

STRICTLY CONFIDENTIAL

**Comments on the Ruml pay-as-you-go plan
for the individual income tax**

The plan presented by Beardaley Ruml before the Senate Finance Committee 1/ 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 income would be cancelled, and the return filed in March, 1942, would be considered a computation of a tentative tax on 1942 income.

Mr. Ruml proposes a special relief provision for persons whose income from personal services 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.

1. The introduction of collection at source into the Ruml plan

The Ruml plan could be linked with collection at source from wages and salaries, bond interest, and dividends at a rate of 19 percent, the combined normal tax and first bracket surtax rate under H.R. 7376. Since the tentative tax as computed in (say) March, 1943, would be intended as a tax on 1943 income, the taxpayer could be given a credit for collection at source against the amount payable in quarterly instalments corresponding to the amount to be collected at source. This could be done in either of two ways:

(a) 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 1942 wages and salaries, bond interest, and dividends over his personal exemption and dependent credit. That is, he could make a tentative estimate of the amount to be withheld 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.

1/ This plan is substantially the same as the plan previously presented to the Treasury by Mr. Ruml. The only significant difference is greater emphasis on the special relief provision for taxpayers with fluctuating income. This provision is described below.

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

2. Effect on the taxpayer

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.

a. Keeping the taxpayer out of debt to the Government

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.

^{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.

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.

b. 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	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.

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.

Linking the Ruml plan with collection at source, on the other hand, 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. 7375 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.

From the point of view of an adequate and flexible fiscal policy for wartime, 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.

Without collection at source, the Ruml plan does not remove these defects. Consequently, the Ruml plan deserves serious consideration as a wartime reform only if it is linked with collection at source.

e. Burden on taxpayer in filling out his return

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.

If collection at source is linked with the Ruml plan, the taxpayer must, in addition, compute the tentative amount to be withheld on the basis of the income of the preceding year subject to collection at source.

3. 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 peacetime to wartime activity.

This defect of the Ruml plan could be mitigated, though not eliminated, by providing for the cancellation of either 1941 or 1942 liabilities, whichever is smaller. When the individual filed his return in March 1943, he would compute the tax on 1942 income at present law rates and exemptions. 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.

While this modification would soften the inequity involved in the cancellation of a year's tax liabilities, and would eliminate any refunds because of such cancellation, it would discriminate against persons with fluctuating incomes.

b. The revenue effect of the Eual plan

a. Without collection at source

Actual collections during 1943 under the Eual plan, with rates as in H.R. 7378 and without collection at source, would be as follows:

(in billions)

(a) Tentative tax on 1943 income, based on 1942 income (payable in quarterly instalments)	\$8
(b) Deficiency payable on 1942 income:	
Liabilities on 1942 income (present law rates and exemptions)	\$5
Tentative tax paid on 1942 income (liabilities on 1941 income under present law)	<u>\$4</u>
Aggregate deficiency (payable in March, 1943)	<u>1</u>
Total collections	\$9

Total collections of \$9 billion under the Eual plan would therefore be approximately \$1 billion larger than under H.R. 7378, if collection at source is disregarded, since liabilities under H.R. 7378 would be equal to the tentative tax on 1943 income under the Eual plan.

It should be noted that the aggregate deficiency payable in 1943 involves paying more than one year's taxes in one year -- the tentative tax on 1943 income plus that part of the tax on 1942 income not discharged by the tentative tax computed on the basis of 1941 income. The additional amount payable in this way is quantitatively almost as large as the additional amount payable under the 5 percent collection at source plan in H.R. 7378 -- \$1 billion compared to approximately \$1½ billion.

Despite larger collections than under H.R. 7378 without collection at source, the Ruml plan would probably be less effective in withdrawing purchasing power from the market for consumer goods. The reason for this is that persons who had accrued their 1942 tax liabilities during 1942 would be able to pay the tentative tax on 1943 income from amounts accrued during 1942 and would be under no compulsion to accrue the 1944 tax during 1943. Under H.R. 7378, on the other hand, such persons would discharge their 1942 liability in 1943 with amounts accrued during 1942, and would accrue in 1943 their 1943 liabilities payable in 1944. 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 would be less effective in withdrawing purchasing power from the market for consumer goods than H.R. 7378 even though it yielded more revenue.

b. With collection at source

If collection at source at a 19 percent rate is added to the Ruml plan, the revenue estimate given above becomes: 1/

\$9 billion minus 19 percent of 1942 income subject to withholding
plus 19 percent of 1943 income subject to withholding.

Similarly, if collection at source is taken into account, the revenue during calendar 1943 from H.R. 7378 becomes:

\$8 billion plus 5 percent of 1943 income subject to withholding

The difference between the two becomes:

\$1 billion minus 19 percent of 1942 income subject to withholding
plus 14 percent of 1943 income subject to withholding.

Income in 1943 will doubtless be higher than in 1942. However, the ratio of 1943 income to 1942 income is unlikely to be so high as 19 to 14. Consequently, with collection at source under both H.R. 7378 and the Ruml plan, collections under H.R. 7378 are likely to fall short of collections under the Ruml plan by considerably less than \$1 billion, and, indeed, may even exceed collections under the Ruml plan.

1/ This estimate and those that follow are on the basis of the amount of taxes withheld from taxpayers. They are therefore larger than actual collections, since the amount withheld during the last quarter of the year (October - December) would not be turned over to the Bureau of Internal Revenue until January of the following year.

5. Conclusions

a. The Ruml plan deserves serious consideration as a wartime reform only if it is linked with collection at source at the combined normal and first bracket surtax rate.

b. Even if linked with collection at source, the Ruml plan is less satisfactory than the plan contained in H.R. 7378, since it would be less effective in withdrawing purchasing power from the market for consumer goods and would be less equitable.

c. If linked with collection at source, the Ruml plan might be preferable to a continuation of present methods of tax collection, i.e., to self-assessment and quarterly instalment payments with no provision for collection at source.

d. 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.

e. The cancellation of 1941 liabilities provided for by the Ruml plan would confer a windfall gain on persons with abnormally high incomes in 1941. This defect could be reduced but not eliminated by providing for the cancellation of either 1941 or 1942 liabilities, whichever is the smaller.

f. The cancellation of one year's liabilities would shift part of the tax burden from persons who are now taxpayers to persons who newly become taxpayers.

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

h. 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 preceding two years.

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