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AN ECONOMIC LIMIT ON TAXES: SOME RECENT DISCUSSIONS

RICHARD GOODE *

THE IDEA that there is an economic limit to the taxable capacity of a country has long been a subject of speculation. Several eighteenth and nineteenth century writers agreed that taxes amounting to 15 per cent of the national income are excessive in all but the most exceptional circumstances.[1] Shortly after World War I Sir Josiah Stamp presented a systematic discussion of the concept of taxable capacity and the factors governing it.[2] His reasoning gave no support to the opinion that any one limit holds for all times and places; rather, he emphasized significant differences in the amount of revenue that can safely be raised. This approach has generally been followed in the extensive discussions of fiscal capacity in connection with equalizing grants-in-aid. The variability of political and administrative limitations on taxation has also received attention.

More recently Colin Clark, the well-known Australian economist, has put forward a new thesis regarding the economic limit of taxation. Clark notes that, according to the usual theory of fiscal policy, an important function of taxation is to prevent inflation. He argues, however, that in nontotalitarian countries in times of peace, taxation ceases to be effective in controlling inflation when it exceeds approximately 25 per cent of national income.[3] The 25 per cent figure is for all taxes—national, state, and local—regardless of form and applies to the ratio of total taxes to national income rather than to the effective rate on any one person's income or property or on any particular transaction. Clark's generalization, therefore, must be sharply distinguished from the proposal for a constitutional amendment limiting federal income taxes to 25 per cent.

The validity of Clark's thesis is of immediate practical importance in the United States inasmuch as taxes currently exceed one-fourth of national income and the country is faced with an inflation problem. Federal, state, and local tax liabilities are estimated at the following percentages of national income: [4]

* The author is a member of the staff of the International Monetary Fund. Opinions expressed in this note are his own and do not necessarily reflect the official views of the Fund.

1 C. F. Bastable, *Public Finance* (3d ed.; London: Macmillan & Co., 1903), pp. 136-7.

2 *Wealth and Taxable Capacity* (London: P. S. King & Son, 1930), Chapter IV. Hugh Dalton took a very skeptical view of the arguments advanced by Stamp and others, concluding that "absolute taxable capacity is a myth." (*Principles of Public Finance* [London: Routledge & Kegan Paul, 1948], pp. 163-71.)

3 "Public Finance and Changes in the Value of Money," *Economic Journal*, LV (December, 1945), pp. 371-89; "The Danger Point in Taxes," *Harper's Magazine*, December, 1950, pp. 67-69.

4 Report of the Joint Committee on the Economic Report and Materials Prepared by the Staff, 82d Cong., 2d sess. (Senate Report No. 1295, February, 1952), p. 41.

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Calendar year 1939 ... 22.5 per cent
Calendar year 1944 ... 28.7 per cent
Fiscal year 1951 ...... 31.6 per cent

Recognizing the significance of the topic, the Joint Congressional Committee on the Economic Report included the subject in its hearings on the President's January, 1952, Economic Report and in its own Joint Economic Report.[5] The purpose of this note is to summarize the Clark thesis and these recent discussions. I shall not attempt an independent critical evaluation of the thesis or of the discussions.

Clark's Thesis

In his original article (*Economic Journal*, 1945) Clark emphasizes a quasi-political explanation of the tax limit. He argues that when taxation exceeds 25 per cent of national income, influential groups will favor inflation as a means of reducing the burden of the public debt and other fixed charges in the budget. After inflation has brought taxes below the critical level, these groups will favor stabilization. This article is open to the interpretation that the limit of taxation is simply the point beyond which democratic countries will refuse to tax themselves, except perhaps in wartime.

In his later article (*Harper's*, 1950), however, Clark makes it clear that he believes the anti-inflationary power of taxation is subject to a strict economic limit. He agrees with the common opinion that deficit spending is inflationary but adds that " if a government incurs very heavy expenditures, and these *are* covered by taxation, so that the budget is balanced, the trend—while it may be deflationary for a time —will in the long run be toward inflation if the rate of taxation is too high to be borne" (p. 67). The " long run " is defined as ordinarily a period of two or three years, although it may be longer in wartime.

Clark attributes the economic limit to three consequences of high taxation: (1) weakening of employers' normal resistance to wage increases; (2) wasteful business expenditures; and (3) a decrease in the amount and efficiency of work. He appears, however, to rest his case mainly on a statistical examination of the experience of a number of countries in the interwar years and in the period since World War II.

In comparison with earlier discussions of taxable capacity, Clark omits several points that have usually been considered important. (1) Apart from the broad recognition of a difference between totalitarian and nontotalitarian countries and between wartime and peacetime, Clark makes no allowance for variations in countries' political and administrative conditions. Apparently he considers political maturity, a tradition of voluntary compliance with tax laws, and a skilled administration of little fundamental significance in determining the extent to which taxes can be raised. (2) He also disregards the absolute size of the national income, applying the same limit to poor countries such as Italy and Japan and to rich countries such as the United States and New Zealand. The usual view is similar to that of Bastable who said, " Expenditure requiring 10 per cent. of the annual income of India would be much more burdensome than if 30 per cent. were to be required in England or

[5] *January 1952 Economic Report of the President*, Hearings before the Joint Committee on the Economic Report, 82d Cong., 2d sess., January-February, 1952; Report, *op. cit.*

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the United States."[6] Clark does endorse the common belief that in a country where the distribution of income is comparatively equal, the limit of taxation is lower than in a country where inequality is greater, although he does not explain why this is so. (3) In the articles already cited, Clark gives no attention to the form of taxation or to the progressivity or regressivity of rates. A reader could reasonably infer that Clark believes that the same limit holds for a tax system composed exclusively of regressive consumption taxes and for a system relying solely on progressive taxes on income and profits. It seems, however, that only taxes on profits would stimulate wasteful business expenditures or weaken employers' resistance to wage increases. (4) Clark does not explore the relation between the yield of the tax system and the level of money income. It is generally recognized that if the system as a whole is progressive, revenues increase more than proportionately when money national income rises. It appears, therefore, that in many countries inflation, far from lightening the tax burden, would increase it unless tax rates were lowered. (5) Finally, aside from great stress on interest and service charges on the public debt, Clark takes no account of the purpose of government expenditures. Most writers believe that a sharp distinction must be made between transfer payments and expenditures for goods and services, and between expenditures that increase the stock of social capital and productive efficiency and those that do not.

[6] *Public Finance*, p. 137.

The foregoing characterization applies to the statements of the Clark thesis already cited. Since writing these articles, however, Clark seems to have modified his views to some extent. In January, 1952, Grover W. Ensley, staff director of the Joint Committee on the Economic Report, cabled Mr. Clark mentioning the practical problem of policy faced by the United States and asking whether he still believed that the 25 per cent limit held for this country. In a letter dated January 18, 1952, Clark replied: ". . . all the reasoning and conclusions of my article in Harpers magazine, to the best of my knowledge, still stand. No information which has become available since that date will effect any important alteration" (Hearings, p. 316). He went on to say that the 25 per cent is a round figure and that the limit should be stated as 24-26 per cent or even 23-27 per cent. He added a more significant concession by saying that if highly regressive taxes are adopted, it may be possible to go a "few points" beyond the 25 per cent limit without causing prices and incomes to rise. Inasmuch as Clark's letter is of considerable interest, the relevant passages are reprinted at the end of this note.

Joint Committee Discussions

The Joint Committee on the Economic Report included the Clark thesis on the agenda of a panel discussion held January 31, 1952, as part of its hearings on the President's Economic Report. Participants were Prof. Alfred G. Buehler, University of Pennsylvania; H. van Buren Cleveland, research staff

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member, Committee for Economic Development; Prof. Milton Friedman, University of Chicago; Prof. Walter W. Heller, University of Minnesota; Prof. John P. Miller, Yale University; Prof. Richard A. Musgrave, University of Michigan; Prof. Carl S. Shoup, Columbia University; and Prof. Arthur Smithies, Harvard University.

Professor Heller took the lead in discussing the limit hypothesis (Hearings, pp. 315-25). He argues that Clark's statistical evidence does not support his proposition. For the postwar period Clark does not show that inflation was worse in countries where taxation exceeded 25 per cent of national income than it was in other countries. Heller attributes the general postwar inflation to deficit spending during the war, liquid asset accumulations, and postwar dislocations. He points out that in 1950 the price rise experienced by the United States increased the ratio of taxes to national income, allowing for rate changes. For the interwar period Heller contends that some of Clark's own data support the reverse of his limit thesis.[7]

Heller concludes that the statistical data do not establish the 25 per cent rule, but he goes on to examine the supporting arguments. He points out that taxation is inflationary only if it reduces total supply of goods and services more than it cuts aggregate demand. Heller then considers Clark's reasons for believing this may occur when tax rates are high. He doubts whether it can be shown that high taxes promote wasteful business expenditures. He asks if it is not equally plausible to assume that businessmen will carefully guard their limited profits and will be concerned about damaging their competitive position by letting their costs get out of line with those of other firms. He concedes that some " nest-feathering " outlays which will yield a return in the future may be stimulated if they can be written off against current income subject to high tax rates. Lowered resistance to wage increases, he believes, may reflect a labor shortage rather than high taxation. With regard to work incentives, Heller says that taxation may have adverse effects or may stimulate the individual to work more in order to reach his income " target," and that we do not know which response is more important.

In conclusion, Heller rejects the 25 per cent limit thesis but concedes that there is a limit on our ability to prevent inflation by taxation. He explains that government expenditures are inflationary under full-employment conditions and says that as expenditures rise it becomes increasingly difficult to counteract their inflationary effect. He believes that in the United States additional taxes are anti-inflationary far above 25 per cent of national income and, indeed, that there is no sudden change to inflation at any one point but rather a gradual deterioration of the anti-inflationary power of taxation. He considers marginal rates more significant than average rates and apparently feels that highly progressive taxes are least effective in controlling inflation.

[7] A more comprehensive review of Clark's statistics is contained in an article by Joseph A. Pechman and Thomas Mayer, published in the *Review of Economics and Statistics*, August, 1952.

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Professor Musgrave commented briefly on the Clark thesis, saying that a 25 or 30 per cent upper limit on taxable capacity is an " imaginary notion " and that he believes the United States is nowhere near the limit of its taxable capacity (Hearings, pp. 311, 313).

In a few remarks on the limit idea, Professor Buehler expressed the opinion that taxable capacity varies with the national income, type of taxes, suddenness of tax increases, purposes of government expenditures, public attitudes, and other factors. Although he doubts that the Clark thesis can be substantiated with statistics, he suggests that the argument may have merit in the sense that at some point the government and the people would prefer inflation to higher taxes. He considers it an open question whether that point has been reached in the United States (Hearings, pp. 326-27).

At the end of the session, Senator Joseph C. O'Mahoney, chairman of the committee, said that he understood that the panel did not support the Clark theory of a 25 per cent limit on taxation. There was no dissent (Hearings, p. 358).

In its report the majority of the Joint Committee commented on the limit thesis as follows:

> There appears to be some upper economic limit to taxes, although not an inflexible percentage of the Nation's income, but an area beyond which further tax increases would aggravate inflation and reduce initiative and output. Some may believe that this limit has been reached.
>
> Much evidence was presented to the committee indicating that the United States has not yet reached the economic limit beyond which an increase in carefully distributed taxes would necessarily prove inflationary. The committee concurs with this view, although it is concerned both with the burdens already being borne by low-income families and with the adverse effects on incentives and deterrents to venture capital in the high-income brackets.[8]

The committee, nevertheless, opposed any general increases in tax rates, although it advocated elimination of inequities and tightening of administration (Report, p. 15).

The staff of the Joint Committee, in materials prepared to accompany the committee report, stresses the purpose of government expenditures as a factor determining taxable capacity. It points out that taxes to finance important services which are part of the standard of living are similar to fees or prices for services rendered and are not burdensome in the same sense as taxes to pay for defense expenditures (Report, pp. 82-83).

Points for Further Investigation

The Joint Committee on the Economic Report has rendered an important service in stimulating discussion of the extent to which inflation can be controlled by taxation. Witnesses before the committee, the majority of the committee, and the committee staff agreed in believing that the 25 per cent limit is not applicable in the United States at the present time. But they did not reject the idea that at some point taxation will cease to be anti-inflationary and may become positively inflationary. It is not the purpose of this note to appraise these judgments,

[8] Report, p. 8.

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but I do want to suggest the desirability of further clarification of exactly how the limit is supposed to operate. A showing that excessive taxation has undesirable economic consequences does not prove that taxes are not anti-inflationary, although it may indicate that other means of controlling inflation or a limited degree of open inflation would be preferable to higher taxes. A careful theoretical statement of how the limit is supposed to operate, even if in purely abstract terms, might greatly assist in further inductive studies of the relation between taxation and inflation. If statistical studies are to shed much light on the subject, they should include factors such as the size of the deficit, the size and composition of the public debt, interest rates, changes in the money supply, and purposes of government expenditures as well as the ratio of taxation to national income. An international comparison of this type would encounter great statistical and conceptual difficulties, but it might help show whether the limit is already at hand or only a remote possibility.

LETTER OF COLIN CLARK [9]

ECONOMIC SERVICES,
SOUTH BRISBANE, JANUARY 18, 1952

MR. GROVER W. ENSLEY,
STAFF DIRECTOR, JOINT COMMITTEE ON THE ECONOMIC REPORT,
WASHINGTON, UNITED STATES OF AMERICA.

Dear Mr. Ensley: In reply to your cable of January 9, I would advise that my proposition about the 25-percent limit was originally put forward in an article in Economic Journal, December 1945 (published in England) a copy of which is presumably available to you. The article in Harpers supplemented this and brought it up to date without printing the original information in full detail. I would say that all the reasoning and conclusions of my article in Harpers magazine, to the best of my knowledge, still stand. No information which has become available since that date will effect any important alteration.

There is, however, one point which I should like to emphasize further, and that is the undoubted effect of high marginal rates of income tax on businesses, encouraging them to spend money freely on all those fields of expenditure which are allowed as a deduction for income-tax purposes. To my mind it is significant that so careful and responsible a periodical as Fortune recently published an article by a highly qualified taxation counsel, advising businessmen how to spend what is called 18-cent dollars; i.e., that each dollar spent on maintenance and in certain other ways only made a difference of 18 cents to the firm's net profit after taxation.

It is true that the loss of 18 cents remains a loss of 18 cents, and no business will overmaintain or otherwise spend money on purely unnecessary objects, but when it is in doubt whether or not to spend, it will always be biased in the direction of spending of more rather than less. In many respects such as the payment of higher wages, salaries, and bonuses, the payments for advertisement, entertainments, and public relations, the business can obtain definite advantages for itself in the future at the expense of the United States Treasury in the present.

This now brings us to the question of whether there are any grounds for hope that the 25-percent limit could be safely exceeded, and if so, under what circumstances. As you will see from the original articles in Economic Journal and Harpers the 25 percent is a round figure rather than a precise

[9] *January 1952 Economic Report of the President,* Hearings before the Joint Committee on the Economic Report, 82d Cong., 2d sess., January-February, 1952; pp. 315-17.

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limit and should certainly be written 24-26 if not 23-27. When, however, your figure is as high as 27 I should say myself, I would be willing to bet with a fairly high degree of probability on a further increase of money wages and consequent inflation to the national income as a whole.

If taxation of this order of magnitude appears unavoidable, you may then ask whether there is any form or forms of taxation least likely to cause an upward pressure on prices and incomes.

Under circumstances envisaged with an inescapable necessity of imposing taxation at a level of 27 percent or more, on national income, we can minimize the upward pressure by a system which, in general terms, keeps down marginal taxation with consequent necessary raising of average rates of taxation. Such a program, it need hardly be pointed out, would be extremely unpopular. It would mean removing, where possible, the progressive elements in the tax system, charging lower rates on the high incomes and higher rates on the low incomes, relying upon indirect rather than direct taxation, and making indirect taxation fall upon necessaries rather than upon amenities.

Recently I spent a month in Italy, followed by a short visit to Britain, and could not help being struck by the contrast in fiscal policies between the two countries. It is probably true that in these countries I picked extreme representatives of the two different schools of thought. In Britain the necessaries of life are not only undertaxed, they are strongly subsidized with subsequent need for additional taxation elsewhere.

But on everything else, both direct and indirect taxation fall with extraordinary severity. Most wage earners pay substantial income tax and in addition immense taxation is imposed upon the modest amenities of the English workingman's life, beer and tobacco. Prohibitive purchase tax falls on many classes of household goods which would be regarded as necessaries in any country, and therefore, as a consequence of all this, production is sluggish and there are constant demands for higher money wages. A high official of the British Treasury agreed with me that the only way to reverse the process was to make the necessaries of life much dearer and the amenities much cheaper. This is what Italy has done and her production is increasing with extraordinary rapidity, while prices are stationary or even falling. The Italian has to work hard to buy the necessaries of life, but a slight further effort will bring him some of the amenities which are almost unobtainable in Britain. Italy has virtually no income tax and relies upon a system of indirect taxation, which falls, quite shamelessly, upon the necessaries of life.

If therefore, you think that you can advocate such a policy for the United States, you may be able to go a few points beyond the 25-percent limit without causing prices and incomes to rise.

. . . .

Yours truly,
Colin Clark

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