

Kyoto University Economic Review

MEMOIRS OF
THE DEPARTMENT OF ECONOMICS
IN
THE IMPERIAL UNIVERSITY OF KYOTO

VOLUME VIII



PUBLISHED BY THE DEPARTMENT
OF ECONOMICS IN
THE IMPERIAL UNIVERSITY OF KYOTO

KYOTO UNIVERSITY

ECONOMIC REVIEW

MEMOIRS OF THE DEPARTMENT OF
ECONOMICS IN THE IMPERIAL
UNIVERSITY OF KYOTO

VOLUME VIII

(July 1933)

NUMBER I

PROGRESSIVE TAXATION ON THE INCOMES OF CORPORATIONS

FOREWORD

One may recommend by way of coping with the existing financial difficulties of our country either a policy of sparing or an increase in State revenue through an additional tax burden. But I would rather urge that both of these elements be embodied in the financial reform. I shall not here dwell on a policy of sparing; I shall confine my discussions to different methods of increasing the State revenue through taxation. There are many different schemes of increasing taxes and various methods may be employed in carrying out each of these schemes. But, if we are to effect a tax reform without fundamentally altering the existing tax system, I would recommend a revision of the present system of taxing corporations on their incomes. Our corporate income tax is a proportional tax. I contend that it should be turned into a progressive tax. The minimum rate of the

new tax should be five per cent (the same as the present rate for ordinary incomes in the existing income tax system), and the maximum rate should be 20 per cent. The above minimum rate will be little higher than the minimum rate for Class C incomes now in force; and the above maximum rate will be little lower than the maximum rate for Class C incomes now in force.

Such a tax reform will not only enable us to attain the object of increasing State revenue, but will be harmonious with the principle of justice in taxation as well as with the ideals of social policy. It is noted that the taxes on corporate incomes in such countries as Great Britain, France, the United States, Germany, Italy, Austria, and Czechoslovakia are proportional and not progressive. This fact is taken by some as a formidable proof of the superiority of a proportional income tax over a progressive scheme. We cannot accept such a sweeping view. On the other hand, a deeper examination into the merits and demerits of both of these two systems seems to indicate that the progressive scheme has many reasons, often outweighing those in favour of the other system. There are divergent ways of imposing such a progressive income tax on corporate incomes. I am inclined to believe that the tendency of the Powers is towards the adoption of a progressive corporate income tax. I shall, therefore, treat this important subject in detail in both theory and practice.

PART I REASONS FOR PROGRESSIVE TAXATION OF CORPORATE INCOMES

Before proceeding to evince reasons for the adoption of the principle of progression for the taxation of corporate incomes, I shall first examine the reasons for the principle of proportion now forming the basis of the existing income tax systems of many nations, including our own.

1. Reasons for the proportional corporate income tax:

(A) Consideration from justice in taxation:

(a) From the standpoint of taxation according to the ability principle:—

(i) From the standpoint that regards the corporation as a means of profit-making for individuals. There are two views of the nature of a corporation: the one regards it as an independent personality with all the attributes of a personality; the other considers it as a means of profitmaking for those individuals who are its members. We shall refer to the former view later and we shall here dwell only on the latter. According to this view, the income tax is levied on corporations on the theory that it is more convenient to tax corporations than individuals who compose it and who use it in making profits. The obvious objection to this view is that the members or shareholders of corporations are unknown to the revenue officials to some degree and that they present the difficulty arising from their mobility. One may further object to such a view that it is impossible to tax corporations according to the shareholders' ability to pay. In actuality, it is seen that the ability to pay varies among the members or shareholders of corporations in an amazing degree. Some of them have only a single share each and depend thereon as the only source of income; and their income, if classified as Class C of the Income Tax Law, should be below the exemption point. On the other hand, other members or shareholders have an enormous number of shares, the income from which would be taxed at very high progressive rates, were it classified as Class C income. Such people may also have much income from some other sources which, if classified as Class C income, would be also taxed at the highest progressive rates. In other words, it is impossible to tax the shareholders of corporations indirectly and according to their ability to pay. If the income tax is to be levied indirectly on the shareholders of corporations, the adoption of some average or middle rate will be necessary in order to assure a measure of justice to different shareholders.

Nor can the size of corporations be taken as a basis of taxation. For such a tax basis presupposes that all the shareholders of big corporations making vast profits have large incomes, and that all of the shareholders of small corporations having a small earning capacity have but small incomes—a supposition which does not hold water. Of course, if such a supposition is true, then the taxation of different corporations according to their incomes would eventually result in a similar indirect taxation on their shareholders. But the fact is that there is no relationship between the size of corporations and the amounts of their shareholders' incomes. Big corporations may include among their shareholders those having but a single share each; while some of the shareholders of small corporations may have large incomes. It is clear then that, if the size of corporations be taken as the basis of taxation, it would be unfair to their shareholders; such a tax would prove relatively too light for the big shareholders of small corporations and relatively too heavy for the small shareholders of large corporations. Because of this injustice, the adoption of some average or middle rate for the proportional income tax has been found imperative.

(ii) From the standpoint that regards the corporation as an independent personality. The corporation may be treated as a taxpayer who is the subject of independent rights. But even from such a standpoint, the revenue of a corporation cannot be properly be called "income" in the real sense of the term; it is rather more properly be regarded as a sum of products. Corporate incomes are real rather than personal in nature, and the tax thereon is not an income tax but a tax on products or business. Corporate income should be more rather considered as an object of the business tax. Now, in the case of such real objects, progression has no place; rather a proportional tax should be levied. The conception of income involves the idea of consumption. But the corporation does not consume, although it is engaged in business and realizes profits. Its

activities do not include personal consumption, although it is regarded as an independent personality, shoulders the duty of paying taxes, and carries on business in its name. For this reason, it may be argued that the principle of progression cannot be applied to corporate incomes, or rather products, because that principle in the case of personal incomes is really based upon the fact of consumption:—wasteful consumption is taxed heavily and necessary consumption is taxed lightly, there being various degrees according to the nature of consumption of incomes. Thus, justice in taxation is assured by progression in the case of personal incomes. Obviously, such a principle is inapplicable to corporate incomes. Rather, the principle of proportion should be adopted, because it is more appropriate for all taxes on products or business.

(b) From the standpoint of taxation according to the benefit principle. Taxation according to the benefits received by taxpayers are applicable to local taxes but not to national taxes. Inasmuch as local additional charges are allowed to be attached to the corporate income tax which is a national tax, and so long as corporate revenue is "income" only in name and in reality is a sum of corporate products (and therefore the tax thereon is a sort of business tax), we cannot leave out the benefit principle. One may indeed say that corporations earning big incomes receive greater public services than those earning small incomes. However, no one can say that the former receive relative greater benefits than the latter. Such is the chief objection to the adoption of progression in the taxation of corporate incomes.

(B) Consideration from social policy. The argument advanced in (A), (a), i.e. that when the corporation is regarded as a means of profit-making for individuals, the progressive taxation of corporate incomes does not assure justice to the shareholders of corporations, may be further extended to prove that such a system of taxation is inconsistent with the social feeling on the part of individuals. Such a progressive system may place an excessively heavy

burden on poor shareholders and an excessively light burden on wealthy shareholders, and thus may prove objectionable from the standpoint of social policy. One may, therefore, urge the adoption of proportional taxation in order to escape from such evil consequences.

(C) Consideration from State revenue. As to State revenue, progressive taxation based upon the methods I have explained at the outset is, perhaps, more remunerative than the present proportional taxation. But, such a progressive tax may induce corporations to report their incomes as small as possible to the revenue office, the result being that the amount of State revenue is smaller than under a system of proportional taxation at an average rate.

(D) Consideration from economic policy. The development of modern industry was largely due to the activities of big corporations, and if its further growth is desired, they should be allowed to develop themselves by carrying on their enterprises unmolested and unchecked by any heavy tax burden. One may assert that the imposition of a progressive tax will certainly impede their future development. Proportional taxation, on the contrary, will prove advantageous to big corporations and stimulate industrial progress. It will prove advantageous and beneficial not only to investors, especially big investors, who will be enabled to have a more reliable calculation of their business investment, but also to the general public which will be benefitted by a general industrial progress. For it will ultimately assist the development and growth of industry.

(E) Consideration from tax technique. Proportion is simpler and more convenient in the administration of taxation than progression, when considered from the standpoint of tax technique. Where progression is adopted, attempts are made to make the tax-bases as small as possible by taxpayers in their hope to evade the payment of taxes. Thus, the adoption of progression will have immoral effects.

So far I have given the reasons for the adoption of a proportional tax for corporate incomes. They are quite

plausible and are entitled to due respect. On the other hand, there are reasons for the adoption of progression and some of them have a greater force than these for the other principle. At any rate, a comparative study of the two is highly desirable. I shall next set forth the reasons in favour of progressive taxation.

2. Reasons for progressive corporate income tax:

(A) Reasons themselves:

(a) Consideration from justice in taxation:

(1) In the case of progression based on the amounts of incomes:—There are two forms of progression: progression based on the amounts of incomes and progression based on profit-rates (the proportion which profits bear to capital invested). Taking the former as more desirable, I shall proceed to explain it in detail.

a. When the corporation is regarded as an independent person. Although a corporation may be said to be an independent person, the fact remains that it does not consume like natural persons. In consequence, no reason in favour of progression can be given from the standpoint that regards a tax as a sacrifice of consumption. But since the corporation is engaged in an act of earning and the size of its earning power may be taken as the basis of a progressive tax. The corporation (which is a juridical person) is an industrial entity with a big capacity to pay. It is enabled to remain a big organisation with such a capacity because of this essential nature. Big industries usually have greater profits than smaller industries. Those individuals and corporations who are wealthy and having great amounts of capital can secure greater profits than those who are less wealthy and having lesser amounts of capital. Corporations as independent persons carry on enterprises and compete with others both corporations and individuals. Corporations having comparatively greater capitals and efficient managers occupy a position much advantageous over smaller corporations and individuals. The former are able to realize profits which are both absolutely and relatively greater than those

secured by the latter. Thus, big corporations are able to pay a greater amount of tax out of their profits than smaller corporations. In other words, big corporations or corporations having an enormous earning power can successfully compete against individuals having a small earning power; and have a greater capacity to pay than individuals having a smaller earning power. Thus, viewed from the standpoint of earning capacity, corporations should be taxed progressively according to the amounts of their capitals, or rather according to the amounts of their incomes, for such a system of taxation would be highly conformative to the ability principle.

b. When a corporation is regarded as a method of earning for individuals. It is true that the shareholders of big corporations which secure big profits are not necessarily big earners; nor are the shareholders of small corporations which secure small profits always small earners. In actuality, however, it is seen that the incomes of big corporations which earn big profits usually go into the pockets of big earners, while the majority of the shareholders of small corporations with small earning powers are small earners. Even when a corporation is regarded as an instrument of earning for individuals, and, in consequence, the corporate income tax is considered as an indirect method of taxing shareholders, the fact is seen that the tax on big corporations fall ultimately on big earners. In other words, a differential tax based on the amounts of corporate incomes proves a differential tax on individuals. Of course, such a tax cannot be considered as an appropriate tax in which the amounts of individual incomes are directly known and taken into consideration. But the results of the two systems are similar to each other. Where a proportional (middle rate) tax is levied on the incomes of corporations, individuals with big earning powers will form corporations in order to evade the high progressive income tax rate for individuals; and thus there will be an unfair distribution of the tax burden for those who do not form corporations, and who

in consequence must pay the high progressive tax on their incomes. If, on the other hand, progression is applied to corporate incomes, such unfairness can be mollified to a large extent.

(2) In the case of progression based on the rates of corporate profits:

a. Affirmative reasons from the standpoint of justice in taxation:—(i) When viewed from the real ability to pay on the part of the capital invested by a corporation, progressive taxation based on that corporation's profit-rate would be more appropriate than progressive taxation according to that corporation's incomes, because the investor having a high profit-rate is able to pay a correspondingly great amount of tax. The same assertion may be made from the standpoint which regards the corporation as an independent person. At any rate, no one can reasonably declare that a corporation's capacity to pay has no relationship with the amounts of its profits, although we can safely say that profit-rates are more adequate as a tax basis than the amounts of corporate incomes.

(ii) From the standpoint of unearned gain:—It may be said that the high rates of profit are often due to forces external to one's efforts as much as to the efforts put in by the earner. For this reason, it is just that he be taxed heavily.

b. Negative reasons:

(i) The assertion that real capacity to bear is better indicated by profit-rates only applies to corporations but not to natural persons. Under the system, wealthy persons who are able to make big profits (but whose profit-rate is comparatively low) will be more lightly taxed than less wealthy individuals with small capital (but whose profit-rate is comparatively high). If such a progressive taxation is adopted for corporations, it must not be applied to individuals. In other words, there should be two sets of such progressive taxation—one for corporations and the other for individuals. The former should be based on profit-rates and

the latter on the amounts of profits. The only conceivable ground for such a differentiation may be expressed as follows: "The corporation is a person only in name; it is a real entity but does not consume like individuals; it is only engaged in business; therefore, it should be taxed differently from individuals who are engaged in consumption economy." Such an assertion will be met by the refutation that some of individuals consume to such a negligible extent that they are not substantially different from corporations. Thus, the ground for differentiation has some theoretical weakness. It appears that progressive taxation of corporate incomes according to their amounts is more logical than that according to profit-rates.

(ii) As to the second reason, it should be noted that the high rate of profit is not entirely due to external forces, but due, in a large measure, to the ability, efforts and initiatives of the taxpayers. Such consideration greatly weakens the second reason, but is not sufficiently formidable to overturn it.

(iii) Another objection to this progression is found in the technical difficulty of determining the definition of capital, which is to be the basis of the progressive tax. This difficulty may be somewhat alleviated by the existence of such an income tax precedent as the excess income tax in our country. But the economic effects on the taxpayer will be felt, inasmuch as this method of taxation will tend to have a retarding effect on his economic activities. Moreover, the rates of corporate profits are not the same for different sort of industries. Enterprises involving high risks usually have high rates of profit which are higher than those of less risky enterprises. But such a fact is not taken into consideration by this progressive taxation which regards all industries in the same light. This is the most serious objection to the scheme of progressive taxation.

(b) Reasons from social policy :—It is generally seen that corporations with big capitals and big earning powers are in a position to overcome the competition of other

corporations with smaller capitals and smaller earning powers as well as individual enterprisers. So powerful are the former that the very existence of the latter is threatened. This is widely seen in our business world. Such a state of affairs should not be allowed to exist unchecked, when viewed from the standpoint of social policy. The best way to control the undue exercise of power by big corporations is to apply progression in the taxation of corporate incomes. A proportional taxation such as now in force will only tend to augment the power of the big corporations and weaken the position of the weaker ones, because it treats them all as equals. Corporations with greater earning powers should be taxed more heavily. Such a differential taxation is necessary to protect corporations with less earning powers. True, as we have pointed out before, there is the danger of placing a too heavy burden on poor individuals who are the shareholders of big corporations. But such an excessive burden is pardonable. At any rate, the evils resulting from the unchecked power of big corporations are much more serious upon the business world in general.

(c) Consideration from State revenue :—We have already seen that when the proportional tax is levied as a middle rate, it would meet the needs of State revenue more successfully than a progressive tax. However, it would be impossible in our country today to increase the rate of our proportional tax on the ordinary incomes of corporations, for the reason that smaller corporations would be unable to bear such an increased burden, although bigger corporations may be able to bear it. But if we should adopt a progressive tax according to my plan such a difficulty will not result. A progressive scheme, as I have planned out, will allow the continuation of the existing tax rate for small corporations (namely, 5 per cent) and higher progressive rates (the maximum being 20 per cent) will be levied on big corporations. Such a system would place no additional burden on smaller corporations, nor any unbearably heavy burden on bigger corporations. Moreover, it will enable the State to

increase its revenue.

(d) Consideration from tax technique:—Proportion may be simpler and more convenient than progression when seen from the standpoint of tax technique. However, the latter cannot be said to be impracticable. It will be able to overcome whatever difficulties it may meet.

(e) Consideration from the nature of corporation:

(1) Inasmuch as the corporation is an independent personality, it should be taxed along the same line with natural persons. True, the corporation has peculiarities of its own and does not consume like natural persons; and, in consequence, is entitled to some special consideration. However, it is highly desirable that the methods employed in the taxation of natural persons should be extended over to corporations as far as possible. If natural persons are taxed progressively and corporations are taxed proportionally, there will be partiality in favor of the latter which will pay a lighter tax burden than competing individual enterprises. Moreover, the burden on smaller corporations will be unduly heavy. Such consequences should by all means be avoided. Corporations should be made to pay the tax to the same degree in which they would have to pay, were they individuals. The imposition of the tax burden being excessively heavy or light, simply because the taxpayer happens to be a corporation, should not be allowed.

(2) Since its very nature is a privilege given by the law, the corporation should be taxed more heavily than individuals. A corporation comes into existence through the special privilege of the law and the State is thus entitled to tax it heavily in return; at any rate, it is unjust to show a greater leniency to the corporation. But if corporate income is taxed proportionally, at least big corporations will be greatly favored. In order to avoid such a double privilege, the adoption of progressive taxation is necessary.

(B) Necessary precautions. As we have seen, there are many reasons in favor of the progressive taxation of corporate income, but there are some necessary precautions

we have to observe.

(a) From the standpoint of the ability principle :

(1) Lack of basis from the standpoint of consumption :—

As has been pointed out, corporations earn but do not consume. Therefore, there is no basis of progressive taxation from that standpoint, although there is a basis from the standpoint of their earning power. Because of this fact, it seems fair that some consideration should be given to the rate of progression for corporations.

(2) There is no necessary connection between the amounts of corporate incomes and that of the incomes of shareholders. As we have already pointed out, inasmuch as the income of corporations ultimately become the income of shareholders, it may happen that the income of big corporations go into the pockets of small earners instead of big earners ; and the income of small corporations may go into the pockets of big earners. Thus, progressive taxation on corporate income may not conform to the ability principle, which fact should entitle corporations to some favourable consideration in fixing the rate of their income tax.

(b) From social and economic policies :—We have already seen that there are arguments pro and con regarding the progressive taxation of corporate income from the standpoint of social policy. We have also seen that the argument in favour of progressive taxation has a greater force than the negative reasons. On the other hand, we must admit that the negative reasons from the standpoint of economic policy have a greater force than the affirmative argument from the same standpoint. Thus, we have to decide between the two alternatives : the affirmative reasons from the standpoint of social policy and the negative reasons from the standpoint of economic policy. We are inclined to believe that the question as to which we should choose largely depends on the national importance of the two at a particular time ; and that at present in our own country greater importance should be attached to the considerations of social policy. However, it is well to note the injurious effects of

progressive taxation on the economic world, and due consideration should, therefore, be given to corporations in order that the development of industry may not be impeded.

(c) From the standpoint of tax technique:—If the progressive tax is levied on the dividend only, corporations will reserve their income as much as possible in order to reduce the amount of their dividend in their hope to pay a lesser amount of tax. It is therefore necessary to tax the entire income of corporations.

PART II METHODS OF PROGRESSIVE TAXATION ON CORPORATE INCOME

We have set forth reasons for the progressive taxation of corporate income. Let us next consider what kind of method we should employ in the administration of such a tax. There are precedents of some methods employed both here and abroad. We shall take these and add to them other conceivable methods.

1. To tax the shareholders of corporations on their dividend. This is an indirect tax on corporate income. Such taxation may be truly regarded as part of the personal general income tax, and thus may be considered as outside of our present question. There are two different methods in this form of taxation.

(A) The entire dividend of shareholders are added together with their other incomes and a general income tax is imposed on their total lump sum. This method is seen in the general income tax or surtax on income in such countries as Great Britain, France, Italy, Austria and the United States.

(B) Some deduction is made from the dividend of shareholders before it is added to other incomes and a general income tax is levied on the combined amount. In Japan, the rate of deduction is 40 per cent. In Germany, a deduction of 10 per cent from dividend is made in the

income tax of individual taxpayers whose income is below 20,000 marks and whose income includes dividend by some limited corporation, the utmost amount being ten per cent of 5,000 marks.

2. Progressive taxation on the income of corporations themselves: There are various progressive taxes on the income of corporations themselves. An example of such taxes is found in the progressive tax on family companies which have as their purpose the evasion of the tax on Class C income. But there are the following other methods:

(A) Ordinary progression, or progression according to the amounts of corporate incomes:

(a) Such a progressive tax only may be levied on all corporations:—I am in favour of this system because of the reasons I have already presented.

(b) A basic proportional tax may be levied on all corporations alike and then in addition a surtax may be levied on some of them, or a degressive tax may be attached to the basic proportional tax. There are the following different forms of this scheme:

(1) A progressive surtax is levied on corporations with comparatively great earning powers. This system has the following two forms:

a. A progressive surtax according to the excess amounts of incomes is levied on corporations whose incomes are above some definite amount (say one million yen).

b. A progressive surtax according to the excess amounts of incomes is levied on corporations whose rates of profits is above some definite point (say seven per cent).

(2) Degressive taxation for corporations with comparatively small earning powers. This system is adopted in Germany, Austria and France, and it is attached to the basic proportional income tax. Here are found the germs of a progressive tax such as I am advocating. In Germany, the basic corporate income tax of 20 per cent is levied. In that country a progressive tax is levied on limited corporations having head offices within the country and whose paid

capital or asset does not exceed 50,000 marks each. The highest rate of this progressive tax is 30 per cent, but the tax is limited below 20 per cent of the whole income and in no case is higher than the proportional rate. In Austria, the general rate is 25 per cent, but different tax rates are adopted in the case of savings banks as follows: 10 per cent for those whose incomes are below 10,000 shillings; 17.5 per cent for those whose incomes rang between 10,000 shillings and 30,000 shillings; and 25 per cent for those whose incomes are above 30,000 shillings. Cooperative societies and building associations whose incomes are below 1,500 shillings are exempted from the income tax; an 8 per cent tax is levied on those whose incomes are between 1,500 and 3,000 shillings; and a ten per cent tax on those whose incomes are between 3,000 shillings and 4,500 shillings; and a 12 per cent tax on those whose incomes are above 4,500 shillings. The basic rate of the French business income tax (which is also levied on corporations) is 15 per cent. But this rate is applied to corporations whose income is above 50,000 francs. For the incomes below this amount, a degressive tax is levied, the lowest rate (for under 800 francs) being 2.81 per cent.

(B) Specific progression :

(a) Differential tax according to profit-rates :

(1) A simple progressive tax according to the profit-rates may be levied. Such an example may be found in the corporate income tax of the State of Wisconsin (adopted in 1911). The rates of this tax ranged between the minimum rate of $1/2$ per cent for profit-rates below one per cent and the maximum rate of 6 per cent for rates above 11 per cent.

(2) A progressive surtax according to profit-rates may be levied on corporations whose profit-rates exceed a certain fixed point (say 10 per cent), in addition to a basic proportional tax which is levied irrespective of differences in profit-rates or in addition to a basic progressive tax according to the amounts of incomes. Such a surtax is found in the case of our excess income tax which is levied on corporations

whose profit-rates are 10 per cent or more. Czechoslovakia also has such a tax. That country levies a basic special corporate income tax of 8 per cent and a surtax on stock companies, etc., in addition to the basic tax. The rates of the excess income tax in Czechoslovakia are as follows: 2 per cent for profit-rates between 6 and 8 per cent; 3 per cent for profit-rates between 8 and 10 per cent; 4 per cent for rates between 10 and 12 per cent; 5 per cent for rates between 12 and 14 per cent; and 6 per cent for all rates above 14 per cent.

(b) A differential tax according to the variety of business. Some kind of corporations may be levied at lower rate, for the sake of its national importance, than the others.

CONCLUSIONS

To summarise: the prevailing view is that unlike individual incomes, corporate incomes should be taxed proportionally rather than progressively, and the existing tax systems of most countries support the view. A closer scrutiny into the matter, however, reveals that there are many reasons in favour of progressive taxation of corporate incomes from the standpoint of the ability principle, social policy, and State revenue. These reasons are open to some doubts, it is true, but the objection is not powerful enough to overturn my contention. Such objection should be overcome and the present system of proportional taxation should be replaced by a progressive method. Nor are insurmountable difficulties involved in tax technique. Various methods of progressive taxation may be suggested, but the germs of such taxation can be found in the existing tax system of this country as well as those in several other countries. These germs should be given impetus for development. The adoption of a system of progressive taxation on corporate income is urgent in view of the existing necessity for finding new sources for State revenue.

MASAO KAMBE