OBJECTIVES OF TAXATION

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1

A CONSIDERATION of American tax structures (Federal and State) and the way these structures are altered, repaired, patched up, and expanded, suggests a building with several wings, each of which was constructed in a different era and according to a different style of architecture. In part, this motley appearance and nature of our tax structures is probably inevitable; it is hardly practicable, within the framework of a democratic government, ruthlessly to tear down an entire institution, in order to build anew and according to well-organized plan, although such an idea is, of course, intriguing.

Much of the confusion, however, is due to a failure to sort out the possible objectives and goals of taxation, and to work steadily toward that objective which seems most desirable. It is not always clear just what objective or goal (or even logical combination of objectives or goals) executive branches and legislative bodies of our governments are seeking to attain, and this condition is encountered as well in the discussions and writings of many persons outside government.[1] It might be added that this failure adequately to distinguish and to push forward a particular goal is especially noteworthy in the case of the Federal Government, where the wider scope of possible activities and the greater choice of possible goals compounds the chance of confusion.

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What, then, are the possible objectives of taxation from which a choice must be made before there can be any substantial progress toward a more logical tax structure? [2] If this question were put to,

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[1] An example here will illustrate the point made above. One sometimes hears such taxes as those on alcoholic beverages and tobacco products defended both on the ground that they produce substantial amounts of revenue and on the ground that they repress consumption of undesirable products. Clearly these are contradictory objectives, and both cannot be attained in an overwhelmingly successful manner by the same tax.

[2] It is assumed here that the " area of taxation " has already been clearly and

say, twenty persons at random, the common answer probably would be "to obtain money for the government."[3] This is merely the "sidewalk" version of what we may call the "revenue objective" of taxation. It is the oldest of the objectives which may be said to be current today. It is also the one which we may designate as "conservative" (even "reactionary" in some hands!) according to common current usage of that troublesome adjective.

Adam Smith seems to have been imbued with a definite "revenue objective" in his consideration of taxation.[4] Smith conceded that there would be some things which government must or should do even in the "natural order" of competition, small business, division of labor, and the invisible hand. The scope of government should be the defense of the realm from external attack, the preservation of internal law and order, a minimum of elementary education, and those public works deemed highly desirable but at the same time unprofitable and impracticable for private enterprise to undertake.

These proper activities of government would have to be financed out of taxation for the most part, inasmuch as Smith had a typically classical (and Scotch!) attitude toward public borrowing.[5] Hence, Smith turned his attention to the proper characteristics of such a system. First and foremost there was the matter of equity, which, to Smith, meant taxing people "as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."[6] In addition, a good tax system would be characterized by certainty (as to time of payment, amount, etc.), convenience (as to time of payment, method of payment, etc.), and economy ("every tax ought to be so contrived as both to take out and to keep out of

deliberately marked off from the "area of non-tax revenues" (e.g., government prices, fees, fines, etc.). This demarcation itself requires important public policy decisions. Borrowing may here be regarded as an alternative to or supplement for either taxation or the collection of non-tax revenues.

[3] It should be pointed out that "obtaining money for the government" and "taxation" are not necessarily synonymous. The Federal Government, for example, has extensive powers for borrowing and for printing money.

[4] See Adam Smith, *The Wealth of Nations,* Book V, Chapter I.

[5] Even in these areas admitted to the scope of government, Smith considered the possibility of placing the activities outside the "area of taxation," e.g., his comparison of self-equipped militiamen with professional soldiers forming a standing army. He concluded here in favor of the professional army financed out of general government revenues. On the other hand, he was of the opinion that courts of law probably could sustain themselves by the fees collected in the course of their work.

[6] Adam Smith, *The Wealth of Nations,* Book V, Chapter II.

the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.")[7]

In brief, Smith was saying in *The Wealth of Nations* that after delimiting the area of government activities that should be supported at public expense, sufficient taxes should be provided to meet such expense. Taxes should be apportioned among the people as equitably as possible and with due respect to the convenience of the taxpayer, the avoidance of purely arbitrary tax laws and regulations, and economy in the costs of collecting the taxes.

The "revenue objective," as put in the above paragraph, is sufficiently flexible to include the most rabid and intransigent advocate of *laissez faire,* as well as the moderately conservative individual of today who might be willing to go along with a reasonable amount of government intervention. After all, whether Smith realized it or not, his "public works" category in the listing of permissible functions of government is subject to some elasticity of interpretation.

The important point is that today's ultra-conservative "rugged individualist," as well as today's moderate rightist, while they might disagree as to the exact extent of government intervention in the affairs of the economy, would probably agree that (1) in general, government activity is at the expense of private activity, since there is a definitely limited quantity of productive resources available, (2) government must therefore be regarded as a kind of necessary evil, to be held in check insofar as practicable in order that the individual (as worker, employer, or consumer) may have as complete freedom as possible, (3) as for taxes, it follows from (2) that these should be held to the minimum amount consistent with essential and unquestionably desirable government activities,[8] (4) while taxes should be kept to a minimum, they should also cover total expenditures of government.[9] In other words, budgetary deficits would generally be deplored.

[7] *Ibid.*

[8] There would be, of course, room for some argument among subscribers to the "revenue objective" as to what constitutes "justice" or "equity" in apportioning this minimum amount of taxes among the people. This aspect of tax theory is outside the scope of this paper. However, it may be noted in passing that ultra-conservatives are likely to stress commondity or excise taxes and to deplore the extent to which taxation of income at progressive rates has gone. The more moderate conservatives are likely to be somewhat more amenable to a reasonably "stiff" income tax as an integral part of the tax structure.

[9] More accurately, taxes plus any non-tax revenues (other than proceeds of borrowing) should be sufficient to cover total expenditures.

There are two arguments which one may present in opposition to a " revenue objective " as sketched above.

In the first place, any assumption that government activity is necessarily at the expense of private activity is basically unsound. The economist will recognize this as the assumption of full employment of all resources as a " normal " state of affairs. Suffice it to say here that the " Keynesian revolution " has caused a very large proportion of American economists to question such an assumption regarding a capitalistic economy.[10]

Where there is substantial underutilization (unemployment) of the factors of production, it is entirely possible that increased government activity (involving increased public expenditures) might add to the total output and income of the economy and hence deprive the economy's private sector of no resources which otherwise might have been employed.[11] Whether such would be the result of an increased public outlay (in time of significant factor unemployment) would depend on such things as the method of financing the increment of government expenditures and the effect of the government's policy on that elusive element generally designated as " business confidence."

In the second place, since full employment of resources is not a " normal " state of affairs, and since (in the absence of government countercyclical measures) total income and employment are likely to fluctuate rather widely, it becomes a virtual certainty that it will be impossible (despite excellence of intentions) to hold government expenditures to some reasonably constant " minimum " and always to cover this " minimum " with tax and other non-borrowed receipts.

Modern governments cannot (for practical as well as ethical

[10] See J. M. Keynes, *The General Theory of Employment, Interest and Money* (Harcourt, Brace and Company, New York, 1936). It would, of course, be true that, given full employment, an *increase* in government activity would divert resources which otherwise would have found employment in the non-governmental sector of the economy. Since a minimum of government activity may be regarded as a prerequisite to any significant production at all, it can hardly be said that *all* government activity is at the expense of the private sector, even under conditions of full employment.

[11] Under conditions of less than full employment for the economy as a whole, there might still be the possibility that an increased public outlay might actually deprive the economy's private sector of output from *particular industries* which might be operating virtually at capacity. This would seem more likely to occur, however, during the upswing and approach to full employment than during the depths of a serious depression.

reasons) allow extensive unemployment to go unnoticed; expenditures must therefore increase. At the same time, declining total income must bring with it declining tax and other non-borrowed receipts.[12] The likely result is a budgetary deficit, even where the announced objective is the contrary. In time of depression and unemployment, the "revenue objective" is likely to be a losing proposition, impossible of attainment, and resulting only in the government's appearing to be helpless and unable to achieve its goal. For those who fear the effect on "confidence" of deliberately incurred deficits, it might be pointed out that the effect of a deficit obviously incurred despite strenuous efforts to avoid it may prove far more harmful to business "confidence" and "morale."

Lest one conclude that the criticisms of a "revenue objective" apply only to periods of unemployment, and therefore are meaningless under present-day conditions, let it be pointed out that the "revenue objective" is not entirely flawless even in times of full employment, including periods of war and heavy defense spending. In such times, a strict adherence to such an objective might necessitate reducing taxes to bring outgo and income of government revenue into balance. Yet, nidirectly such action could contribute to inflationary pressures which the accumulation of a surplus might lessen.[13]

Concerning an objective of annually seeking to obtain just enough revenue to cover the legitimate expenses of government, one might therefore conclude that such an objective is really unattainable and, further, that any persistent attempt to obtain it would accentuate cyclical fluctuations.

3

The objective of taxation most likely to be contrasted with the "revenue objective" is what one might call the "stabilization objective." Such an objective would consider the stabilization of

[12] This decline in the government's tax receipts may be more than in proportion to the fall in total income where the tax structure relies heavily on income taxation (especially an income tax using a markedly progressive rate structure). To one subscribing to the "revenue objective" this would be a decided weakness of the income tax; as will be pointed out below, in terms of a "stabilization objective," it would be a most attractive feature of the income tax.

[13] In the more extreme case of war, heavy military outlay probably would result in some deficit financing regardless of the taxation objective. However, the use of various control techniques to counteract the inflationary deficits would appear to be more consistent with a "stabilization objective" than with a "revenue objective."

national income and employment at high levels of more importance than an annually balanced budget. In terms of taxation, the income-employment effects of taxes would be of greater significance than the revenues which such taxes would produce for government.[14]

Behind a " stablization objective " lies the following reasoning: (1) The level of income and employment is a function of the aggregate effective demand for goods and services, including the demand of governments and foreign nationals, for the output of the domestic economy. (2) In the absence of government adjusting its own expenditure and revenue policies to offset any fluctuations in private demand, there is no assurance that the total spendings of the economy's private sector will always be sufficient to provide and keep a high level of national income and to insure full employment of resources.[15] (3) The attainment of a continued high level of income and employment requires that a national government be prepared to " compensate " for any fluctuations in private spendings. This government would do by " releasing " net purchasing power in times of declining private spendings and " absorbing " net purchasing power in those times when total private spendings might be more than enough to sustain a reasonably high level of income and employment without serious price increases.

A policy of " compensation," to attain the objective of stabilization, could suggest one or more of the following tax policies: (1) Reducing or increasing taxes to produce a deficit (net release of purchasing power in time of depression) or a surplus (net absorption of purchasing power in time of prosperity); (2) devising a tax system with maximum " built-in flexibility," i. e., one which would automatically tend toward depression deficits and prosperity surpluses, assuming no significant counteracting movements in public expenditures; [16] (3) shifting the emphasis in taxation from " strong " to " weak " marginal spenders (depression) and vice versa (prosperity).

[14] Where stabilization of income and employment is the primary objective of government policy, taxation would be only one aspect. The attainment of such an objective might entail manipulation of expenditures and borrowing, as well as of taxation.

[15] This is, of course, the Kenynesian denial " that the whole of the costs of production must necessarily be spent in the aggregate, directly or indirectly, on purchasing the product." See Keynes, *op. cit.*, pp. 18-22.

[16] A highly progressive personal income tax would be the basis of any tax system where the aim was to have tax receipts vary directly and sharply with the movements in private spendings. Cf. footnote 12 above.

The tax policies sketched in the preceding paragraph are not to be regarded as being mutually exclusive. As a matter of fact, if government set out aggressively to " compensate " for serious cyclical fluctuations, a combination of all these policies might have to be utilized.[17] The important point to note here is that all such tax policies would clearly emphasize the objective of stabilization at a desirable level, rather than the mere obtaining of revenues.

Two questions occur here. Assuming the validity of the reasoning behind the "stabilization objective " (which most economists seem ready to accept, at least in broad outline), (1) is the objective attainable within the framework of a reasonably free-enterprise economy and (2) should every thing else in public finance in general, and in taxation in particular, be sacrificed to the quest for a high level of income and employment?

That government, through vigorous use of its arsenal of public finance weapons, can lift national income to full-employment level, is demonstrated by our experience during the war era 1940-1945. It is true that the objective during a war era is military victory, and that income-employment effects are secondary to this objective. However, World War II more than demonstrated (in passing) the efficacy of " compensatory " finance, at least from a short-run point of view. If a clear-cut decision were made in favor of the " stabilization objective," and if there were willingness to pay whatever price might be required, the objective could probably be attained.

But what would be the price? More specifically, could such an objective be attained without seriously altering the structure of our mixed capitalistic system?

Keynes himself thought that the answer was generally " yes," that the policy implications of his analysis were " moderately conservative," and that aside from " establishing certain central controls in matters which are now left in the main to individual initiative " there would be no threat of " a system of State Socialism which would embrace most of the economic life of the community." [18] On the contrary, he argued, it might be possible

[17] The discussion above is largely in terms of cyclical fluctuations. However, the Keynesian analysis suggests at least the possibility that relatively wealthy and mature capitalistic economies may have to consider the matter of compensation for secular stagnation as well as for cyclical fluctuations.

[18] Keynes, *op. cit.,* pp. 377-378.

to cure the disease of instability " whilst preserving efficiency and freedom." [19]

In more recent years, there would appear to be a growing undercurrent of doubt on this point. World War II left us with large financial commitments—interest on the public debt, veterans' benefits, and the necessity for developing the largest peace-time military establishment in the nation's history—which tended to rigidify the Federal buget. In the period when, according to " compensatory " tenets, we should have been cutting expenditures of the Federal Government, increasing taxes, and accumulating substantial surpluses for retirement of part of the Federal debt, we found ourselves violating just about all the rules at one time or another, or at least being unable to follow them as closely as the circumstances seemed to indicate. While flexibility seems to be the essence of " compensatory " finance, the essence of post-war budgetary experience appears to be inflexibility insofar as restrictive and indicated deflationary measures are concerned. As one study made prior to the Korean episode remarked:

> If the managed compensatory system is to make any progress toward reducing the debt, it must count upon creating large surpluses in prosperous periods by raising taxes and cutting expenditures. But expenditures resist downward change and taxes resist upward change. In the present state of economic forecasting, it will always be possible to make out a plausible case that depression is around the corner. Such a prediction will permit both unpleasant alternatives to be avoided, since under the managed compensatory theory the forecast of depression requires lower tax rates and higher expenditures.[20]

It may be argued, of course, that our experience since the end of World War II is no fair test of managing the " boom " phase of the cycle by " compensatory " measures, that the years since 1945 have been marked by unusual disturbances external to the economy itself, and that these disturbances of foreign origin have compelled us to do things which we would never have done in their absence. But such an argument is not entirely convincing. International developments may have intensified the problem, but one may doubt whether they created it.

[19] *Ibid.*, p. 381.

[20] The Research and Policy Committee of the Committee for Economic Development, *Taxes and the Budget: A Program for Prosperity in a Free Economy* (New York, 1947), p. 24.

What seems to bother some economists today is not whether it is possible to raise national income to full-employment level through fiscal devices, but instead whether it is possible to prevent things from getting completely out of hand once full employment has been reached.[21] It may be relatively simple to bring about increases in expenditures and cuts in taxes to curb or forestall the ravages of depression; it is probably more difficult to accomplish the reverse when inflationary pressures develop.

If it is true that we have substantially lost the element of (downward) flexibility in Federal finance, then, during a full-employment period, we may have to resort to more elaborate controls than appear to have been contemplated by the earlier presentations of the theory of compensatory finance, thereby interfering still further with the allocation of resources through the mechanism of free markets.[22] There is the fear that one step in the direction of controls leads to another, and so on.[23]

The problem grows out of the fact that most people appear to want continued high levels of national income, security of employment, low prices (at least for the things they buy), and a government that minds its own business (except to regulate the other fellow). The economist can only say: "Make up your minds; then I may be able to offer some concrete suggestions about how to obtain your more limited objectives."

As for taxation, it can be a very useful weapon in attacking the problem of instability.[24] But stabilization, however attained, carries a price tag.

[21] At about the time of our entry into World War II, the concern was with the first point mentioned above. It may be, of course, that we tend to over-emphasize the problem of the moment and to lose sight of its opposite number.

[22] This is not to imply that we would have only "free markets" in the absence of the controls mentioned above. There would still remain significant monopoly elements in the economy's private sector.

[23] On the question of the relation between a high and rising level of government activity (in time of full employment) and the market price mechanism, see Paul Strayer, "Public Expenditure Policy," *American Economic Review*, vol. XXXIX, (March 1949), pp. 396-397.

[24] The author is not inclined to agree with Professor Groves's statement that "the tax instrument does not lend itself readily to the objective of cyclical control." Groves stresses the delay in enacting major changes in tax laws. But timing difficulties are not peculiar to the tax instrument, nor have we as yet fully explored possible techniques for reducing these timing difficulties. See Harold M. Groves, *Postwar Taxation and Economic Progress* (McGraw-Hill Book Company, Inc., New York, 1946), p. 360.

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The " revenue objective " and the " stabilization objective " are mutually exclusive. There are various other objectives which are not necessarily excluded by both of these major purposes. These subordinate objectives would include (1) greater equality in income distribution, (2) minimum interference with private enterprise, and (3) maximization of consumer satisfaction.

Greater equality in income distribution might be advocated on the ground of fairness and equity, or on the ground of strengthening the community's marginal propensity to consume.[25] The latter argument is likely to appear in the writings of those persons who suspect (or fear) a tendency toward chronic failure of the economy's aggregate spendings to sustain a high level of employment.[26] But in these terms, the equality objective is perfectly consistent (as a subordinate goal) with a primary objective of stabilization.

Other writers, as suggested above, propose greater equality of income distribution as something desirable *per se* for reasons of fairness and equity. Thus, we find Professor Simons defending Adolph Wagner's contention " that taxation must be conceived as an instrumentality for altering or correcting the distribution of wealth and income," [27] because " the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely." [28] The goal of greater equality in income distribution should be regarded as paramount in importance, and deviations from it on behalf of " incentives " should be held to a minimum.[29]

[25] Reducing inequality in income distribution, through sharply graduated personal income taxes, together with subsidy payments to low income groups, may also be used to effect a higher level of aggregate consumer satisfaction. See A. C. Pigou, " Some Aspects of Welfare Economics," *American Economic Review*, vol. XLI (June 1951), pp. 287-302. Thus, the " equality objective " could, in effect, become merely a prelude to the " maximum consumer satisfaction objective."

[26] See, for example, Alvin H. Hansen, *Fiscal Policy and Business Cycles* (W. W. Norton and Company, Inc., New York, 1941). See also footnote 17 above.

[27] Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (The University of Chicago Press, Chicago, 1938), p. 15.

[28] *Ibid.*, pp. 18-19. It is interesting to note that Simons rejected the " temptation " to strengthen his argument for greater equality in income distribution by weaving into it the effects of highly progressive income taxation on the community's marginal propensity to consume. Such ideas he dismissed as " sophistries of the kind recently propragated by Mr. Keynes in England and, more journalistically, by David Cushman Coyle in this country." *Ibid.*, p. 23, footnote 14.

[29] Henry C. Simons, *Federal Tax Reform* (The University of Chicago Press, 1950), pp. 10-11.

A somewhat more moderate position was taken by Keynes, who was inclined to regard equality of income distribution as something of incidental (but not of primary) importance in the determination of government policy. To Keynes the humanitarian, some moderation of income disparities could be justified on the ground of fairness and equity. To Keynes the man of affairs and practical statesman, a reasonable degree of inequality in income seemed necessary, and in any event, the inherent instability of a capitalistic economy appeared to be of more pressing importance.[30]

A taxation objective of minimum interference with private enterprise while providing for the essential needs of government will be held by those persons who would argue that economic progress and full employment require that the fruits of the individual's labor be reduced as little as possible through taxation. It would mean, as one conservative student of taxation has expressed it, " if you want to make a dollar by any honest means you are free to try, and if you succeed you may keep it." [31] According to this point of view, economic progress requires a minimum of interference (including interference via taxation) with the quest for personal income, even though this may result in considerable inequality in income distribution.[32] One need only observe here that there may be some difference of opinion concerning Professor Lutz's concept of " economic progress."

An objective of minimum interference with private enterprise is, in reality, not an independent goal, but rather a further refinement of the " revenue objective." It would appear doubtful that a primary objective of income-employment stabilization could comfortably accommodate this secondary objective. Why this is so should be clear from a consideration of the difficulties encountered in the actual implementation of the " stabilization objective," as sketched in section 3 above.

Finally, one might advocate taxation primarily for purposes of maximizing consumer satisfaction. This is the province of " welfare economics," which, according to one prominent economist, " is concerned to investigate the dominant influences through which the

[30] Keynes, *op. cit.*, pp. 372-374.

[31] Harley L. Lutz, *Guideposts to a Free Economy* (McGraw-Hill Book Company, Inc., New York, 1945), p. 206.

[32] *Ibid.*, p. 82.

economic welfare of the world, or of a particular country, is likely to be increased." [33]

Consumer satisfaction, derived from the consumption of material goods and services, is the usual meaning assigned to "economic welfare." [34] In our economy, the ability of an individual to consume is primarly a function of money income, which is unevenly distributed. The inequality in income distribution means, it is argued, that the satisfaction which a poor man would receive from an additional dollar's worth of consumption is greater than the loss of satisfaction which the rich man would sustain by being deprived of a dollar of income. Hence, taxation of the relatively well-to-do according to a graduated income tax and the use of the tax receipts to pay subsidies to low-income groups would thus increase the aggregate of consumer satisfaction.[35]

Such an approach to taxation would appear to make sense only under conditions of full employment.[36] One could scarcely concern oneself primarily with such relatively subtle changes in aggregate consumer satisfaction when confronted by the more pressing problem of widespread unemployment. Yet there would appear to be no reason why such an objective should not occupy an auxiliary role in conjunction with a primary objective of stabilization. At the same time, it would hardly seem compatible with a pure "revenue objective."

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To summarize: Any sensible repair of our tax structures must be based upon some decision as to what objective is being sought by taxation.

One such decision might be that the purpose of taxation is to provide revenue for meeting the cost of essential government functions (usually rather narrowly defined). Opposed to this, there is the stated purpose of concentrating on stabilization of national income and employment at high levels, regardless of the effect on

[33] Pigou, *op. cit.*, p. 287.

[34] *Ibid.*, p. 288.

[35] Unless, of course, the tax-subsidy structure indirectly reduces the total of income (through, for example, its effects on incentive to work and the inducement to invest). See Pigou, *op. cit.*, pp. 301-302.

[36] "Welfare economics," in fact, in the hands of the Cambridge school of followers of Marshall, was a development based firmly on the classical tradition with its assumption of full employment as the "normal" state of affairs.

tax receipts and budgetary balance. These two objectives would appear to be mutually exclusive.

Since one needs to make a clear-cut choice, that choice would seem to lie with the " stabilization objective." The scope of government today is such that governmental fiscal activity is bound to influence significantly the course of total economic activity, and one may as well seize this fact and turn it toward a solution of a free-enterprise economy's basic dilemma, viz., wasteful swings in the degree of factor utilization.

At the same time, it must be recognized that the eagerness with which the idea of " conpensatory fiscal policy " was accepted by some following the " Keynesian Revolution " has been tempered somewhat. There seems to be a growing feeling that fiscal policy, as that term has come to be employed, implies a greater degree of flexibility than the Federal financial structure is now capable of demonstrating.[37]

Where there is a clear-cut acceptance of a primary " stabilization objective," there may be added at least two subsidiary objectives, if desired, viz., (1) achieving greater equality in income distribution and (2) increasing the aggregate of consumer satisfaction. A third subsidiary objective, minimum interference with private enterprise, would appear somewhat more difficult to incorporate in the primary goal, except possibly on a *ceteris paribus* basis.

[37] It should be noted, in passing, that a " stabilization objective " would (in our own case) be a possibility only in the case of the Federal Government. State and local governments do not possess the monetary and credit powers sufficient to deal with such an objective; they must, as a rule, content themselves with a " revenue objective," however unsatisfactory this may be. For a full discussion of this point, see Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy* (W. W. Norton, New York, 1944).