporations was increased to 2 per cent, and the surtax rates were also greatly increased. This act became a law on September 8, 1916.

### Revenue Act of 1917

The need for greater revenues necessitated a further increase in rates and the Act of March 3, 1917 was enacted. Actually, no taxes were collected under this act, but it was replaced by the Revenue Act of 1917, enacted October 3, 1917. This act was really a war measure. The normal rates and the surtax rates were greatly increased and, in addition, the excess-profits tax rates were made to run as high as 60 per cent. The amount of the excess-profits tax was allowed as a credit against the taxpayer's net income, both for normal tax and surtax purposes. A new exemption from normal tax was introduced in the form of \$200 for each "dependent" other than spouse. The "normal" rate for corporations was increased to 6 per cent. Graded surtaxes ranging from 1 per cent to 50 per cent were likewise superimposed upon those of the 1916 law.

### Revenue Act of 1918

The great demands of the war made it necessary for the Government to draft the Act of 1918. The Act became effective January 1, 1918, but it did not become a law until President Wilson signed it February 24, 1919.

The 1918 Act was an entirely new revenue act, complete in itself. The excess-profits tax on partnerships and on individuals was discontinued permanently and after 1917 partnerships were not subject to any form of tax. In all other years the individual partners were subject of a tax on their respective shares of the partnership income. The excess-profits tax rates imposed on corporations were made as high as 80 per cent, while the income tax rate was fixed at 12 per cent. The income tax rates to which individuals were made subject were fixed as high as 77 per cent.

#### Revenue Act of 1921

The Revenue Act of 1921 became a law on November 23, 1921. The excess-profits tax on corporations was continued only for the year 1921 and was then abolished. However, the income tax rate was increased from 10 to 12 per cent. Beginning January 1, 1922, the maximum surtax rate was reduced from 65 per cent to 50 per cent. This act included a new type of income known as "capital gains" which applied exclusively to the profits resulting from the sale of investment property held by the taxpayer for at least two years.

#### Revenue Act of 1924

The Revenue Act of 1924 to reduce the high war tax rates, which had been continued for many years after peace had been restored, became a law on June 2, 1924. It left unchanged the rates for corporations but reduced decidedly the burden on other income taxpayers. "Possibly the most important innovation was the creation of the United States Board of Tax Appeals, 'an independent agency in executive branch of the Government'"<sup>1</sup>

<sup>1</sup>Klein, J. J., Federal Income Taxation, p. 10.

### Revenue Act of 1926

The demand for further tax reductions led to the enactment of the Revenue Act of 1926, on February 26, 1926. Radical reductions in rates and many other changes were made effective as of January 1, 1926. The personal exemptions for married persons living with spouse and for "head of the household" were increased from \$2,500 to \$3,500, and from \$1,000 to \$1,500 for others. The maximum amount of "earned" income was increased from \$10,000 to \$20,000. Estate taxes were reduced and the gift tax was repealed.

### Revenue Act of 1928

The Revenue Act of 1928 was approved May 29, 1928. No important changes were made in the personal income tax. However, there were reductions in the corporation income tax rate. The corporation income tax rate was reduced by the 1928 Act from 13.5 per cent to 12 per cent; the reduction took effect for 1928 income. Further, the specific credit granted to domestic corporations with a net income of \$25,000 or less was increased by this act from \$2,000 to \$3,000.

### Revenue Act of 1932

There was an increase in rates on both corporation and individual incomes and a reduction in the personal exemptions. The normal rates on individual income are 4 per cent on the first \$4,000 and 8 per cent on the remainder, all being upon the net income in excess of the credits allowed.

The surtax rates begin with 1 per cent on the total amount of net income above \$4,000 and up to \$10,000, and on the amount from \$10,000 to \$12,000 the rate is 2 per cent. The rate is progressively increased by

steps of \$2,000, and the rate on the amount between \$98,000 and \$100,000 is 47 per cent. From that point the rate is progressively increased by uneven graduations until above \$1,000,000 the rate is 55 per cent.

In the case of a single person there is an exemption of \$1,000; to the head of a family or a married person living with husband or wife a personal exemption of \$2,500 is allowed. Only one exemption is allowed to husband and wife living together. A further credit is given of \$400 for each dependent. No credit is allowed on account of earned income.

#### Revenue Act of 1934

The Revenue Act of 1934 was approved May 10, 1934. A new method of treating capital gains and losses was adopted. The normal rate on individuals is 4 per cent upon the net income in excess of the credits allowed. The surtax rates (applying to net incomes after deduction only of personal exemptions and the credit for dependents) begin with 4 per cent upon the amount of surtax net income in excess of \$4,000, increasing by graduations of 1 per cent for each \$2,000 bracket up to \$16,000; and 2 per cent for like brackets up to \$22,000. From this point, the rate is progressively increased by uneven graduations until above \$1,000,000 the rate is 59 per cent.

The personal exemptions are the same as in the 1932 Act with the same allowed on account of earned income. The act abolished consolidated returns, except as to railroads, and disallowed losses on sales and exchanges between members of the same family.

#### Revenue Act of 1935

The Revenue Act of 1935 was very short and most of its provisions merely amended sections of the 1934 Act. Corporation income rates were

completely revised. In place of the former rate of 13 $\frac{3}{4}$  per cent, a progressive scale was introduced, starting at 12 per cent on the first \$2,000 of taxable income and reaching a maximum of 15 per cent on taxable income in excess of \$40,000. The rates of the special tax on the undistributed profits of holding companies were increased to 50 per cent on income between \$500,000 and \$1,000,000 and 60 per cent on income in excess of \$1,000,000.

The excess profits tax rates were also revised. A rate of 6 per cent was imposed on profits in excess of 10 per cent but less than 15 per cent, and a rate of 12 per cent was imposed on profits in excess of 15 per cent.

Beginning with the amount over \$50,000 the surtax rates were increased 1 per cent for each successive income bracket until on the amount over \$5,000,000 it is fixed at 75 per cent, which is 16 per cent more than the 1934 rate.

#### Revenue Act of 1936

The need for greater revenues necessitated a further increase in taxation in the Act of 1936. This Act became a law June 22, 1936. The most important feature of the 1936 Act is that it introduced a new method of taxing corporations, while retaining, in a modified form, the old corporate income tax. Dividends received by individuals from domestic corporations are subject to normal tax as well as surtax, and corporations are taxed a flat rate of 15 per cent on dividends received. The taxable income was subject to an excess profits tax and a new surtax on undistributed profits. The undistributed profits tax was a graduated tax ranging from 7 per cent of the undistributed net income, when income retained is not in excess of 10 per cent of the adjusted net income, to 27 per cent of the amount of income retained in excess of 60 per cent of

the total income. A new method of taxing non-resident alien individuals was included in the act.

### Revenue Act of 1938

President Roosevelt allowed the Revenue Act of 1938 to become a law on May 28, 1938 without his signature or approval. The provisions of the new act to which he particularly objected were those relating to the taxation of undistributed profits and to the treatment of capital gains and losses.

The principal change made by the Act of 1938 in respect to individual incomes concerns the treatment of gains and losses on the sale of capital assets. A distinction is made between short term capital gains and losses, which are those from the sale of capital assets held not more than 18 months, and long term capital gains and losses on assets which had been held more than 18 months before being sold. The long term capital losses are figured at 66 per cent of full value if the asset has been held not more than 24 months and at 50 per cent if the asset has been held over 24 months.

The Act revised the method of taxing corporate incomes and imposed a graduated tax of  $12\frac{1}{2}$  per cent to 16 per cent on corporate income over \$25,000.

The principal of the undistributed profits tax was retained with a nominal rate of  $2\frac{1}{2}$  per cent. This is a marked reduction from the undivided profits rates, graduated up to 27 per cent in the Act of 1936. The corporate income tax sections of the Revenue Act of 1938 were extremely complex and were the results of a series of compromises between various groups in the Senate and the House.

The normal and surtax rates remained the same.

The rates are to apply only to the years 1938 and 1939.

A COMPARISON OF THE AMOUNTS PAID ON DIFFERENT CLASSES OF INCOME  
IN THE UNITED STATES AND GREAT BRITAIN

A large number of people in this country accept the British tax system as the standard by which to measure American tax institutions. It is true that the British system as a whole applies the principle of the ability-to-pay more consistently than any other country. Taxable capacity may depend on how taxes are distributed. "Someone has said that a nation is like a peddler and that which it can carry depends considerably on the way it arranges its pack."<sup>1</sup> Great Britain relies mostly upon direct taxes--particularly income and inheritance taxes--for a large part of its revenue. Direct taxes of this sort constitute a well arranged pack "because they do not deprive the weak taxpayer of the necessities and because they least disturb the consumer's ability to pay."<sup>2</sup> In the following table an attempt is made to show a comparison of the various kinds of taxes in the two countries in 1932. (The pound is taken to equal \$4.92.)

Table I

Sources of Tax Revenue for All Governmental Units in the United States and Great Britain, 1932

<u>Source</u>	<u>United States</u>	<u>United Kingdom</u>
Total Tax Burden	100%	100%
General property tax	56.84	18.45
Income tax	14.06	35.15
Miscellaneous taxes	7.09	2.23
Gas tax	6.24	---
Excise tax	5.47	13.95
Customs	3.98	18.69
Motor vehicle tax	33.94	3.13
Death duties	2.38	8.40

<sup>1</sup>  
<sup>2</sup>Groves, Harold M., British Taxes and Ours, New Republic, August 21, 1935.  
Ibid.

<sup>3</sup>Statistical Abstract of the United States and United Kingdom.

The most striking fact in the table given is the importance of the general property tax in the American tax system. It completely overshadows the income tax, which ranks a poor second in importance. The income tax is low in the comparative table because both state and federal taxes are included whereas in the table to follow in which the income tax for 1932 amounted to 56.1 per cent only federal taxes were included.

It is true that comparisons between income taxes in the two countries sometimes leave out of account the state income taxes. It is also sometimes complained that no account is taken of the corporation income tax in comparing British and American tax burdens. Both countries tax corporate income, but the British tax is mainly a collection-at-the-source device and not a business tax; that is the British taxpayer may offset the corporation tax against his personal tax whereas the American taxpayer cannot. In addition the personal tax and the collection at the source from corporations, the British now impose additional taxes on businesses for war purposes. This tax is discussed in a later section of this paper.

In many instances the British pay heavier death taxes than we do. The exemptions are very much higher in the United States than in Great Britain, and the rates in the lower brackets are much lower (See Table VI.); on the other hand, the highest brackets of the American tax carry substantially higher rates than the British.

The British have no gift tax and as a consequence the British tax is easy to evade. The British do have a provision that gifts made within three years of death are conclusively presumed to have been made in contemplation of death and are taxable under the estates-tax law. A similar provision in American laws was declared unconstitutional by the Supreme Court.

Some idea of the comparison of the amount of taxes paid by the United States and Great Britain may be gained from a discussion of the economic burden of taxation in the two countries.

In 1930 the average individual tax in Great Britain was larger than that of a citizen of the United States. On a per capita basis tax collections for 1930 were \$90.83 for Great Britain and \$34.40 for the United States. These figures were obtained by using the conversion rates which prevailed prior to the devaluation of the dollar and include all taxes both national and local. There was a marked decline in receipts by the National Government from 1930 to 1933 and an upward trend after that date. The amount of taxes collected by the National Government in the United States for the fiscal year 1936 amounted to \$77 per capita and for 1938 they amounted to \$87. Taxes collected in Great Britain have been stable in recent years. On a per capita basis the amount of taxes collected for the year 1936 was \$101.85.

In Great Britain from 1930 to 1933, the taxes collected increased somewhat.

This method of comparison may not present the situation accurately for the reason that abnormal conditions prevail in governmental financing. During these years the United States have been suffering from a severe depression while Great Britain has experienced prosperous years.

Until recent years except in times of war taxes about equaled the amount of expenditures and in many years exceeded that sum. Now for several years, although taxes have been increased, huge deficits have accumulated. In the following table an attempt has been made to show the increase in the public debt or deficit on a per capita basis. This does not include the interest charges on the debt.

Table II

A Comparison of the Public Debts in the United States and Great Britain  
for the Years 1930, 1934, 1938, and 1939

<u>Year</u>	<u>Exchange Rate</u>	<u>Gross Debt United States</u>	<u>Per Capita</u>	<u>Gross Debt Great Britain</u>	<u>Per Capita</u>
1930	4.86	\$16,185,308,299	\$131.49	£7,469,060,000	\$788.78
1934	5.04	27,055,141,414	213.65	7,822,330,000	856.80
1938	4.89	37,164,740,315	285.43	8,026,127,000	855.75
1939	4.90	40,437,522,411	308.29	8,163,289,000	940.80

Adding to the figures for the National Government the figures for State and local governments, we have a total of about \$56,000,000,000 which is greater than the indebtedness of any other country in the world. However, the national debt of Great Britain is larger than that of the United States. When the national and local debts are considered the per capita indebtedness of the United States is only about \$440 as compared to over \$1000 for Great Britain.

In addition to the personal tax and the call-at-the-source tax from corporations, the British now impose emergency taxes for war purposes. At this point it is well to consider Briton's new emergency income taxes, levied in 1939-1940, which are the highest in British history. On September 27, 1939 Chancellor of the Exchequer, Sir John Simon presented Parliament with his first war budget. To finance the first year of the new war, Simon had to raise by taxes or loans the staggering sum of \$8,000,000,000. The income tax was immediately boosted. The basic or standard rate was increased from 5 shillings and 6 pence in the pound or 27 per cent to 7 shillings or 35 per cent for the fiscal year ending March 31, 1940. For 1940-1941 it will be 7 shillings and 6 pence or 37½ per cent to become effective April 1, 1940.

Every class is hit by the new program. Even the \$10 a week clerk will contribute to Briton's wartime income tax coffers, and the industrialist with an income of as much as \$400,000 will pay more than \$320,000 to the Government. He levied a new indirect tax on beer, wine, whiskey, and tobacco. The price of beer increased from 15 cents a pint to 18 cents and the price of cigarettes has increased to 28 cents for a package of 20. Simon also announced a great many changes in other direct taxes. The surtax was increased greatly and death duties rose 10-20 per cent. The 60 per cent excess-profits tax previously imposed only on armament firms was extended to all businesses.

When the nation's estimated income was determined for 1939-1940 it amounted to approximately \$4,000,000,000 or only half the outgo.

As high as American personal income tax rates are now here is the way in which they (federal taxes only) compare with the new British taxes in a few representative brackets:<sup>1</sup>

Table III

<u>Income of Married Person</u> (no children)	<u>Total British Tax</u>	<u>Total United States Tax</u>
\$ 4,000	\$ 871	\$ 44
12,000	4,021	602
20,000	8,220	1,589
80,000	52,668	21,269
400,000	323,068	232,194

The above conclusion can be supplemented by the fact that in Great Britain the income tax furnishes over 35 per cent of British national and local tax yield compared with only about 15 per cent in the United States. In many instances State income taxes are not considered when comparisons between income taxes in the two countries are made. However, the inclusion

<sup>1</sup>The figures in the table were taken from "The Briton Foots the Bill-- U. S. Takes Warning", Business Week, October 7, 1939.

of State income tax would not greatly alter the picture, since in only five States does the rate range higher than 7 per cent. Moreover, in most States federal taxes are allowed as a deduction in calculating income for State income taxes, and State income taxes are allowed as a deduction in calculating income for federal taxes, which makes the combination less burdensome than it may seem.

A COMPARISON OF THE STUDY OF TAXATION IN THE UNITED STATES  
AND GREAT BRITAIN

Direct and Indirect Taxation

Taxes are often classified as "direct" and "indirect," and while this classification is not exact it has been used by authors of distinction in the past and is still used by some governments. John Stuart Mill stated the distinction between direct and indirect taxes as follows:

"A direct tax is one which is demanded from the very persons who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another."<sup>1</sup>

Unfortunately this definition is not exact. Professor Seligman<sup>2</sup> says that "this criterion of distinction has been abandoned by modern science." He also calls attention to the fact that in former times "the mass of indirect taxes rested upon the poorer classes," and that in modern times "the so-called indirect taxes have largely been removed from necessities of life, and imposed upon luxuries or articles of harmful consumption." This statement does not hold true today. Although in most cases articles of food have been made exempt from the recent sales taxes many of the necessities of life are subject to sales taxes. "Direct" and "indirect" as applied to taxes very often fail to determine the incidence thereof, and for that particular reason such a classification is of but little value.

<sup>1</sup>J. S. Mill, Principles of Political Economy, p. 823.

<sup>2</sup>Seligman, E. R. A., Essays in Taxation, pp. 690, 691.

The United States use of direct taxation is wholly a modern development, reflecting the improved fiscal education and responsibility of the citizens.

Although the emphasis upon direct taxation reached its maximum in the course of the World War, it has not substantially diminished in Great Britain or in the United States since.

Professor Seligman in Essays in Taxation points out that direct taxation "generally forms the last step in the historical development of public revenue. At first regarded entirely as an extraordinary means of support, it gradually assumed the character of an ordinary form of revenue." This tendency has been illustrated in the United States where direct taxes advanced from one-tenth of the revenue to almost two-thirds, in the years following the war. The course through the years may be indicated as follows:

Table IV

Percent of All Federal Taxes from Direct Taxes

<u>Year</u>	<u>Per cent</u>
1929	66.0%
1930	66.5
1931	66.3
1932	56.1
1933	40.3
1934	27.7
1935	30.2
1936	36.2
1937	41.8
1938	43.0

In the table we find that direct taxation increased in the United States to 66.5 per cent in 1931 and then it began to gradually decrease until 1934 it was only 27.7 per cent of the total taxes collected. This decrease may have been caused by the depression which was at its worst about this time. Beginning with 1935 direct taxation has increased each

year until 1938 it amounted to 43 per cent of the total taxes collected.

The degree to which the British use direct taxation and the weight of the British tax load are apparent in the comparative income tax schedules in the two countries:

Table V

Comparison of Effective Rate of Income Tax for a Married Man

With No Dependents (All Income Earned)

<u>Amount of Income</u>	<u>U. S. Tax</u>	<u>Effective Rate</u>	<u>British Tax</u>	<u>Effective Rate</u>
\$ 1,000			\$ 6.97	.69%
5,000	\$ 80	1.60%	637.08	12.74
10,000	415	4.15	1,665.78	16.63
25,000	2,489	9.95	6,727.02	26.90
50,000	8,869	17.73	18,317.32	36.63
160,000	30,394	30.39	45,448.02	45.44
1,000,000	571,394	57.13	613,874.00	61.38
Personal Exemption		United States		Great Britain
Single		\$ 1,000		\$ 492
Married		2,500		738
Normal Rate of Tax		4%		22.5%
Corporation Tax Rate		13.75		22.5

Table VI

Comparison of Estate Tax (Before Credit) Paid on Specimen Net Estates in 1935

<u>Net Estate Before Exemption</u>	<u>United States Tax</u>	<u>British Tax</u>
\$ 2,500	None	\$ 24.50
5,000	None	98.40
50,000	None	1,968.00
100,000	\$ 1,600	7,872.00
500,000	59,100	93,480.00
1,000,000	169,100	236,160.00
10,000,000	4,387,600	4,428,000.00
100,000,000	50,336,600	49,200,000.00
Exemption	\$50,000	\$492

In America many states impose income and estate taxes in addition to the federal taxes shown in the above tables. On the other hand the income and estate taxes have constituted only a minor source of revenue in most of the states.

The Federal Government allows a credit against the federal estate tax for a considerable part of the inheritance tax paid the states. The American estate tax is the only federal death tax, whereas the British have a succession duty somewhat like our state inheritance tax in addition to the others.

It is also true that while British income and estate tax rates are generally higher than ours it is in the lower and middle brackets that the principal differences appear. These differences may be noted in the above tables.

In the United States our system has in many respects followed that of Great Britain. It was the example of Great Britain that led us to adopt the income tax, and the tax on estates of decedents. We also obtained from the same source the excess-profits tax which was so successfully applied during the World War and for some time afterwards. Like Great Britain we have always heavily taxed intoxicating liquors and tobacco by excise taxes and like her we have never levied a general sales tax. The United States taxes imports on the protective principle while Great Britain imposed a tariff for revenue only. However in the last few years England has changed its policy and now imposes duties on many classes of manufactured articles which which undoubtedly is to protect her manufacturers.

"In both Great Britain and the United States the principle that taxes should be levied in accordance with ability to pay is recognized to a greater extent than in any other nation. The main feature in the English

system may be said to be a progressive income tax in which the maximum rate is comparatively high and the exemptions low."<sup>1</sup> A special effort has been made to eliminate taxes of a vexatious nature and those which are difficult and expensive to administer. The method of collection devised has made evasion difficult. Avoidance has also been hindered by not unduly extending the allowances and deductions that the taxpayer may take.

The method of computing the income tax in Great Britain, where the income arises in connection with real estate, is very different from the method used in the United States. The basis of the assessment on real estate is what is called the "annual value"<sup>2</sup> or rent. The tax is usually assessed against the occupant on the "annual value." If he is a tenant and pays the tax it is deducted from his rent. In both Great Britain and the United States the rent received from a house is income and in Great Britain if the owner occupies the house instead of renting it, its rental value is still income and is taxed as such.

The British do not consider the profit made by sales or transfers of capital assets to be income unless these transactions are made in a trade or business of the taxpayer and, as they do not tax capital gains they do not allow capital losses to be deducted. A great difficulty arises from this practice in determining whether the profit resulted from a transaction in business or was from a sale or transfer of capital and the opportunities for evasion are frequent.

The British do not allow many deductions or allowances. They make no allowance for depletion, allow limited depreciation only on machinery

<sup>1</sup>Green, W. R., The Theory and Practice of Modern Taxation, p.239.

<sup>2</sup>Ibid, p. 240

and equipment, and allow for no loss on the discard of machinery and equipment not replaced. This does away with some of the most serious complications in the American system.

In Great Britain business losses may be used to offset business gains for as long a time as six subsequent years and may also offset income from lands, interest, and from miscellaneous sources for the year in which the loss is incurred. This practice reduces the tax but not to the extent that our system of allowances for depreciation and depletion.

The British organization for the collection of revenue is superior to the American organization, and works more smoothly, more effectively, and with less expense than any other country. This superiority is largely due to the excellence of the staff which is charged with the collections. This is due to the success of the English Civil Service system, an incorruptible force of high and long experience. On the contrary the United States Internal Revenue Bureau contains many untrained employees. The fact that somewhat more profit can be made by opposing the collection of taxes than in enforcing them as a government official, has lured many talented government employees into private practice.

Evasion and avoidance constitute two of its greatest defects and cause some injustice in the application of the income tax. There is probably less evasion under the English system than under our own, and it is certain that there is much more avoidance in our country. Much of this avoidance is caused by the restrictions imposed on taxation by the Federal Constitution which prevents in many respects the application of taxation by either scientific or equitable methods.

Mr. Green<sup>1</sup> says that there is another difference worth noting which

<sup>1</sup>The Theory and Practice of Modern Taxation, p. 244.

affects the collection of taxes in England. That is the high ethical standards of business men and people of wealth generally in England. Like all others, the Englishman dislikes to pay taxes, but as a rule he does not avoid them by questionable methods.

Evasion may be practically impossible in England because of the system of "collection at the source" used there. The tax on all dividends, rents, salaries, interest, and other payments due from anyone to the taxpayer is collected at the standard rate from the person where the debt originates. This system is not used in the United States to any great extent.

As a result of this practice there has been much complaint on the part of the British taxpayer with reference to the trouble involved in obtaining the settlement of small claims arising by reason of too high rate having been collected under the system of collection at the source.

The United States has a normal tax rate applicable to all of the taxable income and Great Britain has a "standard rate" likewise applicable to all the taxable income with an exception as to very small incomes which are taxed at a lower rate. Both countries have progressive surtax rates in addition to the normal rate or standard rate. Both make an allowance on earned income and both make a deduction for dependents. The standard rate in Great Britain is so much higher than the normal rate in the United States. However, the very large incomes in the United States are taxed much more heavily than those in Great Britain.

### CONCLUSIONS

"The United States income tax law is a modern, carefully drafted, and logically arranged statute, whereas the British law is antiquated, ill-arranged, and obscure and ambiguous in its provisions."<sup>1</sup>

Anyone who has made a careful examination of the income tax laws of any other country will be convinced that our statute is better drawn and more logically arranged. Yet for various reasons it is certain that the law works with less friction and litigation in England than it does in the United States. This is largely owing to the authority given in England to treasury officials, sometimes rather far down the line, to adjust and compromise disputes as to the amount of the tax, which authority we are reluctant or unable to give in this country. These officials also have greater authority in fixing the amount of the tax than could be given them under our constitution, consequently their decisions are final to a greater extent and numerous technicalities which are raised in our courts in tax cases are ineffective under the British practice. The result is that there is far less litigation under the income tax in Great Britain than in the United States. The Constitution also limits the kinds of taxes that may be levied by the Federal Government, and prevents Federal taxation from interfering with the governmental prerogatives of the states. These matters add to the complications of our taxes and make difficulties in applying them.

As each year goes by, practice with reference to the income tax becomes more settled, its application becomes more definite, and there is less complaint about its administration.

<sup>1</sup>Spaulding, H. B., The Income Tax in Great Britain and the United States, (London, 1927)

However, we know that there is considerable avoidance, which results in unequal application of the law, and also more or less evasion, which defeats the law entirely.

That the income tax has its defects must be admitted, but in this respect it is merely an example of the principle that there is no such thing as a perfect tax.

Both the American and English systems are defective in providing means of enforcing the law, although our present laws give enough authority if it were exercised. The law requires that the taxpayers keep such records as the Commissioner with the approval of the Secretary of the Treasury may prescribe. If this definite provision were enforced, thousands of small taxpayers who have taxable income but never keep any books or make any returns would be compelled to pay in the aggregate large sums to the Government.

Many people have the notion that compared with the British we are a lightly taxed people. Three reasons may be identified why the ordinary citizen acquires this erroneous idea:

1. He may overlook State and local taxes: over half the taxes in the United States are local in origin, whereas less than one-fifth are local in Great Britain.

2. He may keep too much in mind the direct taxation, in particular, the personal income tax: only about 14 per cent of our revenues come from personal income taxes, whereas the British Government raises 35 per cent of its total revenue in this way.

3. In recent years deferred taxation or "deficit" has been much greater in the United States than in Great Britain. (See Table II.)

By "deferred" taxation we mean that the United States is spending more each year than it collects in taxes. As a result of this excess spending the Government is piling up a huge debt which in the future must be paid by some form of taxation. It is evident that by creating a debt which must be paid by taxation at some future time we are merely deferring taxation.

It is true that as a nation we have been spending money very much faster than we have been raising it. If this tendency continues it is well that the taxpayer become alarmed because the taxes will have to be raised to meet the increasing costs of government. The load which rests upon the people of these two nations therefore is not merely composed of taxes but piled on the taxes is the mass of accumulated deficits for which so far no provision has been made. For these and many other reasons, it is practically impossible to make more than a rough comparison between the nations as to the tax burdens.

A word may be added concerning the concept of taxable capacity. When does a nation reach the point where any increase in the tax load would be disastrous or at least highly undesirable for the nation's economy? All will depend upon the circumstances of time and place. Mr. Harold M. Groves says that it will also depend on "the purposes for which the money is raised, the morale of the taxpayer and particularly the perfection of the taxation instruments which are employed. Presumably no taxation is too high if the majority of the nation feels it necessary to prevent annihilation by a foreign foe. And perhaps the same holds true for the prevention of widespread starvation; or for a restoration of morale to those who have long been without a decent opportunity and who are living far below their standard."<sup>1</sup>

<sup>1</sup>Groves, H. M., "British Taxes and Ours," New Republic, July 13, 1938, p.276.

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