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THE ROLE OF DIRECT AND INDIRECT TAXES IN THE FEDERAL REVENUE SYSTEM

Introduction: The Issues

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THE question of the optimum relative role of direct and indirect taxes in the federal tax structure has been a perennial one for forty years. The last year has seen revival of interest in the question, prompted in large measure by the emphasis given by the European Common Market countries to harmonization of their tax structures, by concern over United States exports, and by a continuing lag in investment spending in the country, with consequent failure of economic growth to attain the rate regarded as desirable. It is the purpose of this introductory paper to outline briefly the history of the controversy, and to state the issues as they stand at the present time.

Some Concepts

To lessen confusion and the need for detailed discussion of concepts in the papers to follow, and to lessen analysis of questions which are incidental to the main issues of the conference, a statement of the meaning to be given to certain terms and of assumptions on several key issues for purposes of the conference will be given in this section. Little is to be gained by seeking to establish definitions of direct and indirect taxes. Instead, we shall simply interpret the term "direct tax" as referring to personal and corporate income taxes and death taxes, and "indirect tax" as referring to levies upon the production or sale of commodities. The question of the classification of payroll taxes is not of major importance for the conference as a whole, and will be raised only in the Eckstein paper. The same is true of property taxation.

There are two principal categories of indirect taxes: excises, imposed upon the production or sale of particular commodities or related groups of commodities; and sales taxes, imposed upon the sale of all commodities except those specifically exempted. Since broadening of the base of the federal excise tax structure is not under serious consideration, the prime issue of concern is whether the federal government should introduce a sales tax to replace a portion of the revenue now gained from personal and corporate income taxes. There are four major possible forms of sales tax worthy of serious consideration: those imposed, respectively, upon the manufacturing level, upon the last wholesale transaction through which a commodity passes, upon the retail sale, and upon value added, either at the manufacturing level or at all stages in production and distribution. In turn, the value-added tax may take the income or consumption form, as discussed in the Eldridge paper.

It will be assumed that excises and sales taxes are borne primarily in relation to consumption expenditures through increases in the prices of consumption goods relative to factor incomes. The validity of this assumption has been subject to question over recent years,[1] but in the context of the present issue, which relates to the alternative choice of income and commodity taxes to finance a given level of government activities, the assumption would appear to be the most suitable one. It is recognized, of course, that there are exceptions to the rule of shifting, a portion of the tax undoubtedly resting on the owners of specialized resources, and upon the recipients of excess profits. The issue of shifting is considered to some extent in the Musgrave-Richman and Eldridge papers.

The Historical Development of the Sales Tax Issue

The United States federal government is one of the few major national governments that have never imposed a general sales tax.[2] Possible use of such a levy became a major issue in four periods: the Civil War, the post-World War I period, the depression years of the thirties, and World War II. In addition, there has been sporadic interest on several

[1] The criticism has taken two major forms. Earl Rolph argued that the analysis of incidence of a tax should not consider the use of the revenues, and that thus the tax brings about a decline in factor prices and is borne in the same fashion as a proportional income tax. (See "A Proposed Revision of Excise Theory," *Journal of Political Economy,* April 1952, pp. 102–117.) J. M. Buchanan, and to some extent Rolph and George Break in their more recent work, have argued that an increase in the general price level cannot be attributed to a sales tax, since such increases can result only from monetary changes, and thus a sales tax cannot be "borne by consumers." (See J. M. Buchanan, *Fiscal Theory and Political Economy,* Chapel Hill, 1960; and E. R. Rolph and George Break, *Public Finance,* New York, 1961, p. 294.) Musgrave has demonstrated that a sales tax on consumption goods is borne in relation to consumption expenditures, regardless of whether the general price level increases or factor prices fall. (See *The Theory of Public Finance,* New York, 1959, Chaps. 10, 11, 16.) A summary of the conflicting points of view is to be found in Due, "Sales Taxation and the Consumer," *American Economic Review,* December 1963, pp. 1078–1084.

[2] With the imposition of sales taxes in recent years in Sweden, Denmark, and Eire, the only countries in western Europe not imposing sales taxes are Spain and Portugal, although the British purchase tax is of restricted scope. In the Western Hemisphere, Canada, Mexico, Brazil, Chile, the Argentine, Uruguay, and some of the smaller countries use sales taxes. They are found also in Australia and New Zealand, and extensive use is made of them in India.

occasions in the last fifteen years. Currently, while the proposal is not a major political issue, it has received renewed attention in various studies of tax revision. The earlier interest in the tax warrants brief review.

CIVIL WAR

Early in the war, Congress imposed an income tax and a comprehensive system of excises, the first important internal revenues ever employed by the federal government. These were highly unpopular and not well administered, and proposals for a broad-based sales tax were made, even though sales taxation was not currently used in any country, outside of vestiges of the *alcavala* in Spain and in Latin America. In 1862 the New York Chamber of Commerce and other business groups proposed to Congress the introduction of a sales tax, and in 1864 the proposal was endorsed by the Commissioner of Internal Revenue. But the Ways and Means Committee rejected the proposals, and the House did likewise when amendments for a sales tax were offered.

THE POST-WORLD WAR I PERIOD

Not until 1920 did interest in a federal sales tax revive. During World War I, sharp increases were made in income taxes, and an excess profits tax was levied, as well as a number of excises. After the war, strong opposition to these levies developed, primarily among business groups, and a sales tax was widely proposed to allow reduction in other taxes. The movement was strengthened by the enactment in this period of sales taxes in France, Germany, Canada, and other countries. The proposals were considered in the hearings of the Ways and Means Committee and the Senate Finance Committee in 1920 and 1921. In 1921 several bills and amendments, two calling for a turnover or multiple-stage tax and one for a manufacturers' sales tax, were introduced by Senator Smoot, but all were defeated.[3]

THE DEPRESSION

A decade later, interest revived in a sales tax as a means of eliminating depression-induced federal deficits. The Hearst newspapers led the campaign for the tax, with the Canadian sales tax as the model, and the Ways and Means Committee gave serious attention to the proposal, despite initial Treasury opposition (largely based on administrative

[3] A detailed account of the 1920–22 sales tax movement is to be found in the article by K. M. Williamson, "Literature on the Sales Tax," *Quarterly Journal of Economics*, August 1921, pp. 618–633.

considerations). The committee included in the Revenue Bill a provision for a $2\frac{1}{4}$ per cent manufacturers' sales tax similar to the Canadian tax, and Secretary of the Treasury Ogden Mills (who in the early twenties had proposed a spendings tax) withdrew his opposition, but argued that the tax should be a temporary emergency measure only. However, the bill was amended on the floor of the House to strike out the sales tax provision. The Ways and Means Committee endorsement was the closest Congress has ever come to enactment of a sales tax. Except for the Townsend old-age-pension proposals, which were based upon a turnover tax, little was heard of a federal sales tax for another decade. Meanwhile, between 1932 and 1937, retail sales taxes had become important sources of state revenue.

THE WORLD WAR II PROPOSALS

With the outbreak of World War II, interest in such a tax was immediately renewed, primary support coming from business groups, and opposition from the Treasury, labor, and others. While most of the proposals favored a manufacturers' sales tax, the Treasury, after an extensive study, recommended the use of the retail form if the tax should be used.[4] Despite considerable support in Congress, the proposals did not obtain approval of the Ways and Means Committee, and a supplement to the income tax called the Victory Tax was imposed instead. For the remainder of the war, little was heard of the sales tax issue.

THE POST-WORLD WAR II PERIOD

The sales tax has received sporadic interest since 1945. While the issue has not been a major one, on the other hand it has never entirely died out. However, the emphasis has shifted over the period, both in terms of sponsorship and type of sales tax proposed, and in recent years the proposals have been influenced by European experience and a similar issue in Great Britain.

In the early fifties, spurred in part by the realization that high defense spending was not going to permit over-all tax reduction, the National Association of Manufacturers took the lead in urging a federal sales tax at the manufacturing level. The primary argument used by the NAM was the need for elimination of the discriminatory system of excises, but stress was also placed upon the need for reduction of income taxes

[4] The study was published under the title *Considerations Respecting a Federal Retail Sales Tax, Hearings* (on Revenue Revision of 1943) *of Ways and Means Committee,* 78th Congress, 1st Session, 1943, pp. 1097–1272.

because of their adverse incentive effects.[5] The greater stability of revenue (an argument which is unacceptable in terms of modern fiscal policy) and the greater ease of administration and compliance were also advanced as arguments for the tax. Bills embodying the NAM proposals were repeatedly introduced into Congress by Representative Mason (Republican, Illinois), but were pigeonholed in the Ways and Means Committee.

In the late fifties and particularly in the last three years, the source of support for increased relative reliance on indirect taxation, the nature of the arguments, and the specific types of proposals have changed in considerable measure. The Committee for Economic Development gradually came to support a federal sales tax. In the mid-fifties the CED had repeatedly expressed support for a reduction in excises, with the statement that if expenditures remained at high levels the excises should ultimately be replaced by a retail sales tax. After 1960, the CED shifted toward positive support of the introduction of a retail sales tax; note, for example, the statement in the December 1962 publication, *Reducing Tax Rates for Production and Growth* (p. 38): "The Federal government needs to raise more of its revenue from taxes on the use of income for consumption and less from taxes on the earning of income by work and investment. . . . Therefore the Federal government should have in its revenue system a general excise tax on a very broad base at a moderate rate."

Sympathy for a federal sales tax in one form or another has come from such economists as William Fellner,[6] Arnold Harberger,[7] W. J. Baumol,[8] H. M. Somers,[9] D. T. Smith,[10] and others. Continuing support has been expressed in the First National City Bank *Monthly Economic Letter*, for example, and in England by the *Economist*. Most of this recent sup-

[5] See, for example, NAM News, *Special Report, A Manufacturers Uniform Excise v. a Retail Sales Tax*, May 5, 1951; *A Tax Program for Economic Growth*, New York, NAM, 1955; and the papers by H. L. Lutz, "Place and Role of Consumption Taxes in the Federal Tax Structure," Joint Committee on the Economic Report, *Federal Tax Policy for Economic Growth and Stability*, Washington, 1955, and R. Robey, "The Relative Role of Federal Taxes," in *Tax Revision Compendium*, U.S. Congress, House of Representatives, Committee on Ways and Means, 1959, pp. 215–219.

[6] "Possibilities of Broadening the Tax Base, Reducing Tax Rates and Promoting Economic Growth," *Tax Revision Compendium*, pp. 193–200.

[7] "The Corporation Income Tax; An Empirical Appraisal," *Tax Revision Compendium*, pp. 231–248.

[8] K. Knorr and W. J. Baumol, *What Price Economic Growth?*, Englewood Cliffs, N.J., 1961.

[9] "Theoretical Framework of Sales and Use Taxation," *Proceedings of the National Tax Assoiation for 1961*, pp. 607–618.

[10] *Federal Tax Reform*, New York, 1961.

port is based upon much more careful argument than in the past and thus is much less doctrinaire. A retail sales tax or a value-added tax is favored, rather than the manufacturers' sales tax. The arguments for the proposals have been made primarily in terms of economic growth, and the support from economists of high reputation has without question been due in part to increasing emphasis on the lag in investment as the source of continuing unemployment and a slow rate of economic growth. In the last two years, concern with the United States balance of payments and its export position, together with the development of the Common Market in Europe and the stress given in Common Market countries to the significance of taxes for export, have increased support for a specific plan substantially different from the sales tax proposals of earlier years, namely, the replacement of the corporate income tax by a value-added tax. This point of view appears in the writings of Harberger and Smith, for example, and in the *Economist* proposals.

OTHER DEVELOPMENTS

Since the late twenties, the relative reliance of the federal government on indirect taxes, namely, excises, has changed very little, ranging between 12 and 18 per cent of the total tax revenue, except for the depression years, when sharp declines in income tax yields and some increases in excises raised the figure to as high as 45 per cent in 1933 (Table 1). In the decade since 1953, the percentage yield has varied only in the narrow range between 12.6 and 13.8 per cent. Except for increases made in 1950 in liquor and tobacco and motor vehicle excises for a temporary period but continued down to the present year, and later increases in the motor fuel taxes, the trend has been to reduce and eliminate excises, as a product not of any deliberate policy but of the pressures of the various industry groups on Congress. The sharpest reductions were made in 1954, when most of the excises outside of the liquor, tobacco, and motor vehicle fields were reduced in half. The excise tax on transportation of freight was eliminated in 1958 and that on passenger transport in 1962 (except on air transport). In each session of Congress there is strong pressure from various industry groups to make further changes. Further disintegration of the excise structure is almost inevitable, partly because of the lack of any logic underlying the selection of items for tax. Table 2 shows the major excises in 1963 and their revenue yield.

At the same time, state sales taxation has grown steadily; the number using the tax as of January 1, 1964, was 37, and more are certain to be

TABLE 1

FEDERAL EXCISE TAX COLLECTIONS, SELECTED YEARS, 1902-63
(million dollars)

Year	Total Tax Collections[a]	Total Excise Tax Collections	Excise Tax Collections as Percentage of Total Tax Collections
1902	513	244	47.6
1913	662	302	45.6
1922	3,371	834	24.7
1929	3,541	540	15.1
1933	1,871	839	44.8
1939	5,500	1,768	32.1
1949	40,857	7,579	18.6
1954	70,525	9,532	13.5
1955	66,895	9,211	13.8
1956	75,814	10,004	13.2
1957	80,926	10,634	13.1
1958	80,778	10,814	13.3
1959	80,746	10,760	13.3
1960	92,898	11,865	12.8
1961	95,409	12,064	12.6
1962	100,549	12,749	12.7
1963[b]	105,917	13,410	12.7

Source: Treasury Bulletin; U. S. Bureau of the Census, Governmental Finances in the United States, 1902-57.

[a]Including employment taxes.

[b]Preliminary.

added to the list. In addition, extensive use is made of the tax by the municipalities in New York State, which itself does not use the tax, and in several other states. In the 1962–63 fiscal year the tax yielded 23 per cent of the total tax revenue of the states and 31 per cent in those states using the tax in that year, with a range from 48 per cent in Illinois to 19 per cent in Louisiana. Table 3 indicates the yield of the tax by state in the 1962–63 fiscal year, the tax rates as of January 1, 1964, and the year of introduction.

The Issues

With this brief historical sketch completed, attention will be given to the major issues involved in the question of relative reliance on income

TABLE 2

MAJOR UNITED STATES FEDERAL EXCISES

Type of Excise	Rate, January 1, 1964[a]	Revenue Yields, 1962-63 Fiscal Year (million dollars)
Sumptuary		
Distilled spirits	$10.50 per gallon (proof)	2,507
Wine	$ 0.17 to $2.25 per gallon, according to alcoholic content	104
Beer	$ 9.00 per barrel (31 gallons)	831
Cigarettes	$ 0.08 per package of 20	2,011
Cigars	$ 2.50 to $20.00 per 1,000 according to selling price	50
Other tobacco products	$ 0.10 per pound	18
Slot machines	$250 per year	26
Wagers	10%	
Total, sumptuary		5,547
Luxury		
Manufacturing level[b]		
Radio, TV, etc.	10%	212
Electrical appliances	5% (air conditioners 10%)	130
Musical instruments, etc.	10%	20
Sporting goods, etc.	10% (firearms 11%)	42
Cameras, film, etc.	10% (projectors 5%)	25
Light bulbs	10%	36
Pens, etc.	10%	9
Matches	$0.02 per 1,000	4
Playing cards (stamp)	$0.13 per pack	9
Retail level		
Luggage	10%	74
Jewelry	10%	182
Furs	10%	29
Toilet preparations	10%	158
Services, etc.		
Admission and cabarets	10%	83
Club dues	20%	71
Telephone and telegraph	10%	881
Passenger transport (air)	5%	234
Safe deposit boxes	10%	7
Total, luxury		2,206
Highway		
Allocated to Highway Trust Fund		
Trucks and buses	10%	303
Truck use tax	$3.00 per 1,000 pounds	99
Gasoline and diesel fuel	$0.04 per gallon	2,610
Tires, tubes, etc.	$0.05 per pound, and others	399
Total		3,411
To general revenue		
Automobiles and parts	10% (parts 8%)	1,784
Lubricating oil	$0.06 per gallon	74
Total		1,858
Miscellaneous		
Business machines	10%	75
Stamp taxes on transfer of securities, etc.	Various	140
Total, miscellaneous		215
Other		173
Total		13,410[c]

NOTES TO TABLE 2

Source of revenue data: Treasury Bulletin.

[a]Percentage of selling price of the firms subject to tax, except where otherwise noted. There are exceptions to some of the rates listed.

[b]The highway levies (except the truck use tax), the business machines tax, and the liquor and tobacco taxes are also imposed upon the manufacturer.

[c]After adjustments for depositary receipts.

and sales taxation at the present time. There is no attempt in this paper to analyze the issues or evaluate the arguments; this task is the function of the papers which follow. The issues can be classified into several major groups, relating, respectively, to economic growth; to resource allocation, including questions of international trade; to equity considerations; to administration and compliance; and to intergovernmental fiscal relations. The significance for United States policy of the experience in Europe and elsewhere with the two forms of taxation is also an issue.

POTENTIAL ECONOMIC GROWTH

It is important to distinguish clearly between the potential and the actual paths of economic growth. The former describes the maximum possible output over time, given the changes occurring in technology; the changes in the supply and quality of resources, including labor; and the S/Y ratio, which determines the rate of capital formation possible at full employment. The actual path of growth cannot rise above the potential growth path, but will lie below it if full employment is not attained. The first major issue is the relative effect of income and sales taxation on the growth of potential output. There are several types of effects which must be considered.

1. Does the sales tax increase the percentage of national income saved at full employment by shifting a greater portion of the burden from those families which save high percentages of their incomes to those which save lower percentages and thus must absorb a larger amount of the tax from the portion of income which would otherwise be spent on consumption? This result will be attained if the use of a sales tax shifts a greater portion of the total tax burden to the lower income levels, provided that the over-all marginal propensity to save is lower in the lower income groups than in the higher ones. It is obvious that the average propensity to save is lower in the lower income groups, but it is by no means so obvious that the marginal propensity is lower. This is

TABLE 3

STATE RETAIL SALES TAXES, 1963

State	Yield, 1962-63 Fiscal Year[a] Amount (thousand dollars)	Yield, 1962-63 Fiscal Year[a] Percentage of Total Tax Revenue	Year of Introduction	Tax Rate Jan. 1, 1964 (per cent)
Illinois	548,363	50.8	1933	3 1/2[b]
Michigan	499,884	43.7	1933	4
Hawaii	56,900	42.7	1935	3 1/2[c]
Washington	231,778	42.2	1934	4
Georgia	171,965	38.9	1951	3
Arizona	78,291	37.6	1933	3[c]
Mississippi	80,391	36.3	1932	3[bc]
Kansas	84,333	35.3	1937	2 1/2
Arkansas	66,722	35.2	1934	3
Tennessee	121,266	34.4	1947	3
Utah	41,175	33.7	1933	3[b]
Kentucky	112,073	33.3	1960	3
Missouri	135,369	32.7	1934	3
Florida	191,339	32.3	1949	3
South Dakota	20,688	31.9	1933	2
California	813,310	31.8	1933	3[b]
Alabama	100,338	31.4	1937	4[b]
Pennsylvania	397,770	31.4	1956	5
Maine	30,137	30.8	1951	4
South Carolina	80,497	30.5	1951	3
Iowa	88,133	30.4	1934	2
Connecticut	101,861	30.3	1947	3 1/2
Ohio	277,459	29.9	1935	3
Nevada	19,490	29.7	1955	2
New Mexico	42,847	28.8	1934	3[c]
Wyoming	12,400	27.5	1934	2
Rhode Island	28,930	27.4	1947	3
North Dakota	17,607	25.7	1934	2 1/4
Maryland	110,664	25.4	1947	3
Colorado	57,926	25.0	1934	2
North Carolina	145,942	24.8	1933	3
West Virginia	51,231	22.7	1933	3
Oklahoma	72,379	22.5	1933	2
Louisiana	96,900	19.0	1936	2
Texas	180,489	17.3	1961	2
Wisconsin	55,440	9.2	1962	3
Indiana[d]	0	0	1963	2
Total	5,222,287	31.6[e]		

Source: U. S. Bureau of the Census, State Tax Collections in 1962 and in 1963, and Detail of State Tax Collections in 1962 and in 1963.

[a]Excludes yield from nonretail portions of the taxes; includes yield from separate levies on automobile sales and transient accommodations.

[b]Plus municipal taxes in many areas.

[c]Rate on retail sales; other rates are on certain nonretail transactions.

[d]Not in operation during 1962-63 fiscal year.

[e]Of those states using the sales tax.

an empirical question upon which studies of recent years have thrown additional light.[11]

Even if there is no significant difference in marginal propensities to consume at various income levels, however, the relative burden on families within particular income groups will vary according to the percentage of income spent on taxable items; increased use of the sales tax would presumably, from this source alone, have some net influence on the over-all propensity to save.

2. Will use of sales taxation provide greater incentive to save? The sales tax can be avoided, at least currently, if income is saved; with the income tax, no such escape is possible. The significance of this influence depends, of course, upon the relative importance of various motives for saving; for example, if saving is made for saving's sake, the tax is effectively avoided; if funds are saved for the purchase of taxable goods in the ensuing period, when the tax will still be in operation, there is merely a delay in payment of tax.[12] The basic issue is, therefore, What is the relative importance of various motives for saving, and what is the relative responsiveness of savings made for various purposes to the two forms of tax?

3. If a higher rate of saving is regarded as desirable, can this be obtained more easily by changes in the tax structure or, as suggested by Musgrave,[13] by a higher over-all level of taxes and a budget surplus?

4. What are the relative effects of the two forms of tax upon the incentives to work, to gain greater education and skill, to take more responsible positions, and to undertake the development of business enterprise? The effects of the income tax on work incentives has been analyzed at some length in recent years, and is currently the object of a study by Daniel M. Holland for the National Bureau of Economic Research. Recognition of both income and substitution effects makes it clear that the answer cannot be attained by deductive reasoning, and that further empirical evidence is needed. Much less attention has been given to the effects of sales taxes on work incentives; the usual argument is that their nonprogressive nature and the ability to escape them by saving additional income received result in less effect than income taxa-

[11] For a summary, see T. R. Beard, "Progressive Income Taxation, Income Redistribution, and the Consumption Function," *National Tax Journal*, June 1960, pp. 168–178.

[12] Note the discussion of this question in the article by M. A. Willemsen, "The Effect upon the Rate of Private Savings of a Change from a Personal Income Tax to a Personal Expenditure Tax," *National Tax Journal*, March 1961, pp. 98–103.

[13] See R. A. Musgrave, "Growth with Equity," *Proceedings of the American Economic Association for 1962*, pp. 323–333.

tion. But the answer to the question depends upon the relative reactions of persons to the two forms of taxation. It is by no means impossible that, for many taxpayers, increased cost of goods resulting from the tax may have the same effect as a tax on the income itself. This is more likely to be true in underdeveloped economies than in the United States, but the relative importance of this phenomenon in the U.S. must be explored as well.

5. What are the relative effects of the two forms of tax upon relative efficiency in production? The corporation income tax, it is argued, penalizes efficient producers since it is paid only by profitable enterprises. As a result, the tax shifts claims on resources from efficient to inefficient corporations.[14] Moreover, it exerts a bias in favor of the use of labor inputs and against the use of capital; hence, it impedes optimum input combinations. A value-added tax, on the other hand, would shift more of any given business tax burden to inefficient firms. In addition, it is neutral with respect to the choice of factor combinations in production. The significance of this argument depends, in part, upon the nature of the "marginal" firms and the source of the higher rate of profit of the "supramarginal" firms. To what extent are low profits the result of other considerations than inefficiencies, such as recent establishment of the business? To what extent are high profits the result of efficiency or of monopolistic restrictions? Whether substitution of value-added taxation for profits taxation would result in better combinations of factors in production depends on the elasticity of substitution of capital for labor. Moreover, sales taxes themselves are capable of producing changes in methods of doing business which may have serious effects on efficiency; application of tax to goods used in certain techniques of production and not to those used in others, as is typical, may alter production processes. The turnover form of sales tax is capable of producing serious distortions in production organization and methods.

EFFECTS UPON LEVEL OF EMPLOYMENT AND ACTUAL PATH OF ECONOMIC GROWTH

As noted, the economy will fail to attain the potential growth path if full employment is not realized. Failure to attain full employment, in turn, is primarily the result of inadequate total spending in the economy,

[14] Committee for Economic Development, *Tax Reduction and Tax Reform—When and How,* New York, 1957; Dan T. Smith, "Capital Formation and the Use of Capital," *Proceedings of the American Economic Association for 1962,* pp. 314–322; Martin Norr, "The Value Added Tax in France," *Report of the 1962 Conference,* Canadian Tax Foundation, pp. 243–253.

and thus is likely to be influenced more by the over-all level of government spending and revenues and the relation between these two magnitudes (and thus the budget surplus or deficit) than it is by the types of tax employed. But the issue, so far as the question under discussion is concerned, and one of the major ones in the entire direct-indirect tax controversy, is that of the relative effects which the two forms of taxation have upon total spending and thus upon the extent to which the potential rate of economic growth is actually attained in the economy. This general issue can, in turn, be broken down into several elements:

1. What are the relative influences on the volume of investment—the element in total spending which has lagged in the last five years—of a tax on the earnings from investment, on the one hand, and inadequate consumption, on the other? Or, in other words, to what extent has investment been deterred by existing income taxes on individuals and corporations? To what extent would the collection of the same amount of revenue from commodity taxes reduce investment by curtailing consumption? There are a number of elements which affect the answers to these questions: the extent to which the corporate income tax is shifted, the nature and location of investment decision making in the corporation, the portion of total investment which is sufficiently marginal to be affected by the income tax, and the propensity to consume at various income levels.

2. To what extent will a shift from income to commodity taxation reduce total consumer spending? In part, of course, the answer depends on the nature of the reduction in income taxation; if this takes the form of a change in the corporate income tax, the net effect will be different from what it will be if the personal income tax is reduced. But, as noted earlier, the effect will also depend upon the marginal propensities to consume at various income levels and among families within particular income levels.

3. To what extent will a shift from income to commodity taxation increase United States exports relative to imports? This question is discussed below.

4. To what extent do adverse investment incentive effects of the income tax result from particular features of the structure of the income tax rather than the use of the income basis of taxation as such? May it not be possible to reduce the adverse effects by changes in the income tax more easily than by introduction of a sales tax?

The interrelation of the relative effects of the two forms of tax upon the potential and actual growth paths must of course be noted. To the extent to which the shift to indirect taxation increases the potential rate of growth, it may aggravate the task of attaining the potential path. An increase in the propensity to save, while increasing the rate of capital formation possible at full employment, may bring about a reduction in total spending and thus an increased gap between the actual and potential growth paths. Whether or not this occurs will depend in large measure upon the extent to which the shift in tax, by reducing the direct burden on the gains from investment, will increase the volume of investment.

RESOURCE ALLOCATION AND INTERNATIONAL TRADE

Recently attention has been given to an issue almost ignored in earlier years: the relative effects of the two types of tax in producing undesired distortions in resource allocation, with particular emphasis on the effect of the income taxes in adversely affecting United States exports.

So far as domestic production is concerned, the issue has been raised most emphatically by Harberger,[15] who charges that income taxation, particularly the corporate tax, produces a distortion of resource allocation in favor of those lines of production, such as housing and agriculture, not significantly subject to the corporate tax. Replacement of this levy by a uniform-rate value-added tax applied to all types of business would eliminate the distortion. There are several issues involved, however. What is the quantitative significance of this distortion? Harberger attempts to provide an answer, but obvious questions can be raised about the reliability of his estimates. To what extent can the pattern of resource allocation attained in the absence of the corporate tax be regarded as the optimum? To what extent can a sales tax be devised which will in fact apply to all lines of production in a uniform fashion? No sales tax yet devised, value added or otherwise, has ever accomplished this goal, because of the difficulties, administrative and political, of reaching certain activities, and because of nonuniformity in shifting.

The foreign trade aspect is the one which has received greatest emphasis, in part because of the attention given to tax aspects of the European Common Market and the significance of these aspects for American exports in a period in which the United States is suffering from payments deficits. The French value-added tax has been accepted tentatively as the standard form of sales tax for the Common Market countries; under this form of tax, exports are exempted and the entire

[15] "The Corporation Income Tax: An Empirical Appraisal," *Tax Revision Compendium,* pp. 231–248.

amount of sales tax which has accumulated at various stages in the process of production and sale of a product is refunded at the time of export. Imports are subject to tax. Thus, it is argued, exporters sell free of any tax element. By contrast, American exporters receive no equivalent refund of tax which they pay as a result of their conduct of economic activity. This argument is presented simply and clearly in the CED's monograph, *Reducing Tax Rates for Production and Growth* (pp. 39–40):

> A major advantage of a general excise tax is that it would tend to improve the ability of the United States to compete with others in world markets. France, Germany and several other countries already have such a tax and it is likely to be adopted by still others under the policy of harmonizing taxation within the Common Market. The tax is not collected, or is rebated, on exports, so that countries having the tax are able to sell abroad at prices below the prices charged their domestic consumers. At the same time a compensating tax is levied on imports. Thus a country like the U.S. which does not have such a tax receives imports from a country that does at prices below the domestic price level of the exporting country. At the same time the prices at which we must try to sell abroad are increased by the compensating tax on exports. It will become increasingly important for the United States to equalize this situation as tariffs between us and the Common Market are reduced.

This argument would appear to be valid only to the extent to which the corporation income tax is now reflected in the prices of exported goods, or to the extent to which an indirect tax would be shifted backward. If the corporate tax is not shifted forward, the imposition of a tax which would be reflected in prices and the subsequent rebate of this tax on exports would not benefit the American export industry. If the indirect tax were not shifted forward, the price level exclusive of tax would fall, and exports would benefit in the same fashion as from devaluation of the dollar. But given institutional wage and price rigidities, backward shifting would not appear to be significant. Thus the basic issue is the old and familiar one: to what extent is the corporation income tax shifted forward? There are also other ramifications relating to exchange rates and terms of trade which will be considered in the Musgrave paper.

EQUITY CONSIDERATIONS

Traditionally, the primary argument against commodity taxation has been based on equity grounds. There are two major complaints: against regressivity in the distribution of tax burden relative to income, and against distribution within particular income levels which is not in conformity with usual standards of equity, such as the relatively heavy burden on large families compared to smaller families at a given income level.[16]

There are several issues involved in the question: To what extent is the actual burden distribution of a sales tax regressive relative to income? Empirical studies over the last decade suggest that a sales tax with food taxable is regressive, while one with food exempt is more or less proportional in most income ranges.[17]

Serious question has been raised about the appropriate basis for comparison; it has been argued that the permanent component of income, a concept developed by Milton Friedman, is a more suitable basis for comparison than actual income received during the period. If Friedman's conclusion that the percentage of permanent income saved is constant at all income levels is accepted, the sales tax will not be regressive relative to permanent income, and in fact is likely to be progressive.[18] Thus the question resolves itself into two issues:

1. The validity of the Friedman hypothesis of the constancy of the ratio of consumption to permanent income. This has been questioned in various empirical studies.

2. The relevance of the permanent-component doctrine for appraising the equity of burden distribution. Under usual standards of equity, is it preferable to tax a person on the basis of the actual income received during the year, or this figure adjusted to omit transitory components? May the positive transitory elements be regarded as even more suitable as a basis for taxation than the permanent elements? May the negative transitory elements be regarded as significantly affecting taxpaying ability?

Given the pattern of burden distribution which a sales tax produces, what significance should be attached to this pattern in the evaluation of the desirability of increased federal use of this form of tax? This is, of course, a value-judgment issue, which can be resolved only in terms of the pattern of distribution of real income which a person regards as the optimum. But there are certain aspects of the question which must not

[16] This question has been explored by Reed R. Hansen; see "An Empirical Analysis of the Retail Sales Tax with Policy Recommendations," *National Tax Journal*, March 1962, pp. 1–13.

[17] See, for example, the articles by D. G. Davies, "An Empirical Test of Sales Tax Regressivity," *Journal of Political Economy*, February 1959, pp. 72–78; and "Commodity Taxation and Equity," *Journal of Finance*, December 1961, pp. 581–590.

[18] See D. G. Davies, "Progressiveness of Sales Taxes in Relation to Various Income Bases," *American Economic Review*, December 1960, pp. 587–595; D. C. Morgan, Jr., "Reappraisal of Sales Taxation," *National Tax Journal*, March 1963, pp. 89–101.

be overlooked. One is the need for considering the pattern of distribution in terms of the federal tax structure as a whole, not of a particular tax; this raises the question of the patterns of the other taxes, which have been studied extensively by Musgrave and others. Second, the same persons are both federal and state-local taxpayers; the most meaningful picture is one which considers the combined federal-state-local pattern.

As noted above, the sales tax produces widely varying burdens among various persons within given income classes, on the basis of their circumstances—family size, age, urban or rural dweller, and so on.[19] The burden may be regarded as perverse in some instances; the larger family will spend higher percentages of income on taxable goods and thus pay more tax, whereas its taxpaying ability may be regarded as less. The significance of this perversity is a value-judgment issue.

Another equity consideration often raised is the fact that the sales tax ensures some payment from persons able to evade or avoid income tax. This is obviously true; the basic issues relate to the significance of such evasion and avoidance in reducing the equity of the income tax, and the relative suitability of the sales tax approach to the problem compared to that of improving the structure and enforcement of the income tax.

A final problem arises in connection with proposals for substituting a sales tax for the corporate income tax. Such a substitution would greatly enhance the value of the corporation as a tax shelter for individual stockholders unless provision were made for full, current taxability to the stockholder of his share in the corporation's earnings.

ADMINISTRATIVE AND COMPLIANCE CONSIDERATIONS

An argument which has frequently been advanced for a sales tax is the relatively greater ease of administration and lessened problems of taxpayer compliance. The validity of this argument in the context of a federal sales tax is open to serious question, since the issue is not that of replacement of the income tax by a sales tax, but increased relative reliance on commodity taxation. The issues therefore center around the question of the relative administrative costs and effectiveness of the two programs: the present system, and one which includes a sales tax. It is difficult to argue that the latter would be less expensive for a given degree of effectiveness in enforcement. The precise answer depends on several considerations:

1. If a federal sales tax were introduced, would the exemption figure

[19] See Hansen, "An Empirical Analysis."

of the income tax be raised? This would reduce both enforcement and compliance costs to a much greater extent than a lowering of income tax rates without a change in the number of taxpayers.

2. What form would a federal sales tax take? From a cost-of-collection standpoint, clearly the manufacturers' sales tax, on the Canadian pattern, is the most inexpensive, and a value-added tax confined to the manufacturing sector would be comparable. But in many respects, which have been widely discussed in the literature, the retail sales tax, or a value-added tax extended through the retail level, is a much more satisfactory form of levy. The collection costs would, however, be somewhat higher. State experience suggests that with a 3 per cent tax rate, effective collection requires administrative expenditures of roughly 1.75 per cent of revenues.[20] Since the expenditures would not be significantly greater with higher rates, a 10 per cent tax would require a collection expenditure equal to perhaps .7 per cent. The collection costs of the 11 per cent Canadian manufacturers' sales tax is .37 per cent.[21]

INTERGOVERNMENTAL FISCAL RELATIONS

Another major issue is the significance of the introduction of a federal sales tax for federal-state fiscal relations. As noted, the sales tax has become the major source of state revenue, with a definite upward trend in the number of states using the tax, in rates, and in the coverage of the taxes. There are several major issues:

1. Would federal use of the tax retard further state usage; if so, where would the states turn in their quest for needed funds? It can be argued that state-local functions are now less adequately financed than federal functions, and that a federal sales tax would aggravate the situation. The net result might easily be an increased program of federal grants to the states, a trend to which there are obvious objections.

2. If state usage was not retarded, would the combined federal-state sales tax burden be regarded as unreasonable, even if the federal tax in itself was regarded as acceptable?

3. Would there be less interference with state use of the tax if the federal government levied its tax at the manufacturing level? This is the argument long advanced by the National Association of Manufacturers in its defense of the choice of the manufacturing level for the tax.

[20] J. F. Due, *State Sales Tax Administration*, Chicago, 1963.

[21] Information supplied by Canada, Department of National Revenue, September 1963.

Or would this only complicate matters by creating two different types of sales taxes? In Canada, where the provinces tax at the retail level and the federal government at the manufacturing level, increased support has been developing for coordinating these two sets of taxes into a single levy at the retail level.

4. Would federal intervention in the field facilitate state enforcement of taxation on interstate transactions? This development is possible if the federal government should use the retail form of tax. The change would improve administration, but might lessen the tax autonomy of the states. The equity, administrative, and intergovernmental issues are considered in the Eldridge paper.

EUROPEAN EXPERIENCE

The argument has been raised that the countries of western Europe have expanded more rapidly than the United States in the last decade and have experienced less unemployment because of the greater relative reliance on indirect taxes.[22] Thus, it is argued, a major step necessary for more rapid growth in this country is the revision of the tax system in the direction of greater reliance on indirect taxation. This point of view has been repeatedly expressed in the First National City Bank *Monthly Economic Letter*, and is stated in moderate form in the Committee for Economic Development's *Reducing Tax Rates for Production and Growth.* This point is regarded as of sufficient importance to warrant extensive analysis, the results of which appear in the Eckstein paper. There are several major issues:

1. What have been the relative growth rates in western Europe and the United States? What has been the relative growth in the United States and such countries as Canada which have similar economic conditions but rely more heavily on indirect taxes than the United States?

2. What is the actual relative reliance on the two forms of taxes in the various countries? The answer to this question is not as easy to find as it might appear to be. There are questions about the inclusion in the totals of various social security levies and the classification of property, payroll, and other taxes. There is a tendency to make the comparison only in terms of national government taxes; would a comparison includ-

[22] Descriptions of European sales tax systems are to be found in the paper by Clara Sullivan, "Sales Taxes in the European Economic Community and Some Important Issues Involved in their Harmonization," *Report of the 1962 Conference, Canadian Tax Foundation*, pp. 254–265; in J. F. Due, *Sales Taxation*, Urbana, Ill., 1957; and in OEEC, *The Influence of Sales Taxes on Productivity*, Paris, 1958.

ing all levels of government not be more appropriate? This basis encounters the difficulty of varying tax structures of the subordinate levels within a country.

3. Is not the significant question the relative burden of the two forms of taxes in the various countries, rather than the percentage reliance on each form? A country might rely exclusively on income taxes, but employ much lower rates than those used in countries in which, despite extensive reliance on indirect taxes, high government expenditures relative to national income necessitate high rates.

The tasks of comparing relative burdens of particular taxes among countries are themselves very serious. Mere comparison of tax rates alone is misleading, since differences in coverage, exemptions, special concessions, administrative effectiveness, and the like are significant but difficult to measure in quantitative terms.

4. Do not the patterns of public expenditures and the general attitude of the public toward the government, the tax structure, the effectiveness of tax administration, and other factors have significant but unmeasurable influences on the relative effects of the various tax structures on economic development?

5. To what extent can differences in the rates of economic growth be attributed to tax differences, rather than to other factors? Will not a country-by-country comparison be more revealing than a general comparison between the United States and western Europe or the Common Market countries as a group?

OTHER ISSUES

There are a few other issues which are now regarded as being of minor significance. At one time the supporters of indirect taxation made extensive use of the stability-of-revenue argument: the yield of indirect taxes falls less rapidly in depressions than the yield of direct taxes. There are two questions to be raised: (1) What is the actual difference in the two patterns of behavior?[23] (2) To what extent is stability of revenue over periods of fluctuating national income desirable? In terms of modern fiscal analysis, stability is an undesirable characteristic.

Another issue is tax-consciousness: the desirability that taxpayers be aware of the tax burden which they are bearing. Awareness is maintained with the retail type of tax or the value-added tax extended through the

[23] For a recent empirical study, see the article by D. G. Davies, "The Sensitivity of Consumption Taxes to Fluctuations in Income," *National Tax Journal*, September 1962, pp. 281–290.

retail level; it is lost with the manufacturing or wholesale sales taxes, since the tax cannot be kept separate from the prices of the products with these forms of tax. But the basic issue is the importance to be attached to the tax-consciousness argument.

A third consideration is the argument that indirect taxes, particularly general sales taxes, make all persons contribute to government, whereas the usual income taxes do not. This argument can be debated on both equity grounds and those relating to the attainment of optimum levels of government expenditures. Should all persons be made to pay some taxes, in order to keep them aware of the real costs of governmental services? Are such payments at the state and local level not sufficient to accomplish this purpose? Is the fact that low-income groups are almost certain to experience a net gain from governmental activities anyway, even if they must pay some tax, an effective answer to this argument?

Conclusion

This statement of issues serves to emphasize one well-recognized aspect of the controversy over increased federal reliance on indirect taxation: there can be no scientific answer to the question. The resolution of many of the particular issues must be based upon value judgments and upon inadequate evidence about economic effects of the various taxes. Furthermore, value judgments rather than scientific analysis must serve as the basis for weighing the relative importance of various conflicting considerations so far as the major issues are concerned: equity versus economic effects, for example. But it is hoped that the papers prepared on various aspects of the problem and the discussion of them may aid in the reaching of more intelligent judgments on the question. The conference, therefore, should aid in the clarification of the issues and thereby contribute to public policy formulation in this area.