CHAPTER NINETEEN

INDIRECT POLICIES. I. TAX POLICIES

CLASSIFICATION OF TAXES

In this chapter on tax policy we want to discuss all basic decisions which determine the total system of taxation. These decisions include, first, the choice of the type of taxes, then, the rate structure with possible fluctuations in rates, and, for certain types of taxes, the degree of progression. We start the systematic description of tax policy and its consequences with a classification of taxes according to economic considerations. On this basis, taxes may be classified as follows:

1. Direct taxes
   i. Income taxes
      a) On total income
      b) On certain forms of income (wage tax, profits tax)
   ii. Capital taxes
      a) Recurrent capital taxes
      b) Death duties

2. Indirect taxes
   i. General (turnover taxes)
   ii. Specific
      a) Excises
      b) Customs duties
      c) Social security payments

This classification does not include all existing and conceivable taxes; the few taxes, however, that cannot be incorporated in this scheme are usually unimportant and may be left out of consideration here.

Each of these taxes has a rate; most indirect taxes are fully determined by the rate because they are proportional. Direct taxes, on the other hand, are usually not determined by one single rate; there usually is a whole series of rates with a certain
progression. Finally, tax rates and progression may be variable over time; this element will also have to be known in order that the tax system be determined.

Before discussing the effects of the institution, increase, or decrease of any one of these taxes separately and before expressing a judgment with respect to them, we want to make certain general observations concerning these effects.

The immediate consequences of any tax consist, obviously, in taking away certain amounts in one spot of the economy and adding these same amounts in one or more other spots. It follows, therefore, that the use of receipts of a tax determines in part its effects. With respect to the use of the sum total of tax receipts we assume in this discussion, except in the beginning, that it is given in advance and is not changed; the tax receipts are spent in given amounts for salaries of officials, expenditure on supplies, interest payments, unemployment expenditure, etc. We shall therefore consider only such changes in the tax system as leave the total yield of all taxes unaffected; we shall always consider the replacement of one tax by another.

In principle, every such change would affect the equilibrium position of the economy, that is to say, it would affect all variables entering into this equilibrium position.1 The increase of a certain excise duty means not only an increase in the yield of that tax but also, in principle, a change in the basis of the tax, namely, the price of the article taxed, and this change will lead not only to direct but also to certain indirect effects. In order to obtain an entirely accurate knowledge of the effect of such changes, it would be necessary to determine the new equilibrium position. Although not very much can be said a priori concerning the results, it may be stated that in the great majority of cases the indirect consequences are smaller than the direct ones, so that a change in taxes which affects a certain category of economic subjects unfavorably in its direct effects is likely also to affect that group unfavorably in its total effects.

If the economy is not in static equilibrium but performs cyclical movements, these movements will also be affected by the tax system. In principle the change in the cyclical pattern would also have to be known before a final judgment on any tax

change is possible; in practice, however, rough approximations will often be both necessary and satisfactory here.

**DIRECT AND INDIRECT TAXES**

We shall turn now to tax policy and its effects, and, in order to do that, we shall successively open for discussion the various decisions which have to be taken to determine the entire tax system of a country. As a first decision we take that of the total amount of taxes. We have discussed this question above when dealing with the extent of the government’s operations in the economy; it is a more general question which is not suitable for treatment in this chapter. We may therefore move on to the next decision. That is the decision of the distribution of taxes between direct taxes and indirect taxes. As indicated, we shall discuss this decision in the form of an increase in direct taxes accompanied by an equally large decrease in indirect taxes. It will readily become clear that the effects of a shift of this nature depend much more on other characteristics of these types of taxes than on the mere fact that they are direct or indirect.

Let us assume, first, for a country without foreign trade, a choice between two taxes, namely, a proportional direct tax on income and a proportional indirect tax with the same yield imposed on all uses of income. Both these taxes would be somewhat unusual, the direct tax in that it would be proportional, that is, without progression, and the indirect tax in that it would bear not only on all expenditure but also on savings. It will readily be seen that the effect of these two taxes would be the same. The direct tax would constitute a proportional reduction of all incomes, the indirect tax an equally large proportional increase of all prices; in real terms nothing would have been changed in the relation between incomes and prices.

Replacement of an indirect tax on all uses of income by a direct tax on all incomes would also have no effect even if the country did have foreign trade, if the indirect tax had been accompanied by an import duty of the same amount on all imported commodities and an export subsidy of the same amount on all export commodities, and both were then abolished at the same time as the indirect tax.

These conclusions are changed when, as is usually the case,
the indirect tax is in one respect or another a partial tax. A first
eexample of this is that the indirect tax is not levied on savings.
The increase of a direct tax which is to correspond to a decrease
of an indirect tax can in this case be smaller percentage-wise
than the decrease in the indirect tax. This will lead to relatively
larger consumption and a reduction of savings. In other words,
the segment of the economy that was not subject to the indirect
tax will be unfavorably affected: the reverse would apply if the
indirect tax were increased—in that case the sectors which were
subject to this tax would be unfavorably affected.

Similar considerations apply when there are no compensating
import duties and export bounties or when they exist for certain
commodities only; in that case, indirect taxes affect the domes-
tic segment of the economy unfavorably, compared to the for-
eign segment. A reduction of indirect taxes will then improve
the position of the domestic sector.

The most important differences between indirect and direct
taxes, however, is usually that the latter have a much more pro-
gressive character than the former, so that much higher per-
centages are levied of high incomes than of low incomes. Indi-
rect taxes, on the other hand, are on the whole regressive rather
than progressive in character, except in so far as first necessi-
ties are exempted. The replacement of an indirect tax by a direct tax
with the same yield will therefore usually mean heavier taxation
of higher incomes and the payments made out of these incomes,
including savings, and a reduction of the burden on lower in-
comes.

As a consequence, a greater proportion of national income will
be consumed and a smaller proportion saved. It is not certain
in advance whether this fact in itself will change total national
income and, if so, in what direction. If all savings are necessary
for investment, the smaller amount saved may, in the long run,
lead to a reduction of the amount of capital compared to what
it would otherwise have been. In that case, national income will
fall. If, on the other hand, not all savings are necessary for in-
vestment, there would be no such effect, and, owing to the
greater consumption demand, the volume of production would
in fact be above what it would have been otherwise. There is,
further, an indirect influence of an increase in direct taxation on total national income. The higher direct tax may affect the incentive of the earners of higher incomes (usually the entrepreneurial group of the economy) and may therefore restrain their activity.

It will be clear from this that the effect of the shift on the level and the general trend of production cannot be stated in general. It would be necessary to have much more knowledge of the relations to which we referred, in particular of the effect of high direct taxes on the entrepreneurial activity and of the amount of savings that can be invested. It is usually assumed that the level of production will be somewhat unfavorably affected, but for rich countries the opposite may be true. Especially in poor countries, the rate of growth of production is likely to be affected unfavorably. More positive conclusions can be drawn with respect to the influence that an increase of direct taxes combined with a reduction of indirect taxes would have on the cyclical fluctuations of production, although here, too, no final conclusions can be drawn. The higher taxation of high incomes will exercise a more restraining effect in a boom than in a depression because in a boom a much larger amount is represented by high incomes than in a depression; and, since in the depression a part of the savings will not be used anyway, there will be little, if any, restraining effect at that time. Only the stimulating effect of the reduction in indirect taxes will then be operative. Hence, such a change in tax policy would lead to a certain stabilization of cyclical fluctuations. This in itself may favorably affect the level and the rate of increase of production because of the reduced uncertainty and the lesser tendency toward hoarding that may result.

The change in the tax system referred to will affect not only the trend and cyclical movement but also the economic structure in the more limited sense of the word; thus, an increase of direct taxes combined with a corresponding decrease in indirect taxes would lead to greater economic justice.\(^2\)

In order to arrive at a final opinion with respect to the change discussed, it would be necessary to know more about the effects

\(^2\) Cf. p. 264, supra.
on the level and the trend movement, with respect to which the two unsolved problems raised above are of much importance. Our preliminary impression would be that a further increase of progression would have a favorable effect. Since progression cannot increase much more for the very high incomes, the taxation of the middle incomes could most appropriately be increased.

GENERAL AND SPECIFIC TAXES

The next step in the determination of the tax system is that of the distribution of indirect taxes over general taxes and specific taxes. The general principle of this distinction has already been discussed in the preceding section, in connection with the point that even the most general indirect tax, the turnover tax, is not entirely general. An increase of indirect taxation in a certain segment of the economy, with a corresponding simultaneous reduction of a more general indirect tax—a relative increase therefore of the degree of taxation on that particular segment—must always make production in that field of the economy more difficult. A relative increase of the excise duty on tobacco will reduce the activity in the tobacco industry with respect to activity in general; a relative increase of wage costs compared to other costs, e.g., by an increase in social security payments, will mean a reduction of employment in comparison to the use of capital, etc. An exception to this rule might be found only in some cases of increased taxation of so-called “inferior commodities,” the demand for which can increase as prices rise. A change in relative indirect taxation, therefore, constitutes a means by which less desirable types of production can be restrained or other, useful, types of production can be promoted. Thus, employment may be increased by a reduction of social security payments and a corresponding increase in other taxes that are not proportional to wages or by an actual employment bonus. Domestic production may be favored compared to imports by making it relatively cheap, i.e., by levying import duties rather than a general turnover tax. Again, it will not be clear a priori in such cases whether total production will be increased or decreased.

The effect on total turnover depends on second-order effects
of these changes. The meaning of this term may be clarified with the help of an example. We assume an increase in the excise duty on tobacco, combined with a corresponding reduction in the general turnover tax. The resulting increase in the price of tobacco products and the decrease in the price of all other commodities will lead to a decreased demand for tobacco and an increased demand for all other commodities. As far as production as a whole is concerned, there is, therefore, a certain tendency toward compensation. If the elasticities of demand and supply for both categories of commodities were the same, there would be no change in total demand. Such changes in total demand as do occur are therefore the effect of the differences between these elasticities. One speaks of second-order effects in particular when these differences are rather small.

Since the effect on total turnover is a second-order effect, this type of change in taxation will usually not be advocated on the basis of considerations of general economic policy. On this account, these changes are of relatively less importance for our present purposes. Since, moreover, the effects of each concrete change of this category can be determined only if one knows the specific conditions and the actual numerical values of the elasticities involved, we shall not pursue further the discussion of this type of changes.

INCOME TAXES AND CAPITAL TAXES

A further decision is to be made between the distribution of direct taxes over income taxes and capital taxes. A capital tax which is so low that it can be satisfied out of the income from that capital is in fact the equivalent of a tax on unearned income. A shift from income tax to capital tax will, therefore, affect, on the one hand, capital formation and, on the other, the use of labor.

With respect to the former point, there is a difference of opinion as to the effect of a reduction of unearned income. On the one hand, such a reduction may be expected to affect capital formation unfavorably, because the same amount of saving will now yield a smaller result. On the other hand, this smaller yield may stimulate the incentive to save in order to achieve the same
total income as before. Pending a further investigation of these questions, it may be assumed provisionally that the effect of this shift on capital formation would be small.\textsuperscript{3}

It is usually assumed that a relative decrease of taxation on pure labor income will stimulate activity. However, the opposite effect may also occur. To the extent that one can neglect the opposite tendency, a moderate shift in the direction assumed would therefore be favorable with respect to activity.

If a shift in the direction of capital taxes were so pronounced that these taxes could no longer be paid from the income, liquidation of capital would take place. In that case, the effect on private capital formation would become pronouncedly unfavorable. Unless the government were to allocate the yield of this tax to capital formation, total capital formation would also be endangered, and the net result would be unfavorable, except in situations where the need for capital was saturated. As income taxes are almost always highly progressive and bear therefore most heavily on high incomes (which, on the average, contain also the highest amount of unearned income), a shift of the nature discussed will not constitute an important shift in the total taxation of the different income groups. The use of income will, therefore, as a first approximation, not be much affected, and the influence from a cyclical point of view will probably also be small.

In the light of the above, a trend effect will be noticeable (and in an unfavorable sense) if (a) the capital tax becomes very high, (b) its yield is not applied to official capital formation, and (c) all savings can be used for investment because the country concerned is not in a situation of a capital satiation.

An important form of income taxation is the tax on corporate profits. This tax may be levied either on total profits or on distributed profits or on undistributed profits. A special tax on distributed profits would tend to promote corporate savings which may be a long-run advantage for a country where capital is short: it would speed up the trend of capacity. In countries where capital is abundant and where corporate savings are less necessary, the cyclical aspect of this type of tax will be more

\textsuperscript{3} Cf. the discussion of the effects of the rate of interest on saving, above, p. 190.
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important. This aspect would be unfavorable: the tax would promote investment in a boom and promote hoarding in a depression. Hence, from the cyclical point of view this tax should be rejected. An extra tax on undistributed profits has the opposite effect and may be recommended for countries with abundant capital because of its anticyclical effects.

Every tax on corporate profits, whatever its details (unless the progression were based on the rate of profit), has always the disadvantage that it cannot be really progressive. There is no reason to assume that the shares of large corporations are in the hands of persons with higher incomes than are those of the shares of smaller corporations. The opposite may well be true. Therefore, higher taxation of the profits of large corporations than of those of small corporations constitutes an intervention in the degree of concentration of corporations, and it is by no means certain whether this serves any social purpose. If it is intended to tax the large shareholders more heavily, other means can be employed.

The broad determination of the amount of the different types of taxes indicated in the preceding paragraphs implies at the same time the determination of the average rate of these taxes. Given, for instance, the total national income and the total desired yield of the income tax, the average rate is determined. Similar considerations apply to other taxes. The degree of progression, however, is not yet determined. It may still be changed without affecting total yield; more can be levied from the higher incomes and correspondingly less from the lower incomes. We do not need to discuss separately the effects of a change in progression, as we have discussed this question already when we compared indirect and direct taxes.

FLUCTUATIONS IN RATE OVER TIME

The determination of the average rate still leaves open a possible variation of the rate over time. The most important choice which is open here is the following: Should rates remain unchanged during the period of a cycle, or should they be adjusted anticyclically, or cocyclically? In the past the unconscious reaction of tax rates with respect to business cycles has almost al-
ways been that of an anticyclical variation. In bad times taxes were increased; in good times they were lowered. The interest of the government's finances was considered the primary consideration: in the depression a budget deficit had to be avoided at all costs, and in good times no need was felt to create a surplus. It was believed that the objective of a balanced budget also served the economy as a whole; it would promote confidence in the government's credit and, in that way, promote the stability of the monetary system as a whole.

Gradually the view has gained ground that the interests of the economy as a whole are also harmed by this policy— in a way which at first had not been realized so clearly— and this the more the larger the share of the government in the total economy; for this policy implied the imposition of heavier taxes in times of depression, thus stimulating the depressive forces, and the promotion of the expansionist forces in the boom by tax reduction. The government failed to use for purposes of monetary equilibrium the large amounts over which it had control. If part of the high tax yields of the boom were taken out of circulation and these same amounts were used in the depression to exercise additional demand for commodities and services, monetary equilibrium would have been promoted. Gradually, then, the opinion has made headway that the anticyclical movement of tax rates is not desirable and that it would be preferable either to change rates with the cycle, increasing them in the boom and lowering them in the depression, or to keep rates constant during a cycle.

By either policy, the yields of taxes in the boom will be higher than in the depression; the difference will be greater when rates are changed in accordance with the cycle. Although this greater fluctuation in tax yields is no doubt beneficial from a business-cycle point of view, the frequent change of rates, on the other hand, is a disadvantage for business. Stability of rates provides an element of stability in business planning and is hence beneficial to total activity. It will exercise a favorable effect on the level of production and its trend movement. It is further possible even at stable rates to affect the fluctuations in yield: the higher the degree of progression, the greater will be the differ-
ence between boom yields and depression yields. In the light of these considerations, it would appear to us that much is to be said for constant rates through the cycle.

With respect to the experience of tax policy, much less can be said with certainty than might have been expected. There is, of course, an abundance of data with respect to the tax policies in most countries. But studies that analyze systematically the effects of different tax policies, in particular with respect to the more general problems are as infrequent as they might have been useful. There are various reasons for this.

In the first place, the statistical and other material on tax policies is extremely detailed; a large preliminary study is therefore necessary to make this material intelligible and to put it in a form which makes it comparable for different countries and different periods. Some notable results have been achieved in this respect; we may mention in particular an important report published in Sweden, concerning the burden of taxation in a number of countries before and after the first World War. The League of Nations Secretariat has also published important material concerning the level of import duties in a number of countries before and after World War I.

Second, the effect of the general characteristics of tax policy, such as the total level, the distribution over indirect and direct taxes, etc., depends on the economy as a whole to such an extent that every comparison of results involves necessarily a comparison of the general economic situation of the countries and periods concerned. But the proper description of this general economic situation also requires extensive and comprehensive work of a type not satisfactorily achieved until the past few decades; in this respect, we refer in particular to the studies on national income of various countries.

Furthermore, the differences between countries in their general economic situation depend not only on differences in taxation policy but on many other factors as well. One of these, a


very important one, is the relative availability of capital. The separation of the effects of such factors on the welfare of a country is a problem that has become manageable only very recently and that requires very good statistical data for all the other relevant factors. Data with respect to the capital intensity of production in various countries, however, are not among those which can be said to be particularly good.

These various factors may perhaps explain why so few inductive studies have been made in this field. Most results have been achieved with respect to more specific and partial problems. Studies have been made, for instance, of the effects of increases or decreases of excise duties or import duties for a few commodities and of the influence of the tax changes in the United States after 1933. Generally speaking, it may be said that the direct effects of partial changes in taxation are in accord with theoretical expectations. With respect to the indirect effects, the "shifting of the tax burden," usually very little can be said with certainty; this is due to the fact that for this purpose the elasticities of demand and supply of the markets concerned have to be known, and here again only the very first steps have been made.

SUMMARY

On the basis of an assumed given total yield of all taxes, we have, in the absence of sufficient quantitative studies in this field, successively analyzed in a qualitative way the effects of changes in the distribution over direct and indirect taxes and over the different types of indirect and of direct taxes. We have seen, in this connection, that an increase of specific indirect taxes will almost always lead to reduction of the activity taxed; accordingly, these taxes provide certain instruments of control which, however, do not have great significance with respect to total activity. We have further seen that the four following policies (1) relative increase of direct taxes, (2) relative increase of capital taxes, (3) relative increase of the taxation on undistributed profits, and (4) increase in progression lead to (a) greater equality and (b) a reduction in savings and an increase in consumption. We may refer to the preceding sections for the qualifications that apply to these statements. The reduction in
savings and the corresponding increase in consumption will lead to three sets of consequences: (i) in general, the trend development will become slower as a result of reduced capital formation; only in rich countries with an abundance of capital may this effect be absent; (ii) in rich countries where part of income is hoarded, the volume of production will increase; and (iii) in all cases, the cyclical movement will become more stable.

A scientifically justified choice of changes in the tax system will be possible only when more information is available concerning the magnitude of the reactions indicated. Clearly the effect will then depend further on the size of the changes in rate or in the changes in progression, etc., applied. Our provisional impression is that a higher degree of progression than that existing in this country shortly before the war or corresponding changes in other taxes would have a beneficial effect. It should be accompanied by rates which are stable over time.

Although a certain degree of stabilization of production may be achieved in this way, it is not possible to achieve complete stabilization by tax policy only; despite a high degree of progression, total expenditure in a boom will always remain higher than in a depression; only a further quantitative study can determine by how much.