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OUTLINE OF A MODEL SYSTEM OF STATE AND LOCAL TAXATION

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Introduction

Systems of taxation are not made to order, but grow out of the history and environment of the people. Changes are generally the result of new habits of life, new methods of business, new forms of property and general modifications of environment. Any consideration of a model tax law adapted to all the States must be governed by the fact that no two States

have precisely the same history, or law or conditions. All that can properly be attempted is such an outline as may readily be adaptable to the conditions in any State. In the following outline every State will find something already in force, and the elastic character of the system proposed allows easy modification and change, as conditions and habits of thought may change.

It is beyond the bounds of possibility that the wisdom of the present shall suffice for succeeding generations. One of the best features any tax system can have is susceptibility to easy modification and one of the worst is a condition of crystallization.

Constitutions

The constitutions of the older States as originally adopted contained few provisions in regard to taxation. The constitution of the State of New York was absolutely silent on the subject until 1901, when an amendment was adopted prohibiting exemption of real or personal property by private or local bill. The constitutions of Massachusetts, Connecticut and Pennsylvania contain almost nothing to limit the power of the legislature. All of those States have profited by this freedom from constitutional restraint.

The federal Constitution prohibits discrimination between subjects of the same class, and between residents and non-residents; it prohibits interference with interstate commerce. These constitutional guarantees afford ample protection to the citizen. Further restraints upon the power of the legislature are efforts to impose the will of a living generation upon all those that are to come.

The constitution of Ohio provides that: "Laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies or otherwise; and also all real and personal property according to its true value in money." The evils of such restraints have become very apparent in all States which, like Ohio and others of the West, have legislated by constitution. These evils will grow worse and worse as the conditions of modern civilization become still more complex. Minnesota has amended its constitution, and Washington and Missouri have amendments pending. The constitution of the new State of Oklahoma will restrain the

legislature no more than that of Minnesota. The Constitution of Minnesota was amended to provide that: "The power of taxation shall never be surrendered, suspended, or contracted away. Taxes shall be uniform upon the same class of subjects and shall be levied and collected for public purposes." The same amendment is pending in the State of Washington. This is vastly better than the former restrictions, but needs the following modification, "within the territorial limits of the authority levying the tax," which should be added so that the sentence may read, "Taxes shall be uniform upon the same class of subjects within the territorial limits of the authority levying the tax."

To legislate by constitution is to legislate for the benefit of courts and lawyers and against the interests of the people. The constitution should furnish a skeleton of government and not a code of laws.

Divorce of State from Local Taxation

Until about twenty-five years ago, the main reliance for state revenue was upon the general property tax. Property was assessed locally by local assessors and a tax imposed on such assessments for state and county purposes, as well as for city or town and other local purposes. Many years ago it was apparent that this was a bad plan, because local assessors were induced to make low assessments in order to save their own localities from paying a proper share of revenue to the State. To remedy this evil, boards of equalization were established, which were supposed to supervise the work of local assessors, and to equalize and bring to a common level the assessments in every county, so that each county should contribute its proper quota of state expenses. The conditions are such that no state board can perform this duty accurately, and their work has always been severely criticised, sometimes justly, as directed by political and personal considerations.

It is inevitable that so long as the State relies upon a tax upon property as assessed by local officials, they will be influenced by the fact that their work affects the contribution of their own districts to larger political divisions. The competition between local assessors to cut down the burden of state

taxes results in assessments contrary to law at a small percentage of the true value of property, and inequalities in local assessments are sure to follow. When assessments are made at a percentage of full value gross inequalities may exist without being apparent. If, for example, the average assessment is only one half of full value, some property may be assessed at only 25 per cent of what it is worth without attracting much notice, and other property may be assessed at 75 per cent of the sum for which it would sell, without the injustice attracting the attention even of the owner. If every assessment in such a place were doubled, some property would be assessed at a great deal more than its selling value, and the injustice and inequality would immediately appear. Assessment, as the law directs, at the full value of property is absolutely essential to secure equality.

From every point of view, good government requires the divorce of state from local taxation.

Exclusive Reliance upon Special Taxes Objectionable

For the last thirty years, economists and state administrators have seen the necessity for some form of divorce of state and local taxation, and have attempted to separate the sources of revenue by providing for the needs of the State by special taxes on selected subjects, laid at unvarying rates. In a few States this effort has been so far successful that the State is wholly supported by such special taxes. Everywhere, however, evils have appeared as a result of this policy. This system admits of no elasticity. Sometimes the state revenue is excessive, when extravagance is inevitable, and sometimes it is insufficient, and the State is forced to borrow or curtail legitimate expenditures. The lack of elasticity, moreover, deprives the people of the State of any direct concern with the management of the state expenditure. Every owner of taxable property should feel a direct concern with state affairs. Extravagance of state officials or of the legislature should come home to him immediately in the increase of his tax payments. To supply the State with money by means of special taxes levied at unvarying rates does not solve the problem. Some such taxes may properly be levied, but there should always be a margin

to be levied so that the amount necessary will vitally interest every taxpayer.

Apportionment on the Basis of Local Revenue

A method of raising so much state revenue as may be required in excess of that produced by special taxes is already in operation in the State of Oregon, and has been advocated in the State of New York by such responsible bodies as the New York Tax Reform Association and the Chamber of Commerce. By this plan so much state revenue as may be required is apportioned to the several counties in proportion to the actual local revenue raised for all purposes in each county. A state board is charged with the duty of obtaining reports from every taxing district in the State, showing the amount of its revenue. Each county is required to pay to the State that proportion of the total sum to be raised which its local revenue is of the total local revenue throughout the State. If the local revenue raised by any county and all the taxing districts within it is one tenth of the total local revenue, that county would pay one tenth of the state tax.

The statistics compiled to carry out this plan of apportionment would be exceedingly valuable in themselves. The taxpayers in every county would have an interest in keeping down their local expenditures, but as those local expenditures would be very much more than the sum they would be required to pay to the State, this inducement would not operate so strongly as to lead them to curtail proper expenditures for local purposes. Every taxpayer would get a bill annually showing the quota of his county to the State and the quota of the preceding year. If the amount increased, his attention would immediately be called to it, and he would inquire whether the state expenditures had increased, or the expenditures of his own town had increased so as to increase the town's share. Every taxpayer would thus be interested in state affairs, would resist the undue extension of state functions and extravagance in conducting the business of the State. By apportioning the state burden in this manner, local assessments would no longer have any influence whatever in determining the amount of state taxes any community would pay. It would be prac-

ticable and probably desirable to provide county revenues by apportionment among the smaller political divisions of the county, such as towns and cities. In this way all questions of county equalization, which are frequently as troublesome as state equalization, would be avoided.

Subjects of State Taxation

The selection of proper subjects for state taxation must be governed by the history and present conditions of each State. Revenue is now derived from some States under laws which are not by any means perfect, but which have been in existence so long that it would be undesirable to change them at present. In some cases the State should perform the work of assessment, and whether it should retain the revenue or distribute it to the cities and towns is a question which must also be solved in view of the existing conditions in the State.

The following subjects, if taxed at all, will generally be found suitable for state revenue:

Inheritances,
Mortgages,
Insurance,
Business corporations,
Mineral rights,
Public service corporations.

Inheritances

A tax imposed on the transfer of property at death, commonly called an inheritance tax, is becoming a common source of state revenue, and is employed by many foreign countries. There are, therefore, a large number of precedents in the form of laws which have been in existence for a number of years, and which have been construed by the courts. It is a tax which, if imposed at all, must be imposed at unvarying rates, and the proceeds must go to the State, for the complications which would arise from an attempt to enforce the tax locally would be almost insuperable. There are certain principles which should govern the drafting of an inheritance tax law, principles which are frequently disregarded.

An inheritance tax law should not offend against interstate

hazard of fire and damage of various kinds, or to insure business enterprise against hazards of almost every description.

Insurance, then, is designed to relieve the State from the support of dependents, and to keep in being property or business enterprises which contribute, in one way or another, to the support of the government. It is, therefore, generally far from a fit subject on which to impose any material part of governmental support. While it is true that insurance companies of various kinds make large profits, it is also true that any tax equally imposed on any form of insurance will ultimately be shifted to the insured by an increase in premium rates.

No tax on the business of insurance can be justified, but a tax imposed only on the surplus funds withheld from distribution would be open to less objection than a tax which would directly increase the amount of the premium charged.

Real property belonging to an insurance corporation should be assessed and taxed for local purposes only. If any tax for state purposes should be imposed, in the form of a percentage of premiums earned on contracts made within the State, the tax should be the same in form on the premiums for all kinds of insurance, whether the contracts are made by foreign or domestic corporations or individuals. All reciprocal legislation, which is really in its nature retaliatory, should be avoided; it savors of war between the States, and introduces a feature of contention injurious to the State and very adverse to the proper business of insurance.

If a state tax be levied on premiums, the personal property of insurance corporations should be exempt from local taxation.

Business Corporations

In almost every State there is some provision for a tax on business corporations for state purposes in addition to the local taxation of their real and personal property. Some States, as New Jersey, impose this tax solely upon corporations of their own creation for the privilege of incorporating under their laws. Other States, as New York, impose a tax alike on foreign and domestic corporations in proportion to the part of their capital invested in the State.

There seems no good reason for imposing any taxes on busi-

ness corporations in excess of the taxes imposed on individuals doing the same class of business. If the opportunity to incorporate is open to every one for the payment of a small fee, there is no special privilege involved, and all are equally at liberty to avail themselves of the continuous existence and freedom from personal liability obtained by corporate organization. The invention of the corporation provides conveniently for the coöperation of many people in an enterprise, all of whom cannot participate in the management. Doing business in corporate form is becoming a necessity of modern conditions, and there is no excuse for penalizing an efficient instrument.

All corporations, domestic and foreign, may properly be required to pay a small license fee to meet the cost of administration incident to their proper registry.

Mineral Rights

Mineral rights are a proper subject for state taxation, because their value does not depend upon local expenditure, or the value of local government or on the extent of local population. Deposits of coal, iron and other minerals owe their value to the demand for their use by the country as a whole. If mineral rights are taxed only for local purposes, the tax will be inadequate to induce their best use, and the locality in which they are situated will contribute too small a proportion of the state's revenue. If the State relies for part of its revenue on a tax apportioned in proportion to local revenue, towns in which there are valuable mineral rights will not contribute their share, unless such mineral rights are taxed directly by the State for state purposes.

Ordinarily a state tax on mineral rights should not be imposed upon the site value of the land, because the surface can be used for agriculture or other purposes, while mining is going on beneath the surface. In some cases the deposits of ore are so close to the surface that the operation of mining the ore is like quarrying stone. In this case it might not be possible to allow the local community to tax the site at all, and provision might be made for a division of the proceeds of a tax on the mineral rights. With the exception of such mines as are practically quarries, the tax for state purposes could be imposed

on the mineral rights alone, and the local tax districts could be allowed to tax the surface for local purposes.

Such a tax on mineral rights should be imposed whenever possible, upon the capital value, excluding the value of the surface. If, for any reason, this is not practicable, the tax can be imposed in the form of a royalty.

Public Service Corporations

The real estate of public service corporations not used in the operation of the service should be taxable locally for local purposes. Any tax in addition to the local tax should be assessed by a state authority by mathematical rules so that the necessity for judgment on the part of assessors shall be eliminated.

Public service corporations should be so dealt with as to secure the best service at the lowest cost to users, and the plan of taxation should be so devised that it may be easy to reduce taxes as the charges for service are reduced. When the accounts of public service corporations are kept as public accounts, and their net earnings are limited by the reduction of charges to a reasonable return upon the actual capital invested, any tax will be a tax upon the users of the service. So long as charges for service are unlimited by law, or charges are permitted greatly in excess of the cost of rendering the service, the power of taxation may properly be used to recover for the public part of the monopoly value due to the liberality of the franchise.

In most of the American States the taxation of railroads and other public service corporations had its beginning in the general property tax. This was soon found defective, and in some States has been abandoned altogether, in others supplemented by new forms of taxation, while in a few states at least railroads were never subjected to the general property tax, but were taxed from the beginning by special systems devised for the purpose.

State Railroad Commissioners condemn General Property Tax

In 1878 the convention of State Railroad Commissioners appointed a special committee, consisting of Charles Francis

Adams of Massachusetts, W. B. Williams of Michigan and J. H. Oberly of Illinois, to examine and report as to the methods of taxation as respects railroads and railroad securities then in vogue in the various States of the Union, as well as in the various counties, and to report a plan for an equitable and uniform system for such taxation. These commissioners issued a circular and interrogatories in relation to the matter, which was sent to all the state executives, to a large number of railroad corporations and to a number of foreign countries. The replies are printed in full as part of the report of the committee, and a compendium of the system in use in all the States of the Union was prepared. In their reports the Committee said: "The conclusions reached by the committee as a result of their investigations can be very briefly stated. The requisites of a correct system of railroad as of other taxation are that it should, so far as it is possible, be simple, fixed, proportionate, easily ascertainable and susceptible of ready levy. . . . The conclusion at which your committee arrived was that all the requisites of a sound system were found in taxes on real property and on gross receipts, and in no others." The committee proposed that the real estate outside of the right of way should be locally assessed exactly in the same way as other real estate. Beyond that a certain fixed percentage should be assessed on the entire earnings of the corporation, and this should be in lieu of all forms of taxation upon the property of the corporation and upon its securities. The entire burden should be imposed in one lump on the corporation, and levied directly. The committee proposed that when a railroad is only in part in one State the tax should be apportioned in proportion to mileage.

The committee discussed various forms of taxation and condemned the law of Massachusetts as it then was and said:

"Clumsy and devoid of scientific merit as it unquestionably is, however, the Massachusetts system would seem to be preferable to that still in use in New York, concerning which the State assessors, in their annual report for 1873, expressed the opinion that under it there was no uniform rule for any road in any county, each assessor being governed entirely by his own views. In certain towns the railroads appear to pay about one third

of the entire taxes, while the assessed valuation in 1878 varied from $400 per mile to $100 per rod. The difference in the assessment of the New York Central and Hudson River road, where for all purposes that the road can be used it is of the same value to the company, is $24,000 per mile. In short, it is scarcely an exaggeration to say that the assessments are as unlike as the complexion, temperament and disposition of the assessors. It does not need to be pointed out that a system such as this, and it is the system in most general use, compels the corporations in self-defence to an active participation in local politics. Indeed, it is not too much to say that as a system it is open to almost every conceivable objection."

The New York system, which is so severely condemned, remains unchanged to this day, though supplemented by other taxes. One railroad in the State of New York, which has by no means the largest mileage, pays more than 1900 separate tax bills every year, and all the railroads have constant trouble with local assessments, and are obliged to keep track of an enormous number. This is an obvious waste of effort and source of demoralization.

Gross Earnings Tax Unjust

Professor Edwin R. A. Seligman, in his work on "The Taxation of Corporations," speaks of the inadequacy and practical failure of the general property tax. He speaks of the general property tax as applied to railroad and other public service corporations as primitive, unequal and furnishing an incentive to dishonesty. The only system now in use in any American State which he commends is that employed in Connecticut, that is, measuring the tax by the market value of the stock plus the indebtedness in the proportion that the mileage in the State bears to the total mileage, the assessment of course being made by one single board. Professor Seligman makes a very strong and I think conclusive argument against the gross earnings tax as economically unsound and legally invalid. He speaks of the report of the Railroad Tax Commission, from which I have already quoted, with much respect, but says of the gross earnings tax which they recommend, that while it possesses many undeniable advantages, it has a fatal defect. "It is not proportional to the real earning capacity, it takes

no account of cost, nor does it pay regard to the expenses which may be necessary and just. . . . Of two corporations which have equally large receipts, one may be in a naturally disadvantageous position which increases unduly the cost of operation or management. Clearly its ability to pay is less than that of the rival company in possession of natural advantages." Professor Seligman argues in favor of a net receipts tax, but recognizes that there are certain dangers connected with this plan.

A New Method proposed for the Taxation of Public Service Corporations

I think that all the objections that can be raised against the net receipts tax can be obviated by imposing the tax in a similar manner to the United States internal revenue law of 1864. The tax was imposed on all dividends and all interest. In framing such a law for the use of any State it would be necessary to use all dividends and interest simply as a measure of the tax. The tax could not be imposed directly upon the dividends and the interest, or we should meet the same difficulty as that experienced by Pennsylvania in its attempt to tax foreign-held bonds. This difficulty is entirely met by using the dividends and interest on indebtedness simply as the measure of the tax upon the corporate property within the State. For the purpose of illustration I have made a computation from the data contained in the report of the New York Railroad Commission, and I find that the total taxes of all kinds paid in all States by the steam surface railroads reporting to the Railroad Commission in the State of New York amount to slightly less than 15 per cent of the total disbursements of these roads on account of interest and dividends. When the property of a railroad or other public service corporation is situated in more than one State, the tax must be apportioned on the mileage basis now in common use.

If the tax on dividends and interest were exclusive, it might be objected that if there were no dividends and interest there would be no tax at all. To obviate this objection it would be proper to impose a very small tax on gross earnings, not exceeding, for example, 2 per cent. So long as the tax on gross

earnings exceeded the tax on dividends and interest, the latter should be omitted, and as soon as the tax on dividends and interest exceeded the gross earnings tax, the tax on gross earnings should be discontinued.

In the case of a public service of an interstate character, the tax on gross earnings can only be imposed upon the earnings arising from business done within the State.

Let us briefly consider some of the advantages of this manner of taxing all public service corporations.

If the tax on all the corporate property is measured by the dividends and interest paid, the corporation has only one assessing board to deal with, and that assessing board has purely ministerial functions to perform. It ascertains the amount of interest and dividends paid, a matter which cannot be concealed, and performs a simple sum in multiplication. The corporation knows exactly what tax it will be obliged to pay, it has no interest in the personnel of the board that does the assessing, because no dispute can arise as to the amount of the tax.

When a new corporation starts its tax will be light. If it earns neither interest nor dividends, it will pay only the small tax on gross earnings, and the tax should be small, because it is rendering a public service at cost. If it earns interest and dividends for those who contributed the capital, in proportion as it pays them it must pay taxes to the State. In prosperous years its taxes will rise and in lean years will fall automatically.

It may be objected that if a railroad or other public service corporation becomes bankrupt, the tax will be very small; but this is an advantage, not a disadvantage, for it is for the public interest that a corporation in such condition should be rehabilitated as soon as possible, and the automatic reduction of taxation will operate to that end. As soon as it earns enough to pay investors, the tax will increase. It may be objected that a corporation could refrain from paying dividends and accumulate a large surplus. This, again, is rather an advantage than an objection, for in the long run its accumulated surplus will enable it to perform better service, pay larger dividends, and in consequence heavier taxes.

From every point of view and in accordance with the testimony

of all experienced observers with whose writings I am familiar, it is clear that all public service corporations should be taxed as a unit, and it seems self-evident that discretion on the part of assessors should, if possible, be eliminated. I have suggested a method already tried and found effective, by which the assessment can be made without judicial discretion.

The proper disposition of taxes imposed on public service corporations remains for consideration, and to a great extent the answer must conform to the conditions now existing in each State. In some States the major part of taxes on some or all of the public service corporations is retained by the State; in others, State revenue from this source is small. As a general principle it is wise for the State to retain a large part of the taxes on public service corporations which own their own right of way, and to distribute to the localities in which the public service is performed the taxes on those corporations which use the streets and public places. The street-using corporations owe the value of their property to the extent and character of the population and government of the communities in which the service is rendered. The cost of their protection is mainly a local charge. The distribution of the taxes paid by such corporations is a comparatively simple matter, because they frequently own property in no more than one taxing district.

The case of steam railroads is very different. The value of their property very largely depends upon terminals, and it is impossible to assign a definite portion of the value of their property as a whole to any particular section of it. Communities without a single mile of railroad track contribute largely to the value of the corporation's property, and no local distribution of the taxes can compensate such communities. It seems, therefore, that the State may properly retain a large part of the revenue from railroads and other public service corporations which make little use of streets and public places, so that all the communities in the State may share in the revenue.

When taxes on public service corporations are distributed to the localities in which the service is rendered, a fair and practical measure of the distribution is to apportion the tax in proportion to the length of the railroad track, or the pipes, wires or the like

in each tax district. In the case of steam railroads, the apportionment should be based on the total length of tracks, including branches, sidings and switches, so that terminals and large cities may receive a fair proportion. Even on this basis rural districts will be somewhat favored.

Elasticity Essential

It must not be forgotten that a considerable part of state revenue should be apportioned to the local tax districts in proportion to local revenue, and raised by direct taxation. It is not only unnecessary but very undesirable to obtain all state revenue from the special taxes imposed on subjects of state taxation.

The legislature must at every session be obliged to fix an amount of money to be raised locally by direct taxation. This is essential that the people may control the legislature, restrain extravagance and limit the extension of state functions.

Subjects of Local Taxation

If the power of the State to tax is limited to the subjects previously described, all other subjects will be left to the jurisdiction of the local authorities. The following subjects are generally taxable locally:

Licenses imposed pursuant to the police power,
Business licenses, if any,
Banks and trust companies,
Personal property, not taxed by the State,
Real estate,
Revenue from public service corporations.

Licenses imposed Pursuant to the Police Power

The most important source of revenue from licenses is from the licenses for the sale of liquor. It would be beyond the scope of this paper to make suggestions in regard to the amount of such licenses, but it seems obvious that whatever the amount may be it should be retained by the local community. It is common for local communities to have the power to prohibit the sale of liquor altogether, and it is certainly unfair that a community in which no revenue is derived at all from the sale of liquor

should share in the receipts obtained in other communities. If the State takes any part of such receipts and expends them for general state purposes, every community in the State receives the benefit of a fund to which some communities do not contribute.

Business Licenses, if Any

Certain business may properly be licensed for purposes of police regulation, but business licenses should not be imposed for revenue. If they are so imposed, the local communities should retain the proceeds, for it is the local communities that protect the property and render the business profitable.

Banks and Trust Companies

The power of the State to tax banks being limited by federal statute, the field of discussion is narrowed. National banks cannot be taxed at a greater rate than other moneyed capital, and it seems only proper that the taxation of other moneyed capital should not be at a greater rate than the taxation of national banks, and, so far as practicable, should be identical in manner as well as rate. The decisions of the courts as to what is moneyed capital have placed trust companies in the same class as banks, and have excluded almost every other corporation. For practical purposes, then, we can consider banks and trust companies as members of the same class and the only members of that class.

In the experience of New York and other States a law requiring the assessment of bank shares at market value is very unequally enforced. When the rate of taxation is the same as the ordinary local rate, there is a very great difference between both the rate of taxation and the assessment of banks located in different towns but otherwise similarly situated.

It is unfair and improper that any person or corporation as a stockholder of a bank should receive a bonus by special exemption, or by deducting indebtedness from the value of the shares owned. Any tax should be on the book value of all shares alike, and should be paid by the bank. Under these circumstances a much lower rate than the average local rate will generally yield as much revenue as the usual form of assess-

to exempt from taxation any class of property, or to reduce the assessment upon any class of property, it would be possible for any progressive community to adopt methods already proven valuable elsewhere, or to make experiments on its account which would be useful object lessons to the rest of the country.

The policy of Pennsylvania has already demonstrated the great advantage of exempting certain classes of capital used in manufacturing, and of imposing a low rate of taxation on certain classes of securities. In Baltimore, Md., the rate of taxation imposed on securities was greatly reduced, and the revenue largely increased. In some States certain agricultural improvements are exempt, and the exemption has been very beneficial. It is universal experience that manufacturing machinery is most difficult to assess, and local power to exempt is frequently exercised in States where this power is enjoyed.

This local option would give power to those most deeply interested, and who have the best opportunity to judge of the facts. The exercise of the power could have no ill effect on any other community in the State.

With a complete divorce of state from local taxation, and a large measure of local self-government accorded to local communities, we may confidently expect a continuous and rapid advance toward an equitable system of taxation, which will aid and encourage agriculture, commerce and manufacturing, promote the general welfare and finally equalize natural opportunities.