BUSINESS TAXATION AND ECONOMIC DEVELOPMENT*

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The privilege of being with this group constitutes a high challenge indeed. My own experience and study include more than a few topics about which I might talk here, but I suspect that your group has studied some of them as much as I (or more) except for the most specifically American aspects. Choice of subject has been difficult. Even more so has been the decision about what precisely to try to say about topics as broad as those I have chosen.

"Taxation of business" offers little possibility of saying anything really new. Yet it offers endless opportunity for suggesting how mankind might run its affairs better — in lands like my own, whose economic development puts it in the forefront in this respect, and others still in earlier stages. If one thing strikes me as clear it is that not all policies of economies which have generally developed well can serve as best for those which are closer (on either side) to the threshhold or "takeoff" "Avoid the mistakes of others" should in itself be valuable advice, counsel resting on costly experience.

General Considerations

Aspects of the general setting of public finance can be noted briefly.

Need for Large Revenues. Some of us if free to fashion our ideal economy might try to develop one in which the need for taxes would be much less than is the case today. Realism, however, leaves no doubt that the "tax take" must be high to pay for the expenditures which modern publics apparently insist upon or at least tolerate.

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*) The views expressed are my own and not necessarily those of any organization with which I am associated. In a few places this paper reuses phrasing which appears in earlier of my writings on the subject.

Danger of Hight Tax Rates. High revenue yields require high tax rates. High tax rates do more than bring in revenue. They alter human actions, and in ways different from the effects of prices. In the market one pays for what one gets, and in competitive markets we generally get about as much as we pay for. But the services of government which a member of society receives are largely independent of the taxes *he* pays. He has incentive, therefore, to try to avoid a tax.

If tax rates are low, it will not often be worthwhile to sacrifice what is essentially one's best interest in order to save tax. But purely tax considerations can be decisive when *tax rates are* high — and when the *differences* in the tax consequences of different actions are large. What is basically a less efficient alternative will sometimes seem best when taxes are taken into account. Taxpayers will act accordingly. Private benefit then conflicts with the public welfare in two ways. 1) The part of the cost of government which one person saves must be borne by others. 2) Resources are not used as productively as possible. Capital investment flows to take account of taxes as well as of productivity; skilled effort is devoted to saving taxes rather than to creating goods and services of positive value.

Difference Between Taxes and Prices : Role of Self-Interest. Tax laws take from the individual (or prevent him from getting) what would otherwise be his without a specific *quid pro quo.* In the free market, in contrast, what a person gives up is presumably matched in worth by what he gets. To get what one wants, one must provide equal value for others. The vigorous pursuit of self-interest in a competitive market economy will generally serve the public interest. The pursuit of self-interest through the political process (in government) ,however, often tends to conflict with the interest of others — dramatically so when taxes are concerned. A person who gets his own taxes reduced will benefit by just that much. He can expect no less governmental service, but he pays less.

Whatever we may think about the wisdom of our collective (governmental) decisions, by no means everyone will be well satisfied with what his taxes buy for him. But even if everyone did feel that government services are worth their most, many of these services could not be sold as are the products of the market place. No mechanism exists to make the individual share in the cost of government except by the use of compulsion. No one will question the necessity of such coercion, but who will not question the amount and nature of such compulsion? Here we face the fundamental issue of the relative roles of government and business, of taxes and prices. The larger the proportion of economic activity carried on by government, the greater the role of taxes relative to prices[1].

But why raise this obvious matter? To make one point explicit: The total of taxes will be higher, and the role of prices smaller, the larger the governmental sector. Consequently, taxes as they *directly* affect business will tend to be more burdensome. This tendency, however, need not become an actuality, or, more accurately, the kind of taxes used can have more or less effect on business.

Environment as Affecting Tax Policy. Some "requirements" for a "good" system of taxation are applicable, while others which are suitable in one place will be inappropriate in another. Institutional and structural conditions vary from country to country — the quality of the civil service and the individual's attitudes toward taxation, to give two examples. Legal systems differ, and the law inevitably affects the kind of taxes an economy may impose — for example, laws concerning corporations, trusts, inheritance, the disposition of property, and relations between national, state, and local government. The saying "An old tax is a good tax" does embody a bit of wisdom.

Size of the Taxing Jurisdiction. An environmental factor of first-rate importance is the size of the taxing jurisdiction. When the benefits received by a taxpayer — an individual acting for himself or the manager of a giant business acting for the whole company — are not clearly associated with the taxes *he* pays, then the power of government to coerce him into paying tax depends to some extent upon his ability to escape to the jurisdiction of other governments. Some businesses are more firmly localized than others, and all are more limited in freedom to shift in the short run than in the long run.

Small taxing jurisdictions face more rivalry than do larger ones. In competing for businesses — the providers of jobs, the sources of income — to locate (or remain) its boundaries, each American locality

1) Government enterprise-type activities financed partly or entirely by charges constitute an intermediate case. Even when prices or something close to them are used instead of taxation, how often do they result from the forces which determine prices in the market? Rarely, if ever. Consequently, they cannot do the full allocative job expected of prices in free (or even monopolistic?) markets.

may face active competition from dozens of others and indirect competition from hundreds or thousands[2]. Each of our 50 states faces competition from many others in attracting and holding the business organizations which are needed to expand the economic base. And even the United States as a whole finds that in one way or another it must recognize foreign competition in the struggle for capital, jobs, and markets.

Although tax laws are generally much less important than other determinants of location, no foresighted (by definition!) government will ignore the influence of the tax outlook it offers to business, relative to its "competition". No large fraction of total economic activity will ordinarily be sensitive to differences in taxes in various jurisdictions, dodestic and foreign. But some companies, actual and potential, will find tax factors significant at the margin.

If lawmakers believe that such considerations are influential, the general result — at least judging from American experience — will be for moderation in taxes on business as such, compared with what would otherwise seem politically attractive. The larger the tax jurisdiction — international (as governments cooperate through treaties) compared with national compared with state (or provincial) compared with local — the less is the restraint which the tax officials experience in taxing business.

People, Not Things, Bear the Burdens of Taxation. Taxes are paid by people. One may speak of taxes falling on business, corporations, cigarettes, property, inheritances, income, or some other tax base. Yet it is not things, but people, who are deprived. Use of one name rather than another will not change the realities of economics. But in trying to do so we can add to the real burdens of taxes by inducing misallocation of resources and, very probably, reducing the supply of productive capacity which becomes available over the long run.

Hidden Versus Evident Burdens. In some cases it is much easier than in others to judge which individuals will be affected by a tax — and

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2) Agriculture and other land-oriented economic activity decline in relation to the total. This tendency appears increasingly important as one thinks of the longer run in which retailing, housing, finance, and utility services serving business and consumers locate where other factors draw population. Manufacturing stands out as a type of activity which has choice about where to settle and which in making its selections influences other decisions about location.

by how much[3]. In choosing to use hidden taxes, those which "conceal" the costs of government from the persons who pay, society sacrifices one instrument for helping make better rathen than poorer decisions. True something can be said in favor of arrangements which free us from worry about taxes. Yet is there not more to be said for the principle of selecting taxes which are sufficiently evident to the taxpayer to enable, or force, him to relate them to the expenditures of government?

Justice in the Distribution of Tax Burdens. Taxes, whether borne directly or indirectly, will be not only heavy but also unequal in the sense that some people will pay much more than will others. Being heavy, unequal, and the result of the use of government's power of coercion, taxes in a democratic society must seem to be moderately fair, just, equitable; otherwise they will eventually be modified. The last statement may reflect a certain naivete, but another will unquestionably seem realistic: tax *proposals* which do not seem to be fair will have decidedly less possibility of adoption than proposals which appeal as equitable. Few if any considerations have greater emotional appeal when Americans discuss tax policy.

Two points seem worth making in this connection: 1) Business taxes can be inequitable by *any* reasonable standard, or on this score they may compare moderately well with other taxes; 2) one basis for condemning present American taxes on business (and those in other countries if my impressions are not unduly imperfect) is that these levies run counter to reasonable standards of fairness. The public, however, seems not only indifferent but sufficiently misguided to support the continuation of taxes whose real effects differ considerably from those assumed. Although reform efforts may not require an extensive foundation of popular support, even a strong leader will have difficulty if his tax proposals violate the popular sense of equity.

The United States has acquired (or subjected itself to) a "system" of taxing business which could benefit from reform[4]. The same is true in other countries.

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3) Debates over tax shifting, which I shall scarcely touch upon, continue with enough vigor to demonstrate that doubt about the eventual resting place of some taxes remains a fact most clearly true of some business taxes.

4) The system grew up more by accident than as the result of any carefully conceived and logically justified reasoning. See W. J. Shultz and C. Lowell Harriss, **American Public Finance**, 8 th edition (Englewood Cliffs, N. J. : Frentice-Hall, 1965).

Business Taxation - Some Basic Issues

Some taxes collected from business firms are intended to fall on the consumer (or perhaps the employee) and probably do, more or less as intended. Other taxes, however, such as those on business net income, are presumably intended to "burden the company" — whatever this term may mean. Still other taxes, such as those on purchases by business firms, on the property they own, or on payrolls (as for social insurance), are less easily classified as to either the intent of the lawmaker or the actual result. My comments will concern primarily *net income* taxes.

The Wisdom of Taxing "Business". Businesses are the organizations upon which the Western World relies to produce most of its output. Although the efforts of teachers, judges, military personnel, and other employees of government — as well as the efforts of those who work for private organizations not seeking profit — yield valuable results, most real income consists of what people accomplish through business firms.

Business, to rephrase, is the public's major agency for organizing labor and capital to produce — and to produce more, rather than less, efficiently. Businesses are groups of people seeking to benefit themselves by serving others. It is this service, whether in producing and distributing things or in rendering services directly, which the public wants. The process of rendering service can be more or less efficient in terms of inputs per unit of output. A market economy relies primarily upon competition in markets to induce efficiency — and to stimulate growth. For it is in business organizations that we find, not only the source of more of the old, but also most of the venturesomeness which leads to the innovations that contribute so much to rising living standards.

The public interest calls for each business to: 1) Turn out products or services which are wanted more than something else, as reflected in freely made consumer decisions expressed in the market, or through government agencies. Part of this task of business is to anticipate, identifying wants which will be satisfied by new types of goods and services. 2) Produce by methods which economize on labor, materials, capital, and other "inputs" according to their relative scarcity and productivity.

The total accomplishment of people working as business organizations will depend upon many things: the training, inherent ability, and acquired skill of workers; their willingness to exert effort; the amount of capital — in the physical sense of buildings, equipment, and inventory, and also in the financial sense of money, without which transactions as we know them would rarely be possible; the degree of competition; the state of technology and speed of scientific advance; the competence of management; and other things. Among the "other" things are some services produced by government. The system of law and order is one. The tax structure is another.

Taxes are obstacles in the sense that they take from the taxpayer without directly giving him an equivalent. Taxes on business do not improve the process by which consumers indicate the relative importance of their desires. Taxes on business income do not help indicate to managers the relative scarcities and productivities of inputs. But taxes do affect the alternatives, the incentives which a business must consider. One is to save on taxes. In adopting methods which reduce the tax bill, however, a business does not economize on the "input" of government nor reduce in any perceptible way government's use of resources. Nor does the firm increase its operating efficiency in the sense of using less input per unit of output.

A business, in fact, may wisely adopt methods which are inherently "second best" because the artificial factor of taxes makes such methods the best under the circumstances. Taxes thus give rise to an element of conflict between private and public interest as they induce the manager to redirect the firm's activities, away from what is fundamentally most efficient. Taxes lead to results which are less than optimal when judged on the basis of economic productivity.

The distortion of decisions may be only trifling, or it may be of some importance. Productive capacity is not allocated to the uses, and in the proportions, which are fundamentally best. Too much investment goes into forms with less bundensome tax consequences; too little goes where taxes will be high. The loss of real income is a burden — but one which is concealed. Even inventive and courageous economists will hesitate to estimate the magnitude of such losses to society.

Reasons Advanced for Taxing Business Income. How, then, can we account for the heavy taxation of business as such. Each country's history will have its unique features. But, at least in my country, accident and temporizing to meet emergencies, notably war, have played a larger role than has any rational evaluation of alternatives. Other reasons have also played a part.

From time to time in the United States "business", especially big business, has drawn sharp criticism from persuasive writers and fighting "reformers". Whatever the bases for the criticisms, school books have tended to perpetuate attitudes which contain no small hostility to business. There is also a deep-seated public belief that "business" somehow has taxpaying capacity — "business" or "corporations" as distinguished from people as stockholders, consumers, or employees. The big corporation seems assumption that the shareholder bears the burden, and recognizing that shareholders, especially the owners of large numbers of shares, are the more prosperous members of society, advocates of separate taxation defend the tax as progressive[5].

High U.S. corporation tax rates went into effect during time of war and postwar boom when employees, owners, and government could all increase their "take". Concurrently, the rise in rates of tax on personal income appeared to justify substantial increases in the rates on corporations. As the years have passed, justification has also been found in the argument that to varying extent present burdens have been capitalized in the prices of shares.

Some economists contributed another argument: A tax on pure economic profit, they said, is a tax on a true surplus, not a payment for an essential cost of production. Whatever the theoretical merit of this concept, it is not the one used for tax purposes. Lawmakers framing income taxes have come up with definitions of taxable income very much broader indeed than the notion of pure profit as a true surplus[6].

Today's tax in the United States gets some support from another fact. The corporation income tax qualifies as one an "automatic stabilizer" of

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5) The progression is crude at best; it is not the type of progression which can be defended as leading to either vertical or horizontal equity Furthermore, in the United States it is not true that a corporation income tax resting on shareholders imposes no burdens on low income groups. Some shares are held by people with "low" incomes. Large amounts are held by philanthropic, educational, medical, and other organizations whose activities serve even the very poor. Moreover, pension funds for employees of businesses, nonprofit organizations, and even some state and local governments have substantial holdings of corporation stock.

6) Wartime attempts to tax "excess profit", it is true, have tried (to varying degree) to tax that element of return to capital which is a pure surplus. The history of these efforts reveals abundant evidence of the tremendous difficulty of identifying pure profit.

considerable force, a feature which space limits will not permit me to discuss.

Legal systems do permit the establishment of organizations such as corporations which to some extent *are* separate from their owners — and in ways which *can have* tax significance. Two aspects demand mention: 1) the equality of tax burden on incorporated and unincorporated activity; 2) the possibility of tax avoidance. Let me first say a few words about the second.

Not all corporation earnings are paid out in dividends. Those kept in the business are not subject to personal incoma tax. The owners are not so well off, presumably, as if they had received the income in cash free of tax; but at least those in control must expect to be better off than if they had gotten the earnings in cash and paid the personal income tax. The ownership interest in the business becomes more valuable because of the growth of assets. Another problem is the capital gains[7]. Conversion into capital gains of what would be dividends obviously has tax significance. One need only, look at the literature on "tax minimization". In short, the existence of the corporation does make a difference in taxes.

For logical solution to the problem of retained earnings, however, one will hardly look to a tax on *all* corporation earnings. Whatever is paid out to shareholders gets into their taxable income. 1) One "solution", a crude one, is to tax (only) undistributed profit. 2) Another possibility is to require the individual eventually to make a complete accounting for tax purposes. An effective tax on net capital gains, including those embodied, in transfers at death, comes to mind at once — but not to the tax laws. 3) A third approach allows the dividend recipient a credit for tax paid by the corporation. Among the defects of this method is the fact that management decisions will still be influenced by the tax on the corporation. None of these approaches can be fully satisfactory. The guides of the market would not operate free from tax considerations to determine the amount of saving and the direction of investment.

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7) Such accretion of economic power free of personal income tax seems — at least to me — less than the ideal of fairness when other accretions, such as wages, are taxed. Even in the far from opulent circles in which I move, ne great effort would be needed to find disagreement on this conclusion. Any argument starting with questions of equity and fairness rarely will quickly move to other considerations, perhaps capital formation.

Uncertainty about "Who Really Pays".

One problem in learning about who actually bears the tax is to distinguish between the effect in the short run and those over the longer run. *Changes* in tax on business profit — whether resulting from fluctuations in pretax earnings or from a change in the tax rate or the definition of the tax base — are likely to be reflected, at least for a while, in what remains for stockholders. As time passes, however, adjustments take place.

Supplying business with equity (ownership as contrasted with debt) capital costs something. The stockholder sacrifices the opportunity to use his wealth in some other way. This sacrifice is an economic cost. Income tax law and traditional accounting, however, do not recognize this cost as a deductible expense of doing business. Yet even statutes of long standing will not always alter economic reality, and this is one such case. Consumers will not get equity capital to work *for* them — and employees will not get equity capital to work *with* — unless the people who can provide ownership capital expect total net benefits which will equal those obtainable elsewhere.

Suppliers of capital, whether in debt or equity (ownership) form, expect to be rewarded. The reward that counts is the reward *after tax*. A "normal" return on equity capital is an *essential economic cost*. The net after-tax return which a supplier of equity capital will insist upon be as high a yield (conceived broadly as total net benefit) as he could obtain from any alternative use of his funds.

The equity capital already in a business, of course, is largely sunk, it will remain for a time, regardless of actual returns. To get new capital, however, the business must offer attractions which are equal to those otherwise available to the suppliers of funds. In turn, the company must look to customers for dollars (lira or pounds) to reward those who provide capital. If the corporation tax rate is 50%, and if potential supplier of new equity capital insist upon an *expected* return of 8%, then the corporation must expect to get a price from customers which yield 16% before tax. Only new projects offering a 16% gross return get equity financing.

The corporation will not succeed in selling new shares of stock unless the prices which it expects from its customers will bring an adequate after-tax yield. The growth of output (in a growing economy) will lag until prices *are* high enough to give profits which satisfy investors. Over the long run, then, some or much of the corporation income tax will tend to be shifted to consumers. The indirectness of the process, conceals it. The result, however, is a tax on consumption, but one falling capriciously, unevenly, and not in line with any concept of fairness familiar to me. Corporations which are not growing and which do not seek new capital, may never be able to shift an increase in a tax rate.

The actual shifting to the consumer will depend to some extent upon what happens to the *total supply* of, and *total demand* for, capital[8]. The amount of capital available for new investment in business is not fixed. The amount available for investment in corporations is certainly not fixed.

Let us assume that the tax on corporation earnings makes the prospective yield on corporation earnings less than otherwise. The potential supply of equity funds out of a given total of funds for investment) will decline. Meanwhile, more of the total of savings will move to seek investment in debt form; the rate of return on new debt will fall. The tax on corporation income, therefore, tends to reduce not only the after-tax yield on equity capital for a time but also the yield for suppliers of debt capital. The corporate tax thus becomes a *more generalized burden on the suppliers of capital*. The magnitude and the distribution of this burden, however, cannot be measured nor compared with the amount passed on to consumers. And who will be able to learn for sure how the amount and type of capital formation will change?[9].

Any proces of shifting operates in an environment in which conditions constantly change. Lags and frictions will inevitably slow the proces. No single set of forces has an opportunity to work itself out completely and fully. Some corporations will be more successful than others in getting a satisfactory after-tax return. Competitive factors differ widely. For example, businesses competing with others which are free from the tax — notably those operated by government — must expect considerable difficulty in passing the tax to consumers through the market process.

8) If other revenue sources, such as personal income or sales taxes were relied upon to raise revenue equivalent to that from a tax on corporations, demand and supply conditions for capital would be affected by all the tax factors, not merely those of business taxation.

9) Investment in relatively undertaxed forms will tend to be greater than otherwise, reducing the prices of output relative to what would have been the case. Investment in more heavily taxed lines will lag, and product prices will be higher as a result.

Other factors are foreign competition, the extent of production from firms with large proportions of debt finance, and "special features" of the tax law (or its administration).

One conclusion seems clear: A major tax whose economic effects are so difficult to identify and measure — but some of which wise men would shun rather than seek — can hardly be the best man can devise.

Difficulties of Defining the Tax Base and the Taxable Unit. "Income" or "profit" or "earnings" may seem reasonably clear concepts — until one tries to define them for purposes of taxation. Then difficulties appear. They multiply, and they grow. The same applies when trying to prescribe just what is the business unit to be taxed as a single entity, e.g. a corporation or a group of related corparations, to say nothing of corporate reorganizations and family partnerships.

If tax rates are low, and if differences in tax rates are small, the results of one, as contrasted with another, provision or interpretation may be inconsequential. Today, however, considerable tax may depend upon even apparently minor details of definition. And some matters become major determinants of business actions — treatment of depreciation, for example, or the variation of tax rates according to either the amount of earnings or the percentage distributed. The tax paid by the individual business, especially over a decade or so, may be appreciably different from what a casual look at the tax law would suggest. Moreover, the whole economy may be affected by seeming technicalities. Unfortunately, the results will tend to appear slowly — no, not always "appear" in the sense of becoming fully evident. One should expect a long "recognition lag" by businesses themselves and more often by the public. Correction will take still longer and may never occur. Government can be slow to act.

Other consequences of difficulties of definition might be discussed. For example, inequality of taxation will result in the sense that the amount of tax borne by different taxpayers, whoever they are, will not be in line with the realities of their economic positions. Perhaps the differences are those intended by the lawmaker and generally desirable, perhaps not: Technicalities permitting escape from tax become available to only a minuscule portion of the public. "Public" laws are in fact vehicles for serving narrow private interest. Often, no one can be sure of the results because of another consequence — complexity.

The complexity of income taxation has become worse than baffling. In itself it is an impediment to progress. Specialists on one or a few features of tax law will be the first to admit doubts about what most other provisions really mean and the fruits they produce[10].

One detailed provision breeds another — to try to plug a loophole or to create another with no more, or less, merit. The conduct of business becomes ever more complicated for reasons inherently unnecessary.

"Tax Incentives"

The existence of high tax rates in a sense creates an opportunity. The high tax barriers can be reduced for those who do something especially desired. Provisions which lower the tax obstacle here and there are sometimes called "tax incentives". This term does not appeal to me. But terminology counts for little compared with fact. What are the facts?

In several countries the post-war record shows that numerous objectives have been advanced by the offer of opportunity to escape from the impact of very high tax rates. Some of the objectives have unquestionably been worthy, but not necessarily the most worthy; some by reasonable standards may have been unimportant relatively to one or more receiving no favoritism. With any given amount of revenue loss possible, broad, general reduction in tax rates on business seems to me better for the long run than concentrated reductions here and there. Specific adverse discriminations, for revenue, or other purposes, are generally subject to criticism on the same grounds.

Such provisions introduce an element of coercion rather than free choice to influence decisions - about what to produce, how, and for

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10) Anyone speaking in public lays himself open to the charge of being either superficial by ignoring vital details or inaccurate when he tries to do so. Going beyond generalization requires 1) technicality which will be incomprehensible to listeners and readers or 2) imprecisions which an opponent may pick on to discredit the speaker. Nothing even resembling informed public opinion is possible. Even to say that Congress or Parliament "intended" something may be unwarranted; few lawmakers can have made the study needed really to understand modern tax laws.

More and more of the country's best talent is drawn into fundamentally sterile activity. The most skilled government officials work away the years on technicalities of no intrinsic merit. So do tax practioners. The money value of their efforts will appear in GNP, but what results is not real product but in fact a waste of potential. Moreover, where laws are so complex. mediocre men make errors which are costly to those whom they serve. The small, and not-so-small, business will be most likely to suffer.

whom. Opportunites are altered for reasons which reflect votes in the ballot box (and then, perhaps, very indirectly) rather than economic choices expressed by economic means. Anyone, of course, can propose ways to improve any allocation of resouces[11]. Good intentions, however, are not enough. In using taxation, both *ends* and *means* must be selected by the political process. This process inevitably brings into the decision-making men with no special competence and men whose interests differ widely. Results are reached only with compromise, desirable for some things but not in operating an economy[12]. Moreover, at least in the United States, removal and even adaptation to changing conditions is always difficult, often impossible.

"Tax incentives" have another disadvantage. Their "cost" tends to be high[13]. Legislatures have no way to limit tax concessions to those actions which would not be taken without the tax favor. For the mar-

11) When I was a university student, and that was not yesterday, I was taught a principle which was then old enough to be "clasic" Society could improve on the free market's allocation of resources by taxing increasing-cost, and subsidizing decreasing-cost, industries. With this wisdon long available, how have we used it? Legislatures in the United States "apply" the principle more often in just the wrong way, perversively. At all levels of government, public utilities (often cited in textbooks as decreasing-cost producers, a conclusion not proved) and their services have been subjected to adverse, discriminatory taxation: I know of no attempt to determine whether increasing or decreasing cost conditions prevailed. The academician may dream about what lawmakers ought to do, but action can be rather different.

12) Obviously, I oversimplify. I shy away from distinguishing 1) **broad** issues of allocation between the government sector and the private economy which only the political process can accomplish, from the 2) more specific **detailed** matters which get into granting tax favors for this, relative penalties for that. The injection of a variety of economic issues into politics complicates the truly important job of solving society's essentially political problems.

13) When government buys autos, it pays for what it gets and no more. When it tries to get something by granting a tax concession, however, it is likely to "pay for" a good deal more than it gets. Suppose, for example, that the majority agree that the public interest will be served by stimulating investment by small businesses. A tax concession will stimulate such investment. Therefore, a favor is granted — but to **all** such investment. The public grants the favor to everyone in the group, including those who in any case would have acted as they did. For what may be a small **additional** investment of the type desired, society "pays" for what it would have gotten without the tax concession.

ginal (incremental) benefit obtained, the public may pay very dearly when it grants tax favors to *all* in the class. Meanwhile, other objectives more desirable at the margin get no tax stimulus.

Nevertheless, the results of special tax incentives may be dramatically impressive. The alternatives sacrificed rarely if ever appear. And if I were a manager trying to serve the owners employees and customers, of a corporation, how could I justify not working industriously for special provisions to aid my company a great deal, in preference tax rate reduction of equal total amount to be shared by all corporations? The incentive structure for getting tax burdens reduced has elements which encourage the proliferation of special features with their distorting, complicating, and deceiving consequences.

Taxation Of Unincorporated Business

Personal Income Tax as a Business Tax. Though not labeled as a business tax, the personal income tax (in the tax systems with which I am familiar) aplies to the earnings of unincorporated businesses. When rate schedules are high and progressive, high personal income tax rates take a bite out of business income more often than the "man in the street" would probably expect. Supporters of steeply graduated personal income tax rates characteristically give little attention to the fact that the tax in effect falls directly on business income.

Three kinds of results may be noted: 1) Some business decisions are influenced by marginal tax rates which are high enough to be distorting. 2) The tax applies to earnings which are, or would be, used, not for consumption by the owner's family, but for building up the business. 3) Proprietors who are free to use an alternative form of legal organization will tend to do so when there is a procpect of reducing the tax bill[14]. A single proprietor may take in partners, or a partnership may increase the number of partnership interest, for tax, rather for business, reasons. By doing so they shift some income from higher to lower brackets. Another possibility is to incorporate.

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14) For each business, it seems to me, the choice about legal form of organization should depend to the fullest extent possible upon the underiying economic merits, with taxation exerting a minimum of influence. Present U.S. law permits partnerships in some cases to choose to be taxed as corporations; some corporations may elect to be taxed as partnerships. The requirements for qualifying are often complex.

Each of these results has elements which are undesirable from the point of view of freedom, efficiency, and progress.

Where taxes have substantial effect, there will be inequality because not every business will in fact have approximately equal opportunity to take advantage of the options. Moreover, there will be some economic waste resulting from the choice of "second-best-made-best-by tax options. And another fact will lead to waste: arrangements which are good at one time become poor as circumstances change; before the company becomes willing to undergo the cost of new change, however, it will have suffered somewhat.

Unincorporated Business in the Economy. In the United States unincorporated producers account for nearly one-fourth of business done (as measured by receipts). One fourth or so of the business economy is in itself important. For at least two reasons, however, the relative ·ignificance of these firms is greater.

1) Some of those companies *provide competition* which helps keep to whole market economy operating more competitively, even much bigger firms.

2) In the future, as in the past, much *economic growth will* start, and much will take place, in unincorporated businesses. Enterprising men and women will try to start *new* businesses. Owners will work and save to *enlarge* companies already operating, to *improve efficiency* by reducing costs, to provide *more and better products* and services. The variety and the oportunity of an economy will lie more extensively than often recognized in widely decentralized economic undertakings. People seeking new jobs will often lookl to the businesses nearby. Useful employment for an expanding population will depend upon the availability of new jobs, not only in the big factories — which cannot be everywhere — but also in the small, and often new, businesses scattered over the country

Some of the goods, and many of the services, men seek as part of a rising standard of living can be supplied only from business sources close at hand. New sources of supply, as well as the competition which keeps everyone under pressure to do better, will frequently depend upon new firms. True enterpreneurship is not confined to big businesses. New nd small companies contribute to economic growth of the most creative and the most progressive type.

Growth of new firms requires, among other things, both capital and the prospect of profit, High income taxes, unfortunately, can make capital accumulation out of earnings exceptionally difficult. (There is truth indeed in the statement that present income taxes penalize, not so much being wealthy as gaining wealth.) Yet if a company is to compete effectively, if it is to be able to pay prevailing wage rates for labor of good quality, it must have good equipment and ample working capital. Both leasing and borrowing will often meet some needs, but as a rule only if equity funds are available to provide security for protecting lenders. Outside equity financing (by attracting partners) is uncertain at best, often impossible, and probably costly.

Progressive tax rates frequently add another obstacle to growth. Risk will usually be present. Often the chances of loss are large. If things do turn out successfully, a large fraction of the reward can be taken away in taxes. But if results are unfavorable, losses can be deducted, if at all, only from lower brackets than those in which the profit would be taxed. Progressive tax rates can reduce the net after-tax return from risky undertakings. Small firms cannot have wide and well established diversification which provides a form of "insurance". This range of considerations, however, requires much qualification to take account of many details.

Finally, high personal income tax rates influence personal incentive to effort. This theory issue lies largely outside my province. The quality of management, however, does make a difference to business, and taxation of management rewards will affect the supply of effort. High tax rates on money income certainly make leisure relatively more attractive.

Special Considerations

Four other points seem to me worth making briefly.

Certainty in Administration. Taxes in fact are not necessarily what the statute pays. Often no one knows what the law actually means; and even when provisions seem generally clear, considerable scope for the exercise of judgment — or whim — can remain. No small amount of tax may sometimes hinge upon the more or less unchecked, and often uncheckable, decision of an administrative agency or even a single administrator.

Individuals rightly complain about actual or alleged favoritism, arbitrariness, and inconsistency. (A person on the "receiving" side of favors is more likely to keep his mouth shut.) Such personal hardship constitutes a problem calling for reform. Yet the implications of tax uncertainty for business seem to me more serious.

1) Much business requires commitment of capital (and more or less specialized labor) for long periods. Uncertainty about the tax consequences of any action add to the inevitable risks of long-run undertakings. Doubt about future taxes and their administration must increase the cost of conducting business — a cost for which it is difficult to find offsetting "benefits" (inputs).

2) Competitive relationships will be disturbed. Not every company will get the same rulings from administrators. No improper action on the part of officials is necessary to lead to lack of uniformity and inequality among competitors, though impropriety cannot be ruled out as a possibility. In general, I suspect, there is a bias against relatively small firms. The giants of industry can afford to press their case to a point far beyond what is economical for most firms. Growing complexity of tax laws aggravates the problem. High tax rates add to the money significance of rulings which do discriminate among competitors.

Incentives for Governmental Ownership (Socialism) and Other Tax-Exempt Operation. High taxes on private business encourage the expansion of governmental operation as well as that of any tax-favored organizations, perhaps cooperatives. In the United States prospective saving on taxes has played a part in the conversion of privately owned companies — chiefly, in the supplying of electricity, gas, and water locally — to governmental (municipal) agencies.

3) Tax favoritism of governmental business-type operations gives them a competitive benefit over private, taxpaying suppliers. A legislature imposing high taxes on business may have no recognized desire to subject private producers to serious rivalry from government. Yet what can one expect? If there is direct competition between private and governmental suppliers, one has a tax advantage. In a close contest the tax discrimination may tip the balance. Once again, seriousness is a function of the height of tax rates.

Housing and Land Rent. The provision of housing, though a form of business, and a large one, frequently escapes discussion as a bussines. It is one which presents peculiar tax problems. Side by side in U.S. cities one can find housing which is taxed heavily and housing which is not only tax exempt but which also receives subsidy. Subjecting housing to taxation equal to that on other consumption (or suppliers of consumption goods) is a subject which in itself warrants examination as a problem in business taxation.

One aspect of such examination would be the broader subject of land taxation. Profit as taxes, I argued earlier, is by no means an economic surplus. Land rent or its equivalent, however, will often contain a true economic surplus. I shall deal with this subject in another lecture.

Inheritance, Estate, Legacy other Death, and Gift Taxes. Taxes on the transfer of property at death or by gift can be heavy. When the bulk of the property consists of interests in a closely held business, the enterprise as such can be affected adversely. Typically, the effects begin long before death as the owners alters his investment program to acquire assests, such as life insurance, which will be liquid and available for paying tax at death; over the years, as a result, fewer dollars are available for investment in his business. The owner may arrange to merge with a larger firm in part, at least, in anticipation of death tax problems. But when the results of the tax are concentrated at death, considerable disruption of operations may result.

In the United States we know much less than we should about the extent and seriousness of this problem today. But one is safe in saying, "Here's something to think about", the analysis should include the effects on business of death taxes designed to be *personal* levies.

Directions Of Progress In Taxing Business

Getting rid of existing defects in business taxation requires action affecting the revenue structure at many points.

One essential, seems clear — a vision of the general *goal* and *why* it is desired. My comments up to this point have implied some of my views and the underlying reasons supporting them. A more explicit formulation standing as a sort of conclusion (based largely upon conditions in the United States), would run somewhat as follows, not all exceptions being noted.

1. Resource allocation will be most efficient if taxes impede as little as possible the operation of the market proces[15]. Choices, in other

15) Problems of income distribution and redistribution are passed over here — as they would not be in a complete analysis.

words, will reflect more accurately the alternatives which are at issue when taxes do not influence the results[16].

2. To this end, taxes should be neutral or impartial in their effects on resource allocation — among industries (including private and governmentally owned), occupations, regions (internally and domestic versus foreign), methods of operation and finance, forms of legal organizations, present versus future, and so on. In general, the economy will operate most productively if taxes exert a minimum of influence upon decisions about what to produce, how, and for whom[17]. The more fully this condition is realized, the greater will be the total of real income available for consumption and investment, including consumption and investment through, and by, government[18].

3. Major reliance for revenue should be taxes which draw from the flow of income at the *personal level* — by taxes on persconal income received and on the use of income and wealth in consumption expenditure

Use of both income and consumption (expenditure) for the tax base will generally be preferable to exclusive reliance upon one or the other. (a) For reasons of fairness and equity in the distribution of burdens, the use of two bases has one great advantage over the reliance upon one or the other. In the real world, each base will have defects, but they will not be the same. Some crude averaging and compensating will result if both are used. (b) When tax rests upon both income and consumption, the tax rate on each can be materially lower than if all the revenue must be obtained from a single base. Consequently, the evils of high tax rates as such will be less. Use of taxes to redistribute income may be easier under personal income taxes than under spending taxes, but the latter *can* be modified for this purpose. One type of taxation, however, *cannot* be used for anything approximating rational redistribution — taxes on business.

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16) An exception of some importance exists when the tax has direct relation to the amount of governmental spending, e.g., taxes based on net profit.

17) One must recognize the existence of a potentially valuable, but ealisy abused, exception for regulation in the public interest.

18) Taxation and governmental spending may be used to "force" saving and speed the accumulation of capital so that over the long run income appears to be higher. But is real income truly higher? How does one weigh, as must be done for an answer to this question, the loss of welfare of persons forced to save when they would have preferred to consume.

4. Assuming that the personal income tax has a prominent, perhaps predominant, place in an ideal revenue system, it should be reexamined in the light of its bearing upon unincorporated business. In this connection the chief consideration in the United States, would be the reduction of high (marginal) rates. The revenue from these rates is important chiefly for its insignificance. The adverse effects on the economy, in relation to any general benefit, are by no means restricted to those which result from the impact of the tax on unincorporated business. But the latter call for special examination.

5. For the taxation of consumption as such, *retail sales taxes* more or less as used in most American states — or taxes imposed upon sale *to* the retailer (at the wholesale stage) — seem to me clearly superior per unit of revenue to selective excise taxes or to general turnover taxes. A tax on *value added,* however, would probably be my first choice — in part because as a matter of expediency it offers a realistic alternative to the taxation of corporate income at high rates. Application of the tax to the output of governmentally owned business-type activities, and to such tax entities as cooperatives, would seem to me generally desirable in principle.

6. Tax rates on corporation income would be reduced. Both the speed of reduction and the level conceived as the eventual goal would depend upon revenue needs (in the light of alternative changes to raise revenue) and such other factors as personal income tax rates and opportunities for avoidance. Within relatively few years as such things go, normal economic growth will in itself expand the base so that revenue can be maintained while rates go down.

7. For 15 years or so I supported in principle "base broadening" and "loophole closing" to facilitate rate reduction and to make for greater fairness. Simplification has also seemed to me, not only a highly desirable goal but also one attainable within degree. Although "hope springs eternal", I am not "holding my breath" waiting for success. Fortunately, some of the objectives can be atained indirectly. (a) Growth of national income in itself broadens the tax base and permits rate cuts if government spending grows less rapidly. (b) Reduction of high tax rates would also reduce the equity significance of loopholes and the practical importance of the myriad features which, having been adopted for good reasons and bad, make for complexity.

Concluding Comment

Discussion of the tax system which would be most in conformity with characteristic of a free society may seem to be little more than an example of the lack of realism attributed to academicians — something of the world of dreams. For one thing, evidence, hard fact, measurement — notably lacking in my paper — are needed, not only to help us learn with certainity which choices are best but also to persuade those votes and officials who must be persuaded. At least I am optimistic enough to believe that men respond to evidence. Response, however, calls for public education. Unfortunately, no small amount of latent, and some overt, opposition must be overcome.

Finally, a more difficult job will be unending — restraint on the growth of government spending. Over the long run, freedom for manoeuver to reform business taxes — and in my opinion reform is reduction of tax rates — will depend upon the budgetary position.