CONDITIONS FOR DIRECT TAXATION*

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I. *Tax Ideals and Tax Systems*

There are many kinds of tests or norms for judging the propriety of tax systems. But it is usually very difficult to decide which would be the most appropriate. Principles of taxation, to a large extent, are the product of philosophy, social and political. It is not part of the empirical sciences, but of metaphysical inquiry to deal with the principles of taxation.

Many modern writers, for instance, seem to have accepted the "ability to pay principle," but a few considerations will show the concept "ability" is not always apparent. A precise interpretation of "ability" would at once give rise to considerable differences of opinion, since "ability," as we shall see hereafter, depends upon various factors, of which the relative weighting differs widely according to each interpretor.

Many different methods of measuring "ability" have been presented both in theory and practice. If, for example, the solidity of income sources is to be taken into account in measuring the ability to pay tax, the "earned" income from labour must have much less "ability" than the "unearned" income, say, from land does. But when the continuity of income sources should be reckoned as a decisive factor, the "unearned" income arising from a temporary success in a vicissitudinous trade will properly be thought to bear a lesser tax burden than the "earned" income continously derived from labour.

If, however, these examples are not persuasive enough to show the difficulty in estimating "ability," we can mention an example of much practical importance. When a heavy tax burden tends to impair the diligence of the well-to-do people to such an extent as to prevent the desired formation of national capital, what will take place?

Some writers, facing this fact reluctantly or willingly, declare that the "ability" principle should concede to practical necessities, or that it should be adjusted by other "principles" such as "expediency," or "the

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least cost of collecting taxes" principle. Some other writers wish to be true to their ability principle, declaring that the ability to pay tax of those wealthy people who do not consume but save their income or wealth, should be considered comparatively less than that of those who consume. The former attempt naturally brings about the problem of how to decide the priority between multiple "principles," while the latter solution, too, meets the troubles arising from the different opinions with regard to the estimation of saving.

Those who are aware of these difficultiies try to arrive at a solution in such way that the fiscal purpose of taxation should necessarily concede to the higher purposes of society or State. It is often emphasized that capital formation is a prerequisite not merely for a satisfactory tax yield, but also for the entire national economy or society, and in consequence, the ability principle should be limited by the principle of capital formation, or of national welfare.

If this solution be approved, the ability principle would become one of the corollaries derived from the most general purpose, whose precise determination will by itself cause further complicated problems.

Such being the case, it is hardly possible to maintain any ideals or principles of taxation as being perfectly free from criticism made from the standpoint of empirical sciences. In some cases, however, theorists pretend to reach an universally appropriate conclusion with the statement that taxes must be constructed so as to "minimise the social aggregate sacrifice," — a statement of as yet entirely abstract character. This formal principle is, no doubt, universally approriate, just because of its formal character; but we at once come up against many difficulties in measuring "the aggregate sacrifice," and in deciding what methods of taxation can best realize the principle.

Nevertheless, we should observe that there is another aspect of the issue.

It is, indeed, illogical to assert some tax ideals as universally objective, but this will hardly deny the fact that tax ideals have exerted a far-reaching influence upon the actual formation of tax systems. Tax ideals have often become, and can become, a kind of social factor hardly to be ignored. Adam Smith, for example, with many of his influential successors, played a significant rôle in the formation of English fiscal policy and system. Likewise, Adolph Wagner and his school have had a great influence in formulating German taxation, as we shall see later.

Apart from examining the theoretical consistency of the principles of taxation, we can assert and trace the influence of tax ideals upon the systems of taxation. At the same time, however, we have to take into account the reverse influence of the actual tax systems upon the ideals or principles of taxation. Both the ideals and systems are interdependent and interact on each other.

In this article, it is not intended to explain the principle of taxation as such, nor to demonstrate any solution for the problem of priority between multiple principles. The main problem discussed here will be the relation between the tax ideals and actual tax systems. In other words the intention of this article is to consider social and economic conditions for the realization of the tax ideals. In this case, tax ideals should be dealt with as one of the social factors objectively explained. We can thus refrain from arguments that might induce us to deal with metaphysical problems.

II. *Tax Ideals and Direct Taxes*

Despite many difficulties in measuring the ability to pay, and notwithstanding the difference of opinion as to how to weigh the relative importance of the factors upon which ability depends, many writers on Public Finance and taxation have reached a considerably wide agreement in requiring that taxation, in some way or other, should be in accordance with the ability principle. Again, in spite of insufficient determination of the concept "ability," the ability principle has now become one of the most powerful principles in advanced countries.

Admitting that the ability principle is the prevailing one as compared with the "benefit" principle, are there any methods to find out the extent to which the actual tax systems of any country, as a whole, satisfy this principle? Naturally, an exact method will not be available. In this respect, opinions differ, and many factors are involved in considering that extent.

But there can be no doubt that the ratio of direct tax revenue to indirect tax revenue, other things being equal, should be taken into account as a decisive factor in the valuation of the tax system as a whole. If we are informed of the ratio of direct/indirect tax revenue, we are able to obtain some notions about the propriety of the tax systems cocerned. It seems to have been widely accepted that direct taxes, from the point of view of the ability principle, are superior to indirect taxes. The following is a pertinent example.

Prof. C. S. Shoup in his *Report on Japanese Taxation* states as follows:

> "The ratio of direct-tax revenue to indirect tax revenue is a rough indication of the extent to which the people are conscious of their tax obligations. It also usually shows whether the system as a whole is reasonably fitted to individuals' differing degrees of ability to pay. Direct taxes can be so fitted, in general; indirect taxes, usually not."

After remarking the ratio in Japan which was 54–46 in the national budget, and 37–63 in the local in 1949–50, and the ratio in the United States that was 80–20 in the Federal Government, and 70–30 percent in the total federal, state and local tax revenues in 1947, he continues:

> "This 50–50 ratio for the entire tax system is not particularly remarkable; it indicates a position somewhere betwheen what might be expected under the older types of tax system and the one that has developed in the United States under the pressure of War."

As the Shoup recommendations cover almost all the problems of Japanese taxes and taxation, from major principles to minor items concerning tax administration, and not always consistent with the ability principle, it will be going too far, if unreasonably great emphasis is laid upon these brief citations. However, it is worth noting that the formal Report supported to some extent the ability principle, and acknowleged the merit of direct taxes, though with necessary reservations, fitted to satisfy that principle.

But is it alway true that indirect taxes do not accord with the ability principle? Are direct taxes everywhere true to it? If not, what kind of direct taxes should be levied in order to meet the ability principle?

Before answering these questions, a brief survey of the terms "direct" and "indirect" taxes will be necessary, because there are writers who reject this classification. As Prof. Bullock proved, we can enumerate more than a dozen different meanings of the terms "direct" and "indirect" taxes.[1] But three out of these different meanings are outstanding. The distinction, firstly, related to the method of tax collection. On collecting taxes, if a list or roll is used, the taxes are called direct. Secondly, taxes are classified either as "indirect" or "direct" according to whether they shift from tax-payers to others, or not. Thirdly, the will of legislators is related to the classification. These three distinctions do not precisely cover each other, and have defects respectively.

The *first* distinction is rather technical. To take an extreme case, the tax on Japanese *sake* (liquor) is assessed and collected through the lists, and yet it would be incorrect to classify it as "direct." The *second* classification was for the first time introduced by the French *économistes* who tried to ascertain the possibility of tax-shifting from the point of view of their unique doctrine. But the shifting process was soon proved not to be inherent in taxes. For example, the land tax was considered by the physiocrats, and, to some extent, by Adam Smith, as a sole tax which does not shift, but it was soon argued that it might be shifted from landowners to capitalists or labourers, as the case may be. The *third* classification has been popularized largely by John Stuart Mill. He said,

[1] Full treatment of this subject is contained in C. J. Bullock, "Direct and Indirect Taxes in Economic Literature," *Political Science Quarterly*, XIII (1898), pp. 442-472.

"A direct tax is one, which is demanded from the very persons who, it is intended or desired, should pay. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another."

But this theory, too, is open to valid objection. In the first place, it is often difficult to determine the mode of incidence, and, in the second place, it is also difficult or impossible to decide beforehand where the will of legislators exists, a matter not always possible to be read accurately in the law.

In this manner, the value of the terms "direct" and "indirect" has frequently been called in question. Thus, Prof. Walter Lotz criticizes the distinction, saying that "as it is used in some tax-laws and party programmes, it is not useful in the science of public finance."[3] Similarly, Prof. Harold M. Groves insists that "the classification of taxes as direct or indirect is of no great significance, except that in the United States it may have much influence in determining the constitutional validity of a tax."[4] And Profs. Shultz and Harris even assert the entire insignificance of the classification, saying that "such confused and contradictory usage has robbed the terms 'direct' and 'indirect' of any value they might have had in fiscal economics."[5]

Of all these negative arguments, Prof. F. Terhalle's conclusion seems impartial. He says: because it is far from being "eindeutig" (apparently evident), it must be used carefully.[6] Difficult as the clear distinction between direct and indirect taxes may seem, no one can deny the difference that exists, say, between taxes on property and income, and those on commodities, collected from the producer or dealer. In any classification there are always boundary-line cases. This, however, does not mean that it loses its validity, nor does it mean that boundary-line cases may well be left untouched. So far as the ratio of direct tax revenue to indirect can be regarded as the indicator of the fitness of tax systems, the classification must be clearer than now.

A clearer distinction is needed more keenly when we use the ratio in an international comparison as attempted by the Shoup Mission, than when we use it in comparing systems of different periods in the same country. But the further treatment of this problem would exceed the range of this article. Returning to the main issue, we should consider again to what extent will the ratio of direct to indirect tax revenue be of use in estimating the system as a whole.

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[2] J. S. Mill, *Principles of Political Economy* (Ashley's edition, 1917), p. 748.
[3] Walter Lotz, *Finanzwissenschaft* (2. Aufl., 1931), p. 290.
[4] Harold G. Groves, *Financing Government* (revised ed., 1945), p. 51n.
[5] William J. Shultz and C. Lowell Harris, *American Public Finance* (5th ed., 1949), p. 198n.
[6] Fritz Terhalle, *Lehrbuch der Finanzwissenschaft* (1930), p. 138f.

No matter how rough an indicator the ratio may be, if once it is recognized as an indicator, and if, according to it, the 50--50 ratio for the entire Japanese tax system, as the Shoup Mission declares, should indicate "a position somewhere between what might be expected under the *older type* of tax systems and the one that has developed in the United States...," is it really possible to provide satisfactory explanations of the following figures ?

Table 1. Amount of Direct Taxes, Indirect Taxes and Other Taxes of Selected Countries

	Total National Taxes		Direct Taxes		Indirect Taxes		Other Taxes	
	Amount	%	Amount	%	Amount	%	Amount	%
U. S. A. (1951) $	60,321	100.0	51,489	85.4	6,945	11.5	1,887	3.1
England (1951) £	4,015	100.0	2,247	56.0	1,581	39.4	187	4.6
France (1951) *Frcs*	1,685,200	100.0	565,000	33.5	249,400	14.8	870,800	51.7
Germany (1950) *Mks*	16,170	100.0	5,671	35.2	4,636	28.6	5,863	36.2
Italy (1950) *Lira*	10,067	100.0	2,243	22.3	4,115	40.9	3,709	36.8
Japan (1951) *Yen*	557,591	100.0	299,554	53.7	248,970	44.7	9,067	1.6

If we admit the view contained in the Report, it would be inferred from the figures that France, Italy and Germany have "older types of tax system," while Japan and England alike are nearly in the same stage of advancement. To my regret, we are not in the position to gain access to the full information of the world outside Japan, and are especially not acquainted with the real circumstances of the continental countries of Europe. For this reason, it is difficult to form a decisive estimate of this inference, but, nevertheless, our experience leads us to the view that the Japanese tax system has certainly not made such a great advance during the war as the alleged indicator would imply (Figures will be shown on page 162); and that the tax system in Japan has never been working, nor is working, so efficiently as it has been, and, I believe, is, in England; and moreover that "older types of tax system" in European countries may have been, and may be more in accordance with the ability principle properly interpreted than the "intermediate" type of tax system has been, and is, in our country.

I may be accused of flimsy arguments. But these argument, to some extent, relate to the issue that the ratio of direct to indirect tax revenue should be considered a *rough* indication of the advancement of the tax system. The problem is: "how rough is it?"

This problem will not be answered before we have some notions about what the ability principle expects, or requires from direct taxes. Expectations or requirements of the ability to pay principle, however, as a matter of course change with the development of the economic, social and political structure of society, while the concept "ability" is affected widely by these changing expectations or requirements. In order to do justice to the problem, at least a rapid survey of historical development of expectations should be attempted by pointing out their close relation to the ability principle, which we may here assume as representing tax ideals. This done, we shall next treat of more concrete conditions for direct taxes by illustrating the recent developments in Japan.

III. *Requirements of Direct Taxes*

Needless to say, the ability principle, so far as it desires to assert itself, is to aim at some particular taxes, or tax systems. It has already been indicated that the present day ablility principle requires direct taxes, and such direct taxes as shall be illustrated later. But it is not always true to consider the ability principle inseparable from direct taxes.

In the early stage of taxation, taxes had nothing systematical, and, in the main, the problem of legal competence of taxation arrested the attention of the learned of those days. They, therefore, hardly recognized the difference between direct and indirect taxes. It was not until the middle of the seventeenth century that a great deal of controvercy about tax systems was provoked by the urgent cash demands of kings and princes. Despite differences of opinion, there was, on the whole, a remarkable tendency to support excise and custom duties as against direct taxes. Politicians and writers alike considered that those who consume commodities *per se* demonstrate the existence of the ability to pay taxes, and regarded the excise and custom duty on consumption goods as in accord with the ability principle.

William Petty, one of the most excellent economists at that time, remarked that a man was actually and truly rich according to what he consumed. He was of the opinion that excise is the best way to raise money according to what he actually enjoyed without forcing the tax payers to pay from where there are no money, or to pay double or twice for the same thing.[7]

[7] *Cf.* William Petty, *A Treatise of Taxes and Contributions* (Hill's edition, 1899, Vol. 1), p. 75.

A great majority of mercantilistic writers in Holland, Germany, England and France generally supported indirect taxes. It may not be too much to say that, with a few important exceptions, the actual tax system, too, was developed in favour of indirect taxes. Naturally the advantage of indirect taxes was profoundly injured when the *financières*, as in France, farmed the indirect taxes. They caused ever-increasing vexations to tax payers with their intermediate exploitation. In spite of these exceptions, we are able to demonstrate, from abundant historical facts, that there was a particular period advantageous to indirect tax both in theory and practice.

As modern capitalism devoloped from the stage of *Frühkapitalismus* to that of *Hochkapitalismus*, to use Werner Sombart's terminology, the aspects gradually changed. Opportunities were provided for the improvement of direct taxes. In this connection, the theory of physiocrats was an emphatic protest against the mercantile system. Direct taxes, as mentioned above, were made much of as a clue for solving fiscal problems, but without much effect. Notwithstanding the objections of economists, tax system did not improve for a long time in France.

Adam Smith, though influenced by François Quesnay, did not push his arguments to such an extreme as to dignify l'*impôt unique*. It is true that the ability principle, in reality, owed its diffusion to a large extent to him, but his opinion was eclectic. As is generally known, Adam Smith censured those indirect taxes mainly levied upon necessaries for being injurious to the poor people, acknowledging the regressive character of these taxes. At the same time, he did not allow taxes upon profits and interest on the ground that they would inevitably produce vexatious troubles between the taxation authorities and the tax payers. The land tax, house tax, custom duties upon imported goods and excise upon beer and other luxuries, according to Adam Smith, were the four best taxes permissible under "the system of natural liberty."

If we carefully proceed along his arguments, we can even suggest that he was supporting "progressive" taxation. For instance, he said "a tax upon house-rents would in general fall heaviest upon the rich; and in this sort of inequality there would not, perhaps, be anything very unreasonable."[8] It would seem not impossible to take these words as a strong pfoof of his being an advocate of progressive taxes.

Nevertheless, this is not true, for Smith was merely giving his concent to the progressive effect of a particular tax, which, to follow the modern usage, was levied according to the external sign of income or property. He would by no means accept progressive taxation requiring an "inquisitorial" inquiry into the net income and property of each earner or owner.

[8] Adam Smith, *Wealth of Nations* (Modern Library ed.), p. 794.

Inquiry into books and other materials, as is generally performed by the present day tax authorities in order to ascertain the real income or wealth, would, in his opinion, do grave injury to the natural course of economic progress. The essential problem for him was to keep free competition from any arbitrary taxations. Hence, his was not the intention to substitute direct for indirect taxes at the expense of the taxpayers.

According to A. Smith, the ability principle is, indeed, to some extent, related to income or revenue rather than expenditure, but this did not mean that taxes should always be levied directly, not to say, progressively. Hence, even when direct taxes were preferred to indirect ones, it was because direct taxes were considered suitable from the viewpoint of taxing *in proportion to* ability.

Taxes should as much as possible be in proportion to income or property, and the taxation authority should refrain from an "inquisitorial" inquiry. Such was the leading idea of Smith, and, of his followers.

The leading idea of the classical school had been gradually accepted and put into practice to a certain extent, but the actual systems of taxation were often greatly deformed. For example English indirect taxes upon necessaries were mostly kept untouched during the 1830's on account of the hasty repeal of the income tax which the government had made use of during the Napoleonic War.

In spite of the Smithian recommendation, indirect tax revenue had been greatly increased during the first quarter of the nineteenth centnry. It showed the amount of 40 million pounds as compared to 25 million direct tax revenue. The income tax was usually rejected except in case of a national emergency. Parliaments, when they introduced it in an emergency, were always prepared to annul it as soon as possible, regardless of the abundant revenue demonstrated in war time. An income tax aroused detestation in general because of its arbitrariness.

Meanwhile J. S. Mill for the first time made a not insignificant step towards the subjectivist interpretation of the ability to pay tax; his equal sacrifice theory made a clear distinction between the "earned" and "unearned" income. But his opinion was also eclectic. J. S. Mill, on the one hand, admitted that the progressive income tax was "apparently the most just of all modes of raising revenue," but, on the other hand, faithfully reflecting the prevailing opinion of his days, could not extricate himself from the traditional views in arguing that direct taxes on income should be reserved as an extraordinary resource for great national emergencies. Moreover he added that the progressive income and property tax would favour extravagant at the expense of the prudent, diligent and economical person; the income tax above all would, in reality, be unreasonable owing to the impossibility of ascertaining the real incomes "in the present low state of public morality."[9]

Apart from the occasional formation of a progressive (that is to say, degressive) income tax, deliberate progressive taxation in England was not brought into being until 1894, when the inheritance tax became law. By this time Mill's equal sacrifice theory had greatly been reinforced by the marginal analysis of the seventies. An accurate interpretation of "ability," it asserted, had to take into account the fall in the marginal significance of money as income rises, so that even an "equal sarifice" of income would call for progressive rather than proportional taxation, though the interpersonal measurement of marginal utilities aroused another difficult problem.

Thus the progressive income tax finally found its way into the British tax structure in 1909. But we should remember, this was not the first of all progressive income taxes.

Adolph Wagner and his school had been making an energetic effort in propagating the idea of progressive direct taxation before English Liberals admitted it. They called for progressive taxes in order to redistribute income and wealth among the members of a society from the state socialistic viewpoint. Their keen desire to demonstrate the superiority of progressive taxes on income was not only stimulated by state socialistic ideals, but also by the necessity to allot to the Prussian Government an independent source of revenue for which it had no need of competing with local units. For this reason they elaborated the concept "Einkommen" (income at large) distinguished from "Ertrag" (income separately considered, namely wage, rent, profit, interest and so on).

In 1884 Gustav Schmoller[10] elaborated the concept "Einkommen." "Einkommen," considered as expressing the ability to pay tax, had to be related to, and subject to, its earners, large or small, according to the different circumstances of each taxpayer. Taxes upon rent, profit, interest, etc. should be separately collected without making allowance for different circumstances of the recipients, so that the land, house or capital affording the same value of rent or profit would bear the same amount of tax, regardless of whether the recipients were rich or poor, whereas, in the case of the income tax, one should compute all the revenues synthetically, no matter from what sources they may arise, as regards every recipient, and apply different rates of the tax after making necessary allowances or deductions according to different cases.

The idea of progressive taxation thus developed by German writers crystallized into the Income Tax Law in 1891 in Germany, about fifteen

[9] J. S. Mill, *Principles of Political Economy* (Ashley's ed.).

[10] Gustav Schmoller, "Die Lehre vom Einkommen in ihrer Zusammenhang mit der Grundprinzipien der Steuerlehre," *Zeitschrift für die gesammte Staatswissenschaft*, 19. Jahrg. Heft 1, pp. 1-88.

years earlier than in England.[11] This fact, however, did not in the least mean the greater advancement of the German tax system as a whole, compared with the English system, for the greater part of financial revenues of Germany was still depending upon custom duties, excise and the profit from public railway enterprise.

At the beginning, the rates of progression were remarkably low. But now we find everywhere such a high rate of progression as seems to confiscate the whole income or property (in case of the succession duty) above a certain limit.

From this brief survey of the historical development of taxation, we may understand that the full development of progressive tax belongs to the relatively later period of capitalism.

The ability principle has changed from the principle of proportional taxation to that of progressive taxation and has contributed to the formation of a high rate of progression as mentioned above. This change, in my opinion, corresponds largely with the actual development of capitalism.

Before arguing the point, it must be ascertained that the ability principle, objectively observed, tends to have a preference for direct taxation, because only direct taxation can properly be thought to be indispensable for meeting various requirements derived from the ability principle; firstly, exemption of minimum cost of living; secondly, allowance for personal circumstances of the taxpayers; thirdly, consideration for the difference of income sources; lastly, but not least, the application of progressive rates of taxes to higher incomes and properties.

These requirements have not merely been introduced by the efforts of theorist to improve the *status quo*, but, were greatly stimulated by the unequal distribution of income and wealth which has grown in extent with the progress of capitalistic methods of production.

According to Josef Kaizl,[12] there are four factors which have a significant effect upon the formation of tax systems. Firstly, the size and continuity of public expenditure; secondly, the economic conditions and relations of the people; thirdly, political and fiscal power, and the ideals, political or ethical, which the power occasionally chooses; fourthly, the range of the executive as well as the tax collecting technique. Kaizl regarded the third factor as decisive. But fundamentally considered, the first factor should be of the greatest importance, other factors being regulated by the economic conditions and relations of the people.

The modern economic system, called capitalism, has many distinct

[11] By the way, Japan, mainly influenced by the German system, introduced the modern income tax with graduated rate from 10% to 55% as early as 1900.

[12] Josef Kaizl, *Finanzwissenschaft* (übersetzt von Alois Körner, Wien, 1900-1901), Bd. II, pp. 136-157.

features, which can exemplarily be seen in the activities of a joint-stock company. Joint-stock companies are the miniature of capitalism. We see there a tremendous accumulation of capital with the application of most advanced technologies, creating employment for a large number of people who are being deprived of their means of livelihood except labour power.

Under the capitalistic system, a great progress in productive power may usually be seen, while the split of society into classes of those who have and those who have not, usually takes place concurrently. The spirit of rationalistic computation with adventurous profit-making becomes more and more prevalent. The freedom of the people, though formerly praised for emancipating humanity and productive powers, is gradually limited in reality to that of the big business men who can well afford capital expenditure. Owing to the keen competition in markets, at home and abroad, capital tends to be concentrated with accelerating speed.

Thus it follows inevitably as a natural consequence of free competition that capitalism develops to a high degree of maturity and continously becomes more monopolistic. Under the system of capitalism, this is generally true even in agricultural production. The separation between business and household must be a general rule even in rural life, if the capitalistic method of production is to be carried through.

The immense accumulation of capital and wealth, on the one hand, and the ever-increasing discrepancy between the rich and the poor, on the other hand, also account for the rapid growth of social policies, many of which are aware of the fact that money makes money without any particular sacrifices or efforts on the part of money-makers.

Hence, the act of saving, for an instance, previously considered highly respectable, is now often condemned as deepening the unequal distribution of income and wealth among the members of a society.

Progressive taxation supported by the advocates of the ability principle, it should be observed, is representing these tendencies.

IV. *General Conditions for Progressive Taxation*

As explained, progressive taxation and monopolistic capitalism go hand in hand. If it is permissible to say that indirect taxes were the ideal taxes at the early stage of capitalistic development, and that proportional taxes were appropriate to the second stage of capitalism, progressive taxation may be said to be proper for the last stage of capitalism, i.e., for *Spätkapitalismus*, to use Sombart's terminology. In this stage of development, public expenditure cannot be met without relying upon the progressive taxation because of the unequal distribution of wealth and income. Facing the fact that the great part of wealth and income is accumulated in an intangible form of valuable papers such as securities, bonds and shares, one must contrive a rather complicaded but workable mechanism, which will enable us to know the real incomes and properties independently of the external signs of them.

However, the will to accord with the principle is one thing, and the real possibility to achieve the will is another. Needless to say, a tax system as a whole may in reality show a limited application of the principle, even if direct taxes are, separately considered, sufficiently magnificient from the standpoint of the ability principle. Prof. Shoup, as was shown on page 151, suggested that the ratio of direct and indirect taxes revenue might be a rough indication of the extent to which the given purpose is achieved, but the problem remains with regard to the estimation of the ratio as an indicator.

I believe that the above survey of the historical backgrounds will to some extent answer the question. Enumerating more concretely the general conditions for direct taxation — as supported by the adovocates of the ability principle of today —, I will consider the problem.

In the first place, direct progressive taxation requires, above all, the exact computation of the amount of real incomes aud properties. But whether the exact computation and, accordingly, an accurate assessment can be made or not, depends entirely upon the degree of capitalistic develoment of an economic society. The direct taxation which the modern ability principle is aiming at can never be applicable to pre-capitalistic economy where business management and housekeeping are conexistent. All products in this case are not brought to the market. Hence, the "income" arising from the partly self-supporting primitive industry cannot adequately be estimated in terms of money, a part of products being more or less consumed without realizing themselves. Besides, considerable difficulties in estimating the value of home labour also constitute a problem. If the value of home labour is beyond exact computation, the cost of products will not be distinct, which will make it hard to distinguish profit from wage.

Secondly, in order to allow exemption of the cost of living from taxation, there must be a relatively high level of national income. As has been explained, progressive taxation can be effective only when a society attains a high degree of development in productive power and shows great inequalities of wealth. If there were no discrepancy between the rich and the poor, the rate of progression would operate just in the same way as the proportional rate of taxes does. And if, in this case, the tax were applied even to a low level of income, it would endanger the life of a great majority of the members of a society. This problem at once relates to the third condition.

Thirdly, the number of taxpayers should be adequately restricted, in order to make it possible to allow consideration for individuals' differing degrees of ability to pay, and to make a necessary distinction between incomes arising from different sources. The restriction of the number of the taxpayers is necessary also for exactly ascertaining the real income. It cannot be computed without a rather complicated allowance for interest on debts, for depreciation on stocks and so on. If the number of the taxpayers is beyond a certain narrow limit, the marginal collecting taxes will surpass the marginal tax yield, giving rise to a variety of troubles and frictions.

Fourthly, a system of information-at-source would be required, especially when direct taxation is acompanied by self-assessment instead of collection-at-source (or withholding-at-source). It would be a lofty ideals of taxation if the voluntary compliance of taxpayers reaches so high a level as to render inspection unnecessary. But in reality correct self-assessment can be expected only by inspection, especially for incomes such as capital gain, dividends, etc., which are difficult to seize. Without a reliable system of information-at-source, direct taxes which do not rest upon external signs of income or property cannot operate adequately, and thereby an excessively hard strain will be imposed upon taxpayers compliance, or, if not so, the tax offices will be oppressed with a heavy burden in the re-assessment of returns without trustworthy information necessary for checking, and their re-assessment will inevitably raise complaints among taxpayers.

Fifthly, as a condition for direct taxation, should be mentioned the development and spread of the art of bookkeeping, and the establishment of certified public accountants with a system of compulsory auditing, as well as the pervasion of the practice of using cheques in business transactions. All these conditions are necessary for the adequate ascertainment of the amount of income or wealth, or for the information-at-source system. They, however, depend upon the general developments of capitalistic economy. Bookkeeping is in its essence nothing but a child born in answer to capitalistic rationalism — to cite Max Weber's and Werner Sombart's words.

The sixth condition for direct taxation is, needless to say, the existence of an efficient tax collecting organization. This is true in the case of indirect taxation, too, but nevertheless direct taxation needs it more keenly, because the former is more delicate to be dealt with, owing to its lack of external standard.

The seventh condition concerns more concrete problems, i. e. those of tax rates. They include a variety of questions concerning the mode and form of rate scales ; the amount of basic exemption ; that of allowance (credit) for dependents, and for earned income, if any ; the limit of deductions; the method of depreciation authorized in tax laws. Mere observation of rate scales would not lead anyone to any sufficient solution of the problem. It involves many considerations, which will soon be seen when we discuss it in relation to the actual developments in Japan.

The eighth point is that within direct taxes there should be an appropriate interrelation with each other. This point, too, involves many considerations, namely the relation between progressive and proportional taxes; the weight of central taxation compared with local taxation; the problem of double taxation, and so on.

We may be able to add other condition for ideal direct taxation, but on concluding this section, we wish to assert again with emphasis that the most important condition is the objective development of capitalism into maturity, with a series of remarkable phenomena such as mass production, concentration of capital, especially in urban districts, unequal distribution of wealth, predominance of intangible over tangible property, thoroughly rational management of business, separation between ownership and management, etc.

V. *Recent Developments in Japan*

It is not too far to say that Japanese taxes and taxation since 1950 have been under the sway of the Shoup recommendations. As pointed out before, Prof. C. S. Shoup recommended that Japan should not have

Table 2. Amount of Direct Taxes, Indirect Taxes and Other Taxes Compared (National Taxes)*
(*in millions of yen*)

	Total		Direct Taxes		Indirect Taxes		Other taxes	
	Amount	%	Amount	%	Amount	%	Amount	%
1930	1,103	100	378	34.3	638	57.8	87	7.9
1935	1,114	100	421	35.0	688	57.2	94	7.8
1940	4,219	100	2,696	63.9	1,288	30.5	235	5.6
1942	7,529	100	4,786	63.6	2,347	31.2	396	5.2
1944	12,863	100	8,376	65.1	3,947	30.7	540	4.2
1946	37,438	100	21,332	57.0	14,260	38.1	1,847	4.9
1947	189,601	100	99,409	52.4	82,571	43.5	7,621	4.2
1948	445,956	100	222,744	49.9	190,037	42.6	33,176	7.5
1949	636,068	100	344,374	54.1	243,445	38.3	48,249	7.6
1950	557,115	100	304,150	54.6	241,932	43.4	11,033	2.0
1951	557,591	100	299,554	53.7	248,970	44.7	9,067	1.6

* *Monthly Report on Finance* (in Japanese), No. 20.

an "older type of tax system." But the ratio of direct and indirect tax revenue in this country has displayed little change. Now let us observe the figures on page 162.

Prior to 1930 the ratio had been more favourable for indirect taxation. The change started from the year of crisis in 1928, showing the ratio of 28—72 in 1923 compared with that of 32—68 in 1928 and 34—66 in 1930, as shown on Table 2. A remarkable change in the ratio was shown during the Sino-Japanese War preceeding the second world war, 35—65 in 1935 and 64—36 in 1940. In 1944 the ratio was most favourable to direct tax revenue, reaching the high figure of about 65—35.

This achievement was, however, for the most part due to the fact that under the pressure of war, consumption goods had successively been placed under governmental control, thereby exhausting the source of indirect taxes, while direct taxes were extended to an extreme. It follows as a matter of natural consequence that direct taxes, far from being able to achieve the tax principle, degenerated and became regressive before the end of the war. But, in spite of this, they were effective in restricting consumption and distributing public charges among the people, before the catastrophe in 1945.

Referring to the conditions enumerated above, let us now consider whether these conditions for direct taxes can be found in this country.

Firstly, cocerning the industrial structure, we must take into consideration that there still exist many pre-capitalistic factors. A great part of agriculture as well as an overwhelming majority of small manufacturing and trading enterprises are carried on under a pre-capitalistic management. Meanwhile, about 20 percent of national wealth was destroyed during the war and the dreadful crisis after the unconditional surrender, together with the policies of SCAP, dissolved the older industrial systems in every respect. Rehabilitation has been delayed by several causes not to be mentioned here.

Secondly, national income underwent a striking decline. War damage, loss of assets abroad, agrarian reform, enforcement of capital levy, dissolution of the plutocracy, restriction of concentration and monopoly, all these have had an equalizing effect upon the distribution of wealth and income, although the drastic inflation between 1945 — 1949 had an opposite influence. Inflation produced an extraordinary amount of unlawful profits, and thereby accelerated the unequal distribution of wealth, but unlawful profits to a large extent have been concealed, so that the tax office has never been successful in seizing them. A great rise in prices caused an insufficient depreciation of capital. Thus the nominal rise and real fall in national income went hand in hand with a somewhat equal distribution of wealth. Engel's coefficient was beyond 60 percent since the end of the war, and is even now beyond 50 percent, compared to 38 percent, on an average, in the pre-war period, and at the same time, a progressive rate, with a sharp rise in wages, has also generally been applied to small income earners, and the minimum standard of living has been greatly depressed.

Thirdly, the number of taxpayers, especially that of income taxpayers have tremendously increased owing to thc inevitable extention of the range of income taxation. The following figures show how rapidly and drastically it has increased.

Table 3. Number of Income Taxpayers, Amount of Gross Income and Amount of Income Tax *

	Number of Tax-Payers *in thousands*	Amount of Gross Income *millions Yen*	Amount of Income Tax *millions Yen*	Ratio of Tax to Income %
1930	938,925	2,469	110	4.4
1931	782,814	2,023	85	4.2
1935	941,604	2,489	109	4.4
1940	4,079,380	9,260	867	9.4
1942	7,019,850	15,533	1,794	11.5
1944	12,431,518	27,017	3,395	12.6
1946	12,315,311	189,423	27,133	14.3
1947	19,782,889	524,714	111,098	21.2
1948	20,534,038	1,412,729	235,164	16.6
1949	21,097,705	2,075,289	334,931	16.1
1950	15,771,000	1,995,146	259,917	13.0
1951	12,683,000	2,063,718	240,169	11.6

* *Abstract of Tax Statistics of Japan*, 1950.

The figures in the second column include the number of those from whom income tax is collected at source, and the number of self-assessment returns is rather small, as will be shown later on page 169. They clearly show that the income tax reform of 1940, which in the main followed the English example of income tax system, had a great effect upon the change in the number of taxpayers. The number of taxed corporations has also increased from 36,750 in 1930 to 117,675 in 1948. It will at once be realized that this rapid increase in the number of taxpayers provokes an immense degree of inaccuracies. Though the income tax reform of 1951 may be expected to produce favourable results with regard to the number of taxpayers, the number will not be sufficiently reduced to relieve the heavy burden of the tax offices.

Fourthly, the conditions in regard to information-at-source in this country are far from satisfactory. In this respect the *Shoup Report* had reason to accord special attention to the problem how to deal with tax

Table 4. Rate of Income Tax Collection as of the End of Each Month

		Budget Amount *millions Yen*	April %	May %	June %	July %	Aug. %	Sept. %	Oct. %	Nov. %	Dec. %	Jan. %	Feb. %	March %	April %	May %
1947 F.Y.	Total Tax	135,422	1.3	4.1	7.1	11.5	15.5	20.2	24.7	29.2	35.0	47.5	70.0	92.8	108.4	109.3
	Income Tax															
	Withholding-at-Source	19,843	4.5	9.8	15.1	23.1	32.1	42.2	54.5	66.3	80.4	97.9	114.8	135.3	135.3	140.9
	Self-Assessed	49,201		0.1	1.1	3.7	5.1	7.4	8.6	10.8	11.4	21.3	50.4	78.9	104.8	104.3
	Total	69,044	1.4	2.9	5.1	9.3	12.9	17.4	21.8	26.8	31.2	43.3	68.9	95.1	113.5	114.8
1948 F.Y.	Total Tax	316,097	1.5	5.1	9.1	14.0	20.4	26.2	32.8	41.1	51.4	63.1	81.0	102.7	109.0	109.4
	Income Tax															
	Withholding-at-Source	61,271	5.2	12.2	19.8	26.3	32.6	40.1	48.9	57.8	70.9	87.7	112.8	120.3	124.5	124.7
	Self-Assessed	122,196	0.1	2.0	3.8	7.3	13.6	16.3	19.9	27.7	33.0	42.0	63.3	87.7	93.6	93.6
	Total	183,467	1.8	5.4	9.1	13.6	19.9	24.2	29.6	37.7	45.7	57.3	76.4	93.7	103.9	104.0
1949 F.Y.	Total Tax	515,970	2.3	7.5	13.9	22.3	29.5	36.3	44.2	54.0	64.1	74.9	86.8	95.7	100.0	100.5
	Income Tax															
	Withholding-at-Source	129,486	4.9	14.1	21.9	30.3	39.1	47.9	57.3	66.4	76.1	89.2	98.4	107.7	109.2	109.8
	Self-Assessed	170,325	0.2	1.8	5.1	14.4	17.2	19.1	23.4	32.5	40.8	48.5	64.5	74.7	80.5	80.6
	Total	299,811	2.3	7.1	12.3	21.3	26.6	31.5	38.1	47.1	56.0	66.1	78.1	89.0	92.9	93.1

evaders. But the valuable recommendations, such as the enforcement of the transfer of shares, the prohibition of anonymous deposits, etc. are not put into practice on the theory that such prescriptions would give rise to friction in business transactions. In this manner, many tax invaders have been overlooked, while those who pay taxes at source have no chance of evasion.

Although the budget amount of each tax was fulfilled by a behindhand collection from tax delinquents, those who are subject to collection at source, namely wage earners and salaried people, must have carried a heavy tax burden throughout the inflation period. Table 4 will distinctly show the unequality caused by the inadequate tax administration for lack of a complete system of information at source.

There is a distinct contrast between the efficient collection in the withholding system and the inefficient one in the self-assessed system. The ratio of the former usually surpasses the budget amount before the end of the fiscal year. On the contrary, the ratio of the latter at the end of December does not reach a level as low as 11% in 1947, 33% in '48, and 41% in '49. This fact is a concentrated expression of many things. Lack of information-at-source, inability of tax officials, insufficient development of rational management, etc., in short, undeveloped capitalism together with influences of the war are, I believe, directly responsible.

Japanese taxation was accused of relinquencies and evasions by the Shoup Mission in 1949, and the Ministry of finance accepted many of their advices. But curious to relate, developments since then are not favourable to those who pay taxes under the system of withholding-at-source.

The estimated ratio of withholding income tax has gradually risen, as the following Table shows.

Table 5. Budget Amount of Withholding and Self-Assessed Income Tax Compared

	Withholding *billions of Yen*	Ratio %	Self-Assessed *billions of Yen*	Ratio %
1947	19.8	29	49.2	71
1948	61.2	33	122.2	67
1949	129.5	43	170.3	57
1950	98.3	40	150.3	60
1951	105.0	47	117.6	53

These figures to some extent indicate that the tax offices have confined themselves to a simple method of collection without organized effort to improve tax administration, but at the same time they also show that, without adequate conditions, it is impossible to do justice to tax ideals. The respective amounts of 127.5 billion yen for withheld income tax and 92.6 billion yen for self-assessed income tax in 1950 instead of the budget figures of 98.3 and 150.3 billion yen, proves clearly the difficulty of self-assessment.

As to the fifth problem, the Shoup Commission devised "blue form returns" to mitigate taxpayers complaint against one-sided re-assessment. Under this system, a taxpayer, who registers with the Tax Office his willingness to keep accurate books and records, will be permitted to file his returns on a blue coloured form and will be assured of not being subject to re-assessment. At the same time, emphasis was laid upon the necessity of establishing a certified public accountant system. It is true that many efforts have been made in this direction, but without notable results.

I shall mention a single example. The following figures show the number of those who wished to register with the Tax Office their willingness to keep books and records.

Table 6. Number of Applicants for Blue Form Returns in June 1950

	Number of Taxpayers *thousands*	Number of Applicants *thousands*	Ratio %
Commerce & Manufacturing	2,356.0	168.9	7.1
Agriculture	3,379.0	111.0	3.5
Others	921.0	13.1	1.4
Total	6,656.0	293.1	4.4

Needless to say, the great majority of income taxpayers consists of wage-earners, salaried people, etc. who are largely subject to collection-at-source, and the figures of taxpayers in the above Table 6 may be considered to be engaged in the main in business. Only seven business men out of a hundred, the Table shows, are willing to keep books and records. This is a striking but natural fact, due to the pre-capitalistic mode of small-scale business in this country. A more singular fact is that nearly a half of the corporations are not willing to keep the books required.

Concerning the sixth condition, i. e., an efficient tax collecting organization, our taxpayers have had bitter experience. In this respect, too, Prof. Shoup has given us valuable advice. But improvement will not be attained in the near future. The quality of work depends upon the quantity of it. The tax offices are now up against many tasks which surpass their ability. I shall present a statistical survey of those who are engaged in taxation. Tax revenue officials number 59,311, upper and lower officials combined. The following figures show length of service.

Table 7. Number of Tax Officials Classified According to Length of Service, 1951

Classification	Number of Officials	Classification	Number of Officials
Up to 1 year	3,743	Up to 10 years	3,632
Up to 2 years	5,314	Up to 15 years	2,246
Up to 3 years	16,739	Up to 20 years	575
Up to 4 years	11,339	Up to 25 years	767
Up to 5 years	1,175	Up to 30 years	725
Up to 6 years	4,308	beyond 30 years	492

Since 1949 there have been great efforts to improve the efficiency of the tax revenue administration. The above figures show the results of these efforts. Tax Offices are being reinforced by new officials. Thus there are more than 35,000 officials classified as "up to 4 years," from which is seen that, two years ago, about 28,000 officials were in the class "up to one year."

From the standpoint of school career, this circumstance is far from favourable. According to statistics not related here, a little more than 2,000 officials are graduated from universities, and those who finished colleges or similar schools numbered about 9,000, while more than 42,600 only finished middle schools.

Seventhly, the rate scale of taxes is an essential item to be considered for ideal taxation, but, as shown above, this includes many important problems. Let us consider them without referring to details.

As pointed out, the change in the ratio of direct to indirect tax revenue in favour of direct taxes in this country since 1940, was to some extent due to the income tax reform from the German to the English type of taxation, introducing the standard and super rate. Since then, inflation has progressed continuously. As a result, tax rates operated more and more oppressively. The following Table will show this:

Table 8. Income Tax on ¥1,200 Yearly Earned Income on the Basis of Prices in 1930

Year	Base Income *Yen*	Amount of Income Tax *Yen*	Ratio %
1930	1,200	0	0
1935	1,224	0	0
1945	11,810	3,466	29.3
1947	115,790	44,384	38.3
1948	198,710	54,055	27.2
1949	248,020	68,984	27.8

Table 8, however, is upon the assumption that a wage-earner who had an income of yearly 1,200 yen in 1930 would have been given a larger income as prices rose, and thereby would have maintained the same level of living. It shows that the amendment of the income tax rate was usually too late to be in accordance with the rise in prices, and in this case, also with wages. To be more accurate, it will be necessary to take into account the real figures, but the results will be enough to show the same tendency. As shown in Table 8, the oppressive operation was greatest in 1947. Its after-effects linger to this day.

By a recent amendment of the income tax, the base exemption is raised from ¥30,000 to ¥38,000, and the allowance for dependents from ¥15,000 each to ¥17,000 each, rate brackets also being changed in favour of taxpayers. Therefore, the income tax upon average workers with three dependents, earning a wage of ¥15,000 monthly will be ¥716 (4.77%) instead of ¥1,417 (9.44%).

But if we estimate the real value of ¥15,000 when prices have risen about three hundreds times from 1930, ¥ 15,000 will be worth ¥ 50 (¥15,000÷300) in terms of 1930 yen. In the United States an average worker with three dependents earning $3,000 a year is expected to pay only $20 (0.67%). $3,000 being converted into ¥1,080,000, if taxed in Japan, would bear an income tax burden of more than ¥430,000 (40%).

Such being the case, the direct tax, if its worth be appraised, should be moderate so as not to infringe that part of income which is necessary for maintaining the lowest standard of living. The following is an evident proof of the necessity of lowering the rate of income tax here. In 1949,

the number of total income taxpayers,	
self-assessed was	7,737,000 (100%)
of those who filed returns	6,689,000 (89%)
those reassessed	3,286,000
those assessed without filing returns	868,000 (11%)

And in the same year,

the total amount of assessment was	191,581 *millions*(100%)
the amount as reported	127,024 *millions*(66%)
amount increased by reassessment	65,557 *millions*(34%)

For 1950, improvements were expected at the beginning of the fiscal year as follows:

the number of total income taxpayers,	
self-assessed, would be	4,266,000 (100%)
of those who filed returns	4,158,000 (97%)
those reassessed	252,000
those assessed without filing returns	108,000 (3%)

and similarly

the total amount of assessment would be	100,600 *millions*(100%)
the amount as reported	81,987 *millions*(81%)
increases by reassessment	18,613 *millions*(19%)

Betraying these estimations, relinquencies were rather formidable in 1950. The total amount already collected by the end of Oct., 1951, is less than ¥93 billions compared with the budget amount of ¥117 billions.

For 1951, too, the amount collected by the end of Oct. is only ¥ 24 billions (17.5% of the budget amount). This lamentable fact gives rise to the further confusion of the taxation system. In this sense, a heavy rate of direct taxation may be worse than indirect taxes with a similarly heavy rate even from the point of view of the ability principle.

As to the eighth problem of adequate interrelation between central and local taxation, etc. , there are many interesting developments. But space is too limited to go further in this direction.

VI. *Conclusion*

I have endeavoured to explain conditions necessary for direct taxation, to which the ability principle of today has given a particular quality. Examining the historical background of the principles of taxation as well as the growth of the concept "ability," we reach the view that the concept "ability" does not necessarily require direct taxes. That the concept "ability" combines best with direct taxes cannot be explained from the concept as such, but from considerations of the historical development of an economic society.

At the stage of early capitalism, the ability principle required indirect rather than direct taxes. When capitalism came to its best, proportional direct taxes were called for in the name of the same ability principle for the sake of capitalistic freedom. Freedom of circulation of money and goods is the highest ideal of progressive writer of that day. In spite of the actual growth of progressive direct taxes in their older form of graduated degressive taxes (proportional taxes with exemption), which, in reality, were antecedent to modern progressive taxes, active advocates of progressive taxation were not in evidence until the end of the nineteenth century, when the idea gradually assumed its particular shape that the freedom of business circulation should sometimes concede to the necessity of mitigating the discrepancy between the rich and the poor.

Partly reinforced by the Austrian marginal analysis, the equal sacrifice theory finally called for the progressive instead of the proportional tax. But at the beginning, the degree of progression was limited for fear of falling into socialistic ideas, for many socialists decidedly advocated a radical progression to confiscate the wealth of the bourgeoisie.

As the monopolistic tendency of capitalism appeared more and more distinctly, even the Liberals accepted progressive taxation. On the other hand, even when the idea of "cheap government" betrayed itself in England by large public expenditure for colonial expansion, both Gladstone and Disraeli pretended to reject the income tax as an ordinary source of public revenue.

The time arrived at last when the progressive income tax became necessary to cover financial deficits and to mitigate class antagonism. Direct progressive taxes were needed to reduce the indirect tax burden upon the labouring class, and redistribute wealth. The direct progressive tax was appraised not only for its productiveness, but for its desired result of wealth redistribution. Fundamental condition for direct taxation in advanced countries existed through the great progress in productive power, and the unequal distribution of wealth. This was one of the main points of this article.

The next problem was to define more concretely the conditions necessary for direct taxation.

This article enumerates eight conditions, each of which includes a variety of problems, and interrelates with each other.

Lastly, I tried to examine the conditions in Japan. Conditions for an ideal direct tax, in my opinion, are premature in this country. The ratio of direct to indirect tax revenue, I admit, is to some extent useful for measuring the advancement of the tax system as a whole, but a mere change in ratio does not prove the direction of a tax system. A large revenue collected through an income tax sometimes oppresses the lowest standard of living. I showed that in 1930 the income tax did not affect incomes of ¥1,200, while to-day, even after significant mitigation an income of ¥50 pays about ¥5 in taxes.

The *Shoup Report*, from the standpoint of capitalistic freedom, took decisively unfavourable attitude to taxes on communication. The ability-to-pay of corporations, too, was theoretically denied from the same standpoint.

But, if a heavy rate of income tax is maintained in place of the sales tax or taxes on textiles, the problem must be put into another light. Frictions and injustice in tax collection will render the tax system as a whole unworkable, and the ratio of direct to indirect tax revenue would be reduced in its meaning and importance.

Several important problems are consciously left untouched here. The inseparable relation between parliamentarism and taxation implies a political aspect of direct taxes. There is a close relation between the spirit of capitalistic rationalism and the system of government, and hence, that of tax administration, which is another problem deserving of a sociological study. But each of these problems would require another monograph.