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THE INDIVIDUAL INCOME TAX AS A METHOD OF INFLATION CONTROL

Some people who oppose the use of taxation for any purpose other than the raising of revenue object to its use as an instrument of inflation control. Aside from the basic question of what are the proper uses of taxation, it may be observed that the purpose of raising revenue is itself closely tied up with inflation control. Underlying the purpose of raising revenue is a more fundamental purpose, that of avoiding the harmful effects which would follow if expenditures were indefinitely financed without taxation – which in general would mean using the printing press or the banks as the source of funds. If such methods of financing produced no ill effects there would be no reason for the hair shirt of taxation. But such methods do produce ill effects of which the most spectacular and perhaps the most important is inflation. Over the centuries, the desirability of taxation as a source of funds has become somewhat detached from its underlying rationale and has acquired an authority of its own. **At bottom, however, a fundamental objective of taxation, which largely determines the validity of the revenue objective, is the prevention and control of present and future inflation.**

Accordingly, no apologies are necessary in considering taxation as a means of inflation control. Before proceeding to the discussion of the individual income tax as a method of inflation control, an introductory summary statement of certain conclusions about inflation, which for the present purpose serve as assumptions, may be found helpful.

1. Inflation used here as synonymous with inflationary price rise is not a curse visited by some supernatural power but groups out of human institutions and human actions and is therefore preventable and controllable if people, especially people in organized groups, understand its causes and phases and are willing to take the steps necessary to prevent and control it.

2. Inflation is characterized by a situation where consumers and business organizations are able and attempt to buy more goods and services than are available under conditions where the normal mechanisms for increasing supply and limiting demand are not operative, due to restrictions on increases in the supply of goods and accompanied by continued additions to the volume of spendable funds.[1]

3. By inflation control is meant the deliberate action of an organized society to prevent, delay, or limit inflationary price rises through removal of the restrictions on supply and of additions to spending power that cause such price rises, or through modifying their impact on prices.

4. Some control measures are:

(a) Increasing the supplies of civilian goods through increased efficiency, increased use of natural and human resources, improved transportation and increased imports, as well as by diversion of resources from other uses.

(b) Decreasing, or limiting the increase, of spendable funds by (1) reduction in governmental expenditures which tend to increase such funds, (2) reduction or limitation of credit expansion for private purposes, and (3) appropriate taxation and borrowing measures.

(c) Reducing or limiting the efforts of consumers and business concerns to spend current income and accumulated savings, through priorities, rationing, patriotic appeals and through a policy of preventing price increases by directive.

5. Legal limitation of price, although a useful measure of control in avoiding increases in efforts to spend available funds, can be fully effective only temporarily in inflationary forces continue or other control measures are not taken.

6. Heavy taxation, although by no means the only method needed for inflation control when inflationary pressures are great, is a basic method which (a) reduces spendable funds, thus striking directly at causes, (b) encourages private loans to Government by indicating the serious intention of Government to control inflation, and (c) if applied

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[1] The restrictions are often not complete and the additions not unlimited, so that inflations are usually self-limiting without conscious control methods.

on a rising scale which the spending public believes will continue to rise, discourages spending because of anticipation of higher taxes.

7. Different forms of taxation may be considered alternative or complimentary for the purposes of inflation control. If all taxes have the same anti-inflationary influence per dollar of collections, the control of inflation is not a consideration in comparing the desirability of taxes; but if the extent of the effects are different, the control of inflation becomes a consideration in comparing the desirability of different taxes in a period when inflation control is desired. For policy purposes it cannot be assumed without evidence or demonstration that different taxes and different rate schedules producing the same revenue will have equal anti-inflationary effects.

The foregoing summary is not intended to be complete; it is intended rather as general background.

This paper is directed to a consideration of the factors affecting the anti-inflationary effects of the individual income tax. By individual income tax is meant a tax on individual net income above personal exemptions and credits for dependents such as is imposed by the Federal Government. In general, this paper does not proceed to the state of comparing the anti-inflationary effects of the individual income tax and other taxes.

EFFECTIVENESS IN REACHING INCOME

Since current income is the principal source of spendable funds, one factor determining the effectiveness of a tax is the extent to which it is able to reach income. The individual income tax does not reach all income; some income is excluded from computation of the tax, some is eliminated through deductions, while personal exemptions and credits for dependents reduce the balance.

Under war conditions, with total income received by individual citizens about $150 billion, roughly $35 billion is removed from the tax base by “exclusions” (chiefly the tax-free allowance of $1,500 per annum for members of the armed forces) and deductions for interest, taxes, extraordinary medical expenses, contributions, etc. This leaves a net income, in the sense of the income tax law, of roughly $115 billion.

Of this $115 billion, about $60 billion is taken out of the tax base, chiefly through the personal exemptions and credits for dependents claimed by those subject to tax, though the figure also includes the total net income of persons who are not taxable because their exemptions and credits for dependents exceed their net income. The remaining $55 billion (between 35 and 40 percent of total income payments) is the amount subject to the regular income. A considerably greater amount is subject to Victory tax, in view of the much smaller exemption allowed heads of families under the tax; but since the Victory tax rate of 3 percent is so low compared with normal tax and surtax, this special-purpose addition to the tax base contributes little to revenue or anti-inflation effect. Less than $300 million of tax is expected to be paid at 1944 income levels by persons subject to Victory tax who are below the exemption levels of the regular tax.

While the tax base under the income tax is very much smaller than the total national income, it is still sufficient to make the income tax very effective. The principle of exempting the taxpayer's bottom dollars makes sense not only from the standpoint of fairness but also from the standpoint of directing our measures against inflation to the right address. As was just mentioned the greater part of the income which disappears from the tax base represents exemptions and credits for dependents. Most of the income so exempted is required to support taxpayers and their dependents at the minimum level for health and working efficiency. Admitting that inflationary pressure would be less if more citizens were so poor that they could not reach this minimum standard, it is still appropriate that pressure to reduce spending should be applied only to the excess over minimum standard.

Needless to say, there is no perfectly satisfactory way of deciding how much is essential and under wartime conditions it is necessary to be less generous in gauging essentials than in normal times. If a larger tax base is needed, it can be obtained under the income tax by less generous treatment of the types of income now excluded and deducted, and by reduction of income tax exemptions. Even if lowering exemptions means that some part of the necessary minimum is taxed, this can be defended as preferable to going over to types of taxes whose base includes the entire necessary minimum.

No exemption system can even be perfect; ours certainly is not. The necessary minimum which has a claim to be protected from taxation undoubtedly varies according to the occupation, the length of work week, previous living standard, and similar factors. There are also very important differences in the standard of living which a given amount of money income can support. Dollar for dollar of statutory net income, a farm family can enjoy a more adequate standard of living than can a small town family, which in turn can support a more adequate standard than a city family. At the city end of the scale, less people are able to raise their own food. More are obliged to live in rented houses or apartments; and for those who rent, rents are higher. Furthermore, what is considered an "adequate" standard of living is on the whole more elaborate in large cities than small towns or in the country. Thus, a level of personal exemptions and credits for dependents which is too low to keep up working efficiency in an industrial city might simultaneously be more than adequate in small town and country areas.

Another factor bearing on the adequacy of personal exemptions is that families differ very much in their make-up and in the number of persons who contribute to family support. In families where several adult members contribute their earnings, the total amount of untaxed income for the family as a whole may be very much larger than where all the income is earned by husband and wife. On the other hand as between families where both husband and wife are at work and families where only husbands work, and where total income is the same, the family which enjoys the wife's services as full-time housekeeper is plainly better off; but no offset to this advantage is offered by our present tax system (except a difference of less than $20 of liability under the Victory tax).

TIMING OF PAYMENT

The effectiveness off a tax as an anti-inflationary devices is determined in part by the timing of payment. If, for example, incomes generally increase by 25 or 50 percent in the course of a year and the taxes are not collected until the year following receipt of income, the current effect on spending will be less than if the tax is collected immediately. The prospect of payment in the following year has a restraining effect on spending in the current year but not to nearly the same extent as current payment which removes the ability to spend.

Up to the past few months, the individual income tax collections have lagged by as much as a year behind the receipt of income. Under the Present current-payment act the timing is much closer although it is not yet perfect. That portion of the tax that is withheld at sources is withheld concurrently with the payment of the income and never reaches the hands of the consumer. The rest of the tax is to be paid in quarterly installments near the end of each quarter and are supposed to represent one-quarter of the estimated tax for the whole year. Because of the nature of this estimated tax system there is not adequate provision to prevent some postponement of payment. One-fifth may be paid without penalty in the following March instead of during the current year. There is now no penalty for underestimate and underpayment during the current year if quarterly installments are paid based on income at least as large as that of the previous year. Protection is not adequate against allowing the tax liability to accumulate during the year and to be paid more largely in the latter half of the year. Specific provision is made to permit farmers to pay no tax before December 15, to pay as little as two-thirds at that time and to pay one-third the following March 15.

Despite the exceptions, however, if the purpose and spirit of present law are carried out in operation, the timing of the income tax payment is satisfactorily coordinated with the timing of the receipt of income.

Tax rates can now be raised or lowered at any time during the year making the income tax available as an adjustable tax to meet changes in inflationary requirements. However, even leaving aside the political problems of such adjustments, the flexibility is not as great as appears on the surface. For incomes withheld at source there is no great problem in increasing the rate of withholding within a period of thirty or sixty days after the change in law is passed. With respect to the estimated tax the change would involve a new estimation by all taxpayers subject to making the declaration of estimated tax. This is not impossible but would enlarge the not inconsiderable compliance problems of existing law. Moreover, changing the rate of tax during the year increases complications and imposes a handicap on tax simplification.

EFFECTS ON SPENDING AND SAVING

The effectiveness of various dollars of income tax in reducing spending varies from person to person. No attempt will be made here to go into all of the variations in situations which may cause a dollar of tax to reduce saving or spending as the case may be. In general an additional dollar in tax would reduce spending more in the case of a person with a low income than a person with a high income since the margin for saving is much less. Persons subject to the income tax (not including the Victory tax) account for roughly three-fourths of the total expenditures. In view of the fact that for every family a certain amount of expenditure is absolutely necessary and cannot be considered inflationary in character, the income tax applies to persons who make a much larger proportion of the total potentially inflationary expenditures than this ratio would indicate.

Spendings may be made from accumulated savings as well as from current income and such savings are an important source of funds for normal purchase. In addition to these normal purchases the accumulated savings for the past years furnished a substantial threat to prices in case there should be anything approaching a mass movement of the use of such savings for the purchase of goods and services. The income tax places no penalty on the spending of accumulated savings and does not operate to freeze such savings although it does reduce the further accumulation of savings.

In addition to the effects of taxes on the ability of persons to buy are the effects on their willingness or decision to buy assuming they have the ability. The income tax does not place any special penalties on the expenditure of money and accordingly does not discourage spending except insofar as it reduces the amount available to be spent.

REACTION ON WAGES, ETC.

Another factor in determining the effectiveness of a tax as an anti-inflationary instrument is the extent to which it results in pressure for higher income. Specifically there is always the danger that the imposition of an increased tax will result in so much additional pressure for higher wages that the actual reduction in income achieved by the tax will be much smaller than the amount of the tax and may in fact be negative. Moreover, the higher wages would not only contribute income to the spending stream but would increase the costs of doing business and thus force price ceiling to be raised, thereby reducing the effectiveness of various price and inflation control devices.

Different aspects of the individual income tax work in opposite directions with respect to the effect on the demand for higher wages and salaries as compared with other taxes. The pressure is reduced by the fact that the income tax has personal exemptions which protect from the higher tax a minimum standard of living. Moreover, the exemptions differ from person to person depending on family status. A unified demand for higher wages is less likely to develop among people who are differently affected by a tax than among people who are uniformly affected by the tax. The income tax moreover is a direct tax and is recognized as being intended to fall on those with income. Less excuse is offered for demanding offsetting income increases than where the tax is indirect. Moreover, the exemption and progressive rate features of the tax give it a fairness in application which undoubtedly reduces the hostility of workers towards rate increases.

On the other hand, the income tax on workers is for the most part collected through the withholding of tax at source by the employer. The result of an increase in tax is thus to reduce the amount in the pay envelope. The effect of the tax on the spendable income is very direct and is brought immediately to the attention of the employee. Moreover, the apparent reduction in income may be blamed emotionally on the employer even, though the worker knows that the employer has no choice in the matter. The reduction of pay in the form of increased withholding would likely be a substantial influence in the direction of demand for higher wages, and much more so than if the tax were not due until the following year. In the latter case the separation of the date of receiving the income from the date of paying the tax would, at least to some extent, separate them in the mind of the taxpayer and give him less immediate cause for demanding higher pay, although when the tax came due in a lump sum the worker's reaction might be accentuated even though postponed.

With a highly organized labor movement, a good deal of the effect of tax increases on demand for wage increases will depend on how labor leaders feel and what educational campaigns they undertake with their members. Of course even such an educational campaign has its limitations, and pressure from the rank and file of the members may be the controlling factor in determining the policies of the leaders.

EFFECTS ON CONSUMER SUPPLIES

Thus far the discussion has concerned the effectiveness of the income tax as the means of reducing demands with respect to its withdrawal of income, its discouragement of spending and its encouragement of demands for higher compensation. There remains to be discussed the effects of the income tax on the supply side, that is, on the amount of goods and services that will be available for purchase. To the extent that persons are engaged in war production, a decrease in their output may result, in either a reduction in war goods and a consequent lengthening of the period of the war or a necessity for shifting more labor to war production from civilian goods production with a consequent decrease in the amount of civilian goods available. To the extent that persons are engaged in production of civilian goods and services, a decrease in output would be directly reflected in a reduction of the supply of civilian goods and services.

Taxes may decrease production by reducing the standard of living below the point necessary for maximum efficiency, as previously discussed. They may also decrease production by affecting willingness to work. The effect of an income tax on the willingness of workers to produce would be closely tied in with its effect on the demands for higher compensation. Higher compensation which overcame the effects of the income tax would no doubt also overcome any adverse effect of the tax on their willingness to produce.

If the higher compensation were refused the result might be a slowing up of production and the diminution in output even in the absence of a strike.

A minor indication of the effects of higher taxes on production has been given in recent months by the bracket scale of the withholding tax. The withholding tax is, of course, not the final income tax and any over-or under-withholding is evened out at the end of the year. Nevertheless, there are on record cases of workers who refuse to earn additional sums of money in the course of a pay period where the earning of such additional sums would have resulted in application of a higher bracket of withholding and a smaller net wage after withholding. This applies to only small areas of compensation, and as workers come to understand the relation between the amount withheld and the final tax liability the effect should disappear. Nevertheless, it shows that marginal rates of tax are considered by the workers in determining whether they will work more or work less.

In some situations, higher taxes may encourage the taxed person to work more hours per week in order to take home the same amount of net earnings after taxes. In such cases higher taxes would have the effect of increasing the supply of labor a high marginal rates of tax may discourage work since the worker may feel that rest and leisure and opportunity to enjoy his income are more important to him than the compensation for additional hours of work after meeting heavy taxes. This would be especially true in the case of overtime work because of the greater exhaustion and loss of leisure accompanying such work. It would also be especially true in the case of a working wife who might find that her earnings after taxes did not compensate her for the additional family costs and the inconvenience accompanying her work outside the home in industry.

Little, if any, evidence has been observed that taxes and rates now imposed or that have been contemplated in programs presented to Congress would actually have a substantial and adverse effect on the willingness to work and on the supply of civilian goods and services.

In the cases of many well-to-do lawyers, professional people or corporation executives, the high level of income tax rates appears to have caused a diminution of effort, the taking of long vacations or early retirements. Whether this has been serious during the war, in the face of the strong pressure of patriotism for additional effort, may be questioned. Likewise the effects of high rates of tax on the taking of risks cannot be ignored. In view of the shortages of manpower and materials, and especially of man-power, it may be that no additional willingness to undertake risks in civilian industry would be of much help in increasing civilian supplies during the war period.

Another general effect of the income tax on the supply side relates to the question of general morale. It is not possible to eliminate entirely the equity consideration from the discussion of anti-inflation forces. The willingness of the workers, for example, to give full effort may be impaired if they do not feel that taxes are equitably imposed. Thus one of the factors in choosing between types of taxes for anti-inflation measures and in determining the rate of an income tax if that tax is chosen is whether the resulting distribution of the tax burden will be recognized as an equitable one. The income tax imposed at progressive rates is believed to be recognized generally as the most equitable form of tax.

WORKABILITY

An important factor in determining the effectiveness of taxes for the control of inflation is practicability of application. However effective a tax may look on paper, it is of no value if it cannot be practicably applied. The practicability of the individual income tax is as nearly assured as that of any tax. It is true that the recent lowering of exemptions and introduction of current collection raise a question as to practicality which has not yet been fully answered. Only after a year or two of operation can it be said positively that the present income tax system is an assured reality for practical use. **However, the income tax as revised is bringing in the money, which is the most important factor of practicability for inflation control.**

SUMMARY

In summary, the chief characteristics of the individual income tax that have a bearing on its effectiveness as a device for inflation control are these: The tax is a logical method of inflation control because it is measured by the chief inflationary force, namely income. The income tax has a long history of successful operation. It is collected currently with receipt of income. It can reach a large part of income since the tax base can be adjusted by raising or lowering exemptions. Lower bracket incomes escape the tax in whole or in part but much of the spending from such income is necessary and should not be considered inflationary. The income tax reduces both spending and saving. It does not introduce any special inducement not to spend. It does not reduce expenditures from accumulated savings. It permanently removes purchasing power and so reduces the accumulation of savings in the form of government debt, thus reducing the threat of future inflation. It may cause pressure for higher wages but gives less actual reason for acceding to such demands than do most other taxes. High marginal rates may discourage overtime work and the work of women. The income tax avoids reduction in the ability to produce. The existence of the personal exemptions and credits for dependents furnishes a margin of untaxed income to take care of the basic necessities for maintaining health and strength and security which are the foundations for high productivity in industry.

For these reasons it can be safety concluded that the individual income tax is an appropriate and effective instrument of inflation control.

Converted to text by Larry Becraft