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By C. LOWELL HARRISS*

Taxes are one of the necessary restrictions on the freedom of business, or anyone else, in an enterprise economy. Taxes also curb freedom in a socialist economy as Britain and a good many other countries have learned. Yet the restrictions that taxes will impose can be more or less, and they can be of many different kinds. The public must make choices about the extent and the nature of these tax limitations on freedom. The choices will be made by default if they are not made deliberately. The decisions involved have become increasingly important as tax rates have gone higher and higher; in making these decisions, one major consideration must be the effects of taxes on free enterprise. Although there are many other important considerations, I shall deal with this one particular part of the problem. Yet this is a part which has so many facets that one can do little more than suggest and illustrate.

What Is Free Enterprise?

One of the first problems is the meaning of "free enterprise." The term is not easily defined. I think there is considerable lack of agreement about what are the essential elements of such a system. Many freedoms, it seems to me, are needed if a system is to be one of free enterprise—especially if it is to function efficiently and vigorously. It is easy for each of us to overestimate the relative importance of a few freedoms. Generally, however, we mean absence of *governmental* re-

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straints, either (a) prohibitions or (b) compulsions to act, on such matters as what to produce, where, how, when; on prices, investment, the use of earnings. The direct bearing of taxes on these aspects of business varies, but on most of them is not great. But I shall say more on this later.

Freedom of enterprise, however, and freedom more generally—means not only freedom *from* things but freedom *for*, in the sense of opportunity. Discussions of free enterprise sometimes slight the more positive aspect of freedom as the range and variety of opportunities for business. (I should argue, for example, that a highly regulated public utility can, and usually does, have many kinds of freedom.) There is still another aspect of a free enterprise economy: there are some freedoms we do not include—certainly freedom to combine to limit the freedom of others (except within certain prescribed rules). Nor do we mean freedom from the restrictions of the market, from competition. Taxes, of course, are bound to affect markets, and relative freedoms in markets, but some tax structures will affect relative market positions more than others. The best structure, in my opinion, will be one that is neutral except for differences made openly, rationally, and reexamined frequently.

Role of Taxation in Raising Revenue

The major role of taxation in a free enterprise economy is to get money to finance government spending—to get *enough* money. "Adequacy" of government spending is difficult to define, if only because of the highly intangible nature of the benefits of many kinds of government services. Yet nowadays "enough" spending is a lot. Much of it is necessary for business. Many freedoms of enterprise are based upon government spending. The range of business choices depends partly upon governmental expenditures financed by taxes. Let me illustrate.

Transportation is one example. Transportation opens markets and thereby facilitates specialization, more refined division of labor. Transportation enlarges the area of competition, the area of opportunity for both individuals and businesses. Government, using some of our tax money, plays a vital part in providing transportation. Yet it does not have to play the whole part. We need not get all of our transportation facilities through tax-financed expenditures. One can cite the railroads as an important exception. Taxation in itself—without regard to government spending—has a part to play in deciding how much of our total transportation will be provided through government and how much privately. Here is a case in which the public can use taxation as an allocative device, i.e., to affect the pattern of resource use. Lower taxes on railroads and other private facilities and higher taxes for use of government facilities will affect the total balance. Discrimination in the way taxes are imposed can help. I have just suggested to a New York commission that the graduation for automobile license charges be according to the length of the car rather than horsepower, weight, or value. My reasoning is that today space is the limiting factor on streets and highways and that tax incentives to take up less space will tend to induce economy in use of the scarcest resource. Solution—mitigation is perhaps all we can hope for—of the problems of urban congestion, now a real impediment to freedom and enterprise, will depend upon government expenditure and taxation, the way taxes are imposed to pay for the spending.

Let's look at another example of tax-financed expenditure that affects the range of free enterprise. What a business can do depends upon the people it can employ and whom it serves; their education makes a big difference. The extent, quality, and kind of education in this country depend largely upon government spending. We must raise funds primarily by taxation to finance education; the more we raise, and the better we do it, the greater our opportunities. In this case taxes finance spending which gives a positive contribution to, a positive enlargement of, certain important freedoms. Or we may look at a much narrower area of education, one which affects free enterprise very directly—the provision of information for business on markets and all that is bound up with the census. Knowledge is power. It expands opportunity. And government, relying on tax funds, has a constructive role to play.

Still another example of government spending that influences business freedom will be found in police and courts, the simple but crucial protective agencies of government, financed by tax funds. There is more true freedom, and more scope for enterprise, if protective functions are performed extensively and efficiently. This costs money, but money well spent.

Now, as we focus on the restrictive aspects of taxation—as is natural in a tax conference—we inevitably slight spending for which taxes are imposed. Yet at least a good deal of the spending is to preserve and enlarge freedoms for business and other aspects of life. I trust that my illustrations have helped make this point.

Taxation and Economic Stabilization

Unquestionably, to get the amounts we now need for even a low level of government expenditure we must have taxes which are bound to be very burdensome. This brings me to a second role of taxation in an enterprise economy—or in any economy—to help regulate the level of economic activity (the volume of employment) and the level of prices. With taxes at the levels of the modern world the way we raise them, and the way we spend the money, will influence significantly the broad levels of economic activity and prices. This function, one that has in a sense been thrust upon us, is relatively new. In two decades a new dimension has been added to thinking about taxes and their role in an enterprise economy. General economic stability is desirable for many reasons, but one of the most important is that it helps make for healthy enterprise over the long run. Both depressions and spurts of inflation are bad for business.

Taxes have a big part to play in securing healthy stability. Yet, I ask, "Have we not been asking too much of our tax system, at least in preventing inflation?" Mr. Paul commented on the problem this morning. He and Dr. Blough worked skillfully and tirelessly during World War II to try to show the country the wisdom of using taxes for helping prevent inflation. In such circumstances we could not overemphasize the importance of taxes. In conditions as they have existed since the war, however, the conclusion might very well be different. For several years, I think, we have been expecting too much of the Federal tax system as a device for stabilizing the economy at full employment. Until 1951 officialdom focused on the Federal budget as the key to financial stability, to the virtual desregard of monetary policy. I say virtual because some people did emphasize monetary policy, quite a few economists in fact. Today there is no doubt that we can have inflation with a cash surplus in the Federal budget; we did in two or three post-war years. On the other hand we can run a Federal cash deficit year after year without inflation, depending upon monetary policy and other elements in the economic picture. Taxes and the state of the budget are important, but *not* all-important! This range of problems of the role of taxation as a stabilization device is much more complex than often appears in the discussion. We must not try to eliminate these problems from considerations of tax policy. Yet it is easy, at least for some of us, to exaggerate their importance.

A reasonable conclusion might be this: The "proper" use of taxation at the national level can be a positive device for stability; it can make a decisive contribution to economic well being. On the other hand, like any big and powerful instrument, it can be used wrongly and do great damage. Generally, however, our knowledge of what is wise and proper use is inadequate. Today, at least, we should not overlook the complexities involved in this aspect of tax policy. Nor should we overlook the importance of monetary policy and expect taxation to do the whole stabilization job—which it cannot do.

Since our topic is the role of taxation, and since the word "role" has different meanings, I now take the liberty of looking at aspects of rather different kinds of "role" than the two I have just discussed. We now face points which involve choices that are more specific and much more varied. All deal with relations to free enterprise in the world of *high* tax rates.

Taxes as Direct Impositions on Business

One problem this country should face more frankly and clearly is this: "How much is it wise to tax the process of *creating* income, i.e., business, rather than the results, the income created, or the use, spending"? It is not easy, of course, to draw a line and say that *this* is a tax on creation of income while *that* is a tax on income after it has been created or on the spending or use of income. Nevertheless, we can make some useful distinctions.

In doing so, it is wise to keep in mind one characteristic of taxes, a fact that makes us try to treat taxes differently from other outlays. Although the public may get good value for the spending of tax money, the individual business will usually get just as much governmental service whether or not it pays a particular tax. This, I think, is the rule rather than the exception. There is no *quid pro quo* for the individual firm. The manager's inducement to try to reduce taxes, therefore, is different from his inducement to try to reduce labor, raw material, or similar costs. Two contrasting varieties of freedom are involved in the freedom to economize on taxes and that to economize on labor or materials. Moreover, the amount of government services required, or provided, will depend little on these specific business decisions.

In general, it seems to me, the more that taxes enter the decision making process of business, the more likely we are to have distortions and less good utilization of resources than if taxes were not part of this process. Essentially irrelevant considerations come into the making of decisions about the use of resources. The freedom for the best use of normal business judgment is reduced somewhat. The amount and type of enterprise—I speak in the very broadest sense—is bound to be affected. The identity under these conditions of business and public interest in the efficient use of resources is destroyed somewhat. The economizing incentives and motives are changed.

Another aspect of this problem of focusing our "tax take" on the business income generating process, rather than on the results of that process, involves incentives. High taxes can certainly have an adverse effect upon incentives. This, of course, is a subject about which much can and should be said. Yet, even though Dr. Blough cut out his proposed remarks on the subject today, I shall not try to fill in on that score—except to say this: By and large, taxes that focus on business, cannot help incentives to operate most constructively and vigorously. Whatever the effects, large or small, they will be in the wrong direction. It is a little like throwing sand in the gears of a machine to tax business, the income-generating agency of society (except where the purpose is to induce business to use, directly or indirectly, fewer government services).

Mr. Paul pointed out that we have never had such prosperity as since the war, just when tax rates have been extremely high. This is quite true. Nevertheless, it is easy to be complacent, overly complacent, about this experience. There has been in the post-war period a tremendous pent-up demand. It has been accentuated by such things as the growth of population and the basically inflationary forces stemming from war and post-war monetary policy plus "easy" financing which helps explain at least some of the activity in construction. We can take much comfort from the fact that business has maintained a very high level of activity, real vigor, in years of high tax rates—but we should not be confident that recent experience shows there is no danger.

There has been an expansion of tax-motivated distortions of the economic process. Real deterrents to efficient enterprise are not inconceivable. Not everyone will agree with me about the long-run prospect. Others, agreeing, may still ask, "What can we do about it? What are the alternatives?" Later I shall propose one specific alternative. Generally, however, I should say that as far as enterprise is concerned we shall be better off to choose taxes that rely on income in ways that have the minimum influence on making the decisions to produce that income. It is impossible, of course, to have a personal income tax that is not in a sense a business tax because unincorporated firms cannot be distinguished clearly from their owner's personal affairs. Nor is there any prospect of abandoning taxation of corporations. The practical question is one of degree and amount. My serious plea—only partly because I believe in free enterprise—is for more restraint and moderation in taxing business.

Effects of Taxation on Capital Formation

Another aspect of the role of taxation in a free enterprise economy is the effect on capital accumulation and investment. Let me deal with just one phase of this problem. Business growth and development ordinarily require investment. And certainly one of the basic freedoms of a free enterprise system is the freedom of investment, especially the freedom of entry into an industry (or expansion). This is crucial. More, perhaps, than any other economic freedom, freedom of entry will help assure enterprise. The more fully it exists, the less we need to worry about monopoly and general restrictive devices that are the antithesis of free enterprise. In the modern world the new producer often needs a great deal of capital; yet our present system of taxation obviously hampers the accumulation of capital, especially by the relatively new and growing business, the one which normally grows by reinvestment of earnings. The established firm certainly has an advantage.

Here again, however, judging by post-war experience, things do not seem so bad as one might have predicted. Part of the explanation is the fact that within the tax structure there have been some partial remedies or preventives. Loss deductions, for example, are much more reasonable than they used to be. Highly favorable treatment of capital gains and in some cases generous depreciation have eased the difficulties. (The more generous provisions of the 1954 Act for handling depreciation will aid the growing firm still more.) Moreover, outside the tax field there has been development of new methods of financing which help meet the problem.

Year after year we have had large net accumulation of capital (despite high taxes). There has been extensive investment in business as well as in housing. New firms have been established and have grown even though less luxuriantly, perhaps, than some of the enterprising owners might have wished. (Fortunately, our position is vastly better than that of many under-developed areas where very high tax rate might be much more of a threat to capital accumulation.) It appears, therefore, that capital accumulation and the investment "needed for" an enterprise system exist despite taxes that a generation ago would have seemed impossibly stifling and repressive. Yet we may not have as much as would be best in some sense. Moreover, weaknesses exist, especially at the point of new and growing business. Proposals for trying to meet this problem raise other problems of equity and fairness, the things Dr. Blough spoke about this morning. Personally, I think we should try for improvement in this respect because taxation's role might be made to fit better into the long-run needs of an enterprise economy.

Molding of Specific Business and Personal Affairs

Turning from the broader problems, let us look at a few situations in which taxation has a powerful influence in channeling business activity. High taxes in a sense impose generally heavy impediments to an economic system; in order to get anywhere, we must jump a tax hurdle, a high one. This is bad—many of us have a hard job getting over, and some cannot make the jump. Therefore, we begin to make exceptions, ways to lower the burden for some people and perhaps eliminate it in certain other cases. These exceptions may seem, then, to enlarge the freedom of particular businesses or individuals. In this sense the tax system can be converted into an instrument of freedom—make taxes bad enough, then ease them a little.

As a result of both accident and deliberate design, our tax system now has many such devices. They both create and distort opportunities. In a sense all businesses are not equally free because in practice these special provisions are not open to all on the same basis. A useful purpose is sometimes served by these "exceptions." An example at the local level will illustrate. It seems logical where housing shortage is a serious problem to give real estate tax reductions to firms that will meet certain conditions in providing new dwellings. A chain of reactions will likely result, including the housing that is desired. The fellow who must collect real estate taxes out of rents, however, not only faces a bit harder competition, but may also have to carry a higher tax load than if no one were exempt.

Special tax favors have proved extremely difficult to deal with under our system of legislation. It is another version of the old lesson of tariff history—vested interests combine effectively to protect their favors. I cite four examples. One is a problem where tax rates are high—percentage depletion. For a generation or so Congress has provided and extended allowances for particular types of economic activity. The freedom of some enterprises has been enlarged. Others must have been hurt. The results certainly include price and investment structures that are at least somewhat different from those that would exist in a system of more tax equality.

My second example is of a case involving a very low tax rate, the three percent on freight transportation. I used to assume that a three percent rate is too small to make much difference. A leading transportation economist, however, says I am completely wrong. Firms can escape tax by providing their own trucks. Consequently, private carrier operations have expanded tremendously until about half the trucks on the highways are private, rather than contract, carriers. (One cannot set up a private railroad to do a comparable job.) Some shift away from railroads and on to not-undercrowded highways has resulted. The pattern of economic activity has changed, and certainly not in ways deliberately planned by those who framed the tax laws.

A third example may be still less important, but it illustrates how taxes may affect business. The tax on fur garments was imposed during the war for particular reasons. The war ended and with it the reasons for the tax. Yet as a practical manner Congress could do nothing. The fur industry has had considerable difficulty for a good many years. The adverse tax differential was not the only reason, but it was one. It certainly impeded the industry's freedom and scope for enterprise—by accident not reasoned desire.

The fourth example I cite is the problem of differentials among communities. State and local finance sometimes lead to difference in patterns and levels of taxes which may seem important enough to induce individuals and businesses to change their activities, to do things differently from the way they would otherwise. In a decentralized system such as ours we cannot escape this sort of thing, but we must take it into account in studying taxation and the effect of taxes on enterprise. Incidentally, it is one about which we ought to know more.

The last group of things that I want to mention are those molding both business and personal decisions. Even though "free enterprise" is rarely interpreted to include the individual who is not in business for himself, I think we can legitimately consider some problems that arise. They are consequences of taxes, whether or not they have been designed as such. One example involves pensions. Tax favors provided pensions since 1940 have certainly encouraged the growth of pension plans. Personnel and investment policies of businesses, savings and other personal affairs of individuals, and the economy as a whole have been changed. The relatively favorable tax treatment has molded activity widely. Today it is almost imperative that a plan qualify for favorable tax treatment. Consequently, Congress, in deciding on what a plan must contain to qualify, can affect tremendously the nature of pension systems throughout private enterprise. For example, it might be possible now to enlarge freedom by Congressional requirement that qualified pension plans must give vested benefits. Individuals would be freer to move to other employers.

Or we can look at one effect of taxes on business finance—the choice between equity and debt financing. This problem, relatively unimportant when tax rates were low, has grown. The law puts a very substantial premium on debt finance and leasing. I am certainly not able to appraise the effects on business activity and finance. As a general matter, however, debt creates inflexibilities which can certainly cause trouble in a changing economy. We give businesses freedom to escape taxes on that part of the earnings of an enterprise available for those who provide capital in one way and deny it in others. Our tax system is far from neutral in this respect.

Another example also involves corporation decisions on earnings. I am inclined to argue that one element of a truly free enterprise system is that the owner of a business shall be free to decide how the earnings from his property are to be used. If I am right, could we not expand the area of freedom by a tax which would stimulate the distribution of business earnings? Corporation officials might not like the idea, but many stockholders would. Here is a power which the people who frame tax laws can exercise if they want. Yet some vocal champions of free enterprise might object on the grounds that the interests of the firm (enterprise) should take precedence over the freedom of the owners.

Finally, among these more specific cases of molding individual or business decisions, I call attention to death and gift tax provisions which create vast advantages in using a few types of property disposition in making certain kinds of arrangements about the use of property. The pattern of behavior of individuals with even modest fortunes is certain to be affected, assuming taxpayer intelligence. Tax laws modify personal affairs significantly. Some results may spread through the economy generally—growing trustification of wealth, for example. Other effects may be relatively small except for the property owner. Yet as far as he is concerned, his freedom in decision making is modified substantially by details of the tax law.

Conclusion

I hope I have said enough—and if I haven't others have—to indicate that the role of taxation is indeed very complex. It has become more so as the realities of the modern world have modified the major positive job of taxation, that of raising revenue. A host of indirect and often incidental results appear. Many affect profoundly the conditions under which businesses must operate and individuals carry on their more personal economic affairs. My illustrations have ranged from major issues of general prosperity to relatively minor issues of personal finance and the health of a small industry.

The details of tax laws can be framed consciously to produce results that seem to enlarge the scope of free enterprise, certainly to modify its operations. I have yielded only once, I believe, to the temptation to suggest changes. I wish to close, however, with a comment on a basic issue.

Many of the problems of taxation arise from the height of tax rates. A reduction in tax rates would reduce the seriousness of most of these problems. It seems to me, unfortunately, that there is little hope that economies in government expenditure will permit substantial rate reductions (unless, as seems most improbable, all reductions feasible are concentrated on top brackets). Certainly, as far as state and local governments are concerned, the dominant need is for more, rather than less, revenue despite all efforts at economy.

Happily, however, our hopes for tax rate reduction need not rest entirely on economies in government expenditure. There is another possibility—enlarging the tax base. If the definition of taxable income (or estate or payroll) were broadened, or the list of taxed commodities expanded, the revenue could be obtained with lower rates. To me, such base-broadening seems to be wise as a general objective.

At the national level, however, post-war policy has moved in just the opposite direction. There was split income, the marital deduction, more generous depreciation provisions, more "realizations" afforded capital gains treatment, and so forth. Reversal of major, or even minor, post-war decisions made deliberately is perhaps impossible. (Things may, of course, get so complicated, as Dr. Blough suggested this morning, that we shall start over again, but I would not bet on that in the near future.) Nevertheless, one more major hope remains. The growth of our economy will inevitably enlarge the potential tax base. At the national level, barring the growth of international tension, the increase in tax base will permit some opportunity for reduction in tax loads, as a percentage of income. As we choose in the future, I suggest that we would do best, so far as the enterprise economy is concerned, to take full advantage of the broadening tax base to permit a reduction of tax rates.