Jjr

BEARDSLEY RUML
151 West 34th Street
New York, N. Y.

PAY-AS-YOU-GO INCOME TAX PLAN

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In our national effort in this total war, the financial and economic program, though less spectacular and less decisive than the military and the diplomatic, must nevertheless make its appropriate contribution in the winning of victory.

The policies guiding our financial and economic program have now been placed under the unified command of Justice Byrnes. The several operating departments and agencies which have the administrative responsibility of making this program effective are now able to move vigorously ahead. They now know that individually their policies are complementary and not contradictory, and that collectively they are an integrated whole.

The establishment of a unified command over our national financial and economic war program makes it increasingly worthwhile to correct important and long-standing defects in our customary ways of doing things. These defects, if permitted to continue, will obstruct and weaken actions that need to be taken. They will cause avoidable hardship at a time when necessary war-time measures will inevitably bring their own burden of hardship and distress.

The Pay-As-You-Go income tax plan falls into the class of corrective measures which, if adopted, will make it possible to do other things that need to be done. At the same time, it brings a just relief to millions who will one day be injured because of our present income-tax procedure.

It is from this point of view that I wish to discuss the Pay-As-You-Go plan.

When the federal income tax bill was passed in this country in 1913, it had one defect which at the time seemed of no practical consequence but which has since come to have the greatest importance. This defect was that a citizen was required to pay in the year 1914 a tax on his 1913 income. In this way, we got started on a vicious practice of paying out of one year's income a tax on the year that had already gone.

I have said that at the time the defect was of no practical consequence. The reason is that income tax rates were low and affected comparatively few people. In 1913 the rates began at 1% and the top, (normal + surtax) was 7%. Exemption for a single person was $3,000. Contrast this situation with that which confronts us in the Revenue Act of 1942. Excluding the Victory Tax, after exemptions for a single person of $500, rates begin at 19% and from that point move sharply up to 88%.

The consequence of these increasing rates is that the debt which people owe to the federal government for tax on their last year's income has become a national danger. Nothing is to be gained by arguing that people <u>ought</u> to have saved the tax on last year's income out of last year's income. The fact is that they did not do it and now they cannot do it.

Few people seem to realize how much money they owe the government for income tax. They seem to feel that since they have paid an installment on September 15, and since the next payment isn't due until December 15, for the time being at least, they are not in debt for income tax. They are wrong. They are in debt now for the installment still due this year, and worse, they are in addition in debt for income tax on what they have already earned so for this year. Under our present system this debt will have to be paid whether next year they then have any income or not.

If they die, this amount will be taken from whatever estate they leave. If they lose their jobs, there will be a charge against what they have saved. If their earnings are less, the full tax has to be met out of the lower earnings. Nothing can stop the march of the days, and when the due date comes they must pay the tax they owe on the income they have already had. It is a real debt, and practically all income-tax payers are actually in debt <u>continuously</u> for about one year's full income tax.

There are two broad purposes for reforming our historic income tax practice in order to place our income taxes on a current basis and to eliminate the accumulated income-tax debt. The first purpose relates to the financing of the war, and to the reduction of potentially inflationary purchasing power. It also relates to the preservation of the integrity of our income-tax system through obtaining the highest possible level of collections and the lowest possible level of defaults. The second springs from the personal and humane desirability of removing from millions of citizens the constant threat of unpaid tax debt, a debt imposed under a faulty tax system, unwittingly unprovided for by our citizens, a debt now grown so large under present tax rates that loss of current income for any reason by the individual taxpayer brings acute financial and personal distress.

The first purpose, that of financing the war and maintaining the integrity of the income-tax system appeals powerfully to all students of taxation, in and out of the government. They are well aware that the economic well-being of the country will be safeguarded by collecting the taxes on our rising 1943 income in 1943 and not a year later in 1944. They are also aware of the probability that it will be necessary to supplement the present tax program with a program of compulsory savings, and that this program too must be related to the current income of the citizen.

These authorities are also apprehensive about income-tax collections and defaults. Can we expect ten million new taxpayers to make declarations and begin to pay income tax under the old scheme on what they earned last year? Can we expect these new taxpayers, or even the old ones, to keep up their payments for tax on their last year's income at present rates if their current income should slacken or abruptly cease? How would the defaults be handled? Would the federal government seize their savings, their war bonds, and their homes?

All these considerations force the placing of income taxes on a current basis and at once, regardless of any personal or humane reasons for doing so. But it is impossible to get on a current basis without eliminating the tax debt on 1942 incomes. No current program, whether it be withholding, compulsory savings, or spendings tax, can be applied at the rates necessary as long as the 1942 tax debt is also simultaneously payable. There is no escaping the conclusion that the income tax on 1942 incomes must be either dropped or deferred.

The second broad purpose for this income-tax reform rests on personal and humane grounds. On the first of January under our present system some 27,000,000 citizens will be in debt to the federal government for income tax. If we estimate two persons back of each taxpayer, we have 80,000,000 people involved in the hazards of income-tax debt. It is inevitable, even in 1943, that some small percentage of our taxpayers will suffer loss of income from one or another cause. Even if as few as 4% were so affected, this would mean more than a million taxpayers in trouble because of income-tax debt. What are the reasons that might make for lower current income for the individual income-tax payer? Men are called into the armed services, others go into government work at lower pay, men and women are displaced from peace-time industry by war-time dislocation, some suffer sickness and accident, others must retire because of advancing years. All of these find that now with the new high tax rates their income-tax debt becomes an intolerable hardship, wiping out savings that have been accumulated over the years. And for the hundreds of thousands that have already been injured, millions of us are in danger, because we are each subject to the same hazards and the same inevitable loss of income.

The present system is a bad system for all of us, and it should and can be corrected. It is clear that the government cannot continue for long to be the creditor of some 27,000,000 taxpayers and their families in debt for income tax, particularly when there is no substantial question of revenue involved in skipping a year and getting the whole country on a current pay-as-you-go basis.

In order to accomplish this desirable objective of getting our income taxes on a current basis, I suggested to the Treasury in March of this year and to the

Senate Finance Committee in July a plan which I called the Pay-As-You-Go income tax plan. This plan is to be applied to individuals, not to corporations. Since then there has been a great deal of discussion, many suggestions and a little criticism.

I welcome this opportunity to make a statement about the plan which will bring it up to date, adding to and modifying the original plan in the light of the suggestions and criticisms which I have received.

The first problem is how to get our personal income taxes on a current basis without paying two years' taxes in one year. The answer is as simple as daylight saving. Let us turn our tax clocks ahead one year. The taxes we have been paying this year out of our 1942 incomes are taxes on our incomes received in 1941. We can solve the problem in either of two ways:

First, we can redefine our taxes, and simply say that the taxes we are paying in 1942 are taxes on 1942 income, and thereby let 1941 drop out of the tax calendar. forever, or

Second, we can go on letting our present income taxes be taxes on 1941, but begin 1943 by paying on 1943, thereby dropping out 1942 instead of 1941.

In my original testimony before the Senate Finance Committee, I suggested dropping out 1941, but the Treasury preferred that if any year was to be dropped, it should be 1942. As the year grows later, it becomes increasingly likely that the Treasury is right, and that 1942 would be a better year to skip. But only on one condition, that the income-tax payers who are serving the people of the United States in the armed forces or in the federal civil service should be allowed to choose whether they prefer to skip 1942 or 1941. Since there is an alternative, each should be allowed to choose the one that serves him best.

The question arises at once in everyone's mind, how can we drop an income-tax year out of the calendar in this way without having the Treasury lose a lot of money that is badly needed for the war effort? The answer is that we shall all go along paying our income taxes as we have before, only they will be on a current basis. The Treasury will also go along getting its revenues. The only difference is that when a taxpayer dies or ceases to receive income he does not owe a tax as he does under the present system. Reduction of tax payment by the taxpayer as a result of setting the tax clock ahead occurs only at some future date, when and as the taxpayer's income ceases or declines. The reduction is therefore spread over the whole life-time of the present income-tax paying generation, and occurs beneficially for each taxpayer at the time when his income fails. As for the Treasury, the Treasury has never considered taxes receivable as an asset, and accordingly they can be written off the balance sheet of the government without the change of a single penny.

Since the loss would be spread over a period of some 35 to 50 years, the gross amount of eight billion dollars estimated as the tax liabilities on 1942 income would amount to an average of only $160,000,000 to $220,000,000 a year over this period. This gross loss of revenue in any case would be partially offset by better tax collections and collection methods and also by recoveries through the estate tax of part of what would otherwise have been payable as income tax. The loss in revenue is relatively not substantial.in comparison with the gross tax revenues to be received in those years. Another way of looking at it is that the net loss over a generation would be about the same as one month's current expenditures. It is a small cost to achieve a basic income-tax reform, preserving the integrity of the system and affecting beneficially 27,000,000 citizens.

The question is sometimes raised as to the effect of the plan on inflation. The only persons that would have more cash on hand under the plan are the few who have accrued their income taxes. These are few indeed and they are not spendthrifts. As a matter of fact since Pay-As-You-Go will make withholding taxes possible at a high level, and since we will be collecting for 1943 in 1943, the total effect will be anti-inflationary rather than otherwise.

The Treasury feels that a withholding tax at a high rate is important in keeping taxpayers current. I too favor a withholding tax, because it makes it easier for people to keep on a pay-as-you-go basis. And if we want a withholding tax at a high rate, the Pay-As-You-Go plan does solve the problem of having a withholding tax without having some amount of double taxation; that is, of paying two years' taxes in one. However, if a withholding tax provision at a high rate turns out to be either undesirable or impractical, the Pay-As-You-Go plan stands on its own feet as a sound

The second point in the Pay-As-You-Go Income tax plan is designed to solve the problem of how we can pay our income taxes on a current basis, when we do not know at the beginning of a year what our income is going to be in that year. The way of solving this problem is not too difficult. We will go ahead as we do today, filing an income tax schedule about the fifteenth of March declaring our previous year's income. But this will be a tentative return for the year then beginning and we will pay our current taxes on the basis of this tentative return. After the year had ended there would have to be an adjustment up or down depending on whether our actual income for the year was greater or less than that on our tentative return. But this adjustment would be made on the same blank and at the same time as our return for the following year. This return would be at one time the final return for the old year and the tentative return for the new. There would be no doubling of returns involved and only a few extra lines for the adjustment computations.

The third feature of the plan is the provision for relief in case a taxpayer knows his income in the current year is going to be less or greater than that of the year of his tentative declaration. The plan provides that he may declare his true knowledge of lower or higher income, as a result of salary changes, and so forth, which have actually occurred, and make his current payments accordingly.

This provision eliminates the awkwardness of avoidable year-end adjustments and keeps the plan closer to a true pay-as-you-go basis than it would otherwise be.

The fourth point about the plan covers the special provisions for minimizing objectionable "windfall" cases. These provisions were not included in the original plan and have been added to meet a widespread feeling that, even though the number of cases be few, it is desirable to guard against them.

Any plan that gives equal treatment to all taxpayers would produce a certain number of "windfall" cases, cases of individuals who will benefit unduly because of the fact that for them, 1942, or whatever year is skipped, happened to be a year of unusually large income, larger than that of the year that preceded or that follows. Consequently, whatever year is selected, some persons would receive unintended benefits.

I have made the following three suggestions for minimizing the problem of these "windfall" cases:

(1) Do not cancel the income tax on capital gains. Capital gains are not like ordinary recurring income, and can properly be separated out in the plan.

(2) Provide a special death tax to recover what may be considered "windfall" arising because of death in 1942, or during some appropriate transition period.

(3) In all cases where claim for credit exceeds $10,000, or some other suitable amount, take an average of 1941, 1942, and 1943. The average of the three years will be a practical way of determining a fair normal income instead of "windfall" income.

These three provisions will catch all of the most objectionable"windfall" cases. But even so, there may still be a few remaining. What then?

There are some things that are worse than a few "windfall" cases. One would be not to adopt any Pay-As-You-Go plan at all. Another would be to adopt a plan so complicated or so uncertain in its effect that the great good of Pay-As-You-Go would not be achieved. Another would be not to give equal treatment to all taxpayers under the plan lest the "windfall" cases receive undue benefits.

Much as I dislike windfalls, even if they cannot be entirely eliminated, I am still for the plan. I cannot bring myself to the point of refusing to do good for millions simply because I will be doing too much good for a few that don't deserve it.

The fifth point about the Pay-As-You-Go income tax plan is that it proposes to give equal treatment to all taxpayers under the plan. This means to skip a tax year for all alike in every bracket and start the whole country income-tax-debt free.

These are my reasons: For those in the lower brackets, the plan will obviously have far-reaching beneficial results since unfortunate circumstances of loss of income will not be doubly unfortunate because of last year's debt.

For those in the middle brackets, the plan will eliminate countless personal and family tragedies, free many able citizens for public service, and step up the efficiency of American industry by making possible the retirement and pensioning of executives who are holding on, largely to pay their income tax and never catching up.

For those in the upper brackets, it will make much less practical difference than might appear. First, because like anybody else, as long as they have their income they continue to pay their taxes; and, when they die, what otherwise would have been payable as income tax on the taxpayer's previous year's income is subject to estate taxes in his highest brackets.

But apart from the practical considerations, the reason I favor over-all application of the principle is because it gives equal treatment to all taxpayers under the plan. In adopting Pay-As-You-Go by skipping a year, I believe we should treat all citizenss alike As we turn the tax clock ahead for some, we should turn it ahead for all, and get the whole nation out of income-tax debt by the beginning of 1943.

In so far as we want more equality of income and of wealth we can have these through the progressive income tax and the progressive estate tax, but we should not use this general income-tax reform--Pay-As-You-Go--unequally to accelerate indirectly the impact of progressive taxation. Let us achieve such levelling, or lack of it, as we desire, directly through legislative action on measures explicitly drawn to serve that purpose.

The Treasury has proposed a modified plan which would apply to the full tax debt of some taxpayers and to only a part of the tax debt of the rest Concretely, the Treasury proposed that the tax year be skipped for only the normal tax and the lowest bracket rate of surtax,--that is, a total of 10 per cent and that the balance of the tax debt remaining should be paid over the next two years,---this in addition to current income taxes that will be payable in those years. The Treasury conceded that this would leave between 10 and 20 per cent of our taxpayers still owing the government for taxes on their last year's income This group of 10 to 20 per cent includes practically all of the country's technical, administrative, and professional workers, men and women who need freedom from income-tax-debt danger as much as anyone else.

Much has been made of the differences between the Treasury's proposal (made not as a recommendation, but as a preferred alternative) and the Pay-As-You-Go plan. As a matter of fact, the area of agreement is far more significant than the remaining differences.

The points of agreement are as follows :

(1) The Treasury proposal agrees with the plan as to the high importance of getting the country out of income-tax debt and on to a current pay-as-you-go basis as soon as practicable.

(2) The proposal accepts the principle of setting the tax clock ahead, that is, of skipping a tax year, as a means of arriving at this objective.

(3) The proposal agrees to the use of the method of tentative return and year-end adjustment as a method sound both in principle and in practice of keeping income taxes on a current basis from now on.

(4) The Treasury wants a withholding tax and I agree that the plan would be a better plan if an acceptable withholding tax at a high rate can be worked out.

(5) The Treasury prefers to skip 1942 rather than 1941 and I have agreed subject to qualifications affecting the federal civil service and the armed forces.

(6) The Treasury has been apprehensive about "windfall" cases, and since submitting the original plan, I have made three proposals that will catch all the most objectionable cases.

The difference at the present time seems to rest solely on the point that whereas the Pay-As-You-Go plan applied to all the income-tax debt of all individual taxpayers, the Treasury's modified plan would apply to the full tax debt of some taxpayers and to only a part of the tax debt of the rest. In other words, what the Treasury is saying is that as a practical political matter, the full benefits of the Pay-As-You-Go plan cannot be given to taxpayers in the higher brackets, even though measures to minimize "windfall" cases are adopted. I feel that the Treasury misjudges the political tides because it is too close to the waves. I believe that the country is tired of indirection in the attempt to achieve a levelling beyond the explicit acts of Congress. In all my speaking to varied groups, the plan has never been attacked or even questioned for the reason that it proposed to skip a tax year for all citizens alike. And personally it is a point of principle that I have felt worth while defending.

But this point of principle is one that Congress properly will decide. I must point out frankly that if the principle is not so important, or if I have wrongly construed it, then it is entirely practical to draw up a pay-as-you-go plan that would leave a residue of debt remaining to be paid by taxpayers in the higher brackets. The Treasury plan is of this sort, and so also is a proposal which has been drawn up by Representative McLean of New Jersey. Neither of these plans as they stand is satisfactory because the residue of debt remaining is not sufficiently closely related to ability to pay. But a plan could be drawn up that would leave a residue of debt payable and at the same time relate this debt sharply to the taxpayer's ability to pay.

One criticism of the plan that has been made by some individuals stems from a feeling that somehow it is wrong to cancel a debt. But it is a common practice, as evidenced by the experience of banks and other commercial institutions, to reorganize debtor-creditor relations, upon the initiative of either party, whenever it becomes necessary in furthering the best continuing interests of both.

And certainly the cancelling of debt, in order to further the welfare of all concerned, has had the high approval of age-old moral authorities.

An interesting suggestion has been made recently by Senator George. "In order to avoid tremendous hardships and many defaults in 1943", he said, "we are going to have to adopt some sort of pay-as-you-earn method of collecting income taxes. To do that, it may be necessary to postpone an entire year's tax liability for individuals until after the war when it could be amortized and paid off in installments.

This suggestion by Senator George seems to reflect the urgency of doing something about the problem now, together with some uncertainty as to whether the best solution can be found in the few weeks remaining before action must be taken. It seems unfortunate that we cannot have a final solution now by simply turning the tax clock ahead. Perhaps this can yet be done, but if it proves impossible, a postponed solution is better than a makeshift compromise that might do more harm than good. If in the end it is decided that any postponed income-tax debt should be amortized rather than cancelled, let us be sure that the amortization program is closely related to ability to pay.

The chances of getting the new year 1943 on a pay-as-you-go basis seem to me to be distinctly good. I feel that a Pay-As-You-Go plan in a form acceptable to Congress will certainly be adopted, because income-tax payers want to pay their taxes on a current basis, they want to be free of income-tax debt and they know it can be done without hurting the Treasury and without paying two years'' taxes in one. The taxpayers know that Pay-As-You-Go solves the problem simply and fairly by skipping an income-tax year. They know the whole trouble was caused by a basic defect in our income-tax law which has existed from the beginning, that of paying a tax on last year's income out of this year's receipts. This defect was not their fault and they know it. They want it corrected and they want to be on a pay-as-you-go basis by the beginning of 1943.

Enough time has elapsed since the plan went to the Treasury and since it was made public before the Senate Finance Committee to permit the development of criticism, suggestions, and modifications of the plan. The critics have not been negligent and I feel sure that the objections which have been raised are the result of painstaking examination. At the same time, the lack of force in the objections which have been made to the plan has been apparent to press and public alike and has been the subject of nation-wide comment

It seems to me that we are rapidly approaching the time when the Pay-As-You-Go plan will be in the realm of legislative action. I hope that this may be the last public speech I shall make on the subject--not because my interest is any less, but because the needed decisions and compromises are the appropriate responsibility of others. The evidence is in. Let us have earnest consideration and early action.

As a nation of individuals we will be better able to meet the present and to attack whatever the future has in store for us if we are paid up in our income tax, and, being out of income-tax debt, we can pay as we go out of what we earn.