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Some Aspects of State and Local Taxation

By VERNON G. SORRELL

THE problem of raising and spending governmental funds is an ever-recurring one, whether we have in mind the local, state, or national government. This situation probably is, on the whole, inevitable. As economic conditions change new methods of taxing, borrowing, administering, and spending must be devised to meet the new conditions. It is quite possible that certain taxable industries may come suddenly into existence while others may as suddenly decline and disappear; as time goes on, new conceptions of the scope of governmental activities may develop; new ideas concerning the use of taxing power to force a redistribution of wealth may spring up from time to time; it may be considered desirable, at different periods, to tax out of existence certain devices and practices which are held to be inimical to the public welfare; all of which inevitably result in fundamental changes in the system of collecting and disbursing of public monies. The economic history of the American people bulks large with the perennial tax problem. Those who fondly hope for an ideal system that will stand the test of all times and all conditions probably never will see their dreams realized. As economic conditions change, the system will change, perforce, to meet them.

However, in spite of the fact that conditions change, there are certain fundamental ideas that should be borne ever in mind in the matter of civic housekeeping, or at any rate, civic housekeeping in the twentieth century. It is the purpose of this article to discuss in summary fashion certain of these fundamental ideas with particular reference to state and local problems.

At the outset it is well to remind ourselves that the only purpose of raising public money is to spend it. It is an un-

wise policy for any jurisdiction to save in the sense that individuals save. If, then, all monies are to be spent, the subject of public expenditures is the most important one in the entire field of public finance. At once this raises the question of the proper scope of the state's activities. This question, in turn, depends on the political philosophy of the people, who, as individuals, will differ in their opinions. No one nowadays seriously questions the advisability of the expenditure of huge sums of money on our public school systems. Again, no one will argue earnestly that the building of roads, care of the dependents, administration of justice, etc., are not proper functions of the state. On the other hand, no one will contend, although there might be exceptions, that the state should provide a job for everyone upon his attainment of a certain age. Over the border line cases, however, controversy waxes warm, as, for example, whether a city should own and operate its public utilities, or whether a state government should engage in the manufacture of some commodity which hitherto has been supplied by private enterprise.

While great differences of opinion exist regarding the scope of governmental activity, nevertheless there is a principle which should be the guide. The end and purpose of all economic endeavor is to provide means for the satisfaction of man's material wants. This being true if a state is able to satisfy human wants better by state expenditure than individuals are able to do by their own expenditures, it is bad economy for the state government not to incur the expenditures. Adam Smith, years ago enunciated this principle, with the further warning that care should be taken that the cost of collecting and disbursing of the state's revenues should be held to a minimum so that the advantage derived from shifting the activity from individuals to the state would not be overcome by the high cost of administration. Governor La Follette of Wisconsin has said the same thing in 1931. If a state government is able to engage in certain

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economic activities, so the governor says, in a more economical manner than individuals, then it is unproductive for society if the state does not so engage in those activities.

It goes without saying that governmental expenditures should increase the well-being of the people. Wealth, preferably, should be increased, but in no event should it be decreased. The patrimony of a people must never be diminished by the taxing power. To do so, as unfortunately it has been done frequently by governments of the past, impoverishes the people, invites revolution, and leads to the decay and destruction of organized society.

It seems to be the better fiscal policy for a people to decide first what the government should spend in carrying out its various functions and then devise ways and means to meet the proposed expenditures. This policy does not mean, however, that in making budgets due regard should not be taken of the probable sources of revenue. In this respect governmental policy is different from the policy of individuals. No one would argue seriously that as a general rule individuals should make provision to spend their incomes before they had received or had contracted for them. Rather the opposite is true. But inasmuch as government exists for the carrying out of functions delegated by the people, the functions should be determined first and the necessary funds raised afterwards.

The chief ways in which governments raise funds are by means of fees, special assessments, borrowing and taxation. Taxation is the most important of these means. A tax is a general compulsory contribution of wealth levied upon persons, natural or corporate. The different kinds of taxes are legion. There are, however, relatively few of importance under modern conditions. Under the more important taxes may be listed (1) the income tax, (2) the general property tax, (3) the corporation tax, (4) the inheritance tax, and (5) the sales tax. In a system of state and local

taxation the use of all the above in one form or another is probably desirable.

Even a cursory examination of the tax systems of the states of the Union will show that they are extremely complex. Systems have "just growed," like Topsy, without apparent rhythm or reason.

For many years students of taxation have dreamed of a simple tax system in which a tax on a single thing would be the basis of the system. In theory, a tax on personal incomes meets all the requirements of such an ideal tax. After all, personal incomes ultimately bear the entire tax burden, regardless of how the tax is imposed; otherwise capital is impaired and wealth destroyed. Wealth is valuable only as it produces an income, and a tax on the income is likewise a burden on the wealth that creates it. Again, income is by the large the best index of a man's ability to pay, regardless of whether the income is derived from property in any or all its forms or from personal services. While in theory an income tax is the ideal tax, yet no one seriously contends that it should be the only tax under present conditions.

Within the past several decades the income tax has gained decided favor amongst both theoretical students of taxation and practical statesmen. Wisconsin was the first state to have an income tax law, which was enacted in 1911. Since that time some nineteen or twenty states have made use of the tax in one form or another. The first Federal income tax law was passed October 3, 1913, several months after the passage of the Sixteenth Amendment. This Act was the culmination of several decades of discussion and controversy: The income tax had to be justified from a theoretical as well as a practical point of view, and difficulties concerning constitutionality had to be overcome. The states have been slow in adopting the idea of such a tax, and those states that have adopted the idea have had difficulties

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in forming a workable law. However, there can be no doubt of the trend at the present time toward state income taxes.¹

Perhaps the chief practical argument for a state income tax is that it will hit a source of ability to pay that invariably escapes under other types of taxes. The general property tax is the oldest of our taxes and it grew up when practically all wealth existed in tangible form which was fairly easy to assess and quite difficult to conceal. At present, however, an ever increasing portion of the nation's wealth consists of intangibles—stocks, bonds and other securities. Now it is a notorious fact that intangibles are seldom taxed under the general property tax—the owners simply evade the tax. Yet it is certainly true that wealth in the form of securities represents taxable ability. A tax on personal income, it is argued, will strike at this ability to pay.² Furthermore, such a tax will relieve the burden on general property, which, it is admitted by all, bears a burden, in comparison with other taxable sources, entirely out of proportion to the ability represented thereby. Governor Harry H. Woodring, of Kansas, said in his recent message to the legislature of that state, "To my mind the only feasible and equitable method of broadening the base of support of the various governmental activities; of lifting a part of the load now borne by real and tangible personal property, is through a graduated tax which adjusts the tax to the ability of the tax payer to pay; a graduated income tax law that restricts the revenues so derived to an actual reduction of the general property tax. I am firm in my belief that every

1. This trend may be discerned from a reading of recent messages of the Governors of the different states to their respective legislatures.

2. There is no evidence that income derived from intangible property escapes the federal income tax in any very appreciable amount. According to the treasury report covering the 1929 returns, dividends from domestic corporations constituted the second greatest source of taxable income, being 16.74 per cent of the total. (Wages and salaries came first with 37.34 per cent). It seems that people will make an honest return to the federal income tax collector, whereas they will not turn in their intangibles to the local assessor. Whether this is because they have more fear of the strong arm of the federal government or whether they have more respect for the income tax, is perhaps difficult to say definitely, but probably the latter is the more important reason.

person having taxable ability should pay some sort of a direct personal tax to the government under which he is domiciled and from which he receives the personal benefits that government confers." There are few who will disagree with the governor.

Modern income taxes usually take the form of graduation. That is to say, the rates are so devised that a greater proportion of a large income is taken by the government, than of a small income. This principle of progression seems to have become well established in the theory of taxation, although up to the end of the last century it was argued that the idea was "socialistic" in that it effected a redistribution of wealth—an argument which is seldom heard now. While it is true that progressive taxation has its effect on the distribution of wealth among the different classes in society, nevertheless, no one would argue seriously that a man with an income of \$100,000 bears a heavier burden if he pays \$5,000 in taxes than the man with an income of \$3,000 who pays ninety dollars. In the first case the rate is five per cent, while in the second it is three per cent.

Never before has there been a more propitious time for the introduction of state income tax laws than at present. The federal law has been in operation 18 years and during that time the public has been educated to the idea of this kind of tax. While, no doubt, there are defects in the national law, nevertheless, on the whole it has worked well and the public is fairly well satisfied with it. There seems to be no reason why the states in administering their income tax laws should not be allowed to utilize the federal machinery already in existence. As an outstanding tax authority puts it, a state income tax might very well "lean up against" the federal law. It seems desirable that Congress make provisions to bring into existence co-operation of this nature. Under such a co-operative plan the tax payer would make one return which would be used as the basis for both federal and state levy.

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The oldest and most universal of taxes is the general property tax, which, at present, is the greatest source of revenues for state and local jurisdictions. This tax is levied generally upon all property, real or personal, tangible or intangible, and the rate is the same for all property. In its origin it was intended to be a direct personal tax; in more recent time the theory has changed somewhat and it is now considered to be a tax on objects irrespective of their owners. This property, in some states, may be taxed in the name of "unknown owners." The levy is based upon the true value of the property.³

The general property tax has been the subject of controversy for many decades; it has been "cussed" and discussed from many angles; often it has been spoken of derisively, and in many quarters it has been the butt of jokes and ridicule. A discussion of the weaknesses of this tax will serve two purposes; it will show its essential nature, and it will show further the reason for its falling into disrepute.

In the first place, the general property tax is universally evaded. This is not true so much in the case of land, buildings, and certain items of tangible personal property, but it is notoriously true in the cases of intangibles. Yet even in the case of tangible personal property the picture is none too rosy. According to the tax roll of a fairly prosperous and populous county in a certain western state, so the writer has been informed, there is not a single piano nor a solitary diamond ring! (No one believes there are no solitaires, however.) And when we come to the matter of evasion of monies, credits, and other intangibles, the picture is black indeed. Professor Daniels, one of the outstanding authorities on public finance, says, regarding the effectiveness of oaths, affidavits, etc., that the tax payers must make in declaring this type of property: "If Jove

3. Invariably the tax laws use the expression "fair value," "full value," "true value," or "fair market value," or some equivalent phraseology.

laughs at lovers' vows, he probably guffaws at tax payers' oaths. . . . Where the tax payer's conscience is tender, he finds (as one puts it) that virtue is perforce its own reward. This phase of the system is described in one tax report as 'a tax upon ignorance and honesty,' and in another report we are told that 'the payment of the tax on personal property is almost as voluntary and is considered in pretty much the same light as donations to the neighborhood church or Sunday School.'" Other tax authorities and tax commissions have been even more condemnatory of this ancient tax.

In the second place, there is an inherent weakness in the matter of assessment. The laws state that the assessment shall be based on the true value of property. But what is the true value? Now the best notion of the value of anything is what it will fetch in a free market. The true value of a bin of wheat, for example, may be fairly easily arrived at because wheat is bought and sold every day of the year and it is a simple matter to obtain the current quotation. But the vast amount of property, especially tangible property, is not the subject of regular and steady sales. Consequently, the assessor is more often than not forced to make a guess. If the owner thinks the guess is too high he makes his own guess and the matter goes before an equalization board of some kind. What happens there is usually a compromise between the two guesses. And the problem becomes increasingly more difficult as the property increases in amount, variety and permanency. The property of public utilities is a case in point. The legislators and courts have struggled with the problem of fair valuation for a number of decades and the problem seems to be getting no nearer a solution. The problem perhaps has more practical bearing on the matter of rate making than in levying a tax, yet in essence it is the same problem. What should be the basis of valuation? Is it original cost of production, original cost of production less depreciation, cost of repro-

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duction new, or less depreciation, or capitalized value of earnings, or what not? There is no unanimity of opinion. The supreme court has favored reproduction cost in recent cases for rate making purposes.⁴

It is beyond the scope of this article to discuss the various possible bases of valuation; it will be sufficient to say that the writer favors the capitalized earnings basis for taxation purposes.

Because of the inherent difficulties of assessment and ease of evasion, a number of undesirable features result. There is the tendency to assess all property of a like kind at a uniform rate whether or not the different properties are equally productive. This is clearly unjust to the owner of an unproductive piece of property. Again fraud, dishonesty, and perjury, apparently unavoidable, concomitant features of the tax perpetuate a very undesirable moral attitude toward the tax, toward taxation in general, and toward the government. And further, an inequitably heavy burden is placed upon the owners of land because land cannot be hid from the assessor. Finally, the tax stands in the way of more efficient systems of taxation.

The glaring defects of the general property tax have led to various and sundry so-called reforms of the tax itself. Yet the problem is not being solved. A number of writers think the only solution is an abolition of the tax entirely, but with the retention of a special tax on land and permanent improvements. It is believed that greater justice will prevail if the public revenues are obtained from other sources, notably the income tax.⁵

4. The utilities are often between two fires on the question of valuation. They desire as high a valuation as possible for the establishment of a rate for their services, but as low as possible for the tax levy. Consequently, we have had the interesting spectacle of their officials appearing before a utility commission with one set of figures and before a tax commission with another.

5. There is much to be said for the retention of a tax on real estate. Land and buildings cannot escape the assessor easily, they represent in a fair measure ability to pay, and such a tax is fairly easy to administer. No tax jurisdiction is ready, under present conditions, to adopt the income tax as the sole tax, consequently, it seems wise to retain this important element of the general property tax.

Sales taxes, often known as consumption or excise taxes, take varying forms and are used by both federal and state jurisdictions. Taxes on tobacco, liquors, drugs, etc., are imposed by the federal government, not so much for the purpose of raising revenue as for the purpose of regulation. The states have not made great use of sales taxes, except in one notable instance, i. e. the gasoline tax. There are several principles that should guide in sales taxation. First, the tax should be imposed on articles of widespread consumption. This increases the productivity of the tax and distributes the burden more equitably. Secondly, being a consumption tax, the point of imposition should be as close to the consumer as possible, otherwise an undue carrying charge is thrust upon the producer.

It has been argued that a sales tax should bear but lightly, if at all, upon the subsistence level of living. That is to say, basic commodities, like bread, meat, tea, and coffee should not be taxed on the theory of justice which says that a certain per cent of the poor population, by virtue of their poverty, should not contribute toward the support of the government. To this principle there may be certain justifiable exceptions. There is justice in the view that every person should contribute something, however small, to the support of government, provided he has at least some ability to pay. If this principle is accepted, then a tax on basic commodities becomes an ideal tax for the purpose of imposing a part of the total tax burden on the lower income groups for the reason that seldom, if ever, are they taxed in other ways.

The most important sales tax among the states is the gasoline tax. In many ways it is a good tax. It is levied upon a commodity that has widespread consumption; it is a good revenue getter; the burden is widespread and the tax is levied in the first instance, as a rule, on stock in the hands of the wholesaler and at a point as close to the consumer as is justified from an administrative point of view.

Furthermore, because the use to which the revenue has been put, i. e. improvement of roads, has resulted in a tangible and real benefit to the users of gasoline, it has never been an unpopular tax. In addition, the rate is not felt to be excessive, which has further enhanced its popularity, although there is some evidence at present that some states may increase the rate to such an extent that it will become burdensome to at least a portion of the public.

Other forms of sales taxes used by the states may be mentioned. Eleven states tax tobacco; a number of states tax soft drinks, candies, etc., prize fight admissions and one state, South Carolina, taxes theater admissions. Occupation taxes, severance taxes, i. e. tax on material extracted or "severed" from the earth, privilege taxes, etc., are other forms of this tax.

A tax that has gained popularity among the states in the past several decades is the inheritance or estates tax.⁶ At the end of 1928 only three states were without this tax in some form. The rates usually are progressive in two ways: The rate may increase as the value of the estate increases; if the tax is levied on the distributive shares the rate may increase not only with the size of the share but also with the degree of relationship of the beneficiary to the decedent, that is to say, collateral heirs are taxed more heavily than direct heirs, and strangers more heavily than collateral heirs. Practice differs on the point of imposition of the tax; some states tax the estate, others the distributive shares. The federal inheritance tax imposes the tax on the total estate.

Opinion is fairly unanimous that the inheritance tax should be a state tax, rather than a local or federal tax. Congress might well repeal the federal estates tax, leaving this field to the states entirely.

6. If a tax is levied on distributive shares it is known as an inheritance tax; if levied on the entire estate it is known as an estates tax.

In its development the tax on inheritances had met much opposition from a theoretical point of view. These objections have been overcome in large part until now it is generally conceded that this tax is a permanent part of our tax system. Justification for this tax is based on the following considerations. First of all, private property is a creation of society, and what society has created it may abolish. The view that property rights, i. e. rights to possess, use, transfer, bequeath, etc., are "natural," may have been good philosophy in the eighteenth century, but it is hardly in accord with twentieth century ideas. If the right of bequest is a right conferred upon ownership by society then there is no inherent reason why society may not curtail this right by taxation. In the second place, the tax strikes at ability to pay. A sudden increase in the beneficiary's income certainly increases his taxable ability, and in justice he should be taxed on this ability. In the third place the tax, in a measure, leads to a desirable redistribution of wealth. The opinion is gaining strength that a man's wealth should bear some direct relationship to his efforts in creating it. Wealth received by direct windfalls, to use an English expression, seems to be a peculiarly fitting object of taxation. Then again, it is a notorious fact that huge fortunes often are dissipated by the heirs. There is truth in the old adage that there are but two or three generations between shirt sleeves and shirt sleeves.

Another fairly new tax used in the several states is the corporation tax. Practice varies widely on the method of levying the tax: Seligman enumerates sixteen different bases for the levy, among which are, value of property, gross earning, net earning, franchise, dividends, and capital stock plus total debt. Space will not permit discussion of these methods; we will content ourselves with a brief discussion of the general principles of the tax.

In the first place the question might well be raised—why tax corporations at all inasmuch as they subserve only

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the ends of individuals who create them? This is a fair question, although to a considerable extent academic. Corporations are artificial persons enjoying no benefits *per se* and have no income other than that which is destined for individuals, and a direct personal income tax is the best tax on personal ability represented by this income. Yet from an administrative and practical standpoint much is to be said for a tax imposed upon corporate capacity and for this reason, if for no other, states should make use of this tax.

Granting the desirability of the tax it is to be noted that in the first place it is unfitted for local purposes because the scope of activity of the corporation invariably extends beyond the boundary of local jurisdictions, and for this reason state governments logically should impose the tax. In the second place, the tax should be levied upon earnings although this need not be an iron-clad rule. Net earnings is a more logical basis than gross earnings. Again, because from a practical point of view no single type of levy will be suitable for all corporations so the method of taxation should vary with the type and scope of activity of the corporation. For example, how will a state tax a hydro-electric plant which is distributing power over a wide area, covering a number of adjacent states? Will it be taxed in the same manner as a corporation engaged in the milk business, whose scope does not extend beyond the confines of a single county? There is no reason why different methods might not be used in these two cases. Lastly, inasmuch as the corporate form of business organization is predominant in the economic world, the increased ability to pay resulting from the greater economic efficiency effected thereby should have a predominant place in any tax system, regardless of the kind of taxes which make up the system.

Another subject of outstanding importance in any local or state tax system is that of the incidence of the taxes in the system. By incidence is meant the final resting place, i. e., that upon which the burden eventually falls. It is a

matter of common knowledge that the tax may be, and often is, passed on from the person who in the first instance pays it to some one else. In fact, many taxes are levied with this intention. Certain principles seem well established, covering the matter of shifting and incidence.

At the outset it should be pointed out that the only way a tax may be shifted is through prices, i. e., if it is a shiftable tax the person who has the tax to pay is able to charge a higher price on some commodity or service, and thus recoup himself from the higher price.⁷ We shall discuss this subject in relation to certain specific taxes. An income tax obviously cannot be shifted. Presumably the income of the recipient is as large as it can be and a tax cannot make it larger. A tax, it is true, may have the effect of stimulating the incentive to earn, but this is not shifting. A tax on land and permanent improvements has long been held to be non-shiftable but the value of the property is lowered to the extent of the capitalized value of the tax. For example, a tax of \$100 on a piece of land capitalized at 5% will lower the value \$2,000. Such a tax will fall entirely on present owners, while subsequent owners will escape. For this reason old land taxes are said to be "burdenless." A tax on less permanent forms of property is shiftable, depending on the nature of the supply of and the demand for the thing taxed. For example, a landlord may shift a tax on the value of his apartment house by raising rents if there are no other available apartments into which his tenants may move. Otherwise he must bear all or considerable part of the tax himself. The same general considerations apply to the incidence of a sales tax. If the demand for the thing taxed is such that the consumer will purchase the same amount if the price is raised the consumer will bear the burden, otherwise the tax is borne by the producer. As a general rule the burden of sales taxes is diffused between the consumer and

7. Shifting should not be confused with evading; nor should the incidence be confused with the effect of a tax.

producer, unless, of course, the producer has a monopoly and the tax is levied upon monopoly profit, in which case he will bear it. Frequently a tax will have the opposite effect of that which was contemplated, due to the factor of shifting. No doubt the burden of the gasoline tax, for example, is meant to be borne by the motorist, and unquestionably the aim is achieved; but the tax on the value of a mortgage, as Plehn points out, results in an increase in the interest charged by not only a rate equal in amount to the tax but something in addition. In other words, the borrower not only bears the burden of the tax but the cost of shifting as well.

In conclusion it may be said that the solution of problems of governmental getting and spending in the modern complete economic society requires a knowledge of the facts, a thorough acquaintance with the economic principles involved, a keen sense of justice, and an appreciation for honest and capable administration. The old rule-of-thumb methods must give way before scientific principles. The principle of the Irishman wielding his shillalah in a saloon brawl of "see a head and hit it" is hardly a just rule for authorities to follow in exercising the tax power. Nor is the rule embodied in the time-worn taxation adage—"Pluck the goose with the least amount of squawking," in keeping with twentieth century ideas. The problems of state and local finance are varied and complex, and that community gains which calls upon the best tax authorities in the country for aid in the solution of those problems.