TO:

Hon. Marriner Eccles

Pursuant to telephone conversation with Mr. Paul this morning.

From: MR. PAUL

The Ruml Plan

1. The plan

The plan presented by Beardsley Ruml before the Senate Finance Committee contemplates that each year the individual would pay (a) a tentative tax computed on the basis of the preceding year's income, plus or minus (b) the difference between his actual liability for the preceding year and the tentative tax paid in that year. Item (a) would be payable in instalments as at present; item (b), if positive, i.e., if a deficiency, would be payable in one lump sum on March 15. In order to get the system started, liabilities on 1941 incomes would be cancelled, and the return filed in March, 1942, would be considered a computation of a tentative tax on 1942 income.

For example, on March 15, 1943 an individual would compute his tax liability on 1942 income at the new higher rates enacted in this bill. Suppose this turned out to be $1,000. Although exactly equal to the tax liability payable under present law, this amount is interpreted differently, being treated as a tentative tax on 1943 income rather than as an ultimate liability on 1942 income - it is item (a) above, and is payable in four equal instalments in 1943. Second, the individual would compute his tax liability on 1942 income at existing rates and exemptions. This would be his ultimate tax liability for 1942 income, say, $525. Against this amount, the individual would credit the taxes actually paid in 1942, say $400. (This assumes a lower income in 1941 than in 1942). The difference, or $125 would be the deficiency payable in one lump sum on March 15, 1943. The total amount payable would therefore be $1,125. To summarize:

Tentative tax on 1943 income		$1,000
Final tax on 1942 income	$525	
Tentative tax paid on 1942 income	400	
Deficiency payable on March 15, 1943		125
Total payable in 1943		$1,125

It is clear from this example that 1941 income drops out of the picture, involving a cancellation of 1941 liabilities. The actual tax paid on 1941 income is treated as a prepayment of 1942 tax liabilities. It is also clear that the application of the higher rates is postponed to 1943 income since the final 1942 liabilities are computed at the lower rates.

Essentially the same procedure is followed in future years. In 1944, for example, the amount payable would be equal to:

> Liability on 1943 income at 1944 rates,
> plus liability on 1943 income at 1943 rates,
> minus liability on 1942 income at 1943 rates.

Mr. Ruml proposes a special relief provision for persons whose income <u>from personal services</u> fluctuates. Taxpayers whose income from personal services decreases would be permitted, upon proper certification, to compute their tentative tax on the basis of the lower income rather than the income of the preceding year. Similarly, taxpayers whose income from personal services rises would be permitted to compute their tentative tax on the higher income. This special treatment is not to be accorded income from property, although ordinarily income from property is probably more variable than income from personal services.

Mr. Ruml points out that collection at source can be incorporated into his plan. However, he has not outlined any specific procedure for doing so. This memorandum will therefore first consider the plan without taking into account collection at source.

2. <u>Critique of the Ruml plan, without collection at source</u>

a. <u>Effect on the taxpayer</u>

There are two related objectives that the title "pay-as-you-go" seems to imply: (a) keeping the taxpayer out of debt to the Government, (b) synchronizing the payment of taxes and the receipt of income.

The Ruml plan in large measure accomplishes the first of these objectives; without collection at source and without the special relief provision for taxpayers with fluctuating income from personal services, it accomplishes the second objective hardly at all. In addition, it increases the burden on the taxpayer in filling out his return.

i). <u>Keeping the taxpayer out of debt to the Government</u>

The Ruml plan would accomplish this objective entirely, at least in a bookkeeping sense, for all individuals whose incomes were unchanged or declined from one year to the next; and would accomplish it very largely for individuals whose income rose. At the end of 1942, the individual whose 1942 income was the same as in 1941, would have all his liabilities paid up. True, he would still be obligated to pay the same amount in 1943 as at present. But if his income in 1943 were small or negligible, he would not be parting completely from his money; rather he would be lending it to the Government, engaging, as it were, in compulsory saving or in the compulsory purchase of a tax anticipation note. He would be building up an asset on which he presumably could borrow, an asset that would be redeemed in 1944. True, also, he would be required to engage in compulsory saving when he could least afford it, i.e., when his income had declined sharply; but this is certainly better than making him pay taxes that he will never get back.

The individual whose income has risen from 1941 to 1942 will not be entirely out of debt to the Government, but his debt will be only a fraction of what it is at present, since it would be equal solely to the excess of 1942 liabilities over the tentative tax paid in 1942.

ii) Synchronizing tax payments with receipt of income

The Ruml plan without collection at source and without the special relief provision admittedly does not involve the collection of liabilities simultaneously with the receipt of income. The tax payable in 1945, for example, would depend not at all on actual income in 1945, but solely on income in 1944 and the change in income from 1943 to 1944; i.e., actual tax payments in any year under the Ruml plan depend on the income history during the preceding two years.

Indeed, for persons with fluctuating incomes, the plan would make the payment problem worse rather than better. This is indicated by the following example, which assumes unchanged tax rates:

Year	Tax liabilities	Tax payment: Present method	Tax payment: Ruml plan
1942	$10,000		
1943	15,000	$10,000	
1944	10,000	15,000	$20,000
1945	15,000	10,000	5,000
1946	10,000	15,000	20,000

In a year following an abnormally good year, the amount to be paid is high because, as at present, the tentative tax is figured on the preceding year's high income and, in addition, because there is substantial deficiency payment on the preceding year's income. Conversely, in a year following an abnormally bad year, the amount to be paid is low because the tentative tax is figured on a low income and because a tax credit is due for the preceding year.

In general, in any year following an increase in income, an individual would pay more than one year's tax liability since he would have to pay not only his tentative tax for the current year but also a deficiency on the previous year's income. Similarly, in any year following an increase in national income (as, for example, 1943), taxpayers as a group would have to pay more than one year's tax liability.

The special relief provision suggested by Mr. Ruml is not an adequate solution to the lack of synchronization of tax payments with the receipt of income. In the first place, it would apply only to income from personal services. For administrative reasons, it could not be extended to income from property, and, indeed, might have to be restricted even further to wages and salaries alone. Yet business income and income from property are typically far more variable than income from wages and salaries. In the second place, the provision would be optional, not mandatory. Consequently, it would tend to be invoked only when income decreased, although the need for synchronization is at least as great when income increases. In the third place, even if restricted to wages and salaries, the provision would involve serious administrative difficulties. Information returns are now received from employers only for wages and salaries during the preceding year. To check individual declarations of reduced wages and salaries would require information returns for a year ahead. It is dubious whether the gain from the relief provision would be worth the administrative cost, except possibly for persons who go into military service. For these persons, the administrative problem is least, and the need for relief greatest.

From the point of view of an adequate and flexible fiscal policy for war-time, the lack of synchronization of tax payments with receipt of income would be a fatal defect. At present, neither a change in tax rates nor a change in national income affects tax collections until March of the following year. Further, present methods of collection—self-assessment and quarterly instalment payments—are completely inadequate for an income tax with higher rates applicable to some 30 million persons. Such a tax requires methods of collection adapted to the needs of the masses of the people accustomed to budgeting in terms of weeks or months rather than quarters or years. The major problem of income tax reform is to remove these defects, which prevent the income tax from playing as large a role as it should play in the financing of the war.

iii) <u>Burden on taxpayer in filling out his return</u>

Under the Ruml plan, the taxpayer will in March of each year have to compute (a) the tax on the income of the preceding year at the rates, exemptions, and definition of taxable income applicable to the current year; (b) the tax on the income of the preceding year at the rates, exemptions, and definition of taxable income applicable to the preceding year. Item (a) is the tentative tax for the current year; item (b) is his actual liability for the preceding year. This double computation raises no problem if rates, exemptions, and the definition of taxable income do not change, since (a) and (b) would then be the same. It does, however, seriously complicate the computation of the tax if any of these items changes, involving in essence the preparation of two tax returns instead of one.

b. Shifts in the tax burden under the Ruml plan

The cancellation of 1941 liabilities would have no effect on the taxes paid by persons with stable incomes until incomes ceased because of death or retirement. At that time, one year's tax payments would be eliminated. This shifts part of the total tax burden from individuals who are now taxpayers to persons who newly become taxpayers. The latter will pay a tax for all years during which they receive income; the former for all but one year.

The cancellation of the 1941 liabilities would constitute a windfall gain to persons whose incomes were abnormally high in 1941 and a relative loss to persons whose incomes were abnormally low in 1941. This feature is particularly undesirable since abnormally high incomes in 1941 in many cases resulted from the war effort. True, in some cases the decline in income from 1941 to 1942 may reflect a shift into wartime activities that might well have deserved special treatment. However, the Ruml plan would confer relief only after the need for it had passed since such persons will already have arranged to pay their taxes on 1941 income. Moreover, many, and probably most, of the declines in income were not associated with such a shift from peace-time to war-time activity.

Since the Ruml plan delays the application of the higher rates in H.R. 7378 until 1943 (in March of which year the taxpayer pays at the new rates on estimated 1943 income) it also provides a windfall gain to persons with abnormally high income in both 1941 and 1942. Their 1941 liabilities would be cancelled, and their 1942 liabilities would be at the present lower rates, whereas under present methods of taxation, the new higher rates would apply to 1942 income.

c. Effects on demand for consumer goods

Actual collections during 1943 under the Ruml plan (with rates as in H.R. 7378) would be approximately $9 billion, or $1 billion larger than under H.R. 7378 (disregarding collection at source), the extra billion dollars arising from the aggregate deficiency payable on 1942 income. Despite these larger collections, the Ruml plan would probably be less effective than H.R. 7378, even in the absence of collection at source in withdrawing purchasing power from the market for consumer goods. The reason for this is that persons who had accrued funds during 1942 to pay their 1942 tax liabilities in 1943 would be able to pay the tentative tax on 1943 income from such funds and would be under no compulsion to accrue the 1944 tax during 1943.

In order to offset the extra billion dollars that would be collected under the Ruml plan, only 1/8 of the $8 billion liability under the rates of H.R. 7378 would have to be accrued. While the amount actually accrued is not known, it seems likely that considerably more than 1/8 would be accrued. Consequently, the Ruml plan, even though it yielded more revenue, would be less effective than H.R. 7378 without collection at source, in withdrawing purchasing power from the market for consumer goods.

3. <u>The introduction of collection at source into the Ruml plan</u>

a. <u>Method</u>

The Ruml plan could be linked with collection at source at a rate of 19 percent, the combined normal tax and first bracket surtax rate under H.R. 7378. Since the tentative tax as computed in (say) March, 1943, would be considered a tax on 1943 income, the taxpayer could be required to pay in quarterly instalments only that part of the tax that would not be collected at source. This could be done in either of two ways:

(1) In computing his tentative 1943 tax on the basis of his 1942 income, the taxpayer could be given a credit equal to 19 percent of the excess of his <u>1942</u> income subject to collection at source (wages and salaries, bond interest, and dividends) over his personal exemption and dependent credit. That is, he could make a <u>tentative</u> estimate of the amount to be withheld during 1943 on the basis of his receipts during 1942 from sources subject to withholding, in the same way as he makes a tentative estimate of his 1943 tax.

(2) The taxpayer could credit against each quarterly instalment payable in 1943 the amount actually collected at source in the preceding three months (or for the first quarterly instalment, the preceding two months). That is, against his March instalment, he would offset the amount collected at source in January and February; against his June instalment, the amount collected at source in March, April, and May; etc.

Alternative (1) seems distinctly the better. Alternative (2) would involve greater administrative complexity 1/; would deny an offset to individuals who wished to pay the tax in one lump sum; and would offset amounts withheld from <u>1943</u> income against a tentative tax computed on the basis of <u>1942</u> income. Consequently, in what follows, we shall assume that alternative (1) would be adopted.

1/ The administrative problems would arise because of the need to give employees receipts or information slips every two or three months, and because of the timing problem raised by the necessity of having receipts within 15 days after the close of the month.

b. Effect

Linking the Ruml plan with collection at source would go a long way toward synchronizing tax payments with receipt of income, accomplishing this objective entirely for the first bracket rate and for sources of income subject to withholding. At the rates included in H.R. 7378 and at 1942 levels of business, a 19 percent withholding rate would mean collecting at source almost $5 billion out of total liabilities of $8 billion, or more than 60 percent of total liabilities.

The introduction of collection at source into the Ruml plan would largely remove one of the chief defects noted above. It would permit changes in tax rates and changes in national income to be reflected in tax collections immediately, and would adapt the income tax to the needs of the large group of small income recipients who budget on a weekly or monthly basis. The Ruml plan deserves serious consideration as a wartime reform of the income tax only if it is thus linked with collection at source.

4. Other possible modifications in the Ruml plan

As noted above, one of the chief remaining defects of the Ruml plan is that the cancellation of 1941 tax liabilities would constitute a windfall gain to persons whose incomes were abnormally high in 1941 and a relative loss to persons whose incomes were abnormally low in 1941; the postponement of the application of the higher rates to 1943 income would lead to similar though less serious effects for 1942. Two possible modifications in the Ruml plan that would mitigate this defect are suggested below.

a. Cancellation of either 1941 or 1942 liabilities

One possible modification of the Ruml plan would be to cancel either the taxpayer's 1941 liability or his 1942 liability, whichever is smaller. When the individual filed his return in March 1943, he would compute the tax on 1942 income under rates and exemptions in the present law. If this tax were higher than the tax he computed in March, 1942, on the basis of 1941 income, he would be required to pay the difference. But if the tax on 1942 income were lower than the tax on 1941 income, he would not be given a credit or a refund. Instead, the tax computed on 1941 income would be treated as the tax due. Even with this modification, windfall gains would be realized by persons with abnormally high incomes in both 1941 and 1942. This, too, is undesirable since many persons profiting from the war will be in this situation.

b. Cancellation of part of 1942 liabilities

Another possible modification in the Ruml plan would be to cancel only part of 1942 liabilities computed under existing law. The part cancelled would be the normal tax and the first bracket of surtax, and the balance of the tax would be payable in two years. The advantage of this procedure would be that no taxpayer would be relieved of liability under the progressive part of the rate structure. A person with abnormally high income in 1942 would still receive a windfall gain, but this gain would only be the flat rate part of the total tax, and the gain would not be progressively larger the higher the income. Details of the plan are as follows:

i). Taxes payable in 1943:

(a). Tentative tax for 1943. In March, 1943 the taxpayer would compute his tentative 1943 tax at the proposed rates and exemptions on the basis of his 1942 income.

(b). Credit for collection at source. Against this tentative tax, the taxpayer would credit 19 percent of the excess of his 1942 income from wages and salaries, bond interest, and dividends over the personal exemption and credit for dependents. This represents a tentative estimate of the amount to be withheld during 1943. Like the tentative tax, it is based on 1942 experience. The balance of item (a) would be paid in quarterly instalments as at present.

(c). Collection at source. During all of 1943, the taxpayer would be subject to collection at source from wages and salaries, bond interest, and dividends at a rate of 19 percent, the combined normal and first bracket surtax rate.

(d). Settlement of 1942 liabilities. On his March 15, 1943 return, the individual would be required to compute a tax on his 1942 income under existing law provisions, except that the normal tax and first bracket surtax rate would be omitted; i.e., he would compute his tax using a rate schedule identical with the existing law surtax schedule except that the initial 6 percent rate would be replaced by zero, and all other surtax rates would be reduced by 6 percent. This computation would, therefore, be required only for individuals with more than $2,000 surtax net income in 1942. Individuals with low incomes would in effect have their 1942 liabilities cancelled. The 1942 liabilities computed in this way would be payable in instalments during 1943 and 1944.

ii). Taxes payable in 1944 and later years

Except for the balance of 1942 tax due from persons in the upper income groups, the original Ruml plan will govern tax payment in 1944 and later years, the procedure being integrated, of course, with collection at source.

5. <u>Revenue effect of alternative plans</u>

Estimates of aggregate collections from the individual income tax for calendar 1943 and hypothetical calendar years 1944 and 1945 are summarized in the following table for (a) H.R. 7378, (b) unmodified Ruml plan without collection at source, (c) a modified Ruml plan with collection at source at a 19 percent rate and with the cancellation of part of 1942 liabilities. (See section 4 (b) above). While the figures for 1943 are based on an estimated level of income for 1943, those for 1944 and 1945 were derived by assuming that the level of income would be the same as in 1943. The figures include the total amount withheld from taxpayers at source, even though some of it would not yet have been turned over to the Bureau of Internal Revenue by the withholding agents.

Calendar year	Aggregate collections		
	H.R. 7378	Unmodified Ruml plan	Modified Ruml plan
	(a)	(b)	(c)
1943	9.4	9.0	9.8
1944	10.4	10.0	10.8
1945	9.0	9.0	9.0
Total	28.8	28.0	29.6

The following table subdivides these estimates into the amount payable in quarterly instalments, the amount collected at source, the deficiency between the final and tentative tax, and the adjustment for uncancelled 1942 tax liabilities.

Calendar year	Amount payable in quarterly instalments	Amount collected at source	Deficiency	Adjustment for 1942 taxes	Total
		(a) H.R. 7378			
1943	8.0	1.4	—	—	9.4
1944	7.6	2.8	—	—	10.4
1945	6.2	2.8	—	—	9.0
		(b) Unmodified Ruml plan			
1943	8.0	—	1.0	—	9.0
1944	9.0	—	1.0	—	10.0
1945	9.0	—	—	—	9.0
		(c) Modified Ruml plan			
1943	3.2	5.3	—	1.3	9.8
1944	3.7	5.3	0.5	1.3	10.8
1945	3.7	5.3	—	—	9.0

For the three years combined, the unmodified Ruml plan yields least. The modified Ruml plan yields $.8 billion more than H. R. 7378. However, so far as its effect on the withdrawal of purchasing power from the market for consumer goods is concerned, this extra revenue is more than offset by two other factors. In the first place, the modified Ruml plan involves the cancellation of approximately $2.4 billion of tax liabilities. Accruals on account of these liabilities would probably considerably exceed the $.8 billion extra collections.

In the second place, the amounts collected in each year in excess of a single year's liabilities come from very different income groups. Under H. R. 7378 this amount comes from the 5 percent collection at source and hence from all income groups. Under the modified Ruml plan, it comes from the uncancelled part of 1942 liabilities, and hence predominantly from the upper income groups since the lower income groups have the bulk of their 1942 liabilities cancelled. Consequently, the extra amounts collected under H. R. 7378 would be much more effective, dollar for dollar, in reducing demand for consumer goods than the extra amounts collected under the modified Ruml plan.

6. <u>Conclusions</u>

(a) The Ruml plan without collection at source in large measure accomplishes the objective of keeping the taxpayer out of debt to the Government.

(b) The Ruml plan without collection at source does not synchronize tax payments with the receipt of income. Indeed, in some cases it may make the payment problem worse than under the present law. Actual tax payments in any year depend on the income history during the <u>preceding</u> two years.

(c) The Ruml plan does not eliminate the payment of more than one year's taxes in calendar 1943. The deficiency payments on 1942 income due in March 1943, are quantitatively almost as large as the amount that would be withheld under the 5 percent collection at source provided for in H. R. 7378. The additional payments would, however, be made by different persons.

(d) The cancellation of 1941 liabilities provided for by the Ruml plan would confer a windfall gain on persons with abnormally high incomes in 1941.

(e) The cancellation of one year's liabilities would shift part of the long-run tax burden from persons who are now taxpayers to persons who newly become taxpayers.

(f) The Ruml plan deserves serious consideration as a wartime reform of the income tax only if it is linked with collection at source at a rate equal to the combined normal and first bracket surtax rate, since this is the only way that tax payments can be synchronized with the receipt of income.

(g) The inequities arising from the cancellation of 1941 tax liabilities can be mitigated, though not eliminated, by cancelling either 1941 or 1942 liabilities, whichever is smaller, or by cancelling only a part of 1942 tax liabilities equal to the normal tax plus the first bracket of surtax.

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