Taxation and the Economy, 1956

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I

As economic conditions in the country have changed, we have seen a shift in the economic ideas which enjoy public prominence in the area of tax policy. The old standbys of course remain on the scene. We will always be reminded by somebody that taxes should not be so high as to impair incentives or impede savings; and we will never be without the advice that taxes should not be so high as to be confiscatory. But, while these and other ancient maxims are always present, it nevertheless is true that there are vogue in tax ideas; and the economic ideas which are in the forefront of public discussion of tax policy quite naturally are closely related to the economic conditions of the period.

During the depression of the thirties there was a great deal of talk about a gap between the effective demand in the private part of the economy and the level of demand required to sustain a high level of employment. This gap was ascribed to various factors, particularly to the belief that our society had matured and that there were no longer profitable uses for the whole amount saved by the population each year. If high employment was to be attained, it would be necessary for the government to bridge the gap by operating at a deficit and thereby create additional effective demand. This thinking produced or encouraged the advocacy of certain tax policies which, it was said, would tend to minimize the gap in the private sector of the economy and thus hold down the size of the government deficit seen as needed to close the gap. It became popular to urge adoption of a highly progressive tax structure in order to redistribute wealth and thereby reduce savings and increase spending by consumers. There was much talk about placing a tax on inactive income—that is, income which was saved and not spent. And also in vogue was the thought that taxes on consumption should be pared down or eliminated.

As we moved into the period of the second World War, these guides for tax policy fell into the background. The principle which advanced in popular acceptance was that taxes were needed to mop up private purchasing power in order to avoid more inflation. But the ideas which had been popularized in the thirties had not died out by any means. With the slight recession in the late forties they again began to be proclaimed. Even today, after years of high employment and near-balance in the government's budget, they have considerable vitality. And I have no doubt that they would regain prominence were our economy to suffer any substantial downturn.

At the moment, however, a number of other guides for tax policy are enjoying increased attention. Each of them was expressed, in the words I quote, in papers submitted last year to the Subcommittee of the Congressional Joint Committee on the Economic Report which was studying the subject of Federal Tax Policy for Economic Growth and Stability. It is these guides which are my subject; and in the course of considering them I will have an opportunity to pay my respects to the older ideas which I have mentioned.

II

We frequently hear today that tax policy should be shaped to encourage a high level of business spending, because that is needed to maintain a high level of employment. It is said that "business investment in new producing facilities is a key ingredient of prosperity . . . if for no other reason than that about one-fourth of our industrial workers, and by and large the best paid industrial workers, are engaged in producing and installing capital equipment." And further we are told that "it is almost a 'natural law' of economics that depression and unemployment are very difficult to avoid unless private capital outlays are reasonably well maintained." The prescription for tax policy which emerges from emphasizing these propositions is so evident that it hardly needs elaboration. Taxes which discourage business investment should be given high priority whenever taxes are reduced.

The difficulty with this narrow view of the economy is that it can always be matched by an equally narrow view which has from time to time enjoyed great popularity. If high business spending is needed for prosperity, it can with like force be asserted that high consumer spending is essential. The observation that a large part of the working population is tied in with servicing business spending can be toppled by noting that a larger fraction is connected with servicing consumer spending. And the quasi-natural law of economics linking high business spending and prosperity is no more potent than the seminatural law equating prosperity and high consumer spending. Thus it can be argued that we should have a different tax policy: When taxes are cut, those which impede consumer spending deserve a high order of priority.

These competing prescriptions of course virtually exhaust the inventory of taxes, since almost all taxes can be found to interfere with business spending or with consumer spending. As appreciation of this has increased, another idea has been coming to the front. "The problem involved," it is said, "is one of maintaining a balance between capital investment by business and spending by consumers which keeps both on a relatively even and expanding keel." This thought has a ring of moderation and reasonableness (and, one is tempted to say, balance as well). But as a prescription for tax policy it leaves something to be desired. Suppose that the economy falls considerably from full employment. If it is thought that tax reduction is in order, how do we know whether maintenance of the "balance" between business investment and consumer spending calls for reduction of those taxes which most inhibit the former activity or
those which most deter the latter? Do we try to reduce these two groups of taxes in that proportion which reflects the relative fall-off in consumer spending and business investment? If so, we must be asked to assume that the previously existing relationship between consumer spending and business spending was the “right” one for a high level of employment. This, however, would be hard to swallow, since we have experienced prosperity with various ratios in the past. On the other hand, if we are not to restore some former ratio, how can we ever tell what mixture of tax cuts is proper for the “balance” required by the prescription? Obviously, there would be no way to tell. And, in any event, can we possibly think it would be good for the everyday workings of our tax system if we kept juggling our taxes in an attempt to maintain such a mythical balance?

These questions suggest what I regard as the only useful guide to understanding the problem. If the economy falls off, and it is thought necessary to reduce taxes to restore demand (and this is a point I will consider later), I submit that any tax reduction will serve the purpose as well as any other tax reduction of equivalent magnitude. A dollar increase in investment by business is just as potent in restoring total effective demand as a dollar increase in spending by consumers. It of course will be necessary to decide which taxes are to be cut; but, in reaching that decision, there is no need to be encumbered by meaningless conceptions of “balance” between various types of demand in the society.

III

Another idea that has been gaining in popular acceptance is that a maximum amount of economic growth is desirable, so that an hour of labor will produce the greatest amount of economic goods. It is clear that such economic growth requires business investment; it is mainly through society’s acquisition of capital that the productivity of labor can increase. A program for maximizing capital growth through business investment would seem to call for a tax system which least retards savings and most encourages enterprise.

The attractiveness of forcing economic growth is easy to trace. To some extent it stems from the obvious fact that our people are materially much better off today than twenty years ago. A good portion of the one-third who were thought to be below the poverty line are regarded as having crossed over it; and it is the increased productivity of the country which seems to have made this transformation possible. It is not too great a stretch of the imagination to visualize the complete elimination of poverty (whatever that may come to mean) if the rate of increase in our productivity is sustained or augmented. The attractiveness of a high rate of growth may in part also derive from a belief that steady inflation in our economy can be avoided only by way of such growth. “Without continuing increases in productivity,” it is said, “money wage increases are . . . likely to lead to corresponding increases in the price level.” But overshadowing these considerations is the thought that maximum growth is required to preserve our position in respect to Russia. Today there is a widely held view that economic power will decide the future of world politics.

Now it is somewhat awkward to take a stand against economic growth. In a country in which material wealth is highly regarded, economic growth is generally accepted as an unvarnished good. The very term “productivity” has a ring of virtue. I do not wish to challenge the contribution of increased productivity to man’s happiness, and I most certainly do not deplore our material gains. But surely it is conceivable that there can be too much of a good thing. We not infrequently have been reminded that for several decades Russia has force-fed its economic growth by starving consumers of goods and services. To be sure, our standard of living is at a considerably higher plane; but it nevertheless is true the maximization of our economic growth would be at the expense of contemporary consumers who would be compelled to do with less goods and services than otherwise. By stunting now, we probably could enable the next generation to trade in houses every year as we trade in cars. Thus the pertinent question is: Do we want forever to hold down present enjoyment for the sake of greater consumption in the future? And, in weighing this issue, we should not overlook the consequences of rapid change itself. At least we should ask ourselves whether we want to move toward greater automation and the four-day or the three-day week as rapidly as possible, and whether social values could be better conserved by a slower rate of progress? Regardless of how we answer these challenges, the point remains that maximum economic growth is not without its drawbacks.

Moreover, the argument advanced in its behalf must not be accepted uncritically. If maximization of productivity were to provide more persons in the future with more goods and services than they otherwise would have, it nonetheless would be surprising to find that future generations are free of concern over the have-nots. Once the subsistence line has been crossed by virtually every one, poverty appears to be a relative condition, associated not so much with the wealth of the society but with its distribution. On even weaker ground is the argument that forced economic growth is required to prevent inflation in an economy in which there are institutional pres-

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sures for wages to rise. During the last fifteen years it is true that money wages have risen while productivity has increased, or while the dollar has declined in value, or while both changes have occurred. From this experience, however, it cannot be concluded that money wages would rise in the absence of such other changes. A non-economically dictated wage rise—that is, one which occurs without an increase in productivity or a decrease in the value of money—could occur only through further restricting entry into the labor force. Such a situation simply is not reached by my crystal ball. Finally, as to the military importance of maximizing economic growth, it might well be that nuclear weapon development has outmoded the doctrine which equates military might with economic power. While we might not be qualified as military strategists, we need not blind ourselves to the evolving possibility that from now on any major war would be decided in its first few hours.

IV

In the face of these considerations it is not surprising that the notion of a “balanced” economic program should make its appearance in this context also. Just as we are told that, to maintain a high level of employment, there must be a balance between consumer spending and business investment, so we are advised that a sound program of economic growth demands such a balance. “A steady rate of economic growth . . . requires that consumption and investment both increase in step with each other. Neither can outrun the other without causing trouble.” And we are then informed that, “from the point of view of tax policy, . . . a maximum [sound] rate of economic growth . . . means a balanced distribution of the tax load between business and consumption taxes.”

I am not sure that I know what it means to say that neither investment nor consumption can outrun the other without causing trouble. Suppose that for some reason consumers on the whole decided that they wanted to consume more—meaning that they demanded more goods at existing prices—and suppose that for some strange reason enterprisers in the aggregate decided that they would not increase the existing capital plant. I would assume that prices of consumers’ goods would tend to rise on the average, but this is hardly trouble. Or take the converse situation. Suppose that enterprisers decided to increase existing productive facilities but that consumers decided they did not want to consume more at prevailing prices. Here I would assume that prices of consumers’ goods would fall and that some investment would turn out to be less profitable than expected—but this likewise does not add up to trouble. Perhaps those who see trouble envisage that prices will not fall and clear the market and hence that production (and employment) will decline; or that, even if prices do decline, the community nevertheless will not respond by purchasing more, and therefore that production (and employment) will decline. No doubt such happenings might spell trouble if the monetary authorities closed their eyes to them or acted perversely. But the facts are that we do have central control over our money system and that the controllers are in a position to act. It would be misleading in the extreme to base analysis and policy on a view which simply ignores these facts.

Even assuming, however, that optimum growth requires the thing called “balance,” were we to rest tax policy upon this principle, we would again confront the problem of divining what constitutes a balance. Let us suppose that we want to have optimum growth for the next decade; and let us assume that the government will undertake to follow policies designed to maintain on the average a relatively high level of employment throughout the period. Our problem is to decide what kinds of taxes should be imposed, whatever the revenue goal might be. “Anti-investment” taxes, it is true, will retard economic growth as compared with “anti-consumption” taxes that produce equal revenue. But, whatever kinds of taxes are selected, the community can then decide for itself, under the tax conditions which prevail, how much it wants to consume and how much it wants to save and invest. There is no reason for believing that enterprisers will more likely fail to equate savings and investment under one type of tax system than under any alternative type. Thus how can it be said that a balance between investment and consumption is any more likely to be brought about by one set of taxes than by any other set producing an equivalent revenue? In brief, while in the long run tax policy certainly can affect the level of investment, it is hard to grasp how it can improve the balance between investment and consumption—assuming, of course, that we know what such a balance is.

A wholly fanciful question perhaps will illuminate this point. Assume that we were so fortunate as to live under a system in which the government could support its operations without collecting any taxes and that the community decided for itself how much it wanted to consume and to save. Is there any reason for believing that the government, if it were to interfere, could or would make a better decision on this issue?

V

Another theme which is thriving today is that, if employment sinks below prevailing high levels, the government should reinvigorate the economy by cutting taxes. This view is substantially the modern version of the old depression notion of a gap between income at a high-employment level and spending for consumption and investment. In the thirties it was argued that government deficits were needed to close the gap and restore high employment. The newer version is that a fall in employment indicates a gap in the process of developing, and
therefore tax reduction to produce a deficit is called for to span the gap and restore the previous high level of employment.

This idea understandably has considerable popular appeal. Paying taxes is hardly ever a pleasure, and any reason which can be found for reducing them almost always is assured of a large sympathetic audience. Especially is this the case where the "reason" seems scientific and where signs of increasing unemployment are appearing. The theme, moreover, is based upon a sound observation. When employment is falling, an increase in spending by consumers or in investment by business will tend to firm up employment. No one will deny that, all other things being equal, such an increase in these circumstances is an unmitigated good.

But the crucial question at this point is whether we should use high employment (or full employment) as the criterion for action by the government. Several serious difficulties are immediately encountered. In the first place, there is considerable ambiguity about what constitutes high employment. Not only will men disagree as to what percentage of the labor force must be employed to have employment high but the size of the labor force itself is somewhat indeterminate. There are, for example, numerous persons who might seek employment when wages are relatively very high but who are content to be homemakers or to retire when wages are somewhat less high. In addition, there are countless others who normally are primarily interested in part-time employment but who might be induced to work longer hours for premium pay. Thus any over-all figure about the number of unemployed is bound to mask the uncertain and fluctuating aspects of that unit which is called the "laboring force."

Putting this matter aside, there is the further difficulty that, when employment falls, there is no way of knowing whether the economy is about to suffer a further decline in employment or is about to become reinvigorated. This will depend upon what millions of consumers and enterprisers decide to do; and, if there is anything that is unequivocal in recent economic history, it is that the professional prophets have usually been more wrong than right in predicting how consumers and enterprisers in the aggregate are about to behave. The significance of this point cannot be understated. If the private sector of the economy were about to increase its spending and investing, and if the government at the same time were to augment demand, the combination could well cause demand for goods to outpace supply. The general price level would then tend to rise—meaning the dollar would tend to go down in purchasing power—unless steps were taken to offset the forces at work. Even in the best of hands such a program would produce a considerable degree of instability or inflation over the years.

However, those who would have the government act whenever employment falls from its high level do not always regard mild inflation as undesirable. We are counseled that "it is not probable that we can achieve in the next twenty years anything like the growth we are capable of without some moderate increases in wholesale and consumer prices." And lest we become too concerned about the injustice of the arbitrary redistribution of wealth that accompanies an inflation, we are assured that "it is fair to say that, under the protection of social security payments, the problem of the impact of price changes on the fixed-income group has become negligible."

I am somewhat at a loss to know how to respond to the argument that the reshuffling of property by government through inflation is not so bad now that government can be counted upon to take care of most people by adjusting social security payments upward. Perhaps it is best just to assume that in such a climate of opinion all long-term fixed-income contracts in time would come to be made on the assumption that a fairly constant degree of inflation lies ahead and that therefore the transition to a steadily inflationary economy would hurt only those who happened to have made their fixed-income contracts before they realized that the change-over had taken place. Be this as it may, I pass over the issue of justice and turn to the basis for urging that we subject ourselves to the inconveniences (if not the injustices) of inflation. And, in doing so, I merely note in passing that a "little" inflation is not a self-defined thing. We can come reasonably close to agreeing whether or not the dollar is in fact staying constant in value; we are likely to have much less success in reaching agreement as to when an inflation is only a "little" one.

At bottom of the acceptance of inflation as an economic necessity is the view that, in a society which has sticky wages and prices, a continuous high level of employment cannot be had under conditions of monetary stability. Now it may be that the rigidities in our system make it somewhat more difficult for the monetary authorities to keep constant the value of the dollar; that is, to stabilize the dollar, they perhaps might feel impelled to act more often and more decisively than they would under a more flexible price system. But there is no indication that the rigidities in our society render stabilization impossible or impractical. In fact, the record of the past few years is strong evidence to the contrary. Once stabilization has been achieved and becomes an acknowledged goal, there is every reason to believe that consumers will hold their spending habits and enterprisers will conform their investing habits to an assumption of continued stability. We have already observed that the willingness of consumers to buy and of enterprisers to invest rests on their expectations as to the future. If, when the price level begins to slip, they expect that it will continue downward, they likely will retrench, and thus a further decline will ensue unless the contraction is otherwise counteracted.
But if, on the contrary, they expect that the value of the dollar will remain generally constant, a slight downward movement will likely encourage them to expand their spending and investment before the dollar has firmed up again. In other words, if the community has confidence in the over-all stability of the dollar, we should anticipate that people will respond to every slight change in value in such a way as to counteract that change, thereby aiding in the preservation of stability.

VI

This suggests that what is most needed is not a policy of deliberate inflationary pressure but one designed to produce monetary stability and maximize the community's confidence that such stability will be maintained. Toward these ends a great contribution can be made by such built-in counterweights as the income tax and unemployment compensation. This combination automatically reduces tax collections and increases government disbursements as the economy begins to fall and automatically increases tax collections and reduces government disbursements when the economy begins to rise beyond the high-employment-stability level. It is conceivable that built-in stabilizers plus adequate confidence in them might in time alone be sufficient to achieve the goal of continued generally high employment under a stable price level, provided that the quantity of money is regularly increased each year by a set percentage to accommodate normal growth in the economy. At present, however, the needed degree of public confidence perhaps can be obtained only by having the government take some positive action to bolster the economy whenever the price level begins to slip. Under these conditions the central question is whether the positive action should take the form of making a monetary adjustment—that is, increasing the supply of money—or the form of a fiscal adjustment—that is, cutting taxes and/or increasing government expenditures in order to produce a deficit which will be financed through the creation of additional money.

As a matter of mechanics I see no reason why either of these two methods cannot be made to work. Both are means of controlling the quantity of money, which, after all, is the most decisive and perhaps the only significant factor determining the price level. Nevertheless, there are two strong reasons for concluding that we should put our primary reliance on monetary action.

One consideration is that monetary adjustments can be made far more quickly than fiscal adjustments and that the monetary control mechanism is capable of more refined degrees of adjustment. This is not to say that the monetary authorities cannot make the mistake of over-compensating for a slight decline in the price level. It is only to say that the likelihood of overshooting the mark is greater where the cruder fiscal adjustment method is utilized. When tax cuts are in the air, there is a strong temptation to deal in wholesale quantities. Furthermore, as a practical matter the correction of an overdose would seem to be more easily accomplished by tightening up on the money supply than by increasing taxes which only recently had been reduced. The fact is that elections do take place every two years.

The other consideration runs deeper. One of the most difficult decisions facing our society is that of determining what activities are to be undertaken by the government. This will always be a highly controversial question, because people will differ in their estimate of the values to be derived from particular governmental activities. Nevertheless, if the decision is to be made on a rational basis, those who make it must weigh the values thought to be involved against the costs entailed. As rough as it may be, this judgment can reasonably be made so long as it is assumed that each governmental expenditure will have to be covered by tax revenues and hence paid for by taxpayers. The real virtue of balancing the budget (at a satisfactory level of employment) thus is that it provides the foundation for making a rational choice about the dimensions of government operations. To call for a change in taxes not because of a revised decision regarding the value of government expenditures but in order to alter demand conditions in the economy is practically to destroy this foundation. How can we sensibly pass on the merits of a proposed new government expenditure when we are told that it will cost us nothing, since a deficit is needed to jack up demand in the economy? And, if it is not feasible to make this judgment, how can we possibly expect to confine the activities of government to proper boundaries—whatever we conceive of them to be?

VII

By now it doubtless will be felt by some that here, indeed, is a strange thesis from one who professes to have a special interest in taxation. Its thrust is that, in setting taxes, we should not be concerned with the relative strength of spending by consumers and investing by enterprisers, that we should not be guided by any conception of a maximum or balanced economic growth in our society, and that we should not try to adjust the general level of taxes in order to preserve a high level of employment. If we follow this advice, what is left to us as a guide in the realm of tax policy other than making sure that our tax system serves as an automatic built-in stabilizer? My answer is simple: Within very wide limits our chief guide should be that of equity. We should, in other words, seek that arrangement of taxes which results in the fairest distribution of the burden among the members of our society. And, if it be said that this is too indefinite a standard, my only reply is that we are less apt to do damage if we follow our notion of what is just than if we determine our taxes by following some economist's crystal ball or some expert's will-o'-the-wisp.