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The Future of the Income Tax

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THE FUTURE OF THE INCOME TAX.

IF the careful observer of national affairs endeavours to anticipate the course along which our political history is likely to travel in the near future, he can, it would seem, hardly avoid the conclusion that finance and taxation are destined soon to become more interesting and important than they have been for 30 or 40 years. There are several reasons for so thinking. (1) The South African War has already caused the imposition of heavy additional taxation, and has temporarily disorganised the national fiscal system. (2) An army of occupation will probably be needed in the newly annexed colonies for some years after the war is ended. (3) The enlargement, reorganisation, and re-equipment of the army may be expected to add largely and permanently to the cost of our military establishments in time of peace. (4) Our navy must, it seems, still go on expanding, to keep pace with the expansion of the French, German, and Russian navies. And, finally, there remain the probability that the recent wave of industrial prosperity may not last much longer, and the likelihood that the stress of American and German competition may soon again assert itself. All this, if admitted, points its own moral.

I.

Of the many financial and fiscal matters which will soon confront Parliament and the nation, scarcely any is more important than the question of the future form and character of the income tax. Every student of British fiscal history will already know that the income tax was at first a war tax pure and simple; that it was later on reimposed for the accomplishment of large financial reforms, but still remained, in theory, a temporary or emergency tax; that, later still, it assumed a more permanent character, with low rates in normal times; and that, finally, its permanence has been firmly established and high rates have

become the rule.¹ The change of position and function has been gradual, and from some points of view not unnatural. But the change is a great one. It is one thing to submit to an obnoxious impost for a limited period to secure the attainment of some great end, and quite another to endure such a tax as a permanent institution for the ordinary and commonplace purposes of government from day to day. What would be cheerfully borne in the one case might be rightly and properly objected to in the other. This brings us to the consideration of two large questions, both of great importance. The first is, whether the ordinary revenue now obtained in normal times by means of the income tax could be more advantageously raised in some other way; and the second is, whether the income tax can be reformed or made more acceptable as a permanent tax for ordinary purposes. The former of these questions is too big to be dealt with fully here and now. But it may perhaps be said that hardly any other instrument could be found or devised which would so effectually and so justly tax the rich without burdening the poor; and that in no other way can the vast wealth represented by property and investments of all kinds be so adequately, so regularly, and so equally laid under contribution as by some such tax as the present income tax.² There is one alternative which might conceivably attain some of these ends, and yield an equally large revenue, viz., a great extension of the death duties. But these duties are open to the serious objections that they fall unequally on different properties according to the frequency or infrequency of the successions to them, and that they can be legally and successfully evaded by gifts during the lifetime of the property-owner. These objections, fortified by the further one that the death duties must often eat up a portion of the capital of the estate, are of sufficient gravity to render their further utilisation in place of the income tax undesirable. So far as the main function of the income tax is concerned, viz., the exaction of a substantial and yet moderate contribution from the annual product of realised property, the present impost is a great success. It combines theoretic perfection with a high degree of practical administrative efficiency. Nearly all the odium which attaches to it relates to that less important part of its functions which concerns the taxation of privately-conducted trades, professions, and employments. These sources only yield about one fourth of the total product

¹ For a fuller historical sketch, see *ECONOMIC JOURNAL*, 1892, p. 637.

² For a discussion of these questions, see the article referred to in last note, and that on "A New Property Tax," *ECONOMIC JOURNAL*, v. 7, p. 607.

of the tax, or less, but involve a laborious and inquisitorial procedure, productive of much friction, some evasion, and considerable grumbling. Under these circumstances, it is not surprising that suggestions should have been made to cut out Schedule D of the income tax as an alternative to total repeal. But this crude proposition could only have been made in ignorance that, besides embracing private trades, &c., Schedule D extends to many forms of personal property which should on no account escape contribution. This subject has been referred to at some length by the present writer in previous numbers of the *ECONOMIC JOURNAL*, and it may therefore, perhaps, suffice to state here, quite shortly, the conclusions arrived at. It is believed to be quite feasible to separate the income from personal exertion from that arising from property, and to restrict the tax to the latter. Such a tax would be the most perfect property tax yet devised,¹ falling with the utmost regularity and exactness of proportion upon the income from every kind of property, and yielding a very large revenue, whilst avoiding the serious disadvantages attendant upon the use of the death duties. It would, moreover, appear to offer precisely the desired alternative to the existing income tax as an impost for the satisfaction of the every-day needs of the nation. There still remains, however, the special function of the income tax as a resource of the very highest order of utility and value for times of war and other serious emergency. This is so important as to make the retention of the income tax in its most productive form, but at a low rate in normal times, practically indispensable. By lowering the normal rate of the income tax to 2*d.* or 3*d.* in the £, the margin for expansion in time of war would be greatly enlarged. In the 1900 Budget the rise of rate for the war was only 4*d.* in the £. If the tax had previously stood at 2*d.* in the £, the margin afforded by a rate of one shilling would have been 10*d.* Furthermore, some of the evils of the income tax which relate to the non-property assessments would be minimised by the adoption of a low normal rate. The effect of the suggested changes may be roughly stated in this form: Assuming 8*d.* to be the existing normal rate, the loss occasioned by the reduction of the rate to 3*d.* could be made good by fixing the new property tax at 6*d.* in the £. Thus the remission of 5*d.* in the £ on earnings would add one penny in the £ to the taxation of property.²

¹ Fully described in *ECONOMIC JOURNAL*, v. 7, p. 610 *et seq.*

² Cf. *ECONOMIC JOURNAL*, v. 7, p. 612. Since that was written the creation of new limited companies has been very rapid, and the imposition of the suggested

II.

Turning from this question to the very closely related one of the reform or reconstruction of the tax, we are at once confronted by the suggestion for the graduation of the tax, or, as some would prefer to say, for the application of the progressive principle. When the income tax was first imposed by Pitt in 1799, all incomes exceeding £200 a year were charged at a uniform rate of two shillings in the £, those of from £60 to £200 were charged according to a lower graduated scale, and those below £60 were exempted. From 1806 to 1815 no exemption was allowed except on incomes from trades, professions, and offices received by persons having a total income of less than £50 a year, all incomes from property of every kind being charged in full. When Sir Robert Peel re-imposed the tax in 1842, after a lapse of 26 years, he charged all incomes of £150 and upwards in full, and wholly exempted those below that figure. In 1853 Mr. Gladstone charged incomes of from £100 to £150 at 5*d.* in the £, whilst those of £150 and over were taxed at 7*d.* In 1863 the method was altered. A uniform rate was imposed, but incomes of £100 and under £200 were charged on £60 less than the full amount. In 1872 the "abatement," as it was called, was enlarged to £80 and applied to incomes of from £100 to £300, and in 1876 further enlarged to £120 in respect of incomes of from £150 to £400, total exemption being then again allowed under £150. In 1894 the limit of exemption was raised to £160, incomes of £160 to £400 were allowed an abatement of £160, and those between £400 and £500 an abatement of £100. In 1898 the present highly complex arrangement was devised. Under it incomes up to £160 are wholly exempt. From £160 to £400 the abatement is £160; from £400 to £500, £150; from £500 to £600, £120; and from £600 to £700, £70. But there are provisos limiting the abatement to incomes of £500 and under in certain cases, and introducing other complexities. We thus have a not inconsiderable degree of graduation at present; but a graduated scale which stops at £700 a year is not usually described as "progressive." To justify the use of that term, the progression would in England need to continue upward to £50,000 or £100,000 a year. The cutting down of the assessments in the lower grades does not destroy the proportional character of the tax, the lower scales at the bottom being new property tax at sixpence in the £ might be expected to provide a revenue of £11,000,000.

described as "degressive," in contradistinction to the idea of an ascending scale which is implied in the term "progressive." It will, however, be seen that we are on a slippery inclined plane, and that there is no necessary finality in the figure of £700 a year. Some persons think that the abatement limit should be raised to £1,000 and others to £100,000; and there is some likelihood of our finding ourselves sliding almost unawares into a progressive income tax, as we have drifted unawares into a permanent one. The objection is, in this case, not to the principle of progression itself, nor even to its application to the income tax, if only a feasible method could be devised. But, so far, no plan has been found by which progression can be secured without destroying all that is really valuable in the existing tax. The English income tax is distinguished from the income taxes which exist in other countries by reason of the large use of the method of stoppage-at-the-source. Two-thirds of the total amount collected are not assessed directly on the ultimate payers. The process is made familiar to most people by the deduction of the tax from the dividends of railway companies and limited companies generally, as well as from rents, mortgage interest, and many other kinds of income. By charging the tax at the source of the income, wherever that is possible, evasion is reduced to a minimum, and the productiveness of the tax is enormously increased. It is a further merit of this method of assessment and collection that persons having incomes from property or investments are not required to make returns of such income or to disclose their possession of them unless they desire to claim exemption or abatement, and then only in order that the title to remission may be proved. Now, it has so far been found impossible to construct a really progressive income tax upon a stoppage-at-the source basis. In order to apply progressive rates it would be necessary to ascertain at the outset what is the aggregate amount of each taxpayer's income, and a full and complete return of every source would be needed from each contributor. Thus two of the greatest merits of the English system, which make it the admiration and envy of foreign economists, would have to be sacrificed to render the application of a real progressive scale possible. More than this, when the chief safeguard against evasion had been destroyed, the imposition of progressive rates would operate with irresistible force in inducing concealment of all income from invisible sources, and the tax would beyond all question become a mighty instrument of demoralisation. The possessors of incomes from

sources visible to the eye of the local assessor would feel the full rigour of the higher rates, whilst the millionaire investor in stocks and shares would escape with ease and safety. A progressive income tax would thus very largely defeat the main object of its existence, viz., the higher taxation of the rich, and could only with great difficulty be made to yield as large a revenue as that obtained under the existing system.¹ Even the present scale of exemption and abatement is weighted with serious drawbacks. Very large numbers of persons are placed in the position of having either to forgo the relief to which they are entitled, or to make a full disclosure and take a good deal of trouble to secure repayment of tax deducted. Many prefer to forgo the relief, and others do so in ignorance of their legal rights; and thus the Crown gets and keeps much more than its due. The department is, moreover, groaning under the enormous labour involved in the examination of perhaps a million claims a year in all, of which one-quarter involve repayments of tax.

III.

A more promising prospect of successful reform is opened up by the consideration of the question, "Should temporary and precarious incomes be taxed at the same rate as those from property and investments?" If the income tax were reduced to 2*d.* or 3*d.* in the £ in normal times, the gravity of this matter would be so much lessened as to justify its being ignored. But the probability of the continuance of high rates in the future gives the question a real importance. The grievance of the non-propertied classes—whether real or ill-founded—is an old one, and has been often discussed. It has seldom been denied that the equal taxation of the two classes of income is on its face unjust. The owner of real or personal property is not under the obligation to make provision for his own old age and for those dependent upon him which rests upon the professional classes and others in like position. He may quite properly spend the whole of his income. The professional or business man may not do this. The latter has not only to work for his income, but, when he has earned it, is not free to spend it all. Then, too, there is much force in the alternative form in which this plea is sometimes presented, viz., that whereas allowances for repairs, renewals, and depreciation are made to owners of land,

¹ See article on "A Progressive Income Tax," *ECONOMIC JOURNAL*, v. 5, p. 527

buildings, ships, machinery, and plant, no allowance whatever is made in respect of the wear and tear of the brain and tissue which constitute the corresponding capital of the professional classes and some categories of business men. The point need not be laboured, the *prima facie* injustice being generally admitted. The answers have been three in number, but one of them can no longer be urged. It used to be said that there was no hardship, because the owners of real property were refused any reduction for repairs, and the one injustice justified the other. It is amazing that such an argument should ever have been considered worthy of use by statesmen and legislators; but it was regularly brought out until 1894, when the statutory allowance of very liberal deductions for repairs of real property was conceded by Sir William Harcourt. Another reply was that no feasible scheme had been devised for giving practical effect to the wishes of those who complained of this particular hardship. This would be a perfectly valid reply, if it could be truthfully added that no feasible plan could be devised by those who administer the tax. But that would not be true, and the argument is therefore invalid. A third and frequently heard reply was used by a Committee of the House of Commons as follows:—"Your Committee also feel that it would be unjust to make any alteration in the present incidence of the income tax without, at the same time, taking into consideration the pressure of other taxation upon the various interests of the country." In other words, they upheld this and other admitted injustices until an entire readjustment of the fiscal system of the country (both local and imperial) could be carried through. This plea has been virtually abandoned, various reforms of parts of the fiscal system having been effected in disregard of it. It is now more generally regarded as good policy to effect reforms wherever possible, and thus to reform the whole structure by stages or instalments. More recently, a stronger argument has become available to the objectors to the grant of relief. Since 1894, the taxation of property by means of the death duties has become much heavier than before, and it is urged that the non-propertied classes may therefore be justly refused any reduction of their income tax. In an article which appeared in the *ECONOMIC JOURNAL* for December, 1897, the present writer calculated the aggregate income of the nation for the year 1894 to amount to £1,377,000,000, of which £475,500,000, or 34 per cent., was derived from property, £633,000,000, or 46 per cent., from manual labour wages, and the remaining 20 per cent. from the personal

earnings of the professional and business classes. Whilst, however, the greater part of the income from property belongs to persons of the income-tax-paying classes, five-sixths of the income from earnings belong to those who are below the income tax level. With the income tax at 8*d.* in the £, the proportion of all our taxation, local and imperial, which falls on property, as such, is about 30 per cent.; but a further 12 or 15 per cent. falls on the owners of property in the shape of taxes on consumption and occupancy. Thus, the bigger half of the entire taxation of the country falls on the non-property income, of which, as I have said, five-sixths fall below the level of £160 a year.¹ It would therefore appear that the non-property income of the nation is still too heavily taxed, and that the receivers of it are entitled to some further relief. But quite apart from all this, the income tax should be made defensible on its own merits, and the grosser inequalities of its incidence should, for this reason, be redressed. John Stuart Mill was of this opinion, and he recommended that a deduction of one-fourth should be allowed from the assessments of all kinds of personal earnings. This seems to be a fair proposal, and one that should be considered if the structure of the tax is not to be more seriously modified, and if high rates are to prevail generally in the future.

IV.

In addition to the matters treated of in the foregoing paragraphs, relating to the main structure of the income tax, there are some others which, although of a somewhat different order, are hardly less important, and are even more urgent. The organisation and machinery provided by the Income Tax Acts are almost wholly out of date and inadequate, and need to be completely overhauled and reconstructed. Certain portions of the legal framework have also become complex and cumbrous to a degree which may be described as dangerous to the whole fabric. Let us briefly consider these matters in their turn.

Owing to the survival until 1842 of the prehistoric fear of extortion at the hands of the Government's taxing officials, the business of the income tax was placed in the hands of local commissioners and their officers; the inspectors and surveyors of the central government having only a limited right of inspection, and a still more limited right of revision. The local commissioners

¹ See *ECONOMIC JOURNAL*, v. 7, p. 613 *et seq.*

are an unpaid body, and to carry out the duties imposed upon them would, in many places, now consume the whole of their time. Their officers, *i.e.*, clerks, assessors, and collectors, are not responsible to the Government nor under its control. There is, moreover, no regular supervision by the Commissioners to whom they are nominally responsible, and, from the nature of the case, none is possible. It is not surprising, therefore, that much of the work done by them displays a lack of the qualities of uniformity, precision, and intelligence which are more than ordinarily necessary in so delicate and complex a business as that of the income tax. The business has, in fact, entirely outgrown the machinery provided by the Income Tax Acts, and from sheer necessity the officers of the central government have had to take up the management of it. Although it is no part of their legal business, the bulk of the work of assessment and adjustment is performed or directed by the surveyors, acting for, and in the name of, the Commissioners. The taxpayers of to-day prefer to deal with Government officials whom they pay and can control, rather than with local unpaid bodies; and they expect the former to conduct the business efficiently. They do not know how little real power and authority these officials possess, and how difficult it often is to secure the qualities demanded in the work of a department so organised. There appears to be no longer any valid reason for the continuance of this state of things. The British taxpayer no longer fears the tax officers of the Crown, and the democratisation of our system of government has been so complete and effective as to render some of the old safeguards against extortion unnecessary and obsolete. It seems to need no arguing that there should be legislative recognition of the altered conditions, and that sufficient legal authority should be given to those who, from sheer necessity, must by hook or by crook carry on this vast and rapidly growing business. Again, it is surely time that the clerical staff of the surveyors' offices should be placed upon the regular establishment of the Civil Service. They are engaged on work of a very delicate and confidential character, and their permanent retention in the Government service would appear to be eminently desirable. Yet they are merely the servants of the surveyors, and can leave or be dismissed at a week's notice. Their pay has lately been improved, but they have no prospect of a pension, and the best of them often leave to better their position in life.

V.

Finally, it is suggested that some effort should be made to lessen the appalling complexity of the income tax laws. Those who are familiar with the large five-page yellow form served upon business and professional men each year will appreciate the statement that this only faintly indicates the bewildering mass of law and practice which lies behind it. No one ever reads that form through. For one thing, it contains greatly too much matter; and if the average business man did read it, he would probably find himself at the end much more mystified than enlightened. Although great pains have been taken to simplify that form, the complexity and cumbrousness of the legal system are such as to render any reasonable degree of simplicity at present unattainable. This is very much to be deplored, because the smooth and efficient working of the machine and the security of the revenue depend very largely indeed upon the confidence and intelligence with which the taxpayers co-operate with the department in the administration of the tax. Perhaps the most serious consequences of these evils arise in relation to the chaos of averages and no averages prescribed for the computation of returns, assessments, and adjustments under Schedules D and E. The bewilderment, irritation, and litigation occasioned by it are fast becoming a matter of grave concern to those responsible for the conduct of the income tax business of the City of London and other important commercial centres. But this matter is too important, as well as too complex, for the tail-end of an article, and must be passed by.¹ The complexities of the system of abatement have already been referred to (although not fully laid bare), and they will serve for further illustration. When Peel reimposed the tax in 1842, there were no abatements; now there are four. And when the abatement limit was last raised from £500 to £700, a cryptic proviso was inserted barring out "persons" who are not "individuals" from participation in the extension; but inferentially admitting a somewhat disputable claim made by some corporate bodies to come in as "persons" up to £500. Again, married women engaged in trades, professions, and employments on their own account are separate persons and individuals if the total income of husband and wife together does not exceed £500, and if both have incomes arising from their separate personal exertions. When

¹ A review of this subject by the present writer appeared in the *Financial Reform Almanack* for the years 1888, 1889 and 1890.

the joint aggregate income exceeds this sum, the wife ceases to be a separate person or individual, and loses her title to exemption or abatement, whilst the husband may also lose his title to abatement owing to the joint income being now regarded as owned wholly by him. A married woman possessed of an income derived solely from property or investments is still denied the distinction of being a person or individual, and her income is treated as part of that of her husband, without regard to the amount of the joint income. So also is the married woman who, although otherwise qualified, has a husband not possessed of a separate income from his own labour. In any case, the income from the investments or property of a married woman is treated as her husband's income. It is quite unnecessary to point out that all these distinctions and refinements multiply the occasions for inquiry and interference; and that such inquiry and interference are bound to be obnoxious and to involve occasional irritation and friction. The old simple rule of treating a married couple as the taxable unit in all cases should have been rigorously upheld. It is conceivable that more injustice is caused (and certainly more sense of injustice is felt) as the result of invidious distinctions than by a refusal to admit any exceptions to the broad general rule. The illustration just given of the complexity of the income tax system relates only to one corner of it, and could be matched or exceeded by examples from many other parts. But the subject is a very technical one, and need not be further pursued.

VI.

A few words more by way of summing up. Now that the permanence of the income tax is assured, and as the continuance of very high rates seems almost inevitable, the consideration of the subject of the reconstruction and reform of the tax assumes a special degree of importance and urgency. In spite of many concessions and reliefs, the tax remains the most obnoxious part of the revenue system of the country. Experience has shown where the income tax system is defective, alike in regard to its main structural outlines, its legal form and expression, and its departmental machinery. The time appears opportune for a thorough overhauling of the whole edifice, and for its rebuilding and refurnishing on a really adequate scale. The lines suggested in this paper and in previous contributions by the present writer include the creation of a new property tax on the

income tax model, to replace the income tax as a fiscal engine for the ordinary and permanent needs of the Government. This would allow of the restoration of the income tax to its proper position as a reserve of infinite value for emergencies, and make possible a return to nominal rates in normal times. Failing this reconstruction, a liberal deduction in computing the income arising from personal exertion is suggested, as called for on grounds of equity and policy. In any case the tax should be placed upon a solid permanent basis both in regard to its legal machinery and its departmental organisation.

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