THE TAX STRUCTURE AND THE FUNCTIONING OF THE ECONOMIC SYSTEM

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SECOND GENERAL CONFERENCE SESSION

THE TAX STRUCTURE AND THE FUNCTIONING OF THE ECONOMIC SYSTEM

WEDNESDAY, SEPTEMBER 5, 1962, 9:00 A.M.

HAROLD M. GROVES, *presiding*

CHAIRMAN GROVES: If you will all take seats we will get started on this Second General Conference Session. I have one or two announcements to make to begin with. There is an important phone call for Mr. Joel Barlow. Call Washington, D.C. Operator No. 23, if Mr. Barlow is here.

And I am also requested to announce that the session on Friday morning will occur at 8:30 a.m. This is the one the Mr. Larry (J.L.) Reuther heads as Chairman.

Also, that the Local Arrangements Committee requests that you exchange boat tickets; that is exchange the one you have in this little booklet for an effective boat ticket. This is to be done before lunch. The boat trips are scheduled for from 2 to 4 and from 4 to 6, I believe, but you are to get your ticket for the excursion before lunch today.

We are now ready to start with the program.

The subject is, "The Tax Structure and the Functioning of the Economic System." I think you will agree that this is a timely and important and a weighty subject. In fact, so important and so weighty, that the Program Committee has departed from precedent and has assigned three speakers to carry the load, and I am sure that everybody on the platform would appreciate a hand from the audience as well. The Program Committee has assembled an all-star cast for the occasion.

Our first speaker has an unusual variety of experience. He was born in Germany, has a degree from the University of Heidelberg, studied in England, at the University of Rochester in New York, and has his final degree from Harvard. In academic institutions he started at Swarthmore College, was at Michigan University, at Johns Hopkins, and has recently moved to Princeton, in addition to which he has had a lot of collateral engagements. To name just a few, the Federal Reserve Bank of New York, the International Bank, Vice-President of the American Economics Association, Consultant for the Government of Japan and so forth.

His many articles and books include distinguished contributions on progressive taxation, the incidence of taxation, intergovernmental relations and other matters of interest. His latest book, "The Theory of Public Finances," published in 1959, is generally rated by the trade

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as the most valuable contribution that has been made in this area during this century.

We couldn't have gotten a more distinguished person to start on this big order.

It is now my pleasure to introduce to you, Professor Richard A. Musgrave of Princeton.

MR. RICHARD A. MUSGRAVE (New Jersey):

Mr. Chairman, Ladies and Gentlemen. I am somewhat handicapped having to follow up with the overgenerous introduction, but I will nevertheless try to go ahead.

THE TAX STRUCTURE AND THE FUNCTIONING OF THE ECONOMIC SYSTEM

R. A. MUSGRAVE
Professor of Economics and Public Affairs, Princeton University

In my first draft of this paper, I undertook a general discussion of why and how the tax and expenditure structure of government is an essential and integral part of our economy. Being a teacher of the subject and feeling strongly about it, this was easily done; but on reflection, it seemed too simple a way out. After all, you are free to read, and even to purchase, a treatise on the theory of public finance or a number of them, without even having to leave the members of this panel. I then decided on the tougher job of examining some of the more controversial issues of tax policy now debated around us. In particular, I shall consider these questions:

1. Is it the high ratio of government expenditure to GNP and the correspondingly high level of tax rates, which is to be blamed for the sluggish performance of our economy?
2. Given the objective of more rapid economic growth, must we undertake a fundamental revision of our tax structure and, indeed, tax philosophy?
3. What place is there for counter-cyclical tax adjustments, as distinct from structural reform?

Some of my answers to these questions may not be pleasing to either you or myself, but that, I am afraid, is in the nature of the problem.

Consequences of high post-war ratio of budget to GNP.

We now have a $550 billion economy. Of the goods and services which comprise this total, about $115 billion involve purchases by

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government (all levels). If transfers are included, public expenditures are about $150 billion, with tax receipts in the same order of magnitude. Thus, over one quarter of the GNP—or, if you enjoy a more scary picture, one third of national income—flow through the public budget. What has this done to the performance of our economy?

To begin with, note that nearly one half of public purchases are for defense and related purposes. This diversion of resources leaves less for other and more enjoyable uses. Had international affairs been peaceful, we would have been better off. Defining economic performance as the enjoyment of potential consumption, the budgetary situation has obviously been burdensome—it has restrained what would have been a more ample level of civilian resource use, including use for the satisfaction of private and especially public wants. This damage, however, was due not to having a large budget or high taxes, but to the need for diverting so much thereof into defense. Moreover, the burden of defense should not be exaggerated. Per capita consumption (measured in terms of constant prices), is now over 50 percent above 1940 levels. While defense has been costly, it has hardly placed the nation on a Spartan diet.

Next, there is the proposition, which I think valid, that the large budget has been helpful in maintaining high employment and stability in the post-war economy. Suppose that it had been possible in the fifties to lower defense expenditures to $10 billion a year. This would (and should) have left other public expenditures somewhat higher, but the total would have been much less, giving us purchases of about $75 billion, total expenditures of about $120 billion, and a budget to GNP ratio near the 1940 level. Federal revenue requirements would have been slightly above one-half of what they are now. We could have lived with, say, a 30% corporate rate, and a 12% first bracket rate under the individual income tax.

What a millenium this would have been—or would it? At second thought, remember that not only would taxes have been $50 billion less, but so would public expenditures. Would the increase in private purchases, due to lower taxes, have been sufficient to provide a full offset? Looking at the behavior of consumption and investment over the last decade, I doubt that such would have been the case. Defining economic performance in terms of high employment and capacity use, the large budget of the fifties may well have been an advantage rather than a burden. It has made it easier to maintain average employment at a relatively high level. Moreover, it has been a stabilizing factor in cyclical fluctuations, due to the presence of sustained public purchases, as well as to the counter-cyclical fluctuation of tax and transfer payments.

So far so good, but it remains to consider the effects of the high budget ratio on the rate of economic growth. Interpreting growth as rise in per capita income, consider the effects which the budget has had on the main sources of economic growth. Improvement in labor

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skills stands to gain greatly from such public expenditures as programs for education and health; but unfortunately such expenditures have not been responsible for the rising budget to GNP ratio. Technical progress, on the other hand, has benefited greatly from the advance of defense technology. So far the net score is favorable. A further source of growth, resulting from additions to the private capital stock, however, has fared less well. It is here that the high budget to GNP ratio may have had a retarding effect.

Plant and equipment expenditures of business have been around 6 to 7% of GNP over the last five years, as against about 10% in the late twenties. With individual income and corporate tax rates at substantially lower levels, private capital formation and the rate of growth might have been larger. But let us be clear as to what would have been required. To remain even, an increase in private capital formation to service private demand would have been needed to take the place of that which did occur to service defense production. Since the latter is more capital intensive, this in itself would have been no easy task, even if fiscal and monetary policies had been such so as to maintain a high-employment economy. To show a net gain, a further increase in private capital formation would have been needed, forthcoming presumably in response to the incentives offered by the reduced taxes on capital income. Evidently, this response would have had to be substantial to produce a *net* increase in capital formation.

My emphasis here has been on effects on capital formation. I am less concerned with effects on work effort. The net rate of return on capital after corporation tax was about the same in the fifties as in the twenties (and less after allowance for individual income tax) but the net rate of return on labor has risen substantially. Average hourly wage rates in manufacturing, net of income tax and adjusted for price change have about doubled. Moreover, the bulk of the labor force has enjoyed a substantial gain not only in the average but also in the marginal net rate of return; and though the marginal net rate may have fallen for salaried and professional people in the higher brackets, there is little or no evidence that work effort has declined.

In conclusion, the high level of defense spending has been costly in the sense of cutting into the availability of resources for other uses. At the same time, the high budget to GNP ratio has facilitated the maintenance of relatively high employment and economic stability. High defense spending, finally, was favorable to economic growth by generating technical progress, but the high budget to GNP ratio may have retarded growth by straining the level of private capital formation. The net effect is a matter of conjecture.

Economic growth and tax structure.

However this may be, there remains our second problem, the potential contribution of structural tax reform to economic growth. Note

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that I say structural reform, not general rate reduction. While I agree with most economists that a secular downward adjustment in our tax structure relative to the level of public expenditures is badly needed so as to reduce potential surplus at full employment, I do not anticipate a general reduction at a scale sufficient to greatly ease the structural problem.

Over-all rate reduction might grease the political wheels of structural reform, but it will not solve the problem. Even if a downward revision in basic rates of, say, $10 billion were envisaged (I mean here a permanent reduction, not a counter-cyclical adjustment which I shall refer to later), a simple across-the-board cut in rates of 10 percent would do little to change the incentive picture. Rearrangement of relative liabilities provides a much larger scope for structural change. The incentive problem, to the extent that it is real and must be faced, is essentially one of structural change.

What then is to be the nature of this structural reform for growth? The key issue, as I see it, is to raise investment, and not to call forth an increased supply of saving. Increased saving, to be sure, is necessary, if there is to be an increased level of capital formation, but it is only a permissive, not a sufficient factor. Unless matched by increased investment, it can only lead to unemployment and a loss of growth.

Provision for increased saving, moreover, may be made without changing the composition of the tax structure. The requisite savings, if this is all that is needed, may be provided by raising the general level of tax rates, incurring a budget surplus (or a lesser deficit) and making the resulting gain in *public* savings available to *private* investment through debt retirement or more expansionary monetary measures. In an ideal (classical) economic system, where investment is always forthcoming in desired amounts, this is all that is needed; but such is not the real situation. In the American economy of the sixties, the flow of savings is not the only or even the crucial issue. What matters most and what must be accomplished first, is to raise the investor's desire to invest. The question is how this is to be done.

The problem is straight forward if we assume that higher investment is obtainable only in response to a raising level of consumer demand. In this case, considerations of tax structure or composition need not arise. What is needed is merely a level of deficit which is sufficiently large (or surplus which is sufficiently small) so as to maintain full employment and stable prices. This will be the best that policy can do. Undoubtedly, strength of consumer demand is an important factor, without which other measures are of little use. But it is not all that matters. The ratio of capital formation to consumption at full employment is not pre-ordained; it depends on other variables as well and these are also subject to influences of public policy. Among them is the supply of internal (as distinct from capital market) funds, the factor most strongly emphasized by business groups. Also (and for

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sake of economic efficiency, I hope significantly so) there is the dependence of investment on the net rate of return. In either case, the problem of tax structure is inescapable: the presumption is that increased capital formation may be encouraged by changing the composition of the tax structure away from profit income. But two provisos must be added.

First, let me repeat the crucial point that this remedy works only if undertaken in the context of a fiscal and monetary policy which assures a high and rising level of total demand. Only then can we expect that the inducement to invest, provided by a change in tax structure, will meet with a strong response on the part of investors. The required fiscal policy may well demand a larger deficit than was needed under a more profit-intensive tax structure. Suppose that a reduction in taxes on profits by $1 raises investment expenditures by 50 cents (be it via the internal fund or profitability nexus), whereas an increase in taxes on wages reduces consumption by 80 cents. A tax structure which is more favorable to investment then reduces the (total) propensity to spend (on consumption plus investment) of the private sector, and the level of tax rates appropriate for full employment (and with any given level of government expenditures) will be lower. Putting it differently, the increase in private saving, associated with the change needed to stimulate private investment, may exceed the resulting gain in investment, thus requiring a rise in deficit. I conclude that contrary to much current thinking among economists, a fiscal policy for growth may well demand a higher (lower) rate of deficit (surplus) than is needed if the objective is one of full employment only.

Second, extensive tax relief for profit income is apt to conflict with basic tenets of tax equity which have been developed and gained acceptance over the last 50 years. These are that a person's tax contribution should be measured in relation to his income; that all sources of income should be treated alike—the principle of horizontal equity; and that the tax structure (especially at the Federal level) should be progressive—the principles of vertical equity. To my mind, these are good standards which should not be sacrificed lightly. Equity in the tax structure is an important attribute of democracy, and the strength of free society in the world of today rests on its sense of social justice as well as on its growth per capita income. I do not conclude that considerations of equity should always be controlling; but I consider them an important factor and believe that the investment problem should be approached with least damage on equity grounds.

General changes in the tax structure, discussed in this connection, include the related problems of (1) reduction in our reliance on the corporation tax, (2) reduction in the high bracket rates under the individual income tax, and (3) increase in the ratio of indirect to direct taxes. Would these changes help and how do they look on equity grounds?

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Reduction in the corporate rate would tend to stimulate corporate investment via both the retained funds and profitability routs. From the point of view of horizontal equity, it would worsen matters with regard to retained earnings and improve matters with regard to dividends paid. The proper solution on equity grounds would be complete integration—be it via repeal of corporation tax plus partnership method, or repeal plus full taxation of realized gains combined with constructive realization at death. Such solutions, however, are as yet too radical to be considered seriously; and chances are that the disincentive effects of wholly closing the capital-gains loophole and of resulting pressures for increased distribution, would go far to offset the direct incentive gains from repeal of the corporation tax. Effects of full integration on vertical equity, finally, would depend on what revenue was substituted, or what other rate reduction was foregone. Since profits weigh much more heavily at the upper end of the income scale, the effect would undoubtedly be towards reducing progression.

The argument of the preceding paragraph implies that the corporation tax falls initially on profits. If it is shifted in the short-run sense of price increase or wage reduction, then the double-taxation argument is invalid. The big question is whether rate reduction or repeal would be reflected fully in negative shifting. If so, the result of corporate rate reduction would merely be one of cutting what in effect is a sales tax. There would be no gain on grounds of investment incentives. But I doubt that this would be the case. While a substantial part of a tax increase is probably shifted in the short-run sense, it seems likely that rate reduction or repeal would give rise to very partial un-shifting only. Rate reduction therefore, would leave a gain to investment incentives, though not to horizontal equity.

Reduction in the high bracket rates of the individual income tax poses no great problem from the point of view of revenue loss. The issue is essentailly one of equity rather than revenue policy. However one may feel about the desirability of steep bracket rates as a matter of vertical equity, one must realize that they now apply in a most spotty fashion only, and that a reduction in top rates would involve a substantial gain on grounds of horizontal equity. By the same token one would like, on these grounds, to see their removal combined with steps to assure fuller taxation of high incomes at remaining rates, i.e. fuller taxation of capital gains, including especially constructive realization at death; but if carried too far this might void (or render negative) the value of the exercise as an incentive device.

All this leads to rather unsatisfactory conclusions. General integration of corporate and individual income tax may be the wrong thing on incentive grounds. Relief to profit income which is now undertaxed would make things even more lop-sided. Reduction in top-bracket rates with closing of the capital gains valve would be equitable but hardly helpful on incentive grounds, while rate reduction without the latter would be dubious as a matter of equity, and so on and so forth. Can

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the conflicts be minimized by a more selective relief to profit income? Instead of a general reduction in corporation tax, one may limit the reduction to profits from new investment, restrict accelerated depreciation to new investment, or reward current investment by an investment credit. Thereby, the tax relief is restricted to those who actually invest, more can be accomplished (in the short run at least) with a given revenue loss, and the magnitude of required burden-transfer to other tax-payers is reduced. Going somewhat further, the incentive might be focussed at the margin, as suggested in the initial proposal for an investment credit, by limiting it to increases in the firm's rate of investment above some stipulated threshhold.

In addition, fancier and more unorthodox approaches might be considered. Instead of general reduction in the high-bracket rates of the individual income tax, rates might be cut on capital earnings from risk investment only, thus reducing the necessary flattening of over-all progression. Or, the degree of tax relief to investment earnings might be granted at the personal level and be related inversely to income size. More adventurously still, a progressive tax on consumer spending might be combined with a tax on hoarding, the rate of return on risk taking might be raised by permitting losses to be credited at a higher rate than that at which profits are taxed, and so forth.

By relying on a more selective device of investment incentive, the equity implications (mainly vertical) may be rendered more acceptable, but this will hardly solve the problem. Some of these devices involve too great an unneutrality between firms, others would not be acceptable to Congress, and (I am afraid) most all of them would be (initially at least) disliked by the businessman, the soliciting of whose responses is the very purpose of the exercise.

Finally, there is the proposition that emphasis on growth demands a substantial shift in our tax structure towards indirect taxation. This I believe to be an erroneous conclusion. To begin with, such a change is not needed to increase the supply of saving. The supply of saving is not the crucial problem at this point, and even if it were, there are more efficient means (i.e. budget surplus) of meeting it. Moreover, such a change is not needed to meet the problem of investment incentives. This problem relates to the higher bracket rates, not to the lower rates which furnish the great bulk of the income tax yield. An adjustment in higher rates, therefore, could be made with very little change in the over-all ratio of direct to indirect taxes. Given the proposition that the income tax is a more equitable means of taxing the large majority of the people who are in the lower and middle income brackets—and I find it difficult to see how this can be denied—growth considerations do not require general revision of tax structure away from direct taxation. While there may be a real conflict between equity and growth considerations with regard to the taxation of profit income and the application of high marginal rates, this conflict does not

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extend to the direct versus indirect tax issue. Such, at least, is the case as far as the economics—as distinct from politics—of the matter are concerned.

Compensatory tax adjustments.

The preceding discussion has dealt with the longer-run issues of structural tax reform. In concluding, let me refer briefly to my third problem, which deals with counter-cyclical tax adjustments. Here I find the going much easier, because I am convinced that compensatory rate adjustments are a desirable, proper and effective means of stabilization policy.

One of the facts of economic life is that our economy does not stabilize itself, and that a balancing wheel of public policy is needed. This task was assigned traditionally to monetary policy, which continues to play an important role, but fiscal policy has a contribution to make as well. Partly this contribution is rendered by the working of built-in fiscal stabilizers, and partly it must be met by discretionary adjustments. As the Commission on Money and Credit has suggested, these adjustments should be made primarily on the tax side, especially where relatively minor and brief fluctuations are concerned; also, as the Commission has suggested, the adjustments should take the form of simple changes in individual income tax rates, of a more or less neutral sort so as to avoid involvement in the always controversial problems of structural tax reform. Only then can we hope that the adjustments are made with the degree of promptness and flexibility that is required for cyclical stabilization.

That this should be done is especially important in conjunction with a policy for rapid growth, so as to avoid the waste of unused resources and in order to render effective structural changes designed to further capital formation. These adjustments will be doomed to failure, or greatly reduced in effectiveness, unless they are undertaken against the background of a high-employment economy. While I reject the notion that investment is a function of high consumption only, a high rate of consumption is surely a necessary condition. Not only does it provide a direct stimulus to investment, but the prospect of expanding markets greatly increases the response to any given tax-induced increase in the supply of internal funds or in the rate of return.

Once a policy of cyclical rate adjustment is accepted as a matter of course, we shall be able to avoid the unhappy situation which developed in recent weeks, where the rate cut was presented as something to be considered in the most dire emergency only, thus endowing the relief measure with most adverse announcement effects. I hope that we shall learn in time to undertake these counter-cyclical adjustments as a matter of course, as are open-market operations, and as a normal function of economic policy.

Having listened so patiently to this discussion, you will not suspect me of considering taxes an unimportant factor in our economy. Yet,

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I would close on a note of de-emphasis. Fanned by many fires, the public (though hardly Congress) appears to have developed somewhat of an obsession regarding the need for tax reform, and there has arisen a notion that nothing else can be done, unless the tax picture be "straightened out" first. This, of course, is not the case, nor is it likely, considering the genesis of the current tax bill, that a fundamental reform will come to pass very soon. Some helpful changes can be looked forward to, and they will do some good, but even here exaggerated expectations are out of order. There are many other things to be done as well, be it by business, government or other sectors of the economy. It would be a serious mistake, I believe to call a moratorium on all these, while awaiting the Apocalyptic dawn of total and heroic tax reform.

CHAIRMAN GROVES: Thank you, Mr. Musgrave. Among the other merits of that speech was the fact that it ran for twenty minutes exactly, right on the head, which is in accordance with our rule.

Now, perhaps, I could lighten the fairly heavy program a bit by telling a little story at this point that seems to fit the occasion. I hope it is good for a chuckle and it is not sacreligious. A commentator a while ago compared the economic system with the Model T Ford, and those of us who are old enough to have had some experience with Model T Fords know that they could suffer failures of performance that were very mysterious.

On one occasion the Deacon was out with his Model T Ford and he suffered one of these failures. He tried everything in the Rule Book, and otherwise, and nothing seemed to work. You begin to see how this is analogous to our problem. When down the road came the Minister, and the Minister asked him if he had tried prayer. He conceded that he had not, and so the two of them knelt on a stump nearby and prayed, after which the Deacon tried the crank and sure enough the Model T responded. He thereupon jumped into his car and went scurrying down the road. The Minister is then alleged to have been overheard by a chipmunk to have muttered, "Well, I'll be damned."

The next speaker on our program is by coincidence rather than design also born in Germany. He was educated at Princeton with a final degree from Harvard where he is now Associate Professor of Economics. During 1959 and 1960, he was engaged as the technical director on the study for the Joint Economics Committee on employment, growth, and price levels; and though the biographical note he submitted to me is very brief and modest, I happen to know that our speaker has made, in addition to this, a distinguished contribution in the study of benefits and costs in water resource allocation, bringing a little illumination to a very dark area.

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He has also recently sponsored the study comparing American budgetary techniques with those used in Europe and this has triggered both interest and controversy in what is known as the greatest deliberative body in the world.

It is now my pleasure to introduce to you Professor Otto Eckstein of Harvard University.

MR. OTTO ECKSTEIN: I thought today I'd speak on just a few simple questions which we have to face up to in connection with the tax changes which presumably will come forth next Spring.

THE TAX STRUCTURE AND THE FUNCTIONING OF THE AMERICAN ECONOMY

OTTO ECKSTEIN
Professor of Economics, Harvard University

We have been assured by the President that tax reform and tax reduction will be the first order of business of the Congress next January. The proposals then to be considered promise to be far-reaching.

Since the promotion of economic growth and other broad economic objectives is to be among the purposes of the tax changes, it would be very desirable if we had an accurate understanding of the effects of the tax system on the economy, particularly if we knew precisely with what respects the effects of taxation were especially adverse. I give away no secrets when I tell you that economic science does not offer such precise answers. Nevertheless, I do believe that we have some useful knowledge which can aid in the evaluation of some of the central issues that tax policy will face next January.

In my presentation today, I shall deal with five such issues: first, does the fiscal system as a whole restrain the expansion of the economy? Second, is the burden of direct taxation particularly heavy in the United States and is it impairing saving? Third, how does the tax system interfere with the investment process? Fourth, how does the tax system lead to waste through distortions in the allocation of resources? And fifth, does our tax system promote the objective of balance-of-payments equilibrium?

The Fiscal System and Economic Growth

It is now generally recognized that the economy has been runnig below its true capacity for the last five years. During the last business cycle, unemployment stuck at 5 percent during the expansion; in the

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