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INTRODUCTION

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The functions of taxation, particularly at the national level of government, have undergone dramatic changes in recent decades. The very title of this symposium bears testimony to this fact. For while it has always been proper to regard and analyze taxes in terms of their revenue-yielding capacities, they have rarely been considered appropriate tools for the deliberate manipulation of social and economic phenomena. Undoubtedly, economists and politicians were aware of the fact that compulsory levies upon a population would have some impact upon behavior, but this apparently failed to lead them to the conclusion that the impact *ought to be planned* in order to contribute to the attainment of certain social ends. Such a conclusion could not readily be reached in Western economic thinking until a better understanding was had of the appropriate fiscal functions of modern market-oriented government.

Contemporary thinking in fiscal economics recognizes several broad problem areas in which the state may properly employ its fiscal instruments of taxing, spending, and borrowing. These problem areas stem from several sources: there are major limitations and deficiencies inherent in the private market mechanism that militate against the optimum use of a nation's scarce resources; also, even when the "invisible hand" of the market process performs its assigned functions perfectly, it may yield a result that is in conflict with the values of the society; and finally, the evolved political and social institutions of a nation often necessitate complementary fiscal action. To help remedy the resulting problems, nations have undertaken responsibilities in at least three, and possibly four, broad functional areas in which taxes may be used as effective policy instruments. These are sometimes referred to as the Allocation Function, the Redistribution Function, the Stabilization and Growth Function, and, in states organized along federal lines, Fiscal Federalism. The papers that are included in this symposium deal with some of the issues related to the use of taxation in carrying out one or more of these functions.

The Allocation Function of the state concerns the composition of the national output. For numerous reasons, it will be necessary for governments to divert resources from the production of market-directed goods and services to the production of what may be termed *public goods*. Labor, land, and

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capital that might otherwise be employed in the production of, say, more private automobiles, more household appliances, and more electric toothbrushes are instead used for the production of, say, more missiles and space capsules, more courtrooms, and more miles of highways. By deliberately intervening in the resource allocation process, the state causes a change in the *quality* (though not necessarily the quantity) of the total output. Such intervention is essential if resources are to be utilized so that they yield the greatest individual and social satisfaction. For the fact is that certain types of goods and services simply cannot be adequately provided via the private market process.

Though the reasoning behind this conclusion is well known to professional economists, some of the more important factors may be summarized here. First, there are technical conditions that may prevent the private sector from optimizing the use of resources. Some products when used optimally are unprofitable. A bridge, for example, exhibits a near-zero marginal cost for usage, that is, there is virtually no additional cost associated with additional crossings. Its most effective use would therefore be a near-zero price per crossing, which would hardly render it a profitable private investment.[1] Some products provide indivisible benefits to all regardless of whether one personally pays for the product. A defense system may be cited as one such commodity not subject to what economists call the "exclusion principle."[2] In a similar vein, some products yield primary as well as secondary benefits. Education yields utility not only to those who are educated, but also to the society as a whole. But these spillover benefits cannot readily be priced in the private marketplace.[3]

Another set of circumstances, which may call forth allocative activities on the part of the state, has to do with the conflict between consumer sovereignty and the democratic process. The basic market decision is expressed through buying power such that those who have this power will determine the way resources are to be used. But private resource-use decisions may not always coincide with the moral or aesthetic value system of the group. Thus, a part of this decision is transferred out of the market and into the political sphere where majority opinion and not dollar-votes determines the product-mix in the system.

For these reasons and some others, there has always been some allocative function assigned to the state, even among the foremost proponents of free enterprise economics.[4] But how should these publicly provided goods and

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1. We assume that bridge crossings exhibit rapidly declining marginal costs and that marginal cost pricing prevails.

2. The "exclusion principle" may be defined as the condition whereby a consumer is excluded from enjoying the benefits of a good or service unless he is willing to pay the market price.

3. The discussion of spillovers or "external economies and diseconomies" has been quite extensive in recent years. *See, e.g.*, M. KAFOGLIS, WELFARE ECONOMICS AND SUBSIDY PROGRAMS (1961).

4. *See, e.g.*, L. ROBBINS, THE THEORY OF ECONOMIC POLICY IN ENGLISH AND CLASSICAL POLITICAL ECONOMY (1962).

services be financed? What type of tax system, if any, should be employed? An extensive body of literature has developed around this aspect of the allocative function, particularly around the two fundamental principles of tax burden distribution—benefit taxation and ability-to-pay taxation. It may be forcefully argued that the nature of the allocation function calls for taxation according to benefits received, recognizing, however, that often such benefits may be related positively to private income. On the other hand, maximizing total social utility may require an ability-to-pay tax system, and perhaps even a highly progressive one at that, but this position is subject to serious qualification.[5]

The second major taxing function of the state, the Redistribution Function, may be defined as the deliberate use of taxing and spending powers so as to change the distribution of the nation's income from what it would have been in the absence of any such deliberate activity. This function arises because of the possible conflict between the distribution of the product among the citizens by the market process and the distribution that is considered "just" in some ethical sense. While the allocative function concerns itself with the *kind* of pie, the redistributive function is concerned with the *size of the slices.* In both cases we assume the size of the total pie to remain unchanged. This is perhaps the best example of an issue arising from the conflict of two equally noble ends, namely freedom and justice. On the one hand, economic freedom refers to a system of free enterprise that, when in ideal operation, leads to distribution on the basis of individual performance—marginal productivity. In other words, a consequence of this particular economic organization is a particular income distribution. This is simply a truism and is mathematically demonstrable; in no way does it imply that it is ideal in any *ethical* sense. But there is an ethical end that *is* concerned with distribution based on some belief concerning social justice. Whether it be based on humanitarianism or egalitarianism, some form of distributive justice is a goal of our society; and it need not be identified with the distribution based upon personal marginal productivities. Here we have conflicting values that must be resolved by the state through its redistributive function.

But how? In its simplest form, this activity requires taxing one group (presumably the rich) and transferring these resources to the other group (namely the poor). Whether the transfer consists of money or commodities is another area worthy of debate. But in either case, redistribution requires that those with higher incomes (or wealth) pay higher taxes. Precisely how much higher is a political decision based upon the extent of the desired redistribution. It is in this context that progressive taxation can find its strongest defense and presumably this is the basis for much of the statutory progression in this country and elsewhere. But the true extent of the politically desired redistribution may better be revealed by the effective rate struc-

5. For a rigorous analysis of both tax principles see R. A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE chs. 4-5 (1959). The most extensive critical examination of tax progression theory is W. BLUM & H. KALVEN, THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953).

ture, which can hardly be regarded as radically progressive.[6] The illusion is no longer a secret!

Two of the articles presented here are devoted to problems related to tax burden distributions especially with respect to progression. Professors Vickrey and Smith criticize the existing taxes on income, though from different vantage points. Vickrey, on the one hand, analyzes the erosive impact of tax loopholes and the failure of Congress to rectify its errors. He explores the possibilities of a completely new progressive tax structure based upon expenditure and net worth taxes. Professor Smith presents a criticism of the present income tax based upon his position concerning the inefficiencies and inequities of steeply progressive rates. His arguments are clearly stated and cogently developed and represent a point of view that is not too often stated in the economists' literature these days. His position in favor of a maximum marginal rate of fifty per cent is worth serious consideration.

The third basic taxing function of the modern state, and the one that is the most recent addition is the Stabilization and Growth Function. This policy area results from the cyclical fluctuations and secular sluggishness (or exhilaration) that may occur in the performance of the economy. It is a direct result of the revolution that took place in economic thinking with the publication of John Maynard Keynes' *The General Theory of Employment, Interest and Money* in 1936. The fundamental argument in support of this governmental activity may be stated succinctly. If a nation is to utilize its resources optimally, it must experience stable economic growth uninterrupted by depressions, stagnation, or inflations. When contemporary economies tend to exhibit such inefficiencies and inequities, deliberate policies for their eradication are called for. To this end the instruments of monetary and fiscal policy are useful. This function of government in a free society is a much more recent one than the previous two mentioned; unlike those, it is concerned with the performance *of the economy as a whole* (*the size of the pie*) rather than with particular segments of it. The personal and national economic disasters of the 1930's demonstrated conclusively how impotent laissez-faire economics could be in the face of a depression and indirectly suggested how much waste and suffering could be avoided through deliberate anti-depression policy. Similarly the threat of inflation, which was so evident immediately following World War II and again in recent years, could only be ameliorated by positive government action. Hence, while there is room for debate over which particular monetary and fiscal instruments are most desirable, there is hardly any question of the legitimacy of this stability-growth function of government.

The role of tax policy in furthering the goals of stabilization and growth is becoming widely recognized, even among politicians, as exemplified by the tax cut of 1964 and the recent tax increase. Professor Poole, in his paper,

6. For a recent study of effective rates in the United States see Gillespie, *Effect of Public Expenditures on the Distribution of Income*, in ESSAYS IN FISCAL FEDERALISM 122 (R. Musgrave ed. 1965). Gillespie finds that in 1960 the effective federal rate structure was moderately progressive ranging from 17.8% on family incomes below $2,000 to 30.6% on incomes of $10,000 and over. *Id.* at 136.

explores some of the frustrations and gratifications of using the various fiscal instruments for this purpose. His analysis of the aggregate effects of fiscal policy upon the capital markets complements the paper by Mr. Slowinski, which is particularly welcome because of its timeliness. In an economically interrelated world, domestic economic policy cannot be separated from foreign policy, particularly if either policy effects the flow of capital. Poole and Slowinski provide the reader with an abundance of clear thinking and information related to this topic. While the former concentrates upon the economics of tax policy with respect to saving and investment, the latter summarizes the changes in the law that bring about economic reactions, both at home and abroad.

We turn now to the fourth and final major area in which taxes may be considered significant instruments of policy. The preceding discussion summarized the fiscal functions that are a part of the duties of every modern Western nation. However, in countries organized along federal lines, there is an additional problem area that cries out for solution. In the unitary state, the central authority possesses the power to conduct all fiscal functions in whatever way it wishes. It may or may not choose to delegate some of its responsibilities to the local level and can change these at any time. On the other hand, in the federal nation, an intermediate level of government exists between central and local authorities. This additional level, known as the state government as in the United States and Australia or the provincial government as in Canada, possesses certain fiscal responsibilities of its own, which it derives from interpretation of the nation's constitution and not simply from the central authority. In other words, in a federal union the central government is sovereign in some fields with the member states sovereign in others, while the local governments have no inherent sovereignty but merely perform those activities delegated by the states.

To preserve this system it is vital that the various levels be given the jurisdiction over certain functional areas and the *revenue* necessary to carry out their functions. It is a basic tenet of federalism that the several levels of government must maintain a reasonable degree of independence. If this is not adhered to, then the political structure becomes transformed into a unitary-type state with all power at the center, or else a confederation where the members are virtually sovereign while the central level is without any authority. An example of the latter was the United States under the Articles of Confederation. The national government was almost completely powerless and without any independent sources of revenue, while the states behaved as if there were no union whatsoever. For all intents and purposes, the American states were separate nations in 1786, even to the extent that some carried out their own foreign relations. There is no better example of this particular type of departure from the concept of federalism.

On the other hand, federalism can disintegrate when the member states are left without any significant powers. Under Hitler, for example, the various states in Germany were stripped of their political and financial authority to the extent that all power rested with the central government. In effect, Germany became a unitary nation.

In both of these examples, the importance of the fiscal aspects stands out. If federalism is not to be undermined, then some balance must be struck between the allocation of duties and revenues so that each level is capable of carrying out its responsibilities.

In his paper, Professor Hellerstein presents and evaluates the various alternative arrangements that are currently being proposed as possible solutions to the apparent fiscal dilemmas of many state governments. Included in these proposals is the much celebrated Heller-Pechman plan for block grants. Hellerstein's criticisms of this and other schemes and his defense of more extensive conditional grant programs are important positions and welcome additions to the professional literature.