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A GENERAL VIEW OF THE INCOME TAX

IRVING FISHER

The concept of income lies at the center of all economic science and, consequently, at the center of the tax problem.

In so short an article as this it is possible only to take a general or a bird's eye view. Elsewhere¹ I have used the microscope. This may excuse me for here passing over detailed proofs and even indulging, at times, in mere assertions. Anyhow, the microscopic method and the telescopic method both lead to the same result.

Microscopically, the income from any capital item or asset consists of the net value of the series of services, sometimes microscopic, which that asset renders to its owner, over and above its disservices. For example, services rendered by a bond include the interest payments which it yields; those of a share of stock, the dividend payments it yields; those of a leased piece of real estate, the rent payments, less the costs of collection and any other disservices.

In these examples the services consist of money payments. As to those assets whose services are in kind, a dwelling is such an asset. The income it brings the owner is in the form, not of money payments, but of shelter. His wardrobe of clothes is another such asset, rendering, as its services in kind, the wear or uses of the clothes. In like manner his larder of food serves him with nourishment. And there are many other such assets including all goods for personal use. Every little asset, even a lead pencil, yields its quota of income, consisting of the series of services which it renders its owner.

Disservices may be considered as negative services. Almost every asset occasions some negative service whether it be money cost or cost in kind, such as labor. The shelter of the dwelling house is only the *gross* income it brings in. From this gross must be deducted the cost of repairs and of betterments and all other negative services. Likewise, the wardrobe and the larder must be debited with the costs of mending, replenishment, and so forth, in order to get the net income which they yield in a year.

Most services credited to one asset are at the same time disservices debited to another asset. Thus, the very same payment for interest which was credited to the bond must be debited to the bank account into which it is paid. Such pairing of a credit with an identically equal debit is the familiar double entry bookkeeping.

¹See especially, *A Practical Schedule for an Income Tax*, the TAX MAGAZINE, July, 1937, Chicago, (largely a condensation of *Income in Theory and Income Taxation in Practice, Econometrica*, January, 1937, which is a mathematical elaboration of certain parts of THE NATURE OF CAPITAL AND INCOME, [1906].

John Smith's entire income is simply the sum total of all the services (positive and negative) rendered him by all his assets (positive and negative). His own body and mind may be included among his assets as being the source of wages, salaries, professional fees, or commissions.

When this grand net total of all the microscopic services, positive and negative, is computed, it will be found to be substantially equal to the money paid John Smith for his work plus the net money from his investments. All the rest of the services and disservices will substantially cancel themselves out. In particular, the credits and debits to his bank account will, in the long run, be nearly equal, as will the credits and debits to his goods for personal use.

So much for the microscope. Now for the telescope. John Smith's "real" income is, of course, not money at all. It is what he gets for his money; that is, from the personal-use goods and services for which he spends his money.

Money has no significance except as purchasing power directly or indirectly for food, shelter, clothing, amusements, and all the other personal uses (so-called "consumption"²) which make up real income. Primitive man used no money. Yet he certainly had income in the only sense that counts—shelter, nourishment, clothing, amusements. In fact, his real income was more in evidence than is the real income of civilized man. Nowadays real income is overlaid and hidden by the veil of money, especially since the advent of sophisticated accounting. In our preoccupation with money income, we almost forget that there is such a thing as real income. It even requires an effort to translate money wages into real wages.

Unless real income and net money income correspond, something must be wrong with our accounting. By microscopic accounting of all services and disservices, or credits and debits, we find John Smith's total net income to be the net money receipts from his work and investments, after all due deductions (including deductions for reinvestments³); and this should agree with the real income which can be seen by the telescope of common sense.

In short, what money a man gets from his work and investments and does not put back *into* investments must be spent for personal uses, or his real income; and what is thus spent for his real income during a year may be presumed to measure the value of the real income enjoyed by him during that year.

²*Consumption*, strictly speaking, should be confined to goods like food, which are destroyed by being used. We do not, in that sense, consume a piano; but we *use* both the piano and the food. Both render services or uses.

³Under our present self-inconsistent system such deductions are made when the reinvestment is done for the individual by a trustee or (until the recent undistributed profits tax) by a corporation, but not when done by the individual himself or by a partnership of which he is a member.

What he reinvests represents what he abstains from enjoying during the current year and defers to future years,—presumably with increase.

All the minute adjustments involved in this reconciliation between the two ways of viewing income have been fully discussed elsewhere. Only the final result need engage our attention here. In homely phrase, this result may be restated as follows: "Income is what is used (or spent) as income."

While this fundamental equality between total net money income and real income is a demonstrable fact, it is not usually appreciated in all its important implications nor even always recognized as a fact at all. It is largely because of the failure to see this vital truth that we are now witnessing so dismal a failure of the income tax. Income tax evasions, avoidances, and litigations have recently been filling the public press. Most of these difficulties would never have arisen had our eyes been kept on real income. We have almost lost the bird's eye view.

Federal tax decisions on controverted questions have already filled 15 volumes, besides 33 additional volumes of reports of the Board of Tax Appeals. Every year, some 1500 new decisions are made by this Board and 1,000 by the Federal Courts.

Too often these decisions leave doubts in the minds of litigants, if not of judges. Still more serious is the fact that the decisions, even when there is no room for doubt as to the law, are felt to be too "legalistic" and are bitterly resented by the defeated litigants as unjust.

Finally, there is the equally distressing fact that the Government itself, when defeated, often feels that the taxpayer has escaped only by taking an unfair advantage of "loopholes" in the law.

At its last session, Congress, following an urgent appeal of the Treasury Department, sought to "plug" some of these loopholes. But such patching up of our flimsy legal garment is not enough. We must cast the garment aside and make a firmer fabric.

Much of this loophole-plugging has been in reference to personal holding companies, and the incorporation of yachts and other personal-use properties. Some 25 out of the 50 pages of the new act are given over to foreign personal holding companies, described as devices used exclusively for tax evasion and avoidance.

The trick of the tax evader of this type is to set up a personal holding company, make over to it his stocks and bonds, and systematically "borrow" of this company "capital sums" equal to the dividends and interest received "by the company" from its stocks and bonds. He then spends these "capital sums" for his living expenses—converts them into his real income. That is, while he uses them as income, he pretends they are borrowed capital.

Under a true income accounting, such a trick would avail the trickster

nothing whatever; for his real income would evidently come out the same, however he got it. If now he can hide it by juggling accounts, it is because now the accounting is at fault; and the accounting is at fault because it is based on false concepts of income and capital.

Incidentally, we may repeat that the microscopic service-method would admit of no juggling any more than the common sense bird's eye view which keeps in view only the real income.

Another hole which Congress tried to plug was the "artificial" taking of a loss. This device consists in selling a security when it happens to be lower in price than the price at which it was bought (thus registering a "loss"), and then, as soon as the law allows, buying it back again. Although the buying back puts the evader in exactly the same economic position in which he was before the transaction, yet, under the fallacious definitions and accounting of the present tax law, he has "realized" a loss. This "loss" can be used to reduce his computed income and income tax. Merely "plugging" this "hole" will do little to correct the evil; for the evil is based on fundamental fallacies of accounting which have been fully analyzed elsewhere.

Capital gains are not income but capital. Moreover, capital gains and losses are not correctly measured under the present law. It is said that the most by far of the federal tax controversies are over capital gains.

If income taxes were confined to real income, capital gains would, of course, not be taxed. A man's capital gains are not consumed, not eaten, not worn, not used for shelter, not in any other manner "used as income." On the contrary, they are expressly put aside and subtracted from current real income. They should likewise be subtracted from taxable income. Capital gains, savings, undivided profits, appreciations of any and all kinds, are never real income. They mean skimping real income this year for the sake of increasing real income later. We cannot have our cake and eat it too; and any accounting which tells us otherwise is fallacious.

The bird's eye or general view makes all this clear enough. The microscopic service accounting also gives the same result, when fully carried out under double-entry bookkeeping. When capital gain is taxed, the tax is virtually a tax, paid in advance, on the future expected income which that capital gain stands for. If, when that expected income actually arrives, it also is taxed, it has evidently been taxed twice—once in anticipation and again in realization. That is, there is a subtle form of double taxation, the duplication being not simultaneous but successive.

To put this in figures, if during a certain year a man's gross income from his work and from his stocks and bonds and other investments is \$10,000 and if he saves and reinvests \$1,000 in an additional 5% bond, then his net and real income for that year is \$9,000. His income tax that year should

therefore not be levied on the \$10,000; for \$1,000 of it is not used as income but merely stands for \$50 a year of future real income, properly to be taxed only when it comes. Any tax on this \$1,000 of savings, capital gains, undivided profits, appreciation—however it may be labelled—is not a tax on current real income but a pre-tax on the future real income of the \$50 a year for which that \$1,000 accretion of capital stands.

It does not follow, of course, that capital should never be taxed; but if we do tax it we should know what we are doing. We should know that we are taxing not current real income but pre-taxing future real income. This article is not so much a plea for abolishing taxes on capital as it is a plea for a correct accounting and thinking.

It is true, however, that my own personal preference would be to abolish all forms of capital gain taxes except those on inheritances. The accumulations of capital by a Henry Ford would then be taxed not annually but taxed at his death. This would still be double taxation, of course; but it would fall on the inheritor and not on the creator of the wealth. Its purpose would be less economic than sociological; it would tend to forestall the danger of an hereditary plutocracy.

But, even as a tax on capital gain, our present capital gain tax is a delusion and a snare, (1) because it is levied only on *realized* capital gains on sales made within the taxable year; and (2) because it takes account of purchases in *prior years*.

As to the first fault, any appreciation of capital, even though not registered in the form of a purchase and sale, is just as truly a capital gain as one that is so registered and should, therefore, be included in any true capital gain tax. Yet any such capital gains are excluded under our present capital gain tax.

As to the second fault, it is manifestly absurd to include as capital gains of the current year the gains of previous years. Yet such capital gains are included under our present law. A man who sells in 1937 at \$100,000 a security he bought in 1935 for \$40,000, is taxed on \$60,000, all in 1937, though this capital gain accrued not all in 1937 but through two years.

Our present law is therefore at fault both by including some capital gains of past years and by excluding some capital gains of the current year.

The true capital gain of John Smith during any given year is the gain in his entire net worth. A logical capital gain tax would therefore be—a tax on the year's increase in an individual's net worth—the *zuwachs* tax of Germany.

But, even so, it would not be an *income* tax. A true income tax can only be a tax on real income, whether looked at by the bird's eye view of common sense or through the microscope of credits and debits of money payments.

Even those who still insist on adding to such personal use the extraneous element of capital gain ought to admit that, of these two parts of this conglomerate "income," the personal use or "consumption" or "real" part can be most accurately measured by the methods here proposed, i.e., as the net credits of money payments from work and investments or (identically) as spendings, while the other part, the savings or "capital gain" or appreciation or undivided profits, can be most accurately measured as increase of net worth.

The present system is illogical not only because it is a conglomerate, mixing and confusing real income with the capitalization of real income, but also because neither of these unlike parts is reckoned in a thoroughgoing manner. Not all real income is included. Not all appreciation is included, and some is included which does not belong to the taxable year.

If we are ever to obtain a logical and well integrated system of taxation, we must begin by obtaining a logical workable concept of income.

This will enable us to avoid the chief abuses of personal holding companies and of the "artificial" taking of realized *losses*. Above all it will give us the only sound foundation on which to build, or rebuild, our whole tax structure.