THE ECONOMIST'S APPROACH TO TAXATION: SOME INTRODUCTORY NOTES

by

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The purpose of taxation is to make people poorer. This blunt truth, obvious though it is, is often overlooked and often misunderstood. It does not mean that taxation is the only way of making people poorer; indeed, as I shall argue below, inflation is an alternative way. Nor does it mean that a country would be sensible to abandon both all its taxation and all its government expenditure. What it means is that the purpose of taxation is to reduce the claims exerted upon economic resources, to cut down spending.

Sometimes taxation is imposed to restrain the use of some particular resource, and sometimes to cut down claims on productive capacity in general. Sometimes a tax may achieve both results, for instance a tax imposed upon a commodity with an elasticity of demand less than unity will both reduce the consumption of that commodity and leave its purchasers with less to spend on other things.

Let us first look at taxes designed to keep down the use of some particular resource. The reasons for imposing such a tax can be of various kinds. For example moral disapproval may be urged in support of a heavy tax on alcoholic drinks, a shortage of foreign exchange may be held to justify the imposition of import duties on luxury goods or a desire to keep down the price of milk used for cheese-making may be the ground for taxing milk consumed in liquid form. Obviously the economist may have a good deal to say about the effects of any particular actual or proposed tax using the established partial equilibrium method of analysis. This is a major field for the economist to work in. But I shall not go into

detail with respect to any particular tax; my aim is to survey the territory which properly belongs to the economist, and the point here is that the study of the effects of various taxes is a traditional and legitimate part of this territory.

There is one general point about such taxes which is worth making. This is that the imposition of direct controls such as import licensing, material allocation, rationing etc. constitute an alternative method of restricting purchases. Thus even when it is decided, for political, social or any other kind of reason, to restrict the purchases of some particular commodity, a choice has to be made between using the price mechanism (taxing) and partially suspending its operation (controls). Now this choice must inevitably involve value judgments and cannot therefore be regarded as a technical problem in economics. But the economist can point out the factors which are relevant to the choice by examining the different effects of the alternative measures. Firstly the administrative aspect must be considered by examining the complexity of the administrative task and the possibility of avoiding corruption and favouritism. Secondly, whereas a tax will cause the available supplies to be allocated between users in proportion to effective monetary demand, direct controls will allocate upon some alternative basis, for example in proportion to consumption in some base period. The choice between taxation and controls must therefore pay heed to the fairness and economic effects of the different patterns of allocation. Lastly there is the point that if purchases are restricted by taxation the buyers will have less purchasing power available for other expenditure than if purchases are restricted by direct controls. Thus limitation of purchases of a particular commodity by taxation will also have a general deflationary effect.

Let us now examine the use of taxation to restrain spending in general. Expenditure on the current output of an economy comes from three sources: the government, foreigners and private firms and households. There are thus three major components of aggregate effective demand: Government expenditure, Exports and private expenditure. On the supply side goods and services to meet this demand come from two sources: home and abroad. Thus the components of aggregate supply are domestic output and imports.

Demand	*Supply*
Govenment expenditure	Domestic output
Exports	Imports
Private expenditure	

Improvements in efficiency, good harvests, the completion of new investment or growth of the labour force will all raise domestic output and hence the value of supply measured at constant prices. If demand rises equally, constant prices will be achieved. But suppose that the tendency is for demand to rise faster than this. What will happen then? Let us list the possibilities; they may occur singly or in combination:

a) The pressure of demand sucks more imports into the economy and draws goods away from export markets into the home market. Thus in the absence of any contemporary increase in foreign lending, the foreign balance will deteriorate and foreign exchange will fall.

b) The increase of expenditure is met by a drawing-down of stocks of goods at all stages of production. After a certain point this will have adverse effects on the efficient functioning of the economy.

c) Prices rise, pulled up by the pressure of demand.

d) If prices are not allowed to rise, demand will be choked off in some other way so that would-be purchasers who are willing and able to afford the controlled prices are frustrated. This may be done either by official rationing and allocation or by the formation of queues. It is to be noted that if there is a widespread black market, official price control being ineffective, the situation differs from case (c) only in a reduction in the efficiency of distribution.

If all four of these posibilities are to be avoided, private expenditure must so be regulated that total expenditure is no more than sufficient to take up total supply forthcoming at current prices. This result can be secured by using taxation to make people as poor as is necessary. Thus if inflation is to be avoided we can see that *other things being equal* taxation must be heavier (people must be made poorer) :

1) The lower is productivity.

2) The worse the terms of trade.

3) The smaller the amount of long-term finance available from other countries.

4) The larger the amount of Government expenditure.

The first of these factors means a smaller amount of goods and services available, the second and third raise the amount of exports required to achieve any given volume of imports and the fourth also helps determine the amount left over for private use.

If inflation is to be avoided, the considerations just discussed determine the overall weight of taxation. But this leaves the pattern of taxation to be decided, and here there is clearly a multiplicity of possibilities. In comparing them it is convenient to separate the discussion into three parts.

The first aspect is the administrative one. This is a technical matter. Secondly there is the problem of equity. Here the economist is, in principle, no more expert than anyone else so that his job is to pose alternatives rather than to judge between them. In practice, of course, economists make value judgments just as readily as other people and it could even be argued that they make better value judgments because they are more used to thinking about the problem. In the same way the aesthetic judgment of an art expert may be superior to that of a layman even though both have in principle an equal right to their opinions.

The third aspect of the choice between different tax systems really is the province of the economist. This is the problem of analysing the economic effects of taxation and includes most of traditional theory although my personal belief is that the concepts of incidence which have been used are all either useless or imprecise. But even if the old terminology is scrapped, the problems are there and cry out for further research. Consider, for example, just how little we know about the effects of corporation taxes.

Let us briefly examine an important question in the light of this threefold classification. There are two groups of ways in

which a government can cause the private sector to become poorer and so release resources for governmental use. One is the use of ordinary forms of taxation. The second is inflation.

The point I want to make now is that an open inflation where prices rise because the government meets part of its expenditure by creating money is like a tax on money. If prices are continuously rising, the real value of money holdings is continuously falling. This simply means that the owners of money holdings are being made worse off in proportion to the size of their holdings. Since a tax on money holdings would achieve precisely the same result we are justified in regarding inflation as equivalent to a tax on money.

This being the case, the question of whether heavy expenditure on development should be financed by inflation or not boils down to a choice between taxing money or not taxing money and instead levying taxation only on incomes, expenditure and/or capital. The Turkish government and hence, in a free country, informed public opinion obviously believes that the first of the following two alternatives is preferable to the second :

1) Taxing money and other things

2) Taxing other things more heavily and money not at all. Administratively (this is the first of our three aspects) the reason for this preference is clear: it is much simpler to print money than to improve and extend the tax system.

Sor far as equity is concerned (our second aspect) one can only suppose, firstly, that theTurkish government regards money holdings as constituting in part a fair measure of people's and firms' ability to pay tax. Secondly, the Turkish government must believe that the redistribution of incomes which result from inflations (away from civil servants, pensioners and university teachers etc.) is desirable or at least not so unfair as to make more taxation of other kinds a perferable method of finance.

Thirdly, the economic effects of taxing money must be examined. This is the big question which requires an answer, which is topical and important and which is a non-political matter lying

within the economist's sphere, I therefore close these simple notes by asking the economists and public financiers of Turkey: What are the effects of taxing money as compared with the effects of other taxes ? If they, with all their experience, give an answer founded on both theoretical and empirical research they will incur the gratitude of economists everywhere.

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