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A Study and Comparison of the Consumption Basis of Taxation

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A STUDY AND COMPARISON OF THE CONSUMPTION BASIS OF TAXATION

FOREWORD

This treatise is a study and comparison of the three measures of economic well-being and their use as bases for financing government. Particular emphasis is given to the study of the consumption basis of taxation.

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In this world nothing is certain but death and taxes.

—Benjamin Franklin

PART I. INTRODUCTION

A. Sources of Revenue

"Taxes are a privilege not a burden", said Justice Oliver Wendell Holmes, "they are the price we pay for civilization".

The price of civilization is an ever increasing one until today it takes about 20 percent of our national income.

Public expenditures before the Revolutionary War were very modest. Government assumed a very limited responsibility for public works and none for the social welfare of the people governed. Public officials either depended on fees for their pay or served gratuitously. One tax not seen today that existed in Colonial times was the church tax supporting the Minister and his family as well as building and maintaining the church itself. Some present day support from the government could be said to occur through tax free income from personal contributions and through exemptions from sales taxes and property taxes.

Several different taxes were used in Colonial times to support the various colonies, such as: poll taxes, faculty taxes, and the property tax. Each tax received particular emphasis in different parts of the country. New England emphasized the property tax while also utilizing the other two. Poll taxes were first used in the South and the middle colonies but later more reliance was placed on excise taxes, mostly duties on commerce. This primary reliance on different ways of financing government had a profound effect on the political aims of these different segments of our early nation until the Civil War and even until World War I.

The poll tax is now used in only 7 states and there it is used mostly to disenfranchise the Negro vote and to perpetuate the existence of certain political machines. It is in danger of being eradicated by a Constitutional

Amendment when used for voter registration purposes.

The faculty tax, supposedly begun by statute in New Plymouth in 1643, taxed the colonists according to their estates or faculties or rather their returns and gains from property as well as trades. The property tax is still with us today in much the same form as in early colonial days but with the addition of taxing intangible property as well as tangible property.

During the ill-fated Confederation the payment of taxes by the colonies was considered a voluntary contribution or charity with the subsequent result that the central government defaulted on its debt. Out of this debacle arose the Constitutional Convention of 1789 and the new Federation with ample taxing powers. This convention gave to Congress the power to lay duties, and collect imposts, excises and to pay debts, provide for the common defense and general welfare of the United States.

Until the Civil War government finance relied upon the tariff. Quickly the Congress passed an income tax but it never provided adequate revenue to fight a war so other taxes were called into play. After the Civil War social and economic discontent were manifest throughout the states. These were the days of Henry George, who advocated the single tax based on land values; Edward Bellamy, who portrayed a Utopian nation in "Looking Backward 2000-1887" where taxation was unnecessary; and Grover Cleveland under whose administration the Supreme Court ruled the federal income tax unconstitutional. On July 5, 1919, W. H. Taft proposed an Amendment to the Constitution that would allow a progressive income tax. On October 3, 1913, a new income tax law went into effect as a section of the Underwood-Simons Tariff Act. This was just in time to help finance the first real global war that was to start in 1914. The federal income tax has suffered many ups and downs until today it provides more than 86 percent of the total revenue. Other federal taxes are: excise taxes, 11%; custom duties, 1%; and estate and gift taxes, 2%.

The States and their political subdivisions have also experimented with various taxing combinations including death taxes, sales taxes, income taxes, property taxes, and excise taxes. Today major state revenue sources are sales taxes, 25%; motor fuel taxes, 18%; motor vehicle taxes, 8%; personal income taxes, 13%; corporation income taxes, 6%; property taxes, 3%; liquor and tobacco taxes, 9%; special business taxes, 9%; and miscellaneous taxes, 6%. Local revenue sources are: property taxes, 88%; excise and sales taxes, 6%; income taxes, 1%; and miscellaneous taxes, 5%.

Why these tax monies are spent and how they are spent have no place in this paper but here is a presentation of how the combined governments generally spend their income. About 30 percent of the total combined tax revenues goes into national defense and foreign aid. About 24 percent goes into health, welfare, and farm aid. About 13 percent is spent for education. About 4 percent is used up in overhead costs of legislation, administration, courts, and protection against fire, crime, and social disorders. About 6 percent goes respectively to highways, interest, and miscellaneous classifications. Veterans, and transportation and natural resources each take 3 percent while the postal system and public utilities used up 5 percent. The tax dollars expended by the three levels of government has increased $75 billion since 1953. The current estimated annual increase is $12 billion.

B. Principles of Taxation

"Perfect uniformity and perfect equality of taxation in all the aspects in which human minds can view it, is a baseless dream." So said the Supreme Court of the United ~~Stes~~ STATES in the case of Patton v. Brady.[3] Not withstanding such a statement certain standards have been proposed for tax systems.

1. Canons of Adam Smith.

When the principles of taxation are referred to the majority of people think instantly of the famous four canons of that physiocratic scholar Adam Smith. It might do well to repeat them:

> 1. The subjects of every state ought to contribute towards the support of the Government as nearly as possible in proportion to their respective abilities, i.e., in proportion to the revenue which they respectively enjoy under the protection of the state.
> 2. The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.
> 3. Every tax ought to be levied at the time or in the manner in which it is mostly to be convenient for the contributor to pay it.
> 4. Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.[4]

These canons, while widely quoted for over 150 years, are now inadequate for a modern welfare oriented economy. Modern economists first set goals as objectives for the economic system then they create principles of taxation to be applied in attaining those goals. "The consensus of opinion in present day society is considered to regard four goals as of paramount importance for optimum economic welfare: (1) Maximum freedom of choice, consistent with the welfare of others; (2) Optimum standards of living, in terms of available resources and techniques, and in the light of consumer and factor-owner preferences; (3) An optimum rate of economic growth; and (4) A distribution of income in conformity with the standards of equity currently accepted by society."[5]

2. Characteristics of tax systems.

In terms of these goals, three major principles or desirable characteristics of the tax system have come to be generally accepted:

> 1. Economic Effect. The tax structure must be established in such a way as to avoid interference with the attainment of the optimum allocation and use of resources and, when possible, to assist in the attainment of the optimum.
> 2. Equity. The distribution of burden of the tax must conform with the patterns of income distribution regarded as the optimum by the consensus of opinion in contemporary society.
> 3. Minimum Costs of Collection and Compliance, consistent with effective enforcement. This rule requires that taxes be established in such a manner as to minimize the real costs of collection, in terms of resources required to collect the taxes and to comply with the tax laws on the part of the taxpayers, as well as in terms of the direct inconvenience caused the taxpayers in the payment of the tax.[6]

3. Economic Effect.

If we accept the theory of optimum standard of living taxation must not alter or interfere with the choices of action on the part of members of society except when interference will allow closer attainment of the goal. So long as the unregulated functioning of the economy will allow the attainment of optimum output relative to consumer and factor-owner preferences, in the private sector of the economy, taxes will reduce the levels of living below the optimum if they alter consumer or factor-owner choices.

On the other hand, when automatic attainment of the optimum adjustment is not realized, appropriate selection of taxes may allow <u>closer attainment</u> of this adjustment. Thus, for example, if the consumption of liquor becomes excessive relative to the optimum because real costs to society due to drunkenness are not borne by producers of the products and thus do not appear in the price, a special tax on this product designed to reduce consumption and production to optimum levels is justifiable in terms of the goal of optimum adjustment of production.[7]

4. Equity. The second requirement is a distribution of tax burden among various persons which conforms with accepted standards of equity. Determination of equity in taxation must rest upon value judgements relating to the overall pattern of income distribution which is regarded as desirable; the most equitable tax system is that which is most closely in conformity with the standards of equity in the distribution of real income which are accepted as most desirable by the consensus of opinion in society.

Two major aspects of equity are: (1) the proper treatment of persons in like circumstances, (2) the desirable relative treatment of persons in unlike circumstances. Two principles have evolved as basis for taxation, benefit and ability. The benefit principle involves the application to the entire governmental sector the <u>commercial</u> rule that goods be paid for by the user. This analogy is rarely useful because the government, for the most part, performs those functions that private enterprise can not undertake and because the benefit derived by the citizen can not be measured on an individual basis. It is applicable where benefits are directly measurable such as toll highways, sewage service, and the like. The second principle, ability, is the one which conforms most closely with the generally accepted standards of equity. By ability in present-day usage, is meant simply economic well-being or the over-all level of living enjoyed by the taxpayer. The present-day justification for the ability principle is simply the fact that, from all indications, it is in accord with the consensus of attitudes toward equity in the distribution of real income and of tax burden.[8]

5. Compliance. A final principle of taxation is that of minimizing the costs and difficulties of collection of the taxes. Effective and inexpensive administration is important if the use of resources to effect the transfer is to be minimized, since, to the extent that resources are used for this purpose, the output of goods and services in the economy is curtailed. Likewise, effective administration is essential for maintenance of equity. No matter how equitable a particular tax structure appears to be in theory, it will not actually conform with accepted standards of equity if substantial numbers of persons are able to evade or avoid the tax.[9]

6. Shifting and Incidence. A very relevant question in the mind of every tax student is: Who ultimately bears the economic burden of a given tax imposed by the government? Students of taxation have long realized that many taxes do not "stay put" upon the person or business unit which initially pays the tax. In some instances the tax law is phrased in such a way as to push the tax on to someone other than where they are originally levied. No topic in public finance is more important; for in every system of taxation, the cardinal point is its influence on the community.[10]

"A word as to terminology. In the process of taxation, we must distinguish three concepts. First, a tax may be imposed on some person; secondly, it may be transferred by him to a second person; thirdly, it may ultimately be borne by this second person or transferred to others by whom it is finally assumed. Thus the person who originally pays the tax may not be the one who bears its burden in the last instance. The process of the transfer of a tax is known as the shifting of the tax, while the settlement of the burden on the ultimate taxpayer is called the incidence of the tax.[11]

Tax shifting takes place through transaction and changes in price. In the event that the taxpayer increases the selling price of the goods and services he purveys, he is said to shift the tax forward in the direction of the ultimate consumer. In the case of the manufacturer who buys raw material, labor, etc., if he can pay less for the goods and services purchased, he can shift the tax backward to his suppliers. A third type of shifting known as tax capitalization occurs when there is a transaction involving a long-term durable good already existing as a part of a stock of goods. Capitalization results when the present owner is forced to "absorb" the taxes which the buyer of the durable good must pay in the future. This is also known as buying free of the tax.

Factors to be considered in analyzing tax shifting are: (a) the type of tax imposed; (b) cost conditions in the industry; (c) the degree of competition in the industry; (d) nature of the demand for the product.

PART II. MEASURES OF ECONOMIC WELL-BEING

If the ability principle is to provide a workable criteria for establishment and evaluation of tax structures, suitable measures of ability or economic well-being must be developed. Three primary ones have been utilized: income (usually adjusted for various circumstances affecting expenditures necessary for a given standard of living), personal wealth, and amounts spent, either for certain categories of goods or in total.[12]

A. Current income as the measure.

1. Income. Income is generally regarded today as the best measure of ability, in the sense of economic well-being, since income is the primary determinant of the level of living which a family enjoys. In general, income is the amount that a family obtains from activity during a certain period for consumption or saving. The quantity of goods persons are able to acquire during the period and the <u>net</u> increase in savings constitute the best measure of how well the family lives or, in other words, its level of living during the period.

However, the actual level of living which can be attained with a given amount of money income depends in part on certain circumstances affecting the amounts that are committed in order to attain a given level of living. Among these factors are: the number of persons in the family, medical expenses, interest charges, etc. Accordingly the income figure must be adjusted for these factors.[13]

2. Definitions of income. We must face now the task of defining "income". "Whereas the word is widely used in discussions of justice in taxation and without evident confusion, the greatest variety and dissimilarity appear, as to both content and phraseology, in the actual definition proposed.

The consistent recourse to definition in terms which are themselves undefinable (or undefined or equally ambiguous) testifies eloquently to the underlying confusion. At no place in the Internal Revenue Code is income simply defined."[14]

a. The economic defination. Income, as the economic gain received by the person during the particular period, may be defined as the algebraic sum of two items: (1) the person's consumption during the period and (2) the net increase in the individual's personal wealth during the period, each measured in dollar terms. At the beginning of this period the person has net personal wealth of a certain value. He enjoys a certain amount of consumption during the period; and at the end of the period, he has a certain figure of net wealth, which may be different from that at the beginning. If there has been an increase, his total economic gain from the period is measured by the value of his consumption during the period plus the increase in the value of his wealth. If his net wealth has decreased, his net gain is the value of his wealth; in this case, his consumption has exceeded his income.[15]

b. The tax definition. Actual tax legislation in the United States and Canada, as well as most other countries, interprets the concept of income in terms of flow of wealth--of receipt in money or goods--to the taxpayer during the period. The "flow" method produces two primary differences in tax treatment from the "consumption plus increase in net wealth" method:

(1) Taxation is established on a realization rather than on an accrural basis.

(2) The tax applies only when a transaction occurs between other persons and the taxpayer, as only in this case is there a flow of wealth to the taxpayer.

Expediency dictates the use of the "flow of wealth" method.[16]

3. The personal income tax. The concept of an income tax is not as new as most Americans think. A 10 percent income tax was advocated in France by Pierre Boisguillebert and Marshall de Vauban in the early 1700's. In England it appeared in the tax structure as early as the Napoleonic Wars and became a permanent part of the English tax system after 1842.

In the United States, the first federal income tax appeared during the Civil War but it did not become a permanent part of the federal tax structure until after the adoption of the 16th Amendment in 1913. On the other hand, state income taxes can be traced back to the faculty taxes in colonial days. The faculty taxes were a distinctive but crude form of taxation adapted to the simple economic life of colonial society. They were a combination of specific property taxes and income taxes.

4. Revenue produced.

a. Federal. The personal income tax produced $47.9 billion in revenue in 1963. This represented an increase of $21.2 billion over the 1954 figure. (See Table number I). Including payroll taxes, it now accounts for 62 percent of the total federal tax revenue. This compares with 22 percent in the 1930's and 44 percent during World War II. Today's tax is higher as a percentage of real income than under peak rates of World War II.

b. State and local. Personal income tax laws are prevalent in 36 states and the District of Columbia. Local governments in five states levy income taxes, but they are widely used in only two states, Ohio and Pennsylvania. The total combined state and local government receipts from personal income taxes was $3.224 billion in 1962 compared with $2.153 billion in 1959 and $0.913 billion in 1952. This is a $2.311 billion increase in just ten short years. Virginia received $80,405,348 in 1962 from the personal income tax.

5. Incidence and economic consequence of the personal income tax. It is generally conceded that net income taxes are the most difficult to shift.

TABLE NO. I.

Personal Income Tax. Amounts and as a percentage of personal income and GNP, 1954 - 1963. (Billions)

YEAR	NO. OF RETURNS (MILLIONS)	PERSONAL INCOME TAX	GNP	PERSONAL INCOME	TAXES AS A PERCENTAGE OF NATIONAL INCOME	TAXES AS A PERCENTAGE OF GNP
1954	56.9	26.7	363	290	9.21	7.36
1955	58.3	29.6	397	310	9.55	7.36
1956	59.2	32.7	419	333	9.82	7.80
1957	59.8	34.4	443	351	9.80	7.76
1958	59.1	34.3	445	360	9.53	7.71
1959	60.25	38.6	483	384	10.05	7.99
1960	61.0	39.5	503	401	9.85	7.85
1961	66.5	41.3	518	417	9.90	7.97
1962	71.0	45.6	555	442	10.32	8.22
1963	71.32	47.9	578	452	10.60	8.29
Estimate: Percentage Increase 1954-63		79.4%	59.2%	55.9%	15.1%	12.6%

Source: Statistics of Income 1960. pp 100-101, Survey of Current Business, July 1963, p.12

Several factors figure in this resistance to shifting: (1) the tax is general in character and reasonably "uniform treatment" is given to incomes from various sources; (2) it is "net" tax; it does not impinge on the "cost of production" and therefore is not prone to affect changes in relative supplies. However, there are certain economic conditions under which the possibilities of shifting a net income tax will occur. Shifting of the tax may occur if the tax produces changes in the quantities of various factors available. If the quantity of labor falls, wages will rise and part of the tax is shifted to business owners. This increases the "cost of production" and will lead to upward adjustments in prices. As a consequence, the tax in part shifts forward onto persons in their capacity as consumers. The different types of labor supplied complicate the picture of incidence. Similar influences affect the price of money capital. If the total supply is reduced, the interest rate and the earnings on equity capital will tend to rise. However, this can be countered by the central bank policy.[17]

6. Conclusions. The personal income tax is generally regarded as the most equitable means of distributing the burden of the costs of government. Its burden is correlated with economic well-being more satisfactorily than that of any other tax. Not only is the tax based directly upon income, the primary determinant of economic well-being, but it can be defined in terms of family size, medical expenses, and other considerations affecting the level of living which may be enjoyed with a particular income. The degree of progression must always be based on consensus of attitudes of society on equity in the distribution of income.

From a practical standpoint, the most serious limitation to the tax is the inability to prevent some evasion on the part of certain groups of economy. From the standpoint of economic effects, the chief danger is that of adverse effects upon incentives, particularly to develop and expand business and to take more responsible positions. The present federal income tax structure contains unnecessary loopholes, which create inequity and lessen the degree of effective progression. On the other hand, some of these loopholes probably lessen the adverse economic effects of the tax.

B. Personal wealth as a measure.

1. Wealth. An alternative measure of economic well-being is personal wealth, in the sense of the value of goods, claims, and property rights owned. This measure is not a flow during a particular period but the value of a stock of wealth of a person at a particular period but the value of a stock of wealth of a person at a particular moment of time. To the extent that this wealth is placed in income-yielding investments, the wealth is in part reflected in income. But nevertheless, if two persons have the same income and are in otherwise similar circumstances but have different amounts of wealth, they are not equally well off. The person with wealth is not under the same compulsion to save as is the person without. The person who has little wealth must save in order to attain the same degree of security against risk as the other person and therefore cannot enjoy the same current level of consumption. Furthermore, the person with wealth may, if he chooses, spend a portion of this wealth each year to maintain a higher level of living than that which the person without wealth can attain. The problem is much the same if the person with wealth has invested it in durable consumption goods, particularly a home. Logically the rental value of the home should be included in taxable income, but in practice it is not. Accordingly, if income alone is used as the measure of ability, the person who has such wealth essentially enjoys some tax-free income, since he avoids the heavy rental payments of the person who has not yet acquired his home, and he likewise is not under the same obligation to accumulate a reserve.[18]

2. Property tax. Taxation of wealth has played a major role in the overall tax structures of the United States since colonial days. The

taxes, however, have not been imposed on the net personal wealth of individuals but on all property, or certain types of property, regardless of ownership, and on gross value without deduction of any claims outstanding. There are 91,236 governments in the United States of which 91,235 may levy property taxes.[19] These are composed of:

Federal	1
State	50
Municipal	17,997
Township	17,144
School District	34,678
Special District	18,323

a. Federal government and property tax. Because of the constitutional provision that all federal "direct taxes" must be apportioned among the states according to population, the federal government has never utilized the property tax very extensively. It attempted to do so several times during the 19th Century but was never successful in the actual collection of revenue. The property tax, therefore, is practically of no fiscal significance to that unit of government.

b. State government and property tax. Since the close of the last century, property tax revenues have been of a declining significance to state governments also. There has been a conscience effort on the part of state governments to withdraw from the property tax field. In 1900 over 50 percent of all state tax revenue came from this source. In 1948, only one state, Nebraska, received over 20 percent of its tax revenue from this source. In 1960, only three states received more than 10 percent of their total tax revenue from property taxes: Nebraska, 29.9%; Arizona, 17.3%; and Wyoming, 16.3%. Three states do not levy property taxes: Oklahoma, Rhode Island, and Tennessee. In 1961 only 3.3 percent of total state tax receipts was from property taxes. (See Table number 2.) State assessed property for the year 1963 amounted to $27.8 billion. Virginia collected $197,347,266 in 1961 from an assessed property base of almost $7 billion which was 4.5 percent of all tax collections.

c. Local property taxes. Property taxes are the very substance of local tax structures. The local units are not soverign and therefore can only levy such taxes as they are permitted by the state. All states have permitted the local units a good deal of latitude in levying property taxes. Only five state constitutions limit the overall property taxing power while statutes limit the power in four other states. Sixteen state constitutions place specific limits on the localities taxing power while statutes in 16 other states limit the power. The revenues of local governments for general government purposed totaled $32.9 billion in 1960. The corresponding total was $21 billion five years earlier, $14 billion in 1950, and about $7 billion during the years of World War II. Local governments raise about 70 percent of their current revenues from their own sources. Approximately 30 percent of the current revenue of local governments is state and Federal aid, chiefly state. State aid includes, of course, some funds which originated in Federal aid to states. (See Table number 3.)

Many functions of civil governments are traditionally local and their cost has outpaced the yield of local government's own revenue sources. Despite substantial increases in the amount of state and Federal aid, many cities, counties, and school districts, have been able to finance their burgeoning activities only by recourse to taxes not well suited for local use. The revenue requirements of local governments will continue to mount as the quantity and quality of their programs are brought into better conformity with the further growth and urbanization of the population and with rising living standards. Significant adjustments in State-local fiscal relations will be required to prevent the aggravation of disparities between local needs and local resources.

TABLE NUMBER 2.

State tax collections, by source, selected years, 1902 - 1962.

(Millions of Dollars)

YEAR	TOTAL EXCLUDING EMPLOYMENT	INDIVIDUAL INCOME TAX	PERCENT OF TOTAL	PROPERTY TAX	PERCENT OF TOTAL
1902	$156	———	———	$ 82	52.6
1913	301	———	———	140	46.5
1922	947	43	4.5	348	36.7
1932	1890	74	3.9	328	17.3
1942	3903	249	6.4	264	6.8
1952	9857	913	9.3	370	3.7
1956	13375	1374	10.3	467	3.5
1957	14531	1563	10.8	479	3.5
1958	14919	1544	10.3	533	3.3.
1959	15848	1764	11.1	566	3.6
1960	18036	2209	12.2	607	3.4
1961	19002	2353	12.4	631	3.3
1962	20600	2730	13.3	not available	not available

Source: Tax Overlapping in the U.S. - 1961, p.13
Taxes, The Tax Magazine, June, 1963, cover.

3. Shifting and incidence of property taxes. The analysis of shifting of the property tax must be made in terms of the various classes of property which are subject to the tax. No overall generalizations are possible, because the shifting of some portions will differ substantially from that of others.[20]

a. Land taxes. In the usual discussion of land it is contended that because the supply of land is relatively fixed shifting is not likely to occur except in the form of tax capitalization. Land receives an income called rent, and if the supply of land which is actually used can be shown to vary with the amount of tax, a tax on land could be shifted. Upon the sale of land a form of shifting known as tax capitalization tends to take place. The prospective buyer tends to discount the future anticipated taxes which reduce the income from land, and so they offer a lower price for the land, thus forcing the seller to absorb future taxes.

b. Building taxes. If a property tax is levied on an owner occupied building, there is little he can do to avoid bearing the burden except to keep down the assessed valuation. On rental buildings if income is reduced it will tend to curb construction of additional rental units. However, in a period of steadily expanding population the demand for housing may increase. Under those circumstances landlords may be able to raise rents and thus shift property taxes. Another way owners react with advent of higher taxes if to postpone upkeep and repairs.

c. Business inventories. If the tax is permanent and is levied on all competitors, there is a likelihood that it will be shifted. The tax becomes a cost of doing business and is tacked on to the price.

d. Intangible property. Here the usual experience is that a large fraction of the property evades the tax. If taxing is successful shifting can occur only through a change in the price of the intangible or in a change of return upon it.

4. Effects of the property tax and its shifting. The property tax and its incidence have had some adverse effects upon the construction of rental housing and especially low-cost housing for the low income people. The tax has caused a good deal of migration of citizens away from the cities and has motivated the establishment of tax colonies in suburban areas. It has stimulated the construction of smaller houses and buildings. Tax capitalization has had the tendency to depress real estate values, and thus it has discouraged investment in real estate. In general, the taxes on business seem to be more shiftable than those which fall upon the ultimate user or consumer. Taxes on buildings and improvements appear to be more easily shifted than taxes on land. Finally, the more universal and uniform the impact of the tax on various classes of property, the more likely it is to be shifted.

PART III. CONSUMPTION EXPENDITURES AS A MEASURE.

A. Theory. A major alternative to income as the basis for taxation is consumption expenditures. Despite the general acceptance of income as the most suitable measure of economic well-being, substantial use has been made of the expenditure base as well, and arguments have often been advanced for increased, or even exclusive, reliance upon this basis in preference to income. In terms of the basic definition of income (consumption plus increase in net wealth), a consumption based tax would apply only to one segment of total income, namely, consumption, while increases in net wealth would be excluded from the base of the tax. In terms of the "flow of wealth" definition of income employed in the tax laws, only the portion of the flow employed for consumption purposed would be taxed. For persons who are spending more than their incomes, the potential tax base is greater under the expenditure approach than under the income approach.

1. Income defined as consumption. "A group of writers over a long period of time has argued that income is appropriately defined for tax purposes as consisting only of consumption expenditures, because economic well-being is determined by consumption alone. The chief exponent of this doctrine in later years was Irving Fisher, but the idea is to found in earlier writings. Classical economists such as John Mill and Pigou followed a similar line of reasoning in arguing that the taxation of both the portion of income saved and the subsequent earnings from the sums saved constituted double taxation, since the principal is reduced by the amount of the tax, and then the earnings. This terminological approach is not particularly fruitful. The definition of income which includes sums saved as well as sums consumed is more generally accepted, in line with

Local Government General Revenues, by Source:
Selected Years, 1927-1960. (Figures in Parenthesis are Percentages.)

YEAR	Intergovernmental Federal	State	From Total	Local Property	Sources Other	Other General Revenue	Total General Revenue
	(12)	(10)	(89.8)	(73.9)	(2.0)	(13.9)	(100)
1927	9	596	5298	4360	119	819	5903
	(.2)	(14.1)	(85.7)	(73.1)	(2.0)	(10.6)	(100)
1932	10	801	4879	4159	115	605	5690
	(.8)	(25.0)	(74.2)	(60.0)	(4.9)	(9.3)	(100)
1942	56	1780	5286	4273	352	601	7122
	(1.4)	(29.8)	(68.8)	(48.9)	(7.0)	(13.0)	(100)
1952	237	5044	11671	8282	1185	2205	16952
	(1.8)	(28.5)	(69.7)	(48.1)	(6.9)	(14.7)	(100)
1960	592	9361	22912	15798	2283	4831	32866

SOURCE: Tax Overlapping in The United States--1961, p. 64.

the point of view that saving a portion of income constitutes a contribution to the person's economic well-being and reflects a deliberate choice. . . . the argument over the desirability of excluding saving from the base of taxation can be resolved only in terms of the merits and limitation of doing so, not by labeling the failure to do so as "double taxation".[22]

2. Equity and the consumption tax. The key argument on equity grounds for the expenditure basis dates back several centuries to the statement of Hobbes that equity requires the taxation of persons on the basis of what they take out of the common pool (National product) rather than what they put into it. "...the Equality of Imposition consisteth rather in the Equality of that which is consumed, rather than of the riches of the persons that consume the same."[23] A person's direct and immediate level of living depends upon his consumption expenditures; when he saves now and consumes later, he will be caught at the time of ultimate consumption. If a person currently consumes from previously accumulated or inherited savings, equity requires that he make some current contribution to government on the basis of this expenditure, especially in periods of severe shortages and inflationary pressures.

The income tax ignores the different spending capacity of various incomes; spending capacity, rather than income, is the best measure of tax paying ability. The differences arise in part out of the varying wealth status of the recipients. A person who has not yet accumulated and must put some of his income aside does not have the same consumption power as another person with the same income who has already accumulated. Thus, income taxation tends to discriminate against persons gaining their incomes primarily from wages compared to those gaining them from already accumulated savings. This discrimination can be offset in various ways, but with the expenditure basis, it does not arise at all. In general, under the expenditure basis, no attempt is necessary to adjust for the varying degrees of spending power, since these are automatically reflected in the expenditures which persons actually make.

3. Savings and the consumption tax. Further defense for the expenditures basis is built on the argument that income taxes, by reducing the net income from savings, distort the choice of the individual between present and future consumption, by making the latter less attractive than it would otherwise be. Persons are given added incentive to consume now. Kalder argues that the higher income groups in Great Britain have ceased to save because of the present progressive income tax treatment. "That the wealthy classes in Britain have ceased to save and dis-save on a considerable scale---at least in relation to their taxed incomes---is not, I think seriously contested by anybody: The statistics of net incomes after tax already referred to provide sufficient evidence of this.[24]

By contrast, the expenditures basis would eliminate this bias, and even reverse it if persons believed the tax to be temporary or discount future tax payments. Apart from these incentive effects, an expenditure tax, especially one imposing substantial burden on the lower income groups, tends to reduce consumption to a greater extent than the income tax by concentrating its burdens on persons who must reduce consumption because they have inadequate savings margins from which to absorb the tax.

4. Effects on Incentives.

a. Risk. Distinct from the question of relative effects of the expenditures basis upon the incentives to save is that of the relative effects, compared to the income basis, on the incentives to undertake investment and to take risks in a broad sense. The income basis, particularly with present progression, not only takes away a substantial portion of the incomes of corporations and wealthier persons who are in a position to undertake the risks of business development, but also reduces the incentive to do so, since the government will absorb most of the possible gains. The expenditure basis, which does not apply to earnings so long as they are saved and used for further business expansion or other purposes, avoids the excessive draining of savings away from investing groups and the incentive penalties.[25]

b. Work. The expenditure base may have less severe effects upon work incentives than the income base, since the taxes imposed upon the former can be escaped, at least temporarily, by saving, whereas the taxes based upon income cannot be. The use of the expenditures tax exclusively would permit elimination of the corporate tax. No consumption occurs at the corporate level. No effort would be required to distinguish among various capital gains to determine which ones constitute income, since to the extent that the recipients regarded them as income and spent the sums, they would be reached by the tax.[26]

5. Arguments for consumption levies. Several major arguments have been presented by those favoring consumption taxes.

a. Consumption taxes are adequate and the revenue flows immediately. Consumption taxes, while not totally adequate, provide a substantial amount of needed revenue annually and to dispense with this revenue vehicle would result in a shift in the tax burden to another income raising source.

b. They are easily adaptable for sumptuary control. This argument is clearly an ethical proposal and must be based on the assumption that a community is in substantial unity upon those goods which are considered "harmful". It also assumes that the imposition will automatically decrease the use of the harmful product.

c. They provide a relatively stable source of revenue over the business cycle. The income tax is sensitive to cycles and the government loses much needed revenues during depressions while consumption expenditures are stable over the cycle causing the government to have a steady supply of funds.

d. Consumption taxes are also defended on the ground that they make everybody contribute to the government. Everyone should contribute, it is said, first, because everyone receives some benefits from the government and second, because it will tend to make everybody interested in the government and less likely to support extravagant public expenditures. Where a few people pay all the taxes and the masses enjoy the benefits of government, the many are likely to exploit the few by voting for every new bond issue and public service. On the other hand, consumption taxes are poor protection from governmental extravagance. The correlation if any between benefits and consumption is weak, and the imposition of consumption taxes upon even those who are recipients of relief would be like charging the inmates rent at a poor house.

e. They promote tax consciousness. They impress on the greatest single "class" in society--the consumer--the necessity of tempering it's demand for government services. Critics say that many of the taxes are hidden and create no tax consciousness. A poll tax in making people tax conscious would be much more effective.

f. They are economical to collect and convienent to pay. This adheres to Adam Smith's canon that all taxes should be convenient to pay.

g. They are desirable because they offset other tax burdens and, therefore, spread the total costs of government over a wider range of individual taxpayers. They are said to offset the progressive income and inheritance taxes. In addition, one hears, at the local level, the cry that increased taxes on property will result in tax delinquencies, "property-owner strikes" and so on; the best way to prevent such occurrences is to initiate new or increase old consumption levies to cover proposed governmental expenses.[27]

6. Arguments against consumption levies. Arguments here are broken into two major classifications: (1) those of special significance to the individual, and (2) those which affect the economy as a whole.

a. From the viewpoint of the individual.

(1) Upside down taxes. The consumption taxes have been called "upside-down income taxes" and taxes that are based upon the "inability to resist" rather than the ability to pay.

(2) Regressive in effect. Consumption taxes, it is argued, are uniform in rate upon all. They hit the lower income groups hardest in that they take from them a larger percentage of their income than from the wealthy. Those with small incomes spend practically all of their earnings mostly for commodities which are purchased at the retail stores. On the other hand, the recipient of a $1,000,000 income does not spend all that he receives; most of his income more or less automatically goes into savings while another substantial part is spent for services.

(3) Ability to pay disregarded. These taxes make no adjustments for the consumer's ability to pay. They take no account of dependents and other "need" factors such as illness and education. Nor do they give any consideration to the unemployed; in fact these taxes embezzle away part of the unemployed allowances. These taxes take away from the poor man the dollars which have a high utility to him. They place upon him a maximum sacrifice.

(4) Pyramiding. One of the more subtle features of a consumption tax is its tendency to take more from the pockets of the taxpayers than the government intends or receives. Pyramiding occurs particularly in connection with manufacturers' sales taxes and general sales taxes. While

a product is passing from the raw material to the finished stage and through the hands of various distributors to the ultimate consumer, several sales may be involved before it reaches its journeys end. Since the value of the commodity increases as it approaches the consumer, the percentage tax adds an ever-increasing burden which is compounded with each sale. And in addition, profit mark-ups are calculated on the basis of the compounded tax costs.[28]

b. From the point of view of the economy as a whole. These taxes can affect the overall operation of the economic system.

(1) Deplete overall purchasing power. Consumption taxes strike at a strategic point in that they appropriate purchasing power from those who would ordinarily spend it for private consumption. Whenever consumption levies subtract from the total purchasing power of a community, the effective demand for goods is decreased, unless the expenditures by the government are returned to consumers in the same proportion as taxed. The preponderent majority of governmental expenditures are redirected into the economy, but there is no planned re-apportionment along consumers' lines. Thus low-income groups suffer a direct, immediate loss, with only a possibility that they will recoup a portion of the tax by an indirect, remote expenditure.

(2) Curtail employment and investment. Whenever there is a reduction in total effective demand in an economy, sellers of goods are the first to receive the impact. Sales decrease, inventories accumulate, and total receipts decline. This is turned back on the producer, for he must adjust his output to equilibrate the volume sold. The producer may be forced to reapportion his production of goods and allocate his resources into different combinations. Consumption levies which curtail

production force the lay-off of employees. This in turn forces additional decrease in total purchasing power and effective demand. Investors, sizing up the possible markets for their funds, keep a close eye on total receipts and profit margins of different industries, and if their outlook is dampened by the decreased demand, they will withhold funds from investment.

(3) Cyclically rigid. This argument contradicts the stability theory of the tax's proponents. Taxes which run counterclockwise to the cycle produce rigidities in price variations. A consumption tax may be only nominal at inflated wages and prices in prosperity, but it will be burdensome during the deflated conditions of a depression. In addition, consumption levies may have little effect on curtailing price rises during booms, but they may serve as an anchor on business expansion at the cyclical trough.

(4) Affect business methods. They tend to eliminate the middleman by fostering the growth of large, multiple process establishments at the expense of smaller concerns. They tend toward the integration of business firms, the substitution of brokers for wholesalers, the extension of selling on consignment and other changes in business structures in order to avoid the tax.

(5) Tends to injure small business. Because of highly competitive conditions in many retail businesses, it is often argued that small retail establishments are forced to absorb part or all of the tax. This is true in communities where there are large department stores and chain stores with competitive price policies. They must all collect the tax, but the larger retail units may be able to charge lower prices. This may create a smaller base upon which to apply the tax. It is even more true in communities near state boundaries where the small business may have to compete with those across the state line not affected by the tax. The absorption of the tax and the subsequent loss of sales affect small outlets in several ways. First, this condition reduces their profits. Second, it reduces the purchasing

power of the small business people and their families. And third, it eats into their capital for expansion and improvements.[29]

B. Methods of levying consumption taxes. There are two basic approaches to the levying of a consumption tax. One is the direct approach through a "spendings tax"; the other is the indirect approach though commodity taxes.

1. The direct method.

a. "Spendings taxes". The term "spendings taxes" was popularized in the United States in a proposal by Congressman Ogden L. Mills after World War I, to substitute a graduated tax upon personal expenditures for the surtax. This would leave the normal tax as the only individual income tax. A graduated spendings tax would be levied directly upon consumers, in conjunction with the net income tax. The basis of the tax would be the expenditures of the consumers as defined according to legal requirements and reported to the government. The tax would be collected through the use of tax returns filed by individuals, supplementary to or a portion of, the regular income tax returns. The taxpayer would determine his net savings during the year, that is, the net change in his total savings, as indicated by larger security or real property holdings, payments on life insurance, reduction in debt, etc. He would then subtract this figure of savings from taxable income to determine the amount of expenditures made during the year. Expenditures for expansion of a business owned by a person would be regarded as a form of savings and thus would not be taxed. Should the figure of net savings be negative, the sum would be added to income. Exemptions comparable to those of the income tax would be allowed to exclude minimum necessary expenditures from the tax and adjust the burden in terms of family size. Certain other deductions, such as expenses for medical care and education, could be permitted. The tax could be made progressive, and very steeply as, if the tax were intended primarily as an anti-inflationary measure. The amounts due would be paid in conjunction with income taxes at the end of the year.

b. Evaluation of the spendings tax. In general, the use of the spendings tax would allow the attainment of the goals of the expenditures basis much more adequately than the commodity taxes. The desired pattern of burden distribution could be obtained in much more precise fashion than by the use of commodity taxes. The use of the exemptions and progressive rates would not only eliminate regressiveness but also allow the attainment of desired degrees of progression. The relative burden on various persons would conform much more closely with desired standards of equity than that of sales and excise taxes. The spendings tax is likewise much less likely to generate wage increases.[30]

(1) Failure to reach savings. The objections to the spendings tax are two-fold. In part, they include the basic objections to the expenditures basis, particularly exclusive use of it--the failure to reach on a current basis the large accumulations of wealth made by persons saving high percentages of their incomes, lessened built-in flexibility, and the greater deflationary effect, a disadvantage in non-inflationary periods.

(2) Administrative problems. The other basic objection is that of administrative complexity. Several problems must be solved:

(a) In addition to the problems of income taxation, one additional step is required, namely, the calculation of net savings during the period. This is not an insuperable task, but is an additional source of nuisance, error, and evasion.

(b) Special treatment must be given to consumer durables, to avoid the inequities consequent to irregularity of expenditures with progressive tax rates.

(c) The delineation of consumption expenditures from those for investment and for business purposes would be troublesome.

(d) The treatment of gifts is troublesome and could lead to outright tax evasion.

(e) The anticipatory effect of introduction of the tax and changes in the rates could be very troublesome to the economy. Timing of expenditures is subject to personal discretion. [31]

Conclusion. It may be that a spendings tax if inaugurated at the right time, could be a useful instrument of fiscal policy in a war emergency. It no doubt could be a good revenue raiser and perhaps could serve as a buffer against inflation. It would reach luxury and conspicuous consumption. It could also encourage saving at a time when additional capital formation was necessary.

(3) The spendings tax at work--India's Expenditure Tax. A spendings tax has never been employed in the United States, Canada, or Western Europe; to date, the only countries to use the tax have been India and Ceylon.

A tax on personal expenditures has been in effect in India since April 1, 1958. The enactment was a result of a study conducted at the request of the Indian Government by Nicholas Kalder of Cambridge University. The tax is levied annually on expenditures incurred by individuals and Hindu undivided families during a base year. It is based on world-wide expenditures, expenditures within India, or expenditures within India and expenditures outside India from Indian sources, according to the residence and citizenship status of the taxpayer. Expenditures above a standard allowance, generally $30,000 are taxed at sharply progressive rates. The basic intent of the Act is to tax expenditures, exceeding the standard allowance, which is in the nature of personal consumption. Expenditure for expenses of business or employment, investments, capital outlays for personal use, and gifts are therefore exempt. In addition, certain expenditures which do represent personal consumption are exempted as basic living costs.

(a) Highlights of India's Expenditures tax. Persons subject to the tax:

(i) citizens who are residents are taxable on world-wide expenditures regardless of the source of funds;

(ii) citizens who are not residents and aliens who are residents are taxed on expenditures in India and expenditures world-wide if made from funds derived from Indian sources;

(iii) aliens who are not residents are taxed only on expenditures in India but regardless of source of funds.

(b) Corporations are not subject to the expenditure tax.

(c) Exempt taxpayers. Any taxpayer whose income from all sources does not exceed Rs36,000 in any base year is exempt for that year. Former rulers of Indian States are treated specially. Expenditures out of their privy purses are exempt.

(d) Expenditures incurred. In effect expenditures are taxed when paid or accrued, whichever occurs first.

(e) Attribution rules. (i) Expenditures made by other persons to satisfy an obligation of the taxpayer in excess of Rs5,000; and (ii) if the taxpayer is a Hindu undivided family, any expenditure incurred by a dependent of the family out of any income or property transferred directly or indirectly to the dependent by the taxpayer are treated as incurred by the taxpayer.

(f) Certain durable goods. Expenditures "by way of capital expenditure" on the purchase of bullion, precious stones, jewelry, furniture and other household goods, automobiles and other conveyances, or any other articles "for the personal use of the taxpayer or any of his dependents" must be spread over a five-year period for purposes of tax. Twenty percent of the expenditure is included in expenditures for the year in which it is incurred and 20 percent is added to the expenditures for each of the four succeeding years.

(g) Exemptions. Any revenue or capital expenditures incurred by the taxpayer "wholly or exclusively" for the purpose of his business, profession, vocation, or occupation or for the purpose of earning income from any other source is exempt from the expenditures tax. Capital expenditure wholly and exclusively for the purpose of the taxpayer's business is exempt from expenditures tax. Certain non-business expenditures are also exempt, such as: investments, contributions to capital, repayment of loans, interest payments, acquisition of immovable property, contribution to a provident, thrift, or pension fund, and insurance premiums.

Purchase of books, works of art, or the purchase of livestock are exempt. Expenditures within India for a public or religious purpose are exempt. Gifts, donations, and settlements are exempt. All taxes except those on movable assets, customs duties, and local property taxes are exempt. Finally, certain personal expenditures are exempt; such as: those of a taxpayer whose total income is less than Rs36,000, those incurred in a civil or criminal proceeding, marriage expenditures, those incurred for the maintenance of taxpayer's parents, medical expenses, and those for education outside India.

(h) Yield. The expenditures tax was expected to yield 10 million Rupees for each of the fiscal years 1958 to 1959. (A Rupee is worth approximately 21 cents in United States currency.)[32]

2. Indirect or commodity taxes. Commodity taxes may be classified under three headings--customes duties, specific commodity taxes, and general sales taxes. Closely allied in economic character are levies on the payment for certain services, such as amusement ticket taxes, taxes on transportation, telephone messages and telegrams, taxes on hotel rooms and club dues taxes, stock issue and transfer taxes, back check taxes, mortgage recording taxes and other levies on financial transfers may be convienently listed in connection with commodity and service taxes, since such transfers may be viewed as a form of service.

a. Customs duties.

(1) The concept. Tariff or custom duties are taxes levied upon goods crossing national boundaries, and they are generally collected from importers seeking advantage in the country which levies such duties. Consequently, such duties can be considered a "premium" upon the economic advantage the producers of one country can gain by selling their commodities in foreign markets.

Classification of tariff rates. Tariff duties are levied in two basic patterns: (1) specific duties, and (2) <u>ad valorem</u> duties. Specific duties are levied as a definite sum of money upon the given units of goods--such as 2 cents per pound on sugar or $1 per gallon on Scotch whiskey. <u>Ad valorem</u> duties are levied according to the value of the imported good--such as 25 percent on the value of diamonds or 10 percent on the value of automobiles. Specific duties are more flexible and are inclined to be regressive in relation to the cheaper goods. They are cheaper to administer because there is no process of valuation involved. <u>Ad valorem</u> duties are more flexible and are not so regressive as applied to cheaper goods. The latter are more expensive and difficult to administer because of the valuation problem.

Objectives of a tariff tax. [illegible]

(2) Objectives of tariff rates. "Three objectives can be followed. They are: the free list, tariff for revenues, and tariff for protection. Those commodities placed on the free list may enter without any custom duty payment. These goods are free to flow without tax hindrances. A tariff for revenue is one where the rates are set at a level that will not discourage the goods from coming in but at a level that will secure the greatest net revenue yield. A tariff for protection is one where the rates are set high enough to give domestic producers adequate protection. A truly protective tariff will yield little revenue because it will actually keep the goods out."[33] Another tax levy is the compensatory tariff; a customs duty imposed on the importation of a commodity produced and subject to excise tax in the taxing country, at the same rate as the excise, to equalize the tax burden on the domestic and foreign products.

(3) Fiscal significance of customs duties. Though our tariffs have been usually called protective, they have raised substantial revenues. From 1789 to 1862 customs duties usually amounted to over 90 percent of the total federal revenues. From about 1868 to 1910 they constituted between 40 percent of national receipts. During the 1920's tariff revenues averaged well over $500 million per year or about 12 percent of total revenue. They dropped off to about 40 percent in the 1930's. From World War II until 1950 customs duties averaged somewhat over $400 million per year. In 1955 customs revenues started climbing soon reaching $606 millions; in 1959 they were $948 millions; in 1962 $1,008 millions; in 1963 they were $1,241 millions or just about 1.4 percent of the federal government's income for that year.[34]

(4) The economics of tariffs.

(a) Tariffs for revenue. The basic objective of many individual tariff rates is to raise revenue rather than protect home industry. The principles to be considered are:

(i) Tariffs should be levied upon those goods which cannot be produced within the country or those which can be produced only at a material disadvantage.

(ii) They should be levied upon a small number of selected commodities for which there is a wide and inelastic demand and upon luxuries.

(iii) Generally, they should not be levied upon the basic necessities of a fair standard of living.

(iv) The rates should be kept reasonable so as to minimize smuggling and evasion.

(b) Tariffs for protection. A protective tariff places major emphasis upon tariff rates high enough to "keep out" certain goods so as to protect domestic industries from foreign competition. Many economic arguments have been advanced in favor of such tariffs: (1) to protect and encourage "infant industries" until they can increase their productivity and lower their costs to compete in world markets; (2) to conserve the "home market" for domestic producers; (3) to aid in building a diversified economy; (4) to insure economic self-sufficiency in the event of war; (5) to maintain the wage and standard of living of the domestic workers; and (6) to protect against the "dumping" of cheap foreign goods upon the domestic market. The counter argument is that for all this protection the consumer really pays and often because the rise in price is more than the tariff rates he often pays a premimum to the domestic producer, in addition to the amount of the tariff. The protective tariff has been called the "mother of trusts" because it places a stronger grip on the domestic economy and tends toward internal monopoly.

b. Excise taxes.

The second category of indirect consumption taxes is the specific commodity tax or excise tax. Excise taxes are levied upon goods and services produced or sold within the boundaries of the governmental unit levying the tax. Generally, the legal impact of these taxes is upon the producer or distributor, although the ultimate incidence may be upon the consumer. Usually "specific goods" are selected for excise taxation--that is, taxes are levied at given rates upon narrow classes of goods, such as beer and liquors, tobacco, leather goods, entertainment, jewelry, and so forth.[36]

There are four major bases upon which the taxation of particular classes of consumer expenditures may be justified. In the first place, the consumption expenditures for particular articles may be regarded as a better measure of tax paying ability than total consumption expenditures as in the spendings tax. If spending capacity, rather than income, is the best measure of taxpaying ability then excises may be regarded as preferable in terms of equity, to the general sales tax. Excises designed to distribute the burden of taxation in proportion to consumption expenditures which are considered to constitute suitable measures of taxpaying ability are known as luxury taxes.

Secondly, excise taxation may be based upon the deliberate desire to curtail the consumption of commodities whose use results in costs to society over and above those incurred in their production and/or to penalize those persons who continue to use the commodities despite the tax. Such excises are known as "sin" or sumptuary taxes. The liquor and tobacco taxes are the most important example.

(1) The Sumptuary Excises.

(a) The argument for the liquor, tobacco, and other sumptuary excises rests primarily upon the contention that the output and use of the commodities involved would reach levels beyond those regarded as optimum were it not for the taxes imposed on them. The use of the commodities gives rise to certain real costs to society which do not appear as costs to the producers, and therefore are not reflected in the prices for which the articles are sold. Evaluation of the sumptuary taxes actually used requires an estimate of these indirect social costs. For liquor, especially that of higher alcoholic content, there is substantial evidence. The effects of excessive use of liquor upon the person's family, his work, and possible crime and automobile accidents are well known. With beer and wine the argument is much less strong; for tobacco, it is even more doubtful. While some disutility may be created for non-smokers by tobacco smoke, fire damage may be increased, and some possible adverse health effect produced, it is difficult to argue that there are very substantial real costs to society arising from the use of the product, not withstanding the Surgeon General's reports to the contrary.

While the taxes have merit in checking excessive use and thus production of the articles, at the same time they place a very heavy burden on the great majority of persons who use the commodities only moderately. This pattern of distribution cannot be justified on the basis of economic effect but must be evaluated in terms of equity considerations. On the one hand, it may be argued that consensus of opinion in society accepts the principle that persons should be penalized taxwise for using the article, even in moderation. Accordingly, the heavy burden which rests on the moderate users is in conformity with the standards of equity in distribution laid down by society, even though it is not consistent with the principles which are generally accepted as the primary basis for distribution of tax burdens.[37]

(b) On the other hand, the sumptuary excises have been subjected to substantial criticism on equity grounds. It is argued that the basis of the taxes is the moral judgment of persons responsible for tax legislation that the users "don't really need" the commodities and could just as well get along without them, or that the use of the commodities is in some sense "sinful". The use of a morality basis for taxation is often regarded as somewhat flimsy at best.

The taxes on cigarettes and beer are critized for the regressive distribution of burden which results. The amount which a person spends on cigarettes is not dependent upon his income if he smokes regularly. With the present tax rates, the absolute burden upon the lowest income groups from the tax is very substantial. The taxes upon liquor appear to be progressive. A final argument against the taxes is that of evasion; present taxes are so high that strong incentive is provided for illicit production of liquor and smuggling of cigarettes. Bootlegging has many undesirable social effects and reduces tax revenue. Increases in Canadian cigarette taxes in 1951 led to wholesale smuggling from the United States, which was difficult to check and became so serious that eventually the rate was reduced.[38]

(c) Yield.

(i) (1) Federal tobacco revenues. The federal tax rate on cigarettes is $8.40 per thousand for those weighing more than 3 pounds per thousand and $4 per thousand for those weighing less than 3 pounds per thousand.[39] Revenue totaled more than $2 billion in 1963 compared to more than $1.9 billion in 1962. (See Table number 4.)

(i) (2) State tobacco revenues. State cigarette tax rates range from 2 cents to 8 cents per package of 20.[40] State cigarette taxes, the first of which was imposed in 1921, have moved from an original total annual levy of $350,000 to $1.12 billion in 1963.

Forty-eight states now impose a cigarette tax. (See Table number 5.) Virginia's cigarette tax rate is 3 cents per package of 20. Its net collection for 1963 was $14.6 million as compared to $13.6 million in 1961. Virginia had no cigarette tax before 1961.[41]

(i) (3) Local tobacco taxes. Local tobacco taxes were first adopted in the late 1920's. These taxes are confined to 10 states. Currently 225 cities, towns, and counties impose cigarette taxes whose total annual aggregate levy is in excess of $40.3 million. Local taxes on tobacco products other than cigarettes are imposed in 21 counties and cities and amount to somewhat more than $600,000 annually. Six cities in Virginia tax cigarettes but not other tobacco products. Total receipts were $1,167,000 in 1963. The city of Norfolk received $570,000 in 1963 from this source.[42]

(ii) (1) Federal alcohol tax revenues. The federal tax rate on distilled spirits of more than 24 percent is $10.50 per gallon, beer $9 per barrel; wines are taxed from 17 cents to $3.40 per gallon.[43] Revenue totaled $3.4 billion in 1963 from all alcohol excise taxes compared to $3.2 billion in 1961. (See Table number 6.)

(ii) (2) State alcohol tax revenues. Although the states obtained some revenue from alcoholic beverage excises and licenses prior to the prohibition era, this source did not become an important revenue producer until the repeal of the 18th Amendment. Immediately following repeal, the states imposed excises on distilled spirits, wine, beer, and other beverages. Thirty-two states currently impose taxes on alcohol. In addition, the states require license fees of distillers, brewers, wholesalers, retailers, and other businesses and occupations engaged in the production and distribution of alcoholic beverages. The monopoly system operates in 16 states where all sales

TABLE NUMBER 4.

Federal Tobacco Revenue
(Millions of Dollars)

SUBJECT OF THE TAX	FISCAL YEAR 1961	1962	1963
Cigars	49.064	49.726	50.232
Cigarettes	1,923.5	1,956.5	2,010.5
Other	17.974	19.483	18.481
TOTAL	1,991.1	2,025.7	2,079.2

Source: Treasury Bulletin, U.S. Treasury Department, September 1963, p.4

TABLE NUMBER 5.

Net State Tobacco Tax Collections; Selected years.
(thousands of dollars)

YEAR	TOTAL TOBACCO TAX	CIGARETTES	OTHER TOBACCO	PERCENTAGE FOR CIGARETTES
1921	324	324	———	100.0
1931	15,947	14,457	1,490	90.7
1941	106,294	103,205	3,089	97.1
1951	451,989	444,409	7,580	98.3
1961	1,027,536	995,144	32,392	96.8
1963	1,153,290	1,132,804	20,486	98.2
AL: since 1921	11,839,335	11,586,004	253,331	97.9

Source: Cigaret Taxes in the U.S., Volume XII, 1963.

TABLE NUMBER 6.

Federal Alcohol Tax Revenue
(thousands of dollars)

SUBJECT OF THE TAX	FISCAL YEAR 1961	1962	1963
Distilled spirits	2,314,746	2,423,330	2,507,068
Wines	97,803	99,922	103,733
Beer	800,252	818,230	830,855
TOTAL:	3,212,801	3,341,282	3,441,656

Source: <u>Treasury Bulletin,</u> U.S. Treasury Department, September, 1963.

TABLE NUMBER 7.

State Tax Collections; Alcoholic Beverages:
Selected Years, 1934-1962
(Millions of Dollars)

YEAR	REVENUE	PERCENTAGE OF TOTAL RECEIPTS
1934	62	3.1
1944	267	6.6
1954	463	4.2
1962	741	3.6

Source: <u>Tax Overlapping in the U.S.,</u> p. 13

are made in State owned and operated liquor stores. State revenues from alcoholic beverage excises and licenses rose from $81 million in 1934 to $774 million in 1961. Excises account for more than 75 percent of the total. ~~In the fiscal year 1961, the net contribution to the general funds~~ of the 16 monopoly states was $237 million.[44] (See Table number 7.)

(ii) (3) Local alcohol beverages. Many cities operate their own liquor stores in Minnesota, South Dakota, North Dakota, and Wisconsin. The total amount of revenue collected at the local level in 1957 was $21 million which was only one-tenth of the total local government revenue collected. Local governments also collected $47 million from the sale of alcoholic beverage licenses.[45]

(2) The luxury excise.

(a) Arguments for the tax. The basic justification for luxury excises is the argument that these taxes allow the attainment of the general advantages of expenditures based taxes with a more acceptable distribution of burden than that which results from a general sales tax. The case for luxury excises is also based in part upon the philosophy that some goods are more necessary for a reasonable living standard than others; thus, expenditures on the less necessary ones are more suitable bases for taxation than local expenditures. "The luxury tax idea is appealing because it seems to indicate that the very wealthy will be taxed upon superfluous extravagances, such as yachts, diamond bracelets, and orchids, and that the hard working lower and middle classes will be correspondingly relieved. Such a picture is entirely erroneous. As in so many tax instances the name is not what it seems. The only luxury taxes that justify the cost of administration are those that burden the poor and leave the wealthy practically unscathed."[46] The height of absurdity is reached in the following quotation: "Every time that a man embraced his wife he would report the fact and have to pay a luxury tax and there would be spies and agents to see that the law is enforced." (Law of the Province of New Mexico, Harvey Fergunsen, Rio Grande, P. 191.)

(b) Arguments against the tax. By a proper selection of commodities for taxation, it should be possible to avoid the heavy burden on the poor and the regressiveness of the usual sales tax, although in practice this result is difficult to accomplish. On the other hand, the principle of luxury excise taxation is subject to very severe limitations.

(i) Discrimination according to preference. A fundamental argument against any form of selective expenditure taxation is based on the wide variation in preference among persons for different commodities. Thus, no matter how carefully a list of commodities for application of excise taxes is chosen, those persons who happen to have a relatively high preference for the commodities which are taxed are penalized. Persons who are in essentially the same economic circumstances, except for the fact that they have preferences for different goods, are not taxed equally, and the relative burden on persons in different circumstances is not in proportion to their economic well-being. The luxury taxes are not deliberately designed to penalize persons who purchase the commodities but merely to distribute the relative tax burden in proportion to certain criteria of taxpaying ability.

(ii) Finding suitable measures of ability. A second and related limitation is the difficulty in selecting categories of commodities which are suitable measures of taxpaying ability. There are relatively few commodities on which expenditures are progressive relative to income, with relatively small amounts purchased by the lower income groups. The goal of a luxury excise tax structure--of taxing those specific consumption expenditures which are better measures of taxpaying ability than total consumption expenditures--is not possible of attainment, if any significant amount of revenue is to be obtained. A study by Musgrove illustrates the regressiveness of the distribution of the United States federal excise structure as a whole including sumptuary as well as luxury and other excises. (See Figure number I.)

(iii) Reallocation of resources. The chief argument advanced against the excises on the basis of economic effects is the tendency of the taxes to bring about a reallocation of resources away from the optimum. The sumptuary excises are deliberately designed to check production of goods the output of which is excessive in terms of economic welfare, and are thus justified on that basis. However, the luxury excises are not intended to bring about this result, except when used as wartime measures to ration "scarce goods", but they almost inevitably do so. When a tax is imposed on the sale of a particular good, some persons will cease to buy the commodity or will buy less of it and buy other things instead. They have failed to obtain optimum satisfaction from their incomes, yet the government has gained no tax revenue. Production of other goods will increase, and that of taxed goods will decrease; if optimum allocation of resources was previously attained, a poorer allocation will result.[47]

(iv) Effect on business owners and other factor owners. Business firms may find shifting difficult, especially when substitute products are not taxed, and a portion of the burden may remain upon the owners of the firms for substantial periods. Marginal firms may be forced out of business and experience a loss of capital in the process. The decline in the output of taxed goods will reduce prices of specialized factors used in their production, and thus lower the incomes of these factor owners, a portion of the burden thus being removed from the consumers of the product. Apart from the problems of shifting, compliance with the tax laws may involve considerable nuisance and cost, the burden of which may rest for a time on the owners, and the tax may create competitive disturbances and alter methods of production. Finally, the basic economic objection to all expenditure based taxes is non-inflationary periods applies to excise as well as to other taxes in the group.

(c) Defects in the actual excise tax structure. The objectionable features of excise taxation are agravated in practice by the failure to adhere carefully to accepted standards in the establishment of the excise tax system. Often such taxes are imposed primarily for the purpose of raising more revenue with little attention to the economic effects and inequities.

(i) Taxation of goods and services used in production. The present United States tax structure includes several excises which apply primarily to expenditures by business firms rather than to consumption expenditures. Taxes on telephone service, business machines, etc., become business expenses and are likely to be shifted to the customers of the firm. The ultimate burden is distributed haphazardly with no relation to ability to pay in any sense.

(ii) Use of specific rates. Use of specific tax rates that do not vary with the value of the product place a disproportionate burden on the users of the cheaper types, increases the regressiveness of the taxes, and tends to drive the cheaper brands off the market.

(iii) Pyramiding. Since the excise taxes are for the most part levied at the manufacturing level, considerable direct pyramiding probably occurs.

(iv) Technical problems. Many of the excise taxes were enacted hastily, with little careful wording of the legislation; the tendency

TABLE NUMBER 8.

State Luxury Tax, Selected Years, 1922 - 1961
(Millions of dollars)

YEAR	MOTOR FUEL TAX	PERCENT OF TOTAL COLLECTION	AMUSEMENT TAX	PERCENT OF TOTAL COLLECTION	PUBLIC UTILITY TAXES	PERCENT OF TOTAL COLLECTION
1922	$ 13	1.4%	——	——	——	——
1942	940	24.1%	33	.8%	$100	2.6%
1952	1,870	19.0%	157	1.6%	228	2.3%
1956	2,687	20.1%	223	1.7%	300	2.2%
1961	3,431	18.1%	301	1.6%	375	2.0%

Source: Tax Overlapping in the United States, p.27

to regard them as temporary lessened the interest in revising the legislation or in developing extensive regulations. "Major problems are:

1). A satisfactory legal basis was lacking for determination of taxable price on direct sales by manufacturers to retailers.

2). Some of the classes of taxable goods, especially those subject to the retail excise, have not been clearly defined.

3). The term manufacturing has not been clearly defined, particularly with regard to such activities as rebuilding, and the treatment of private brand merchandise.

4). Regulations have been inadequate and excise tax rulings have frequently not been published. Appeal procedures are unsatisfactory, and auditing of taxpayers has been inadequate."[48]

(d) State luxury tax systems. The states have not developed extensive excise tax systems but collect substantial revenues from a relatively few items. The most important is the benefit-based gasoline tax, levied in all states. Most state tax levies are limited to amusement taxes, utility taxes, and gasoline taxes. (See Table number 8.)

(e) Local luxury taxes. Local sales taxes are usually limited to municipalities. They may apply to soft drinks, public utility services, admissions, meals in restaurants, or other special commodities. Local government receipts and percentages of total local government revenues from luxury excises items for 1957 were:

Motor fuels	26 million	0.2%
Public utilities	225 million	1.6%
Amusements	26 million	0.2%
Other and unallocable	21 million	0.1%

C. General Sales Taxes. The most important type of consumption-based tax in present-day tax structures is the general sales tax, a tax applied to the sale of a wide range of goods and services. A universal sales tax would reach all consumption expenditures; those actually in use apply to a considerable narrower range, because major items of expenditures, particularly for housing and various personal services, are almost never included within the scope of the tax. The sales tax is the major source of state revenue, and is the most important element in the tax structures of many countries in Europe, South America, and elsewhere. The general sales tax is the subject of Part IV.

PART IV. GENERAL SALES TAXES.

A. Introduction. The third category under the classification of consumption basis is that of the general sales taxes. "Perhaps no more numerous or less well-defined a group of taxes is placed within one class than is generally included in the expression "sales tax". "Sales tax" appears to denote a tax the liability for which arises upon the sale of property. Yet taxes based upon the furnishing of water, gas, electricity, communications and other public utility services, often not "sales" in legal contemplation, are commonly understood to be sales taxes. By common usage the expression also often includes taxes levied on the production of coal, ore, timber, and other natural resource products, prior to sale and indeed irrespective of whether such property is ever sold.

The modern general sales tax is the outgrowth of earlier excises or stamp taxes. It usually appeared first in Europe, as an emergency tax supplementing existing excise duties. From Europe the general sales tax has spread rapidly to many parts of the world, losing, in part its character as an emergency tax, and assuming a regular place in tax systems. It is difficult to say just when an excise or stamp tax becomes a general sales tax. There are as many varieties of the general sales tax as there are nations collecting the tax, for the characteristics of the tax depend upon relative conditions.

The general sales tax is frequently called a turnover tax, a transfer tax, a gross receipts tax, a manufacturers and merchant's tax, a merchant's tax, a producers' tax, a general stamp tax, and other names. But whatever be the name of the tax, it is laid upon the sale by taxable persons as a more or less general tax at uniform rates."[49]

B. History of the general sales tax. Investigation has revealed that the general sales tax like other modern taxes is of very ancient origin. "Ancient

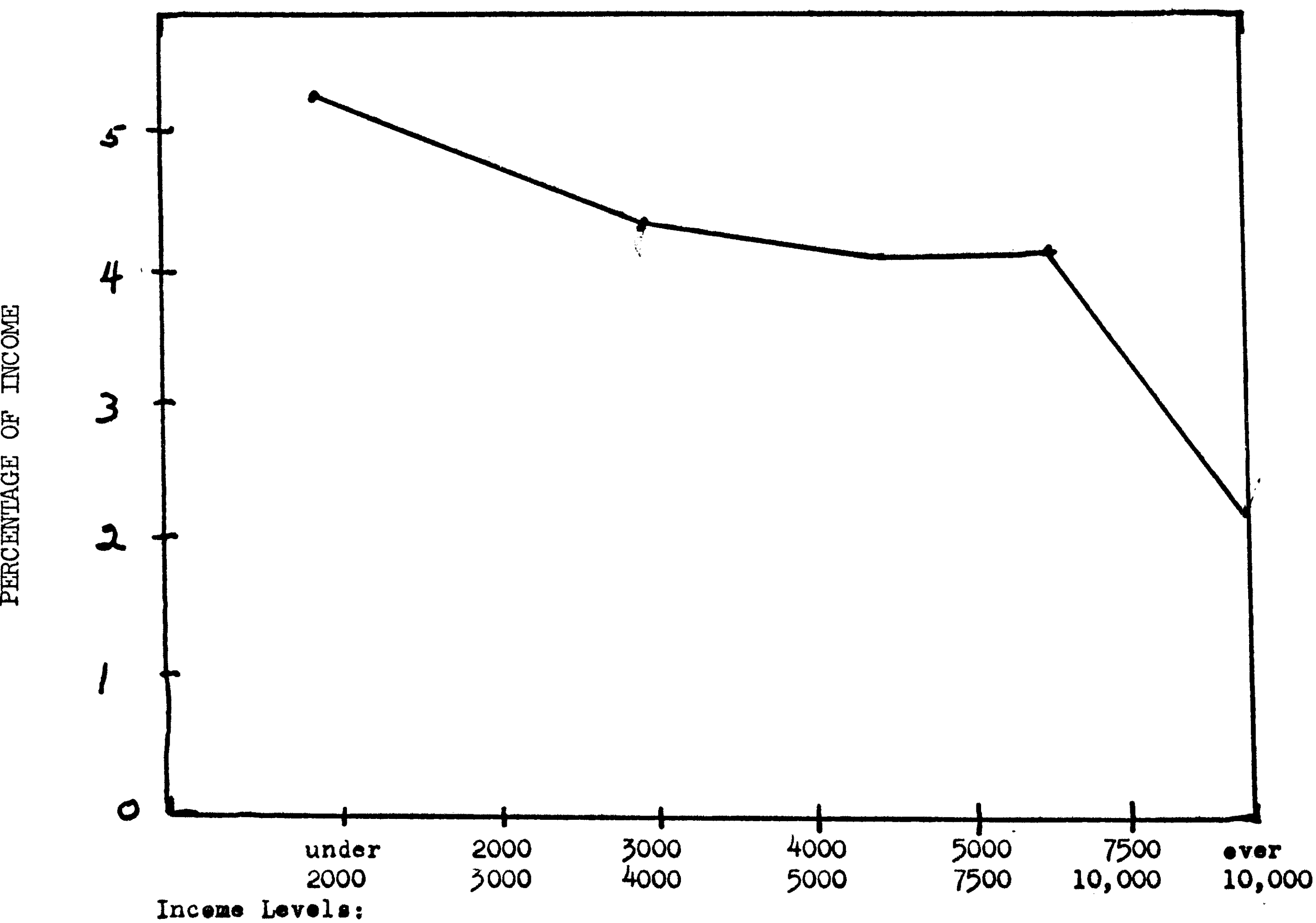
Athens laid various taxes on the sales of commodities in the markets, and on sales of landed property. The taxation of sales of specific commodities, like salt, was common in Egypt, China, India and other ancient states. In Roman times, the general sales tax was introduced by Augustus. He laid a tax of one percent upon all articles, movable goods, or fixtures, sold in markets, or by auction, even at Rome and in the Italian peninsula. On slaves the duty was 2 percent. It led to such resistence that Augustus was able to maintain it only on the plea that it was necessary for the maintenance of the army. Caligula abolished it. In the Middle Ages, when Europe was split up into a number of principalities, the Feudal Lords often tried these general sales taxes, which always met with great resistance. All through the Middle Ages taxes on the sale of particular commodities and especially upon the necessities of life were common. France ventured into the sales tax field several times but each time they were abolished because of intimidation by the taxed. The only country where it was permanently levied was Spain. It was introduced as a national tax in 1342. The alcavala as it was called led to much difficulty but it was continued by Spanish authorities. The consequences of the alcavala are explored very fully by Spanish writers. In those days the large estates were generally entailed and consequently not subject to sale as were smaller properties. The tax therefore fell with crushing severity upon the poor every time their lands changed hands. Some writers have said that the tax was the chief cause of Spain's economic downfall in the later middle ages."[50] Relief from the alcavala was one of the enticements offered to Spanish adventurers to the New World. (Prescott's Conquest of Peru, Page 885.)

C. The general sales tax in the United States.

1. Federal. The first movement for a general sales tax in the United States occurred during the Civil War. The national income tax was adopted and a heavy

FIGURE NUMBER 1

Federal Excise Tax Payments as Percentages of Income, United States, 1954.



SOURCE: R. A. Musgrove, "The Incidence of The Tax Structure and its Effects on Consumption", 1955, p. 77.

and comprehensive system of excise taxes was introduced. The excise duties and the income tax supplied over half of the Civil War tax receipts. Despite the support for the tax of the New York Chamber of Commerce, the Boston Board of Trade, and similar organizations, Congress rejected all proposals for a general sales tax. Even after the War when the tax system was undergoing drastic revisions; such as abolishment of the income tax in 1872 and reformation of the excises and customs duties, Congress failed to adopt the tax.

The post-World War I movement for a general sales tax originated in opposition to taxes laying heavy claims upon business profits and personal income. Senator Borah introduced a gross sales transactions tax bill in 1910 but it failed of adoption. Other subsequent bills were introduced in 1920, 1921, and later, all failed of passage. Several groups advocated passage of the bills each with a different objective. One group demanded a general sales tax as a substitute for all existing federal taxes. The largest group of advocates merely wanted the existing federal tax system revamped with removal of the less desirable taxes such as; excess profits taxes, excise taxes, and surtax on income. It was the fundamental objective of the movement for a general sales tax to lighten the tax burden of the wealthier class of society."[51]

West Virginia's gross sales tax of 1921 initiated the modern state sales tax movement. This law imposed a one-tenth percent rate on sales of extracted products, a one-third percent rate on the "spread" of wholesalers, and a two-tenths percent rate on sales by manufacturers and retailers and on personal and utility services; all taxpayers were allowed a $10,000 exemption. No other state sales taxes were enacted until 1929, when Georgia and Mississippi imposed gross sales tax. In 1933, 12 states turned to sales taxes as a means of eliminating deficits which arose from the depression.

Several factors stimulated the move: "(1) property tax delinquencies ran high; (2) revenues from personal and corporate income were off; (3) needs for education and unemployment relief were mounting; (4) there was resistance to raising property tax rates--in fact some states applied limitations to such rates; and (5) some states were prevented from using income taxes by constitutuional restrictions."[52] Thus the states turned to the sales tax essentially as a last resort. This is in keeping with E.R.A. Seligman's statement that "...the general sales tax constitutes the last resort of countries which find themselves in such fiscal difficulties that they must subordinate all other principles of taxation to that of adequacy."[53] Thirty-six states (including Indiana), the District of Columbia, and a large number of local governments now impose general sales taxes. Sales taxes are levied by local governments in twelve states.[54]

D. The concept of sales taxation. "The general meaning of the concept of sales taxation is obvious, but a precise definition which draws a clear line of demarkation between levies known as sales taxes and closely related taxes is more difficult than might first appear. The definition which offers the most satisfactory statemnt in terms of common current terminology may be states as follows: <u>a sales tax is a levy imposed upon the sales, or elements incidental to the sales, such as receipts from them of all or a wide range of dommodities,</u> excluding taxes imposed at fractional rates upon gross receipts in the form of business occupation or license taxes. A sales may be imposed upon all transactions through which commodities pass or upon one or a small number of stages only. The tax may be confined to physical commodities, or it may apply to some or all services rendered by commercial enterprises, professions, etc., but not services rendered by workers to their employers.

1. Sales vs. Excise Taxes. A sales tax, thus defined, is somewhat arbitrarily delimited from two related forms of levies. One is the type of tax

imposed upon the sale of particular commodities or groups of commodities; these may be called special or selective sales or commodity taxes or excise taxes. Although the latter term is sometimes confined to particular forms of special sales taxes, such as those imposed at the manufacturing level, or on the other hand, extended to all taxes imposed upon activities, as distinguished from taxes on property or persons. A widespread special sales or excise tax system, of course, resembles a sales tax, particularly one with many exemptions. But in most countries, actual taxes fall clearly into one category or another.

2. Sales vs. Gross Receipts Business Taxes. The other necessary line of demarkation is that between a sales tax and a business occupation or license tax measured by gross receipts. From the standpoint of the structure of the tax and probable economic effects, this type of levy is essentially identical with a sales tax. The basic difference between the two is primarily one of legislative intent---not always reflected in the law, and not always easy to ascertain. In the case of a sales tax, it is presumed that the tax will be shifted forward to the consumer; the business firm merely being regarded as charge for the privilege of carrying on business activity, and is presumably intended to be a burden on business as such, and thus on its owners, although actually, of course, such a tax is likely to shift forward in the same manner as a sales tax. In practice the major difference between the two types of levies is in the level of the rate, the business occupation taxes in virtually all cases having rates which are a fraction of one percent."[55]

E. Forms of Sales Taxes. Sales taxes fall into two general classes: the multiple stage tax and the single stage tax.

1. The multiple stage taxes. Two well known taxes come under the

multiple stage classification: (1) the turnover tax, and (2) the value added tax. The turnover tax applies to all transactions through which commodities pass, at all production and distribution levels. The value added tax. The turnover tax applies to all transactions through which commodities pass, at all production and distribution levels. The value added tax, which combines features of both single and multiple stage taxes, applies at each transaction, but only to the value added (selling price less the cost of taxable goods).

a. The turnover tax.

(1) Arguments pro. A complete multiple stage sales tax offers the maximum possible yield at the lowest rate. This is a political advantage since tax rates are one of the focal points of politics. Beyond politics the low rate offers less incentive for tax evasion. The multiple stage taxes are highly inequitable as among various business firms which could cause a tendency towards evasion. Another claimed advantage is that the tax spreads the impact among various types of business firms, instead of concentrating it on relatively few firms. This makes the impact pattern of the turnover tax discriminatory thus shifting is more difficult than under the single stage taxes. The greatest argument for the tax is that it is simple and requires no distinction to be made between taxable and non-taxable transactions.

(2) Arguments con.

(a) . Non-uniformity of the consumer burden. The number of handlers in the market channels and the varying profit margins of various goods will cause the cumulated burden on various commodities to constitute varying percentages of the retail selling prices of the goods.

(b) Integration. Since the tax applies to each sale, the total tax burden is less when goods pass through integrated market channels.

(c) Import goods are favored relative to domestic goods because no pre-import tax is imposed. A problem exists in relation with exports, also dealing mostly with refunds of pre-export taxes collected. There is great difficulty in ascertaining the amount of tax paid.

(d) A universal turnover tax applied uniformly with a low rate would have many administrative advantages. But the taxes are never imposed in pure form. Political pressure groups cause modification and special treatment which seriously complicates the tax.[56]

b. The value-added tax.

(1) Advantages. The value added tax of universal scope offers certain advantages over the retail sales tax. The impact of the tax is spread over all firms, instead of being concentrated on retailers thus lessening evasion and complaints. Producer goods can be excluded more easily alleviating interpretative and compliance problems.

(2) Disadvantages of the tax are: (a) The number of taxpayers is multiplied substantially and the task of determining tax liability is complicated, compared to a true single stage tax. (b) There is less assurance of complete shifting of the tax forward to consumers, as the tax burden, although uniform in all distribution channels, strikes the various firms in different ways. (c) It is more difficult to vary the burden on different commodities, if this is desirable, and to provide exemptions, because of the tax at more than one stage.[57]

2. Single stage taxes. The single stage levies apply only once to each commodity as it passes through production and distribution channels. It may be levied at a single flat rate upon all goods or a given level of production. It is possible therefore to have (1) a manufacturers' sales tax, (2) a wholesalers' sales tax, and (3) a retail sales tax.

a. Manufacturer's sales tax. The first of the three levels for imposition of a single stage sales tax is that of the sale by the manufacturer of finished products.. The basic intent of the tax structure is to apply the tax to sales of finished goods by manufacturers. To attain this goal, all manufacturers are required to obtain licenses, whereas other firms are not granted licenses. The tax normally applies when the sale is made by a licensed manufacturer to an unlicensed buyer wholesaler, retailer, or final consumer.

(1) Advantages. The primary advantage of the use of the manufacturing level instead of all production-distribution levels is the avoidance of the incentives toward integration and the discrimination against non-integrated firms. The small number of payers facilitates the operation of exemptions. No particular difficulty is encountered in defining the taxable transaction, and in excluding from the tax the sale of unfinished manufactured goods.

(2) Disadvantages. "The manufacturing level gives rise to one problem: that of determining taxable price in such a manner as to avoid inequity among firms in various distribution channels. This problem becomes more serious as distribution channels become more complex. Other criticisms are: (a) a certain amount of pyramiding almost has to occur, (b) the final consumer is almost never aware of the tax element in the price, and (c) a higher percentage rate is necessary to yield the same revenue that a lower retail rate will yield."[58]

b. The wholesaler's sales tax. The basic intent is to apply the tax on the last wholesale transaction, through which a good passes, that is, on the sale to the retailer whether by a wholesaler or manufacturer. The choice of the wholesale level in preference to the retail level is made in an effort to minimize the number of taxpaying firms, and to eliminate large numbers of small firms. The wholesale level greatly facilitates the application of the differentiated rate structure, which would be almost impossible if the tax were collected from the retailers. No particular problems are encountered in defining the taxable sale. As compared to the manufacturer's sales tax, the treatment of both imports and exports is facilitated and a lower rate is possible.

(1) Advantages. The primary merit of the wholesale sales tax is its potentiality as an instrument of inflation control, greater, than that of any other tax except a progressive rate spendings tax. A high rate provides an effective incentive to curtail consumption without producing serious adverse effects on incentives to work; thus per dollar of revenue it should produce greater deflationary effect without accompanying adverse effects on production than income or usual sales taxes. The second merit is the avoidance of the regressiveness characteristic of uniform-rate comprehensive sales taxes. Finally, it excludes virtually all major producers' goods. By limiting the tax to specified commodity groups, it is possible to exclude all items purchased for business use except those of a character also widely purchased for consumption purposes, such as office supplies.

(2) Disadvantages. One problem with the wholesale level is the existence of some small scale wholesalers against which enforcement is difficult. A second problem arises out of conduct of both retail and wholesale activity by some firms. It is almost impossible for them to aggregate their purchases between goods to be sold at retail and those to be resold at wholesale.[59]

PART V. THE RETAIL SALES TAX.

A. Introduction. The most important and most prevalent single stage sales tax levy from a source of revenue viewpoint is the retail sales tax. Perhaps more than any other tax, the sales tax has been introduced as a measure designed to raise large sums of money quickly, under the pressure of financial emergency. "Retail sales taxes have received a wide variety of names, including privilege taxes, occupation taxes, consumer's taxes, excises, production taxes, gross receipts, taxes or gross income taxes. Likewise, as a matter of law they attach to many different legal subjects, such as exercising the privilege of engaging in the business of selling or producing, making sales, consummating contracts to sell, exercising the privilege of purchasing, storing or using, or finally the act of purchasing or selling. To these may be added the furnishing of various public utility and other services, including amusements, radio broadcasting, and the like that may not be considered "sales" within the legal definition. The common factor in all these outwardly diverse taxes is the economic property that the amount of the payable is produced by a constant rate applied to the volume or value of commodities or services transferred or exchanged. It bears a directly proportional relationship to the gross amount of business activity and has no functional relation to profits, capital investment or other economic factors."[60] The extraordinary broad base possible with such a tax allows the attainment of a very substantial yield, even at relatively low rates. Thirty-seven states (including Indiana), the District of Columbia, and a larger number of local governments now impose general sales taxes. Most of the state sales taxes are single-stage taxes applying to sales of tangible personal property at retail and to specified services. Total state sales tax collections in 1961 were $4,509 million which was 23.7 percent of all state tax collections for that year and 31.7 percent of the total tax revenues of states levying sales taxes.[61]

Virginia is not a retail sales tax state but three municipalities Norfolk, Virginia Beach, and Bristol levy retail sales taxes. Bristol has a full three percent levy with exemptions while the other two have severely limited laws either as to subject or as to rate.

Retail sales taxes of the American states generally are based on sales of "tangible personal property" at retail and on the furnishing of some services to consumers. Retail sales are defined, for tax purposes, as sales for purposes of use or consumption, rather than for resale. Sales for resale, which are free of tax, include those of goods purchased for the purpose of resale in unchanged form, and, under what is called the physical ingredient rule, sales of goods, such as materials, and parts, which will become physically incorporated into goods which will be sold. The tax not only applies to sales to individual consumers for personal use, but also to sales of machinery, equipment, supplies, and other items to business firms, since these items do not become physically embodied in the products of the firm.

The taxes are applied to the sales of tangible personal property; thus real and intangible property is universally excluded, as well as services, except as specifically included. A number of states confine the levies strictly to commodities, but many include a few services, particularly public utility services, amusements, and hotel and motel rentals. (The city of Virginia Beach levies a 3 percent tax on the total amount paid for board, and/or lodging by or for any transient at any hotel or motel in the city;

The City of Norfolk levies the retail tax on hotel and/or motel accomodations for transients at a 2 percent rate.) A small group of states extends the tax also to charges for storage, dry cleaning, repair services, and similar items. As a consequence a major part of consumers expenditures escapes the tax.

B. The case for the retail sales tax.

1. Advantages. The case for retail sales taxation rests on several primary considerations: (1) the general arguments for an expenditures tax as considered on page 30; (2) the consideration that a sales tax appears to be the most feasible means of reaching persons on the basis of expenditures, without the discriminatory effects of excises; and (3) the administrative advantages relative to the income tax (a) for reaching persons who escape income taxation and (b) for use by states and localities in a federal system. First, the argument for the expenditures tax basis was evaluated on page 27 and need not be repeated here. Secondly, if the use of the expenditures basis is desired, it must be granted that the retail sales tax is administratively more feasible than the spendings tax. Thirdly, the retail sales tax is an effective means of reaching those persons who escape income tax liability by legal or illegal means.

The retail sales taxes offer significant advantages for state and similar units of governments in other countries. They can administer sales taxes more easily than income taxes, and there is less fear that the former will drive people and business out of the state. "With high federal income taxes the economic and political obstacles in the way of high state income taxes are substantial; if the states are to retain financial autonomy, they are virtually compelled to turn to the sales tax."[63]

2. Proponents of the tax. Analysis of the support given the sales tax is a complex problem. In various states and at various times well-directed

campaigns have been undertaken by farm groups, teacher's groups, urban real estate associations, public service corporations, and local governmental authorities. Much of their activity has been directed to forcing measures limiting the tax rates on property, or placing a greatly increased share of the educational costs upon the state government. A direct link between the levying of a retail sales tax and reduction or freezing of property tax rates may be the reason for support of the tax by farmers. It is possible that the term farmer may be synonymous with landlord. D.C. Coyle is harsh in his criticism of this point. "Sometimes a state is pursuaded to adopt a sales tax so as to relieve the burden of real estate taxes. The rich man with large property and a large income will save more on his property tax than he will pay on a sales tax."[62] Urban real estate interests are also supporters of the tax along with a miscellany of utility, manufacturing, and mining corporations usually through their national and statewide organizations. The National Association of Manufacturers is a vociferous advocate of a Federal retail sales tax.

Support for the sales tax also comes from those who stand to benefit from the money to be spent therefrom. The most strongly organized are the representatives of the school system: Teachers, school supply interests, educational associations and parents of school children. An argument used to support the recent Virginia bid for a state retail sales tax was that of obtaining some revenue from the large, standing group of transients, mostly military personnel, who live in Virginia but own no property here, and who maintain legal residence elsewhere, thus, escaping both Virginia realty taxes and income taxes. There are about 56,500 military personnel stationed throughout Virginia with a total annual payroll of $332 million.[65]

C. The case against the sales tax.

1. Disadvantages. Objections to the use of retail sales taxation are listed under two headings: (1) equity, and (2) economic effects.

a. Equity. The most significant arguments against sales taxes are those based on equity considerations. The tax favors those persons who accumulate as savings unusually high percentages of their income. In addition, unlike the spendings tax, it is extremely difficult to make the over-all burden progressive by adjustment in the rate structure, and if the tax is applied uniformly to all consumption expenditures, it is likely to be regressive. On the average, the larger the income, the greater the percentage of income which will be saved, and, with the usual forms of sales tax which excludes most services, the greater the percentage of income spent on non-taxable services. Those with small income spend practically all of their earnings on consumption items. (See Table number 9.) (See also figure number 2.)

b. Economic effects. In addition to the charge of regressiveness, the distribution of the burden of a sales tax is subject to criticism in other respects. In general, the taxes, which cannot, for administrative and political reasons, be made to apply to all consumption expenditures, favor those persons whose expenditures concentrate heavily on untaxed items, such as personal services, foreign travel, or expensive lodgings. On the other hand, the tax discriminates against persons whose circumstances compel them to spend disproportionately high percentages of their incomes for taxable purposes. Thus large families are discriminated against, as compared to smaller families with comparable incomes. Although the former have less, rather than more, taxpaying ability, they pay more tax. (See Figure number 2.) Food exemption lessens the discrimination, because a high percentage of expenditures of the

TABLE NUMBER 9.

Approximate dollar amount per $1000 of income a Sale's Tax takes from different Income groups.

INCOME LEVEL	2% TAX	3% TAX
1000 - 2000	11.72	17.58
2000 - 3000	9.88	14.82
3000 - 5000	8.58	12.87
5000 - 10,000	7.86	11.79
10,00 - 25,000	6.34	9.51
25,000 - 50,000	4.44	6.66
50,000 - 100,000	3.68	5.52
100,000 - 150,000	3.10	4.65
150,000 - 300,000	2.42	3.63
300,000 - 500,000	.84	1.26
500,000 - 1,000,000	.50	.75

Source: Harold M. Groves, Financing Government, p. 321

large families is made for food. Finally, to the extent to which sales taxes, in general, bring about wage increases, the final distribution of the burden is likely to be highly capricious and unrelated to desired standards of equity.[66]

2. Opponents to the tax. During the '30's when the sales tax was hurriedly adopted by legislatures, retail merchants and labor unions were the major opposing groups. In many states the retailers were virtually alone. The retailers were the most organized and the loudest but in most cases oppostion was to no avail. Presently retailers find the tax to be little more than a nuisance once they become accustomed to it, and unions generally realize that it is the only feasible method by which the states can finance desired activities. Consumers as an organized voice were rarely heard in formal protest.[67]

D. Incidence of the retail sales tax. The analysis of shifting and incidence is essentially an application of the theory of price and output determination to the reactions which occur in response to an increase in cost, since the tax constitutes an addition to the costs of the firms upon which it is levied. The "incidence" of a tax is defined to be upon those who bear its direct money burden. "Shifting" refers to the process of adjustment, as a result of which a burden is transferred from one person to another. Sales taxes may impose burdens on persons in other capacities than as consumers, and in amounts less (or even greater) than the amount of taxation of particular transactions; and a burden borne at one period following imposition of a sales tax is often thrust backward or forward to some other party after the lapse of time.

When a tax is imposed upon the sales of a firm, this tax constitutes a direct increase in the expenses of the firm, one which varies in direct relationship to sales of taxed articles and one which must be currently met. The reactions of the firms will depend in large measure upon the nature of competition in the markets in which the firms are selling and must be analyzed in terms of these market types.[68]

1. Purely competitive market. If a tax is levied upon a commodity sold in a purely competitive market, the individual sellers cannot directly shift the burden of the tax from themselves. Thus, if a tax were levied upon the sales of a wheat producer, he would not be enabled thereby to increase the price he receives for his wheat. Some market price adjustments will occur through changes in market supply; when the seller receiving a lower price for his goods will place fewer goods on the market.

Moving from the market period to the short run condition, downward adjustment in output will occur as firms restore equality of marginal cost and price. A portion of the tax is now borne by purchasers, a portion by the owners of the business enterprise and other factor owners who are unable to withdraw their factor units from the industry in the short run period. Over the long run period, more complex shifting becomes possible as some firms quit the industry because they are not making a normal return. Ultimately, all the tax burden must be shifted from the owner of the businesses and an average rate of profit restored.[69]

2. Complete monopoly. At the other extreme in the range of the competitive conditions is complete monopoly. Immediate price adjustment is likely as the monopolist restores equality of marginal cost and marginal revenues. Price will be increased. With constant marginal cost the price will rise by less than the amount of the tax, since average revenue will rise less than marginal revenue. Output will be reduced sufficiently to raise marginal revenue by the amount of the tax since marginal cost is raised by this amount. A portion of the tax will rest upon the consumer, a portion on the receivers of the monopoly profits.

The extent of the price increases will depend on the nature of the monopolists demand schedule at levels above the old price and on the behavior of original cost in the range in which the firm is operating. Price increase will be greater if marginal cost is decreasing than if it is increasing, since the necessary output reduction will be greater. With increasing marginal cost the price increase will be greater, the more inelastic the demand; with decreasing cost the reverse is true. With constant marginal costs, elasticity of demand does not affect shifting. In a cost situation a sharp decrease in elasticity above the old price will encourage shifting, because once the firm gets into this relatively inelastic range, a substantial price increase, perhaps in excess of the tax, is profitable.[70]

3. Non-purely competitive conditions. The typical market situation today is characterized neither by pure competition nor by complete monopoly, but by intermediate ones, which may be called non-purely competitive conditions. The typical case is that characterized by oligopoly in one degree or another. Firms, in reacting to changes in cost, will typically not disregard the probable responses of competing firms to the changes in costs and the readjustments they make in their own prices. Under such circumstances some initial price increase, will be made on every product, except in the cases in which the average or marginal revenue curve appears perfectly elastic above the old price. On the whole, oligopoly is characterized by direct and immediate shifting; the burden of a tax on output or sales is passed directly on to the consumer and thus borne in proportion to consumption expenditures on the taxed product.

There are, however, modifications which alter the results indicated above. In the first place certain retail pricing phenomena will interfere. One of these is customary prices. Prices on certain articles maintained over long periods can be altered only with great difficulty. That is retailers realize that average revenue will fall greatly if the price is distrubed. Likewise the absence of sufficiently small coin denominations will prevent the tax from being collected on items of small unit value. Another feature is the existence of price lines. Experience has shown that some goods sell best in certain definite price lines; it will commonly be felt desirable to avoid any price changes which involve readjustments of class lines.[71]

A further group of factors rigidifying retail prices includes the existence of "suggested retail prices" by manufacturers, actual resale price maintenance, and legal price control. In the first two instances it seems likely that ordinarily the manufacturer will readjust the retail price to include the tax. With legal control of prices, the price ordinarily is set on a "cost" basis: the tax, as an element of cost, would in general be adjusted in exact amount to the price. Since all firms as forced to act in unison, complete shifting is more certain then under other conditions.

A more significant phenemonen involves the possibility of the failure of certain firms in the field to raise prices by the full amount of the tax. Any firm can gain from price cutting in the new situation after all have increased. In retailing, with a high percentage of common and fixed cost, especially great possibilities of gain from price cutting exist. The danger always exist, however, that some firms, especially those emphasizing high turnover and low margins at all times, will attempt to escape from the tax by selling an increased volume of goods. If the firm does not raise prices initially, its demand curve will shift to the right, at the old price more goods can be sold, and the original level of profits maintained or even increased. If only a small number of firms attempt to act in this manner, they may be able to do so without interference, as the rest of the firms, not experiencing serious demand losses, avoid following in order to prevent a general price collapse. But if a number of other firms follow the price cut because they experience a greater demand reduction than expected, a general loss in profits will result, leading to failure of some firms, exodus, and eventual price increase with a reduced number of enterprises.

It is because of this extreme importance of uniform action for full increases to occur without exodus that the provisions of laws requiring shifting are important. Such laws do not make absorption of the tax impossible, inasmuch as merchants can reduce prices by the amount of the tax. But a powerful psychological force is added to the elements facilitating shifting. The force of inertia now favors shifting. Further, such laws may lessen consumer resistence to the tax, giving less advantage than expected to those who cut prices. This is not necessarily the case; with separate charging, the consumer is made aware of the tax much more so than he would otherwise be. But if he is aware of the law, he realizes that the retailer is expected by law to pass on the tax, and may make less effort to find a seller who will absorb the tax.

Under pure competition conditions such laws are futile since no firm can raise its prices at all until some firms leave the industry: with pure monopoly, and optimum pricing, they would not accomplish their purpose since the monopolist would reduce his net price. But under non-purely competitive conditions, where not only the amount of short-run increase, but also the extent of exodus of firms, and the longrun incidence, depend on the strengthening of oligopoly elements, any factors which promote common action will aid short-run price increases, lessen the need for exodus, and cause greater long run price increases than would otherwise be the case. In other words firms in the industry would be driven to price fixing and market sharing.

E. Changes in employment and factor prices. The controversial aspects of the question of shifting and incidence of a sales tax center around the potential effects upon the general level of factor prices. There are several points of view on the question, the differences arising primarily from the nature of the assumptions made about the use of the funds collected from the tax, and the precise meaning given to the concept of incidence.

1. Real factor demand. The traditional approach is based upon the assumption that the governmental expenditures of the funds insures that there is no net decline in actual demand for factor units. The tax revenues are employed by the government to acquire factor units, the governmental demand replaces the private sector demand lost because of the higher commodity prices, and thus there are not general deflationary influences upon factor prices. Firms increase prices in response to the tax; fewer goods are purchased, and thus fewer factor units are used in private sector production, but these factors are used either directly by government or in producing goods which the government needs. If the government pursues a general over-all policy of maintaining full employment, as is a reasonable assumption, the general level of factor prices is maintained, and the tax is borne in relation to consumer spending. There may be shifting of relative demands for various types of specialized factors, since the government demands for particular factors are different from those of the private sector, thus some shifting of relative factor prices will occur as a result of the over-all expenditure and tax program, but this reaction is best regarded as not being an element in the picture of sales tax incidence, but a result of the over-all fiscal program.[73]

2. General factor price decline.

On the other hand, Earl Rolph and others, have long argued that a sales tax is not shifted to consumers. This conclusion is reached as a result of ignoring the use of the revenues collected by the government. Under their assumptions, and further simplifying assumptions of pure competition in factor and commodity markets and perfectly inelastic supplies of each type of factor, the conclusion is reached that the tax will be borne in a fashion proportional to factor incomes received, and thus identical in incidence to a proportional income tax. The basic objection to this point of view is the improper assumption about use of funds. Since use must be made of the tax revenue collected; it may be used to finance additional expenditures, to replace another tax, or to retire debt. The most realistic assumption is that the money is spent on goverment activities. A goverment undertakes an activity and requires facter units for this purpose; it imposes a sales tax to provide the funds to acquire the factor units, and thus to reduce private sector demand for the factor units. The real burden is the loss of these factor units for private sector production. The tax determines the pattern by which this burden is distributed in the economy. Thus the assumption that real factor demand is maintained is a much more satisfactory one than one which ignores the use of the funds.[72]

3. Decline in employment. Suppose that as a result of the sales tax method of financing, the level of employment does fall below the level prevailing prior to the introduction of the tax and use of the funds. This may occur, if the tax is used to replace an income tax or for purposes of debt retirement. Should this decline be considered to result from the tax, and are those workers who lose their jobs bearing a portion of the burden of the tax through the loss of their incomes. Or is this loss a product of the over-all fiscal policy involved? This is largely definitional; but on the whole, it would appear to be satisfactory to regard the loss in employment as a consequence of the overall program, and not an element in the burden of the tax.

4. Tax induced increases in factor prices. The imposition of the retail sales tax may raise factor prices through the effect of the initial increases

in commodity prices upon the cost of living. Wages particularly may be affected. At the present time, many labor contracts contain escalater clauses. When a sales tax is introduced and prices rise, wages covered by these contracts will automatically rise. Even without such contracts the higher cost of living tends to encourage unions to demand higher wages. If the wage increases take place, the prices of the commodities produced tend to rise, and the tax burden is in part shifted from the groups of workers who succeed in getting higher wages to other groups. If the tendency is widespread, much of the burden will come back again to the same groups of workers in the form of higher prices, and some further wage adjustments may occur. The net result is to concentrate a greater share of the burden on those income groups which are least able to obtain income increases when the cost of living rises.[75]

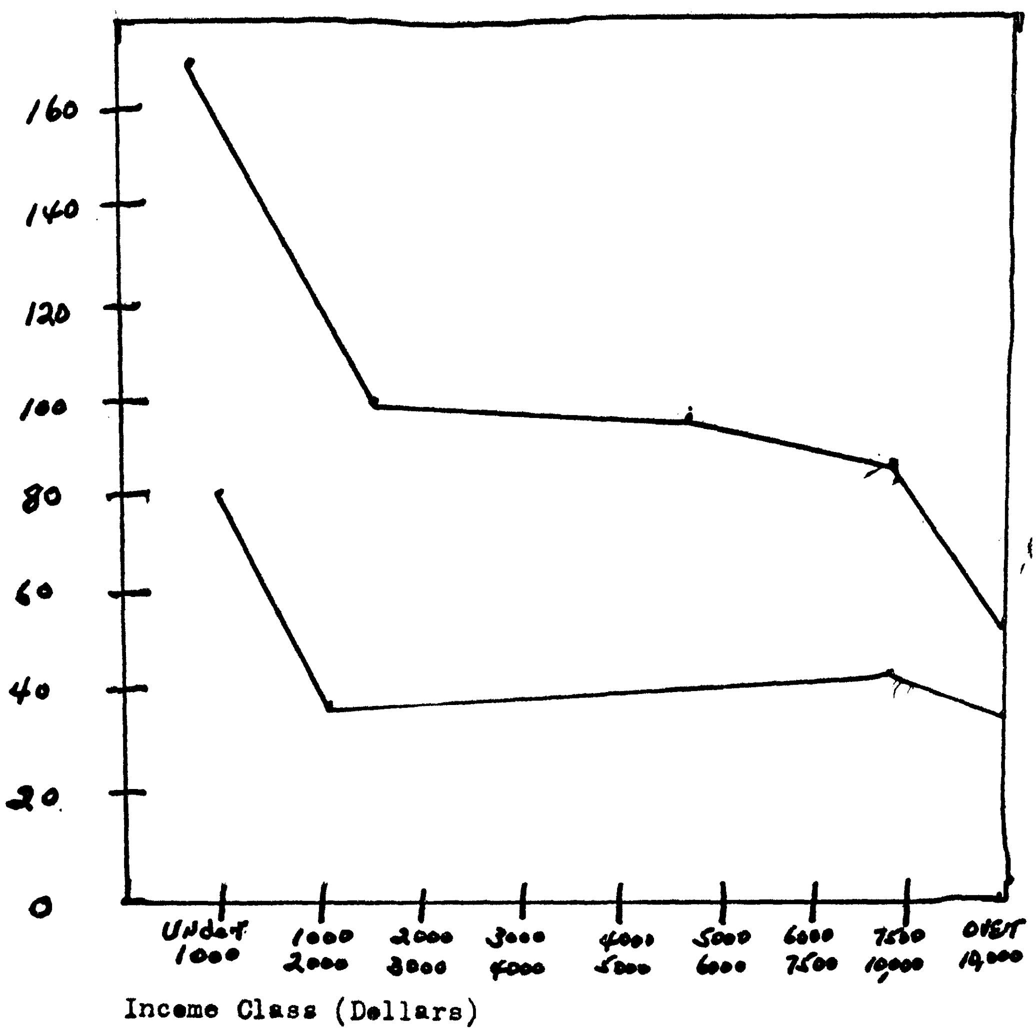
F. Yield from sales taxes. Total revenues collected in 1932 were $7 million which constituted 0.4 percent of the total state revenue collected. In 1960 the total revenue from the general sales tax was $4,509 millions which constituted 23.7 percent of the total state tax collections. (See Table number 11.) Tax rates vary from a high of 5 percent to a low of 2 percent. (See Table number 12.)

G. Use Taxes.

1. Nature and purpose. The experience of the states with general sales taxes indicates that it is desirable to supplement them with use taxes upon articles where they are used, consumed, or stored. These use taxes are a device designed to reach transactions which would otherwise go tax-free as being made in interstate commerce. Residents of the sales tax states go bargain hunting outside the state to a less tax-burdened market for their major purchases. They will likely continue to make minor purchases in-state.

FIGURE NUMBER 2

Percentage of Income Spent on Taxable Goods,
Illinois Retailers' Occupation (Sales) Tax, 1950



SOURCE: John F. Due, Sales Taxation, p. 345.

TABLE NUMBER II

State tax collections by source, selected years 1932 - 1961
(Millions of dollars)

YEAR	REVENUE	PERCENTAGE OF TOTAL DISTRIBUTION
1932	$ 7	.4%
1942	632	16.2%
1952	2,229	22.6%
1956	3,036	22.7%
1957	3,373	23.2%
1958	3,507	23.5%
1959	3,697	23.3%
1960	4,302	23.9%
1961	4,509	23.7%

Source: Tax Overlapping in the United States, 1961, p.88

TABLE NUMBER 12

*Percentage distribution of State Sales Tax rates: 1964

RATE PERCENT	5%	4%	3.5%	3%	2.5%	2.25%	2%
No. of States	1	6	2	17	1		10

*37 States and the District of Columbia

Source: C.C.H., Master Tax Guide - 1964, p.30

The unfortunate result of such extra-state bargain hunting is not merely a short changing of the state's treasury, but local merchants whose transactions are subject to the local sales tax may find themselves at a competitive disadvantage with an extra-state seller who is not burdened with any equivalent tax.

2. Imposition. Most of the states imposing general sales taxes also impose use taxes, ordinarily incorporating them in the general sales tax law. Compensating use tax statutes take the form of a levy on the local privilege of using property within the taxing state, which would have been subject to a sales tax had the property been purchased within the taxing state. The compensating use tax rate is the same as the local sales tax levy, and privision is made that no articles on which a sales or use tax has been paid shall again be subject to the use tax. Apparently one of the purposes and certainly one of the results, of the compensating use tax is to help the retail sellers in the taxing state to compete upon terms of equality with retail dealers in other states who are exempt from a sales tax or any corresponding tax burdens. Another tendency of the use tax is to avoid the liklihood of a drain upon the revenue of the state by removing from buyers the temptation to place their orders in other states in an effort to avoid payment of the tax on local sales.

As a practical matter there is no ordinary means of checking out-of-state purchases except for goods requiring a state registration or license, such as automobiles, boats, trailers, etc. Thus, the revenues from use taxes are relatively low in comparison with sales tax receipts, but they do stop sales tax avoidance to some extent and may also equalize the taxation of domestic and imported subjects.

3. Defects. The use tax has two major defects: (1) incomplete collection

and (2) discrimination against trade between the states. In Helsen and Randolph v. Kentucky the Kentucky Supreme Court faced the problem of the validity of use taxes as applied to articles used in interstate commerce. Here Kentucky attempted to tax gasoline used to power an interstate ferry. The Court struck down the tax saying "If a tax cannot be laid by a state upon the interstate transportation of the subjects of commerce...such a tax cannot be laid upon the medium by which such transportation if effected." Articles acquired or transported in interstate commerce may be subjected, when once they are at rest, either at the end of their interstate transportation or when they are at rest during a break in the trip for the business purpose of the owner, to a levy upon the privilege of local use of the goods.

The defect of incomplete collection remains because the United States Supreme Court in Miller Bros. Co. v. Maryland classified the practice of requiring the out of state vendor to collect the tax a violation of the "due process clause" unless the vendor is engaged in an "aggresive soliciting operation within the taxing state".[77]

H. Legal Problems. Virtually all the present state sales taxes bear evidence of hasty drafting and verbatim copying from statutes and regulations of other states. The Federal Constitution implies that the state may not tax interstate commerce without the consent of Congress, which has thus far been witheld. Another constitutional question is that of jurisdiction. Under the "due process clause" of the Federal Constitution, it is held that a state may not tax persons, property, or activities over which it has no jurisdiction. This problem arises when, during the negotiation of the sale, the buyer is in on state, the seller in another, and the goods in either of the two states or in a third. It may be difficult to determine when the consummation of the sale took place.

A third constitututional problem is based on the implied prohibition of state taxation of the Federal Government or its instrumentalities. This immunity was rigidly enforced up to the 1930's. Since then a more liberal attitude toward tax liability by government sub-contractors has been prevalent. The tax is considered part of the cost of production thereby causing the Federal government to bear the tax especially in so-called "cost plus fixed fee contracts". Many state constitutions also contain "uniformity", "due process", and "equal protection" clauses that may invalidate the use of sales taxes in many area.[78]

I. Exemption. There are, generally speaking, three broad areas of exemptions under statutes imposing sales and use taxes in the United States. They are: (a) Exemptions arising out of the immunities of governmental agencies and instrumentalities, or out of the exercise of governmental functions. (b) Exemptions arising under the commerce clause of the Federal Constitution. (c) Specific exemptions created out of governmental taxing policies or social economic considerations. Each of these areas of exemptions has grown up somewhat haphazardly over a substantial period of time, and very largely as the result of shifting judicial opinion, rather than as a matter of consistent legislative policy.[79]

1. Exemptions arising from governmental immunities and functions.

a. Federal Government. Although no provisions in the Constitution prohibits taxing sales to the Federal Government the courts have read an implied restriction into that instrument and have negated all attempts to collect the tax on sales made to the Federal Government. It is agreed by most state taxing authorities that this immunity is extended to Federal agencies. The most difficult cases usually arise through contracting and sub-contracting work done for Federal Governmental agencies. A valid tax depends upon the wording of the particular federal statute which creates the agency. Another source of confusion is the varying definition of governmental agency. The American Red Cross is a government agency in Georgia but not in other sales tax states. The principle to be followed is that the state should not by taxation hamper or burden activities that it presently or potentialy may perform in furthering the common welfare. The state legislatures have over the years and from time to time expressly recognized this principle by the enactment of specific provisions granting the exemption in more or less uniform statutory language. For this reason in recent years there has emerged a trend by the courts both state and federal, toward more homogeneity in their decisions.

b. Sales to the state and its political subdivisions. This exemption is granted on the theory that collection of the tax would simply take money out of one pocket and put it into another. The extent of exemptions granted depends on the state's constitution and tax law structure. With regard to purchases made by political subdivisions of a state, an exemption from sales taxation is in effect a grant-in-aid by the state. If the exemption did not exist, political sub-divisions would be burdened with a tax on their purchase not offset by compensating revenue, as is the case of state governments. Also government is not the ultimate consumer in the economic sense of the bulk of the goods and services it purchases, but uses them to produce government services for citizens, who are the real consumers. Exemption of such sales is therefore consistent with the theory of a consumer's expenditures tax.[80]

2. Commerce Clause exemptions. Section 8, Article 1 of the United States Constitution serves to restrict state taxing powers over goods moving interstate, Under this "commerce clause" taxing is considered a regulatory power and regulations of commerce is limited to Congress. The Supreme Court exercised most of the regulatory power and up until 1940 the provisions of the commerce clause had always been strictly construed. After the Berwind-White case in 1940, a trend toward liberality can be evidenced based on the theory that even interstate commerce should be made to pay its own way. The general theory of exempting interstate commerce is to relieve or prevent burdening the flow of commerce between the states.[81]

3. Exemptions arising from taxing policies and social and economic considerations.

a. Occasional sales. This exemption is usually achieved by excluding the sale from the definition of a retail sale. Isolated occasional sales are generally defined as sales made by a person not engaged in doing business. A merchant going out of business may sell his equipment tax free but not his inventory. It is likely that there will be no repitition of the equipment sale. Also exempt are sales between two private parties; guns, automobiles, furniture, etc. The possibilities of collecting the tax are so remote that the incurring of the expense is precluded by exempting such a sale.[82]

b. Food. Several of the sales tax states specifically exempt food for human consumption thus removing most of the grounds supporting the regressivity as well as the low income argument against a sales tax. Some states tax on premise food consumption and do not tax off premise consumption; others exempt both categories. Also certain products already subject to certain taxes excise or otherwise may be exempt; oleomargarine, beer, etc. The definition of food varies from state to state and the "human consumption" wording further complicates the problem. Agreement is almost universal that cigarettes are not food. A primary objection to food exemption is the substantial revenue loss which necessitates a higher tax rate to raise a given sum of money.[83]

c. Producer's goods. Application of the tax to producer's goods is objectionable in several ways. The over-all sales tax burden per dollar of consumer expenditure will not be uniform on all goods, since the ratios of cost of taxable capital goods to final selling price of consumption goods will vary widely on different products. Shifting of the tax is likely to be less perfect, and some pyramiding will be inevitable. Complete exemption of certain consumption goods, if desired, cannot be attained since articles used to produce these goods will be taxed. However, those consumer articles that sell in the lowest or zero bracket would bear a portion of the tax burden. The tax will discriminate against capital-intensive methods of production, and make modernization of industry more expensive.[84]

d. Services. Many sales taxes are confined largely or entirely to physical commodities. While services rendered to business firms are not suitable for inclusion within the scope of the taxes because they are producer's goods, there is no justification for blanket exclusion of consumer services since expenditures on them satisfy personal wants just as do those on commodities. Failure to tax services is often a source of administrative problems, because some services are rendered in conjunction with the sale of goods, and separation of the two elements in the price is troublesome. Repair and other service firms are particularly hard hit. General exclusion from tax tends to favor the higher income groups, which on the average spend greater percentages of their incomes on services.

On the other hand, blanket inclusion of all services is impossible partly because many are rendered to business firms, partly because many are unsuitable for reasons of social and economic policy, such as: medical and hospital services. Therefore, taxation of services requires enumeration of specific types to be included. A good case could be made for including those rendered by commercial establishments such as repairs, laundry, dry cleaning, etc.

e. Religious and charitable exemption. Most common among exemptions accorded to legal persons with respect to all their sales or services is that of religious, educational, charitable, or scientific organizations not for profit, to the extent that receipt from transactions are devoted to their respective purpose. These are indirect bonuses by the state on the grounds of social benefit. The principle followed is that the state should not be taxation hamper or burden activities that it presently or potentially may perform in furthering the common welfare.

f. Personal exemptions. Commodity exemptions free from the tax many purchases of persons in the higher income levels as well as giving rise to arbitrary lines of demarkation and discrimination on the basis of relative preference. Numberous suggestions have been made for the establishment of personal exemptions in lieu of the exemption of food and other necessities. Under this system all persons below a certain level of income would be granted exemption on a certain monetary sum of purchases during the year regardless of the nature of the commodities purchased. This system would provide a technique for compensating persons for tax paid during the tax period. Four methods have been suggested. First, is the use of tax stamps issued by the retailer and redeemed from the government in cash. Second, is the use of tax coupons issued by the government to each family and given to the retailer when the purchase is made. Thirdly, the government could issue a cash allowance to each family to compensate for the sales tax. The fourth method would allow a person a credit for sales tax paid against income tax liability, with a refund if this credit exceeded income tax liability. The last would be the best method because it permits the introduction of one of the major advantages of the spendings tax approach to consumption taxation into the framework of a sales tax, without giving rise to administrative problems comparable to those of a spendings tax.[85]

J. Administrative and collection costs.

1. Introduction. The organizations developed to collect the taxes, the methods employed, their costs and their relative operating efficiency are factors of prime importance in any appraisal of the tax. No matter how equitable or beneficient its effect on the economic system may be, any tax will not long be tolerated that is incapable of reasonably good enforcement with moderate

administrative expense in relation to the revenue it produces. Adam Smith's fourth maxim of taxation states the point succinctly. "Every tax ought to be so contrived as ...to take out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state."[86]

2. Organizational tasks. The general task to be faced in setting up an administrative organization for a retail sales tax involves the following principal divisions:

a. Preparation and distribution of tax return forms to taxpayers.

b. Promulgation of rules and regulations interpreting the law and the administrative procedure, within the discretionary powers delegated to the executive branch.

c. Organizations to process returns and payments and to account properly for revenue.

d. Organizations to audit returns and perform investigative work in the field.

e. Perfection of an enforcement organization and legal procedures for dealing with taxpayers who fail or refuse to discharge their liability.

f. Adoption of a public relations policy, defining the relation of the state to retailers and consumers with respect to the tax, and issuing such statistical and other data that may acquaint the public with the nature and purpose of the tax.

3. Nature of sales tax collection costs. Two broad kinds of costs are incurred. First, there are various governmental administration costs necessary for processing tax returns and payments and for discovering and combatting non-compliance. Secondly, retailers and other taxpayers incur certain costs in complying with the various requirements of the tax structure.

... of preparing

...ime required by sales clerks in computing

When a retailer's records are examined or audited, additional demands are made on his time, and if a dispute arises, there may be costs of negotiations and litigation. The compliance costs of consumers would involve time lost through controversy and mis-understanding over the amount of tax due, the annoyance of handling tokens or stamps, and, perhaps the effort of seeking avenues for avoiding the tax.[88]

Tables 13, 14, and 15 present actual cost information gathered by Maldon comparing data from 17 states including the leading twelve sales tax states. In 1955 the lowest cost per $100 collected was $0.85 paid by Michigan while the highest was Ohio with $3.82. The average costs for the three years compared was: 1940--$2.55, 1948--$1.31, and 1955--$1.47. When relating the number of auditors and examiners to revenue collections, it is seen that generally the states with the highest cost ratios also employ a greater number of auditors per $1.0 million of revenue. A common complaint among sales tax administrators was the lack of sufficiently qualified examiners.

About one-half of all sales tax states grant vender's discounts to compensate them in whole or in part for costs incurred in their compliance with a consumer's tax and, perhaps, to encourage prompt payment by retailers. This practice results in a direct reduction in revenue available to the taxing jurisdiction. Discounts ranged from 20 percent in Ohio and Alabama to 5.0 percent in Colorado in 1955. There is no empirical analysis putting forth the actual vendor's cost but in every state authorizing such <u>ad valorem</u> discounts, the cost of such discounts exceeded the state administration costs.[87]

K. Summary of the retail sales tax. "The sales tax is the traditional method by which governments seek to distribute the burden of the cost of their activities in relation to consumption expenditures, in lieu of a feasible method

TABLE NUMBER 13

State Administration Costs of collecting per $100 of Sales and Use tax and Revenue by State, selected year.

STATE	1940	1948	1955
Ohio	1.90	1.10	3.82
California	2.60	1.84	2.01
Florida	____	____	1.85
Maryland	____	2.00	1.76
Alabama	4.50	2.23	1.68
North Carolina	____	.67	1.58
South Carolina	____	____	1.58
Illinois	2.00	2.00	1.48
Michigan	1.70	.96	.85
Average	2.55	1.31	1.47

Source: National Tax Journal, Volume 10, p.230-31.

TABLE NUMBER 14

Number of Sales Tax Auditors and Examiners and the number per millions of dollars of Revenue collected: Selected States, 1955.

STATE	NUMBER AUDITORS	AUDITORS PER MILLIONS COLLECTION
Maryland	63	1.80
North Carolina	98	1.68
California	735	1.50
Florida	111	1.50
Ohio	201	.97
Illinois	109	.53
Michigan	219	.73

SOURCE: NATIONAL TAX JOURNAL, VOLUME 10, P. 231.

TABLE NUMBER 15

Vendor's Discounts, Selected States, 1955
(thousands of dollars)

STATE	AMOUNT OF DISCOUNT	DISCOUNT AS A PERCENTAGE OF YIELD
Colorado	1,828	4.93
Maryland	1,082	3.09
Florida	2,144	2.90
Oklahoma	1,249	2.87
North Carolina	1,610	2.76
Ohio	3,883	1.87

Source: NATIONAL TAX JOURNAL, Volume 10, p. 234

of composing a tax directly upon these expenditures, under circumstances such that, for political, economic, or administrative reasons, income or wealth-based taxes are incapable of yielding adequate revenues."[88] The sales tax once introduced as emergency measures have been insured permanency by reason of their high revenue productivity. Its major attractions are:

1. A sales tax is capable of raising large amounts of revenue in a way that is relatively convenient both to the government and to the taxpayer.

2. It reaches resources otherwise immune from taxation.

3. In periods of deflation sales tax yield is likely to fall less than that of other major taxes.

4. A sales tax is less inimical to the competitive position of a state than other major taxes.

Its major criticisms are:

1. A sales tax if broad in scope, is regressive in relation to income and discriminates unfairly against large families.

2. A sales tax, if made less regressive by exemptions and exclusions, becomes capricious in its incidence, administratively complex, and more modest in its yield.

3. Exclusion of services from the tax base is neither equitable nor administratively simple, but their inclusion runs counter to prevailing practice.

4. Taxation of producer goods involves multiple taxation but their exclusion from the tax base leads to evasion and avoidance.[89]

With respect to the form of the sales tax, apart from certain administrative aspects, the retail sales tax is by far the superior type, in terms of equity, intended distribution of burden, and avoidance of economic effect. Experience with the multiple-stage tax has demonstrated its complete unsuitability in in the way of discrimination against various business firms, of incentive given to integration, of unequal burden on various consumer expenditures, and the inevitable complexity which arises out of the attempt to mitigate the worst discriminatory features. Any of the single stage forms of tax is superior to the turnover tax, and the retail levy offers the greatest advantages along the lines of uniformity of burdens on various consumer expenditures, avoidance of discrimination among firms in various distribution channels, lower tax rate for a given revenue and easier administration. The one major disadvantage is the problem of collecting the tax from large numbers of small firms.

In the establishment of the structure of a sales tax, it is highly desirable to restrict the tax so far as possible to the sale of consumption goods since the taxation of producer's goods is contrary to the intent and philosophy of the tax, yet attainment of this goal is difficult because particular commodities can be used for either production or consumption. On the other hand, it is desirable to insure as broad a coverage of consumption expenditures as possible, to avoid discrimination against various consumers. With different preferences, reallocation of resources, and administrative problems, exemptions must be limited to those instances in which very strong justification can be advanced; food, for example.

With high increasing levels of government expenditures, and pressure against extremely high income tax rates, the sales tax, highly productive at moderate rates, is almost certain to remain an important element in state tax structures; only the development of an administrativly feasible expenditure tax could make its demise possible and this is clearly unlikely in the foreseeable future.

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