

## INCOME TAXATION IN THEORY

We are now ready to apply our concept to the problem of income taxation. Let us imagine the case of three brothers, each of whom inherits the same fortune, say \$100,000. Let us assume that interest is 5 per cent. The first brother invests his \$100,000 in an annuity of \$5,000 a year forever which he does not reinvest.† The second puts his in trust to accumulate at 5 per cent for fourteen years, at which time, having doubled in value, it is to be invested in a perpetual annuity of \$10,000 a year which he does not reinvest. The third, being of a spendthrift type, buys an annuity of \$20,000 a year for (nearly) six years and does not reinvest.

According to the concept here advocated, the first has a perpetual income from his supposed investment of \$5,000 a year; the second has no income for fourteen years, and thereafter an income of \$10,000; the third has an income of \$20,000 a year for six years and thereafter none at all. This mode of viewing the matter also squares with ordinary reckoning.

If, now, we suppose a ten per cent income tax laid on the three brothers, we shall find that, according to the different possible interpretations sometimes given to the term "income", the results will be startlingly different. If the income be taken in its true sense, namely, as consisting of those items whose capital-value is the \$100,000 with which the three brothers started, then an income tax of ten per cent will yield from the first brother \$500 a year; from the second, nothing for fourteen years, after which it will yield \$1,000 a year; and from the third, \$2,000 a year for six years\* and nothing thereafter. The burden of the three taxes on these three brothers will, under these conditions, be exactly equal, when the three are compared by means of their capitalized values. Each brother could theoretically "compound" for his taxes (that is, could pay a fixed sum in advance in lieu of the annual sums) at the same cost, namely, \$10,000. That is, \$10,000 is the sum in present cash which is equivalent respectively to \$500 a year forever; to \$1,000 a year beginning fourteen years hence; and to \$2,000 a year for six years. But, turning now to the spurious interpretation of income as the value of uses *plus* the accumulation of capital, or the value of uses *less* the depreciation of capital, we find that the three brothers would be very unequally taxed. The first would, as before, pay \$500 a year in-

† For fuller analysis see *The Nature of Capital and Income*. In brief, this assumes that the net income from all other sources is zero, including the net income from his pantry stock, wardrobe, etc.

\* Or, to be exact, \$2000 a year for five years and \$1800 in the last year, inasmuch as the capital will be exhausted in a little *less* than six years.