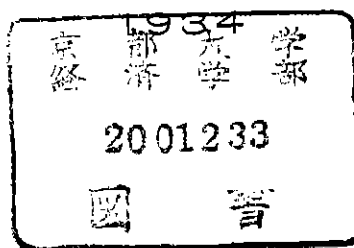


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ON PROGRESSIVE LUMP-SUM TAXATION ON INCOME

FOREWORD

The idea of progressive taxation has become a common-sense point of view in matters of taxation. It is in harmony with the prevailing sentiments of civilized countries, where it is believed in as a matter of course. Although it was at first adopted on theoretical grounds, it is now supported without reference to any particular reason. Legislators have been under the influence of the idea that progression is desirable and should be adopted in matters of taxation even though it involve in some cases certain sacrifices, and that all tax laws should be adjusted according to this principle. Because of this idea, by which people are influenced both consciously and unconsciously, there is increasing adoption of the system of progressive taxation in practical legislation. Nor is this idea limited to legislators. People in general have the same idea and the lawmakers, who serve and obey

the people, must respect their ideas and opinions. I myself have been under the influence of the same idea, but I have always feared that this blind reverence for progressive taxation might lead us into a deadlock, when we should be forced to re-examine its value.

Actual experience in progressive taxation shows that its application is accompanied by various difficulties. What is theoretically correct can not always be successfully carried out in actual practice. It is difficult to adopt a system that is fair and just to all. It is doubtful whether the efforts made in favour of progressive taxation have really been successful and effective or not. Although it was at first approved theoretically and has since been carried into practice very extensively, it has now become necessary to re-examine it, as it is full of irregularities and doubtful points. Of the various forms of progressive taxation, that which is adopted in the case of Class C income-tax in our country, viz., lump-sum progressive taxation on the income of natural persons, seems to be most appropriate and entitled to support. And yet even in this case the justice of the system is open to doubt. Although this does not mean, of course, that it should be given up immediately, it should, at any rate, be re-examined as it contains a number of obscurities and weaknesses. In the present article I shall attempt to make such a re-examination.

PART I

INJUSTICE OF PROGRESSIVE TAXATION ON PERSONAL LUMP-SUM INCOME

The injustice of progressive taxation in the case of personal lump-sum income is twofold. One is the injustice of progressive taxation in general, the other that of progressive taxation on personal lump-sum income in particular.

(I) *The injustice of progressive taxation in general.*
This can also be considered under three headings.

(A) *There is no fixed rule for deciding the rate of the tax, the highest and lowest rates of progression and the manner of movement between the two rates.* These are all decided by the arbitrary will of the lawmaker, and there is no certainty of justice. True, the arbitrary will of the lawmaker is seen also in the case of proportional taxation and is not by any means limited to progressive taxation; but in the case of a proportional tax, a natural tax-rate can be secured by taking the required amount of revenue from the tax and the tax object in question. No such a natural rate can be secured either for the highest or lowest or middle rate. It is, however, possible to fix the rates which move most naturally when the following are presupposed: the highest, lowest and turning points in formula tariff, especially curve formula tariff. At any rate, an element of arbitrariness inevitably enters into the selection of these highest, lowest and turning points.

(B) *The injustice arising from lapse of time.* The progressive tax rate which was just at the time the tax was first established may become unjust in the course of time and as a result of accompanying variations in the value of money. In the case of proportional taxation, which is an ad valorem tax, the right proportion between the two different times is not destroyed despite the changes of circumstances. Suppose the value of money has depreciated to one-tenth of its original value. Under progressive taxation, the same tax rate is applied and no new rate is adopted for the one-tenth value. As a result of this, a much heavier tax burden will now fall upon the taxpayer as compared with his burden before the money depreciated in value. On the other hand, his tax burden will be too light when the value of money has gone up, unless instead of maintaining a fixed rate, a certain amount of flexibility is observed. Such injustices are usually rectified and proper remedies are adopted when the monetary variations are very sharp. But no consideration is shown when the monetary variations are small, and thus the injustice continues to remain.

(C) *The injustice arising from local differences.* Tax legislation presupposes the identity of monetary value throughout the whole country, but in reality the value varies in different places. For this reason, if a progressive tax rate is based on the high prices and in consequence on the corresponding low value of money in some particular locality, such a tax rate will be found to be too low in other places, where monetary value is higher and commodity prices are correspondingly low. It is clear that higher tax rates should be adopted in the case of the latter localities. As a matter of fact, however, such considerations are not taken into account and the same tax rate prevails throughout the whole country. This undoubtedly bring about injustices. To these injustices is added that arising from monetary variations of a temporal nature, as already pointed out. For instance, some localities show much progress and their standard of living rises steadily, while in others a general stagnation has set in and the living standard is in retrogress. With the passing of time, the tax burden borne by these two kinds of localities will become disproportional; and the tax rate which is just for one will not necessarily be just for the other.

(II) *The inherent injustice of lump-sum taxation on income.* This injustice may take one of the following two forms: the injustice arising from peculiarities in the composition of an individual's income; and that which arises from differences in the conditions of individual taxpayers.

(A) *Peculiarities in the composition of an individual's income.* It is needless to state that, in order to have significance, all the numbers of a given sum must be constituted of the same element. If the constituents are different, they should be converted into a common element by means of a common standard. Moreover, the composing elements should be real quantitatively, and should be neither too large nor too small. But inasmuch as it is doubtful whether all the composing elements of income are real quantitatively and of the same quality or, if not, have been converted into

something common, a lump-sum made up of different components is meaningless, and differentiated taxation on such a lump-sum becomes very uncertain.

(a) Injustice arising from the quantitative unreality of the components of income. When differentiation is made on the lump-sums of individual incomes, all the components making up these sums must be quantitatively shown. Unless these components are all declared without a single exception and in their real amounts, differentiation becomes quite meaningless. Quantitative unrealities are due in a certain measure to the classes of income being different or to defects and shortcomings in legislation, but chiefly to the low moral standard of taxpayers, who endeavour as much as possible to avoid paying taxes. In some cases, taxpayers are prompted to evade taxes not so much by their low moral standard as by their dissatisfaction at some injustice in the tax system or some injustice of a political nature. Some taxpayer evade taxes from the standpoint of liberalism, which is opposed to undue interference on the part of the State. It also happens that taxpayer sometimes make incorrect reports to the revenue office because of some defects in their book-keeping or difficulty in calculation, and not because of any desire to make a false report.

1. Injustice arising from differences in the degree of reaching and calculating different incomes. The difficulty of reaching and calculating different incomes is not the same in all cases. It is easy to reach and calculate the salaries of government officials, but loans between private citizens and certain business incomes are very difficult to reach and calculate. But the lump-sum taxation of income fails to take all this into consideration. Injustice arises from treating all incomes in the same way.

2. Injustice arising from differences in the methods of calculation adopted. (a) Income tax usually is levied on net income. In other words, deduction is made of the cost of deriving gross income and the remainder is taken as the basis for taxation. But our income tax laws make no such

deduction in the case of earned income, which is taxed on its entire amount, although in the case of business income a considerable deduction is made on account of cost. This deduction is not based on actual figures but is more or less conjectural. Thus, there is bound to be a certain discrepancy between the actual cost and the amount deducted, and this discrepancy will be different in different business incomes. It is not difficult to see that injustice may easily arise from this state of affairs. (b) The amount of income may be calculated either by taking actual figures or by estimation (by taking the average, for instance). In some countries, external indications are made the basis of calculation. In our country, some incomes are computed by taking actual figures, while others are estimated. This double standard of computation may lead to various unfairnesses.

3. Injustice arising from evasion on the part of taxpayers.

a. There can be an income which either in entirely or in part is not reported to the revenue office, so that some of the lump-sum incomes are real while others are not. The imposition of a differentiated tax on income, therefore, would mean excessively light taxation not only of the class of income, part of which is evaded, but also of the class of income which is reported truthfully. Such neglect to report and such evasion are comparatively easy in business income, but the same thing can happen to a considerable degree in the case of the tax on corporate income and capital interest also, if the tax is levied on the lump-sum income as reported by the taxpayer instead of being imposed by stoppage-at-the-source. The tax on the interest on loans between private individuals is levied on their lump-sums. Evasion must be very great in the case of this tax because interest on personal loans is very difficult to reach. In the case of such a tax, there are various degrees of uncertainty with different incomes, and this results in injustices.

b. Use of assumed names by taxpayers makes the taxation of lump-sum income meaningless. In other words,

a person's lump-sum income may be much smaller than the real sum of his income and he will have to pay less than he would otherwise pay. True, a comparatively higher tax is levied on the incomes of persons who make use of assumed names, but their tax burden is much lighter than under the ordinary circumstances, when each taxpayer shoulders the tax burden for his own income. Thus, use of assumed names proves detrimental to the State treasury. This injustice is liable to occur in connection with the taxation of property and business, rarely with earned income.

c. Objectionable practices born of the special features of our tax system.

i. To select a particular class of income on which no tax is actually levied. For instance, no income tax is levied on the income from investment in government bonds. Suppose a millionaire invests his entire fortune in government bonds, his vast income therefrom will be free from income tax. If a person derives the greater portion of his income from government bonds, the tax rate on his other classes of income is smaller than the rate which would be levied if the income from his government bonds were added to make a perfect sum. A similar injustice arises also from investment in unutilized lands, in curios or land for private purposes, so far as income tax is concerned.

ii. To select stoppage-at-the-source income. In this way, the lump-sum income is made smaller than the real amount and thus the lump-sum system of taxation is undermined. The earners of small incomes may be taxed more heavily under the stoppage-at-the-source system than under the lump-sum system; but the earners of big incomes are taxed comparatively lightly because their stoppage-at-the-source income such as interest on local government bonds, debentures and bank deposits, etc. is excluded from the lump-sum income and the remainder is taxed progressively. In such cases, a tax rate much lower than it would be under the system of entire lump-sum income is levied.

iii. To select the class of income which is entitled to

special rebate while being subject to lump-sum taxation. Such an example may be found in the case of our income tax on dividends on shares, which are entitled to rebate of 40 per cent. Because of this system, a person who derives a large portion of his income from this source is taxed much less than in those cases where no such deduction is made. Such a deduction may be justified to some extent when a person has incurred debts in order to buy his shares, because his income from the shares will be reduced by the payment of interest on his debts, although there is no assurance whatever that a 40 per cent deduction will exactly or even approximately cover such interest. But when a person has no such debts and has purchased shares in virtue of his own independent economic power, his taxable income is estimated at a much less amount than it actually is, because of this 40 per cent deduction for income from shares. Both his income from shares and his income from other sources are taxed unjustifiably lightly.

d. Reports of excessive amounts. It rarely happens that taxpayers report either intentionally or by error their incomes as being greater than they actually are, and in consequence are taxed more heavily than they should be. Such cases benefit the State treasury, but nevertheless constitute an injustice in taxation.

(b) Injustice arising from differences in quality among different classes of income.

1. Injustice arising from differences in quality among different classes of income makes the differentiated taxation of lump-sums very irregular. Each lump-sum of income may be quantitatively correct, but lump-sum taxation will lose its meaning if the different classes of income are not of the same kind or quality. In reality, however, the different classes of income have different qualities and therefore varying capacities. But the income tax law ignores such differences and, in principle, regards all classes of income as being the same in quality. The existence of a difference in capacity between property income and earned

income is universally recognized. To be more precise, there are also differences of quality within property income as well as within earned income, and therefore there are varying degrees of capacity among these different classes of income. Property income may be derived from land, house property, loans, shares, debentures, or government bonds, all of which have different qualities. Moreover, income from unsecured loans is quite different in quality from income derived from loans against security. Again, income from farm land where there is tenancy trouble is not the same as income derived from other farm land having no such tenancy trouble. Income from the shares of an establishment enjoying undisputed public confidence such as the Bank of Japan is different from income from the shares of some newly established corporation of doubtful credit standing. There exist countless degrees of security between these two extreme cases. Business income will vary greatly accordingly as considered from the view-point of the proportion between property and earning or from that of business risks. Earned income also varies considerably: it may be the income of government officials or of employees in some public institution. The income of employees in great companies is different from that of employees in small companies. The income of workers in continuous employment is different from that of day labourers. Nor is it possible to estimate all these differences when the taxassessment. The present system of taxation allows a rebate of 20 to 10 per cent for earned income, thereby discriminating between earned income and other forms of income, but the system is hardly precise enough to assure justice. Thus, in the light of the foregoing discussion lump-sum taxation of different classes of income is meaningless.

2. Injustice arising from changes in time and place. It is easy enough to calculate the lump-sum of a person's income during any single year, if the question of variations in monetary value is left out of consideration. As a matter of fact, however, his income at the beginning of any given

year will be different in value from that which he receives in the middle or at the end of the same year. But the income tax law does not usually take such variations in monetary value into consideration, and takes lump-sums at their face value. But this is taking two different things as being the same and is therefore absurd. Moreover, the value of money may differ according to the place and a person may secure income from different places. Now, if he spends his income in some fixed locality, differences in monetary value are no source of injustice, but if he spends his income in the different places where he derives it, the monetary differences in question must be given due consideration by the State, if justice is to be done.

(B) *Injustice existing among the lump-sums of different individuals.*

(a) Arising from the different qualities of the internal components of lump-sums. This is also seen in the case of the lump-sums of different individuals. Suppose a person's income belongs, say, to Class A income while another person's income belongs to Class B income. If the one's income is obtained in the early part of the year, while the other's income comes in the latter part of the same year, injustice for the one is at the sametime injustice for the other.

(b) Injustice arising from other sources.

1. Differences in monetary value in different localities. If A and B have the same amount of money, but live in localities where the value of money is different, they cannot really be said to have an equal amount of value. Inasmuch as the value of money in A's place is higher and prices are lower than in B's place, a higher progressive tax rate should be applied to A's income, if fairness is to be assured in both cases. But in practice no such consideration is given and the same rate is unjustly applied. On the other hand, it is very difficult to arrive at a differentiated rates for the two cases. Between these two extremes there exists an infinite series of variations which makes exact calculation

almost impossible.

2. Difference in estimation according to individuals. To be more exact, the same amount of income ought to be estimated differently for different individuals. Estimation would depend upon the individual's social position, vocation, customs, habits and moral training. In other words, a differentiated tax should be applied to different individuals with the same income. Failure to discriminate between different individuals cannot but entail injustice. However, one may say that it is impossible for lawmakers to provide for such differentiation and that it is not worth while to make any attempt to do so. One may again point to the fact that the absence of such differentiation is true of proportional taxation also and is not limited to progressive taxation. Although the practical difficulties are great, the absence of differentiation is a source of injustice.

3. Injustice arising from differences of proportion which investment bears to the total amount of income among different individuals. Progressive lump-sum taxation on income presupposes a greater possibility of satisfying personal desires on the part of earners of greater amounts of income. In other words, the greater a person's income, the greater is the proportion of his income available for satisfying his personal wants; and, inasmuch as daily necessities are limited to a comparatively small amount, the proportion between the amount of his income available for personal luxury and the total amount of his income is correspondingly greater. As this idea is presupposed by progressive lump-sum taxation on income, it is thought that justice can be secured by imposing a heavier tax on a greater income. But this totally ignores the fact that a fair portion of the income may be used for the purposes of investment, and as a matter of fact, all persons invest more or less out of their income. A person feels a greater pain in having to pay income tax out of this portion of his income than in paying the same tax out of the portion set aside for luxury purposes. At any rate, he is entitled to an rebate if he has invested

a portion of his income. This consideration is necessary not only because of the pain he suffers but also because it is in agreement with the economic policy of encouraging investment. A person who secures a mere subsistence income is compelled to spend the entire amount for living, and as his income increases his expenditure on luxuries will increase correspondingly. So far progressive taxation on income seems to be quite justified, but there is another fact to be observed. The progressive rate of increase for expenditure on luxuries does not hold good in the case of persons whose incomes are exceptionally large. In the case of persons who secure moderate or large incomes, it is the proportion which investment bears to their total income that increases rather than their expenses for luxuries becoming greater. In the case of persons who secure exceptionally large incomes, the greater portion can be, and often is, invested. In virtue of the above considerations, it would be unjust to earners of such incomes to tax them progressively, although the tax usually proves just in the case of earners of small or moderate incomes. For this reason, the ideal system would be to tax small or medium-sized incomes progressively, but the upward trend of progression when going from medium-sized incomes to large incomes should be tempered to some extent, in order to assure justice to their earners. In short, a progressive curve formula may be adopted with the utmost advantage. But our income tax system provides only straight progressive rates from 0.8 per cent to 36 per cent, and is far removed from the ideal system we have had in mind. Under these circumstances it cannot be said to be just. Nor is there any certainty of justice even if a progressive system such as I have outlined were to be adopted, on account of the various difficulties that exist. First, the proportion between the amount of investment and the total income shows infinite variations among different persons. Different persons getting the same amount of income do not invest in the same proportion. Earners of small incomes may invest in

a greater proportion than those of large incomes. Earners of large incomes may not always make a proportionally large investment. In fact, some of them may spend the whole of their large incomes for wasteful purposes. Because of these reasons, even an ideal progressive system, when actually applied, may not be precisely just.

PART II

ADMINISTRATIVE AND ECONOMIC WEAKNESSES OF PROGRESSIVE LUMP-SUM TAXATION

Although the imposition and collection of all taxes are accompanied by many difficulties, some of which are quite unavoidable, lump-sum taxation is exposed to greater difficulties than the stoppage-at-source system. Lump-sum taxation suffers not only the difficulty of assuring justice (as above stated), but also from certain administrative and economic weaknesses.

(I) Administrative weaknesses.

(A) *The difficulty of reaching incomes.* The assessment of lump-sum income is attended by various difficulties. (a) It meets with moral difficulty, for although some people believe that mankind has improved in moral conduct with the progress of culture and education, the trend seems to be just in the opposite direction. Progress in culture may mean educational advancement, but at the same time it tends to stimulate the spirit of self-interest in individuals through the extension of their economic knowledge and the awakening of their economic consciousness. (b) Although the custom of book-keeping for domestic purposes has developed with the progress of education, thereby facilitating the application of lump-sum taxation, it is far from being precise enough for this purpose, and is still in a state of imperfection. (c) But the greatest difficulty in taxing incomes in lump-sums is due to the change which has taken place in the methods of investment and industrial enterprise. Formerly, both investment and industrial enterprise were

undertaken by individuals in person and it was then easy to ascertain a person's investments and industrial undertakings. But at present, the employment of capital and the management of enterprises are carried out by impersonal organizations such as banks, corporations, associations, etc. True, it is possible to determine to a certain extent the distribution of income from such corporate investments and enterprises through the government inspection of the administration of these organizations. But in our country, taxation laws are very leniently disposed towards such corporations and they are not supervised to any great extent. The idea is held by our lawmakers that such supervision of the internal affairs of financial or business organizations would be tantamount to interference with their management. There is a measure of truth in this notion. Again, the investment may take the form of national bonds, local government bonds, debentures or certificates, all of which are uninscribed and can therefore be transferred from person to person and from place to place, not only within the country but also between different countries. For this reason, it is extremely difficult to ascertain their location or their owners. Moreover, it would be a task of insuperable difficulty to compute the income from these even when they had been reached. It would be easier to reach the income from such sources by the stoppage-at-source system, although this would not be entirely satisfactory. At any rate, it is extremely difficult to reach individuals' incomes from such corporate and uninscribed sources in lump-sums.

(B) *Cost of collection enormous.* In spite of the difficulties above pointed out, progressive lump-sum taxation of income is possible if it is carried out in a through-going manner. If proper inspection were made of the internal conditions of banks and corporations as well as those of individual taxpayers, the collection of such a tax would not be impossible. But it would involve enormous cost both for the State and for the corporations.

(II) *Economic and other disadvantages.* Lump-sum taxa-

tion is troublesome not only to the revenue officers but also to the taxpayers, whose internal conditions are searched into more or less severely. The taxpayers have the uncomfortable feeling of being watched with suspicion by the officials of the revenue office. All this cannot but result in great disadvantages for the people as well as for the nation as a whole.

CONCLUSION

To summarise : progressive lump-sum taxation on income is universally recognized as a matter of primary importance for assuring justice in taxation. It is entitled on the whole to the reverence it receives. A closer scrutiny of the system, however, reveals a considerable number of undesirable elements. Its attempts at justice are often defeated. The system has administrative and economic disadvantages of no mean importance, which greatly detract from its value. The possibility of its fundamental reconstruction may be doubted and cannot hastily be settled. But its defects and disadvantages must be admitted. It should be carefully noted that in the present income tax system the influential factor is the individual's objective position, and that his subjective being is not the one decisive factor.

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