

## THE PLACE OF CONSUMERS' EXCISES IN THE TAX SYSTEM

DIXWELL L. PIERCE\*

*"Taxes are fixed much as wages are fixed, by the play of competitive forces."*<sup>1</sup>

Consumers' excises found a place in the federal revenue system more than one hundred and fifty years ago when the government of the United States imposed its first whiskey tax.<sup>2</sup> That was thirty years before Sydney Smith published his famous commentary on consumption taxes in the *Edinburgh Review*. Tracing the course of excises in the life of man, he wrote:<sup>3</sup>

The school boy whips his taxed top, the beardless youth manages his taxed horse with a taxed bridle, on a taxed road; and the dying Englishman, pouring his medicine, which has paid seven per cent., flings himself back on his chintz bed, which has paid twenty-two per cent., and expires in the arms of an apothecary who has paid a license of a hundred pounds for the privilege of putting him to death—his virtues are handed down to posterity on taxed marble; and he is then gathered to his fathers to be taxed no more.

Improved amusements, transportation facilities, medication and, it is to be hoped, tax technique may have altered matters somewhat, but a modern Sydney Smith might still wax satirical in his comments on present-day taxes. Debating a proposed federal sales tax in the House of Representatives a few years ago, one of the members suggested that the epitaph for unfortunate "John Brown," an average citizen, might well close with these lines:<sup>4</sup>

A tax attacked him when he was born,  
Attacked him till he felt forlorn,  
If they increase, as in this bill  
It won't be long until they will  
Impose a tax on growing corn  
And on the toots of Gabriel's horn.

\* A.B., 1919, J.D., 1921, University of California. Secretary, California State Board of Equalization, since 1926; Deputy Attorney General of California, 1926. Member of the California Bar. Lecturer in law, University of California (1937); President, National Association of Tax Administrators (1938).

<sup>1</sup> Adams, *Ideals and Idealism in Taxation* (1923) 13 AM. ECON. REV. 1.

<sup>2</sup> This was in 1790.

<sup>3</sup> HOYT'S NEW CYCLOPEDIA OF PRACTICAL QUOTATIONS (1922) 334.

<sup>4</sup> From a speech by Hon. Claude B. Parsons of Illinois, March 14, 1932.

Yet, much as excises have been criticized by economists, politicians and the public generally, the United States Government has relied mainly on consumption taxes for its support during the major part of its existence. This circumstance may be traced to the requirement in the Federal Constitution that no direct tax shall be laid unless it "shall be apportioned among the several states which shall be included within this union according to their respective number."<sup>5</sup> Federal property taxes were made impracticable by this restriction and, although income taxes were at first held not direct taxes,<sup>6</sup> a later decision of the United States Supreme Court reached a contrary conclusion.<sup>7</sup> Thus, it was not until 1913, following adoption of the Sixteenth Amendment eliminating the apportionment requirement in so far as income taxes are concerned, that this type of revenue was made practicable for the national government.

A rapid shift in revenue sources ensued. In 1910, 54 per cent of the federal collections came from customs, 33 per cent from liquor taxes, 9 per cent from tobacco taxes, and 3 per cent from corporation taxes measured by income.<sup>8</sup> By 1920, 69 per cent of the federal revenue came from income taxes, 6 per cent from customs, and 5 per cent from tobacco. Owing to prohibition, liquor excises had vanished and the remainder of the federal collections came from a variety of sources. Ten years later, income taxes were still responsible for more than two-thirds of the revenue of the national government. Meanwhile, customs had climbed back to 16 per cent of the total and tobacco taxes were accountable for 12 per cent.

Then came the depression. By 1935, although still the largest single federal revenue source, income taxes had shrunk to 36 per cent of total collections. Tobacco taxes represented 15 per cent, and, as result of the repeal of prohibition, were followed closely by liquor taxes at 13 per cent. Customs contributed 10 per cent; estate and gift taxes, 7 per cent; gasoline taxes, 5 per cent; with scattered sources making up the remainder.<sup>9</sup> Despite some upward fluctuation since 1935, the yield from income taxes in 1940 was still only 36 per cent of the revenues of the national government. Almost all of the remaining 64 per cent of federal collections for last year came from various types of excises. World War II had disturbed foreign trade so seriously as sharply to curtail customs receipts.

Expressed in millions of dollars, federal revenues, actual and estimated, for 1940, 1941 and 1942, may be summarized thus:

<sup>5</sup> U. S. CONST. Art. I, §2. See also *id.* §8.

<sup>6</sup> *Springer v. United States*, 102 U. S. 586 (1880).

<sup>7</sup> *Pollock v. Farmers' Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601 (1895).

<sup>8</sup> (April 1940) 4 TAX ADM'RS NEWS (No. 4) 25.

<sup>9</sup> *Ibid.* Figures are rounded to the nearest tenth of a million and will not necessarily add to totals.

TABLE I  
FEDERAL REVENUES<sup>10</sup>

| Source                           | Actual<br>1940      | Estimated<br>1941 | Estimated<br>1942 |
|----------------------------------|---------------------|-------------------|-------------------|
| Income Taxes.....                | 2125.3              | 3055.0            | 4509.5            |
| Other Internal Revenue:          |                     |                   |                   |
| Liquor Taxes.....                | 624.1               | 810.5             | 839.5             |
| Tobacco Taxes.....               | 608.1               | 691.9             | 716.6             |
| Estate and Gift Taxes.....       | 360.1               | 348.6             | 374.5             |
| Gasoline Taxes.....              | 226.2               | 360.6             | 389.2             |
| Manufacturers' Excise Taxes..... | 220.5               | 262.9             | 277.2             |
| Capital Stock Tax.....           | 132.7               | 166.8             | 193.4             |
| Miscellaneous Taxes.....         | 188.0               | 229.7             | 238.9             |
| Total.....                       | 2344.6 <sup>a</sup> | 2871.0            | 3029.3            |
| Employment.....                  | 838.1               | 898.0             | 968.5             |
| Customs.....                     | 348.6               | 302.0             | 295.0             |
| Miscellaneous Revenue.....       | 268.2               | 527.2             | 169.4             |
| Grand Total.....                 | 5924.8              | 7653.2            | 8971.7            |

<sup>a</sup>Adjustment to daily Treasurer's statement basis (unrevised).

From these figures, it is apparent that the Federal Government is dependent upon excises, many of them of the consumption type, for a large part of its revenue and that this will continue to be the situation indefinitely.

Until recently, states have made relatively little use of consumers' excises in their tax systems.<sup>11</sup> When highway costs proved too great to be met from existing revenue sources, Oregon was first to enact a gasoline tax. In February, 1919, the legislature of that state passed a law authorizing the collection of a tax of one cent per gallon.<sup>12</sup> A similar federal tax had been proposed four years earlier when in 1915 President Wilson had suggested it to the Congress. However, no action was taken by the national government until 1932, when a provision imposing a federal tax of one cent became effective.<sup>13</sup> By that time, every state in the Union had adopted the gasoline tax as part of its fiscal system.<sup>14</sup>

No other excise is imposed with such universality throughout the nation. There are, however, tobacco taxes in twenty-eight states.<sup>15</sup> That the trend toward these taxes is still active may be deduced from the fact that five states added tobacco excises to their tax systems in 1939 and two as recently as 1941.<sup>16</sup> Federal tobacco taxes, although newly imposed in comparison with the whiskey tax of 1790, originated much earlier than the state excises on tobacco, since they were adopted as a war revenue measure in 1862.<sup>17</sup>

Confronted by a dilemma which arose from increasing demands upon government and diminishing returns from the usual sources of revenue, more than a score

<sup>10</sup> ANN. REP. SEC'Y TREAS. (1940) 147.

<sup>11</sup> GROVES, FINANCING GOVERNMENT (1939) 313.

<sup>12</sup> ORE. LAWS 1919, p. 219.

<sup>13</sup> Revenue Act of 1932, §617.

<sup>14</sup> CRAWFORD, ADMINISTRATION OF THE GASOLINE TAX IN THE UNITED STATES (1930) 2.

<sup>15</sup> (May 1941) 5 TAX ADM'RS NEWS (No. 5) 54.

<sup>16</sup> (Nov. 1939) 3 *id.* (No. 11) 1; (April 1941) 5 *id.* (No. 4) 37; (May 1941) 5 *id.* (No. 5) 54.

<sup>17</sup> Hynning and Colm, *Taxation of Corporate Enterprise* (1941) T. N. E. C. MONOGRAPH No. 9, c. 9.

of American states resorted to general sales taxes in the early nineteen-thirties as a means of averting fiscal chaos. The exigencies of the situation precluded as thorough preparation for the tax as might have been desired. West Virginia and Georgia both had gross receipts taxes of general application prior to 1930,<sup>18</sup> but the pioneer state in the general sales tax field, if that appellation may be used with respect to a tax of such ancient origin, was Mississippi.<sup>19</sup> Discussing the law at the National Tax Conference in 1933, A. H. Stone, Chairman of the State Tax Commission, described the opposition to its enactment in these words:<sup>20</sup>

The sales tax law of Mississippi was enacted with the frank declaration that it was in the nature of an emergency experiment. . . .

From the fact that the proposed tax was technically a tax on business, arose most of the opposition which was manifested while the bill was under legislative consideration. The chief objection urged was that business was already subjected to all the taxes which it could bear, and should not be called upon to carry any additional tax burden. This argument was, of course, predicated upon the assumption that the tax could not be passed on to the consumer, since the law made no provision to this effect. Incidental to this was the further contention that any attempt to pass on the tax would drive business out of the state, either to mail-order houses or to adjoining states. This argument was addressed especially to the business interests of the border counties of Mississippi. Maps and figures were diligently used to show the population within trading-area distance of towns in adjacent states, and hence presumably within the influence of this particular appeal.

One of the strongest non-technical arguments made against the bill was that no similar general retail sales tax law had ever been successfully tried by any other state, and hence it could not be fairly assumed that such a law could be made effective for raising revenue in Mississippi. Another argument strongly urged was that the administration of such a tax would be burdensomely expensive. There is no question but that a successful administration of the act was by no means a certainty, when, after a long legislative struggle, it was finally passed. The bill was approved April 28, 1932, to become effective May first.

Commenting upon the fiscal situation which had preceded enactment of the sales tax, Mr. Stone continued:<sup>21</sup>

Like most American states, Mississippi had been living beyond her income. The state's general fund revenues had equalled its general fund disbursements only six times in thirty years. The state's credit was impaired to such an extent that it could sell no bonds for any purpose whatever. Millions of dollars of state warrants were outstanding against an empty treasury. Real and personal property values had kept pace with the general decline, and any increase in revenue from general property taxes was an unthinkable suggestion. Conditions might conceivably have been worse, but only through the exercise of all the functions of a vivid imagination.

Adverting to the significance of the sales tax as a means of replacing other forms of taxation, particularly *ad valorem* taxes on property, Mr. Stone had this to say:<sup>22</sup>

The question asked more often than any other in connection with the Mississippi sales tax is as to its effect upon other taxes. "Has it reduced the tax on property?" "Will it lighten the tax burden on homes and farms?" There is, of course, no possible categorical

<sup>18</sup> JACOBY, *RETAIL SALES TAXATION* (1938) 52, 69.

<sup>19</sup> *Id.* at 61.

<sup>20</sup> Stone, *The Mississippi Sales Tax* (1933) 26 *PROC. NAT. TAX ASS'N* 223, 224.

<sup>21</sup> *Id.* at 225-226.

<sup>22</sup> *Id.* at 226-227.

reply to questions such as these. I have stated that the sales tax was resorted to as a means of bridging a gap of \$2,000,000 annually in the revenues estimated to be necessary to meet the state's operating expenses, after reducing appropriations about one-third. The sales tax, in meeting this revenue deficit, thereby rendered unnecessary an increase of at least four mills, possibly six mills, in the general levy on all classes of property, including homes and farms. Therefore, it may be said to have automatically effected the equivalent of at least a two-million-dollar annual reduction in taxes under the general levy. But no specific form of tax will ever, of itself alone, accomplish the end which all of us desire, but which those of us charged with administrative responsibility know is so difficult to attain. No substantial reduction in the tax burden can be realized except through a substantial reduction in governmental costs, combined with a more efficient and effective administration of the entire tax structure.

As long as the public demands increased and better school facilities, better provision for institutions of higher learning, better facilities and service for the defective and unfortunate groups, larger provision for veterans of wars, and all of the other things which the public does demand—just so long will the granting of these things determine the level of the tax burden which has to be borne in order that they may be enjoyed. And another thing; just so long as good citizens fail or refuse properly to return their property for tax purposes, either as to value or amount, just so long will tax rates remain high and tax equalization remain a farce. The process of shifting the tax burden, no matter how skillfully and adroitly it may be done, can never of itself accomplish a lessening of the total tax load.

At the conclusion of his remarks, Mr. Stone stressed that the sales tax had been, in the main, paid by the consumer, and that public understanding of the purpose of the tax is of great importance to its successful retention in a revenue system. Confining his observation to Mississippi, he said that his experience had convinced him that there is no logical reason why the sales tax should not be made a permanent part of a system of state revenues. Finally, he stressed the need for a comprehensive audit program in sales tax enforcement, saying:<sup>23</sup>

The most important factor in administration, next to public understanding and co-operation, and closely related to both, is a competent field force, adequate in number and sympathetic in an attitude which is genuine and not assumed. Without such field service, I would consider a successful administration of such a tax law as impracticable if not impossible.

At the time that the Chairman of the Mississippi Tax Commission was speaking, October, 1933, general sales or gross income taxes were imposed in twelve other states.<sup>24</sup> By the end of the following year, 1934, two more states<sup>25</sup> and the largest city in the country<sup>26</sup> had adopted sales taxes. Meanwhile, the New York state sales tax, imposed under an emergency act, had ceased to apply.<sup>27</sup> In 1935 six additional states joined the sales tax ranks;<sup>28</sup> one more was added in 1936,<sup>29</sup> and two more in 1937.<sup>30</sup> Since then, no other states have imposed this type of tax. Meanwhile, Louisiana repealed its sales tax law,<sup>31</sup> but a similar tax has been put into effect in

<sup>23</sup> *Id.* at 232.

<sup>25</sup> *Ibid.*

<sup>27</sup> *Id.* at 73.

<sup>29</sup> *Ibid.*

<sup>31</sup> La. Acts 1940, act No. 82.

<sup>24</sup> JACOB, *op. cit. supra* note 18, at 87.

<sup>26</sup> *Ibid.*

<sup>28</sup> *Id.* at 87.

<sup>30</sup> *Ibid.*

New Orleans, the largest city of the state.<sup>32</sup> Although sales tax laws are thus today in force in less than half the states, more than half the nation's population pay general sales taxes imposed under authority of the states or their political subdivisions.<sup>33</sup>

Revenue productivity of state sales taxes is shown in the following table:

TABLE II  
PER CAPITA YIELD OF STATE SALES TAXES IN 1940

| State                        | Rate                      | Kind of Tax               | *Yield       | †Population | Yield Per Capita |
|------------------------------|---------------------------|---------------------------|--------------|-------------|------------------|
| California.....              | 3%                        | Retail Sales and Use..... | \$98,063,000 | 6,874,000   | \$14.27          |
| Washington....               | 2%                        | Retail Sales and Use..... | 20,689,000   | 1,721,000   | 12.02            |
|                              | {.25 of 1% <sup>a</sup> } | Occupation                |              |             |                  |
| Illinois.....                |                           | Retail Sales.....         | 90,818,000   | 7,874,000   | 11.54            |
| Michigan.....                | 3%                        | Retail Sales and Use..... | 60,374,000   | 5,245,000   | 11.51            |
| West Virginia <sup>b</sup>   | 2%                        | Retail Sales.....         | 20,630,000   | 1,900,000   | 10.86            |
|                              | — <sup>c</sup>            | Gross Income              |              |             |                  |
| Wyoming.....                 | 2%                        | Retail Sales and Use..... | 1,994,000    | 247,000     | 8.07             |
| Arizona.....                 | 2% <sup>d</sup>           | Occupation.....           | 4,010,000    | 498,000     | 8.05             |
| New Mexico.....              | 2%                        | Occupation.....           | 4,198,000    | 529,000     | 7.94             |
| Colorado <sup>b</sup> .....  | 2%                        | Retail Sales, Use and     |              |             |                  |
|                              |                           | Services.....             | 8,484,000    | 1,119,000   | 7.58             |
| Utah.....                    | 2%                        | Retail Sales and Use..... | 4,199,000    | 548,000     | 7.66             |
| South Dakota..               | 3%                        | Retail Sales and Use..... | 4,504,000    | 641,000     | 7.03             |
|                              |                           | (Some Service)            |              |             |                  |
| Indiana.....                 | 1%                        | Gross Income.....         | 23,538,000   | 3,416,000   | 6.89             |
| Ohio.....                    | 3%                        | Retail Sales and Use..... | 46,105,000   | 6,890,000   | 6.69             |
| Iowa.....                    | 2%                        | Retail Sales and Use..... | 16,858,000   | 2,535,000   | 6.65             |
|                              |                           | (Some Service)            |              |             |                  |
| Missouri <sup>e</sup> .....  | 2%                        | Retail Sales.....         | 22,332,000   | 3,776,000   | 5.91             |
|                              |                           | (Some Service)            |              |             |                  |
| Kansas.....                  | 2%                        | Retail Sales.....         | 10,080,000   | 1,799,000   | 5.60             |
|                              |                           | (Some Service)            |              |             |                  |
| North Dakota..               | 2%                        | Retail Sales and Use..... | 3,099,000    | 640,000     | 4.84             |
| Oklahoma.....                | 2%                        | Retail Sales and Use..... | 10,952,000   | 2,330,000   | 4.70             |
|                              |                           | (Some Service)            |              |             |                  |
| North Carolina.              | { 3% }<br>{ .05% }        | Retail Sales and Use..... | 12,208,000   | 3,563,000   | 3.43             |
|                              |                           | Wholesale                 |              |             |                  |
| Mississippi.....             | 2%                        | Occupation and Use.....   | 6,743,000    | 2,182,000   | 3.09             |
| Arkansas.....                | 2%                        | Retail Sales and Use..... | 5,514,000    | 1,948,000   | 2.83             |
|                              |                           | (Some Service)            |              |             |                  |
| Alabama <sup>f</sup> .....   | 2%                        | Retail Sales and Use..... | 5,890,000    | 2,830,000   | 2.08             |
|                              |                           | (Inc. Amusement)          |              |             |                  |
| Louisiana <sup>g</sup> ..... | 1%                        | Retail Sales and Use..... | 5,981,000    | 2,356,000   | 2.54             |

\*United States Department of Commerce, Bureau of the Census, State Tax Collections (1940) Preliminary Report, 8.  
†Preliminary Census Release, 1940.

<sup>a</sup> Other rates .001 - ½ of 1%.

<sup>b</sup> Yield for fiscal year ended 6-30-39.

<sup>c</sup> Rates vary .15% to 6%.

<sup>d</sup> Rate is for retail sales.

<sup>e</sup> Yield for fiscal year ended 12-31-39.

<sup>f</sup> Yield for fiscal year ended 9-30-39.

<sup>g</sup> Repealed July, 1940, effective December 31, 1940. La. Acts 1940, act No. 82.

A wide range of revenue productivity is indicated by the foregoing table. California leads the field, both in total sales tax collections and in per capita yield. Three other states, with comparable population and business activity, all impose taxes at the same rate, namely, three per cent, but the productivity of these taxes has been substantially less. One of these states—Illinois—has an annual *per capita* yield of \$11.54 in contrast with California's \$14.27, but if adjustments were made because of taxes imposed

<sup>32</sup> City of New Orleans Ordinance No. 15,201, approved December 12, 1940. C. C. H., INTERSTATE SALES TAX SERV. ¶15661 *et seq.*

<sup>33</sup> (1941) 26 BULL. NAT. TAX ASS'N 226.

in Illinois with respect to transactions exempt in California<sup>34</sup> the *per capita* yield in California would be increased to \$18.34, representing approximately fifty per cent more revenue than is derived in Illinois. The remaining comparable states, Michigan and Ohio, have tax bases more nearly like that in California, although there are significant variations in each.<sup>35</sup> Yet, the *per capita* yields indicate substantially less revenue than in California. While some of this difference may be attributable to the greater buying power of California's population, it is believed that the most important factor involved in the high productivity of the California sales tax is the thorough organization of its field audit program.

Speaking on this point at the National Tax Conference in 1937, A. J. Maxwell, North Carolina Commissioner of Revenue, addressed his remarks to<sup>36</sup>

. . . certain phases of sales tax administration which I believe demand the attention of all of us engaged in that work. In the first place, I desire to stress the importance of an adequate field audit program. In the second place, I want to emphasize the necessity of prompt action in determining additional taxpayers' liability and to point out the inevitable embarrassment which arises from long deferred demands for payments in addition to those which are made by the taxpayer at the time of filing his returns.

When I was in California recently, I had an opportunity to observe what was being done there with respect to field audits and to talk to the men who are in charge of that work. I found that it has been their constant aim to make determinations of additional taxes as soon as possible and to effect these collections promptly. . . .

I want to repeat that, to my mind, a sales tax administration is only as good as its auditing program. A staff of good auditors, intelligently directed in a courteous but firm attitude toward the retailers paying the tax, is essential to successful sales tax administration.

This vigorous summation of the situation impels the conclusion that it is folly for any state imposing sales taxes to attempt to save money by curtailing administrative expense to a point where field audits cannot promptly be made. The nature of sales tax administration is such that it requires constant vigilance if the results are to be satisfactory. Cheap sales tax enforcement will prove, without doubt, the most expensive in the final analysis.<sup>37</sup>

Effectively administered, a general retail sales tax can be made one of the most productive and reliable sources of state income. This has been demonstrated in California where between August 1, 1933, the date when the California act first became effective, and December 31, 1940, revenues from this source totalled \$598,-

<sup>34</sup> *Ibid.*

<sup>35</sup> The Michigan General Sales Tax Act excludes from the meaning of the term "sale at retail" transfers of tangible personal property ". . . for consumption or use in industrial processing or agricultural producing . . ." MICH. COMP. LAWS (Mason, Supp. 1940) §3663-1(b). The Ohio Retail Sales Tax Act provides that "retail sale" does not include sales in which the purpose of the purchaser is ". . . to use or consume the thing transferred directly in the production of tangible personal property for sale by manufacturing, processing, refining, mining, production of crude oil and natural gas, farming, horticulture or floriculture, or directly in making retail sales . . ." OHIO GEN. CODE (Page, 1937) §5546-1. While no such exclusions are found in the California act, these are offset by exemptions of more or less comparable fiscal effect, not found in the Michigan and Ohio acts.

<sup>36</sup> Maxwell, *Discussion* (1937) 30 PROC. NAT. TAX ASS'N 47, 48.

<sup>37</sup> See, further, the emphasis placed upon this by Huston and Berryman, *Collection and Enforcement of State Consumption Excise Taxes*, *infra* this issue.

134,588. For the last completed fiscal year, namely, that ended June 30, 1940, sales and use tax collections represented 37.86 per cent of the California tax dollar. This was the largest single item of state revenue. The next largest item was motor vehicle fuel taxes which represented 19.75 per cent of the tax dollar. Although not the next largest item, excise taxes on alcoholic beverages were among the substantial contributors to the state's tax dollar, accounting for 4.22 per cent of its revenue. Thus, these three consumers' excises produced in excess of three-fifths of the total revenue of the State of California for the last fiscal year.<sup>38</sup>

This trend may be somewhat accentuated in California, but it is not peculiar to that state. Data gathered by the Bureau of the Census of the United States Department of Commerce disclose that sales taxes of various kinds account for 39.5 per cent of the state tax dollar throughout the country.<sup>39</sup> Not only are sales taxes the largest contributors to state revenue, but they accounted for the major part of the increase in state tax collections for 1940 which reached a total of \$4,171,000,000, marking a gain of more than 7 per cent over the corresponding figure for 1939.<sup>40</sup> Commenting upon the part of sales taxes in this gain, the Bureau of the Census has this to say:<sup>41</sup>

Overshadowing in absolute volume all other increases in tax yields was a \$50 million rise in general sales tax collections, an increase of 11.4 per cent. Collections of sales taxes on tobacco showed the largest percentage increase—63.2 per cent—amounting in absolute figures to nearly \$38 million. . . .

The rapid increase in collections of sales taxes of all kinds in the past two decades has been one of the most significant and quantitatively greatest revolutions which has ever taken place in the American tax system. By 1937 sales taxation . . . had practically assumed the place, in State tax systems, that was occupied by general property taxation prior to 1919.

Conforming to this trend, general sales taxes, which were non-existent in 1919, yielded gross collections of \$486 million, or 11 per cent of all State tax collections, in 1940. . . .

Reflecting the increased importance of sales taxes is a related increase in collections from gross receipts taxes on various specified businesses. . . . It is not possible to separate all gross receipts taxes over a period of years from other taxes levied on similar businesses. . . . It is significant to note, however, that the economic incidence of gross receipts taxation is probably the same as that of a sales tax, when levied on the same business. Therefore, in considering the question of incidence of State taxes, or the economic results of the system of taxation now becoming predominant in American State governments, it is necessary to include gross receipts taxes together with sales taxes in the calculations.

Accordingly, the Census Bureau indicates that approximately \$110,000,000 of the 1940 state collections derived from taxes on specific businesses and occupations, consisted of taxes measured by gross receipts which should be added to the \$486,000,000 of sales tax revenue, making a total of approximately \$600,000,000 realized by the states from consumers' excises of various types.<sup>42</sup> These figures express with con-

<sup>38</sup> (Jan., Feb., March, 1941) 3 ASSESSOR'S NEWS LETTER (California State Board of Equalization) (No. 1) 4.

<sup>39</sup> Department of Commerce, Bureau of the Census, *State and Local Government* (1941) Special Study, No. 10, at 2.

<sup>40</sup> *Id.* at 1.

<sup>41</sup> *Id.* at 2.

<sup>42</sup> *Id.* at 4, 7.



vincing eloquence the revenue productivity of taxes of this type as imposed today in the American states.

What, then, of the desirability of such taxes as respects their satisfaction of the requisites of equity? Are they so regressive that their use should be avoided or at least curtailed in order to avert undesirable consequences? What was said in the course of a discussion of this subject at the Thirtieth Annual National Tax Conference in Baltimore, Maryland, four years ago throws so much light on the changing economic thought that a review of the discussion should prove illuminating.

Speaking on the implications of federal financial policies, Professor Herbert D. Simpson, of Northwestern University, made these observations:<sup>43</sup>

. . . the federal government has largely absorbed any potential areas of increased revenues for the states in three fields, namely: income taxation, estate and inheritance taxes, and corporation taxes, particularly through the undistributed profits tax. The one area of income taxation which many of us had hoped might afford a kind of reserve for state government needs was the area of so-called middle brackets, where the curve of federal rates has always thus far left a relative depression. But according to conversations and reports coming from the treasury department, it appears to be the intention of the department to exploit this remaining area in the next revision of the income tax. . . .

This would seem to imply that the states are going to have to lean more heavily than ever upon the one substantial field of revenue still left to them, namely, the sales tax. Most economists have looked upon the general sales tax as an undesirable importation from European and Oriental countries—a tax that is not based on ability, benefit, or on any other accepted principle of equity in the distribution of public burdens. Its one merit is its capacity to produce enormous revenues, regardless of the condition of the taxpayers who pay it. As such, it affords a valuable source of revenue in times of emergency, and throughout the recent depression it has served this emergency purpose admirably. Many of us had hoped that with the passing of the emergency, it might be possible to look forward to a gradual relinquishment of this form of taxation. Any such hopes have been greatly diminished by federal policies of the past few years.

In the field of municipal and local government, most students have recognized the enormous concentration of taxes upon real estate. Professor Fairchild made some pungent comments on that subject last year, with which I am fully in agreement. . . .<sup>44</sup> Property is an index of ability, a legitimate basis for taxation, and one that has demonstrated a high degree of merit.

But nevertheless, most tax students have deplored the pyramiding of public burdens upon this one category of taxable capacity, not only from the standpoint of fairness to property owners, but from the standpoint of the financial stability of local governments. Most of us had hoped for some gradual lessening of property taxes through the transfer of a portion of the burden to income and other forms of taxation.

Four years ago, . . . I presented figures showing that, on the basis of existing taxes and assuming a return to a level of prosperity equivalent to that of 1926, it would be entirely possible . . . to shift approximately one-third of total property taxes to income taxation, without hardship to anyone. I prepared a chart—a beautiful chart—of taxes and income, illustrating this possibility. That chart still hangs on the walls of my study, but it hangs like the harp that hung “on Tara’s walls,” after its soul was dead. The soul of my chart is dead, because, after the developments of the past four years, there is now no possibility

<sup>43</sup> Simpson, *Some Implications of Federal Financial Policies* (1937) 30 PROC. NAT. TAX ASS’N 137, 138.

<sup>44</sup> Fairchild, *The Impact of Federal Taxation on State Finances* (1936) 29 *id.* 283.

of shifting one-third of the burden of property taxes to income taxation—or to any other form of taxation that is now discernible.

Commenting upon what had been said by Professor Simpson, Professor Fred R. Fairchild of Yale expressed gratification concerning their agreement as to the significance of developments, saying that they were in agreement as to the predominant place of the property tax in American state and local finance, and continued that he noted with very great interest Professor Simpson's reference to the sales tax "as about the only available source of large additional revenues open to the state and local governments."<sup>45</sup>

Expressing further gratification, Professor Fairchild continued:<sup>46</sup>

I was pleased to notice that Professor Simpson suggests that the sales tax deserves a little more charitable treatment than it generally gets, at least in popular discussion, and perhaps I am inclined to be even a bit more charitable than he was. I would be disposed to challenge the common assumption that the sales tax bears no relation to tax-paying ability. . . . The amount of the tax bears some relation to tax-paying ability. It does not bear the perfect relation. It does not permit of the progressive relation such as the income tax allows. It does not, perhaps, even place a burden in proportion to the total income or tax-paying ability of the taxpayer, but conceding all of that, we must not make the rather crude error of saying that the sales tax has no relation whatever to ability, when it is well known that some people pay five, ten, twenty, or a hundred times as much under a given sales tax than do others.

The sales tax, then, I say, does have some relation to ability, and it is a tax which in combination with other taxes, some of them progressive, may permit the building up of a general tax system providing whatever relation to tax-paying ability may be desired.

I am also disposed to refer to those of whom Professor Simpson reminds us, who regard the sales tax as an outlandish importation from European and Oriental countries. Let us not forget that broadly defined as taxation of consumption, such taxes have a long and fairly respectable record in the United States.

Following these observations, Harley L. Lutz, professor of Public Finance at Princeton University, joined his fellow economists in the discussion with this pungent comment:<sup>47</sup>

I was particularly interested to have both Professor Fairchild and Professor Simpson begin to take down their back hair, so to speak, with respect to the subject of ability. I have been coming more and more myself to the conclusion that it is about time that someone who was thoroughly competent should reexamine the concept of ability, first, because of some possible question regarding its necessary theoretical function, and secondly, because of the extent to which ability has been overworked. It has been so sadly misused in so many connections that I think it is time we had a clearer and fresher statement of it.

I think in that connection there is a tendency to overemphasize Adam Smith's first canon, and to neglect somewhat the bearing of the other canons of taxation suggested by Adam Smith upon the first one, not with any hope that we can ever get a perfect tax that will ideally carry out the full implications of the four principles together, but with a view to discovering if possible the extent to which the original or the first one might be modified in certain respects by taking into account some of the others.

Let me illustrate. As both speakers . . . pointed out, ability has a certain standardized meaning and we immediately pass judgment on any tax by saying that it doesn't conform

<sup>45</sup> Fairchild, *Discussion* (1937) 30 *id.* 145.

<sup>46</sup> *Id.* at 145-146.

<sup>47</sup> Lutz, *Discussion* (1937) 30 *id.* 155-156.

to ability, meaning, if the small income fellow pays a certain amount of tax and the man with a large income pays the same amount of tax, it is regressive with respect to the smaller income—it is a larger percentage of the small income than it is of the large income.

We assume that that is all there is in the question of ability to pay, and so we have fallen into the habit of condemning certain taxes, conspicuously the sales tax, because we say right off-hand it violates this fundamental principle of ability to pay, it is regressive.

But that isn't all there is to it. Adam Smith said in another one of his famous maxims on taxation, "the tax shall be collected in the manner and at the time most convenient for the taxpayer to pay it." In a practical sense, not in an abstract theoretical and, I might say, mathematical sense, but in a practical sense, I think that has a good deal to be said for it.

Pointing out that instalment tax payments had gained in favor during recent years, Professor Lutz mentioned the fact that the federal law permits payment of income taxes in four instalments; that a few states permit comparable payments in the same number of instalments and that some of them provide for two instalments; that in several states the property tax may now be paid in instalments, it being possible in some of them to divide the tax due into as many as four payments. Continuing this thought, he observed:<sup>48</sup>

You are never required to plank down any large amount in cash on account of the gasoline that you buy. You can pay it in dribblets. None of the sales tax states requires you to fork over a large sum on the first of the month on account of the groceries or the coal or any other commodities that you have bought subject to the sales tax during the month. They apply perfectly the canon of convenience. They are collected at the time and in the manner most convenient for the taxpayer to pay them. Furthermore, I should like to point out that they conform admirably to the other principle that Adam Smith suggested, namely, that the amount of the tax should be certain and not arbitrary. . . .

Few people are ever in any doubt as to the amount of sales tax they are paying. There is never any question of going back over the amount of groceries in the year before last bill and assessing a deficiency tax against them. So far as the certainty of the tax and the convenience of the tax are both concerned, I suggest that many of the indirect taxes stand up very well.

So if we ever get around to that state of mind in which we are willing to think of this question of ability to pay as involving not simply a kind of "bastard" mathematics, because that is what it is in reality, a kind of "bastard" mathematics by which we have concluded that certain taxes are regressive and therefore undesirable, and look at the thing from a more realistic, a more practical, a more common-sense point of view, we may find that we have been on the wrong track in considerable degree in the past with respect to our construction and application of the ability principle.

Cautioning that he was not to be understood as suggesting that we should immediately scrap the income tax or inheritance taxes, Professor Lutz said that he meant merely to imply that economists should liberalize their judgments with respect to the quality of some of the other taxes, such as consumers' excises. He reminded the conference how "exceedingly flimsy a reed you have in the kind of income tax that we use, because it is essentially a prosperity tax." Continuing in this vein, he observed that:<sup>49</sup>

It isn't worth a "hoot" in a depression, and if it hadn't been for the indirect taxes that the federal government used and the indirect taxes the state governments used, I hesitate

<sup>48</sup> *Id.* at 156, 157.

<sup>49</sup> *Id.* at 157.

to try to picture to you the kind of financial chaos in which the federal or state governments would be likely to be.

A little later at the same session of the conference, another speaker<sup>50</sup> expressed the view that the convenience of collection is what is wrong with some of our sales taxes, resulting in a failure on the part of the public at large to recognize the extent of the tax load. Answering this suggestion, Professor Lutz made this comment:<sup>51</sup>

I think we overestimate the ignorance and indifference of consumers when we imply that they do not know what it is all about. I am inclined to say that we ought to, on the other hand, give them credit for enough intelligence to appreciate the merit of that method of collection and to be willing to pay a somewhat larger tax in that way than to have to submit to the inconvenience—in many cases it would be a serious inconvenience—of forking over a smaller total sum in one lump payment.

Adam Smith said, "There is a certain price which men are willing to pay in order to be free from the odious oppression of the tax-gatherer." I believe that a great many people are willing to pay a somewhat higher price for their share of the cost of government and do it in a way that frees them from the inquisitorial methods and the odious oppression of the tax-gatherer to which they are inevitably subject when the tax is based upon net income and is collected in the manner that has become so popular for the administration of that task.

As indicative of the circumstance that the views expressed by Professor Fairchild and Professor Lutz are not wholly shared by other economists, Professor J. H. Hollander of Johns Hopkins fired this parting shot at the conclusion of the conference:<sup>52</sup>

. . . I feel that loyalty to my faith compels a caveat against the views so clearly set forth by Professor Fairchild and Professor Lutz. It seems to me, with reference to the doctrine of ability, a clear distinction must be drawn between what is the principle, what is the ideal to which a tax system should conform, and a rationalization of the tax practices which obtain. . . .

We now face a situation where the economist may either continue crying like a voice in the wilderness or turn and say, "Well, after all, we have, and we are, drifting toward the sales tax and the indirect tax. Perhaps there is something more in it. Perhaps we have been worshipping false idols. Let us see whether after all this to which states have drifted isn't a safer procedure theoretically, a safer principle theoretically, than we had supposed."

Contribution to the state in the form of successive installments is the familiar device of the sugar-coated pill, of the greater ease, and it is in violation of that which I cannot but regard as a fundamental principle of the relation of the citizen to the expenses of government, contribution according to his economic capacity.

A point to be stressed in connection with these arguments as to the equity and desirability of the sales tax is the fact that the functions of government have changed substantially since the traditional views were first formed with regard to the requirements of sound taxation. New conceptions as to what government shall do for the people require new conceptions as to what the people shall do to sustain the government. Increasing governmental activity and widespread extension of governmental benefits necessitate re-examination of economic concepts formed during periods when governmental services were not so universally enjoyed. Broadness of base, universality

<sup>50</sup> Seidman, *Discussion* (1937) 30 *id.* 159, 160.

<sup>51</sup> Lutz, *Discussion* (1937) 30 *id.* 160-161.

<sup>52</sup> Hollander, *Discussion* (1937) 30 *id.* 162.

of impact, ease of collection, distribution of payments in small amounts throughout the year are attributes of a tax law not to be disregarded under current conditions in the American states. If these states should rely wholly or mainly upon consumers' excises, much of the criticism that economists have directed toward such taxes might well apply. On the other hand, if, as in California, state taxes on personal and corporate incomes contribute more than 17 per cent of the tax dollar and are supplemented by inheritance and gift taxes, accountable for 4.12 per cent of that dollar,<sup>53</sup> it would appear that there has not been any substantial neglect of progressive taxes at the expense of consumers taxed indirectly on an excise basis. Moreover, it must be borne in mind that property taxes are still the backbone of the revenues of the political subdivisions in the state and have an annual yield more than three times greater than that of the sales tax.<sup>54</sup> Consequently, it would seem reasonable to assume that no substantial violence is done to sound economic practice when the sales tax imposed in an American state is only a part of a revenue structure balanced by substantial income, inheritance, and property taxes.

It must also be borne in mind that, while for reasons already suggested<sup>55</sup> the Federal Government does not impose direct property taxes, it does impose substantial levies on incomes, both personal and corporate, and on estates and gifts, so that these fields of taxation are, as Professor Simpson pointed out at the Baltimore Tax Conference in 1937,<sup>56</sup> fairly well pre-empted by the national government. In fact, since the recent national emergency, the force of his remarks is much greater than it was when they were uttered four years ago. Thus, while the case for the retention of the sales tax on economic grounds may not be as strong as the most ardent advocates of this form of taxation would like to have us believe, the case against the tax is by no means compelling. The necessity for the revenue which it produces is inescapable and it seems clear that the current need for the retention of the tax is such as to eliminate the possibility of its abandonment unless it shall be shown to be so expensive to administer or so adverse in its effect on business as to defeat the purpose for which it is imposed, namely, the effective production of public revenues.

In California, where gross income from the sales tax has been outstanding, administrative costs have not been disproportionately high. Currently, these costs represent approximately 2.52 per cent of the total collections.<sup>57</sup> It has been demonstrated that for every dollar spent on field audits approximately \$4.50 can be returned in additional revenues. The net result of this has been that the field audit program has of itself produced more than enough to pay the entire costs of administration. Experience in other states has indicated that there is considerable variation in administrative costs which range from less than one per cent to over four per cent.<sup>58</sup> In none of the other states, however, has the *per capita* yield approached that in California so that it may be concluded that in order to enforce the tax efficiently a reasonable, but not excessive, administrative expense is required. Owing to favorable economic

<sup>53</sup> ASSESSOR'S NEWS LETTER, *supra* note 38.

<sup>54</sup> *Id.* at 6.

<sup>55</sup> See discussion at p. 431, *supra*.

<sup>56</sup> Simpson, *supra* note 43.

<sup>57</sup> Cal. State Board of Equalization, *Biennial Rep.* (1939-1940) 4.

<sup>58</sup> Fed. Tax Adm'rs, *Research Memorandum No. 72* (Nov. 1938); Huston and Berryman, *supra* note 37.

and geographical conditions, California authorities may have a somewhat easier task than that confronting sales tax administrators elsewhere, but it seems fair to assume that in the average state an efficient sales tax administration should be achieved at an administrative cost not materially exceeding three per cent of the total collections. If this is correct, it would follow that the expense is not disproportionately high, inasmuch as experience with respect to income and property taxes generally has indicated that effective administration cannot be achieved at costs which are relatively lower. In fact, it has been demonstrated that efficient administration of these other taxes frequently requires expenditures absorbing considerably higher percentages of the total collections. Thus, the efficiency of the sales tax as a revenue producer is not vulnerable to attack on the ground that this form of taxation requires an excessive administrative outlay.

Much has been said with respect to the incidence of retail sales taxes and their effect on business. The principal difficulty in connection with these utterances is that they have for the most part been self-serving declarations of those who were either desirous of demonstrating that the tax is ideal or, contrariwise, that it is iniquitous. As pointed out in a recent article by John F. Due of the University of Utah,<sup>59</sup>

The explanation of the incidence<sup>60</sup> of retail sales taxation has failed to keep pace with the expansion in the use of the levy in the United States. The general belief is that such taxes are borne by the consumer group except under unusual conditions.<sup>61</sup> This view has been accepted by legislative bodies; attempts have been made in some states to insure that shifting will occur by special provisions of the law. However, little careful analysis of the problem is to be found. Neither in terms of the theory of value or retail pricing practices<sup>62</sup> has shifting been explained in any detailed fashion. The empirical studies of Haig and Shoup and others are of limited scope and of questionable significance in regard to long run incidence.

Commenting upon the immediate effect of sales taxation on retail prices, Mr. Due continues:<sup>63</sup>

When a general retail sales tax is introduced, the costs of handling each good are increased by the amount of the tax. Accordingly, firms will attempt to increase the percentage markup; since the tax takes a uniform percentage of the sale price of the goods, the percentage increase in markup will be the same so far as margins are uniform among lines; where they are not, the percentage increase in markup will be greater in the cases in which the margin is smaller. . . . In some cases, the stores may add the tax as a separate charge, quoted separately from the original price; in this case there are essentially two margins, one collected by the retailer for himself, the other for the state.

As to the ultimate effect of the tax on retail prices, Mr. Due has this to say:<sup>64</sup>

<sup>59</sup> Due, *The Incidence of Retail Sales Taxes* (1940) 25 BULL. NAT. TAX ASS'N 226.

<sup>60</sup> By the term incidence is meant the manner in which the burden of the tax is finally allocated as among various groups in the economy. This can be determined only after consideration of all readjustments which occur as a result of the tax, including such secondary reactions as changes in the prices of the factors. (Author's footnote).

<sup>61</sup> That is, that consumers are able to obtain less goods and services from their money incomes because of price increases. (Author's footnote).

<sup>62</sup> The best discussion on this basis is that by Willemssen, A. C., "Operating Aspects of the Retail Sales Tax," *Harvard Business Review*, II: 107-114, Oct. 1932. (Author's footnote).

<sup>63</sup> Due, *supra* note 59.

<sup>64</sup> *Id.* at 227.

In general, the long run incidence of the tax is the same as that immediately after the imposition of the levy, so long as costs, exclusive of the tax, are not affected by the latter. The average cost at the reduced volume of output may be somewhat less in the long run than at the time of the original levying as capacity is readjusted; the additional burden on the consumer may thus be reduced somewhat over a period of time. . . . Once the increase, which allows full shifting, occurs, there is no reason for a subsequent price decline, so long as factor prices remain unchanged.

The point may well be raised as to the significance of certain state laws requiring the addition of the tax as a separate charge apart from the sale price of the goods. Under pure competition, such laws are entirely futile, since no firm can raise its prices at all until exodus; with pure monopoly they would not accomplish their purpose since the monopolist would typically reduce his net sale price. But with monopolistic competition and oligopoly,<sup>65</sup> the provisions are of considerable importance in aiding price increase, since each firm is given added assurance—though of course no absolute guarantee—that the other firms will raise their prices. A powerful psychological force is added to the elements facilitating shifting. No longer does the force of inertia—of letting existing conditions remain—favor absorption, but instead serves to aid shifting.<sup>66</sup>

Developments in the interpretation of the commerce clause of the Federal Constitution, by which use and sales taxes on incoming interstate shipments have been approved,<sup>67</sup> have done much to mitigate the trade-area difficulties to which the Chairman of the Mississippi Tax Commission alluded in 1933 when he spoke of some of the objections made to sales taxes by the mercantile interests.<sup>68</sup> Consequently, it would seem that while such taxes inevitably must affect the volume of trade to some degree just as would any factor increasing the cost of doing business, they do not appear to constitute positive hazards to profitable commercial enterprise under normal conditions. On the other hand, because of the crucial fiscal needs of the states, inclusion of such taxes as a part of their revenue systems would seem preferable to increases in income taxes, either corporate or individual, or property taxes as to which the burden is so heavy that added use of these levies would produce greater hardship to business than would the retention of moderate sales tax rates.

To attempt to forecast the developments in respect of the place of consumers' excises in the tax system, would be rash indeed. Perhaps the best observation would be one made several years ago by that eminent economist, Professor Adams, whose words were quoted at the beginning of the consideration of this topic. To again borrow from Professor Adams,<sup>69</sup>

Taxes are as complex as life. The moralist calls for just taxes; but taxes cannot just be *just*. The administrator asks for simple taxes; but experience shows that they cannot simply be *simple*.

<sup>65</sup> That is, that firms take into consideration the effect of their own policy on that of their competitors. (Author's footnote).

<sup>66</sup> Consumption-tax shifting is analyzed by Martin, *Distribution of the Consumption Tax Load*, *infra* this issue.

<sup>67</sup> *Henneford v. Silas Mason Co.*, 300 U. S. 577 (1937); *Southern Pacific Co. v. Gallagher*, 306 U. S. 167 (1939); *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U. S. 62 (1939); *McGoldrick v. Berwind-White Coal Mining Co.*, 309 U. S. 33 (1940); *Nelson v. Sears, Roebuck & Co.*, 312 U. S. 359 (1941). These developments are traced and evaluated by McNamara, *Jurisdictional and Interstate Commerce Problems in the Imposition of Excises on Sales*; Brown, *The Future of Use Taxes*, both *infra* this issue.

<sup>68</sup> See the quotation at p. 433, *supra*.

<sup>69</sup> Quoted by Stone, Chairman, Mississippi Tax Commission, *supra* note 20, at 230.