

Taxes and Economic Incentives

By

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PREFACE

Continuation of the cold war and the aftermath of World War II, together with insistent pressures for welfare and developmental expenditures, have resulted in extremely heavy claims on the public purse. Faced with heavy tax burdens, it is natural that tax reduction should be demanded by the people; yet the fact is that revenues are running well below expenditures. In this situation a dual approach to the fiscal problem is strongly suggested. First, continuous scrutiny of expenditure programs, including proposals for new expenditures, is needed. Second, every effort should be made to so adjust the tax load that there will be minimum interference with orderly economic progress.

The present study is concerned primarily with taxpayers' reactions and their repercussions in the economic sphere. With tax burdens as heavy as they now are, the effects of taxes on decisions with respect to investment and economic expansion are of paramount importance. Intelligent formulation of tax policy will be facilitated if the economic aspects of the several classes of taxes are more fully understood.

A major portion of the analysis of how taxes impinge on economic incentives is based on materials obtained through questionnaire. To all those who co-operated the Institution desires to express its sincere appreciation. In addition, the author wishes to thank the numerous students of taxation and tax problems, whose advice and suggestions contributed to the development of the study.

The co-operating committee of the Institution consisted of Cleona Lewis, Karl T. Schlotterbeck, and myself.

Harold G. Moulton
President

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INTRODUCTION

A major issue in fiscal policy confronts the American people. The expenditures of government have become so large that the revenues can be raised only in a vigorous and flourishing economy. Annual tax collections—federal, state, and local—amount to over 50 billion dollars, or roughly one fourth of the national income. It is almost universally agreed that, if we are to achieve long-run fiscal stability, federal revenues must equal expenditures over the years and yield a surplus in good times. Yet the federal budget is seriously out of balance in a period of prosperity.

The importance of the current budget problem becomes even more apparent when one recognizes that governmental revenues vary more than proportionately with changes in business activity and national income. Unless production and employment are maintained at high levels, revenues will decline sharply. Moreover, when income falls, public expenditures generally do not contract correspondingly. In fact, major categories of expenditure tend to expand rapidly under adverse economic conditions. Under the present federal tax system, even a moderate decline in national income of 10 per cent could mean a federal deficit of well over 10 billions.

In this situation a tax policy that will promote economic expansion and high-level national income is imperative. A basic requirement is a tax system that will not unduly impair economic incentives. The heart of the tax problem is how to reduce the restrictive effects of taxation to the minimum compatible with raising the necessary revenues. Though at first glance this might seem a truism, in formulating tax policies the conservation of incentives has frequently been overlooked or subordinated to other objectives deemed more important.

In this study we shall appraise the effects of specific taxes and taxes in general upon the major incentives which are essential to a dynamic and expanding economy. We shall be mainly concerned with the effects of taxes on four incentives:

First, there is the incentive for enterprisers to establish new companies or to develop new industries. Unless a large proportion of those choosing between establishing their own businesses and working for others decide in favor of going into business, the vigor of the economy may be impaired. A tax system that would substantially reduce the number of those choosing to go into business for themselves would be uneconomic and undesirable.

Second, there is the incentive for existing businesses to expand plant and equipment and to introduce new machinery and methods. The vitality of major sectors of the economy depends in large measure on decisions with respect to expansion and innovation. High tax rates and low depreciation allowances not only affect the volume of funds becoming available for replacements and expansion; they also influence the psychology of the business community and the attitudes of management towards expansion.

Third, there is the incentive for the people to invest their money savings. Though other considerations are often important, the prospect of an adequate net return after taxes is usually paramount. From the standpoint of the economy, the direction of investment may be more important than the volume. It is essential that a substantial portion of the funds becoming available be employed as equity capital, especially in the more risky enterprises. Heavy taxes inevitably affect both the direction and the amount of investment.

Fourth, there is the incentive to work. Willingness of qualified personnel to assume the exacting tasks of executive and managerial positions is essential for the efficient operation of a private-enterprise economy. Similarly, it

is desirable that the attitudes of the workers be conducive to the effective performance of the tasks at hand. The attitudes of both business managers and wage earners may be influenced by abrupt changes in rates under personal income-tax schedules.

Mere reference to these four incentives suggests that the effects of taxes on economic incentives may be an important factor influencing the capacity of an enterprise economy to pay taxes. It is also clear that an understanding of the nature of taxable capacity is an essential part of the background for an analysis of taxes and economic incentives. Accordingly, we shall begin with a discussion of the nature of taxable capacity and the factors which determine the ability of the American people to pay taxes. The materials relating to taxable capacity are presented in Chapter I.

If one is to study the relation between taxation and economic incentives, it is necessary to consider who bears the burden of particular taxes and their economic effects. A global or over-all approach embracing the entire tax system, without taking into account the special characteristics of particular taxes, would probably yield little more than unconvincing generalities. The principal taxes are therefore appraised in Chapters II to VIII from the standpoint of their effects on economic incentives. In each case a brief statement with respect to incidence precedes the discussion of these effects. The findings concerning the various taxes are summarized in Chapter IX.