HUMAN ACTION

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PART SIX

THE HAMPERED MARKET ECONOMY

Chapter XXVIII. INTERFERENCE BY TAXATION

1. The Neutral Tax

To keep the social apparatus of coercion and compulsion running requires expenditure of labor and commodities. Under a liberal system of government these expenditures are small compared with the sum of the individuals' incomes. The more the government expands the sphere of its activities, the more its budget increases.

If the government itself owns and operates plants, farms, forests, and mines, it might consider covering a part or the whole of its financial needs from interest and profit earned. But government operation of business enterprises as a rule is so inefficient that it results in losses rather than in profits. Governments must resort to taxation, i.e., they must raise revenues by forcing the subjects to surrender a part of their wealth or income.

A neutral mode of taxation is conceivable that would not divert the operation of the market from the lines in which it would develop in the absence of any taxation. However, the vast literature on problems of taxation as well as the policies of governments have hardly ever given thought to the problem of the *neutral* tax. They have been more eager to find the *just* tax.

The neutral tax would affect the conditions of the citizens only to the extent required by the fact that a part of the labor and material goods available is absorbed by the government apparatus. In the imaginary construction of the evenly rotating economy the treasury continually levies taxes and spends the whole amount raised, neither more nor less, for defraying the costs incurred by the activities of the government's officers. A part of each citizen's income is spent for public expenditure. If we assume that in such an evenly rotating economy there prevails perfect income equality in such a way that every household's income is proportional to the number of its members, both a head tax and a proportional income tax would be neutral taxes. Under these assumptions there would be no difference between them. A part of each citizen's income would be absorbed by public expenditure, and no secondary effects of taxation would emerge.

The changing economy is entirely different from this imaginary construction of an evenly rotating economy with income equality. Continuous change and the inequality of wealth and income are essential and necessary features of the changing market economy, the only real and working system of the market economy. In the frame of such a system no tax can be neutral. The very idea of a neutral tax is as unrealizable as that of neutral money. But, of course, the reasons for this inescapable non-neutrality are different in the case of taxes from what they are in the case of money.

A head tax that taxes every citizen equally and uniformly without any regard to the size of his income and wealth, falls more heavily upon those with more moderate means than upon those with more ample means. It restricts the production of the articles consumed by the masses more sharply than that of the articles mainly consumed by the wealthier citizens. On the other hand, it tends to curtail saving and capital accumulation less than a more burdensome taxation of the wealthier citizens does. It does not slow down the tendency toward a drop in the marginal productivity of capital goods as against the marginal productivity of labor to the same extent as does taxation discriminating against those with higher income and wealth, and consequently it does not to the same extent retard the tendency toward a rise in wage rates.

The actual fiscal policies of all countries are today exclusively guided by the idea that taxes should be apportioned according to each citizen's "ability to pay." In the considerations which finally resulted in the general acceptance of the ability-to-pay principle there was some dim conception that taxing the well-to-do more heavily than those with moderate means renders a tax somewhat more neutral. However this may be, it is certain that any reference to tax neutrality was very soon entirely discarded. The ability-to-pay principle has been raised to the dignity of a postulate of social justice. As people see it today, the fiscal and budgetary objectives of taxation are of secondary importance only. The primary function of taxation is to reform social conditions according to justice. From this point of view, a tax appears as the more satisfactory the less neutral it is and the more it serves as a device for diverting production and consumption from those lines into which the unhampered market would have directed them.

2. The Total Tax

The idea of social justice implied in the ability-to-pay principle is that of perfect financial equality of all citizens. As long as any inequality of income and wealth remains it can as plausibly be argued that these larger incomes and fortunes, however small their absolute amount, indicate some excess of ability to be levied upon, as it can be argued that any existing inequalities of income and wealth indicate differences in ability. The only logical stopping place of the ability-to-pay doctrine is at the complete equalization of incomes and wealth by confiscation of all incomes and fortunes above the lowest amount in the hands of anyone[1].

The notion of the total tax is the antithesis of the notion of the neutral tax. The total tax completely taxes away--confiscates--all incomes and estates. Then the government, out of the community chest thus filled, gives to everybody an allowance for defraying the costs of his sustenance. Or, what comes to the same thing, the government in taxing leaves free that amount which it considers everybody's fair share and completes the shares of those who have less up to the amount of their fair share.

The idea of the total tax cannot be thought out to its ultimate logical consequences. If the entrepreneurs and capitalists do not derive any personal benefit or damage from their utilization of the means of production, they become indifferent with regard to the choice between various modes of conduct. Their social function fades away, and they become disinterested irresponsible administrators of public property. They are no longer bound to

[1] Cf. Harley Lutz, *Guideposts to a Free Economy* (New York, 1945). p. 76.

adjust production to the wishes of the consumers. If only the income is taxed away while the capital stock itself is left free, an incentive is offered to the owners to consume parts of their and thus to hurt the interests of everyone. A total income tax would be a very inept means for the transformation of capitalism into socialism. If the total tax affects wealth no less than income, it is no longer a tax, i.e., a device for collecting government revenue within a market economy. It becomes a measure for the transition to socialism. As soon as it is consummated, socialism has been substituted for capitalism.

Even when looked upon as a method for the realization of socialism, the total tax is disputable. Some socialists launched plans for a prosocialist tax reform. They recommended either a 100 per cent estate and gift tax or taxing away totally the rent of land or all unearned income--i.e., in the socialist terminology, all revenue not derived from manual labor performed. The examination of these projects is superfluous. It is enough to know that they are utterly incompatible with the preservation of the market economy.

3. Fiscal and Nonfiscal Objectives of Taxation

The fiscal and nonfiscal objectives of taxation do not agree with one another.

Consider, for instance, excise duties on liquor. If one considers them as a source of government revenue, the more they yield the better they appear. Of course, as the duty must enhance the price of the beverage, it restricts sales and consumption. It is necessary to find out by testing under what rate of duty the yield becomes highest. But if one looks at liquor taxes as a means of reducing the consumption of liquor as much as possible, the rate is better the higher it is. Pushed beyond a certain limit, the tax makes consumption drop considerably, and also the revenue concomitantly. If the tax fully attains its nonfiscal objective of weaning people entirely from drinking alcoholic beverages, the revenue is zero. It no longer serves any fiscal purpose: its effects are merely prohibitive. The same is valid not only with regard to all kinds of indirect taxation but no less for direct taxation. Discriminating taxes levied upon corporations and big business would, if raised above a certain limit, result in the total disappearance of corporations and big business. Capital levies, inheritance and estate taxes, and income taxes are similarly self-defeating if carried to extremes.

There is no solution for the irreconcilable conflict between the fiscal and the nonfiscal ends of taxation. The power to tax involves, as Chief Justice Marshall pertinently observed, the power to destroy. This power can be used for the destruction of the market economy, and it is the firm resolution of many governments and parties to use it for this purpose. With the substitution of socialism for capitalism, the dualism of the coexistence of two distinct spheres of action disappears. The government swallows the whole orbit of the individual's autonomous actions and becomes totalitarian. It no longer depends for its financial support on the means exacted from the citizens. There is no longer any such thing as a separation of public funds and private funds.

Taxation is a matter of the market economy. It is one of the characteristic features of the market economy that the government does not interfere with the market phenomena and that its technical apparatus is so small that its maintenance absorbs only a modest fraction of the total sum of the individual citizens' incomes. Then taxes are an appropriate vehicle for providing the funds needed by the government. They are appropriate because they are low and do not perceptibly disarrange production and consumption. If taxes grow beyond a oderate limit, they cease to be taxes and turn into devices for the destruction of the market economy.

This metamorphosis of taxes into weapons of destruction is the mark of present-day public finance. We do not deal with the quite arbitrary value judgments concerning the problems of whether heavy taxation is a curse of a benefit and whether the expenditures financed by the tax yield are or are not wise and beneficial[2]. What matters is that the heavier taxation becomes, the less compatible it is with the preservation of the market economy. There is no need to raise the question of whether or not it is true that "no country was ever yet ruined by large expenditures of money by the public and for the public."[3] It cannot be denied that the market economy can be ruined by large public expenditures and that it is the intention of many people to ruin it in this way.

Businessmen complain about the oppressiveness of heavy taxes. Statesmen are alarmed about the danger of "eating the seedcorn." Yet, the true crux of the taxation issue is to be seen in the paradox that the more taxes increase, the more they undermine the market economy and concomitantly the system of taxation itself. Thus the fact becomes manifest that ultimately the preservation of private property and confiscatory measures are incompatible. Every specific tax, as well as a nation's whole tax system, becomes self-defeating above a certain height of the rates.

4. The Three Classes of Tax Interventionism

The various methods of taxation which can be used for the regulation of the economy--i.e., as instruments of an interventionist policy--can be classified in three groups:

1. The tax aims at totally suppressing or at restricting the production of definite commodities. It thus indirectly interferes with consumption too. It does not matter whether this end is aimed at by the imposition of special taxes or by exempting certain products from a general tax imposed upon all other products or upon those products which the consumers would have preferred in the absence of fiscal discrimination. Tax exemption is employed as an instrument of interventionism in the case of customs duties. The domestic product is not burdened by the tariff which affects only the merchandise imported from abroad. Many countries resort to tax discrimination in regulating domestic production. They try, for instance, to encourage the production of wine, a product of small or medium-size grape growers, as against the production of beer, a product of big-size breweries, by submitting beer to a more burdensome excise tax than wine.

2. The tax expropriates a part of income or wealth.

3. The tax expropriates income and wealth entirely.

We do not have to deal with the third class, as it is merely a means for the realization of socialism and as such is outside the scope of interventionism. The first class is in its effects not different from the restrictive measures dealt with in the following chapter.The second class encompasses confiscatory measures dealt with in Chapter XXXII.

[2] This is the customary method of dealing with problems of public finance. Cf., e.g., Ely Adams, Lorenz, and Young, *Outlines of Economics* (3d ed. New York, 1920), p. 702.
[3] *Ibid*.