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PUBLIC FINANCE

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INTRODUCTION TO THE SERIES

By the General Editor

SHORTLY after the war of 1914–18 there seemed to be a place for a Series of introductory Economic Handbooks "*intended to convey to the ordinary* reader and to the uninitiated student some conception of the general principles of thought which economists now apply to economic problems".

This Series was planned by the late Lord Keynes under the title *Cambridge Economic Handbooks*, and he wrote for it a general Editorial Introduction of which the words quoted above formed part. In 1936 Lord Keynes handed over the editorship of the Series to Mr. D. H. Robertson, who held it until he became Professor of Economics in the University of London.[1]

The judgment of its originators has been justified by the wide welcome given to the Series. Apart from its circulation in the British Empire, it has been published from the start in the United States of America while translations of the principal volumes have so far appeared in German, Spanish, Italian, Swedish, Japanese, Polish and Lithuanian.

It is symptomatic of the changes which have been taking place in recent times in the development of economic science, changes associated in a high degree with the work and influence of Lord Keynes himself, that within the brief space of fifteen years the text of part of the Editorial Introduction should have stood in need of revision. In its original version the last paragraph of the Introduction to the Series ran as follows:

[1] Professor Robertson now holds the Chair of Political Economy in the University of Cambridge.

"Even on matters of principle there is not yet a complete unanimity of opinion amongst professors. Generally speaking, the writers of these volumes believe themselves to be orthodox members of the Cambridge School of Economics. At any rate, most of their ideas about the subject, and even their prejudices, are traceable to the contact they have enjoyed with the writings and lectures of the two economists who have chiefly influenced Cambridge thought for the past fifty years, Dr. Marshall and Professor Pigou."

When the Editorship of the Series was transferred to Mr. D. H. Robertson, Lord Keynes consented to the retention of his general Introduction, but subsequently re-wrote the concluding paragraph in the following form:

"Even on matters of principle there is not yet a complete unanimity of opinion amongst professional students of the subject. Immediately after the war daily economic events were of such a startling character as to divert attention from theoretical complexities. But to-day, economic science has recovered its wind. Traditional treatments and traditional solutions are being questioned, improved, and revised. In the end this activity of research should clear up controversy. But for the moment controversy and doubt are increased. The writers of this series must apologize to the general reader and to the beginner if many parts of their subject have not yet reached to a degree of certainty and lucidity which would make them easy and straightforward reading."

Still more recent events have produced a world so far removed from that which existed when the foregoing words were written, that it has fallen to the lot of the present Editor to provide a new Introduction.

This is perhaps a good vantage point from which to survey very briefly some of the principal trends in the evolution of economic thought in this country during the past thirty years. Prior to 1914 economic theory here was largely dominated by Alfred Marshall; and economists, following him, thought in terms of the long period tendencies of the different sections of the economic system towards positions of equilibrium, even though ever-present dynamic factors were perpetually modifying the existing structure and presenting new and equally distant, if equally unattainable, goals as stimuli to change and adaptation. Moreover, in the Marshallian system, those tendencies resulted from the working of persistent underlying forces which were conceived of as largely competitive in character. The increasing trend towards monopoly was certainly affecting thought, but not so much in the realm of the theory of value, as in the emphasis which came to be laid on possible discrepancies between the private interest and the social interest. Under the influence of Professor Pigou a Welfare Economics was developing side by side with, and out of, the Value Economics of the older generation.

After 1918 the long-drawn-out agony of the depressed areas, the weakening of the position of this country in international trade, and the tremendous intensity of the economic crisis of 1930–32 (to mention but a few out of the many contributing causes) combined, on the one hand, to focus attention on problems of the short period and, on the other hand, to throw doubt on the extent to which the self-adjusting, seemingly automatic mechanism, which on the whole had operated so effectively during the nineteenth century, was capable of coping with the deep-seated maladjustments and disharmonies which characterized the post-war world. At the same time value theory itself was profoundly influenced by the emergence of a number of writers who approached value problems from the view-point of monopoly, and emphasized the unrealistic nature of an analysis which was based on the assumptions of perfect competition and a perfect market. Most of all, however, economic thought was dominated by the desire to find a solution for the problem of how to maintain the level of effective demand so as to avoid the recurrence of phases of deep depression and widespread unemployment. There was a growing feeling of impatience with the economics of the long period "in which we are all dead," and a great, perhaps even excessive, concentration on the short period in which we live and move and have our being.

The result was a remarkable ferment of ideas, the challenging of ancient orthodoxies, and " for the moment *controversy and doubt [were] increased*". This ferment had by no means subsided when the second war with Germany broke out in September 1939, bringing in its train a degree of State interference with the normal peace-time working of the economic system far exceeding that reached even in the last years of the war of 1914–18.

In so far as it is possible to foresee future trends, they would seem to lie in a much greater measure of conscious public control over many aspects of economic activity than has existed in the past. It will no doubt still remain true, to quote Lord Keynes's Introduction again, that:

> " The Theory of Economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, an apparatus of

the mind, a technique of thinking, which helps its possessor to draw correct conclusions."

Nevertheless, economists may well find themselves to a greater degree than hitherto called upon to express their views on matters of economic policy, and—for a time at least—the writers of future volumes of the Cambridge Economic Handbooks may be concerned rather with specific problems than with the more general aspects of economic theory.

C. W. G.

Cambridge,
JULY, 1946.

PREFACE

The Preface is traditionally the place where the author endeavours to disarm the critics in advance, by explaining why he has written the book he has, instead of some other book which they might perhaps have preferred. The extension within recent years of the subjects which might plausibly be regarded as falling within the province of Public Finance makes this precaution more than ever necessary.

Public Finance, it is generally agreed, forms a part of the study of Economics ; hence it is mainly the interests of economists which I have had in mind in choosing my subject-matter. Some of them may perhaps complain that in that case the book is inordinately concerned with problems of financial administration and accounting. This difference in emphasis, as compared with the traditional make up of books on Public Finance, is quite deliberate. As the economic functions of government expand, the technical aspects of finance, of public accounting and of the control of expenditure, assume a new importance. As professional economists come more and more to take a direct part in the shaping and administration of public policy, a general knowledge of the functioning of those parts of the administrative machine with which they are particularly concerned becomes (or so it seems to me) a necessary part of their equipment. In application, and in such description as has been necessary, I have mainly and inevitably been concerned with British institutions, but I have tried to take examples from other systems whenever possible.

As a result of this expansion on the administrative side, it has been necessary in order to keep the book within reasonable bounds, to trim it fairly finely in some other directions. The exclusions have again been deliberate; they are concerned with outliers in the field of Public Finance which in my view can best be cultivated within the system of the neighbouring fields to which they belong as much as to the field of Public Finance. Three of the outliers are so important that they call for brief comment.

In the first place the discussion is primarily concerned with the activities of *governing bodies*. The economic problems (e.g., price and output policy) as distinct from the financial problems of socialized industry, of public boards and of public utilities are not considered, except in relation to their place in a systematic policy for the economy as a whole, discussed in Part III. A full-dress treatment of the problems of Public Economics is urgently required, but it cannot be provided as an annexe to a book on Public Finance.

Secondly, I have omitted any technical discussion of the process of public borrowing and of the management of the Debt. This limitation may well appear unjustifiable, since with the nationalization of the Bank of England the boundary between public and private finance in this sphere appears to be substantially shifted outwards. The omission is again partly owing to lack of space, but mainly owing to the fact that the introduction of technical detail in a book of this nature would require a description and interpretation of monetary and credit institutions which belong more properly to the field of money and finance. In spite of the nationalization of the Bank it is still plausible, and in many ways convenient, to distinguish between changes in the monetary situation which are due to efforts on the part of public authorities to influence that situation, and changes which result from activities of public bodies in pursuit of other ends. I have endeavoured to exclude the former but to include the latter.

The third omission will probably be found, under present conditions, the least forgivable. Economists will look in vain for an adequate treatment of international fiscal relations. Here above all it seems to me that fiscal consideration cannot usefully be discussed in isolation from the other factors which go to make up the international situation, and from the other instruments of policy—monetary and exchange action on the one side, direct controls on the other—by which a nation endeavours to keep its feet in the world economy. Had I once entered this territory there would have been no practicable stopping place.

A first draft of this book formed part of the course for the School of Special Studies in Economics in the University of Liverpool. I am much indebted to Mr. Henry Hartley, Lecturer in Public Administration in Manchester University, for advice on the parts of the book which border on administration. If any administrative errors remain it is not his fault.

My main debt, as ever, is to my husband. Some considerable part of the discussion stems from our joint work, in the fields of local finance and war finance respectively. For much of the theory of tax incidence (especially in Chapter X) I have drawn heavily on his published work, and still more heavily on his time for innumerable discussions of difficult points. Worst of all, I have in Chapter VII been compelled by the nature of my approach to take a first, and inevitably immature, crop from a field —the theory of the social advantage—on which he has

himself as yet hardly had time to carry out the first operations in the process of cultivation. For this I owe him a deep apology.

URSULA K. HICKS.

Oxford,

APRIL, 1946.

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CHAPTER I

THE STATE AS EMPLOYER AND PRODUCER

§ 1. *Private Enterprise and Public Service.* In Britain, and in countries organized like it, the population can be roughly divided into two groups. The first group consist of those who are dependent on incomes derived from the production of goods and services destined to satisfy (directly or indirectly) the personal wants of consumers; they produce because they anticipate that consumers will be prepared to pay prices for the goods sufficient to make their continued production worth while. The second group are engaged in providing services (and in some cases goods) whose scope and variety are determined not by the direct wishes of consumers, but by the decision of government bodies, that is, in a democracy, by the representatives of the citizens.

In public finance it is with the activities of this second group that we are almost exclusively concerned. The workers in it are, like the workers in the first group, occupied in satisfying consumers' wants, but many (although not all) of the wants are of such a nature that the means of satisfying them cannot be split up into units and sold through the market mechanism (for instance, police protection); the wants have therefore to be satisfied by collective provision.

Since services of this nature cannot be paid for directly by the users, the incomes of producers are not derived from the sales of their output; instead these "public services" are paid for out of taxes—compulsory transfers of private incomes to governing bodies for the express purpose of arranging for the collective satisfaction of wants. The fundamental difference between this and the market method of finance is that there is no relation between the tax liability of any individual and the share of collectively provided services which he will be able to enjoy. Nor, save in very exceptional circumstances, can the revenue from any particular tax be regarded as paying for any particular service. Taxes are paid into a pool; entirely separate decisions govern the distribution of revenue between the public services.

Workers in the first, "private enterprise," group are organized in a great number of different ways. At one extreme they may work on their own, with only the assistance of their families, as many farmers do; at the other they may be employees of a giant firm, the largest of which in Britain has a staff of over 200,000; in the United States there are not a few which are still larger. Whatever their size, all these organizations have this in common, they are independent units, and all, the one-man firm and the big company alike, are motivated by the principle of incentive of profit. The goods and services which are produced are conditioned by the continued receipt of more satisfactory incomes than could be secured by producing other goods and services.

The public service is also organized in groups—the departments of the central government and of the " local authorities " (the corporations of large towns and the councils of small towns and rural areas). In this case, however, the groups are not independent, they work as parts of central and local governing bodies, and in the last resort all are subject to Parliament. Their activities are not in process of continuous adaptation to the anticipated demands of consumers, as is the case with the private enterprise groups. On the contrary what they do, and largely the way they do it, are prescribed by the previously expressed decision of the bodies whose servants they are, and ultimately by Parliament. Their work can only be varied when these bodies decide to alter their policy. The continued production of particular public goods and services is independent of their cost because since the government's power of taxation is unlimited, revenue can always be made available to cover any agreed extension of output.

To this division of the population between " private enterprise " and " public service " there is one important qualification. It is common, and for some purposes necessary, to include among the public services the socialized industries, conducted by departments of the central government or the local authorities, for the purpose of providing goods and services to be sold on the market, like the output of private enterprise.

In spite of the fact that the units are not independent, the organization of this " public enterprise " is more nearly akin to that of " private enterprise " than to that of the remaining public services. Public enterprise is essentially motivated by the principle of incentive, in that the scope and direction of its activities are determined by the anticipated direction of individual consumers' wants.

This similarity between public and private enterprise is often concealed by the fact (as in Britain) that the public trading services are planned in such a way that the gross returns cover only costs, excluding what private firms would regard as a necessary profit. Since any loss which may be incurred by a public trading department can be covered by taxation, there is no room for ordinary shareholders who are prepared to bear the risk of loss in return for the chance of profit.

The kinship of public enterprise and private enterprise is shown by the absence of any logical line of demarcation between the two. In Britain, for instance, the provision of gas, water, electricity and local transport—the typical trading services of the local authorities—was developed partly by public and partly by private enterprise. In the inter-war period about 80 per cent of the country's water supply was provided by local authorities and the remainder by private firms; in respect of the production and distribution of gas, and of the distribution of electricity, the public contributions were respectively about 40 and 60 per cent of the output.

There is, however, a significant difference between the independence of the private firms producing services of this type, and the remainder of the field of private enterprise. Owing to the monopolistic nature of the services, it is necessary in the public interest to subject the firms to a high degree of regulation, especially in respect of price policy. Such industries are consequently known as "public utilities". The firms are nevertheless private in the vital sense that the capital is the property of the shareholders and the directors are chosen by the proprietors.

In the inter-war period a new and important type of public enterprise made its appearance in Britain in the shape of the "Public Corporation".[1] This is a body controlled by a board of directors, with similar rights and duties to those of the directors of a private firm, but who are appointed by the government, and not by the shareholders (since there are none). The public corporation is thus nearer to the trading service in respect of ownership, but to the privately-owned public utility in respect of the conduct of its business. The earliest examples of the new type of public ownership were the B.B.C., the Central Electricity Board and the London Passenger Transport Board ; but these must be regarded merely as prototypes, largely of an experimental character.

The importance of this new development is the opportunity which it appears to offer of combining public ownership with business accounting methods and the principle of incentive. The public corporation can be used either for the transfer of industries from private to public control or for the nationalization of industries already socialized, but organized in the inconveniently small units dictated by the jurisdictions of the local authorities who own them.

The public corporation is capable of very wide application in modern conditions. Abroad it has been put to uses varying from the exploitation of a public monopoly (e.g., tobacco) as a method of raising revenue, to schemes of large-scale social regeneration (as in the famous Tennessee Valley Authority in the United States)—in addition to its more orthodox use of marrying public control and business efficiency. Similarly, the degree of public control is capable of great variation.

[1] This must be carefully distinguished from the "public company", which is merely a private firm with a particular form of organization compelling it to publish its accounts. This caution is especially necessary in respect of the U.S.A. where the term "corporation" is equivalent to the British "company".

In Britain, where the public corporation was founded on nineteenth-century experience of "Public Boards" representative of particular local interests (e.g., dock and harbour users), the early public corporations inherited a considerable "private" flavour. They enjoy a large measure of freedom from Parliamentary interference; there is, for instance, no question of a Minister being responsible for their actions, although some Minister normally has a general supervisory jurisdiction. Their property again, although publicly owned, is vested in the corporations themselves and not directly in the government. The organization of public corporations has thus been considerably more independent and flexible than that of the old type of "nationalization"—represented by the Post Office services—which is under the continuous control of Parliament through its Minister, the Postmaster-General.[1]

From this discussion it will be apparent that the line between "public" and "private" needs to be drawn with a good deal of flexibility in modern conditions. What then is the scope of public finance? For most problems it is convenient to draw the line short of the activities of public enterprise, that is to say of its price and output policy, for the simple reason that the policy of nationalized industry is determined primarily by economic and not by political or social considerations. The problems which public enterprise has to solve are essentially those of firms and not those of governing bodies. The main content of public finance consists then of the examination and appraisal of the methods by which governing bodies provide for the collective satisfaction of wants, and secure the necessary funds to carry out their purposes.

[1] For a discussion of the financial problems due to the extension of this form of organization to coal and other industries, cf. Chapter XX § 2.

In view, however, of the control which the government exercises, not only over public corporations and other forms of trading service, but also over the privately-owned public utilities, when we are concerned with the broader aspects of policy—with questions of maximizing national income and welfare, policy which must also be considered to fall within the sphere of wants collectively satisfied—it is necessary to take into account not only the activities of governing bodies but also of all organizations whose policy is subject to some degree of public control.[1]

§ 2. *The Public Sector and its Finance.* In a democracy, as usually understood, the State (which term is a convenient shorthand covering both major and minor governing bodies) is a particular part of the nation's organization. In its economic and financial aspect it may conveniently be referred to as the " Public Sector " of the economy, a term which is then contrasted with the " Private Sector " comprising the social and economic activities of the community in pursuit of their individual private aims. Since the business of the State is the satisfaction of wants, public finance is essentially a department of economics. It is one aspect of the economic problem of securing the best application of limited means to secure given ends, the ends in this case being given not by the demands of consumers on the market, but by policy determined by

[1] For the sake of completeness we should include here the public credit organizations, although their problems belong mainly to the field of monetary policy and not of public finance. Those which are most concerned with the implementation of public finance policy are the organizations for supplying long-term credit—for public investment (the Public Works Loans Board) and for approved private investment (a function performed by several organizations sponsored jointly by the Treasury and the Bank of England)—and, in the background the Bank of England itself whose task of providing the necessary monetary circulation for the country was under the effective control of the Treasury long before the Bank was nationalized.

the representatives of the people sitting in the governing bodies of Parliament and the local authorities.

The public sector of a modern nation is an organization of great size and complexity, and of growing importance in the life of the community. This is as much true of countries such as Britain and the United States which have hitherto followed a mainly *laisser-faire* tradition, as of countries (such as Sweden among the democracies) where there has long been a tradition of public ownership. One of the most striking and universal phenomena of the inter-war period was the rapid expansion of public sectors.

Measured in terms of purchases of goods and services, the British public sector had come by 1938 to represent about one-fifth of the total activities of the economy, whereas before 1914 it was of the order of only one-seventh. In 1938 something like a million and a half workers (out of a total of 20 million) were directly engaged in producing goods and services required for the collective satisfaction of wants, while in addition, at least as many were on the average employed in producing goods and services subsequently purchased by the public sector for the collective satisfaction of wants. Among the direct employees of the State must be reckoned not only civil servants and teachers, and the administrative clerical and manual staffs of local authorities, but also the armed forces and the diplomatic corps. The goods purchased by the State from private enterprise range from steel and tinplate for battleships to the chalk and dusters, milk and orange juice, supplied to elementary schoolchildren.

As we have seen, the labour and materials necessary for the production of these goods are paid for by taxes levied on all members of the community (including the employees of the State). Besides taxation (and more rarely the use of the profits of public enterprise to finance general government expenses) the State can also borrow the capital of private citizens. In the past the British government has almost entirely confined its borrowing to war periods, when the necessary expenditure exceeded what could be extracted from the incomes of citizens by means of taxes; public enterprises have, however, frequently borrowed in order to finance long-term investment, in a manner analogous to the debenture borrowing of private enterprise.[1]

The importance of loan finance greatly increased during the inter-war period, and we shall have to pay especial attention to the problems which it raises. Nevertheless, the funds spent by the State are likely to continue to be mainly derived from taxes. This statement applies equally to a totalitarian state such as the U.S.S.R., since the citizens (who are then almost without exception state employees) receive their incomes *net* of a deduction which corresponds to a basic tax payment in other countries. In addition, the Soviet Union also levies some further taxes of a more special nature. It is therefore with taxation and its problems that we shall be mainly concerned on the revenue side of public finance.

The activities of the public sector are determined primarily by political considerations, which are a datum for the economic system, either private or public. This does not imply that policy can only be based on party considerations; on the contrary it is possible (as we shall see), and it is moreover absolutely essential for the formulation of a rational policy, to set out in a systematic and objective manner the principles by which the wealth and welfare of the community can best be increased. Once

[1] There has also been a not inconsiderable amount of borrowing to finance the acquisition of capital assets (especially houses) outside the socialized industries.

this has been done it is the duty of the adviser on public finance to show what types of public outlay, and what choice of taxes, are most appropriate for attaining the ends laid down.

Although public finance is the servant of policy it has itself an importance which has often reacted on the political situation. It is hardly too much to say that the permanent well-being of a nation depends as much on the successful solution of the problems of public finance as on the skill and industry of its workers or the bravery of its soldiers. The path of history is strewn with records of national failures which illustrate the vital nature of public finance. Tax bankruptcy was an important contributory factor to the fall of the Roman Empire. Unjust and inefficient taxes set the French Revolution aflame. An important part of the explanation of Germany's failure in the war of 1914–18 was her antiquated tax structure, which proved unequal to the task of controlling civilian consumption, so as to secure proper concentration on the war effort.

Again, in many countries, in England above all, it is in the field of public finance that the decisive battles for personal and political liberty have been fought. The struggle for the very existence of Parliament centred on the financing of Edward I's wars. The freedom of the House of Commons was won over the question of Charles I's Ship Money, and its dominance was finally confirmed against the power of the House of Lords as a result of the struggle for the Finance Act of 1911.[1]

§ 3. *The State and the Individual.* The State is part of the organization of a nation. What then, we must inevitably

[1] On the other side it must not be forgotten that inefficient taxes helped to lose Britain the American Colonies.

ask, is the relation between it and the individuals and smaller groups of which it is composed? This is primarily a political question, the answer to which differs enormously according to the type of political organization in force. We do not need to consider the question at length here, since it belongs to the field of politics, but we shall not understand the significance of British public finance unless we have some broad, but fairly definite, concept of the relations between the State and the individual in such a democracy as Britain. Let us start by considering more closely the nature of the wants which the State exists to satisfy.

In the first place we must notice that although the public services cater for the satisfaction of wants by collective means, the satisfactions themselves are individual (since only individuals can experience satisfaction). In the same way commodities may be said to be taxed, but the taxes are paid by their owners. Many of the satisfactions provided by the State, however, cannot be provided individually—as we have seen the services of the police (and also of the armed forces) are by nature indivisible. As soon as community life is established social wants of this sort are felt, and must be satisfied, either by the citizens acting directly or through an agency. We can thus regard the State as an agency acting for the citizens to provide collectively for their wants.

Thinking along these lines the State appears as a sort of super club, owning and renting property, for instance, as a golf club does and employing servants to provide collective services, as a golf club employs greensmen and waiters to minister to the needs of the members. For understanding many of the functions of government this is a very useful analogy; but we must beware of pressing it too far. A club is a voluntary organization which can be joined or resigned from at will. Failure to pay the subscription can lead to nothing worse than suspension of membership, and there is no compulsion on anyone to join a club at all. The State can only be resigned from by the difficult means of emigration, and it is hardly possible to exist in a "stateless" condition. Failure to pay one's "subscription" (taxes) to the State is punished by imprisonment.

The compulsory nature of obligations to the State gives rise to important questions of social justice. For instance, there is nothing objectionable in having a golf club subscription which is uniform for all the members, because membership is voluntary, those who think that it is too high will simply not join; but to impose uniform taxes on all citizens irrespective of their incomes is recognized as being very unfair indeed. An important part of public finance is concerned with questions of the proper distribution of tax liability between citizens with different incomes.

A parallel distributional problem arises also on the side of public expenditure. Members of golf clubs have similar tastes and expect to enjoy the same services; different individuals have not the same desire or need for public goods and services, consequently it cannot be expected that everyone will agree in detail on the wants to be satisfied by public authorities. In fact a considerable part of the need for public services really arises from the conflict of interests which must always exist between different individuals and classes—the difference between the shopkeeper and the burglar, no less than between the old-age pensioner and the schoolchild, or the ratepayer and the unemployed.

In countries where the distribution of State expenditure is determined in a democratic assembly the policy—and the public finance—which emerges is patently the result of compromise between conflicting interests ; in countries where policy is imposed by the will of a ruling clique or class, the conflict is no less urgently present, although it is driven underground. In such circumstances indeed the club analogy is no longer appropriate.

Although in a democracy the club concept of the State remains useful from many points of view, as a comprehensive account of the relation between the State and the individual it now appears altogether too narrow and passive. The internal functions of the government, for instance, can no longer be conceived in terms of " holding the ring " between different interests, and of providing " amenities " of the type of street lighting and cleansing (which were the typical examples of what was regarded as " beneficial expenditure "). The concept of the proper sphere of the State's activities must be extended in two important directions.

In the first place it is rapidly coming to be accepted that it is the business of the State to ensure that every citizen can enjoy the primary necessities of life—sufficient and correct food, adequate shelter, and health and education services commensurate with his needs. It is now widely held that the State should ensure this minimum by itself buying or producing and distributing the means of satisfying these primary wants, wherever it is apparent that the field is not being adequately covered by private enterprise. In the second place it is now held to be an overriding duty for the State—which alone can undertake the task—to secure the maximum level of economic activity and of social welfare which the resources of the economy permit. These two extensions of the concept of the sphere of the State imply a new and more intimate relation between the State and the individual; both in his capacity of producer and of consumer; they also imply a considerable expansion of the types of public activity.

The State thus tends to figure more and more as a producer and employer. Production is still mainly of services, but the importance of goods, both for current use and as permanent assets, is rapidly increasing. Houses were but one—and the first—example of the sort of capital goods which can usefully be produced by the State to supplement the output of private enterprise. As the capital equipment of a nation increases, and consequently the profits which can be derived from producing further units tend to decline, an extension of public investment may well be the most fruitful method of raising the productivity of the economy. We shall have to consider this question and its bearing on the future organization of public finance when we have completed our investigations into the different parts of the system.

With its new duties in mind it becomes useful to think of the State as a giant firm, owned and run by the citizens for the purpose of producing or purchasing, and distributing, goods and services both to provide collective services in the old sense, and also to satisfy those individual wants which it has been collectively determined should be satisfied. This way of regarding the State is especially useful for public finance because it focuses attention on the economic aspect of the State. The best way to discover how a firm's activities are distributed and how they are prospering is to examine its balance sheet. If we similarly examine the State's "balance sheet" we shall have made considerable progress in discovering how the public sector works. In fact, it is by means of a modified balance sheet (the Budget Accounts) that Parliament annually reviews policy.

There is one complication, however, about regarding the State as a giant firm. The functions of government, the distribution of expenditure and the collection of taxes, are not the monopoly of the national government, but in almost all countries are divided between a major central government and minor local units. (This suggests that the analogy of a holding company and its satellites would really be more appropriate.)

Just what relations are established between the central government and the local units differs greatly from country to country. In the United States there exists a regional government (the State of California) of such importance that it has a jurisdiction of 240,000 sq. miles and a population of over 7 millions; the State legislature being a major government for a large number of local authorities. The State government of California exercises wide independent tax powers and in most aspects of internal administration can frame its policy without regard to other jurisdictions. At the other extreme we might instance a French Commune of a few hundred souls, which for all major policy decisions is dependent on the central government, but yet still possesses a distinct community life of its own. In Britain, in spite of the fact that the national government is unitary and not federal, the collective importance of the local authorities is very great, not merely in carrying out policy, but also in framing it.

Notwithstanding the wide powers which may sometimes be enjoyed by minor governments, the central government of a country must always retain pre-eminence both in general and in financial policy. This is inevitable, since the national government is charged with decisions which are vital to the existence of the nation, decisions relating to war and peace, and all relations with other nations. Internally also the pre-eminence of the central government tends to increase as the scope of public activity expands; for a systematic economic policy concerted action, directed by the centre, is an essential pre-requisite. Thus the finance with which we shall mainly be concerned is that of the central government; but we must not allow it to monopolize our attention completely. Local authorities make an indispensable contribution to democratic organization. The best method of integrating their policy and finances with those of the central government, without sacrificing their independent life, presents one of the major problems of modern democracy.

CHAPTER II

THE NATURE OF PUBLIC EXPENDITURE

§ 1. *The "Duties of the Sovereign"*. There is a fundamental difference between public and private finance which it is useful to note at the very outset of our investigations. Private finance, whether of firms or individuals, starts with a given income as the framework within which expenditure must be planned; public finance on the contrary starts with a given expenditure plan, and the authorities adjust their "incomes" [1] (revenue) by means of taxes and other resources, to match the expenditure. There is naturally an ultimate limit to the amount that public authorities can spend, set by the amount which it is necessary to leave for the support of the citizens; within this limit of "taxable capacity" there may well be another, set by the proportion of their incomes which people are prepared to devote to the collective satisfaction of wants; but that, in a democracy, is a matter for discussion and persuasion.

Since expenditure and not revenue is the governing factor in public finance, it is more logical to start with the expenditure side of the account. British State expenditure is set out annually in great detail, in the appropriation accounts of the central government and the financial statistics of the local authorities; but in order to arrive at a coherent picture it is necessary to group the services in some sort of functional manner.

[1] The only true incomes of public authorities are those derived from property and trading. For further discussion of this point, see pp. 94, 358ff.

The first systematic discussion of public expenditure in Britain was contributed by Adam Smith in the *Wealth of Nations*, published in 1776. Smith has a memorable chapter on what he calls " The Expences of the Sovereign or Commonwealth" (or as we should say, the State). His discussion had a profound effect on his contemporaries; we know from his own words that William Pitt, the father of our modern financial system and one of our greatest financial administrators, was profoundly influenced by Smith's writings. We cannot do better than apply Smith's classification of the " duties of the Sovereign " as a basis for our picture of public expenditure.

According to Smith the " duties of the Sovereign " fall into three classes. The first duty of the State is that of " defending the society from the violence and injustice of other independent societies " ; the second is that of securing internal justice between citizens. It is obvious that these are primary tasks for any government; it is almost impossible to conceive of any stable political system in which they are not recognized as fundamental. Vital differences in practice may, however, arise in the interpretation of the second duty; history has shown that slaves and particular racial groups may be far from enjoying the elementary rights of citizenship in otherwise civilized states.

For modern conditions Smith's " third duty " is much the most interesting, although it is not fundamental, in the sense that an organized community can exist even if it is omitted altogether; it is only as the income of a community begins to rise that it becomes of importance. Smith defines his third duty as " erecting and maintaining those public institutions . . . and works, which though they may be in the highest degree advantageous to a great society, could never repay the expense to any individual". Chief among such "works" he considers "those for facilitating the commerce of the society, and for promoting the instruction of the people".

In modern terms Smith's third duty would be described as expenditure for economic and social ends. It is remarkable that in eighteenth-century England Smith already envisaged the development of these two branches of public expenditure, which have now come to transcend all others in size and importance; and moreover Smith evidently realized the part which the State could play in providing collective services which might be desired by all, but would yet be beyond the scope of private enterprise. Smith's balanced position is a complete answer to the charge that a rigid interpretation of *laisser-faire* has been part of the British tradition.

Let us now see how Smith's "three duties" have been interpreted in modern Britain.[1] Defence expenditure to equip modern forces is a very complicated affair; it must provide for capital equipment, factories and barracks as well as ships, aeroplanes and tanks required for active service; it must also provide for stores—technical equipment on the one hand and food and clothing on the other—which form the "working capital" of the defence machine. Finally, a large proportion of defence expenditure is devoted to the payment of wages and salaries (in cash and in kind) of active personnel and of pensions to retired members of the forces. From a consideration of the variety of this expenditure it is easy to see that substantial changes in the needs of defence affect directly almost every part of the economy. There is no other form

[1] For an account of the development of British public expenditure in the inter-war period, cf. U. K. Hicks, *The Finance of British Government*.

of public works which is so influential in determining the level of economic activity.

Adam Smith was much impressed by the burden of defence expenditure and with the way in which it was tending to increase in his day. This was largely due to the troublous times in which he lived; the same complaint was frequently heard in the inter-war period. Actually in time of peace, defence expenditure has not tended to consume a large proportion of the resources of the British economy. In the inter-war period, when needs were rather exceptionally large because of the heavy cost of pensions accruing from the war of 1914–18, it amounted to about only 15 per cent per annum of the total outlay of the State [1]; by 1944, however, it had risen to some 80 per cent of public outlay.

The "second duty"—of internal justice—is also partly a matter of defence. Peaceful and law-abiding citizens require protection from their more unruly neighbours. The final coercive power of the State over all classes of citizens is as fundamental for the stability of the community as its defence against external enemies. The maintenance of justice between citizens in the complications of modern life requires, however, a much more extensive mechanism than the mere apparatus of police, law courts and prisons. The cost of making and administering laws, the work of Parliament and of the departments of the central government—especially the Treasury and the Home Office—and the administrative work of the local authorities must all be included. It would be more accurate to-day to describe the second duty as that of civil government, a very important object of which is to see that full and equal justice is done, in all respects, between one citizen and another.

[1] Excluding interest on the National Debt

The " second duty " thus defined has two aspects, one protective, the other administrative. The scope and cost of the administration have increased enormously since the eighteenth century, *pari passu* with the growth of the public sector, nevertheless the protective side (police, justice and fire services) still accounted for more than half the outlay on civil government in the inter-war period. It is important to notice that while the finance and execution of the " first duty " are wholly the business of the central government, responsibility for the " second duty " is shared between the central government and the local authorities ; the greater part of the costs falling on central finances but the greater part of the work being carried out by the local authorities. The outlay of the State on civil government in the inter-war period amounted to about 6 per cent of total public expenditure.[1] In spite of its primary importance the "second duty " is no longer one of the major calls on the community's resources.

In Adam Smith's day public expenditure for social and economic ends was on a very modest scale. Public social expenditure was confined to the Poor Law ; universal public education still lay nearly a century in the future, although a first grant towards it was made within thirty years of Smith's death. Nevertheless, the period was one of awakening social conscience, as is apparent from the spontaneous local additions to public assistance which were made during the Napoleonic wars (and which became famous as the " Speenhamland System "). The very fact that Smith included public instruction among the duties of the Commonwealth is highly significant—it must be remembered, however, that he was a Scotsman.

In Smith's day the greater part of public efforts " to facilitate the commerce of the society " took the form of

[1] Excluding interest on the National Debt.

a complicated system of protection, drawbacks and bounties designed to forward the interests of particular groups. Smith regarded this type of public activity with scant favour, and it was largely due to his influence that in the following generation a great deal of the apparatus was swept away. On the other hand Smith was a keen advocate of public works of the type of road construction, which he conceived as operated on a commercial basis (by means of tolls); and which, as he rightly perceived, would greatly increase the productivity of the economy.[1]

§ 2. *Expenditure for Economic Ends.* In modern conditions State expenditure for economic ends also consists of direct services to private enterprise on the one hand and benefits to the community at large (through the socialized industries) on the other. Each of these may, if properly directed, "facilitate the commerce" (in modern terms increase the productivity) of the economy. Expenditure in aid of private enterprise is of two types; the first finances the provision of services useful to all, or to a great variety of industries; the second confers favours on particular branches of production, especially on agriculture. Of the first, typical examples are the work of the Department of Overseas Trade, of the Weights and Measures Department of the Board of Trade, the Employment Exchanges of the Ministry of Labour and the research work of State institutions.[2] The State is

[1] Cf. *Wealth of Nations*, Book V, Part I, "as the expense of the carriage is very much reduced by such public works, the goods notwithstanding the toll, come cheaper to the consumer than they would otherwise have done; their price being not so much raised by the toll as it is lowered by the cheapness of the carriage".

[2] Except where the research is undertaken at the request of a particular firm, when it is virtually treated as a trading service and provided against a fee.

in a unique position to provide such services and they might well be extended, with great advantage to the community.

Public outlay in favour of particular industries has taken the form of subsidies of different kinds, direct and indirect, open and concealed, and has usually been backed up by direct controls (e.g., quantitative limitation of imports), so that the effect of policy greatly transcends the direct influence of the quite moderate expenditure. Benefits have frequently been accorded on strategic or sentimental rather than on economic grounds. Expenditure of this nature is closely parallel to the eighteenth century measures which Smith condemned and he would doubtless have taken a similar view of much modern policy. A general expansion of this type of public outlay took place in the inter-war period, largely as the result of dislocations and changes due to the war. In Britain outlay on this count finally rose in the 1930's to about £30 millions (representing some 3 per cent of total State expenditure). Many other countries subsidized and protected particular industries (especially agriculture and shipping) to a much greater extent than Britain ; a policy which was an important contributory factor to the growth of political tension in the 1930's.

After 1939 an enormous expansion of this type of expenditure took place in Britain (reaching £240 millions in 1944), some of it made necessary by war conditions, some of it intended as part of a permanent national nutritional policy. Expenditure of this nature may be justified on social grounds even if it does not " facilitate the commerce of the society," but it is essential to keep the two issues distinct. In view of the implications for policy of this development we shall have to devote some attention to it at a later stage.

In Britain the socialized industries—apart from the Post Office services—grew up under local rather than under national control, and have been somewhat hampered in their development by the awkward distribution of local jurisdictions—determined largely by historical accident. The first step in nationalizing the socialized trading services was taken by the establishment (in 1926) of the Central Electricity Board to co-ordinate the production (but not the distribution) of electrical current. The substitution of a national system of distribution through public board in place of haphazard local trading services and private companies should not prove a difficult task, either technically or administratively. In addition to the orthodox trading services some local authorities own more adventurous enterprises—Doncaster's race course and Colchester's oyster beds are favourite illustrations. Probably many more local authorities would be prepared to venture in other directions if they could obtain the authorization of Parliament without undue expense and delay.

Traditionally the only important trading service of the British central government has been the Post Office, but it is only in the present century that control over the telephone was made complete; other telecommunications were only added in 1945, although the extension had virtually been agreed on during the war. Broadcasting on the other hand has from the first been a national service, controlled by a public board. The central government has also long operated a few additional enterprises, small but efficient, ranging from His Majesty's Stationery Office to a stake in the public house business known as the "State Management Districts" of the Carlisle neighbourhood.

Although there are considerable differences from country to country, broadly speaking the same sorts of industry have tended to get socialized everywhere, namely, those which in time of emergency it is vital for the State to control, such as the postal services, broadcasting, and the road system (which in many respects deserves to be classed as a trading service), or alternatively those which have an inherent technical tendency towards monopoly, mainly because their overheads are enormously high relatively to running costs, such as gas, electricity and transport. It will be seen that the British socialized industries conform closely to type.

In Europe—in contrast to Britain—it has long been more usual than not for the railways to be nationalized, but other public utilities are State controlled to very varying degrees. Some governments (e.g., in Sweden) also own such things as ore and timber reserves, and these are mainly operated through public boards. In the United States on the other hand, prior to the New Deal Administration, the Post Office was virtually the only nationalized industry; even now the telephone and telegraph are not under public ownership. On the other hand individual American cities sometimes operate extensive trading services.[1]

The determination of the proper limits for public ownership or enterprise falls outside the province of public finance, so that we cannot discuss them here. In practice policy tends to be directed by political rather than by economic considerations, but that is not as it should be, since the basis of an objective decision on economic grounds could be made available. It cannot be assumed *a priori* that public operation will secure maximum

[1] *The city of Jacksonville is quoted as deriving over 30 per cent of* its revenue from public enterprises, cf. Hansen and Perloff, *State and Local Finance in the National Economy.*

efficiency.[1] On the one hand nationalization offers the best prospect of adjusting the size of the units of control to the technical optimum—a consideration which is particularly important in the technical monopolies—on the other the measuring rod of efficiency in public enterprise (production at minimum social cost) is less convenient as a directive than the private enterprise measure (of maximizing the difference between costs and receipts). Only if a systematic enquiry has been made, based on objective policy criteria and statistical investigation, can it be determined in any particular case in which direction the balance of social advantage lies. Economic expenditure of other types should also be subjected to periodical statistical check of efficiency, since if they do not lead to an increase in productivity they can have no justification.[2]

§ 3. *Social Expenditure in the Modern State.* Social expenditure has for some generations now absorbed by far the largest share of British public outlay in normal times. The country has a long tradition of social service. Even in the early nineteenth century expenditure on poor relief was large relatively to the national income, although it declined towards the middle of the century with the rise in Victorian prosperity and the rigours of the " New Poor Law " ; by that time, however, other social services were beginning to supplement its efforts. Before the middle of the century exchequer grants were given

[1] Thus there is reason to believe that the British economy would have profited by a more forward policy of telephone development, cf. Robson, *Public Enterprise*. An important factor in delaying development was the way in which the prosperous telephone services were made to carry the unremunerative telegraph services. This is a form of economic waste which may be a particular temptation to public service, cf. p. 366.

[2] Cf. p. 379.

towards education services; public education as a State service dates from 1870. Public Health services also started before the middle of the century (when they were much stimulated by the effect of a devastating cholera epidemic); they were greatly extended in the early years of the present century, and again as a result of the 1914–18 war, the new emphasis being marked by rechristening the Local Government Board the Ministry of Health.

Social insurance and old age pensions were introduced by the Liberal Administration of the first decade of the present century; they were enormously developed in the inter-war period. House building by local authorities started as a tiny trickle just before the war of 1914–18; by the late 'twenties it had expanded to a major national service, accounting for roughly two-thirds of the new houses built in the period 1924–36. It can be safely affirmed that no other country provided social services on the scale of Britain in the inter-war period, yet they still fell a good way short of the national minimum which is the goal of social security programmes.

The present British social services can be roughly classified under three heads: (i) education, (ii) public health (including housing and health insurance) and (iii) income supplements, in the form of transfers in cash or kind from the incomes of other citizens, through the tax system. These three headings now cover a large variety of services. Under education, for instance, we should include the provision of schools and technical colleges, the payment of salaries to teachers and administrative staff, the award of scholarships and maintenance grants to pupils, the provision of ancillary services, school meals and medical service, and finally the provision of libraries, museums and picture galleries. Over 70 per cent of education expenditure is, however, absorbed by the public elementary schools.

The services usually grouped together under public health expenditure are even more various. First come a number of collective and indivisible services, such as street cleansing, drainage and sewerage, and the provision of parks and baths.[1] Next come services which are collective, but not necessarily indivisible (in the sense that it would be possible to charge fees to cover costs), such as the provision of hospitals, sanatoria and clinics of various types; this is the group which is due for the greatest development with the establishment of a national health service. Finally, we must include national health insurance, in which the supplements to income are mainly given in "kind"—in the form of the services of doctors and the provision of drugs and surgical appliances. Closely allied to this is the compensation for industrial injury, which (starting prior to the establishment of health insurance) grew up outside the State's ægis, financed by a private system of insurance; it has long been ripe for inclusion in the national scheme.

The remaining supplements to personal incomes are given in the form of cash (save for the rent and food vouchers provided by public assistance authorities). Unemployment expenditure varies with the state of trade, but *per capita* payments have progressively approached the level of unskilled wages. *Per capita* pensions payments also show a continuous tendency to rise, as well as a secular expansion due to the ageing of the population.

[1] Many of these services are only loosely concerned with health, and it is probably more appropriate to class them (together with certain other services, such as the more cultural varieties of education expenditure) as "civic amenities" the development of which is an important indication of the wealth of a locality, cf J. R. and U K Hicks, *Standards of Local Expenditure*.

These services are also due for further expansion with the implementation of an integrated social security programme.

During the 1930's the public social services (including war pensions, which have a similar social effect) required an annual outlay of about £500 millions. Of this, roughly one-quarter went to education, one-quarter to health services (including housing expenditure not covered by borrowing), while the remaining half consisted of supplements to personal incomes (social transfers); of this, roughly half went on public assistance and unemployment payments, and half on pensions of various sorts. Social expenditure had thus come to be more important as a provision of incomes than as a provision of services. The large percentage already absorbed by pensions is particularly significant in view of the continued expansion of the pensionable age groups, and of the second crop of war pensions attributable to the years 1939–45.

The economic public services are both provided and paid for by the central government (with the exception of the local trading services); social services on the other hand are mainly provided by the local authorities, but are only partly financed from local funds. An elaborate system of exchequer grants has been built up in aid of these services, partly with a view to stimulating local activity, partly in order to make things easier for the less prosperous neighbourhoods. We shall have to examine the policy implications of this apparatus at a later stage.[1]

Adam Smith envisaged the "public works" comprising his "third duty" as being financially self-balancing, covering their costs out of sales and fees, and thus imposing no charge on the revenue. This is roughly the position with the local trading services; the postal

[1] See Chapter XV, especially Sections 2 and 7.

services are, however, operated to bring in a positive profit (totalling about £11 millions in the 1930's) in support of general revenue. In the eighteenth century road expenditure was made self-balancing by the device of tolls; a similar result was in principle obtained in the inter-war period, during the life of the independent Road Fund (which came to an end in 1937), vehicle duties and fuel tax in principle being set against road expenditure. In practice, however, the revenue collected was largely applied to general purposes.

On the other hand there is now no attempt to make the social services self-supporting. Fees are indeed charged for some services (e.g., in hospitals and secondary schools); the house rents charged in the inter-war period by some authorities were almost sufficient to constitute housing a trading rather than a social service. By and large, however, it is accepted that the social services should be provided free, in order to bring about a more equal distribution of consumers' incomes.

The only type of public outlay which we have not yet discussed consists of payment of interest on the National Debt. To the government this appears as just another demand on the public purse, absorbing revenue which might more usefully have been devoted to social or economic development. This, however, is a misleading way of looking at the debt charge.[1] In the first place the interest is not a burden on the revenue commensurate with the outlay required, because interest payments are subject to taxation. Britain's high rates of surtax ensure that the national debt is self-supporting to a not negligible extent.

A more important reason why we should not regard

[1] For discussion of the economic significance of the National Debt, see Chapter XIX, Section 3.

expenditure on debt interest in the same light as other forms of outlay lies in the nature of the loan. The British National Debt is almost wholly a legacy from past wars. In war-time the government borrows from the private sector, but when the war is over no tangible assets remain to set against the debt, nothing but paper claims from the debt holders against the government. The National Debt is thus similar in kind to the consumption loans incurred by the spendthrift, which are set off against his income (if any). It is more logical to treat interest on the National Debt as negative public income rather than as a positive outlay; in any case it must be clearly distinguished from other sorts of public expenditure.

§ 4. *The Changing Emphasis of Public Expenditure.* It emerges from our discussion that Adam Smith's list of the "Duties of the Sovereign" are still appropriate as a classification of public expenditure. In order to appreciate the importance of the public services in a modern economy it is necessary to give them a statistical content. The relative importance of the different services is best realized by referring them not merely to each other but to the total resources of the community. It is also necessary to have regard to their development over time, and to their variation with good and bad economic conditions. Table I illustrates these movements before 1939 by showing the relation of British public outlay to the national income in the three "normal" years (which are used as the bases of statistical series), 1913, 1924 and 1938, in the good years, 1928 and 1936, and in a bad year, 1932. Some time must elapse before a parallel normal distribution of post-war expenditure can be described.

TABLE I.—BRITISH PUBLIC EXPENDITURE (OTHER THAN EXPENDITURE ON CAPITAL ACCOUNT) AS A PERCENTAGE OF THE NATIONAL INCOME.

Year	Defence	Civil Government	Social Expenditure	Economic Expenditure: General	Economic Expenditure: Roads	Economic Expenditure: Trading
	%	%	%	%	%	%
1913	3·6	0·9	5·5	0·006	1·0	(3·7)[1]
1924	3·2	1·3	10·3	0·2	1·6	(4·0)
1928	2·9	1·3	11·1	0·3	1·7	(4·5)
1932	3·1	1·7	15·8	0·5	1·9	(5·7)
1936	4·5	1·5	13·0	0·6	1·6	(5·2)
1938	7·8*	1·5	13·0	0·6	1·4	(5·7)

* Estimated

The dominance of social expenditure is strikingly demonstrated by this table; the greater importance of economic services than the expenditure suggests should, however, also be borne in mind; it should also be noted that the rate of expansion of these latter services was greater than for any other.[2] In contrast to other economic expenditure road development was allowed to stagnate; it can hardly be doubted that the neglect of the roads in the face of the rapid expansion of motoring was an important factor in the high accident rate, which all deplored. It is interesting to observe the very much higher level of defence expenditure in 1938 compared with 1913.

This was partly due to a greater preparedness for defence in 1938, but also partly to the continuing cost of retirement and disablement pensions accruing from the war of 1914–18.

It should be noted that all services (except the continuously growing general economic services) registered

[1] Since the services are self-balancing no net charge on the revenue is implied.

[2] A more rapid expansion of trading services would be registered if it were not for the fact that the considerable expansion of electrical generating plant under the Central Electricity Board is excluded from this account of the activities of government bodies.

an expansion relative to the national income, in the depression year. This illustrates the rigidity of public outlay, due to the long-term arrangements under which most of the services operate. The rising percentage does not, however, indicate an absolute expansion, except in the case of economic services and social expenditure; on the contrary, every effort was made to economize in order to balance the budget. Even in the case of social expenditure the expansion was merely due to unemployment pay and public assistance; substantial cuts were attempted in other services, notably education. By failing to distribute its normal quota of incomes the public sector thus contributed to intensifying the depression. Fiscal perversity of this nature in the public services is an important factor in policy, which we shall have to consider at a later stage.[1] On the other hand the importance which economic and social expenditure had already attained in the inter-war period was favourable to the implementation of a high employment policy, for which they are the most relevant factors.

Finally, the relation between pre-war and inter-war deserves brief comment. Real income per head is estimated to have been roughly equal in 1913 and 1924, but in the latter year the public services absorbed a larger share of income. The loss of assets during the war imposed only a slight retardation on the process of expansion. It is impracticable to compare the distribution of expenditure in war-time with normal outlay, owing to the distortion of the economy by war effort, but we can be certain that in spite of the greater loss of assets during the later war period, the change from war to peace will again register an upward sweep of the public services, in advance of the recovery of total income.

[1] In Part III.

It will be seen that the expansion in the public sector which the table records was practically continuous throughout the inter-war period; it evidently did not depend on the dominance of any particular political party. The community was just demanding, and getting, more public service in relation to private. What is the significance of this? To an important degree the expansion was merely a consequence of the rise in the standard of living; public goods can be afforded more abundantly by wealthy communities. Only when the most urgent individual wants have been satisfied will democratic majorities agree to the satisfaction of any but the most fundamental collective wants.

There is, of course, another side to the matter. Once an upward trend has been started it is easy and popular to vote an extension of public services when times are good; once a service is established it inevitably tends to grow. Is there not a danger in this process that the community may, as it were inadvertently, provide itself with more public goods than it would really agree to if it could view the development over a period as a whole? The danger is not imaginary, but it can be guarded against in two ways. In the first place an effective administrative machinery is required for the control of expenditure and as a check upon its efficiency; in the second place clear policy objectives must be developed and followed, in order to determine both the limits of wise expansion and the correct priorities between competing claims on the national resources. We shall have to examine in turn the provision for these two controls.[1]

[1] Cf. Chapters IV and VI respectively, cf. also Chapter XV.

CHAPTER III

THE MAKING OF FINANCIAL POLICY

§ 1. *The Sovereignty of Parliament.* Policy is proposed by the Cabinet, but must be agreed by Parliament before it can be implemented. Our interest is not in the political forces which determine policy, but in the financial means adopted by Parliament to carry it into effect, including the policy which governs the choice of means. Success in public finance depends on a judicious balance of stability and flexibility—stability because unnecessary change is costly and loosens the established threads of control; flexibility because in a world of change public finance needs to be kept appropriate to the situation. We have to enquire how far these two qualities emerge from the financial apparatus which has been developed in Britain.

All financial policy is ultimately under the control of Parliament, which has a final responsibility for the activities of every taxing and spending department in the country. It is a principle of the British constitution that Parliament is in a legal sense all-powerful, but the immediate control of the House of Commons, even when the government has a large majority, is clearly much more limited.

We can, in fact, distinguish three degrees of Parliamentary control over the public finances. One part of public expenditure, and the balancing revenue, lies entirely outside the immediate jurisdiction of Parliament (being under the control of the local authorities); a second is reviewed by Parliament, but is agreed to without debate; the remainder is submitted to Parliament in great detail and debated at considerable length. It is obviously this third section which is most fully under control and most amenable to adjustment, but even then the hands of Parliament are to some extent tied by past contracts and by the nature of the services. Public finance never starts with a clean sheet any more than does the finance of any other " going concern ".

It will be useful in the first place to discover the relative importance of these three degrees of Parliamentary control. In the year 1938 the Cabinet presented to Parliament expenditure plans amounting to £1034 mn.; to finance this the government proposed to find revenue for £944 mn.[1] and to cover the remainder by borrowing. Of this expenditure total £242 mn. was to be charged directly on the " Consolidated Fund ",[2] that is to say it belonged to the second degree of control, to be reviewed, but not debated, by Parliament.

The most important item in this section was the interest on the National Debt. Once Parliament has agreed to the debt being incurred it must necessarily agree to the interest being paid. The actual sum required can only be varied by a change in interest rates or by repaying part of the capital out of a budget surplus; there would therefore not be much point in Parliament discussing the debt charge. The other items in this section are also fixed for long periods, either by contract or by design; they include payments to Northern Ireland under the settlement of 1922 and such matters as the household expenses of the Royal Family, pensions to retired citizens of note and salaries of certain officials (e.g., the judges) whose tenure of office is independent of Parliament. It

[1] Cf. the Balance Sheet on p. 101.

[2] The normal inter-war proportion was about 30 per cent, in 1938 total expenditure was swollen by defence borrowing; for the significance of the Consolidated Fund cf. pp. 55, 56f.

is unlikely that Parliament would want to do anything about these, save in very exceptional circumstances.

The remaining expenditure plan—except for an estimate for unforeseen contingencies and another covering the cost of tax collection—was divided into two parts, £253 mn. for the supply of the defence services,[1] £425 mn. for civil expenditure. Detailed estimates of the distribution of this were submitted and duly discussed (save in so far as the defence estimates were in that year shrouded in a security veil). In principle all this expenditure came under the third degree of Parliamentary control, it was within the power of any member to suggest a change of plan during the debates.[2] In fact, however, Parliament was pledged to pay over to the local authorities a sum of about £150 mn. from it, and a similar but rather smaller sum was required to finance the various types of pensions, and to support the social insurance funds. Thus the freedom of action implied in the debates on the estimates, so far as these sums were concerned, was rather of the nature of a reminder to Parliament that it could if it liked take steps to alter the arrangements, than as having any relevance for the year in question.

In addition to their Parliamentary grants the authorities which thus received them collected taxes independently of Parliament (the local rate and the contributions of workers and employers to social insurance respectively), to complete the financing of their activities. On the average, Parliamentary grants covered about 40 per cent of the expenditure of the local authorities on current account. About two-thirds of these grants were allocated to specific services whose conduct was broadly under the

[1] Exclusive of £90 mn. to be financed by borrowing.

[2] So long as the change did not involve an increase in taxation, see p. 59.

control of Ministers responsible to Parliament (such as the Ministers of Health and Education); the remaining third was awarded as a "block" grant or non-specific contribution to local revenues; the amount was fixed in advance for a five-year period and the local authorities themselves determined its distribution between services. Their policy was, however, inevitably deeply affected in the long run by the presence of these substantial grants.[1]

In a similar manner Parliament resigned control of the sums paid over to the independent insurance funds. The funds, however, operated in "predestinate grooves" the broad lines of which had been laid down by Parliament, and could consequently be altered by legislation. In detailed administration nevertheless the funds—especially the Unemployment Fund—exercised a considerable degree of autonomy. Thus in practice the substantial sums paid over by Parliament to the local authorities and to the insurance funds passed out of the Parliamentary orbit, *and belonged essentially only to the lowest order of* control.

We may sum up the situation by saying that Parliament nominally controlled the distribution of just under 60 per cent of public expenditure, but only about 40 per cent was subjected to discussion. Of this, some part (e.g., defence expenditure) was too technical to be usefully debated by laymen, and a further part (e.g., pensions) was fixed by long-term engagements. These proportions exclude trading activities. On the other hand, about 70 per cent of the taxes collected was voted by Parliament, so that control on the revenue side was rather more extensive.

[1] The precise proportion of grants to independent resources, and of specific to block grants, differed considerably from one authority to another (cf. pp. 262, 278ff.), but the degree of control by Ministers varied considerably less.

Although these proportions do not appear very high they are substantially above those controlled by the central government of a federation, such as the United States. Moreover, the opportunities for flexibility are rather greater than appear. Adaptation to economic changes might be incorporated by statute into the policy of the insurance funds, and (less readily) by agreement into that of the local authorities. These are matters to which we shall have to return at a later stage (in Part III). On the whole, however, the British financial system is distinguished for stability rather than for flexibility. Effective changes in public outlay, other than in defence expenditure, have been the result only of legislative changes.

Stability is not a merit in itself, but only so far as it conduces to the most effective distribution of public outlay. An examination of the machine which produces the annual plan of financial policy (loosely known as "The Budget") will enable us to estimate the probability of this.

§ 2. *The Treasury.* The centre of policy in the British system of government is the Treasury. In the later Middle Ages the habit grew up of giving the post of Treasurer to the chief Minister of the Crown. A very notable holder of the office was Lord Treasurer Burleigh, Queen Elizabeth's great minister (the first of many members of the Cecil family to hold important office under the Crown). Since 1714 the duties of the Treasurer's office have always been divided up by "putting it into commission", e.g., appointing a number of people who together form a nominal board or committee and who share between them the ever increasing business of the office.[1] (A similar plan is adopted for the Admiralty.)

[1] For the history of this device cf. pp. 54ff.

The continued importance of the Treasury in policy is shown by the fact that the Prime Minister almost invariably assumes the title of "First Lord of the Treasury". The members of the government are frequently referred to collectively as " The Treasury Bench ".

The Chancellor of the Exchequer, the chief financial officer of the Crown, is the Second Lord of the Treasury. His duties are to advise the Cabinet on financial matters, and to expound the government's financial policy in the House of Commons. The most important occasion on which he does this is when he introduces the Budget,[1] the financial plan for the year; but other occasions in which an explanation by the Chancellor is called for are becoming increasingly frequent as the importance of public finance in the economy increases.[2]

The remaining Lords of the Treasury hold minor political appointments, for instance in the Whip's office; they are known as Junior Lords and have no connection with finance. There are, however, two other important Treasury appointments—the Joint Secretaries. The first of these, the Parliamentary Secretary to the Treasury, holds the post of Chief Government Whip (or political organizer); he is thus closely concerned with policy, but again has no financial duties. His colleague, the Financial Secretary to the Treasury, on the other hand is the deputy of the Chancellor of the Exchequer; he shares the work of expounding the government's financial policy to Parliament; he is also responsible for overseeing the important civil service department called the Treasury.

[1] The first recorded use of the word in its technical sense appears to be in a pamphlet in 1733, cf. Miss D. M. Gill, "The Treasury 1660–1714", *English Historical Review* 1931.

[2] The traditional function of the Exchequer—from which it derives its name—the tallying of tax collections, is now under the Department of Exchequer and Audit, presided over by the Comptroller and Auditor General, cf. pp. 57ff.

Just as the First Lord is the central figure in the government, so the Treasury is the central department in the Civil Service. Up to 1939 the Treasury was quite a small department, by far the smallest of the great Ministries; an officer in one branch was therefore able to know personally his colleagues in other branches and could consequently communicate directly with the officer he required. Contrary to general belief, delays in obtaining Treasury rulings were not due to the red tape of a complicated hierarchy, but were an inevitable result of the difficulty of reaching decisions on matters of high policy.

Since 1914 the Treasury has been undergoing a gradual, but most significant, process of modernization. The fruits of this were seen between 1939 and 1945 when the Treasury stepped out of its watchdog's kennel and showed that, with the aid of the new Central Statistical Office and Economic Secretariat of the War Cabinet,[1] it was capable of acting as a central planning department, not merely for the public sector, but for the whole economy. This revolution was only carried through by a drastic enlargement of the department, accompanied by a large although temporary infusion of new blood.

In normal conditions a less swollen Treasury should be sufficient for it to continue to fulfil its war-time role, and it should be possible to retain most of the old advantages of personal contact, without losing the positive qualities acquired in war-time. It is essential for the well-being of the economy that the Treasury should not return to its traditional role of simply vetoing expenditure, and that the new central organizations connected with the Cabinet Offices should be put on a permanent footing in respect to it. As the technical controller of the public

[1] Cf. p 324

purse the Treasury inevitably controls the implementation of plans; its central position gives it a power which cannot be delegated to any other department. The Treasury must therefore play a very important part in planning, and it is vital that its power should be used in a broad and constructive direction instead of in a narrow and reactionary one. It is hardly too much to say that on the completion of the process of the modernization of the Treasury the success of a systematic economic policy depends.

According to present organization the Treasury is divided into three sections: Supply, Establishment (or personnel) and Finance, corresponding to its three functions of watching over the activities of the other spending departments, of supervising the appointment and pay of civil servants and of preparing the details of financial policy.

The Supply branch of the Treasury embodies the traditional function of checking expenditure. It is a relatively large section, divided into subsections, each of which has under its charge a group of ministries whose financial activities it supervises, helping and advising on the preparation of estimates and on the lay-out of revenue. We shall have some more to say about its work presently.

The Establishment branch in its present form dates from 1919. Its various subsections perform parallel services for similar groups of ministries, in respect of the appointment, promotion and remuneration of civil servants. It has become customary to refer to the senior officer of the Treasury (the permanent secretary) as the Head of the Civil Service, a title which is generally held to imply a policy of closer control and co-ordination than formerly existed. The Treasury also performs parallel services for the defence departments, except that in their case the Treasury organization is adapted so as to bring Supply and Establishment for each service into the closest possible relation, in order to ensure an efficient dovetailing of personnel and equipment.

The Financial Section is the only part of the Treasury which is directly concerned with financial policy; this is also divided into three branches. One has under its wing the financial departments concerned with Home Affairs, e.g., the Inland Revenue and the Department of Customs and Excise; a second covers similarly the Dominions, India and Colonial Offices and the Diplomatic Services. The most interesting section for public finance is the third section, called Financial Investigations. This is where the details of financial policy are prepared; in it the Budget calculations are made, and from it emanate the annual editions of the Public Accounts, and, of recent years, the annual calculations by the Central Statistical Office of the lay-out of the entire income and expenditure of the economy, known, for want of a better short title, as the Budget White Paper.[1]

During the war an immense amount of additional work was thrust on this section of the Treasury. In view of the broader outlook on questions of public finance resulting from war experience and from new demands for a high employment policy, it is an urgent need for the future that the section should be considerably strengthened.

§ 3. *The Annual Financial Routine.* The above comprises the main equipment for preparing financial policy. By briefly following the annual routine of preparing the plans for expenditure and revenue, and passing them through

[1] On the significance of this cf. Chapters VI and XX.

Parliament, we can watch the machinery at work.[1] The Financial Year in the United Kingdom begins on 1st April; formal financial preparations begin some six months in advance of its commencement, when (about 1st October) the Treasury sends to the various Departments a request for the submission of Estimates of expenditure for the coming year. In actual fact this is not the beginning of the Estimates, which may almost be said to be in continuous preparation; as each item of expenditure takes place, minutes on it constitute the first stage in planning the corresponding item next year.

The official opening of the financial, as of the Parliamentary, programme occurs on the reassembly of Parliament for the new session, an event which now takes place in the autumn. At the opening of Parliament the King's Speech (prepared in the Cabinet and submitted to His Majesty by the Home Secretary) briefly reviews the work of the session just concluded and outlines the business of the new session—the legislation which it is hoped to enact and a rough idea of the revenue which it will be necessary to raise, both to cover routine services and to provide for any new legislation which may have been passed in the previous session. It is significant of the British constitution that while the general policy plans are communicated to both Houses together, the Commons are addressed alone when it comes to matters of finance.

The King's Speech is followed by an Address from both Houses in reply to His Majesty (this is also prepared by the Cabinet). The most significant thing about the Address is the opportunities which the debate gives—on the one hand for the Opposition to criticize the general

[1] For further administrative detail cf. Ivor Jennings: *Parliament*, especially Chapter IX.

policy of the government, on the other for the government to gauge the strength of the Opposition. When the Address is carried without amendment the government is in a very strong position.

At this stage in the financial year one further piece of routine machinery is set up. Expenditure and revenue debates do not take place as formal sittings of the House of Commons, with the Speaker in the Chair; instead they are conducted in Committee, but in Committee of the whole House, presided over by specially elected chairmen. Different chairmen hold office according as the House is considering expenditure (when it is said to be in Committee of Supply) or taxation (when it is said to be in Committee of Ways and Means). At the time of the Debate on the Address these Committees are formally set up and the Chairmen selected, although the machinery does not begin to function until some time later. The purpose of this rather odd Committee arrangement is to allow greater freedom in debate—for instance, as to the number of times a Member may speak on the same Motion—than would be permissible under the Standing Orders of the House when the Speaker is in the Chair.

The next stage in the financial year is the consideration of the Estimates by Parliament. These will have been submitted to the Treasury by the departments of the central government about mid-December, and provisionally approved by the Treasury before the end of January; they are brought before the House about the middle of February. The Supply Estimates are presented in four volumes (one each for the Defence Departments and one for all the Civil Departments run together). Altogether they occupy some 2,500 pages of print. From the point of view of policy the Civil Estimates are the most interesting, since a large part of Defence expenditure is technical, and a further large part (e.g., war-service pensions) is subject to long-term undertakings.

The Defence Estimates are introduced to the House of Commons by the respective Ministers responsible for the departments, but the Financial Secretary to the Treasury undertakes the whole work of passing the Civil Estimates through the House of Commons. The Estimates are classified in groups (Classes) relating to the different Ministries—thus Class V is entitled " Health, Labour and Insurance "—and covering the work of the respective Ministries. Each Class is divided into a number of " Votes "—1, 2, 3, etc.—these usually refer to the same type of expenditure every year, for convenience of checking outlay. Each Vote is in turn divided into Heads, A, B, C, etc., and each Head into Subheads, A1, A2, A3, etc., so that the expenditure is finally broken down into quite small sums, occasionally as low as £10, more commonly in sums of £100 or so. Thus the plan of the lay-out of intended expenditure is extremely detailed, but, as we shall see later, owing to the peculiar organization of the public accounts, the details are in practice not very informative.

A major responsibility of Parliament during the spring and early summer is the consideration of these Estimates; but Parliament also has a great deal of other business to attend to—new legislation, the discussion of current events and replies to Members' questions. It has therefore been agreed that the Estimates can only be allowed twenty Parliamentary days for consideration (with provision for three extra days if it proves absolutely unavoidable). These " Supply " days may be arranged almost any time that Parliament is sitting, between February and the end of July, when the Estimates must be passed.

Votes which have not been discussed by that date must be agreed to without debate.[1]

By the middle of April all the main transactions belonging to the previous financial year will have been completed, and the lines are clear for the new year's programme, formally ushered in by the Budget Speech. On Budget Night the House is crowded; foreign diplomats, distinguished visitors and the Press are in their places in the galleries. It is the great moment in the Chancellor's year, perhaps in his life. He is photographed as he leaves home, clutching the fatal dispatch case which contains the jealously-guarded secret of tax changes. He may never be able to say: "I hold in my hands war or peace," but the business world firmly believes that the case holds good or bad trade.

Since the time of Pitt, Budget speeches have been among the most important made in Parliament. In Victorian times, since none of the statistics were printed, the speech was largely a *tour de force* illustrative of the Chancellor's memory; it might occupy several hours, and some Chancellors hardly deigned to make use of the notes provided for them by the Treasury, preferring to produce everything from their own heads. Although there is now much more for a Chancellor to say in his speech, the process has been enormously shortened by making available to Members a printed Financial Statement summarizing expenditure and revenue for the year which has just ended. Even so, Chancellors are wont to make the most of their opportunity, and to attempt to give the

[1] Certain other financial routine has also to be fitted in between the introduction of the Estimates and the end of March, concerned with the completion of transactions relating to the year then ending, and with interim arrangements for meeting bills during the four months of the new financial year which will elapse before the Budget becomes law. The necessary legislation is embodied in two Consolidated Fund Acts. These need not detain us, since no question of policy is involved.

speech an individual flavour in the tradition of a Peel or Gladstone, or even a Churchill or Snowden.

We need not linger here over the plan of the Budget Speech, which invariably follows traditional lines, because we shall have to discuss at some length at a later stage the principles on which it is based. The information given in respect of expenditure is inevitably very summary, since the accounting period will only have ended a couple of weeks earlier, and in fact it does not add a great deal to the weekly summaries of expenditure and revenue published throughout the year; consequently, this part of the speech does not arouse a great deal of interest. The Budget properly so-called consists of the details of the taxes which it is proposed to levy during the year.

This is what the business world has been waiting for. The proposed tax changes will subsequently be debated in Committee of Ways and Means; it is not impossible that the government may have to modify some of the proposals during discussion, at least as to detail, but it is uncommon to meet strong opposition to considerable parts of the tax plan. After all Parliament already knows broadly what it is in for in the way of expenditure, and revenue must be voted to cover it. In order to prevent forestalling of new taxes—for instance by laying in large stocks of a commodity which it is expected will be more heavily taxed—all the financial resolutions but one are taken immediately; if overpayment occurs as a result of subsequent amendment to the Budget, tax which has been paid is refunded. This device secures at one and the same time continuity of revenue collection and opportunity for the discussion of tax changes.

Since 1941 some further statistical information of a very important nature concerning the country's finances has been made available to Members and to the public, on, or shortly before, Budget Night. This consists of the detailed estimates of the national income and outlay, and of its distribution between income groups, which are contained in the Budget White Paper. Some reference to these calculations is made by the Chancellor in his formal speech, but they are detailed and technical; so far it has not been possible for Chancellors to digest the new information sufficiently to reveal its full significance to the public at the time of the introduction of the Budget. If we may borrow a metaphor from the gramophone, the art of recording has for the moment surpassed the instrumental powers of reproduction; this is a matter to which we shall have to return at a later stage.[1]

Several days are usually allotted for the discussion of general financial policy after the Budget has been introduced. The House then goes back to general business, this time interspersing Ways and Means debates with the remaining Supply Days and other matters. When all the financial resolutions have been agreed to in Ways and Means, the Finance Bill is brought in and must be passed through all its stages before the end of July. It contains all the revenue changes, and from time to time a certain amount of general legislation concerning the details of tax administration.[2]

Any of the Estimates which have not previously been passed are taken on the last two supply days, and passed *en bloc*, so that by the end of July the whole of the financial programme for the year will have been agreed to. It is embodied finally in only two Acts—the Finance Act covering taxation and authorizing disbursement of revenue; the Appropriation Act authorizing the appli-

[1] Cf. Part III, especially Chapter XX.

[2] Thus the Finance Act of 1944 contained important provisions relating to the taxation of business profits, see pp. 226ff.

cation of revenue to the purposes stated in the Estimates. Thus, little more than four months after the opening of the financial year, all the vital arrangements for its transactions will normally be complete.

It will have been noticed that we have been concerned so far only with the activities of the House of Commons; before the Finance and Appropriation Acts become law they must also be passed by the House of Lords and receive the Royal Assent. There is now no danger of any serious hitch in the Lords, and the Royal Assent is completely automatic. The last occasion on which the Lords attempted to assert an independent policy occurred in 1909, when the Upper House refused to pass the Finance Bill authorizing revenue for the new social insurance funds. The Lords' opposition was recognized to be against the social rather than the financial policy in question, so that an important constitutional issue was involved. As a result of this attempt to frustrate the policy of the government, the Lords were eventually forced to accept the Parliament Act of 1911, whereby a Money Bill passed by the Commons and presented to the Lords at least a month before the end of the session, becomes law, whether the Lords agree to it or not.

A simplified version of the Budget technique is followed by the more important Local Authorities, the Finance Committee usually playing a more or less parallel role to the Treasury in the preparation and co-ordination of the estimates of the different Committees of the Council. Thus for each main public body in the country, the year's financial plan comes before the elected representatives of the citizens in a single, fairly simple, consolidated account.

The consolidated account is an essential first step in ensuring an efficient lay-out of resources on the one hand,

and an efficient control of expenditure on the other; but it is clearly no more than a first step, in itself it is no guarantee of efficiency in either direction. We have only to consider what sort of control can be exercised by a Committee of more than 600 members which only allows itself twenty days to consider 2,500 pages of estimates. That it cannot be a control of technical detail is quite evident; it is hard to believe that even the broad lines of policy are really clear to many Members. It is therefore not surprising that Parliament has been occupied for centuries in devising means of checking its own financial actions.

CHAPTER IV

THE CONTROL OF EXPENDITURE

§ 1. *The Consolidation of the Public Accounts.* The financial plan which is embodied in the annual Appropriation Act and Finance Act is the joint product of the Treasury, the Cabinet and Parliament (putting the partners more or less in the order in which their contributions are made). This co-operation is necessary, first, to see that the plan *as submitted to Parliament* is satisfactory, in that it provides for an efficient transfer of private resources to the public sector and for their distribution in accordance with the government's policy; secondly, that the plan *as it leaves* the House of Commons really expresses the wishes of the House; and, thirdly, that the plan is *put into execution* in accordance with the decisions of Parliament.

These three conditions need to be distinguished, but they must all three be fulfilled. A not-so-good measure proposed to Parliament may be improved as it passes through the House; on the other hand an initially coherent measure may be torn to pieces or distorted beyond recognition by bright ideas during debate, unless some means of ensuring self-restraint are available. Needless to say even good measures will fail unless carried out according to intention.

The three conditions just set out are not peculiar to financial measures; they are necessary for the carrying out of any legislation, and to discuss them fully would take us far away from the field of public finance; but they have an especial meaning and importance as applied to financial plans. An inefficient piece of general legislation (say, an Education Act) will retard development in that particular line, but it will only in a minor way affect the general situation; an inefficient finance plan may upset the whole of policy and inflict harm on the entire economy; consequently, special measures have to be taken to see that the three conditions are fulfilled in respect of financial measures.

Parliament, as the ultimate authority, has to do its best to assure itself that the three conditions are faithfully carried out, but by its very nature it works under a grave disability. For Parliament is essentially a dual-purpose assembly. On the one hand it is a legislative body in control of the executive, charged with the making of new laws and with the duty of seeing that existing laws are working in accordance with intention; on the other hand it is a forum for the discussion of national and international issues, and for the ventilation of private grievances. Neither of these two duties can be dispensed with, or even markedly curtailed, without damaging our democratic institutions; but it is obvious that the pressure of the second duty severely limits the time available for the first, and so makes success more difficult. When we further reflect that membership of Parliament is not a whole-time job, and that most members have their own businesses to attend to, the importance of the time factor becomes still more apparent.

For these reasons Parliament has found that it is desirable to have the financial plan presented in as simple and unified a form as possible; even so it has to rely heavily on the work of its partners. It is worth pausing for a moment to observe the process by which the modern partnership and division of functions have been evolved, more especially the process of the consolidation of the accounts.

It now seems clear that not merely the Cabinet (whose evolution is related in every school history book), but also the Treasury and the organization of the national finances, were started on their modern careers as the result of a series of vital, but very inconspicuous, developments which took place between the accession of Charles II and the death of Queen Anne. It is interesting to reflect that if the Pilgrim Fathers had sailed a couple of generations later these changes might conceivably have been embodied in the United States constitution, which would then probably have assumed a considerably different form from the one which it has now developed.

In early Stuart times the "Executive" consisted of the "King in Council" that is to say, the King's advisers were outside Parliament, in the manner of the Executive of the United States. The Treasury as a body emerged from this set up when Charles II departmentalized [1] the executive, with the double purpose of making it more effective and at the same time more obedient to his will. Under a succession of extremely able officers, chosen for their financial and business abilities,[2] and under the guidance of Lord Godolphin who held the supreme financial post under the Crown in many ministries and during four reigns, the Treasury soon attained the leading position among the departments. Decisions came to be taken there; the old-fashioned Council found itself effectively by-passed and gradually sank into

[1] Cf. D. M. Gill, *op. cit.*

[2] Especially Sir George Downing, appointed Secretary to the Treasury, 1667, who gave his name to Downing St.; from the fortune which he accumulated was founded two generations later, and by a series of accidents, Downing College, Cambridge. At least equally important was Sir Wm. Lowndes after whom Lowndes Square is called, Treasury Clerk, 1679, secretary to the Treasury, 1695–1724; his family motto records his skill in devising "Ways and Means" of raising taxation. See *Dict. Nat. Biog.*

insignificance. When before the end of the seventeenth century the transfer of the King's Ministers to Parliament took place (and the Executive and Legislature were united as "The King in Parliament"); the Cabinet being a Committee of Heads of departments, the Head of the Treasury naturally became the leading Minister.

From the Restoration the attempt to finance any considerable part of the public services out of the revenues of the Royal Estates had been abandoned (the inadequacy of these had been at the root of much of the trouble under Charles I). The support of the Royal Household and similar expenses were then put on a "Civil List", later merged in the Consolidated Fund. At the extinction of the life revenues granted to Charles I and James II the whole of Supply Expenditure became dependent on Parliamentary grant. It was then possible for the Treasury Lords to prepare Ministerial directions, corresponding to the modern Estimates; but already from 1667 the way had been prepared for this step by the insistence of the Treasury that the departments should furnish weekly accounts of their transactions with the Exchequer. From this period also dates the distinction between the two financial functions of Parliament—on the one hand to "Appropriate" supplies, on the other to find adequate "Ways and Means" to cover the appropriations.

The next considerable step forward in the consolidation of the public finances was the work of the younger Pitt. He has rightly been called the Father of the Budget, because he introduced the practice of laying the whole financial year's programme before Parliament in a single whole—on the one hand the Estimates for all Departments, on the other the total revenue estimated to be required to cover them. Pitt also laid the foundations of a consolidated accounting system, by finally transferring the accounts of all departments to the Bank of England. Modern practice, whereby the Estimates of Expenditure, and of revenue changes, are each passed in a single Act are essentially developments of Pitt's reforms; so too is the single Exchequer Account at the Bank of England (the bank balance of the Consolidated Fund), whereby all in-payments to the government, and all out-payments to departments pass through a single account, under the control of the Paymaster-General.

These three forms of consolidation are of the greatest importance for the orderly conduct of the nation's finances. The device of the Consolidated Fund enables the Treasury very simply to keep a watch over the departments, and makes it possible for the Cabinet to ascertain at any time roughly how things are going, simply by examining in- and out-payments of the Fund. The single Finance Act goes a long way to ensure that Parliament will agree on the necessary taxes, and will do so in plenty of time. For policy the single Appropriation Act is still more important, since it is the guarantee that Parliament has really had the opportunity of considering the entire annual lay-out of public funds as a whole.

This degree of consolidation was not achieved without considerable difficulty. The post of Paymaster-General was created in 1834; the single Finance and Appropriation Acts date from the 1860's, and were mainly the work of Gladstone, who ranks with Pitt and Godolphin as a financial administrator. The improvements were due, however, as much to the determination of the Commons to prevent the Lords from spoiling their plan, by throwing out essential parts (which was easy so long as it was presented in instalments), as to any anxiety to review the plan as a whole.

§ 2. *Departmental Control.* For the routine supervision of the Executive, Parliament relies more than ever to-day on the Treasury. Broadly, Treasury control is exercised in two ways, by taking minute care over the preparation of the Estimates, and by disallowing any departure from the expenditure plan without specific sanction; the Treasury maintains a staff of officers working inside the departments, and it is through them that the control is exercised. The control of the Estimates is largely a matter of routine; the Treasury keeps a "Blue Note" (file record) of each particular Vote; by this means it can detect, and if need be challenge, any departmental change of practice; it can also give especial attention to points which have proved difficult in former years.

Most of the Civil Departments publish detailed annual reports which provide Parliament (and the public) with a further record of performance (the Reports of the Ministries of Health and Education are particularly noteworthy). The Defence Estimates (in time of peace) are accompanied by eight-year comparisons of expenditure for different purposes; they also contain departmental reports similar to those of the civil ministries. Just as an alteration in the allocation of funds (technically known as *Virement*) requires specific Treasury sanction, so Parliament would not alter the arrangement of the Estimates without the consent of the Treasury; the merging of even two Subheads, for instance, would give a department additional latitude in the disposal of its funds.

A parallel system is used to check expenditure as it takes place. The Department of Exchequer and Audit presided over by the Comptroller and Auditor-General keeps a large staff (about 230 in 1938) of auditors continually at work in the departments. In respect of those departments which derive all their moneys from the

Consolidated Fund, control is a simple matter ; but some have additional in-payments—for instance, the court fees and fines collected by the police—the check is then more complicated. All such "Appropriations-in-aid", as they are called, have to pass through the Paymaster-General ; they cannot be retained in the departments. In the same way unexpended balances of funds voted by Parliament have to be returned to the Paymaster-General at the end of the financial year.[1]

The office of Comptroller and Auditor-General emerged from a series of reforms extending from 1832 to the Gladstone era ; the Comptroller is an "officer" of the House of Commons, with status similar to that of a judge.[2] His duties are to enforce the regulations which govern expenditure and to detect and report any waste or irregularity which occurs. The expenditure accounts are drawn up in an exactly parallel arrangement of Votes, Heads and Subheads as the Estimates ; whenever there is a discrepancy, however small, between supplies voted and sums disbursed, elaborate explanations are provided. Important discrepancies are often commented upon in

[1] The expenditure accounts of the British Government come out in three editions: (1) The Financial Statement, issued with the Budget ; (ii) The Finance Accounts, issued in the following autumn. These two also contain details of revenue collected, national debt operations, accounts of the civil list, and sundry other accounts, they differ from each other mainly in detail ; (iii) The Appropriation Accounts, issued some eighteen months later for the civil and defence supply departments, in which are recorded all adjustments between the Consolidated Fund and the Departments.

[2] That is to say he can only be removed by petition of both Houses. The Comptroller and Auditor-General is thus the ultimate guardian of the public purse (and not the Paymaster-General, who is a member of the Government). This was brought out very clearly in the financial controversy of 1909–11, when there was some little danger of a stoppage of the public services, since the Comptroller and Auditor-General would not have continued to authorize expenditure if Parliament had failed to pass a Budget. The episode is excellently described in Sir A. Chamberlain's *Politics from Inside.*

the Comptroller's Report which prefaces the Appropriation Accounts.

§ 3. *Parliamentary Control.* The direct contribution of the House of Commons to the shaping of the financial plan is made in the debates of the Committees of Supply and Ways and Means. The practice of the British constitution goes a long way to ensure that the plan will go through in a coherent form, and probably without major amendment. Three safeguards make this result highly likely. In the first place electoral practice (straight voting in single member constituencies) ensures a workable majority in nearly all situations; secondly, the government's powers of closure, especially the limitation of the supply days to twenty, enable it to impose its will; thirdly, and most important of all, the government has a monopoly of the right to make proposals which would require additional taxation—and few expenditure proposals do not.

The first form of the Standing Order (S.O. 63)[1] on which this most important provision rests, dates from 1713. Unfortunately the state of Parliament's records in the seventeenth century makes it impossible to discover its origin, but we may safely regard it as a further legacy from the great days of Godolphin and Lowndes. It is completely effective in preventing either government back benchers, or members of the Opposition, from wrecking the balance of a financial plan by trying to go "one better" than the government, a habit which is the

[1] In its present form, which dates from 1866, S.O. 63 reads: "This House will receive no petition for any sum relating to the public service, or proceed upon any motion for a grant or charge upon public revenue, whether payable out of the Consolidated Fund or out of money to be provided by Parliament, unless recommended by the Crown." Cf. Jennings, *op. cit.*, p. 250.

source of endless trouble in countries which do not follow the British constitution in this respect.

In theory the Debates in Committee should provide opportunity for the House to examine the Cabinet's proposals reasonably thoroughly. On the expenditure side, as we have seen, the Estimates are drawn up in very great detail, so that there should be no dark corners in the government's policy. On the revenue side it was formerly the custom to ensure adequate opportunities for debate even if no tax changes were proposed, by making the income tax and one other duty (usually that on tea) renewable only from year to year; now that annual tax changes are many and complicated this device is no longer required.

In practice, however, the supply debates do not ensure that the House makes a thorough examination of the Estimates. Apart from the overriding limitation of the time available, Parliament in effect uses the supply days for a different purpose. The Votes of the Estimates are not examined in any systematic manner; instead the Vote to be debated on any day is determined by the Whips in consultation, with the Opposition exercising a final right in the choice of subject. If the Opposition considers that the Government's dirty linen has been insufficiently exposed to public view by a single debate, it is open to it to return to the same Vote day after day, merely by avoiding a division on the Vote in question. Thus in the 1920's the Ministry of Labour Vote was discussed again and again, in order to draw attention to the Government's failure to abolish unemployment.

As a result of this practice it invariably happens that by the time the eighteenth supply day comes round, only a fraction of the Estimates will have been considered at all. It is then necessary for the remaining two days to be spent by members walking in and out of the division lobbies, passing estimates which have never been discussed, and which they may not even have read. This treatment of the Estimates is a striking example of the difficulties caused by the dual nature of Parliament.

In point of fact it is doubtfully necessary or expedient for Parliament to attempt to examine the details of estimates which have already been very thoroughly examined by the Treasury; as we shall see later, the fact that Parliament insists on having these details before it actually makes it more difficult to adopt an effective system of accounting for the public services. On the other hand it is by no means certain that the method used is the most useful for securing the type of general debate on financial policy which should be Parliament's proper contribution to the plan.

The Estimates are debated piecemeal, Vote by Vote; members can raise any topic whatever connected with the department whose Vote is under consideration, but they cannot raise questions relating to other departments. Many subjects, however, are common to a number of departments (for instance, wage policy in the public services), and it would obviously be sensible to have a general discussion upon them. The present machinery makes it almost impossible to fit in such debates; they are too broad for supply days, and too specific for the few days in the session (such as the Debate in the Address) which are set apart for general discussions.[1]

[1] An illustration of this difficulty occurred in the session of 1942 when Sir H. Williams attempted during the debate on E.P.T. to raise the general question of the effect of Government policy in increasing the cost of war materials. He was ruled out of order by the Chairman for raising a Supply question in Committee of Ways and Means. Sir H. Williams remarked: "One of the tragedies of our system is that we never have a Supply Debate, but only a grievances debate." As will be seen, this is not far from the truth.

Parliament has long been conscious of the inadequacy in the control over the lay-out of public resources which can be exercised by Committees of the whole House ; it has therefore attempted to supplement the debates by investigations of select committees of its own members. The oldest of these is the Public Accounts Committee,[1] still another of the Gladstone reforms. It is a committee of fifteen members, drawn from the different political parties roughly in proportion to their representation in the House (in accordance with the usual practice for select committees). In order to ensure a critical attitude the chairman is a member of the Opposition ; it is usual, and obviously convenient, to choose the Financial Secretary to the Treasury in the preceding government.

The Reports of the Public Accounts Committee are considered by the House on a supply day, and most of the evidence is subsequently published. The importance of the work of the Committee, however, does not lie so much in the attention which Parliament pays to its findings, as in the examination of witnesses from the departments. The procedure is for the chairman to sit at one end of a table, the Treasury representative at the other, with the representative of the victim department between them. It is not surprising to find that the most important effect of the committee's work is considered to be the feeling of " wholesome dread " which it inspires in the departments.

By means of the double check of the Department of Exchequer and Audit and the Public Accounts Committee, a high tradition of financial integrity and probity has been built up among public servants. It can confidently be stated that no country in the world wastes less of its

[1] First appointed in 1861, it became a Standing Committee in the following year.

substance through malversation in the public services.[1] All this is excellent so far as it goes, but its effectiveness as a check on the allocation of resources is severely limited in two ways. In the first place to make a detailed examination of expenditure only after it has taken place is apt to be like shutting the stable door after the horse has escaped; in the second place the type of control over the Executive which Parliament secures by these methods seldom rises above a fairly elementary technical plane.[2] Waste of public money is likely to occur in more subtle ways than through the occasional dishonesty of minor Civil Servants.

In order to meet the first of these difficulties Parliament has tried various plans to ensure a more thorough examination of expenditure by submitting programmes as well as accounts to select committees. A Select Committee on the Estimates[3] was appointed for each of the Sessions 1912–14, and again from 1921 to 1939. Its reappointment was announced in 1945. There is general

[1] With a few exceptions the finances of British local authorities are subject to a technical control which is markedly inferior to that of the central government. There is no uniformity either in the method of keeping the accounts, or in the form of the Abstract in which they are presented to the citizens. The accounts of some local authorities, and in respect of some services the accounts of all local authorities, are subject to audit by a District Auditor of the Ministry of Health. Even this partial check is inferior in quality to the control of the Exchequer and Audit Department, since the District Auditor remains in the area for only a short time. It is still open to non-county boroughs to dispense with the services of professional auditors in respect of their general accounts.

[2] Some years ago, however, the Comptroller and Auditor-General made history by detecting a flagrant piece of inefficient buying of telephone equipment by the Post Office. This discovery may well have been due to the more effective method of accounting now used in the Trading Departments as compared with the Supply Departments, see p. 106.

[3] For an excellent summary history of these cf. the Eleventh Report of the Select Committee on National Expenditure for the Session 1943–44, on which also see pp. 66ff.

agreement that the Committee on Estimates has been largely ineffective [1]; this is no doubt partly due to the fact that the interest of members in securing an optimum outlay of resources declines rapidly in quiet times. Thus in the inter-war period there was difficulty in securing a quorum. Very little initiative was shown by successive Committees in developing a technique of examination—the power to appoint sub-committees was scarcely used—and no effective liaison with the work of the Public Accounts Committee was devised.

It would seem that there are also other, more inherent and perhaps more fundamental, reasons why the Estimates Committee has not been a success. In the first place the Committee finds itself even more hampered than Parliament by the time factor; if it rushes forward so as to get its Report in before the Estimates are considered by the House the necessary information is not available; if it waits until the Estimates are complete its Report is too late to be useful. The position of the Public Accounts Committee is very different in this respect, since it can take as long as it likes over its examinations. In the second place, although the Estimates Committee has had some Treasury assistance since 1926, there is at present no department on which it can rely for a comprehensive report on the expenditure plan, as the Public Accounts Committee relies on the Department of Exchequer and Audit.

Thirdly, and most important of all, it is obviously impossible for Parliament to delegate its control of policy

[1] It would appear that its authors entertained no very high hopes of it. Sir A. Chamberlain records (*op. cit.*, p. 475) that during the debate which led to its establishment (April 1912), the Chancellor of the Exchequer (Lloyd George) leant across and said to him: "I suppose you are going to oppose this. I have a minute of yours here arguing strongly against it and I cannot say I differ from you." The minute referred to a similar suggestion in 1905.

to any small committee. In fact, the Estimates Committee is expressly debarred from criticizing policy; this severely limits the field in which it can exercise its powers. These difficulties are perhaps not insuperable but there is no evidence that they are any nearer solution to-day than they were in 1912. In view of this the hasty replacement of the more effective Committee on National Expenditure by a revival of the Estimates Committee, after the end of hostilities in 1945, would seem to be a most undesirable and retrograde step.

Ever since the Crimean War, the abnormal expenditure due to war has aroused Parliament to a realization of the need for watchfulness. Both in the Crimean and in the Boer Wars, Select Committees on National Expenditure were appointed, but their duties were conceived mainly in terms of detecting fraud in the execution of war contracts. In the war of 1914–18, extraordinary as it may appear, no watch whatever was kept over expenditure (apart from the Public Accounts Committee) from 1914 when the Estimates Committee lapsed (owing to the suppression of the Estimates for security reasons) until 1917. A Select Committee on National Expenditure was then appointed, and re-appointed sessionally until 1920, which possessed much wider terms of reference than previous committees. It was charged with three separate duties, first to examine current expenditure (of any type) and to report to Parliament on the possibility of economies consistent with policy; secondly, to examine and make recommendations on the form of the Public Accounts, and on the system of control within the departments and by the Treasury; thirdly, to examine Parliamentary procedure in relation to Supply and Appropriation, with a view to making control more effective.

The committee did stout work during its period of office, particularly in respect of the second item in its terms of reference. In carrying out its duties it had found itself continually hampered by the want of an adequate departmental accounting system which enabled the costs of a department to be seen as a whole. This question raises important issues in connection with the art of budgeting and we shall have to return to it at a later stage in our investigations.[1] As a result of the Committee's protests and recommendations some improvement was made in the accounting system of the trading departments, especially the Post Office, but the main problem remained untouched; with the passing of the emergency, Parliament's will to further reform evaporated.

The mistake of leaving the national finances unattended during war was not repeated in 1939; within four months of the outbreak of war a new Select Committee on National Expenditure was appointed, and continuously reappointed until 1945. The terms of reference were, however, narrower than in 1917; the Committee was empowered merely to examine current expenditure, and in respect only of "services directly connected with the war". In spite of these hampering restrictions—more hampering than they would have been in 1917 because of the more permanent nature of many war works, and their greater adaptability to civilian use—the Committee succeeded in taking a broader sweep in its investigations than any previous body. It developed a useful technique of working through sub-committees which enabled it to save time, without endangering the co-ordination of its programme. Above all it managed to break through the obstacles to examining subjects common to a number of departments, and issued reports on such subjects as contract procedure, design and supply of stores, com-

[1] Cf. Chapter VI, Section 1, and Chapter XX, Section 2.

petitive bidding for personnel and the elimination of waste generally. Although as severely handicapped as the earlier committee had been by the form of the public accounts, anyone looking at its numerous reports (they totalled nearly 100 during its six years of office) cannot but be struck with the grasp of members on the essential aspect of control as implying not so much economy in money terms, as an efficient allocation of resources.

Inefficient allocation of resources in the public service can be traced again and again to particular weaknesses. These are intensified by the rough and tumble of war finance, but they are present none the less in more normal conditions. It is therefore worth examining briefly one or two of the most common forms of waste emphasized by the Committee.

Overlapping of similar services supplied by different departments is one of the most potent causes of the community getting less than full value for its outlay. The Committee on National Expenditure found many examples of this—four departments, for instance, were responsible for camouflage. This is a problem which in normal times has had especial relevance to the work of the different committees of local authorities. Notorious examples have been the development of poor law hospitals into auxiliary general hospitals, and the competitive provision of post-primary education by county authorities and by authorities for elementary education only. This overlapping is a weakness which is likely to become considerably more prominent among central departments as their functions are extended—for instance, into the field of direct provision of housing and related consumers' goods.

Overlapping services are sometimes due to carelessness in initial planning; departmental functions and powers are insufficiently defined; and over-zealous officers extend the work of their departments in unforeseen ways. Overlapping is often extremely hard to prevent, especially with developing services, since their ultimate status cannot easily be determined. In all of this much additional statistical information is required as a foundation of systematic planning. This is a question which we shall have to examine at a later stage.[1] There would also seem to be a need for permanent machinery to review, and if necessary to redistribute, departmental functions, once overlapping is shown to have occurred, without paying regard to established interests.

Another frequent cause of waste, apparently endemic in the public services, is the penny-wise pound-foolish policy of stinting salaries and materials, and so getting less than the best value for a given expenditure. One example of this frequently emphasized by the Committee on National Expenditure was the tendency for departments to entrust initial investigations to junior officers who were insufficiently qualified or experienced; the plan thus had a rickety foundation from the start. There is often a hesitancy on the part of public departments to incur heavy initial expense, even when it is justified; partly no doubt this is a relic of the time when control meant cutting down; partly it probably arises from the fear that the representative bodies for whom they work will take alarm at a big bill with nothing tangible to show, and decree a change of policy before the project is complete.

This difficulty is closely related to one of the commonest forms of waste—alterations of plan after the work has been started. Alterations may become necessary either because planning at the outset failed to take proper account of the relevant factors—this again is largely a

[1] Cf. Chapter XVIII.

statistical matter—or because circumstances change before the project is complete. This latter consideration is especially important in war-time and is one of the main reasons why war-time expenditure cannot be closely controlled, but it should have very much less relevance to normal times. Whenever a change of plan is made, direct waste is caused because expenses have been incurred for what is now useless; indirect waste is likely to follow because of the difficulty of checking costs and revising contracts, once the original agreement has been abandoned. There is urgent need in these and related directions for much more thorough investigation than has yet been attempted.[1]

§ 4. *A Comparison with American Practice.* The merits and demerits of the British constitutional practice in respect of finance can best be appreciated by comparison. British Parliamentary procedure has been widely (but not always wisely) imitated abroad. The Dominions follow British practice so closely in many respects that comparisons between them and the mother country are less informative than might be expected. It is a testimonial to the workability of the British system that it can be transplanted successfully into very different political and economic climates. The most illuminating

[1] When dealing with the control of expenditure reference should also be made to the work of *ad hoc* extra-Parliamentary Committees appointed in times of especial excitement. In the inter-war period the most important of these was the (May) Committee on National Expenditure, whose somewhat alarmist report on the state of the national finances in the summer of 1931 precipitated the withdrawal of foreign balances from London, which led to the collapse of the gold standard. The work of such committees is, however, of only minor interest from the point of view of policy, since they are charged with "economy" in the narrow sense of cutting down expenditure; thus the terms of reference of the May Committee bade it make recommendations "for effecting forthwith all practicable and legitimate reductions in the National Expenditure".

comparison is with the United States, since the American system has the same heritage and general background as the British, but has developed on independent lines. The American financial machinery now controls the largest public expenditure of any democracy in the world. Essential parts of it date only from 1921, but it already functions with much of the prestige of tradition.

Superficially the two nations make use of very similar financial machinery. In the United States the Estimates are also discussed between the Executive and the departments some months (about eight) in advance of the end of the financial year (which runs from 1st July to 30th June). They are subsequently published in a volume of some hundreds of pages. The President's Report on the State of the Union at the opening of the Congressional Session corresponds to the King's Speech. The Budget contains expenditure estimates for the year, and a foreshadowing of the revenue which will be required to cover them, and is accompanied by an explanatory Budget Message from the President.[1] Appropriation Committee meetings parallel British Supply Debates. The detailed revenue estimates are debated in Committee of Ways and Means.

Thus, the whole American procedure is plainly a relative of the British system, but identities of nomenclature conceal important differences of substance, apart from fundamental constitutional differences which affect the whole set-up. The general upshot of these differences is that opportunities for debate are better than under the British system, but control over expenditure is less efficient, and the prospects of successful plan carrying very much worse.

In the first place the procedure for the passing of the

[1] In 1946 for the first time these three were presented together.

estimates of expenditure and revenue is less unified and concentrated in the United States than in Great Britain. Instead of a single Appropriation Bill and a single Finance Bill, expenditure and taxation are gradually determined in a series of separate measures. Moreover, neither of the main British safeguards against failure to pass the year's financial programme as planned is operative in America. In the first place it is open to any member of Congress to propose (and carry) additions to expenditure or reductions in taxes; secondly, all financial arrangements must be agreed to separately by the Senate. This may give rise to enormous delay and to no little friction. The separate Appropriation Bills make it less easy for Congress to view the year's programme as a whole. These differences tend to drag out the annual budget routine so that it is difficult to clear one year's transactions before the following year is well on its way, thus causing confusion in accounting and a consequent loosening of technical control.

Far more important than these differences of procedure are those which arise from the fundamental American principle of the separation of the Legislature and the Executive. The President is the head of the Executive and his residence, the White House, is also the centre of the Administration, having attached to it the important Departments of State, including the financial offices such as the Treasury and the Bureau of the Budget. The President chooses his "Cabinet", but like himself the members are administrative officers. Thus the Cabinet knows everything that is going on, but has no legislative rights. On the basis of his administrative knowledge the President can indeed make suggestions to Congress as to what he thinks ought to be done—for instance, the Budget Message includes a request for a certain tax revenue—but he has no power to require Congress to follow his advice. Congress on the other hand is charged with the duty of making laws, but has no certain means of finding out what the Administration is up to.

A second although less significant difference also arises from the American passion for checks and balances. Instead of a majority remaining in power so long, but only so long as it has the confidence of the Legislature, as happens in Britain, in America all three bodies, the President (and his Cabinet), the House of Representatives and the Senate, retire automatically at short periods and have to be re-elected. The Presidential election occurs every four years, Congressional elections every two, but as only one-third of the Senators retires on each occasion, there is greater continuity in the Upper House than in the Lower. Owing to this electoral system it may very easily occur that towards the end of the Presidential term his party finds itself in a minority in one or both Houses. In that case Congress will probably refuse to pass measures which have the President's support, and he may well refuse to give his consent to those passed by Congress. A complete state of frustration and stalemate then supervenes, in which even the annual routine of the financial plan may be in danger, until fresh elections once more permit the wheels of government to revolve normally.

Such a complete jamming of the machinery is fortunately rare, but even at the best of times provision for plan making and carrying is less watertight than in Britain. Not only is the American "Cabinet" outside Congress, but within the House of Representatives there is nothing that corresponds at all closely to the British Cabinet. The preparation and steering of Bills through Congress is entrusted to Standing Committees, both in the Lower House and in the Senate (the House Committees on Appropriations and on Ways and Means are examples of these). Membership of a committee depends primarily on seniority and not on interest for the measure in hand. As a result of all these roundabout elements in the American system, ways of providing the public with fuller information—of the conduct of the Administration and of the measures before Congress—have inevitably grown up in a manner which is unknown in Britain.

Thus in the first place the preparation of the American Estimates is not solely a departmental affair as it is in Britain. The Bureau of the Budget conducts Hearings at which the departments present their case. The Hearings are not public, but they are not absolutely secret, and in practice a good deal of what is going on leaks out and is discussed in the Press. The Estimates are next considered in Public Hearings by the House Committee on Appropriations, after which the Bills are drafted and discussed by the Committee, and finally discussed on the floor of the House. The practice in respect of Ways and Means is exactly parallel, and the whole procedure in each case is duplicated by the Senate.

In respect of Appropriation Hearings and debates the Senate may set its machinery in motion while the House is still deliberating, but in respect of Ways and Means, in order that the Lower House should have the first word on tax issues (in accordance with British tradition), the Senate postpones its discussions until the House has completed its deliberations. (This respect for its British heritage does not, of course, prevent the Senate from turning the House Bills inside out when it does receive them.) If everything goes smoothly the whole process of Hearings, committee sessions and House discussion occupies some eight or nine weeks, but the time allowed for the final stage of discussion on the floor of the House is quite short, perhaps not more than a week.

Secondly, in order that Congress may have a reliable guide for action, the Administration collects and publishes very much fuller information on the activities of the Executive than are available in Britain. The Treasury Department issues an excellently complete Monthly Bulletin of public activity. Most items are reported with a lag of only a few weeks. The American Estimates are also more informative than the British, although perhaps not quite so detailed. Opposite each item in the Budget Statement is a record of actual expenditure over a term of years, as well as the estimates for the year in progress and the year which is being planned for. These details are, of course, available to the general public as well as to members of Congress.

Finally, the Administration collects from the business community (by means of frequent censuses of production and other investigations) much fuller and more up-to-date information on economic activity than is available in Britain, even to the government planners. This difference is as much due to the attitude of the business community as to the zeal of the Administration, but it cannot be denied that it results in the Legislature obtaining in some respects a more reliable basis for planning than is at present available in Britain. This is a question to which we shall have to return in Part III.

It will be apparent from this brief survey, that the British and American systems are so to speak complementary, one is weak where the other is strong, and vice versa. In the United States, apart from fundamental difficulties arising from the principles of the constitution, which presumably are not amenable to alteration, at least in the near future, the most pressing need would appear to be for better contacts between Congress and the Executive, so that the Legislature is enabled to find out directly what the Administration is doing. With the increased activity of the public sector inaugurated by the Roosevelt regime and extended by the war this has become a matter of urgency. During the war period some improvement in this respect was almost inevitably made. One example was the work of a Special Senate Committee appointed to Investigate the National Defence Programme (the War Investigation Committee) which performed services corresponding to those of the British Committee on National Expenditure. This Committee has been highly constructive, and by the employment of a large staff of expert statisticians and economists has exposed waste and inefficiency in many branches of the Administration. Projects for more permanent contacts have been discussed, but, as in Britain, reform becomes more difficult to achieve as control becomes a less pressing need.

In Britain, where no problem of the division of function between Legislature and Executive can arise, there is a no less urgent need to find better means for Parliament to estimate the true efficiency of the lay-out of public resources. It can hardly be hoped to provide this within the framework of the Supply debates, which are mainly used for less specific purposes. The problem is closely related on the one hand to the need for a firmer statistical basis for planning, on the other to the necessity of reform in the public accounting system. It seems unlikely that a mere revival of the Estimates Committee will go far to solve it. In this respect, as in the provision of statistical information, the experience of the United States in committee investigation, especially in the use of expert witnesses, may well provide a useful guide for Britain.

CHAPTER V

THE PUBLIC REVENUE

§ 1. *The British Tax Structure in* 1938 *and* 1944. The revenue proposals which are presented in the Budget in April, and subsequently debated by the House in Committee of Ways and Means, are not an independent plan in the same sense as the estimates of expenditure. The total revenue required is determined by the total bill to be met (which by that time will be more or less decided); its distribution between the different possible sorts of taxes has not usually aroused any burning political controversy. On only two occasions in the inter-war period were politics deeply involved in revenue discussions—in 1924 when Snowden repealed the "breakfast table" duties in the interests of the working-class family, and in 1932 when Neville Chamberlain induced the House to return—after nearly ninety years—to a general protective tariff. On the first of these occasions the loss to the revenue was a mere 2 per cent; on the second, although the initial difference was small, the eventual effect, even in crude terms of revenue collected, was quite substantial.

Although party issues are not usually very influential in determining the choice of taxes, from the point of view of economic welfare it is most important that the right taxes should be chosen. Economists have always recognized this, and throughout the nineteenth century it was this aspect of public finance which monopolized attention. More recently, with the expansion of the public sector, other problems have thrust their heads up with urgent claims to attention, but we must not allow them to obscure the view of the fundamental issues. Accordingly, we shall be occupied for most of the time in Part II with questions of the choice of taxes. The purpose of the present chapter is to serve as an introduction to that study by familiarizing us with the relative importance of the different taxes in current fiscal practice.

Public authorities do not, of course, rely entirely on taxes for their finance, but in Britain the part played by other normal revenue sources (interest on investments and profits of trading services) has so far been negligible. Borrowing—except for investment in capital goods—has been confined to emergency finance, so that it is with tax revenue that we are almost exclusively concerned in this chapter.

It will be useful to examine the distribution of revenue between different taxes not only in the last pre-war year (as we did on the expenditure side), but also when war was in full swing. A major war inevitably leaves an aftermath of enormously increased revenue requirements. The interest on the new debt requires heavy taxes to cover it ; and apart from that war is a stimulus both to the development of the social services and to the enlargement of the functions of the public sector in other directions. It is inevitable that post-war tax rates should settle nearer to the 1944 than to the 1938 level. On the other hand some war taxes which were important revenue producers in 1944 cannot be expected to be available for normal finance, so that in some ways 1938 is a better guide to the future than 1944.

In the chart the distribution of revenue between the different sorts of taxes (the tax structure) is shown for the two years respectively. This, of course, is not the only, nor even the most interesting, way in which we

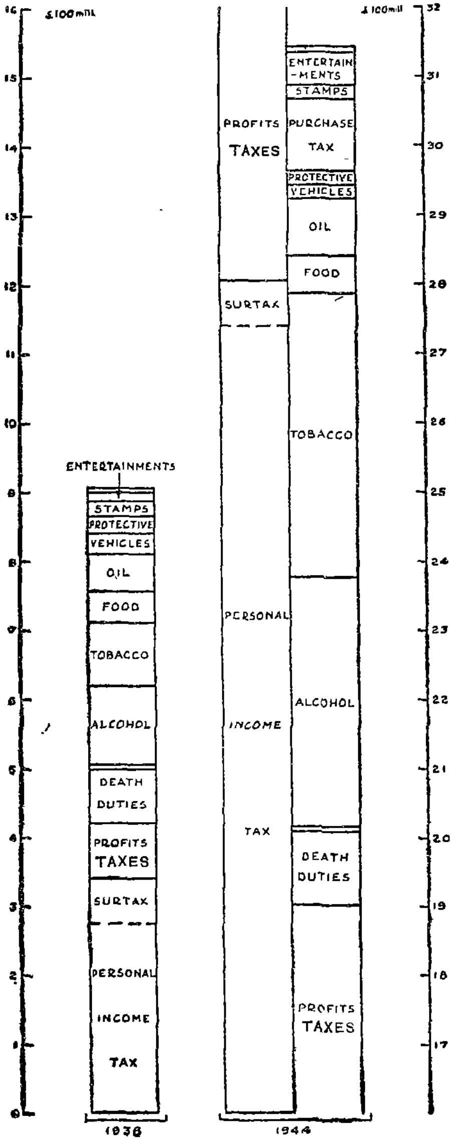

CHART I. BUDGETARY TAX REVENUE—UNITED KINGDOM 1938-9 AND 1944-5.

might arrange the revenue. A more interesting arrangement would show how much of the revenue from each tax is derived from families in different economic circumstances. It will be more satisfactory, however, to postpone an examination of this latter arrangement until we have discussed the relative merits of the different types of taxes; accordingly we shall return to it at the end of Part II.

It will be seen from the chart that with the single exception of the purchase tax in 1944, the types of taxes used, and even broadly their relative importance, were very similar in the two years, although the totals are so very different. This similarity is largely inevitable, because fiscal changes only come about slowly, and moreover, tax experiments are abnormally hard to carry through in war-time, with depleted administrative staffs. It is thus very important to have a normal tax structure which will stand up to exceptional strain with only minor adjustments. In the war of 1914–18 Britain had a decided advantage in this respect over both her Allies and her enemies, but owing to fiscal reforms abroad in the intervening years, her superiority in 1940 was less marked.

In 1938 70 per cent of the revenue of the British national government was derived from only four groups of taxes [1]: (i) personal (net) income tax, (ii) taxes on (net) business profits, (iii) duties on alcoholic liquors and (iv) duties on the consumption of tobacco. In 1944 the proportion of the revenue due to these four groups had risen to over 85 per cent; E.P.T., the special war-time profits tax,

[1] For further details of the composition of the British tax structure cf. Shirras and Rostas, *The Burden of British Taxation*, and Barna, *The Redistribution of Incomes through Public Finance*. For tax changes during the inter-war period cf. U. K. Hicks, *The Finance of British Government*, cit.

played a handsome part in this expansion, but it was not the only cause. Much additional revenue was also gathered from the other groups, partly by raising rates of tax, and partly because of increased consumer expenditure on the limited range of commodities still available in war-time. (Conformably the revenue from the Entertainments tax increased fivefold between the two dates.) On the other hand there were a few fiscal war casualties—import duties and taxes on motoring—but considering the circumstances, the loss of revenue was surprisingly small.

We must now turn to examine briefly the kinds of taxes of which the " rungs " in our " tax ladders " are composed. The first four hang closely together ; they are the taxes collected by the Inland Revenue Department [1] and constitute what are usually called " direct taxes ".[2] What is more important from the economic point of view is that liability to these taxes depends on the general economic position of the taxpayer, and not on the amount of his expenditure on particular commodities.

In normal times the most important member of this group is the personal income tax, which although nominally two taxes (income tax and surtax) in practice forms one continuous levy on all incomes above a low minimum exemption limit.[3] The personal income tax in Britain (and now in most other countries also) is the principal *progressive* tax, that is to say tax liability forms a progressively larger proportion of large incomes than of small. Death duties are also progressive—with the value

[1] So also are Stamp Duties and a few minor duties of which the most interesting is the seventeenth-century Land Tax (cf. p. 138). The revenue from these latter is indicated by the space between the double lines above the revenue from death duties.

[2] For a discussion of the classification of taxes, see Chapter IX, Sect. 1.

[3] For details of the structure of British income tax, see Chapter XII, Section 2.

of the estate—indeed in Britain they were the first progressive tax to be sanctioned by Parliament.[1] They are paid when a property passes at death, and the most important of them is assessed directly on the value of the total property.

In the years which we are considering there were two sorts of profits taxes in operation. The first was the normal tax on the undistributed profits of firms, which is collected with the personal income tax as part of "Schedule D"[2]; the second consisted of the emergency taxes on total net profits (before distribution). In 1938 only one of these, the National Defence Contribution (N.D.C.) was in operation; it took a flat 5 per cent of the profits of industrial firms. In 1944 "E.P.T." (Excess Profits Tax) and N.D.C. operated alternatively, according as current profits were, or were not, in excess of normal earnings.[3]

Five-sixths of the large revenue collected from profit taxes in 1944 was due to these emergency levies, which although tolerable, and indeed indispensable in war-time, are not suitable for a normal tax structure; consequently, a big reduction in revenue from this group must be anticipated. At the same time it is worth noting that the large size of the 1944 revenue was in a sense an illusion. Firms which made less than their standard revenue during the currency of E.P.T. were allowed to set off the deficiency against tax already paid, so that some of the revenue shown will subsequently be returned to the firms. Further, when in 1942 the rate of tax was raised to 100 per

[1] See Chapter VIII, Section 4.

[2] "Profits from Businesses, Professions, etc." It is only from 1938 (with the issue of the Budget White Paper on National Income) that the revenue from this tax can be separated from that of the personal income tax.

[3] For the details of E.P.T. cf. Chapt. XII, Sect. 4, and at greater length in *The Taxation of War Wealth*, by J. R. and U. K. Hicks and L. Rostas.

cent of the excess, a promise was given that 20 per cent of the tax paid would later be handed back to the payers as a deferred credit. A similar undertaking was given in respect of personal income tax where "post-war credits" ranging up to £65 of tax liability in any year are due for repayment to taxpayers. A deduction of £225 mn. should be allowed on the income tax revenue collected in 1944 on this latter account.

The other taxes in the structure are usually designated "indirect"; with a few exceptions they are collected by the Board of Customs and Excise. For the most part these taxes tend to be *regressive* with income; that is to say, the smaller the income, the larger the proportion which tax payments bear to it. By far the most important of these taxes, which fall on particular ways of spending or holding wealth, are (as we have already noted) the taxes on the consumption of alcohol and tobacco. Before the war the liquor duties group brought in the larger revenue of the two, but during the war tobacco was more abundant than beer and spirits, so that the revenue from the latter duties became relatively less important. In 1938 about 60 per cent of the liquor revenue was derived from beer, and nearly all the rest from whisky, in 1944 the beer proportion had risen to over 80 per cent. The immense revenue capacity of these groups of taxes was first exploited in the war of 1914–18,[1] since when rates of tax have been many times raised.

The food duties fall into three groups—which is itself an interesting comment on the abandonment of the Free Trade doctrine of "no taxes on food". First come the time-honoured revenue duties on tea and sugar, typical

[1] But for the presence of Irish members at Westminster it is probable that the spirit duties would have been raised earlier.

colonial products, where there was (until lately) no question of protecting a home supply. Secondly, we have the Imperial Preference group, a number of low duties on Empire products, reinforced by heavier duties on foreign suppliers. Under this head come the duties on dried fruit of the 'twenties and those imposed under the Ottawa Agreements of 1932. Thirdly, come the duties frankly designed to protect the British farmer—and reinforced by direct control of imports and by subsidies—such as the beef and veal duties of 1936. To this group also belongs (in respect of 1938) the wheat levy, the revenue from which does not appear in the tax ladder because it was not a part of the Budget.[1]

Two of these food taxes—the sugar duty and the wheat levy—are worth a little extra notice. The taxation of sugar has been gradually changing over from group 1 to group 3—from a revenue to a protective measure. The production of home-grown sugar first became a matter of practical politics in the war of 1914–18. After the war, instead of retaining the revenue character of the tax (by imposing an equivalent tax on home supply), home production was encouraged by a tax rebate, backed up by a subsidy on sugar beet. Since there is also an imperial preference the position is now extremely complicated, but the old revenue duty has now become quite definitely protective.

The wheat levy is also a tax-cum-subsidy. It was purposely excluded from the Budget, partly because the idea of a tax on bread still had an evil sound in recently free trade ears, partly because it was argued that it is easier to promise that continuous help which farming

[1] In 1938 certain food products from Eire were also taxed, owing to a quarrel with the Eire Government. This was not part of general policy.

subsidies must give if they are to promote long-term planning, by a means which did not annually have to run the gauntlet of the Committee on Supply. The wheat levy-subsidy is also interesting as an example of a tax whose revenue is "earmarked" for a particular purpose, and is thus not available for general revenue needs. The earmarked tax is an apparently plausible device, which in practice is very awkward. Even if initially the funds are appropriate for the purpose, there is naturally no guarantee that they will continue to be so after a lapse of time. Fortunately, this is now generally realized by British chancellors.[1]

Next in importance come the taxes on motoring, in respect of which, in addition to the vehicle and driving licence duties, nearly the whole of the tax on hydrocarbon oils is collected. Motorists—both private and commercial—are thus taxed by two methods, an "overhead" in respect of the size or weight of the vehicle, and a "running cost" charge, according to the fuel consumed. In every country motoring taxes are tending to provide an increasing source of revenue, and there is usually some such dichotomy of charge (which has a sound logical sense), but it is safe to say that in no country are the rates of both sorts of taxes so high as in Britain.

Next in interest, although not in fiscal importance, are the remaining protective duties. These fall into two groups, first the duties imposed in the early 'twenties, either for strategic reasons, or on such "infant industries" as rayon (a tax which for obvious reasons had to include silk), or motor cars and accessories[2]; and secondly,

[1] A notorious Victorian earmarking device was the "assigning" of certain revenues for local government purposes—especially part of the receipts from liquor consumption (colloquially known as "whisky money") for the development of higher education.

[2] Viz. "McKenna" (1915), Key Industries (1921), Silk and Artificial Silk (1925), Duties.

those imposed on the advice of the Import Duties Advisory Board, established to implement the protectionist regime in 1932. Many of these protective duties are levied on the raw materials and semi-finished products of industry, and were originally designed to promote industrial recovery from the depression of 1931. While they undoubtedly helped the industries concerned, and thus raised the general level of employment, the policy behind them and the Ottawa Agreements first brought the British revenue authorities into definite conflict with other countries, particularly with the United States.

We may pass very rapidly over the remaining normal Budget taxes. Stamp duties are mainly collected on property transfers, especially of stock exchange securities, so that they attain considerable importance during stock exchange booms. Other stamp duties are those levied by the *2d.* stamp on cheques and receipts. Entertainments duty is payable on admission fees over *6d.*, and is graduated fairly steeply on the better seats at theatres.

Of more interest than these is the war-time purchase tax, which in spite of the exemption of food and "Utility" goods, and the scarcity of other commodities in war-time, brought in a very considerable revenue, year by year during the war. It was first imposed in 1940 with the express purpose of limiting consumption, and there is no doubt that it acted as an important supplement to the rationing system in this respect. Taxes of this nature, usually called "sales taxes", are a feature of the normal tax structure of many countries. They are especially attractive to regional governments (such as the States in the U.S.A.) because of their administrative simplicity and productive revenue; these conveniences cause their restrictionary effect to be overlooked. Purchase taxes are in principle not a good sort of tax; they are useful in war, but it is much to be desired that they should not remain an important permanent feature of the tax structure; there would, however, be certain conveniences in keeping them ticking over at very low rates.[1]

All the taxes (except the wheat levy) which we have so far discussed are budgetary taxes, but there are also two other important members of the British tax structure of which we must take notice—the "rate" levied by local authorities on the occupiers of buildings and land (other than agricultural land), and contributions to social insurance.[2] The fiscal importance of the local rate has long been declining relatively to the revenue of the central government, but it is still a very important tax, with a yield second only to income tax (£211 mn. in 1938); some 60 per cent [3] of the revenue is now estimated to come from domestic property, and most of the rest from shops and offices, since factories were excused three-quarters of their liability under the Local Government Act of 1929.[4] At a later stage we shall have to devote a good deal of attention to this tax, since it is the pillar of the local government structure.[5]

From the inception of the services, social insurance in Britain has been financed by a tripartite arrangement of contributions from employers, employees and the general revenue, the contributions being paid into separate funds

[1] As a method of cyclical control, cf. Chapter XVII, Section 2.

[2] The net revenue of the Post Office is also sometimes regarded as a tax, the question turns upon how far it should be regarded as the normal profit of a trading service, or as a monopoly charge. In regarding it as a trading profit we are following the practice of the Budget White Paper. In normal times the exchequer receipt was roughly £11 mn.; to this may be added about £3 mn in wireless licences (£4·7 mn. in 1944).

[3] It is a grave defect of the statistics of local finance that this proportion cannot be stated precisely, cf. Chapter XVI, Section 2.

[4] At the same date agricultural land, which had already been partially "derated" at earlier periods, was excused the whole of its remaining liability.

[5] See Chapter XV, *passim*.

for each service.[1] There is undoubtedly a genuine "insurance" element in the employees' contribution, and this has led some people to question whether it should be regarded as a tax; the compulsory nature of the payment, however, determines that it must be so classed. We should thus call the employees' contribution a poll tax, that is to say, an equal per head levy (at rates which vary only with sex and experience) on all workers within the system. The employers' contribution is related to other taxes on factors (e.g., the tax on petrol used in industry).

§ 2. *International Comparisons of Tax Structure.* How does the British tax structure compare with those of other countries? Such comparisons need to be made with great circumspection. It is often misleading, for instance, to compare rates of tax, because the degree of evasion and the scope of exemptions differ enormously from one country to another. Even a straightforward comparison of *per capita* revenue may be misleading; taxes which are nominally similar may be very different according to the type of economic and social milieu in which they operate. For instance, taxes are called income taxes which are very different from the British idea of a highly progressive levy, minutely adjusted to the taxpayer's income, and which are, in fact, no more than a flat proportion taken from each taxpayer, based on a rough estimate of his income made by the revenue authorities, without any reference to the taxpayer himself. Again taxes are called "general property taxes" which are in no sense taxes on total property (or capital) as British death duties are, but are, in fact, almost wholly taxes on land and buildings, and are thus more akin to the British local rate.[2]

[1] Prior to their unification by the National Insurance Act, 1946.
[2] For instance the local property tax in the United States.

The most interesting comparison is once again with the United States—both for its similarities and for its contrasts. Just as in respect of budgetary practice, starting from a common origin, the two countries have developed on broadly parallel lines; but in fiscal policy there have been two major differences. Firstly, the United States has always been a highly protectionist country; secondly, the fact that its constitution is federal and not unitary, causes a very different distribution of resources between major (federal) and minor (state and local) governments from what we have found in Britain.

Until recently its monopoly hold on customs revenue has been the mainstay of federal finance; the Ways and Means Committee of Congress is still regarded as primarily an instrument for the adjustment of the tariff. Federal income tax first became permanently established in 1913; since that time the federal taxation of income and profits has enormously increased, although in 1938 rates of tax were still low by British standards. Owing to the recent expansion of the income taxes in the United States, and to the readoption of protection in the United Kingdom, the tax structures of the two countries are now a good deal more like each other than they used to be.

Table II compares the distribution between taxes of the total revenue collected in the two countries on the eve of war. In looking at the table it should be borne in mind that the overall tax liability of the American citizen was lighter than the British. In the fiscal years represented, tax revenue per head in the United States amounted to \$114·1 (say, £22·2) and in the United Kingdom to about £26. The difference was partly due to the greater wealth of the United States, calling for lower rates of tax to get the same *per capita* revenue, but more importantly because the social services were less fully developed than in Britain. The smaller revenue needs of the United States provide a partial explanation of the smaller use of personal income taxes. In times of emergency it is on the federal income and profits taxes that the extra weight falls.

TABLE II.—PERCENTAGE OF TOTAL TAX REVENUE DERIVED FROM DIFFERENT SOURCES, 1938 [1]

Source	U.S.A.	U.K.
Customs and Excise *	21·1	23·9
Personal (net) income taxes †	10·6	32·0
Business Profits Taxes	12·0	6·9
Inheritance Taxes ‡	3·8	6·3
Motoring (licence and fuel) taxes	10·0	7·3
Wages §	9·8	4·5
Local Property Tax (U.S.) Rates (U.K.)	32·0	17·2
Other ‖	0·7	1·9
	100·0	100·0

* Including U.S. Sales taxes.
† Including employees' contributions to British social insurance.
‡ Including U.S. tax on gifts.
§ Pay roll taxes, U.S.; employers' contributions, U.K.
‖ Mainly stamp duties, U.K.

The small use of the personal income tax, together with the slight development of inheritance taxes, implies that the United States tax structure is decidedly less progressive in total effect than the British.[2] Apart from the question of distribution, the two most important differences between the two total structures are the relatively heavy

[1] The figures relate to the fiscal year 1938 (April 1938–March 1939) in the U.K. and to the fiscal year 1937 (July 1937–June 1938) in the U.S.A. Although not precisely the nearest accounting periods in point of time, they appear to correspond better than any other choice to the development of the national income. Sources: for the U.K., Finance Accounts; U.S.A., Bulletin of the Treasury Department.

[2] This difference is reinforced by a greater number of loopholes for wealthy citizens in the United States, such as investment in tax free public debt, and separate assessment of the incomes of husbands and wives, cf. p. 135.

taxation of business in the United States, and the importance of the local property tax.

The taxation of business profits was much increased by the Roosevelt regime ; the States also take a considerable rake-off from industry and trade. It should be noted that it does not follow from these figures that the American business taxation is proportionately more onerous than British, for the lighter total of the tax structure should be remembered. Nevertheless British manufacturers might well bear these figures in mind when they complain of the hardships of the Schedule D allowances. The United States local property tax is one of those that pretends to be assessed on total property but is in practice almost confined to real estate, hence it is quite proper to compare it with the British local rate. The main difference is the much greater weight of the American tax.[1]

Two smaller differences between the tax structures are also worth noting, although they reflect physical and institutional differences rather than differences in fiscal practice. The smaller proportion of revenue raised by customs and excise in the United States is partly due to the smaller part which international trade plays in the economy, partly to the difficulty of collecting high excise duties on home grown products. The lighter taxation of motoring in the United States (revealed by the fact that tax receipts are roughly proportional to the human and not to the car population in the two countries) is largely due to the greater availability in the United States not only of petrol, but also of the raw materials required for making cars.[2]

[1] At this period *per capita* payment in the U.S A. was \$35 (say £8) and in the U.K. £4·5.

[2] For further discussion of relative tax rates cf. Chapter XVI, Section 4.

Thus when we compare the overall composition of the two tax structures the general effect is much the same; it is when we divide up the revenue between the different classes of taxing authorities that the really striking difference appears. Table III distributes the tax revenue according to type of government. Instead of the simple British arrangement whereby the local authorities have the rate, and the national government has everything else, in no case (except the customs revenue, here not shown separately) does the federal government of the U.S.A. get more than 80 per cent of the revenue from any group of taxes. It has to compete everywhere with the States, and sometimes also with the local authorities.

Nevertheless, when we consider the distribution of federal revenue on the one hand and of local on the other, in the two countries, the similarities are striking (federal income and profit taxes 53 per cent of federal revenue as against 54 per cent of British national revenue; customs and excise 28 per cent as against 30 per cent; local property 92 per cent as against 100 per cent of local revenue). It is the States which constitute the disturbing element, with their wide tax rights, and particularly with their exploitation of motoring taxes, excises (mainly sales taxes) and inheritance duties. Overlapping tax jurisdictions are difficult to avoid in a federation, particularly in one where there are a large number of constituent States with wide constitutional powers. There is little doubt, however, that the United States tax structure is in urgent need of rationalization, and this is fully realized by American writers.[1] The whole question is bound up with that of the political relation between central and local governments and we shall have to

[1] Cf., for instance, Hansen and Perloff, *State and Local Finance in the National Economy*, and Hart and Others, *Paying for Defense.*

consider it in detail when we come to discuss the theory of local taxation.[1]

TABLE III.—SOURCES OF NATIONAL AND LOCAL TAX REVENUE, U.S.A. AND U.K. (1938)

Tax	United States of America				United Kingdom	
	% of Revenue accruing to Federal Government	% Distribution of Tax Revenue between Sources			% Distribution of Tax Revenue between Sources	
		Federal	State	Local	National	Local
Customs and Excise :						
Alcohol and tobacco	77	18	7	0·7	22	—
Other . . .	21	10	19	6·0	10 *	—
Motoring . .	19	5	31	0·6	9	—
Personal Income, Profits, Inheritance	80	53	18	—	54	—
Local Property .	—	—	6	92·0	—	100 †
Wage . . .	51	12	18	—	5	—
Other . . .	31	2	1	0·7	— ‡	—
		100	100	100·0	100	100

NOTES.—Same fiscal periods as previous table. * Including Stamps. † The only other tax source of British local authorities are some licence duties, of trifling fiscal importance. ‡ More precisely, 0·3.

Tax structures broadly similar to those of Britain and the United States are now to be found in most advanced and industrialized countries. Income taxes with some degree of progression (seldom approaching the British) are now almost universal, although the majority date only from the 1914–18 period.[2] Heavy reliance on the

[1] Cf. Chapter XV, especially Section 3.

[2] For a short account of the tax structures of the leading belligerents at that time, cf. Hicks and Rostas, *The Taxation of War Wealth.* An invaluable (but unfortunately not readily available) comparison of tax structures was made by Erik Lindahl for the Swedish Government

taxation of alcohol and tobacco is also very common, although in no country do both sources appear to be so heavily exploited as in Britain. Britain also makes more use of motoring taxes, and to an even greater degree of inheritance taxes, than other countries. More backward countries, where the farming element is predominant, still have to lean heavily on taxes on articles of universal consumption, such as sugar and salt. Such countries are always at a disadvantage in an emergency since the revenue is much less flexible than one largely derived from income taxes. Finally, for local purposes, the use of a tax on land and buildings is very common. Although this is an ancient and rather a primitive sort of tax, it has, as we shall see later, a number of conveniences for purely local use.[1]

§ 3. *Other Sources of Revenue.* In normal times the only alternative source of public revenue for current needs has been income from public property. In Britain, partly owing to the small amount of public property, partly to the price and output policy followed in the socialized industries this source has provided only a very modest supplement to taxation. In 1938 the national government derived an income of only £17 mn. from its property, half of which was composed of interest on past loans (many of them to authorities overseas) ; the trading profits were almost wholly on account of the postal services. At the same time the property income of local authorities amounted to £26 mn., of which £16 mn. was due to interest on the investment of reserves and pensions funds, and to rents on municipal estates, so

in 1936, *Det Samlade Skattetrycket i Sverige och Utlandet.* More recently G. F. Shirras has given an account of *Federal Finance in Peace and War*, covering U.S.A., Canada, Australia, S. Africa and India.

[1] Cf. Chapter XV, Section 5.

that the profits of trading services made a very small contribution indeed.[1]

The slight use of trading profits as a source of revenue in Britain as compared with some other countries (notably Sweden) is largely to be explained by the nature of the industries which have been socialized. Where (as in Britain) public property has been small, and public enterprise traditionally regarded with suspicion, the typical public trading service has been the " natural " monopoly, such as the supply of water, electricity, gas or transport. In industries which have a natural tendency to monopoly there has been an understandable desire to avoid forms of organization which would be able to extract a monopoly profit at the expense of the consumer. This leads to public operation, or at the least to public control. Whether the mere avoidance of the profit motive in public enterprise is sufficient to secure the optimum allocation of resources is a matter which we shall have to consider in detail in Part III.

The third source of public finance in 1938 was, as we have seen, borrowing by the central government; but this was entirely due to the exceptional nature of the times. Except for emergencies such as war, public borrowing by British governing bodies has been restricted to the needs of long-term investment. When faced with serious emergencies central governments have always borrowed freely; they have the right to do so whenever the requirements of public expenditure exceed what can reasonably be extracted from the income of the citizens; and they can borrow quite safely because they have unlimited tax powers, so that (unless there is danger of a

[1] E.g., £10 mn. In Scotland local authorities have traditionally owned more property than in England, and in some places the income from this is a not unsubstantial supplement to rates.

revolution) the means to service the debt can always be found, and in the last resort they can avoid national bankruptcy by depreciating the currency. In respect of minor governments (the local authorities or the constituent states of a federation) the position is substantially different. For them to borrow freely for current needs, however urgent, may put them in danger of bankruptcy, a situation which should not be allowed to arise.[1]

The advantages of borrowing to finance long-term investment have also generally been recognized in the past. By means of loan finance the equipment can be enjoyed by the community at a much earlier date than if it had to be paid for out of current income. British local authorities have sometimes made less use than they might of these advantages, through concentrating on the additional cost of the loan interest, rather than on the additional benefit of the earlier investment. This is a question which we must discuss at a later stage. In the past the borrowing of the British government for investment purposes has been practically confined to the Post Office services, apart from the activities of the Public Works Loans Board,[2] which is really engaged in financing local investment.

The restrained borrowing policy of the British government in the past has on the whole been sound sense. A central government which abuses its powers by allowing casual Budget deficits to develop in normal times, runs the danger of seriously weakening the technical control of expenditure, and opens the door to all sorts of abuses in the civil service. If the government is also unable to control the monetary situation, it runs the danger of heaping up a burden of debt interest which may

[1] Cf Chapter XV, Section 5.
[2] Cf. Chapter XIX, Section 1.

chronically embarrass the Budget, and lead to an impasse which requires a repeated depreciation of the currency. French fiscal history since the Napoleonic wars furnishes several examples of the evils of this rake's progress.

Under modern conditions the situation is completely different. With a new power of monetary control on the one hand, and a new technique for watching and influencing the course of economic activity, loan policy becomes the servant and not the master of governments. A planned deficit provides a new instrument for controlling the size of the national income, and hence the level of economic activity.[1] This does not imply that borrowing for current purposes will be an inevitable or permanent feature of the public finance of the future, but merely that the instrument is available for use when required. As we shall see later [2] there are many technical problems to be solved (especially in the field of accounting) before the new instrument can be used with assurance. Whatever the actual use of deficit finance in the future, the revolution in the place which borrowing occupies in the finance of public authorities has already taken place.

[1] Cf. Chapter XVII, Section 3.
[2] Cf. Chapter XX, especially Section 2.

CHAPTER VI

THE BALANCE SHEET OF THE PUBLIC SECTOR

§ 1. *The Budget Accounts and their Significance.* Now that we have looked at the way in which the State distributes its resources over different services on the one hand, and gets command over the necessary funds on the other, the next step is to consider the two sides of the account together in the form of a complete budget. "The Budget" usually so-called is, as we have seen, the account of the activities of the central government, presented by the Chancellor of the Exchequer on Budget Night. It is, of course, far from being a complete account of the public sector of the economy. In the inter-war period it came short of covering the total expenditure of public authorities on current account by about a third, and was not concerned with capital expenditure at all, except in so far as a small amount of investment might be financed out of tax revenue collected by the central government.

In considering the accounts of the whole public sector we have to include as well two other sets of budgets—those of the social insurance funds on the one hand, and of the local authorities on the other. Of the latter there are in all about 1,300, but for most practical purposes it is sufficient to take into account the activities of the eighty-three county boroughs and sixty-one statutory counties in England and Wales, and a few parallel bodies in Scotland and Northern Ireland, because a great part of the activities of the smaller county authorities are controlled by the county councils. Since the social insurance services were established at different periods they grew up with separate budgeting systems. With the National Insurance Act of 1946 the logical process of amalgamation is complete.

Even with these simplifications it is evident that it is a complicated business to put together an account of the entire public sector. A few years ago it was only possible to do so rather roughly, and after a lag of about two years from the period to which the accounts related. This was obviously much too late to be of any relevance for the direction of policy. With the beginning of the series of Budget White Papers on the National Income (the first of which, it will be remembered, was presented with the Budget of 1941) the situation was enormously improved. We now have not merely a consolidated balance sheet of the public sector, but also an account of the whole economy (which, as we shall see later, is of absolutely first rate importance for the direction of policy). It is still necessary to wait for several years before the details of the activities of local authorities are available.

Of all the British budgets, the most advanced in technique in the past has been that of the Unemployment Insurance Fund, since it has been under the charge of a committee (The Unemployment Statutory Committee) whose especial duty it was to take a long view, and to plan the finances of the Fund flexibly over a ten-year period, taking account of fluctuations in the level of economic activity. The Chancellor's Budget is confined strictly to the accounts of the year just ended and the estimates for the year just beginning, although the Financial Statement also contains a list of total expenditure and total revenue collected over a series of years. The general accounts of local authorities are not kept on any uniform plan (from which it follows incidentally that the returns which they make to the central government are also not very uniform). There is no opportunity of examining local estimates except in so far as individual councils may choose to give them publicity in the local press.

The traditional reason for the central government's lack of knowledge of the intentions of the local authorities is, of course, that their spending plans are to a considerable extent their own affair; and in the local rate they possess an independent source of revenue which enables them to some extent at least to give expression to their individual preferences. The budget of the central government is, however, linked to the budgets of the local authorities by means of the exchequer grants from which a considerable part of their expenditure is financed. We shall have to consider at a later stage what further links are necessary before a concerted policy for the whole public sector can become an actuality. In a similar manner the budget of the central government is linked with the budgets of the Social Insurance Funds, by means of the exchequer contributions to the funds.[1]

In order to find our way about the public accounts, it will be convenient to start with the Chancellor's Budget; from that (with the help of the Budget White Paper), we can proceed to the "balance sheet" of the whole public sector. Finally, again with the aid of the Budget White Paper, we can extend the account to the whole economy. We shall thus have an opportunity of comparing the relative magnitude of the public and private sectors, a comparison which is of obvious importance for the direction of policy.

The art of budgeting is a two-way looking process; the plans for the future must be grounded on the experience

[1] Cf. p. 86.

of the past. This end is provided for by the arrangement of the Budget Speech, which is traditionally divided into three parts, first a presentation of the revenue and expenditure accounts for the year just ended; secondly, a forecast of the extent to which the Estimates for the year just beginning (which will already have been before Parliament for several months) would be covered—or more than covered—at existing rates of tax; and finally, a recommendation of adjustments in taxes, calculated to bring about the desired balance at the end of the year.

The method of presentation of the accounts of the central government is most clearly seen in the Budget Estimate which appears at the end of the Financial Statement. It will be interesting to look at the plan presented to Parliament in April 1938 for the ensuing year, whose revenue and expenditure we have already examined. Since the account is just a summary of the estimates for expenditure and revenue placed against each other, we need not comment in detail on the separate items. (See Table IV.)

As we have seen, 1938, like 1913, is reckoned as a statistical base year, subsequent movements in economic series being measured from it. Unfortunately, on account of the international tension, it was not a very normal year, and this is reflected in the Budget by the provision of £90 mn. estimated to be covered by borrowing, and the £10 mn. reserved for unforeseen contingencies. In a completely normal year tradition would have permitted no mention of borrowing in the Budget, and there would even have been no allowance for contingencies, because Chancellors were expected to provide exactly for all possibilities at the beginning of the year, in order to make Treasury control over the accounts as complete as possible.

TABLE IV.—BUDGET ESTIMATE FOR THE FINANCIAL YEAR 1938–39 (£ MN)

Estimated Revenue			*Estimated Expenditure*		
Inland Revenue			National Debt . .		230·0
Income Tax .	341·3		Payments to N. Ireland		8·9
Surtax .	62·0		Miscellaneous Consol. Fund		3·2
Death Duties	88·0				
Stamps .	24·0				242·1
N.D.C. .	20·0		*Supply Services* *		
Other . .	1·25		*Defence :*		
			Army . .	86·1	
		536·5	Navy . .	93·7	
Customs and Excise			Air Force . .	73·4	
Customs .	227·95				
Excise .	116·15				253·2
			Civil (Votes I–IX) †		
		344·1	Civil Govt. . .	52·6	
Motor vehicle Duties .		36·0	Social services .	331·5	
			Economic Aid and Roads . .	40·7	
Total Taxes . . .		916·6			
Post Office . . .		11·1			424·8
Crown Lands . .		1·3			
Interest on Sundry Loans		5·25	Margin for Supplementary Estimates .		10·0
Miscellaneous Revenue .		10·5	Cost of Tax Collection .		14·3
Total Revenue . .		944·7	Total Expenditure .		944·4
			Estimated Surplus .		0·35
					944·7

* Exclusive of £90 mn. estimated to be financed out of loan. † As the classification into votes has only administrative significance, the simpler classification with which we are already familiar is followed here.

At the end of the financial year 1938 what had actually occurred was that tax collections were only £16 mn. below the estimate, but the deficit was considerably larger than planned.[1] Nevertheless a relatively accurate estimate of revenue in such a disturbed year was no mean

[1] For the calendar year 1938 it was subsequently estimated by the Central Statistical Office at £130 mn.; for the financial year, which included the first quarter of 1939, it must therefore have been higher still.

achievement [1]; in more normal times British estimates of revenue and expenditure have been correct to within a few hundred pounds, a result which is a striking tribute to the efficiency of the financial administration. It is an achievement which can best be appreciated by remembering the many centuries which have gone to the perfecting of the technique,[2] and by observing the difficulties experienced by other countries in attaining even this degree of proficiency.

Budgeting, as it has long been understood in England, is for most countries a comparatively recent innovation. By the time that the smoke of the 1914–18 war had cleared away, the governments of most countries had indeed come to present some sort of an annual statement of taxation and public expenditure, but in many cases it was far from complete. In totalitarian countries, naturally, no means were provided for checking whether the accounts were either accurate or complete. In the U.S.A., in spite of the enormous improvements in financial control which have recently been made, it is as we have seen [3] still the custom to present no consolidated finance bill. Revenue is only available as Congress successively brings itself to the point of agreement on the necessary taxes. This practice inevitably weakens the financial administration; it leads to a considerable amount of at least short-term borrowing, where tax revenue ought to be available.

A much more serious weakening—which was unfortu-

[1] The discrepancy was due to a short fall in revenue from death and stamp duties, both traceable to depressed conditions on the Stock Exchange.

[2] It has recently been established that there were "traces of an organized financial system in England at a surprisingly early date"—e.g., in the ninth century under King Alfred. Cf. F. M. Stenton, *Anglo-Saxon England*.

[3] Cf. p. 71.

nately by no means rare in the inter-war period—was a failure to collect (because of tax evasion), or perhaps even to plan for (because of the weakness of the government) sufficient tax revenue to cover the current expenditure which had already been agreed upon. Governments in such a predicament were accustomed to bundle all the uncovered expenditure—whatever its nature—into an "extraordinary" or "capital" budget, which for the foreseeable future at any rate had to be covered by borrowing, probably from the central bank. If "double budgeting" of this nature becomes chronic (as it was in danger of doing in France in the 1930's), there is a risk of undermining confidence both in the financial institutions whose stability is threatened by the government's importunity and even in a political system where governments cannot keep their affairs in order.

In the inter-war period, however, another kind of Double (or rather divided) Budget was adopted in some countries—notably Denmark and Sweden—in which separate account of capital expenditure was taken in an annex to the ordinary budget. This kind of budgeting is not merely very different from the chaotic state of affairs where the "capital" budget is little more than a cloak for weakness or incompetence; it is also a considerable improvement on the traditional British system, because it is capable of being used as an instrument of policy, which the British budget is not. At a later stage we shall have to discuss the application of this,[1] and other, improved budgetary methods to British conditions. It is not too much to say that the success of a systematic economic policy is conditioned by the successful solution of the budgetary problem in a wide sense. The need for budgetary reform

[1] Cf. Chapter XX, Section 1.

arises essentially from the changed purpose for which the accounts are now required.

The primary purpose of the traditional British Budget is first (in the Estimates) to record the agreement of Parliament to a particular lay-out of public revenue (arranged for in the Finance Act), and later (in the Appropriation Accounts), to certify to Parliament that the revenue has been provided and applied as agreed. The necessity for Parliament to assure itself in detail on these matters is a survival from the days when kings were liable to divert to their own uses monies provided by Parliament for the public services. In fact, Parliament now relies on the Treasury to see that all is in order; and the detailed form of the Estimates, on which the Budget is based, is really to enable the Treasury to carry out its traditional process of control.

As we have seen, however,[1] Parliament has become accustomed to make use of this form of presentation of the accounts for quite another purpose; the Votes and Heads into which the Estimates are divided provide a convenient classification of expenditure from the point of view of choosing suitable subjects for debate in Committee of Supply. This second purpose of the Estimates increases the difficulty of reforming the accounting system, but it could be served just as well by a more summary list of subjects, which would allow of more flexibility in accounting methods.

It is not merely the method of presentation of the public accounts which is a survival from conditions which have passed away, the trouble goes considerably deeper. The actual method of accounting used reflects a stage of economic and political development when accounting technique was dominated by practices appro-

[1] Cf. p. 60.

priate to personal or family expenditure. In order to facilitate the traditional method of Treasury control, the accounts of government departments are kept on a strictly cash basis; only those payments which have actually been made during the relevant period figure in the accounts. Other transactions which may have been concluded in the accounting period, and which properly belong to it, are unrecorded so long as cash has not been paid over. The public accounts are thus merely a cash record, not a true expenditure account; thus they do not provide an accurate record of government activity during the year, and are hardly superior in technique to that of a penny cash book.

Moreover, in the Estimates expenditure is grouped by subject, not by service. To take an example at random, in 1935, Class VI, Vote 1, Head A (General Administration of the Board of Trade) was divided as follows: A1, Salaries, etc.; A2, Travelling and Incidental Expenses; A3, Special Services; A4, Telegrams and Telephones; A5, Expenses under the Dyestuffs (Import Regulations Acts, 1920–24). (The last item looks suspiciously as if it had been put there for want of a better pigeon hole.) On this method of accounting it is next to impossible to compute the total cost of any particular service. For instance, if we want to find out the cost of the services provided by the local Employment Exchanges, we can start by finding the cost of the salaries of the local staff—separately accounted for under Class V—but we are at a loss for the cost of the time of the central staff taken up by connection with this service, which can be by no means negligible. The cost of the buildings and furniture, and purchases of stationery and other stores, are merged with the cost of similar materials used by other departments—mainly under

"Common Services" in Class VII—so that we cannot isolate them properly.

The result of this method of accounting is that it is impossible for any revising body, whether the Treasury, the Public Accounts Committee, or an *ad hoc* Committee on National Expenditure, to say whether a department is being run well or badly. It is usually impossible for the head of a department to tell what his department is costing at any particular moment, much less to compare it with the results of previous years or other departments. In short the method of public accounting is adapted to reveal dishonesty, but not incompetence, in the public services.

This obstacle to an intelligent control of expenditure was acutely realized by the Committee on National Expenditure which sat during the 1914–18 war. As a result of their repeated expostulations some improvement was made in the accounting methods of the trading services. The Post Office, for instance, began to publish "Commercial Accounts" roughly similar to the capital and profit and loss accounts of a business firm. A reconciliation account was then drawn up to square these with the Estimates. Commercial principles are, unfortunately, less easy to apply to the Supply Departments, since in order to draw up a balance sheet it is necessary to determine accounting "units" within the departments, and the definition of these is not always very simple. Reconciliation accounts on a large scale would also be very laborious.

It is pretty clear that some adaptation of the balance sheet principle will have to be evolved for the public departments if efficient planning is to become a reality. This has been realized in Sweden and already some little progress has been made with a change-over of method.[1]

[1] For further discussion of this point, see pp. 371ff.

In Britain the problem would be less intractable if Parliament would be satisfied with a less detailed version of the Estimates, since reconciliation accounts would then be greatly simplified. Parliament would naturally retain the right to call on the Treasury for further details in case of any obscurity.

Another shortcoming of the traditional Budget is that it fails to distinguish the different types of expenditure according to their economic significance. Expenditure on current account may consist of the purchase by public authorities of goods and services—the services of civil servants and other employees, the goods used in collective consumption (e.g., in schools) or in the trading services. Alternatively, it may take the form of a transfer from the incomes of one group of citizens to supplement the incomes of another. Such transfers are of two kinds, payment of National Debt interest to the owners of war loan and other government stocks, and social transfers, e.g., pensions and other payments made as part of general social and economic policy.

It is highly desirable to be able easily to distinguish these two forms of public outlay in the accounts, because the first—expenditure on goods and services—generates new incomes directly, whereas transfers do not, although of course additional incomes may later be generated if the recipients spend the additional income while the transferers would have saved it.

Finally, the failure of the Budget to distinguish income and capital items should be stressed. The Chancellor's Budget may well include—but is sure to conceal—capital items on both sides of the account. On the expenditure side a considerable proportion of the cost of roads and buildings is really new investment financed out of revenue; on the revenue side, if tax collections fail to cover expenditure, it has been customary to balance the accounts by the introduction of what are effectively capital items, in order to conceal the existence of a deficit. In the past the failure to distinguish capital from current items has been of secondary importance, but immediately an active economic policy is adopted it becomes of first rate importance.

In view of these deficiencies of the traditional Budget it is not surprising that the necessities of war finance called forth a method (the Budget White Paper) of supplying additional information on both these heads, as well as giving much further information on the whole state of the economy. As a result a somewhat broader outlook was imparted to the traditional Budget Speech. Members have had the White Paper before them as well as the Financial Statement; it has become customary for the Chancellor to make some reference to the information which it contains; but the Budget White Paper is not drawn up in a form in which its message can easily be appreciated by the layman, and references to it so far have been rather cursory. Some better method of integrating the new information with the Budget accounts is clearly desirable. This is a question to which we shall have to return at a later stage [1]; our present concern with the White Paper information is that it provides the means both for filling out the accounts of the public sector, and for relating them to those of the private sector.

§ 2. *The Consolidated Account of the Public Sector.* The Budget White Paper sets out a complete account of the public sector in what might be called a semi-commercial form—showing income from all sources (including loans)

[1] Cf. Chapter XX *passim*.

on the left-hand side, and total expenditure on the right. This is a consolidated account in the sense that payments made from one public body to another (e.g., taxes and grants) are cancelled out to avoid double counting. It will be interesting to compare the composition of public income and of the lay-out of expenditure in 1938, the last year of peace, and 1944, the last year of war (Table V).

On the revenue side, in 1938, the tax receipts of the central government were about four times those of the combined local authorities, and about eight times those of the Social Insurance Funds; by 1944 the tax revenue of the central government had more than quadrupled, that of the Social Insurance Funds had more than doubled (which mainly reflects the higher level of employment), while that of the Local Authorities had remained stationary. On the expenditure side, in 1938, a little over 60 per cent of expenditure on current account was applied to the purchase of goods and services; by 1944 this proportion had risen to 88 per cent, all war expenditure being reckoned as current outlay, although some part of it does result in a permanent addition to the country's fixed capital The enormous expansionary effect of government expenditure in war-time is apparent from these figures, especially when we recollect that much of it is made to the heavy industries where it would have large secondary (acceleration) effects if these were not very strictly controlled by taxation and rationing.

It will be seen that in a normal year (as represented by 1938), local expenditure on current account was of comparable importance with that of the central government, while on capital account it was very much larger. Although in the future the amount—and probably also the share—of the central government is likely to be larger than in the past, the importance of the activities of local

TABLE V.—INCOME AND EXPENDITURE OF BRITISH PUBLIC AUTHORITIES IN 1938 AND 1944 (£ MN.)

Income	1938		1944		Expenditure	1938		1944	
1. *Tax Receipts*					1. *On Current Goods and Services* §				
Central Government	863		3,107		Central Government	460		4,951	
Social Insurance Funds *	109		251		Social Insurance Funds	14		124	
Local Authorities	211		226		Local Authorities	355		477	
		1,183		3,584			829		5,552
2. *Income from Property*					2. *Transfer Expenditure*				
Central Government	17		47		Central Government	312		603	
Social Insurance Funds	—		—		Social Insurance Funds	136		116	
Local Authorities	10		—		Local Authorities	23		12	
		27		47			471		731
3. *Deficit* (+) *or Surplus* (−) †					3. *Net New Investment*				
Central Government	147 ‡		2,760		Central Government	24		8	
Social Insurance Funds	−22		−100		Social Insurance Funds	—		—	
Local Authorities	90		−50		Local Authorities	101		−50	
		215		2,610			125		−42
Total Resources		1,425		6,241	Total Expenditure		1,425		6,241

* Includes War Damage Contributions in 1944. † Deficit is positive and surplus negative, contrary to ordinary balance sheet practice, because the right-hand side equals total expenditure, not profits. ‡ Including £17 mn. borrowed on behalf of the Post Office for new investment, as well as the Budget deficit of £130 mn. § For war and non-war purposes, including £15 mn. of specific subsidies in 1938, £220 mn. in 1944, and (under the Social Insurance Fund heading) payments for war damage made good.

authorities, and the necessity for persuading them to take concerted action in the interests of national policy, are very apparent. It will be noticed incidentally that the local authorities made a contribution to investment out of current revenue which was not negligible ; in the case of the central government any such application would have been swamped by the deficit due to war preparations. Finally, so far as transfer expenditure is concerned, if we deduct the cost of the National Debt (£192 mn in 1938 and £394 mn. in 1944), the significant part played by the Social Insurance Funds in social transfers is revealed, especially in a normal year when some unemployment exists.

§ 3. *The Public Sector in the National Economy.* In order to compare the relative magnitude of the public and private sectors it will be sufficient to look only at the expenditure side of the account, since this is the more important for policy. It is, however, vital to distinguish between expenditure on current and on capital account owing to their different significance for policy. In Table VI the transfer expenditure of public authorities disappears, because it is really spent in the private sector, and to

TABLE VI.—THE PRIVATE AND PUBLIC SECTORS OF THE BRITISH ECONOMY IN 1938 AND 1944 (£ MN.)

	1938	1944
Private Sector		
Personal Expenditure on Consumption * . .	4,153	5,216
Private gross Capital Formation (at home) .	550	224
Public Sector		
Public Expenditure on Current Goods and Services	814	5,221 †
Public gross Capital Formation (at home) .	235	63

* Including the cost of acquisition and transfer of property.
† Excluding expenditure financed through lend-lease and similar arrangements.

include it in both would be to count it twice. We are thus left with private and (as we may say) public consumption on the one hand, private and public investment on the other.

The figures for investment in this table are shown gross (e.g., including depreciation), because this makes it easier to compare the total relative demands for resources of an investment nature by the two sectors.[1] It will be seen that in 1938 30 per cent of all investment was due to the public sector, and that the proportion of investment to expenditure on current account was higher in the public than in the private sector (nearly 29 per cent as compared with 13 per cent) ; 1938 was perhaps a slightly exceptional year in this respect ; the private sector was already affected by the international uncertainty, while the public sector was if anything spurred to greater activity by the same factor. Nevertheless, these figures show that the investment of public authorities was already an important factor in the economy, although no effort to put a planned investment policy into effect had yet been made. The figures may also suggest that private investment was less than it should have been. When it was revealed by the Central Statistical Office that private net new investment in 1938 consisted wholly of houses and buildings, and not of modernization or extension of industrial plant, the serious situation which had grown up in the 1930's became apparent.

In order to reach an estimate for *net* new investment it is necessary to write down the gross amounts to allow for depreciation, and for transfers to sinking funds. The figures for net home investment then appear as follows :

[1] For a discussion of the reliability of the figures, see p. 386.

NET HOME INVESTMENT IN 1938 AND 1944 (£ MN.)

	1938	1944
Private Sector .	220	−202 *
Public Sector . . .	125	−42

* Indirectly estimated.

These figures give an indication of the rate at which the capital equipment of the country was deteriorating as a result of the prolonged war. In the private sector the disinvestment in 1944 followed a previous disinvestment of about £730 mn. spread over the four preceding years. Even this does not give a true picture of the internal capital position because it takes no account of the deterioration of household goods and domestic capital of all sorts. To realize the deterioration in the total investment position it is necessary to take account also of the sacrifice of foreign assets; this amounted to £70 mn. in 1938 (of which, however, £55 mn. represented the sale of gold previously accumulated), and £655 mn. in 1944. In the intervening years a further £3,191 mn. of (net) foreign assets had been sacrificed.

The most striking difference in the outlay of the national resources in the two years is, however, the enormous relative expansion of the public sector in war-time (the apparent expansion of the private sector is an illusion due to the rise in prices, in terms of constant prices it was considerably reduced). In 1938 public expenditure on goods and services amounted to no more than 15 per cent of the total national income at market prices, by 1944 it had expanded to 73 per cent (excluding in both years overseas disinvestment). In the United States a comparable expansion took place, although there was no net reduction in consumption at constant prices. Even in neutral Sweden the outlay of the public sector more than doubled between 1938 and 1942, a small movement compared with the British expansion of between four-and fivefold, but nevertheless significant. In short, the limit to the expansion of the public sector in war-time is set only by the necessity for keeping the civilian population in a condition to wage war.

Unfortunately the statistics relevant to the 1914–20 period are too deficient to enable an estimate of the relative degree of expansion of the public sector then made. Although, undoubtedly, very large it was certainly smaller than in the 1940's, both because concentration on the war effort was less successfully achieved, and because the control of civilian demand was much less thorough. After the war public expenditure on goods and services shrank back to a point not much above the pre-war level (at constant prices). We may expect once again to see a shrinkage when the reconstruction period is over, but since the trend of the public sector is sharply upward, it will certainly be less pronounced than on the earlier occasion. If a systematic economic policy is put into effect the share of the public sector is likely eventually to expand at a much greater rate than anything previously experienced in Britain, in time of peace.

PART II

THE THEORY OF TAXATION

CHAPTER VII

THE ART OF PUBLIC FINANCE

§ 1. *Political and Economic Aspects.* In Part I we examined the administrative mechanism of the system of public finance. The most obvious enquiry to make concerning a piece of machinery is what it is supposed to do or produce. At the outset of our examination of the effects of public finance it will amply repay us to pause for a moment in order to consider the nature of public finance and the role which it should play in the community.

Our investigations in Part I have shown that public finance is closely related to politics, the art of governing. This must necessarily be so since public finance is concerned directly or indirectly with the actions of governing bodies. The proper conduct of a country's finances is one aspect of government, and clearly one aspect cannot be studied successfully in isolation. Indeed the entire political organization is relevant to the understanding of public finance. For instance, the significance of a departmental estimate depends upon the political system in operation (contrast the practice even in two such similar democracies as Britain and the United States). Again the annual routine of financial planning which we have studied in detail is conditioned by the British Parliamentary system. Nevertheless, public finance is not a department of politics, it is concerned with the satisfaction of wants, not with the art of governing.

The fact that public authorities exist for the satisfaction of the wants of the citizens puts public finance firmly into the field of economics. This implies that its study (and *a fortiori* its successful conduct) presupposes a knowledge of the working of the economic system. It is further clear that it must belong to the field of *applied* and not to that of *pure* economics. Public finance is an art, it is concerned with actual problems. If its analysis is to have any practical application, at a very early stage, a particular economic set-up must be postulated, since both the means to be used, their effects, and in some sense even the ends to be pursued, depend on the type of the economy.

Thus, as we have seen, in a predominantly agricultural community little use can be made of the income tax. Again an apparently identical income tax may have very different effects in a community where the typical business unit is the small family firm, and where consequently investment is mainly derived from private savings, and in a community where the typical business unit is large, and markets more or less monopolistic. Most important of all such differences are those concerned with the optimum size of the public sector in relation to the rest of the economy. In one situation the interests of a nation may be best served by a small public sector, leaving private enterprise to invest freely on expanding markets. At another stage of its development the same nation may require to enlarge its public sector enormously if it is to take advantage of the less obviously profitable methods of improving the standard of living, which may constitute its best path to progress. This is a question to which we shall have to return in Part III.

From these few examples it is clear that the relation of public finance to the other subjects usually included in economics calls for very careful consideration. The duties of the economist to the community cover two quite different services. In the first place he must be able to analyse the working of the system, in the second place, on the basis of his analysis, he should be able to offer advice for its improvement. Thus the discipline of economics can be divided into two distinct processes. In the first place there exists what we may call the positive sector, the business of which is to describe the economic institutions of the society (for instance, the organization of industry) and to analyse the causal sequence of the reactions of these institutions to economic and other stimuli. This part of the discipline may be described as the anatomy and physiology of economics.

In the second place, and no less important, comes the normative sector, the business of which is not merely to determine the correct criteria for policy, but also, on the basis of those criteria, to provide a method of selecting the best among a number of possible economic ends, or alternatively, the economically best route for attaining a given non-economic end. Continuing our medical metaphor this section may be said to deal with the preventive and therapeutic sides of economics.

Public finance, being a part of the general study of economics, also possesses a positive and a normative side, but they have their special characteristics due to the field of operations of the art.

One part of positive public finance is concerned with the description and analysis of the machinery of public expenditure and of the assessment and collection of revenue. A knowledge of the parts of this machinery is necessary to understand its working, e.g., the way in which a particular piece of fiscal policy—a new type of expenditure or a tax change—will affect the economy. Differences in national constitutions and conventions may, as we have seen, make considerable differences to the significance of taxes, or to the means which are practicable for the general direction of fiscal policy. To study this machinery in respect of the British economy has been our task in Part I.

A second and more fundamental part of positive public finance consists in the analysis of the actual process by which taxes (or subsidies and transfers, which are merely negative taxes) of particular types work through an economic system. This analysis is necessary to discover the economic consequences of fiscal changes, and only if the process is carefully traced is it possible to judge the relative merits of alternative means of reaching a given end, and so to choose the best method. It is convenient to refer to this analysis as the theory of Taxation, or Tax Incidence, although it is also concerned with certain types of expenditures. We shall be occupied with this type of analysis in Part II. It should be noted that it is essentially a "one thing at a time" process made familiar by general economic analysis, in the sense that when we are studying the effects of a particular fiscal change we neglect changes in the economic set-up which are not, directly or indirectly, due to it. The entire new set-up caused by the change must, however, be examined.[1]

The third and final part of positive public finance (with which we shall be concerned in Part III) consists in an analysis of the combined effects of the entire system of public finance on the national income; it embraces the fiscal policy of public authorities in the fields of current expenditure, investment, taxation and borrowing. This

[1] For further discussion of this point, see pp. 155ff.

analysis is clearly an essential foundation for a systematic policy of high economic activity and for the direction of social policy; but a knowledge of the theory of tax incidence is an equally necessary requisite, in order that the means selected for bringing about the high level of activity shall be satisfactory from other points of view as well. It will be seen that the theory of tax incidence corresponds in the field of public finance to the theory of the firm or industry in general economic analysis, while the theory of public finance in the national economy is related to the general economic theory of business activity.

§ 2. *The Choice of Policy.* The positive side of public finance, however, cannot long be kept apart from the normative side. The analysis of the working of taxes or expenditures is not an end in itself, but merely a step in the process of selecting the best policy. On the normative side public finance again shows itself to be merely a department of economics.

Just as positive public finance is concerned with a particular department of economic analysis—the effects of the financial activities of public authorities—so normative public finance is concerned with judgments on particular types of economic policy, those which are, or may be implemented by, programmes of expenditure or of revenue collection; the ends which are sought in this manner cannot, however, differ in any way from those sought by other types of economic policy, and may more conveniently be implemented by different means than by public finance.

The policy which is adopted by a nation—such a policy, for instance, as is reflected in the annual financial programme which we have been examining—is composed of a number of strands; some of these have a non-economic, legal or psychological basis—for instance, the desire for legal equality, satisfied by Adam Smith's second duty, or arrangements to secure religious freedom. The greater part of policy, however, is concerned with the satisfaction of wants which are similar in kind to those satisfied (or which could be satisfied) through the market mechanism; in this sense they are individual economic wants, although they may more conveniently be provided on a collective basis.

As the field covered by public sectors expands, the proportion of public expenditure and revenue, and hence of fiscal policy, which is devoted to these economic ends also expands, because the non-economic wants which can be satisfied by government action are necessarily more limited than the economic wants. Hence as public sectors expand it becomes increasingly necessary for policy to be based on firm and objective criteria to which all schemes can be referred; without a definite goal the ship of policy is rudderless, at the mercy of the drifting tides of particular interests. In such a condition it is not merely impossible to draw up a satisfactory programme of the things which should and which should not be undertaken by public authorities; it is also impossible to allot priorities on any rational system between alternative policies, all of which may be accepted as desirable, but which the resources of the economy are not sufficient to implement simultaneously.

It must be logically possible to find and to state such objective criteria for all that part of policy which is concerned with the satisfaction of economic wants by public action. With the current expansion of public sectors this problem is of urgent topical importance, but unfortunately it has received far too little attention. In order that our analysis may not be left floating in the air, but be made to yield definite conclusions, we cannot avoid attempting to state the criteria of policy, however briefly and inadequately.

Remembering that the final end of policy is the satisfaction of wants, an obvious first stage in our quest is to state that the means of satisfying wants—production, output—must be maximized. Clearly if production, with a given volume of resources, is not maximized, however the product is distributed, satisfaction is less than it should or might be. The maximization of output, the "production optimum", is thus concerned with the allocation of resources; the condition for maximization of output is that with any given system of products it *should be impossible, by reallocating factors, to increase the output of one product without diminishing that of another.* This criterion is perhaps not much more than a precise way of stating the oft-quoted maximum condition of equi-marginal returns to factors, but it has the decided advantage that it is independent of any particular system of price weights which may be given to the products, so that it is of general application.

So far there is no logical difficulty, although when we consider the problems set by such complications as indivisibilities, external economies, and complementarity of factors, the implementation of a policy of reaching the productive optimum clearly sets many problems of a technical nature. The second stage in the pursuit of the economic absolute is a little more complicated. Among production optima we have to choose the set-up which will maximize *satisfactions.* And here we are up against the difficulty of comparing one person's satisfactions with those of another. The only way out of the tangle of incomparability of utilities is by the route of compensation. If a particular redistribution of products will make the first individual so much better off than he was that he can compensate the second man and still remain better off [1] than he was initially, then both must agree that the change would be an improvement. The maximization of satisfactions, the "utility optimum", may hence be formulated precisely, in a manner parallel to the production optimum. *Utility is maximized when it is impossible to increase the satisfaction* (improve the position) *of one individual without diminishing the satisfaction of another,* after full allowance has been made for compensation.

The utility optimum clearly takes us up to a higher stage in defining the course of policy, because it brings us into view of the final goal, which is real income and not real output. It does so by eliminating the degrees of freedom which would otherwise exist in the organization of production. Something akin to the utility criterion has been sought in the form of equi-marginal social net products; the concept of social net product, however, contains too many unmeasurable quantities for the basis of actual policy. Both the production and utility optima in the form just stated are capable of being brought into relation with statistical and econometric enquiries, and so are capable of becoming practical directives of policy.

It is obvious, but should perhaps be emphasized, that both criteria need to be interpreted in a dynamic sense; the production that is to be maximized is not this year's or next year's, but is the present value of a future output stream, discounted at whatever rate defines an acceptable compromise between the mortal nature of the individual and the immortality of the community. The utility optimum must similarly be conceived as realized by a stream of satisfactions through time. Some of the

[1] In economic terms, on a higher point on his indifference map.

increase in satisfaction which will signalize progress towards the optima will take the form of a better provision for wants already conscious, and probably already partly satisfied; there is also, however, a large field for the development of want-consciousness, which will lead eventually to higher levels of satisfaction. In this field public authorities can play an important role.

§ 3. *The Implementation of Policy.* Having defined our criteria of policy, we must now attempt to see how they can be applied to the actual direction of policy. Starting with an economy as a going concern (as we must do) we have a given short period potential supply of factors, i.e., the labour and capital existing or shortly obtainable through production with existing equipment, or by exchange. The first condition, required for the production optimum, is that these factors should be fully and continuously employed. We must then use the utility optimum to discover just in what way they should severally be used.

In any economy there are always likely to be an indefinite number of schemes which are potentially eligible for inclusion within the scope of the utility optimum, in the sense that they would severally increase satisfactions and still leave a surplus over cost, after compensation had been paid for lost satisfactions. By estimating for different schemes the relative magnitude of these surpluses, a definite and objective system of priorities can in principle be established. Given adequate statistical data of costs, it should be possible to do this with a reasonable degree of accuracy. In practice difficulties may arise—for instance, owing to discontinuities where the minimum outlay is large—but for the most part it should be possible to make marginal adjustments which are small from the point of view of the whole economy, although they may be large from the point of view of a single unit of control.[1]

When the matter is put in this way the important role which public finance must play in the attainment of the optima is at once apparent. The production optimum can only be reached with a technically correct allocation of factors; in practice there are many reasons why it is often difficult to realize this allocation. For instance, monopolistic control of markets may impose an obstacle; again an inadequate educational system may prevent the best use of the nation's talent. Technical obstacles of this nature are very amenable to treatment by fiscal means, through the use of particular taxes, or the development of particular types of expenditure. Again, on the plane of the relation of public finance as a whole to the economy as a whole, fiscal policy can be directed both to making the public sector the supporting and balancing factor in the economy, and to influencing the activities of the private sector in a direction appropriate to the criteria of policy.

The production and the utility optima are, it will be observed, independent of the type of political organization; in principle they can be pursued successfully by governments of very different political flavour, although the working out of the utility optimum principle will no doubt differ according to the type of government.

Thus some revising agency (for which the government must be ultimately responsible) is required to take into account when determining policy programmes those "community effects" of individual actions which are not apparent to the individual. (For instance, the backwash of *A*'s actions on *B* will not be taken account of by *A*

[1] For further discussion of planning difficulties cf. Chapter XVIII.

because they lie outside his private accounting system, either considered as the utility accounts of the consumer, or the production accounts of the firm.) In the productive field effects of this nature have long been recognized as a type of "external economy" (or *mutatis mutandis* dis-economy), but so far policy has almost entirely failed to take them into consideration. In the field of consumption "community" or "neighbourhood" effects of this nature are no less important, and up to the present much less attention has been paid to them.[1]

Many of the functions of the State in thus revising and integrating policy, whether they are actually performed by the legislature directly or by an agency (e.g., the judiciary acting under legislative direction), are closely related to fiscal policy. In order for them to be carried out to the best satisfaction of the community it is clear that the government must reflect the real wishes of the people as faithfully as possible. It does not lie within the field of economics to discuss the precise form of political organization which will satisfy this condition most appropriately, any more than it does to determine the content of the remaining non-economic strands which go to complete the fabric of policy. Since the economist has nevertheless a responsibility in the implementation of these other strands of policy it is necessary for him to be conscious of their nature.

Some of the non-economic strands of policy are of supreme importance for the life both of the individual and of the society; indeed they take us beyond the utility optimum in the sense in which we have defined the maximization of satisfactions. That this is so is shown by the willingness of members of the society to lay down

[1] Cf. Meade, "Mr. Lerner on the Economics of Control," *E.J.*, April 1945.

their lives in order to secure for their families and descendants the sort of system of which they approve. In policy of this nature must be included the fundamental physical and psychological needs which Adam Smith had in mind as pertaining to the "First and Second Duties of the Sovereign". For policy of this nature there can be no question as to whether resources can be spared, since it must take precedence over the realization of the normal optima of policy.

Besides these fundamental needs of man in society there are also other psychological and social needs which although less fundamental are deeply engrained in the ideology of particular societies, and of which consequently the economist must be aware when he is advising upon policy implementation, although again he must take as a datum the ideology which is enshrined in the policy. An example of such a strand of policy which is peculiarly strong in Britain is the idea of social justice, expressed in the present generation by a demand for the redistribution of income, but traceable in tax ideals stretching far back into history.[1] The economist has an important duty to perform in respect of this policy; he is responsible for reporting to the community on progress, e.g., on the effects of any particular measures of redistribution (or the general pace of redistribution) on the production and utility optima respectively. Policy of this type if carried to extremes may conceivably conflict with the pursuit of the optima; armed with the economist's report it is for the government to take the responsibility for deciding between conflicting ends. Still other types of policy, even those desired by majorities, may conflict more seriously with the pursuit of the optima (we might take as an example the determination to establish an industry

[1] Cf. Chapter VIII.

for which conditions are unsuitable). Policy of this nature needs to be measured very carefully against our criteria. It is unfortunately within the power of majorities to inflict lasting damage on an economy by the pursuit of ends for which the means are not available.

It will be clear from our discussion that in a developed community economic aspects claim a large part of the field of policy. The art of public finance thus takes its place alongside the other means of implementing policy —direct control (by rationing, direction and conscription) on the one side and on the other, indirect control of private production and consumption by monetary policy.

These three methods of implementing policy, public finance, direct control and monetary management, are very closely related to each other. In practice they can often be made to supplement and support each other, as when in war-time subsidies on essential foods are backed up by rationing. The connection between public finance and monetary policy is particularly close because they both impinge on monetary institutions, especially on the capital market. (Hence it is especially necessary that monetary and fiscal measures should be complementary and not conflicting.) In spite of this close relation, the scope of the two methods of implementing policy is quite distinct; for monetary policy influence on the capital market and on monetary institutions is the *purpose* of policy, while it is the *result* of public finance.

Of these three methods of implementing policy, public finance appears to be the most powerful and generally useful where it can be properly applied. On the one hand, in normal times the scope for direct controls cannot be large without a danger of infringing essential liberties; on the other, fiscal policy has the advantage over monetary policy that it can be applied just at the point where stimulus or pressure is required, whereas monetary policy inevitably goes bludgeoning all round the economy. Further, whereas monetary policy can only operate with indirect effects, fiscal policy can be turned at will either to the direct production of satisfactions, or to their indirect production through the stimulus or control of the output of the private sector. Thus the adoption of particular ways of raising revenue may in itself lead to an expansion of income per head (for instance, by promoting industrial efficiency) or to a better reflexion of preferences on the market (for instance, by bringing prices nearer to marginal costs); while at the same time the expenditure of the revenue promotes progress towards the optima (for instance, by the dynamic development of the utility optimum, through better housing or education).

Although it is only the modern development of economic analysis which now enables us to formulate the criteria of policy precisely, in a crude form they can be shown to have been present in the minds of the framers of British fiscal policy from the seventeenth century, from the moment when Parliament finally got full control of the revenue. Until well on in the nineteenth century, however, pursuit of the optima was almost wholly conducted on the tax side. This was inevitable because the greater part of the revenue was required for the satisfaction of the fundamental (non-economic) needs of the community, which as we saw must take precedence over other wants. Thus until quite recently the ideals of public finance were comprised in the theory of tax incidence; before the Gladstone era it was not even realized that the tax structure could, and should, be treated as a unit from the point of view of policy.[1]

Once it became possible to think in terms of a complete

[1] Cf. p. 150.

tax structure, instead of in terms only of its components taken separately, a broader outlook was conferred on policy. It began to be perceived that the tax structure might itself be used as an instrument of policy. Since, however, the main emphasis continued to be on the theory of tax incidence, the principal advice that the nineteenth century had to offer on the policy of public finance was that the public sector should be kept as small as possible. In the early nineteenth century, the age of rapidly expanding population and markets, this was sound economic sense. The opportunities for pioneering by private enterprise were enormous, and no assistance from public sector was required to secure a high level of activity. Nor would it have been possible for the public sector, with inadequate transport and an undeveloped civil service, to take an active part in policy.

As so often happens, however, the policy of slimming the public sector outlived the situation in which it could plausibly be regarded as economically appropriate; but so long as ideas of social and economic expenditure were relatively undeveloped, the scope for expanding the public sector remained limited.

The modern analysis of the effects of public finance as a whole, and hence of the place which fiscal policy might play in the economy, followed quickly on the development of the theory of business activity, associated especially with the names of Wicksell and his pupils in Sweden, and slightly later of Lord Keynes and others in Britain; the new theories were first applied in detail to public finance in Sweden in 1934.[1]

[1] By Gunnar Myrdal, *Finanspolitikens Ekonomiska Verkingar* (The Economic Effects of Public Finance), following Erik Lindahl's pioneer work on the control of the economy through monetary policy, dating from 1928. For further discussion of the revolution in thought which resulted from these analytical developments, cf. Chapter XVII.

The practical application of the new analysis depended, however, on the emergence of two new factors in the situation, first the expansion of the public sector in national economies (due both to the growth of trading services and other forms of public investment and to the development of the social services); secondly, the availability of a better technique for monetary control, once the rigid gold standard of the nineteenth century had been abandoned. Without this latter change the new orientation of policy would have been in danger of frustration on the monetary side.

CHAPTER VIII

TAX IDEALS

§ 1. *The Principles of British Taxation.* When the finance minister of a country is choosing the taxes to go into his budget, what considerations ought he to have in mind? This is usually the first aspect of public finance to attract attention, because it is a matter that affects every citizen. In England we can trace a long tradition of opinion on tax ideals. Before we pass to the economic analysis of the operation of particular taxes it will be useful to see what general principles have lain behind the levies actually imposed from time to time.

There are, broadly speaking, three different types of question which a finance minister might be supposed to put to candidates for the budget before admitting them. In the first place he might ask what (if any) other purpose they were capable of serving besides providing revenue for the satisfaction of public wants. Secondly, he might question them about their distributional effect, what classes of the people might be expected to contribute most of the revenue. Thirdly, he would have to put them through an efficiency test, to ascertain which were the most economical and effective methods of raising a given revenue, or which taxes were most appropriate for serving other given purposes.

The taxes selected by British Parliament have usually been required to give fairly specific answers to these questions, at least from the sixteenth century. The answers may be stated in the form of three principles. In the first place the primary purpose of the revenue should be to finance the public services, consequently those taxes should be chosen which would be most efficient for this purpose. Nevertheless, it is permissible in certain circumstances to choose some taxes whose main object is to serve an agreed subsidiary aim, such, for instance, as improving the balance of payments on international account, or hindering some undesirable form of consumption expenditure. The second principle is that the citizens should be taxed in accordance with their ability to pay, a criterion which should take some account of family circumstances as well as of wealth. Thirdly, taxes should be universal, imposed without distinction of person between citizens similarly placed.

In terms of the policy aims which we were discussing in the last chapter the first of these principles can be related to the productional criterion. The productive optimum in any given circumstances can only be reached if the most efficient taxes are used; a country which tries to make its revenue serve a number of subsidiary purposes at once is almost certainly damaging its chance of attaining the optimum. The second principle is concerned with the question of social justice; but it is also related to the utility criterion. The precise interpretation of "ability" inevitably gives rise to differences of opinion. What is really at stake is the relative weighting which should be given to the various factors on which ability may be said to depend. This question cannot be settled objectively, so that the interpretation of the principle must remain a matter of policy, a matter that is for Parliamentary decision. The interpretation put on the second principle has naturally varied with the state of economic and social development.

The third principle is also related to ideas of social justice by way of Adam Smith's Second Duty, since it is concerned with equality before the law. It is characteristic of the British outlook that a great deal of attention should have been given to this point, and taxes which were otherwise acceptable were often condemned or even abandoned if they could not be made satisfactory in this respect. The third principle is also concerned, though not very obviously, with the efficiency test, which otherwise does not figure very prominently in traditional discussion. The connection, however, was made clearer in Adam Smith's formulation of the principles of taxation.

In his chapter on the Public Revenue, Adam Smith put forward four canons or maxims of taxation, which have had a fame which perhaps they hardly deserved, since they appear to have been mainly a reflexion of contemporary opinion. The second and ~~third canons~~ (the first is merely a restatement of the distributional principle) lay down respectively that taxes should be certain and not arbitrary, and that the time of collection should be suited to the convenience of the taxpayer—partly a question of equality again but partly also of efficiency. The fourth canon, concerned with economy, is much more interesting and it is worth quoting it in full: "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State."

Adam Smith probably had in mind here mainly questions relating to the heavy cost of collecting certain taxes in his day (i.e., the high customs duties which required an army of revenue officials to prevent smuggling). Later economic analysis has shown that the principle of minimizing the difference between taxpayers' loss and revenue's gain can be used to provide an important criterion of a tax, a criterion which is important not merely from the point of view of the productional optimum but even more so from the point of view of the utility criterion.[1]

That Smith was aware of the need for an efficiency test is evident from his canons; that he did not attempt to state it more precisely is hardly to be wondered at when we consider how difficult it was in Smith's day for even a theoretically good tax to be satisfactory in practice, owing to difficulties of assessment and collection. Smith was violently opposed to the income tax, which would seem to have been fully in accordance with his canons; it is probable that his opposition was due to his conviction that in practice it would be uncertain and arbitrary.

Now, after more than a century of efficient fiscal administration, it may seem that the principles of taxation which we have just listed are so self-evident as hardly to be dignified by the name of ideals. They have not always been very well observed, however, even in this country, and abroad very different principles have often held sway. In the history of every country it is easy to find occasions when the revenue has been distorted to serve particular interests, for instance, in the field of foreign or industrial policy. The net result of this has been more often than not to damage total output in the interests of particular groups. In Adam Smith's day the British tax structure was full of levies and subsidies which had been imposed at different times with the purpose of benefiting particular interests. It was largely on this account that it so lamentably failed to provide sufficient revenue to finance the Napoleonic wars.[2]

In France at the same date the tax structure sinned to a much greater extent against Adam Smith's canons. It

[1] See Chapter X, Section 3.
[2] Until the introduction of the income tax. See p. 141.

is notorious that under the ancien régime the taxes were mainly levied on the poor, the rich and aristocratic being very largely exempt. A very common way in which the distribution of revenue between different classes of the community has been distorted is by exempting State employees from income taxes, thus constituting them a privileged class. Where this occurs it is common to find their privileges backed up by legal exemption from the jurisdiction of the ordinary courts. The history of Germany, and even of France, provides many illustrations of the evils to which such privileges may lead.

Another common fiscal privilege has been the exemption of interest on the national debt from income tax. In the United States this has traditionally been the arrangement. Even to-day so much of the debt of the constituent States is tax free that American millionaires can escape no small part of the rigours of surtax by investing in public funds. The British tax structure has not always been entirely free from this latter weakness,[1] but on the whole it is true to say that the country has steadily set its face against fiscal privilege, just as it has against legal privilege. The fact that national debt interest and the salaries of public servants were made subject to income tax by Pitt, on exactly the same basis as other sorts of income, ensured that when the income tax became a permanent feature of the tax structure it would contain no privileges of this nature.

§ 2. *The Development of Tax Ideals.* It is one thing, however, to lay down principles; it is quite another to carry them into practice. To what extent can the taxes imposed from time to time in Britain be said to have

[1] In the war of 1914–18 certain war loans were issued tax free, cf. U. K. Hicks, *The Finance of British Government, cit.*, Chapter XX.

conformed to the ideals? It would take us too far afield to attempt more than the briefest survey,[1] but even this will serve to illustrate the considerable amount of attention devoted to the tax principles, more particularly to the principles of equitable distribution.

We need not start before the time of Elizabeth, although it is probable that the roots of the tradition could be traced considerably further back.[2]

In the sixteenth and seventeenth centuries tax revenue was derived from two sources, a variety of partial taxes on expenditure, and a general tax on wealth. At the beginning of the period most of these partial taxes were on imported goods, and according to current theory, lay outside general distributional considerations, because they were regarded as paid by importers, and earmarked for naval expenditure. As the needs of the revenue increased and the customs duties were multiplied, this theory could no longer be plausibly maintained, and the distributional aspect of taxes on imports had to be considered. For the most part it was aimed to concentrate them on "nice and delicate things", such as silk, wines and tobacco, from the taxation of which the poor[3] could not be expected to derive much hurt.

The chief interest of distributional theory was with the general tax on wealth. This had been reformed by Henry VIII under name of "The Subsidy". Liability

[1] In this field much research still remains to be done. For the earlier period W. Kennedy, *English Taxation*, 1640 *to* 1799, is invaluable. New light on the first income tax has recently been thrown by A. Hope Jones, *The Income Tax in the Napoleonic Wars*.

[2] The medieval Xth and XVth were in intention proportional to wealth. That taxation of the poor could raise a storm at an early date is apparent from the poll tax episode of 1381. Cf. also the unbroken development of the basis of the local rate (Cannan, *History of Local Rates*).

[3] It should be noted that throughout English tax theory "the poor" connotes the working class, and not the recipients of poor relief.

was fixed at 4*s*. in the £ on income, or alternatively at 2*s*. 8*d*. on the capital value of the source of income. The tax was considered to fall mainly on the rich or "the middle sort". A gradual process of totally exempting the poor is discernible and appears to have been complete by the accession of Elizabeth. Unfortunately, the public service was incapable of maintaining the intention of the Subsidy, and before the end of the century contributions had become "stereotyped" (tied to conventional assessments). The result of this was a progressive fall in the amount of revenue collected.

The revenue needs of the Civil War gave rise to a series of attempts to rejuvenate the Subsidy; the most important of these was the Parliamentary "Monthly Assessment" of 1645. This time the income basis was adopted for all assessments; but in order to simplify the administration, as many taxpayers as possible were assessed by rank or station, only the remainder being directly assessed on salary or other income. In order to secure prompt collection it was thought necessary to allow the local assessors to use their judgment as to the most appropriate method of assessment, and presently it was found necessary to allocate a fixed minimum revenue to each district. This soon led to a hopeless degeneration in the tax, and gave rise to great unevenness of burden between different parts of the country.

This second deterioration of the general tax on wealth made it necessary for further reform to be attempted in the reign of William III when the needs of the revenue once again became pressing. The new "General Aid" was again in intention a proportional tax "according to yearly profits". In practice it was assessed in three ways; directly on salaries, indirectly in respect of income from moveable property by imposing a percentage on the capital value, and finally, in respect of income from real estate by collecting tax from the tenants, who stopped it out of the rent.[1] It soon became apparent that it was still beyond the powers of the authorities to collect tax on income from personal property, so that in fact the Aid became a Land Tax. Throughout the eighteenth century it remained an important source of revenue; and it is still paid (but has no longer any fiscal importance) on certain old houses in respect of which it has never been redeemed by a capital payment.

It seems clear from these efforts that in the sixteenth and seventeenth centuries it was the intention of the legislature to raise an important part of the revenue by a general tax proportional to ability to pay; from contemporary writings it would seem that it was customary to pay some attention to family circumstances as well as to wealth.[2] The fact that what emerged was a partial tax on income from real property was due partly to the relative ease with which income from this source could be assessed and the tax collected. At the same time land remained by far the greatest source of income until some way through the nineteenth century, so that the greater part of the receipts of an effectively general tax would also have come from land. The partiality of the tax does not seem to have been a source of serious complaint until well on in the eighteenth century.

There is no doubt that these "general" taxes were mainly paid by the wealthy, and the poor were virtually exempt. The result of sixteenth and seventeenth century

[1] In exactly the same way as much of Schedule A income tax is collected to-day.

[2] Cf., for instance, Gibbons, *Discourse on the Diminution of the Subsidy* (quoted in Kennedy, *op. cit.*), "Sessors ought to look into the charge of a man's family before they can well tell how to charge him by his ability."

policy was to fix the doctrine that income was the proper standard of equitable tax distribution.

In the later seventeenth and early eighteenth centuries the strain on the exchequer of long periods of war required the discovery of another source of revenue. This was found in the imposition of taxes on home-produced goods known as excises.[1] During periods of exceptional strain (such as under the Commonwealth and again in the Marlborough wars), excises were freely imposed on commodities which were largely bought by the poor (especially beer, leather and salt). At first accepted because of the dire needs of the exchequer, and then condoned because of their impartiality, it was later argued that after all the excises were not distributionally unsatisfactory, because rich households made larger per head purchases of taxed commodities than poor families. Only a few of the clearest brains perceived that the excises were still unsatisfactory unless the rich bought *proportionately* more than the poor, which was not very likely.

A more serious argument in favour of taxes on general consumption was derived from Locke's political philosophy[2] which became fashionable in the eighteenth century. This put forward the concept of the State as a voluntary association for the sole purpose of providing for the primary collective wants. Since all must share these wants it was just that each should contribute to their satisfaction, no matter how humble his station. This view was never universally accepted[3]; in Parlia-

[1] The use of the term " excise " in this restricted sense appears to date from 1643, when both the type of tax and the name were taken over from the Dutch. In the United States the more general use of the term previously customary in England continued in use, cf. *O.E.D.*

[2] As expounded in the Treatise on Government, 1690.

[3] For instance, the almost contemporary philosophy of Hobbes put forward a " functional " view of the State, according to which the poor should be exempted from taxation on account of the value of their work, which formed a sufficient contribution to the body politic.

ment (which consisted mainly of landowners) there was always lively interest in the welfare of the poor, the class to which most members' tenants belonged, and a consequent reluctance to tax them.[1]

The view that tax contributions should be assessed in accordance with ability to pay was thus never completely overthrown, but for a large part of the eighteenth century the flame burnt less brightly than at any other period of our fiscal history. Nevertheless, about the middle of the century, when the strain on the revenue was eased, the taxes imposed were in fact less regressive. Excises on commodities in general use were reduced to very low rates, and greater reliance was placed on high rate taxes on luxury goods. The eighteenth century approved of such taxes not merely because distributionally they were more acceptable, but also because they regarded them as to some extent optional; the manner in which he would make his contribution to the revenue might in some sort be left to the discretion of the taxpayer. Only an age of light revenue needs could have failed to realize that services cannot be paid for by optional taxes.

Towards the end of the century, when the needs of the revenue were once more expanding, new taxes were again required. This time the choice fell on a series of external indications of wealth, such as the number of hearths or windows in houses. Such things were easy to assess, and ownership might be assumed to be roughly proportional to wealth. These taxes undoubtedly represented a return towards the old tradition. The small houses were completely exempt; and the window tax was even assessed at slightly higher rates as the number of windows increased.

[1] The Parliamentary storm which arose over Walpole's attempt in 1726 to substitute excises for the degenerated General Aid illustrates this attitude. On grounds of the utility criterion Walpole's plan was better than it sounds, cf. Chapter X, especially Sections 3 and 6.

At the end of the eighteenth century there set in a period of severe financial strain similar to that which had occurred a century previously. Once again tax ideals were thrown overboard in a scramble for revenue. Excises of all sorts were introduced, and continued in operation throughout the Napoleonic wars. They were once again condoned as a war necessity, but it is not improbable that they served something of the same function during the war as the purchase tax of 1940, in restraining consumption which would have been in competition with the war effort.

The imposition of the new excises on top of the hearth and window taxes, the remains of the "optional" taxes, and various other remnants from earlier ages, reduced the tax structure to the utmost confusion. Owing mainly to the degeneration of the old taxes, up to 1797 the revenue was never sufficient to cover more than a minimum satisfaction of the primary collective wants and the interest on new war borrowing. The persistent prejudice against the inequity of general taxes on wealth (as they had so far been imposed) prevented any solution from being found, until Pitt finally succeeded in persuading Parliament to return to the general taxation of wealth in the form of an income tax.

Pitt's income tax of 1797 was enormously more effective than any previous general tax. It produced revenue above expectation, and what was still more remarkable, instead of degenerating after a few years in the manner of all previous general taxes, the longer it was in operation the more revenue it produced. This was no doubt partly due to the rise in money incomes during the war, but it also revealed a new efficiency in the revenue authorities.[1]

[1] The main explanation of the new efficiency was that for the first time the government succeeded in training a reliable and effective staff of tax collectors. The nucleus of this specialist organization was jealously and secretly preserved by Somerset House during the suspension period. Cf. Hope Jones, *cit.*

Like the earlier general taxes, the income tax aimed broadly at an impartial proportionality in distribution; but it took definite cognizance of family circumstances by a system of rebates, and the lower incomes were assessed at a reduced rate. Returns of income were not compulsory, but declarations had to be made in order to claim these allowances. These returns were a substantial aid to correct assessment, and still more important, they formed a precedent for the later compulsory returns, which as experience has abundantly shown, are a *sine qua non* of an equitable and effective income tax.

In spite of its greater efficiency, the generality of Pitt's income tax was still suspect. It did not succeed in catching the profit incomes adequately, and the main burden still fell on land. This was one reason, perhaps the main reason,[1] for the bitter opposition which it aroused, and which led to its suspension at the earliest possible moment after the war. Although the first income tax vanished in 1816, and every effort was made to obliterate its traces, few people believed that it would not return. The door had once more been opened wide on the old tradition of taxation in accordance with ability. None of the Victorians seriously questioned its validity, although they inherited from the eighteenth century the partially contradictory principle that all should contribute to the expenses of government. It is only in the most recent period that these two ideals have been successfully reconciled.

§ 3. *The Subsidiary Aims of Taxation.* Once the income tax was gone, the tax structure inevitably sank back into something like its eighteenth-century distribution. Thus,

[1] There were also loud outcries against the inquisitorial methods of the tax collectors; this would mainly affect the profit incomes, so it is possible that they were not so undertaxed as the landlords believed.

in 1828, over 70 per cent of the revenue came from Customs and Excise, over a quarter being derived from duties on food and non-alcoholic drinks, and a considerable part of the rest from excises on bricks, glass, hides and other commodities which certainly affected the working class. This tax structure probably bore at least as heavily on the poor as that of the late seventeenth and early eighteenth century, but it differed from it in an important manner, in respect of the subsidiary aims to be achieved by the revenue. It will be convenient to turn aside to discuss the change of opinion in this respect before proceeding to trace the modern development of the distributional ideal.

From the middle of the seventeenth century an increasing desire to serve economic ends by differential import and export duties is discernible. At first the main objective was to encourage the import, and discourage the export, of raw materials which might serve to stimulate employment at home. Gradually, the direct protection of home industries and the encouragement of exports came to attract more attention. In the eighteenth century period of revenue ease Parliament was able to experiment widely with differential duties designed to reach the "productional optimum" by favouring particular interests. As usually happens, many of these attempts over-reached themselves.

A striking example of an unlooked-for consequence of the encouragement of industry by the State was the effect on the home production of alcohol of an import duty. In the eighteenth century the protection afforded to the manufacture of spirits [1] resulted in such an enormous

[1] The motive behind this policy was as much antagonism to the import of French wines as protection of home industries. Among the upper classes it led to the substitution of port for claret.

increase of output, and fall in prices, that the spread of gin drinking among the working class alarmed and shocked the whole country. (It was a case, as the phrase went, of "drunk for a penny, dead drunk for tuppence".) The result of this fiasco was the inauguration of the now traditional British policy of drastic excises on intoxicants, with the express purpose of reducing consumption. Already in 1828 a third of the revenue was derived from alcohol and tobacco (the latter duties had also something of a sumptuary purpose). As we have seen this policy has been continued without intermission right up to the present day, not, as must be acknowledged, without considerable advantage to the revenue.

Of greater economic importance were the duties imposed on imports, with the purpose of protecting the balance of payments. It would seem that in the latter half of the eighteenth century a severe strain was felt on the exchanges; this manifested itself in a series of crises, and in high and fluctuating interest rates. The causes of the pressure were complicated, they were compounded partly of the strain of successive wars, partly of the weakness of the Dutch exchange (due to the gradual impoverishment of that country) and the consequent efforts of Dutch nationals to repatriate funds hitherto invested in England.

The customs duties with which the eighteenth century attempted to meet this trouble were clumsy and no doubt inefficient. Adam Smith viewed the tax structure of his day with great disfavour, and no doubt he was right in believing (in effect) that the innumerable duties and subsidies seriously distorted the allocation of resources, and so hindered the approach to the productional optimum. In principle Pitt was also in favour of tariff reduction, but during the war period the state of the exchanges did not allow of any relaxation; indeed the suspension of cash payments by the Bank of England signalled the final collapse of the balance of payments.

Not long after the end of the war, however, Huskisson was able to effect an enormous simplification of the tax structure without any appreciable loss of revenue. This was a reform entirely in line with Smith's doctrine; but it also paved the way for the later reduction of duties on the path to free trade. Nevertheless the repeated exchange crises of the early nineteenth century, and their obvious relation to abnormal food imports (consequent on bad harvests at home), reveal that the balance of payments remained precarious until near the middle of the nineteenth century. It is probable that the most important economic effect of the Corn Laws was their restriction of imports.

From the 1860's the balance of payments was never in serious danger until after 1925. The Victorians, accustomed to rapidly expanding markets and to an unprecedented rate of capital accumulation, looked back incredulously at an age which had thought it sensible to multiply customs duties, and even to attempt to prevent the export of coin. In our own times, faced again with a deterioration in the balance of payments, we may look more kindly on an age when governments had to meet a very difficult international situation with whatever clumsy and primitive weapons lay to their hands.

Although the successive repeal of protective duties (culminating in that of the Corn Laws in 1846) led eventually in the circumstances of the mid-nineteenth century to a substantial increase in the national income and in the standard of living, it entailed for the time being a serious loss of revenue, which sooner or later would have to be made good. Reluctantly it was realized that this implied the return of the income tax. Thus it was that in 1842 Pitt's income tax came back, on the strict understanding that it was a temporary reserve for emergencies. It was soon perceived, however, that many of the old objections to it had lost weight. Partly owing to the increased skill of the Inland Revenue, partly to the rising morality of the business world, the assessments could no longer be accused of partiality. Gladstone continued to the end of his days to affirm that the income tax was only temporary, but the fact remains that when he might have abolished it he refrained from doing so.

§ 4. *The Acceptance of the Progressive Principle.* The principle that a substantial part of the revenue should be raised by means of a tax which paid prime attention to ability to pay, was thus firmly and finally established. The remaining stage of interpreting " ability " as satisfied only by progressive taxation was delayed for a few more decades. Sir William Harcourt's progressive death duties of 1894 were the first step along the new road, but the tax structure as a whole remained strictly proportional up to the second decade of the twentieth century. Yet the concept of progressive taxation, and the policy of bringing about a more egalitarian distribution of income through public finance, were no more than logical extensions of the traditional tax ideals. It is possible to trace the gradual emergence of the modern outlook from at least an early stage in the nineteenth century.

Up to the end of the eighteenth century the progressive idea (if we can call it such) was confined to the (very persistent) attempts to lighten the tax burden of the working class. The choice of excises falling outside the range of working class purchases, and the exemption limits of the hearth and window taxes, are illustrative of these attempts. In the " reduced rate " on small incomes of Pitt's income tax, it is perhaps possible to detect a small further step; historically it did prove to be the first link in the chain of a fully progressive income tax.[1] This tenderness for the poor was based on humanitarian grounds, and was not supported by logical argument; indeed there was a total failure to produce any argument which could stand up to Locke's contention that all should contribute to the expenses of the State.

About the turn of the eighteenth century, however, economists were arguing that the poor should be exempted from taxation on strictly economic grounds. Since (by common assumption rather than by factual demonstration) the poor lived on the margin of subsistence, any rise in prices, such as that due to the taxation of commodities which they purchased, would drive them below the margin. If employers did not increase wages to compensate for the tax, the supply of workers would decline. In either case British production costs would rise and our international competitive position would be damaged. It was an argument that no doubt reflects the unfavourable terms of trade of the early nineteenth century, but it did provide a logical basis for the many who wished to treat the poor generously on humanitarian grounds.

On the whole Adam Smith reflected the eighteenth-century point of view in being relatively uninterested in distributional questions,[2] yet it is evident from other parts of his book that he was extremely interested in welfare problems. It is probable that in his view progress

[1] Cf. p. 214.

[2] But he was prepared to go so far as to say " it is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion ". (*Wealth of Nations*, Book 5.)

towards the "productional optimum" (which would be fostered by a reduction in restrictive duties) would improve the lot of all more rapidly than conscious redistribution. Among his contemporaries, however, there were already some who demanded that taxation should be used "to remedy the inequality of riches as much as possible by relieving the poor and burdening the rich".[1]

By the middle of the nineteenth century such a leading economist as Mill was prepared to support progressive taxation so long as the object could be obtained without taxing "industry and economy". He was apprehensive of the effect of a progressive income tax on investment (a very real danger in the days of small scale private business), but he was in favour of the taxation of economic surplus (Ricardian rent), and also of progressive inheritance taxes. The first of these two alternatives was immediately recognized as being economically admirable. Since pure surplus arises as the result of forces outside the control of the individual (such as the increased demand for his labour or for the use of his property) he can have no incentive to reduce his output if the surplus is taxed away. Unfortunately, the revenue to be gained from taxes on pure surplus is in most circumstances negligible in relation to the costs and difficulties of assessment and collection.[2]

Largely owing to Mill's support, the progressive inheritance tax became law in 1894. By that time it is clear that some degree of progressive taxation had become generally acceptable. Many Liberals would probably have been prepared for a progressive income tax almost

[1] Lord Kames, *Sketches of the History of Man*, quoted in Cannan's edition of the *Wealth of Nations*.

[2] Cf. Chapter XI, Section 4.

immediately.[1] The change in outlook owed much to the marginal analysis of the 'seventies, and its demonstration that an accurate interpretation of "ability" must take account of the fall in the marginal significance of money as income rises, so that even an "equal sacrifice" of income called for progressive rather than for proportional taxation.

A few years after Harcourt's death duties had been introduced Edgeworth was arguing[2] not for "equal sacrifice" but for "minimum aggregate sacrifice"—which strictly interpreted would have implied the confiscation of all incomes over a defined level. Since both these principles required the interpersonal measurement of utilities, they were not capable of providing an objective criterion for the direction of policy (such as is provided by the modern utility criterion). Nevertheless, the general acceptance of the principle of the redistribution of incomes through public finance—which was well on the way by the end of the nineteenth century—owed much to the contemporary discussions of the economists.

At the beginning of the twentieth century it would not have taken a very well informed prophet to foretell that the next substantial strain on the revenue would see the establishment of the progressive income tax. The occasion came with the Liberal Budget of 1909,[3] which called for large additional funds (to finance additional naval expenditure as well as new social services). Thus supertax[4] finally found its way into the tax structure;

[1] Harcourt actually prepared a scheme for a progressive income tax in 1894, but withdrew it, as he thought it would be going a little too fast for Parliament, cf. A. G. Gardiner, *Life of Sir William Harcourt*, Vol. II, Chapter XVI.

[2] *E.J.*, 1897, reprinted in *Collected Papers*, Vol. II.

[3] It was the rejection of this budget by the Lords which led to the passing of the Parliament Act of 1911 (see p. 50).

[4] The name was changed to surtax by Mr. Churchill in 1929.

in 1913 it yielded £3 mn., by 1920 this had already jumped to nearly £56 mn.

Realization of the redistributional potentialities of public finance was greatly facilitated by a new way of looking at taxes which is first discernible in the Gladstone era. Instead of regarding each tax separately, and attempting the impossible task of choosing only those taxes which would pass all the tests, it was suddenly realized that any desired distributional result could be obtained by a compensatory structure of taxes, in which the faults of one would be offset by the virtues of another. It followed logically (although this was only later realized) that expenditure should also be taken into account, or at least so much of it as satisfied wants other than the primary collective needs.

This discovery finally made it possible to resolve the dilemma between the principles that all should contribute to the expenses of government (on political and moral grounds), and that the poor should be exempt (on humanitarian and utility grounds). In Britain to-day working class families do contribute to the costs of government; in respect of income tax it is a fully conscious contribution. Nevertheless on a balancing up of pluses and minuses there is a net redistribution [1] in favour of the lower income groups. By appropriate alterations of the tax and expenditure policy the redistribution can be adjusted to whatever extent, or in whatever direction, is required by the criteria of policy.

[1] Cf. Chapter XVII, Section 3.

CHAPTER IX

THE METHOD OF TAX ANALYSIS

§ 1. *The Classification of Taxes.* A necessary first step in analysis is classification; before we can begin the task of tracing the operation of particular taxes through the economic system we must divide them into convenient groups. In Chapter V we found that income tax and death duties are referred to as "direct taxes"; most of the other taxes in the British tax structure are regarded as "indirect". The direct/indirect distinction is by far the most commonly used classification, especially in Britain, for the reason that it is the one which has legal and administrative backing. For this very reason, taxes are not usually classed quite in this way in other countries, which have different institutions or methods of tax collection.

The essence of the British distinction between direct and indirect taxes lies in the relation between the taxpayer and the revenue authorities. Taxes for which liability varies with the circumstances of the taxpayer have to be separately calculated for each taxpayer, so that the relation between him and the revenue authorities is necessarily a direct and personal one. For certain other taxes it is convenient to the revenue authorities to have the tax collected directly from the taxpayer by an official collecting agency, for others, however, it is simpler to make use of manufacturers or merchants as unofficial tax collectors, so that in that case there is no direct relation between the revenue authorities and the taxpayer.

Into the latter class fall those taxes whose liability depends on the amount or value of a particular product or service purchased, such as the tax on a packet of cigarettes or a seat at the cinema. What is really being taxed in this case is not the packet of cigarettes (which cannot pay a tax), but the enjoyment of the consumer in satisfying his want of a smoke. The enjoyment of goods which are not consumed in a single use, as cigarettes are (for instance motor cars or wireless sets), cannot, however, be taxed by making the merchant or manufacturer an unofficial tax collector, unless the government is content to collect tax only once in the lifetime of the goods, namely, when they are first sold. Consequently, for this class of goods the revenue authorities need an official tax collector, who will collect a yearly sum during the lifetime of the goods, for the right to use them. The British revenue authorities, naturally looking at things from their own point of view, like to regard as direct all those taxes which are either individually assessed on the taxpayers or collected from them by an official agency.[1]

It is clear, however, that there is no essential economic difference between a tax on the enjoyment of smoking and a tax on the enjoyment of motoring, while, on the other hand, a great gulf separates a tax assessed on total income or capital, from a tax which is paid as a condition of satisfying a particular want, such as smoking. It is largely immaterial in the latter case whether the taxpayer meets his liability by means of a single payment (as he must do in the case of a single-use good) or in the form of an annual right to use (as will probably be required in the case of a durable-use good). Again it is immaterial

[1] For further discussion of this, and other points in the present chapter, cf. U. K. Hicks, "The Terminology of Tax Analysis," *E.J.*, April 1946.

—from this point of view—whether the tax is assessed on a main component of the finished article (e.g., tobacco) or on a subsidiary component (e.g., the oil or labour used in manufacturing processes); in both cases the tax will have to be paid before the smoke can be enjoyed.

There is thus a fundamental economic distinction between taxes on income (including taxes on the capital from which income is derived), on the one hand, and taxes on outlay—either for outright purchase or for periodic right to use—on the other. This distinction is of universal validity, and does not depend on national institutions. Its true importance has, however, only recently been recognized, because it is from calculations of the national income and of its distribution among the citizens that it derives its significance, and such calculations have only recently been officially recognized, and used as planning directives.

The national income (or national output) is not a single or simple concept. There are, in fact, two fundamental concepts of the national income, both of which are set out in the Budget White Paper, because both are of significance, although for different purposes. In the Budget White Paper these concepts are called respectively the National Income (Output) at Factor Cost, and the National Income at Market Prices. The first is an objective, technical concept; the different commodities and services in the national income are valued according to the amounts of the factors of production which have gone to make them; the relative prices of the factors are taken to represent the rates at which the various factors are capable of being technically substituted at the margin, so that the cost of a commodity is taken to represent the amount of the nation's resources which have gone into making it. The national income at factor cost is thus a measure of the technical potential of the national resources.

The national income at market prices on the other hand is a subjective or welfare concept. It reduces the different commodities to a common measure not according to their costs, but according to their marginal utilities. The relative amounts of different commodities and services which people buy represent the relative satisfactions which the members of the community derive from the components of the national income at a particular set of prices. The product prices which consumers have to pay in the market are made up of the factor cost and the outlay taxes which have to be paid before the satisfactions can be realized. (Some market prices may be less than factor cost because the government awards a subsidy, this makes no difference in principle, the subsidy is merely a tax in reverse.) Hence the difference between the factor cost calculation and the market price calculation consists of outlay taxes, less parallel (outlay) subsidies.[1]

The market price calculation of the national income is thus a measure of the satisfaction which consumers derive at a given set of prices; and as concerns us more directly in public finance, when a statistical calculation is made of the distribution of the national income among the different income groups in accordance with their share in it, the outlay taxes which are paid as a condition of this share have to be imputed as accurately as possible between the different income groups, in accordance with the outlay of their incomes between different types of consumption.

[1] It should be noted that subsidies can be divided on an exactly parallel basis to taxes, into those which give better value for a particular sort of *outlay*, by enabling consumers to purchase the product at less than factor cost, and those which provide a general subsidy to *income*, e.g., pensions, usually called social transfers

In Chapter XVI we shall be examining the result of this calculation in Britain before 1939.

The distinction between income and outlay taxes is thus of great economic and social interest; but it does not bring out quite fully the distinction which we need for analytical purposes. Let us recall a point which we reached in Chapter VII, when discussing the subject-matter of public finance. Just as in general economics there are some problems which can best be approached from the standpoint of the individual firm or industry (by means of a " partial equilibrium " analysis), and others which call for a general analysis of spending, saving and investment, the factors which determine the size of the national income, so in tax analysis it is convenient to make a similar distinction even at the stage when we are working out the operation of particular taxes, and before we come to considerations of the combined effect of public finance in the economy. We can thus make an analytical distinction between *partial* taxes in which all or nearly all of the working out process takes place in a particular corner of the economic field (e.g., in the industries concerned with the manufacture and sale of cigarettes and tobacco), and *general* taxes which impinge directly on the phenomena which determine the size of the national income.

It should be emphasized that this analytical distinction is essentially one of convenience, not of logic. In practice a partial analysis is appropriate and sufficient for nearly all outlay taxes, while for income taxes it is completely inapplicable; but there may be some outlay taxes which are of such transcending importance in the economy that they require a general analysis; or they may require one if we are interested in long period problems when the operation of the tax will have spread beyond the confines of the markets first affected.[1] A different form of analysis may conceivably be appropriate to the same tax under different social conditions. Thus it would have been perfectly logical for an economist of the early nineteenth century to apply a general analysis—such as Ricardo would have given—to a tax on bread, emphasizing its probable effect in driving the worker below the margin of subsistence; whereas to-day we should regard a tax on bread as not essentially different from a tax on tea, in which we should certainly not be concerned with changes in the size of the national income.

§ 2. *Searching for the "Taxpayer".* The problem of classification thus leads directly to the method of analysis. In the past it has been customary to set out on the process of tracing the operation of a tax through the economic system from the starting point of the party who is in contact with the revenue officials. For instance, in the case of a tax on smoking, this is the tobacco manufacturer who pays the duty on the tobacco leaf as he withdraws it from bond; in the case of the British purchase tax it is the wholesaler, since it is on this stage of the productive process that the revenue authorities have found it most convenient to pounce; in the case of an income tax, however, the process of analysis can only start with the taxpayer, the owner of the income, since no one else is concerned.

Following this method of approach an elaborate theory of "tax shifting" has been built up.[2] To take a simple example, it would be necessary to say that the tobacco manufacturer shifts the tax to the wholesaler, who shifts it to the retailer, and finally to the smoker. The object

[1] Cf. Chapter XIV, especially Section 3.
[2] Cf. especially E. R. Seligman, *The Shifting and Incidence of Taxation.*

of this analysis has been to discover whether the price of the finished article is raised by as much—or more—or less than the amount of the tax. It reflects the view of the revenue official rather than of the economist. It is certainly not the way the Chancellor of the Exchequer looks at the matter, since he regards himself as taxing smokers, nor is it the view of the smoker himself, since he fully realizes he will have to pay the tax as the price of his indulgence.

While this approach does not necessarily vitiate an analysis if it is properly conducted, it is unnecessarily clumsy, and in practice it has not usually led to happy results, for several reasons. In the first place having taken so long to discover the "real" taxpayer (e.g., the smoker) there has been a tendency to break off the analysis at that point, just where it ought to be becoming interesting. Secondly, it has unduly narrowed the range of vision; not even quality changes (which are just as likely as price changes) can conveniently be allowed for. Much more fundamental, however, it is not price or quality changes as such which are important or interesting, but their causes—the degree of monopoly which a given price rise implies—and their consequences—the effect on taxpayers of having to alter their consumption schedules, and on producers in the industries concerned, of having to reallocate factors to take account of the new economic situation created by the tax change.

Finally, it has sometimes been attempted by analogy to develop a parallel theory of the shifting of income tax, by attempting to trace changes in product prices which might be due to income tax payers trying to hand on the tax.[1] As we know, it is only outlay taxes, and not income

[1] *Report on National Debt and Taxation*, Cmd. 2800 of 1927, p. 108 and Minutes of Evidence.

taxes, which are included in the prices at which goods exchange on the market, consequently the search must be vain. More than that it is completely misconceived; the operation of income tax is on the level of incomes, not on the level of prices.

In view of all these difficulties, when we come to analyse the operation of taxes we shall always start with the "real" taxpayer—in the case of income and capital taxes with the owner of the income or capital; in the case of outlay taxes with the party who, by his choice of purchases on the market, determines the difference between the national income at factor cost and the national income at market prices.

§ 3. *Formal Incidence and Effective Incidence.* Recalling the steps in our discussion, it will be seen that we are concerned in economics with two concepts of the falling of taxes on taxpayers, or as it is called, the incidence of taxes. In the first place there is the statistical calculation of the way in which the revenue collected from any particular tax over a given period (usually a year), namely, the difference between the factor cost and the market price of the product on which the tax is assessed, is distributed between the citizens (for convenience grouped according to their income levels); or, alternatively, the proportion of people's incomes which goes *not* to provide the incomes of those who furnish them with goods and services, but is paid over to governing bodies to finance collective satisfactions. The result of this calculation may be called the *Formal Incidence* of the tax—or if we add up the distribution of the revenue from all taxes, of the tax structure. The calculation of formal incidence is of great social interest in connection with questions of the distribution—and redistribution—of income; it is also of great economic importance to the government when planning the national output in order to maintain a high level of economic activity, since it enables them to predict whether the reaction to a given tax change will mainly take the form of a restriction of consumption or of a reduction in saving. These are questions which we shall have to discuss in Part III, especially in Chapter XVII.

Important as it is, however, the calculation of formal incidence tells us nothing directly of the taxpayer's reaction to a change of tax, and its consequences; it is precisely with these questions that the second concept of incidence is concerned. In order to discover the full economic consequences of a tax we have to draw and compare two pictures—one of the economic set-up (distribution of consumers' wants and incomes, and allocation of factors), as it is with the tax in question in operation; the other of a similar economic set-up, but without the tax. It is convenient to call the difference between these two pictures the *Effective Incidence* of the tax. It will be seen that it must often be a very complicated picture; and moreover, since both situations cannot exist together, one of the pictures must be hypothetical, established by reasoning and not by observation.

The establishment of effective incidence thus calls for a systematic chain of reasoning, based on observation of such factors as demand, cost and marketing conditions (in the case of outlay taxes), and as the distribution of income and wealth, the degree of industrialization and the typical size of the firm (in the case of income taxes). Wherever possible the reasoning should naturally be supported by statistical evidence, but owing to the complication and interrelation of many of the factors concerned, statistical evidence can hardly be more than a support for the deductive process. It is only when this chain of reasoning has been carried through in respect of each category of tax that we can be in a position to state which taxes are to be preferred, and which avoided, from the point of view of the criteria of policy.

CHAPTER X

THE INCIDENCE OF PARTIAL OUTLAY TAXES

§ 1. *Types of Outlay Taxes.* If we were to take a look round at the tax structures of the world, at any time we should find everywhere a large number and considerable variety of partial taxes on outlay in force; if we took a look into the past we should find, if not a still larger number, at least a higher proportion relatively to income taxes, than at present. The first reason for this popularity of outlay taxes is that they are extremely simple to collect; consequently, they can be a success in primitive conditions where elaborate revenue machinery is out of the question; this is especially true if they are imposed on imported goods of a type which cannot be produced at home. More recently advantage has been taken of the fact that they yield revenue extremely quickly—it begins to flow in from the day the tax is imposed—they have thus been found useful as stopgaps for a revenue deficit.

In spite of these conveniences, on the whole the importance of outlay taxes relatively to income taxes is tending to decline, for the reason that their income distribution is less satisfactory on modern standards; as we shall see later, outlay taxes are always more or less regressive measured against total incomes. Nevertheless outlay taxes are still a considerable item in all tax structures, and they have a not unimportant part to play in the combined fiscal planning of the future. Consequently, it is necessary to trace their effective incidence with some care, in spite of the complications into which the process will inevitably lead us, complications which are only partially due to the varieties of tax which may be imposed, and much more importantly to the differences in demand, cost and marketing conditions, which exist in the industries whose products are convenient subjects for taxation.

In the first place it will be convenient to look briefly at the different forms which outlay taxes may take. Partial outlay taxes may be imposed either on single-use goods (i.e., those used up in a single process of consumption or production) and on services, or on durable-use (capital) goods, used either in consumption or production. They may be imposed on an isolated commodity (e.g., tea), or on a group of closely related commodities (e.g., hydrocarbon oil products). Taxes imposed on the use of capital goods may take several different forms. They may be assessed on the value of the goods—either on capital or on annual value—or alternatively they may take the form of an annual licence to use the goods—either for any purpose of which they are capable (e.g., wireless licences) or for a particular purpose (e.g., liquor licences for the sale of intoxicants).

If the licence implies more than a nominal restriction of use—if it is not granted freely on payment of the fee—then it acts as a protection to the taxpayers to whom it is awarded. Outlay subsidies may in principle be awarded by any of the methods used for taxes; or again a tax and a subsidy may be used in conjunction to bring about a desired end, as the production of home grown sugar has been fostered by a beet sugar subsidy combined with a differential duty on the imported product.

Liability to a tax assessed on the use of particular goods naturally varies with the quantity of goods used; it may also vary with the quality of the goods, or with their price.

When the rates of tax are expressed as proportions of the selling prices of the goods, the tax is described as *ad valorem*; when it does not so vary, but is expressed as so much per lb. or per barrel, it is known as *specific*. Specific taxes may, however, be graded with the quality of the product, as for instance British motor vehicle duties vary with the size of the engine.

Specific taxes are much easier to administer than *ad valorem* taxes, which may require a very expert revenue department if it is a question of converting prices from the currency of another nation. Owing to the endless possibilities of rate manipulation where this has to be done, *ad valorem* taxes are in favour as a protective measure; indeed they are the cause of most of the administrative friction which arises between nations over tariffs. Specific taxes are rather less productive of revenue than *ad valorem* taxes, and also tend to be rather more regressive, but this disability can largely be eliminated by a system of grading. It is worth noticing that when a general rise in prices takes place, the real rates of specific taxes are reduced, while those of *ad valorem* taxes are automatically adjusted. A considerable part of the rise in the rates of British outlay taxes between 1914 and 1931 can be regarded as a compensatory adjustment in specific taxes.

In the United States the typical partial outlay tax is *ad valorem*; in Britain the specific type has been traditional, and is still the most usual. A very wide use is made of grading, however. The new protective duties of the inter-war period, both those introduced in the 1920's and those which came in with the big change of policy in 1931, are assessed on the *ad valorem* method.[1] The

[1] A variety worth noticing is illustrated by the duties on imported silk, which vary with the stage of manufacture, being highest on finished goods.

local rate, which brings in more revenue than any other outlay tax, also belongs to the *ad valorem* group, although present valuation practice does not lead to a very close correspondence between rents and rateable value.

§ 2. *The Incidence of Taxation under Perfect Competition.* The general sequence of the operation of a partial tax on outlay is that first, the selling price of the product is increased by the tax, this leads to a restriction of demand, so that sooner or later production must also be cut down. In the case of taxes on single-use commodities the analysis can usually be confined to following the ramifications of this process; in the case of taxes on capital goods, however, there is an additional chain of events to consider, due to the fact that capital values will immediately be adjusted to a change in the rate of tax. In the present chapter we may avoid this complication by confining our attention to taxes on single-use goods.

In the normal case it makes very little difference in principle whether the tax is imposed on consumers' or on producers' goods [1]; this can be demonstrated very simply (Fig. 1). In order to start with as few complications as possible, we may assume that perfectly competitive conditions prevail in the industry making the taxed commodity (in the sense that a change in the output of a single producer would make a negligible difference to total output); and further, that there are no closely related products or industries.

[1] The productional stage at which a tax is imposed may be of importance in other connections. A tax on a raw material or on a semi-finished product encourages producers to use it economically; this may be of considerable importance where the material in question has to be imported. Again, the earlier the stage of production at which the tax is imposed, the greater the opportunity for "pyramiding" by adding a percentage to price at each successive stage of manufacture, see p. 174.

In Fig. 1, SS and DD are market supply and demand curves, in the usual Marshallian sense. Under perfectly competitive conditions A is then a position of full and stable equilibrium. If now a tax of dimensions E*a* is imposed, the new equilibrium point will be *a*, whether the tax is assessed on producers (and the supply curve raised to S′S′), or on consumers (and the demand curve lowered to D′D′). In all normal demand and supply conditions *a* will lie above and to the left of A; consumers will have to pay more per unit, and will consequently buy less; producers will have to charge a higher price including tax, and will consequently sell less. The amount sold will be reduced from OM to O*m*, and the price raised from MA to *ma*. The analysis can be applied in reverse (by lowering the supply curve or raising the demand curve) to fit the case of a subsidy.

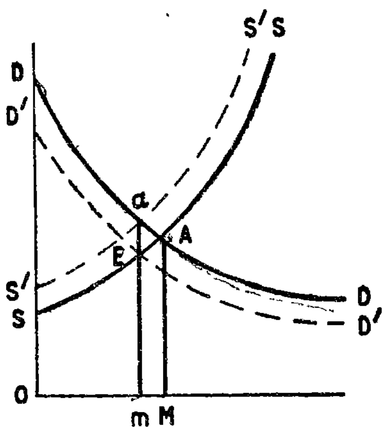

FIG. 1.

It is evident from the diagram that the operation of taxes and subsidies of this nature is a marginal phenomenon; they fall directly on margins of production and spending—spending in general as well as in this particular direction—and so also on saving margins. As between the margins of production and consumption respectively, the direction and extent of the economic readjustments which have to be made as the result of a change of tax, depend on the elasticity of demand on the one hand, and on the ease or difficulty with which factors can be transferred to (or from) other uses, on the other.

As between margins of spending and saving, the result will depend, to an important extent, on the distribution of the consumption of the taxed (or subsidized) product between the different income levels. When most of the consumption comes from the lower income groups, which is normally the case since they comprise most of the population, the readjustment will largely take place at the expense of consumption ; when an important part of the demand comes from the well-to-do, the tax will probably be paid out of saving to a considerable extent.

It is obviously important for the government to be able to predict which margins will be most affected by a given change of tax or subsidy. On one occasion it may be necessary to restrict consumption ; on another it may be desired to raise a given revenue with as little restriction of consumption as possible, or to reduce saving. When a tax is imposed on a commodity which figures in only a limited range of consumption (e.g., sugar) an estimate of the formal incidence of the tax can fairly readily be made, and the effective incidence also is usually not difficult to predict. When, however, a tax is imposed on a factor or a commodity which is common to a very wide range of consumption (e.g., fuel), there is considerable difficulty in establishing even formal incidence, and the course of effective incidence cannot satisfactorily be traced.

The real objection to such taxes " on production in general " as they are sometimes called, is not that they are taxes on production while the others are taxes on consumption—as we have seen all partial taxes fall both on consumption and on production—but rather that, on account of the uncertainty of their incidence, they cannot be fitted into any rational fiscal policy. This is equally a disadvantage whether we are thinking of a programme of income redistribution, or a plan for maintaining a high level of economic activity. Similarly, it is impossible to give a rebate in respect of them on goods intended for export, so that such taxes have the effect of raising export prices.

§ 3. *The Theory of Surpluses.* Returning to the case of a tax whose incidence falls mainly on a single line of consumption, it is apparent from Fig. 1 that the rise in price as a result of the tax will be large or small relatively to the change in output, according as the demand curve is more, or less, elastic. If the demand curve is very elastic the sales of the commodity rather than its price will be mainly affected; with relatively little inconvenience the consumer can satisfy his wants in some other way, the tax is for him, in a sense, optional.

It was this seemingly optional nature of taxes on consumable goods which commended them to the eighteenth century, as much as their "convenience" (in the sense of being paid almost unconsciously by the taxpayer), and their "economy" (in the sense of requiring no expensive revenue machinery, at any rate so long as the rates were not so high as to encourage smuggling). It cannot be denied that there is some convenience to the taxpayer to have a tax which can be paid gradually over the year, and which consequently does not require him to set aside a large cash balance to meet an annual or semi-annual liability, as has traditionally been necessary for income tax; but this disadvantage of income tax can be overcome by deducting the tax from the income before it reaches the owner of the income. With modern administrative technique outlay taxes no longer have as great advantages in convenience of collection, relatively to income taxes, as they used to have.

Since governments must have revenue, the "convenience" of the optional nature of outlay taxes is an illusion; it is illegitimate to compare the "inconvenience" to the taxpayer of a tax which he does not have to pay with the inconvenience of one which he cannot get out of. The correct comparison is between the relative damage to consumers and producers, in the sense of their loss of satisfaction, consequent on raising a *given* revenue by different methods. If we make this comparison we shall find that the eighteenth century conclusion may be quite misleading.

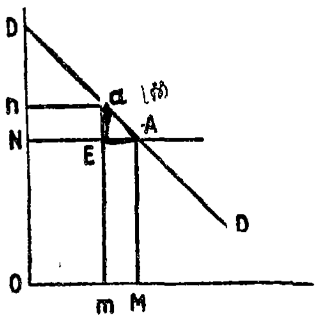

FIG. 2.

In order to concentrate on the essential factors, let us start with a situation in which costs are constant (Fig. 2), maintaining our previous assumptions of perfect competition and absence of closely related products or factors. Before the tax is imposed an amount OM of the commodity is consumed, at price MA. When a tax of amount E*a* is imposed, it will bring in a revenue N*na*E, but there will be a loss of consumers' surplus equal to the triangle *a*AE,[1] in the sense that if the government tried to compensate taxpayers for their loss of satisfaction out of the revenue, there would not be enough to go round.

[1] If the tax is a small one it is quite reasonable to follow Marshall's identification of the demand curve and the utility curve, by assuming the marginal utility of money constant; but the demand curve can equally well be replaced by a marginal indifference curve, so that "income effects", if any, can be allowed for. Cf. J. R. Hicks, "The Four Consumer's Surpluses," *Review of Economic Studies*, Vol. XI, No. 1.

There is thus an initial grave objection to partial taxes on outlay on welfare grounds, in that they cause a net difference between taxpayers' loss and revenue's gain, a flagrant violation of Adam Smith's principle of "economy" correctly understood. There is thus, on welfare grounds alone (e.g., apart from distributional questions), an *a priori* case against partial outlay taxes. Marshall and Edgeworth would have regarded this as a case *for* income taxes, but we shall see later that this argument is somewhat weakened when the rate of income tax is high.

Clearly some outlay taxes will cause a greater loss of surplus than others; we must therefore investigate more closely on what the loss of surplus depends. If we assume that the triangle *a*AE is rectilinear (as is reasonable for a small tax), the loss of surplus—the area of the triangle—is equal to half the reduction in the amount consumed, multiplied by the tax per unit of commodity; while the revenue collected is equal to the rate of tax multiplied by the amount spent on the commodity, post-tax. We can see further that the loss of surplus will vary relatively to the revenue collected—in the same proportion as half the change in amount consumed bears to the total consumption after tax:

$$\frac{\text{loss of surplus}}{\text{revenue collected}} = \frac{1}{2}\frac{m\mathrm{M}}{\mathrm{O}m}$$

It will be observed that the right-hand ratio is equivalent to half the elasticity of the demand curve multiplied by the ratio of the amount of tax and the amount spent:

$$= \frac{1}{2}\,\frac{\text{elasticity of demand} \times \text{revenue collected}}{\text{amount spent}}$$

Hence, we can write the loss of surplus :

$$=\frac{1}{2}\frac{\text{elasticity of demand}}{\text{amount spent}}\times(\text{revenue})^2$$

This is a formula of great importance, because in many cases it should be possible to estimate the magnitudes concerned with a fair degree of statistical accuracy. In practice, however, the situation will often be complicated by the fact that marginal costs are not constant ; and we have therefore also to take account of the elasticity of the supply curve, and of the loss of producers' surplus (e.g., the amount which would be needed to compensate the owners of the factors of production employed *in this industry* for loss of earnings, if the industry were to be cut down, and they were forced to transfer elsewhere). In this case (cf. Fig. 3 where rising marginal costs are shown), the loss of surplus (aAE) is

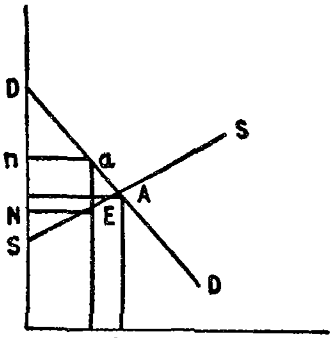

FIG. 3.

$$\frac{1}{2}\frac{ee'}{e+e'}\cdot\frac{(\text{revenue})^2}{\text{amount spent}}$$

where e is the elasticity of demand and e' is the elasticity of supply.

From this analysis it follows that for a given revenue the loss of surplus will be larger, the larger is the elasticity of either demand or supply ; if either is completely inelastic the loss of surplus falls to zero, and in this respect the outlay tax becomes equivalent to an income tax, but obviously without its distributional advantages. The loss of surplus will also vary (this time inversely) with the amount spent on the article, i.e., its importance in consumption. For to raise a given revenue from an "unimportant" commodity, very high rates of tax may be required; with any normal elasticity of demand or supply the loss of surplus will be severe.

From this analysis it follows further that if any important commodity can be found whose supply or demand is completely inelastic, it will minimize loss of surpluses to raise all, or as much as possible, of the revenue by means of it.[1] As long as either of the elasticities is very low, although not absolutely zero, it will still be advisable to tax the commodity concerned heavily, if it is desired to raise a given revenue from outlay taxes.

This is the rationale behind the contention that a country should finance its public services by a single tax, on land. Although the supply of land is very large, and may be taken to be completely inelastic, even a tax which absorbed the whole value of the rents from land would go but a small way towards financing the needs of modern governments. The rents of buildings clearly could not be included, since their supply is anything but inelastic. There are problems here to which we must return when considering the taxation of capital goods.[2]

It must be emphasized that these conclusions refer only to the single question of loss of surplus. In practice, distributional, and perhaps other economic or administrative, questions may also be important. Apart from

[1] Cf. Hotelling, "Edgeworth's Taxation Paradox and the Nature of Demand and Supply Functions," *J.P.E.*, October 1932.

[2] The case for a proportional income tax can also be based on the above argument, but a progressive income tax requires a different basis of justification, see p. 210.

its more general applications, however, the analysis does provide an accurate and practicable method of choosing between different outlay taxes, particularly between those whose income distribution in consumption is similar, and where consequently no clear directive on distributional grounds exists.

§ 4. *Taxation under Monopoly.* So far we have assumed that perfect competition prevails in the industry making the taxed commodity. Before turning to the vast hinterland between competition and monopoly which in the real world includes the greater part of the industrial field, it will be convenient at once to pass to the further boundary, and to discuss the case of pure monopoly, without related products or factors. A situation in which there is a single seller of a commodity not very closely related to others may very well occur locally, and even persist for a considerable period, even when there are no "natural" monopoly elements in the situation; so that the analysis covers a wider field than might appear at first sight.

If the monopolist is maximizing his profits (as we must suppose) he must be making marginal revenue equal to marginal cost. Hence any tax which increases the cost which he has to incur in order to put the marginal unit on the market, will cause him to reduce his output and raise his price. In any but the short period this is equally true of a tax which falls on his overheads and of one which falls on his running costs.[1] The extent to which consumers

[1] Except in the case of a very firm monopolist, of what might be termed the "Elizabethan type", in which the monopolist will be prepared to submit to almost any tax on overheads (say, a licence to produce), and his price and output policy will be unaffected by the tax. In the traditional analysis too much has been made of this rather unreal case.

will suffer depends on the monopolist's ability to increase his selling price without reducing his total profits on the one hand, or attracting rivals and so reducing his monopoly power on the other. A great variety of results is possible, due both to the monopolist's exceptional power of manipulating his costs, and to his control of the market. As Edgeworth pointed out many years ago, one of the drawbacks to taxing a monopoly is the uncertainty which surrounds the result.

If we assume that the demand curve facing the monopolist is a straight line, and that the marginal costs of the monopolist are constant, it is clear from general monopoly theory that the price of the taxed commodity will be raised by *half* the amount of the tax, whereas under competitive conditions it will be raised by the whole amount of the tax.[1] There seems to be no particular reason, however, to assume a demand function of this nature. If there is some concavity in the demand curve, price will be raised by an amount greater than this; if the concavity is such that the marginal revenue curve and the demand curve are parallel over the relevant range, the rise in price will be equal to the tax, as in competitive conditions.

If, however, we assume that the demand curve is not merely concave but of constant elasticity (which, at least for small changes, would seem to be quite as probable as a straight line demand curve with constant slope), we get a much more serious result. The ratio between price and marginal cost will then be constant; since marginal revenue is necessarily less than price, this must mean that

[1] The situation can easily be visualized by interpreting the demand and cost curves in Fig. 2 as belonging to a monopolistic condition. and comparing the result with the analysis accompanying Fig. 2. For the full analysis cf. J. Robinson, *The Economics of Imperfect Competition*, pp. 76ff.

the slope of the marginal revenue curve is *less* than the slope of the demand curve, so that the price will rise by more than the tax—as is indeed otherwise evident, for price is now equal to marginal cost (excluding or including tax) plus a fixed percentage ; after the tax is imposed, the percentage is reckoned on a larger base figure. This hypothesis [1] seems to be consistent with observed conduct of producers ; it is just such an addition of a fixed percentage to profits at each productional stage, to cover the tax, which leads to the phenomenon of " pyramiding " of taxes assessed on the early stages of the production process.

The economic importance of the monopoly analysis, however, does not depend on the existence of a few isolated monopolists who may be able to exert pressure on the community for limited periods, but on the vast intermediate field between the pure competition and the pure monopoly of the textbooks. An important extension of the competitive analysis which we made above (cf. Fig. 3) shows that taxation of a monopolized [2] industry, when it leads to further restriction of an already restricted output, is more damaging to the *community* than taxation of industries where competition prevails.

Let us suppose (Fig. 4) that owing to monopolistic action, output in the industry which it is proposed to tax has already been restricted below the optimum position, by an amount MN, and surpluses correspondingly reduced

[1] For some unexplained reason Mrs. Robinson in the passage quoted above does not extend her analysis to cover the case of constant elasticity.

[2] That is to say under oligopoly as well as under pure monopoly. In a situation of " imperfect competition " (in the sense that there is free entry into the industry, and changes in output are brought about by changes in the number of firms), although the price is greater than the marginal cost of the firm, it is the average cost of the firm which is the effective marginal cost of the industry, and this is not less than the price.

by the magnitude of the triangle PAR. If now a tax is imposed, price will rise to *mp* and output be restricted to O*m*. The loss of surplus is now measured (considering this industry alone), not by the triangle, but by the trapezium *p*PR*r*, which exceeds the loss of surplus under perfect competition by an amount equal to the *whole* reduction in output due to the tax, multiplied by the pre-tax gap between marginal cost and selling price.

When we are considering a situation in which monopoly elements are present we have to be on the look-out for the possibility of product or factor relationship, in a way which is usually unnecessary in conditions of pure competition. This circumstance may have an extremely important bearing on the question of the optimum allocation of factors between different industries.

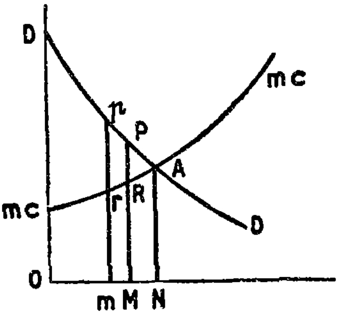

Fig. 4.

The fundamental social cost of monopoly is that it causes factors to be employed in such a way that the social output is less than it might be. Instead of factors being employed in such a manner that in every use the value of the marginal unit of output is just equal to its cost, under monopoly the selling price of the product exceeds the cost of the factors to the industry, by a more or less considerable amount. An extension of output in the industry might well result in a closing of this gap, and a consequent increase in the social income; but such an expansion will not take place as the result of economic forces alone, because (owing to the downward sloping demand curve), with every unit sold, profit declines.

Public action which tends to close the gap by bringing about an expansion of output will usually thus be a social improvement.

The fact that a reorganization of industry in this manner would increase the social output indicates that the social cost of keeping factors in an industry where their marginal product is less than it would be elsewhere, is actually greater than appears, if we take account only of the private cost of the factors to this industry. In order to estimate the true social cost of the gap between selling price and the cost of the factors, we have to value the latter not at their private cost to this industry, but at the social cost to the community of their present utilization. Wherever there is a difference between the private and the social cost curves, there is a possibility that reallocation of factors can improve the social output.

§ 5. *Increasing and Diminishing Cost.* Marshall first drew attention to the possibility of successful public action in this connection, by suggesting that industries with a rising cost curve should be taxed, and their surplus factors transferred by means of a subsidy to industries with falling cost curves. Assuming that selling price is equal to average cost (including rent) in both industries (which is Marshall's normal assumption), an increasing cost industry would be working under conditions of pure competition, while an increasing returns industry would exhibit some elements of monopoly. Since the increasing returns industry could employ more factors at prices that would cover their costs and yet sell the greater output at lower prices, the true social cost of retaining the marginal factors in the increasing cost industry needs to be adjusted upwards to take account of this lost opportunity. If the cost curve of the increasing cost industry were raised to its true social level the equilibrium point would be higher and more to the left than the apparent optimum (e.g., higher and to the left of A in Fig. 4), thus indicating that output in this industry has been carried too far from the social point of view. In the increasing cost industry there is thus a divergence between the private and social costs of the factors. Social output will be increased by a transfer of marginal factors to the increasing returns industry where no such divergence exists.

Although the Marshallian analysis is perfectly valid under its assumptions, it does not tell the whole of the story. Rising costs may occur under monopoly as well as under pure competition. If in any industry there is a gap between selling price and marginal cost, an extension of output in that industry will usually be a social improvement [1]; but unless the whole of the rest of the economic system is working under conditions such that price equals marginal cost, there may be a divergence between the private and true social costs of the industry under consideration, so that action should not be taken to expand its output until the true social cost curve has been estimated, so that the correct target for the expansion can be ascertained.

[1] The social cost curve of an industry which it is desired to expand or contract may also have to be adjusted to allow for external economies. Thus an expansion in one industry may lead to an expansion of complementary industries, which were such that in them price was initially in excess of marginal cost. In this case the social cost curve would be lower than the private cost curve of the industry in question. This is a case of "Marshallian" external economies, depending on the existence of monopoly elements somewhere in the system, although the industry under consideration may be working in conditions of perfect competition. External economies which depend on effects falling outside the private accounting system of the firm (cf. p. 125) may occur in a system of universal perfect competition; an appropriate adjustment of the social cost curve of the industry under consideration must also be made if they are present.

In thus ascertaining the cost curve of an industry whose expansion might benefit the community, two sets of factors need to be taken into consideration; first the extent to which additional factors can be supplied to this industry from unemployed resources, and secondly, the character and organization of other industries from which factors will need to be transferred. So long as factors can be made available from unemployed resources, the expansion of the first industry is sure to be an improvement. If a considerable part of the additional factors have to be drawn from other industries, careful attention must be paid both to the extent to which they are specific to their old industry, and cannot easily or cheaply be moved, and to the degree of monopoly in those industries from which the transfer can most appropriately be made. The true social costs (or benefits) of contraction and expansion respectively in the various industries concerned must be weighed up against one another before the correct policy can be finally determined.

Thus the conditions for the successful reallocation of factors by fiscal means include a knowledge of the technical conditions in all the industries which are likely to be concerned in the transfer. This knowledge, however, should not be of a sort which it is impossible for the government to obtain; but before a policy of this nature is embarked upon the effect of the additional taxes and subsidies on products already taxed should also be considered.

§ 6. *Intensification and Extension of the Tax Field.* So far we have discussed only the effect of a single tax considered in isolation; new taxes should also be considered in relation to those already in existence. A policy of industrial reorganization through taxes and subsidies can soon lead to a multiplicity of new imposts, or to an intensification of those already in existence. More generally it is important to determine how far an intensification of existing tax rates, or an extension of the range of taxes, will increase the loss of surpluses already suffered.

If a group of products or factors are related in such a way that a tax of the same rate raises the price of all the members of the group by the same proportion (as might approximately be the case with an *ad valorem* tax on products produced under conditions of perfect competition), the group can be treated as an economic unit from the fiscal point of view. It follows that if we can find such a group of products or factors where the elasticity (either of supply or demand) for the group as a whole is very low, it will not merely do no harm to extend the taxed field to cover the whole group; it will actually minimize the loss of surpluses if as much of the revenue as possible is raised from the group. This consideration should substantially widen the field in which partial outlay taxes can be made acceptable on welfare grounds.

Further, our equations on pp. 169-70 have shown that with a given elasticity of demand, the loss of surplus decreases as the amount spent on the commodity increases. Hence, there is an *a priori* probability that the extension of a tax from one member of a group to another will decrease the loss of surplus, as compared with a policy of raising the same revenue from the taxation of the single commodity. This may well be true even if the members of the group are not so closely related that they can be considered as a unit; it all depends on the relation between the elasticity of demand for the group and the elasticity of demand for the single product.

If the article originally taxed has an elasticity near zero, but one of the group has a positive elasticity, then the elasticity of demand for the group as a whole will be positive, and the extension of the tax field would be a mistake. On the other hand if we have two commodities which are *close* substitutes in the sense that a fall in the price of either sets up substitutional adjustments which are more at the expense of the other one than of other things in general, the elasticity of demand for the group of two *must* be less than for either article taken separately, so that the extension of the tax to cover both will be a benefit. This will be true by a fairly large margin even if the relation between the two commodities is rather looser than we have been supposing.

This analysis holds good wherever the industries concerned are working under conditions of competition [1]—either perfect or imperfect—where consequently there is no substantial gap between price and marginal cost for the industry as a whole. If, however, conditions of monopoly (including oligopoly) prevail, we have to remember that there is a pre-tax loss of surplus (the consumers of the commodity are in a sense already taxed), so that the post-tax loss of surplus will increase at a faster rate. There is thus an *a priori* case against either extending the tax field to cover a commodity produced under conditions of monopoly, or to raising the rate of an existing tax on a monopoly. Consequently, the other

[1] It can (or so I am informed) be shown by an extension of the mathematical analysis in Hotelling's *Edgeworth's Taxation Paradox* (*cit.*) that if all of a group of commodities are produced under perfect competition, the system of taxes which will minimize the loss of surpluses is one which will reduce the consumption of each member of the group in the same proportion. The above conclusions are special cases of this general proposition. For if any member of the group has a completely inelastic demand or supply, a tax on that member will reduce its consumption by zero ; the ideal tax on other commodities should therefore be zero, for a positive tax will reduce their consumption, that is to say, it will reduce it more than the consumption of the first commodity is being reduced.

arguments in favour of the change would have to be very strong in order for it to be desirable.

§ 7. *International Complications.* So far we have ignored the possibility that taxes may be imposed on goods imported from abroad, and that exports may be restrained by taxes or encouraged by subsidies. We must clearly take some account here of these possibilities, since it is on single-use goods that such taxes and subsidies mainly fall. Nevertheless, although the questions raised by international fiscal measures are of enormous importance, there is not a great deal that needs to be said about them at this stage of our analysis, for two reasons.

In the first place fiscal policy is only one of the means available for carrying international policy into effect; direct agreements between governments, and international monetary and exchange policy, have to be considered alongside, so that to discuss fiscal policy in isolation is not usually satisfactory. In the second place taxes on imports can rarely be considered apart from the fiscal policy of which they form a part, except when they are of the Victorian "revenue only" type. Even though an import duty may initially have the limited aim of protecting only a small range of home industry (e.g., to allow of the development of an "infant industry", or of one complementary with established industries), it is notoriously difficult for governments to resist the extension of protection. In fact, import duties tend to be considered as part of a "system", as indeed the word "tariff" implies.

British experience in the inter-war period is a good example of the typical sequence of events.[1] Starting at

[1] For a fuller account of the gradual adoption of protection in Britain cf. U. K. Hicks, *The Finance of British Government*, pp. 240ff.

the beginning of the period with a limited range of "key industry" and "McKenna" duties, which owed their origin to war experience, protection spread in various directions in the middle 'twenties (under Mr. Churchill), and finally became a "system" in 1931 (under Mr. Chamberlain). The discussion of tariff "systems" belongs to the field of the combined effects of public finance on the economy, rather than to the analysis of particular ways of raising revenue with which we are concerned in this part of our investigations.

Outlay taxes on internationally traded goods fall on the margins of consumption and production, and of saving, in an exactly analogous manner to internal taxes of the same type. We have as usual to take account of the degree of monopoly in the industries concerned, and to be on the look-out for factor or product relation. The operation of an international tax, however, differs in some respects from that of an internal duty.

In the first place some of the productional margins which are affected by the tax will be abroad, beyond the range of the control of the country imposing the tax, and of whatever benefits its public finance policy may bring about. In one sense this implies that only a part of the loss of surplus consequent on the tax falls on nationals; but, on the other hand, especially in the long period, the taxing country may injure itself by damaging its customers abroad.

A second difference is concerned with the effect of the tax on marketing conditions in the taxed industry. There is always a certain danger that an outlay tax may reduce the number of producers in the taxed industry to a point at which their control of the market becomes monopolistic through the elimination of weak rivals; as a result consumers may find output restricted and prices raised against them by more than the tax. Damage to consumers in this manner is probably more likely in respect of a protective duty, because instead of the high cost home producers being eliminated, it is the low cost foreign producers who are cut off from the market, while the high cost home producers are protected.

A third difference between international and internal taxes is concerned with their effects on the terms of trade and the balance of payments. This again is a question whose main reference is to Part III; a deliberate policy of affecting the foreign balance usually calls for a tariff system, supported by direct action. Nevertheless, a single import duty on an article which forms an important import may have effects on the foreign balance which are far from negligible.

What the effects of any particular tax or subsidy will be on the terms of trade and on the balance of payments depends on the relative cost and demand conditions in the countries concerned. Generally speaking, a tax on imports improves the terms of trade and strengthens the balance of payments; a tax on exports weakens both; and a subsidy on exports weakens the terms of trade, but may strengthen the balance of payments. All of these effects may be neutralized or reversed if the taxes or subsidies provoke retaliation.

The classical British case for free trade was tacitly founded on two arguments, first on the universal truth that under conditions of perfect competition and full employment, any international tax or subsidy would hinder the optimum allocation of resources between nations and regions; and secondly, on the purely local argument that as British import duties must inevitably mainly fall on goods of working class consumption, or on raw materials (since these between them accounted for most of our imports), import duties tended to increase the cost of British manufacture relatively to that of other countries, either by increasing the cost of raw materials or by forcing producers to raise wages.

The Victorians were therefore careful to impose only "revenue" import duties; that is to say, the duties were either confined to goods which could not be produced at home (e.g., tobacco), or if the home production of a commodity which it was desired to tax was considerable, an excise equivalent to the import duty was imposed on the home output, so that it received no benefit from the import duty. Import duties of the first type would have no effect on producers' surplus at home; if home demand was inelastic its effect on consumers' surplus would also be negligible (if the foreigner's supply was inelastic the effect on home surpluses would be negligible, whatever the shape of the demand curve). Import duties accompanied by excises would have no more, and perhaps less, effect on surpluses than a purely internal tax, imposed in similar cost and demand conditions.

In the world of to-day the conditions under which free trade would automatically secure an optimum distribution of resources no longer fully hold; it is often only too apparent that the international allocation of resources has already been distorted by monopoly elements or political action. On the other hand, under modern conditions, there are several ways in which a country can benefit itself by imposing import duties, above all when there is unemployment at home, and not all of these will necessarily lead to a contraction of world incomes. It is possible for instance that some import duties may be a necessary part of a national policy whose net effect on the foreign suppliers of the taxed goods is not adverse, because of the effect of the increased activity in the taxing country on its demand for other imports.

While considerations such as these have led the present generation of economists to look with greater tolerance on protective duties than their fathers did, it remains true that international taxes are a dangerous method of pursuing the ends of economic policy. The risk of retaliation, which would wipe out the benefits of the tax, and eventually leave the world poorer, is very great. On balance international taxes tend to cut down world trade and production; if it is possible to restore national equilibrium by methods which expand international demand rather than contract it, it is clearly better to do so.

CHAPTER XI

OUTLAY TAXES ON CAPITAL GOODS

§ 1. *Local Rates and other Real Estate Taxes.* The taxes which we have now to consider are of very ancient origin; in many countries they have been forerunners of a general income tax (as we have seen to be the case in Britain). They have normally been connected in some way with land and buildings—" real estate "—William III's Land Tax and the eighteenth century hearth and window taxes are typical examples. Real estate is still the easiest type of property to tax, relatively simple both in respect of the assessment and of the collection of revenue. In modern times the increase of other forms of consumers' capital goods has made it possible to extend the scope of these partial taxes, but real estate taxes remain the most important type. A tax of this nature may be levied either on the enjoyment of a particular form of property or on its use in production, either in general or for certain purposes. (Taxes of this latter type are often known abroad as franchise duties or severance taxes.) In either case (as will be apparent from our discussion in Chapter IX) the formal incidence is on the consumer—of the direct satisfactions afforded by the property, or of the goods produced with its help.

More rarely partial taxes are levied on income (profits) derived from a particular type of property (as from gold and diamond mines in South Africa). Partial income taxes of this sort are naturally classed by administrators as direct, and they would not normally be among the taxes whose revenue goes to make up the difference between the "factor cost" and "market cost" calculations of the national income; nevertheless their effective incidence is (as we shall see) that of outlay taxes rather than of income taxes.

On the other hand there is a British tax which is (or used to be) referred to as "the property tax", which is a true income tax. This is Schedule A of the general income tax (levied on income from the ownership of land and buildings). This schedule is needed to complete the generality of income tax. If income, derived either in terms of money or of satisfaction, from this particular source were free of tax, it would constitute a subsidy to one particular method of acquiring income. In the United States, where the income which home owners derive from their own houses is free of tax, a limited subsidy of this type is, in fact, available, and can be used by the wealthy for reducing the rigours of progressive taxation.

Taxes on real estate are very commonly used as a source of revenue for local governments. This is partly due to historical accident; in the days of primitive transport, towns and villages had to rely on their own resources for the provision of collective services; local property was then the obvious tax base, and was moreover, at that stage of development, a reasonable indication of ability to pay. These conditions have now passed away, but the independent nature of such a localized tax base still makes real estate taxes a convenient source of local revenue; this is a point which we shall have to discuss more fully at a later stage.[1]

From the point of view of incidence the use of these taxes for local purposes adds an additional complication. Local taxes are inevitably levied at different rates in

[1] Cf. Chapter XV, Sections 5 and 6.

different districts; so that the possibility of evasion of high rates of tax by removal to a lower taxed area is always open to the taxpayer; this tends to enhance already existing disparities in local tax levels, and may have far-reaching effects on the distribution of productive resources.

The general operation of taxes on durable-use goods is similar to that of other partial taxes. A rise in tax causes an increase in market price, this leads to a fall in demand, and later to a readjustment of supply, and a tendency for factors to transfer to other occupations; conversely a fall in tax causes an expansion of demand and a consequent attraction of factors. Owing, however, to the durable nature of the property, and partly also to the length of time required for the production of new units of output, the effect of a tax change on supply takes some little time to become evident. A tax-induced change in the annual rate of construction or demolition of buildings, for instance, makes but a small difference to the total buildings in existence; consequently, in analysing the early stages of the operational process, the supply may be taken for all intents and purposes as fixed.

When a tax is imposed on a single-use good, the main adjustment is on income account; indirectly the capital value of the equipment used in the production of the taxed good will fall as a result of the tax, but how great the effect will be depends on a number of factors—apart from questions of demand—on the life of the plant, for instance, and on the extent to which it is specific to the taxed line of production. Per £ of revenue collected, the effect on the capital values of any particular type of capital instrument will probably not be very large.

The case is very different when the tax is imposed directly on the capital goods themselves; their values will be immediately affected on investment account; and this change will influence production independently of the influence due to the fall in incomes derived from the use of the taxed equipment. If the taxed goods are very durable, and the tax is expected to continue indefinitely, the discounted effect of the change will make a large difference to present capital values. On the other hand if the taxed goods last only a few years, and particularly if there is no organized second-hand market, the effect on capital values may be negligible, and the operation of the tax will approximate to that of a tax on single-use goods. Wireless "licences" provide an illustration of this latter situation; real estate taxes are typical of the other extreme.

A further complication arises from the fact that instead of being consumed by their owners, goods of long life may be hired out for use by others, either in production or in consumption (in either case from the point of the owner they are then employed in the productive process). A single piece of property of long life, such as a house, may be subject to a succession of leases during its lifetime, and alternatively it may be subject to several different kinds of leases at the same time. There may be thus a large number of people whose position is directly affected by the tax change, although they may not all feel the effect simultaneously—for instance, a rise in local rates cannot be of any immediate interest to the holder of a 999 years ground lease in the early years of its currency.

When property is commonly leased the tax may be assessed either on the owner or on the lessee. In the short period the method of assessment makes some little difference to the effective incidence, since until leases can legally be readjusted the whole burden of readjustment to a tax change is thrown on the party on whom the tax is assessed. In this connection it is sometimes necessary to distinguish between legal obligation to pay the tax and method of collection. In England and Wales local rates are assessed on the occupier or tenant, but on all small houses they are paid over by the landlord, who collects the rates at the same time as he collects the rent; in Scotland on the other hand liability is divided between landlord and tenant. An English landlord is thus entitled to pass on to the tenant the whole of a rise in rates as soon as it occurs, although no doubt he does not always do so; a Scottish landlord can take no action in respect of owners' rates until a new lease is arranged.

The possibility that a property tax may be assessed on someone other than the owner is obviously an additional complication which may or may not be present, so that it will be convenient to discuss this part of the operation before we come to the more general analysis of property taxes. In order to simplify the analysis we may confine our attention in the first instance to a tax on property used for consumption (such as the British local rate on dwellings),[1] and further we may assume for the present that the supply of houses is fixed—as it must be in any case in the short period.

§ 2. *Local Rates and the Adjustment of Net Rents.* At the moment of the change in tax it is clear that the tenant (or in Scotland the landlord and tenant jointly) must bear the whole of any rise in rates; equally, after a fall in rates the landlord will not be able to alter a rent contract unfavourably to the tenant during the currency of the lease; but after that point the question arises whether tenants with their small incomes and smaller reserves are

[1] For further discussion of the British tax, cf. Hicks (J. R. and U. K.), *The Incidence of Local Rates in Great Britain.*

in a position to force landlords to lower rents after a rise in rates, or to withstand a rise in rents when rates have fallen.

It is obvious that landlords are normally in a stronger financial position than their tenants, and further, tenants have given hostages to fortune by the fact that they are fixed in their houses. They will have to incur heavy costs—in money and in convenience—if they choose to move out. There are some circumstances in particular (as we shall see) in which tenants will be extremely loth to make a move, and will consequently put up with a considerable rise in gross rents (rents plus rates) before doing so. The superior strength of landlords does not, however, necessarily put them in a position to exercise monopolistic pressure; there are normally few houses or sites so unique that appropriate alternatives cannot be discovered. Families do not generally intend to remain indefinitely in the same house; family circumstances and incomes change as time goes on, and in fact it appears that most households move fairly frequently. In London it has been said that on the average the whole population used to move every three years.

The position becomes clear if we reflect that a rise in rates is for the ratepayer equivalent to a fall in real income. Payments for house accommodation are now larger in relation to his money income than he would wish; he will want to restore his budgetary equilibrium as soon as opportunity offers, either by obtaining a reduction in the net rent, or by moving into smaller quarters. Thus when rates have been rising, tenants taking out new leases will insist on lower (net) rents. There is no reason to suppose that landlords will be able to find similar tenants who will be satisfied with the old rent, since the spending power of all tenants will have been reduced. Hence landlords will have to acquiesce in a fall in rents.

The rent adjustment need not necessarily take the form of a direct money concession; an equivalent effect may be obtained by an alteration in the amount or quality of the repairs and other services performed by the landlord.[1] It is important to notice also that the change in tax does not affect all property equally. After a rise in rates a landlord may not be able to find a similar tenant at the old rent, but he may succeed in finding a tenant with a larger income who previously lived in a bigger house. Thus a rise in rates will affect large houses more than small. The rents of small houses may still tend to fall, in spite of the movement of demand in their favour, because housing expenditure can also be reduced by taking in lodgers.

A change in rates will also tend to affect old and new property differently. Normally new houses are preferred to old, so that a change to new houses would be stimulated by a fall in rates, and *vice versa* for a rise. In Britain during the inter-war period this tendency was largely offset by the fact that the new houses were cheaper to run (and easier to manage without servants), and further that they were often relatively undervalued for rating purposes[2]; but in principle a fall in rates should stimulate the demand for new houses relatively to old.

The extent to which the net rents of houses (or more broadly the conditions of letting) will be adjusted after a change in tax differs according to the type of district where the change takes place. The adjustment of net rents which tenants as a body are able to extract from landlords as a body may be greater than the rise in rates (in declining districts it is likely to be so), or it may be

[1] A change in this respect may follow immediately on the change in rates and should be counted as part of the operation of the tax.

[2] Cf. Hicks (J. R. and U. K.), *The Problem of Valuation for Rating*.

the same or it may be less. In expanding areas net rents may continue to rise in spite of the rise in rates. The amount of the change in rent is no criterion of the extent to which landlords are being forced to share the readjustment after a rise in rates. The only measure of this is the difference between net rents [1] as they become after the rise, and as they would have come if there had been no rise in rates. Only if there is no difference between these two can we say that the tenant has been forced to bear the whole costs of readjustment.

A declining area is one from which population will be moving, consequently at any moment there will be a number of families who value the costs of removal lightly. They have it in mind that they will move shortly in any case, and a slight provocation will tempt them to accelerate the plan; consequently, landlords will be in a weak position to refuse a reduction in rents. In an expanding area on the other hand, alternative accommodation is hard to come by, and tenants will be abnormally reluctant to leave the houses they are in. These local differences in tenants' and landlords' attitudes are intensified by the fact that the rate is a local tax, differing in amount from place to place. Declining areas tend to have high rates, and the high rates provide an incentive for people to leave, and thus hasten the decline. Expanding areas tend to have low rates, and although the cost of providing public services for new housing estates is initially heavy, it is normally compensated within a short period by the increase in rateable value.

There is thus an important local difference in the extent to which, after a rise in rates, readjustment can be forced on landlords by tenants. In declining areas a great part of it can be, in expanding areas probably very little.

[1] Or more strictly, net letting conditions.

Thus if rates rise, in expanding areas rents will be a little lower than they would otherwise have been, but probably not very much. But in declining areas rents will be low, not only because the general prospects of the district make it unattractive, but also because high rates are continually forcing them down.

Another situation in which tenants will be abnormally reluctant to leave their houses in spite of a rise in rates is one in which they enjoy beneficial rents, due either to the effective operation of rent control or to the policy of local councils on their housing estates. Tenants of beneficially rented houses must be prepared to bear the full cost of adjustment after a rise in rates; on the other hand they will reap the full advantage of a fall in rates, whereas in every other situation it must be expected that after a fall in rates landlords will endeavour to push up net rents—to make them higher, that is, than they would have been but for the fall in rates. Thus when opportunity offers it must be expected that tenants will be required to share with landlords the higher real incomes which a fall in rates implies for them.

How long the initial period will be before rents begin to be adjusted depends naturally on the type of rent contract in force, which differs considerably from one part of the country to another. Probably most working class houses are let on weekly contracts, but no change is likely to be made unless the change in tax is expected to last, and in any case rents are notoriously sticky, consequently, the period of fixity should probably be interpreted in terms of months or even a year or two, rather than in terms of weeks. For larger houses leases of six or seven years are common. If in addition to the landlord of the house there is a ground landlord a similar process of adjustment between landlord and ground landlord will eventually take place, but in this case an interval (on the average) of twenty to forty years must elapse before the adjustment process proceeds.

Property owners are affected by a change in tax not merely in respect of the rents they can obtain, but also, and perhaps more importantly, by the adjustment of capital values to the new situation. A rise in rates will cause an immediate fall in the value of house property relative to other forms of investment; it is as if an additional ground rent had been imposed on the property (and vice versa for a fall in rates). Thus after a rise in rates, investment in houses becomes relatively unattractive until equilibrium is restored—usually by a growth in the demand for house room relatively to the supply. In declining areas this point may be almost indefinitely postponed.

Home owners are thus doubly penalized by a rise in rates. Not only must they bear the whole cost of readjustment on income account for so long as they own the house, but the value of their property is also diminished. When they come to sell the house its value will be less than it would have been otherwise because of the discounted value of additional and expected rates.[1] Once again the actual change in value may be more, or less, or exactly the same, as the present value of the future rate charge, according to the type of district. Conversely home owners gain doubly from a reduction in rates—on income account as occupiers, and on capital account as owners.

[1] In the traditional terminology the reflexion of the change in capital values in the selling price of property is described as the "capitalization" or "absorption" of the tax. When a tax has been in operation for some time, without a change in rates, relative capital values become completely adjusted to the tax, and in this sense "an old tax is no tax".

§ 3. *Local Rates and the Volume of Building.* So far we have concentrated on the operation of the tax in the period before it becomes possible for the supply of houses to be altered, so that the values (and rents) of existing houses are affected only by the change in the tax and not by alterations in the number of houses as a result of the tax. A fall in rates stimulates new building because it raises the net price people are prepared to pay for houses (to live in themselves or to let to others). Houses which before it would not have been profitable to build now become profitable. For essentially the same reason, a fall in rates stimulates repairs to existing houses.

As the new houses are built, they add to the supply of houses, and their competition brings rents down. Thus if in the first phase there may be some tendency for landlords to benefit from a fall in rates, in the following phase (logically rather than temporarily successive, since both may proceed simultaneously) the advantage is transferred back to tenants. In the same way, part of the advantage got by home owners from a fall in rates will be lost to them when the increased pace of building diminishes the value of their property.

The same process holds, *mutatis mutandis*, for a rise in rates. The pace of house building will be checked; consequently the ability of tenants to transfer their increased rate liability to the landlord will be limited by the scarcity of houses. Looking at the matter generally we may say that if the effect of rates on new building is small, most of the effective incidence of rates will in the end be transferred to the landlord; but if the effect on new building is large, most of the effective incidence will remain on the tenant.

Consideration of reactions through new building therefore reinforces the conclusions already reached. In a declining area where for other reasons the effective incidence is more likely to be shifted on to landlords, there will in any case be little new building for private profit. Changes in rates can therefore have little effect on new building, and the conclusion that the effective incidence will be mainly on the landlord stands.

In expanding areas, on the other hand, while there is likely to be greater stickiness in rent contracts, nevertheless changes in rates will affect the selling price of houses, and will therefore affect the profitability of new building. There will in any case be some new building in such areas, but its amount may well be affected by such changes in profitability. Thus on both grounds effective incidence will be on tenants.

The local rate—or any similar tax on real estate—is thus from one point of view a tax on building, and a reduction in the tax will have the effect of a sort of housing subsidy. If the aim of policy is to get new houses built, however, a subsidy paid only on them is much more effective and more economical of revenue than a reduction in rates (brought about, for instance, by the transfer of some rate-borne services to central funds). The greater part of a reduction in rates must go to benefit directly the tenants (or landlords) of old houses ; the stimulus to new building is confined to the opportunity given to builders of new houses to get a share in these benefits.

In the first instance a housing subsidy will benefit only the builders (including the producers of building materials) and the tenants of the new houses. Nevertheless, since new building tends to reduce rents generally, the encouragement of new building does indirectly confer a benefit on all tenants ; but if any type of building labour or materials is in short supply and not easily procurable the effectiveness of a subsidy in getting houses built will be partly wasted in a rise in building costs. This is not an argument against subsidies, but merely a warning that any measure designed to expand building may have to be supplemented by direct action to remove bottlenecks and increase the elasticity of supply.

No great extension of our analysis is needed when we turn from taxes on houses to taxes on industrial and business property. The formal incidence of such taxes, it will be remembered, is on the consumers of the products and services provided with the help of the taxed buildings. If the property is leased, in the first instance the effective incidence will be on the occupier, exactly in the same way as a tax on houses; subsequently an adjustment process will take place between landlord and tenant in an exactly analogous manner to that which we have already examined. There is, however, a further relation to consider, that between the manufacturer or businessman and his customers or clients; where the building is owned by the occupier this is the main consideration in the effective incidence of rates on business property.

For the producer the rates which he has to pay are an overhead. In the short run they will probably be paid out of profits (at least this would be the economically correct procedure); but in the longer period rates are one of the costs that must be covered in selling price. The producer has the alternatives of charging additional rates into price, or of transferring his energies elsewhere. Which course he follows will depend on similar considerations to those which determine his conduct when confronted with a new tax on a single-use good, considerations of relative elasticities of supply and demand, the degree of monopoly and the ease with which specialized factors (including his own abilities) can be transferred.

If we are concerned with a tax which varies markedly in severity from place to place, there is a not inconsiderable danger that producers will seek to evade high rates by removal to another area, or more likely by establishing new factories only in low rate areas. From the point of view of local finance the shutting down of a factory is more serious than the gradual drifting away of domestic ratepayers from high-rated areas. The producer is more likely to be influenced by purely economic motives, and among those he does not count the cost to the community of the unemployment which he leaves behind him. This danger was one of the main reasons which led to the derating of "industrial hereditaments" (i.e., those buildings where a manufacturing process was performed) as to 75 per cent of their liability to rates in 1929. By this measure the importance of rates as an industrial overhead seems to have been reduced below the *minimum sensibile*, at least for the time being; in spite of the fact that rate poundages have since risen very considerably in towns where factory property formed a large proportion of rateable value. In such places a heavy additional burden was thrown on the overheads of other business (especially of shops) which remained fully rated, so that the generalized benefits of derating were partly offset by a loss to particular local interests.

§ 4. *Other Property Taxes.* In so far as franchise taxes are imposed on the letting value of property their operation is exactly similar to that of the taxes on real estate we have already considered, except for the fact that the main effects are localized in the particular part of the economic field concerned. Demand, and hence production in that line, will be restricted in the event of a new tax, and stimulated in the event of a tax reduction, analogously to a change of tax on a single-use good. There is, however, the possibility that liability to franchise taxes may be based on an estimate of profits (deduced from past receipts); in this case the operation of the tax will approximate to that of a selective income tax on property (see pp. 204ff.); if the tax is not expected to be permanent at current rates there will be some attempt to adjust the realization of profits over time, so as to minimize the total tax that will have to be paid.

The incidence of taxes on less durable goods (such as the "licence" duties on motor vehicles) differs mainly from the corresponding taxes on real estate by the smaller proportional effect of changes in capital values. Thus the operation of the tax on private pleasure cars corresponds to the domestic rate on home owners; there is an analogous tendency for a rise in tax to cause a shift in demand from bigger or better cars to smaller cars, and for a reduction in tax to stimulate the demand for expensive cars. The precise formula according to which liability is assessed is of very great importance in this respect, since manufacturers will naturally adjust their designs so as to maximize the net attractiveness (satisfaction in use less tax) to prospective purchasers. This is a point to which we shall have to return when we consider the incidence of current British taxes.[1] Similarly, the operation of "licence" duties on buses and taxis follows that of domestic rates on leased property—the lease being considered as a series of short contracts rather than a single durable one; and finally, the operation of licences on such vehicles as lorries and delivery vans is analogous to that of buildings owned and used in production, but in every case without much importance in respect of capital effect.

Before we leave the incidence of taxes imposed directly

[1] See pp. 309ff.

on capital goods themselves there is one further type of tax on real estate which calls for comment; although so far as Britain is concerned it is small in potential fiscal significance, it is large in notoriety. This is the group of taxes which are (or may be) imposed on the value of the site, as distinct from the value of any structure which may happen to be built on it. Valuations for rates (and most property taxes) are based on the property as a whole, site and building being considered as an indivisible unit. It is possible in principle, although in practice extremely difficult (especially when most of the site is covered by buildings), to value site and building as separate entities, and so to assess them at different rates of tax.

Taxes may be assessed on the whole value of the site, but the basic object of site valuation is to provide a means of taxing the "economic rent" or surplus which accrues to the owner of a factor (such as land) of which the total supply is fixed, as the demand expands for the products which the factor in question helps to produce. As Mill pointed out in the 1840's this is a very "proper subject of differential taxation".[1] If it can be taxed, the tax has a double virtue. First, it secures for the community the increase in the value of the property which is due to the expansion of the local community and not to the exertions of the owner; and secondly, since the increment of value is "unearned" by the owner, the tax can have no restrictive effect on enterprise. In order to obtain this result correctly it is necessary to estimate the value of the site in its virgin or "unimproved" state (as originally provided by nature), and to tax only the increment in value due to community action.

In new countries where it has been possible to obtain a selling value basis for undeveloped sites, and where

[1] Cf. p. 148.

development has been taking place rapidly, considerable use has been made of taxes of this nature. Imposed in a country which is already developed and where the population is more or less stationary, the costs and difficulties of valuation outweigh the small revenue which would accrue if the tax is (as it should correctly be) confined to economic rent. Fundamentally objective valuations must be based on selling prices; in a developed country independent selling prices for uncovered (and *a fortiori* undeveloped) sites are not available in sufficient numbers to serve.[1] As Edgeworth said at the beginning of the present century, when the Liberal tax on "unearned increment" was the centre of political controversy, the basic objection to the tax is that "there is no money in it".[2]

The surplus element in real estate, due to the expansion of the community, is not confined to the increased value of the "original and indestructible" gifts of nature; as we have seen, in the short period (which in practice may be quite long) the supply of houses is also more or less fixed. Thus unearned increment could also be taxed by including improvements in the valuation. To value "betterment" in this sense is a much easier task,[3] but a

[1] The valuers under the Liberal measure of 1906 encountered innumerable awkward cases. Typical of the sort of difficulty which may be expected was the case of a piece of land which owed its very existence to the fact that it had been enclosed with a sea wall by the Romans. Should this, or should it not, be considered a "community improvement"?

[2] Cf. Edgeworth, *Collected Papers*, Vol. II, Sections U and V.

[3] The method proposed by the Expert Committee on Compensation and Betterment, 1943 (Uthwatt Report), would not, however, serve for the purpose, since it is based on the local rating valuation, which is well known to vary from place to place, and even between different classes of property. The Uthwatt proposal was for a tax on the increment of value of the site as currently improved but without the structure (if any). Apart from the inappropriateness of rate valuations, there would thus also be an arbitrary element in the separation of site from structure value.

tax on it cannot be expected to be devoid of effect on enterprise in the same way as a tax on pure surplus.

A tax on the betterment of durable property is evidently closely similar to a rate; in its effect on capital values it resembles an additional ground rent. The fall in capital values which results from the tax does not (as was thought by the protagonists of the Liberal proposal) constitute a stimulus to private building; rather it is a consequence and reflexion of the lowered attraction of real estate as an investment—for building or for other purposes. Like rates, a tax on site values will tend to restrict rather than to expand building by private enterprise, whether for domestic or for industrial purposes. If, however, the tax is assessed at *ad valorem* rates on the whole value of the site, it will tend to encourage new building in the country or on the edges of the towns, relatively to building in heavily built-up areas.

At the beginning of the century this relative encouragement to suburban building was hailed as a particular advantage of the tax, as providing a simple method of lessening congestion in city centres. In the inter-war period the outward spread of population under the stimulus of cheap motor transport entirely altered the nature of the problem; heavily built-up areas have often become semi-derelict owing to the outward movement of population and industry; only in London have rents usually been high enough to secure redevelopment of the centre by unassisted private enterprise.

The problem of the taxation of "betterment" is closely related to the problem of the public acquisition of land, and the compensation of expropriated owners, questions which would take us far beyond our field. Nevertheless, although site value taxation is politically related to these questions, it is possible to pronounce on it from the economic point of view, considered in isolation, as a fiscal measure. From this point of view there can be no doubt that in British conditions it is of little importance; if site value taxes are to be imposed in Britain it must be on political rather than on economic grounds.

§ 5. *Partial Taxes on Property Incomes.* We have still to consider the incidence of taxes on capital goods which are assessed not on the goods themselves but on the incomes derived from their use. Such "partial income taxes" are always likely to be exceptional because of the questions of equity which they raise; but it so happens that in the Union of South Africa there are special circumstances which enable the government to raise a large amount of its revenue by this means, by taxing the profits of diamond mining and of gold mining.[1] The peculiar circumstances which make this policy practicable are, in the case of diamonds, the existence of a world monopoly in gem diamonds, and in the case of gold, a world demand which is insatiable at a fixed price, so long as international debts are settled in a medium in any way related to gold. It is not surprising that with such very exceptional demand and marketing conditions uncommon sorts of taxes should be available.

If a partial income tax takes the form of a straight tax on profits and is expected to be permanent, the only consequence of the tax will be to raise the cost of capital to the taxed industry (owing to the fact that profits in it have to bear an additional charge). It is thus only in the peculiar demand conditions of the gold industry that a straight profits tax would differ from a tax assessed

[1] For details of these taxes, cf. Duncan Black, *The Incidence of Income Taxes*, Chapter VI, Section 2, and Chapter VIII, Sections 4 and 5.

on real estate; in the long period production would be cut down to the point where the net returns from the industry were once more in equilibrium with those obtainable elsewhere. The South African gold tax is, however, more complicated than this. The principle is that from a (50 per cent) tax on net profits is deductible an amount (equal to 5 per cent of running costs) down to a minimum tax (of 15 per cent) on profits. Thus if profits before tax exceed 16 per cent there is an advantage in increasing expenditure at the cost of realizing profits. This result is definitely aimed at by the government in order to economize in the use of an important national asset. By encouraging the mining of low grade ore and a higher degree of extraction, maximum production over the life of the mine should be achieved.

Although the South African mining taxes are technically only partial income taxes, the gold-mining industry is of such outstanding importance in the Union economy that its taxation gives rise to many of the effects of a general income tax; that is to say, it influences the factors which determine the size of the national income. Certain outlay taxes also which are of especial importance in an economy, because they influence the whole range of production or consumption, may have general effects in addition to the partial effects which we have been considering in this and the preceding chapter. This is a question to which we must return in Chapter XIV when we have discussed the incidence of general taxes on income and wealth.

CHAPTER XII

GENERAL TAXES ON NET INCOME AND PROFITS

§ 1. *The Loss of Satisfaction due to Income and to Outlay Taxes Compared.* For outlay taxes the rates of tax to be paid do not differ between one person and another; individual liability differs only because of differences in the amounts or qualities of taxed goods which are purchased. For income and capital taxes, in contrast, each taxpayer's liability has to be separately calculated, according to his wealth and circumstances.

In respect of a personal income tax two preliminary questions have to be settled before this calculation can be made. First, receipts on income account must be separated from receipts on capital account (since a true income tax seeks to tax only the former) [1]; secondly, a decision has to be reached as to the costs which are to be allowed to the individual in reducing his gross receipts to the net income which is the basis of his liability. In British income tax a further stage is also required, consisting of the reduction of net (or " actual ") income to " taxable " income by the deduction of a number of reliefs or allowances, which are designed to take account of the taxpayer's personal circumstances; we shall have to discuss these in detail at a later stage.

The task of distinguishing true income from capital

[1] This does not prevent some income taxes (e.g., in the U.S.A.) from including a levy on capital gains, and sometimes an allowance for losses. This is, in effect, a combination of two taxes in one, for discussion of the result, cf. p. 247.

receipts is not usually a difficult one ; there are, however, always a few borderline cases which may give trouble—for instance, where income is normally derived from a series of capital transactions (as the income of the stock-jobber). In such a case as this it is perfectly correct to tax capital gains as income. Difficulties of another type arise because it is sometimes within the power of tax-payers to substitute capital gains for income (e.g., by *arranging to receive bonus capital distributions in lieu of* dividends, from firms in which they have a controlling interest). Such capital gains are truly income and should be subject to income tax, but it is not always easy to detect them, and much of the evasion of surtax which takes place is probably of this nature. This type of tax evasion cannot suitably be guarded against by the extension of income tax to cover capital gains in general [1] ; but means of taxing particular methods of substituting capital gains for income can usually be found, within the framework of the income tax, by a diligent revenue department.

The process of determining the costs to be allowed in reducing gross income to net, gives rise to more general difficulties. In practice " personal " costs are determined by revenue authorities in a quite conventional manner ; in Britain they include a limited allowance for occupational and living costs (such as tools supplied by the workman, life insurance premiums and mortgage interest on a dwelling house) ; but they exclude the cost of acquiring a professional position (such as the purchase of a doctor's practice). The costs to be allowed to a business firm for the non-personal section of British income tax are also settled in a conventional manner ; those acceptable to the revenue authorities are not necessarily those which

[1] Cf. American experience, described p. 247.

an accountant or an economist would consider appropriate, and this may make a given rate of tax more onerous than it need be. This is an important point to which we shall have to return later.

The most serious technical difficulties in assessing income tax probably arise in distinguishing between costs, profits and personal income in the case of the small firm. The indifferent accounting methods often used by such businesses cause their owners in many countries to escape a not inconsiderable part of their tax liability. The inequity caused by this sort of evasion has been one of the main reasons for the unpopularity of the income tax when first introduced, both in Britain and in other countries. The difficulty has now been largely overcome, in Britain at least, partly by the expansion in the size of the typical firm and the decay of family ownership, partly by improvements in the technique of business accounting. In advanced industrial countries at least, income taxes can now be collected with a high degree of interpersonal equity, even if from the economic point of view the conventions used by revenue authorities still leave something to be desired.

Income taxes are inevitably closely linked with capital taxes, not merely because capital receipts are sometimes hard to distinguish from income, but because the two types of taxes are similarly based on the whole body of the individual's wealth—in the one case on its annual value, in the other on its capital value. In practice the connection between the two types of taxes is very close indeed, since a tax which is assessed on income may, in fact, be paid out of capital, and vice versa. Thus a temporary high income tax in war-time can be met without a proportionate reduction in consumption by selling assets [1]; *mutatis mutandis* a capital tax imposed year after year will tend to be paid out of income. Nevertheless, even if the same amount of revenue were to be extracted annually from each taxpayer, the effective incidence of a tax assessed on capital would probably differ to a not unimportant degree from that of an income tax assessed in a more normal manner. Thus we have to take account not merely of how the tax is paid, but also of how it is assessed.

In analysing the operation of general taxes on income and capital we must continue to follow the "one thing at a time" (partial) method, in the sense that we are still not concerned with the effects of the disbursement of revenue. We have seen that the expenditure out of the revenue from an individual tax can only be isolated for separate discussion in the case of an earmarked tax, so that the whole question of the allocation of revenue must await the general discussion of public finance in the economy. Nevertheless, our analysis must now become general in the sense that we can no longer confine our attention to changes in particular markets, but must discuss the effects of taxation on the general phenomena of consumption and investment, the factors which determine the size of the national income.

The classical (or rather Victorian) case in favour of income taxes as compared with outlay taxes (see p. 169) implicitly assumed that when the taxpayer is confronted with the choice of paying a certain revenue by a particular partial outlay tax or by a general income tax, his initial liability in both directions is zero. In

[1] This circumstance has sometimes led to the demand for a capital levy in war-time. We shall see later (cf. Chapter XIII, Section 2) that it would be ineffective for the purpose of controlling consumption and prices, and might even have the opposite result, depending on the extent to which levy payers could borrow.

these conditions it is right to assume that he would prefer an income tax. In the first place by this alternative his distribution of outlay will not be disturbed. Secondly, since the rate of income tax [1] to bring in the same revenue will almost certainly be lower than the rate of the outlay tax, it will have less effect upon him. It is unlikely indeed that he will be conscious of any shift in his relative preference for work and leisure as a result of paying the income tax, and so he would sustain no loss of surplus.

The conclusion that an income tax entails no loss of surplus rests fundamentally on a neglect of the costs of acquiring an income—the wear and tear to the individual, and the subjective disutility of work—so that it is only strictly true of a tax on income from work so long as the rates of tax are moderate. Nevertheless, in many circumstances it is true that there will be a gain in satisfaction as a result of a change from outlay taxes to income taxes; the main advantages however must be sought in the field of distribution.

By far the greater part of the revenue from outlay taxes is derived from the lower income groups (merely on account of their larger numbers); the revenue from income taxes on the other hand mainly comes from the upper income groups, because of their larger incomes. Thus a switch over from outlay to income taxes would make the tax structure substantially less regressive, and would improve the relation of taxation to ability to pay. It also follows from this income distribution of revenue, that outlay taxes tend to be paid at the expense of consumption, income taxes partly at least at the expense of saving. Thus a switch over to income taxes would tend to stimulate spending in the economy, by enabling

[1] On account of its "importance", see p. 171.

the lower income groups to spend more, while not seriously preventing the higher income groups from spending as much as before.

Except for the possibility (which we shall have to consider) that the increased taxation of saving might have hindered private investment, the switch over to income taxes in the 1930's would thus have been a definite advantage. It cannot, however, be assumed without further inquiry that the higher rates of income tax which would have been required for the change we are supposing (which at 1938 incomes and prices would have entailed a rise of about 1*s.* 6*d.* in the standard rate) would have been without effect on the individual's ability or willingness to work and enterprise. An increase of this magnitude would have brought the rate of tax well above the inter-war normal; a rise of this amount would be still more serious at the higher rates of tax resulting from the war. In order to appreciate the dangers in this direction—and also in order to judge how far they might be mitigated by internal improvements in the tax—it will be desirable to examine the rather peculiar construction of the traditional British income tax.

§ 2. *The Structure of British Income Tax.* Since the introduction of supertax in 1910 British income tax has been made up of three distinct elements: (i) a simple proportional tax falling universally on personal incomes above a certain low exemption limit, and assessed at a single "standard" rate [1]; (ii) a tax on the undistributed profits of all firms, assessed at the same "standard" rate; and (iii) a progressive surtax on personal incomes above a certain limit (now £2,000) assessed at rates that

[1] Apart from complications concerned with "reduced rates," and with "reliefs" or "allowances", see pp. 213, 214, 219ff.

increase fairly rapidly on successive increments of income. Administratively British income tax is thus effectively three separate taxes, but economically it consists of two taxes only, a progressive personal income tax, with a low exemption limit, and a flat rate tax on business reserves. The first two of the three administrative elements are the direct descendants of Pitt's original income tax; the third is the successor to the supertax of the Liberal government of 1910, when, however, the exemption limit was £5,000.

Liability to the two personal elements of the tax is determined at one operation on the basis of a return of total income made by the taxpayer soon after the beginning of each financial year; but the collection of income tax and surtax takes place in two operations, surtax being due a year in retard of income tax. On the other hand a large part of the personal and impersonal revenue from income tax (as distinct from surtax) is collected together by a very simple device. The total profits of firms are taxed at the standard rate, and dividends are then distributed to shareholders net of this amount of tax.

This "deduction at source" constitutes a first approximation to discharge of liability to the personal tax; each individual's position is subsequently adjusted, with reference to his return of income and the reliefs to which he is entitled, by means of an additional payment or a refund, according as his correct rate of tax is below or above the standard rate. This method of collection is an important safeguard against evasion through the taxpayer failing to return the whole of his income from property; if the standard rate is fairly high it also follows that a large part of the revenue is collected in this painless manner with a very brief time lag.

British income tax has always attempted to take account of the taxpayer's ability to pay, not merely in respect of his receipts but of his needs also. Some small allowances were already a feature of Pitt's income tax, and the necessity of making a return of total income in order to claim them was cunningly used as a method of reconciling the taxpayer to disclosing his total receipts, a process which experience has shown to be a *sine qua non* of an effective and equitable income tax.[1] Since the beginning of the inter-war period fixed sums have been given by way of reliefs in respect of children, other dependants and old age, in addition to a "personal" allowance for the taxpayer and his wife. In addition, a percentage allowance, up to a certain maximum amount, is given on income from work, thus constituting a small discrimination against rentiers.

As a result of these allowances, the tax is made progressive with needs as well as with income; its relation to ability to pay is also improved in two other respects. In the first place, for most taxpayers, the effective exemption limit is raised considerably above the nominal limit (thus in 1938 with a statutory exemption limit of £125, a married couple with three children were virtually exempt from tax if their income did not exceed £500); in the second place a general element of progression is imparted into the tax, even in the range in which there is no difference in nominal rates. The effect of the allowances on the lower ranges of incomes is thus very important, but as income increases they gradually sink into insignificance.

The progression of the personal income tax is, however, mainly secured by the device of charging successively higher rates on successive increments of income (this device is widely adopted for progressive taxes, both on

[1] Cf. p. 142.

income and capital). In the " income tax " range (below the surtax exemption limit), there have been two such steps since Pitt's day, known respectively as the " reduced rate " and the " standard rate ". (A third was added in the second Budget of 1945 by dividing the reduced rate.) The progression of the surtax range is now achieved by means of about a dozen steps.

When these stepped or marginal rates of tax are averaged over the whole of the taxpayer's income the progression of his tax liability proceeds in an almost smooth curve as his income expands. The position is illustrated in Chart II where the curves MM and EE represent the marginal and average (or effective) rates of tax respectively, in 1938 (for simplicity the crude rates are shown, without allowances). The " reduced rate " and the " standard rate " are the marginal rates for the ranges R and S respectively; the effect of these two big steps is clearly reflected in shape of the average curve also.

Since the marginal curve rises throughout its length, the average curve necessarily lies below it, but as income increases the two curves approach asymptotically—since there is a definite limit (100 per cent) above which the marginal curve cannot rise. Even when this point is near to being reached (as the diagram shows to have been the case in 1941) it is still possible to make the tax more progressive by introducing the maximum rate at a lower income level. The chart shows that the progression of British income tax was considerably stepped up in 1941, at the same time as its scope was expanded. It is obvious that any deterrent to personal incentive inherent in the tax must thus have been considerably increased.

§ 3. *The Effect of High Tax Rates on Incentive and Enterprise.* It is not possible to say in general whether a particular

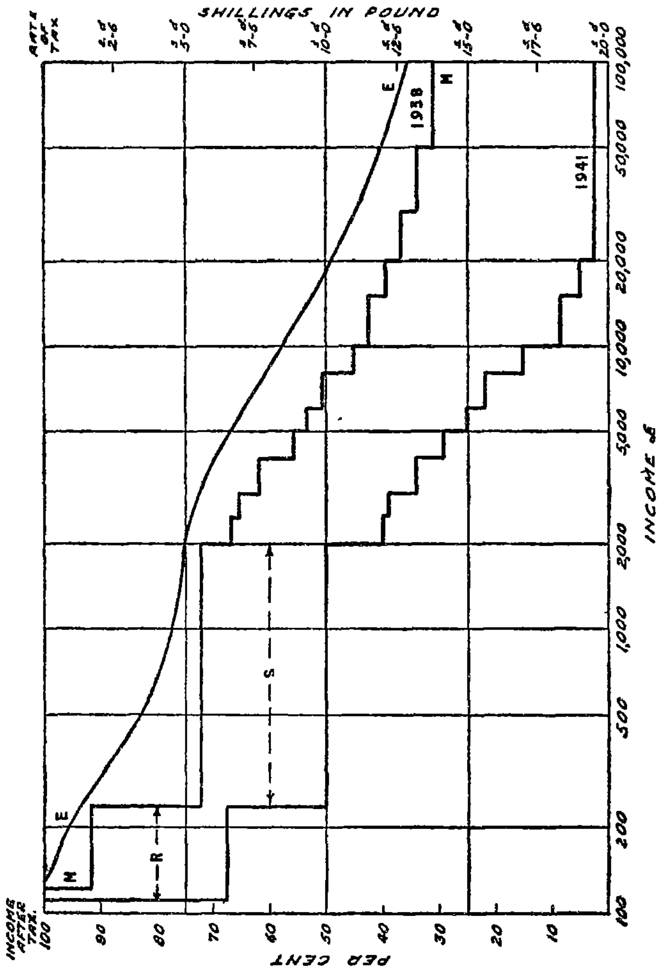

CHART 2. RATES OF BRITISH INCOME TAXES 1938 AND 1941-45.

taxpayer will work harder or less hard when faced with a rise in income tax; it depends on his "elasticity of demand for income in terms of effort". We can, however, postulate a probable difference in his reaction, according as the increase in tax falls mainly on marginal or mainly on average income. If the change is felt mainly in the average rate of tax, its effect is as if the taxpayer had been shifted down into a lower income group; we may expect that he will normally work harder in order to maintain his customary standard of living. If, however, the increase falls mainly on the marginal rate (and especially if it is very marked) there is a natural reluctance to incur the additional income, or, to put it the other way round, to make the additional effort.

The difference between marginal and average rates of tax at different points on the income scale thus assumes a considerable significance, especially when (as in war-time) it is especially desired that workers should put forth all their efforts. It will be observed that in the years illustrated in the chart there were two points on the income scale where the difference between the marginal and the average rate was exceptionally wide—at the point of first liability to tax, and at the point where the full standard rate became payable on marginal income. The enormous rise in the 1941 curve between zero liability and a marginal rate of tax of 6*s.* 6*d.* is especially noticeable. It is obvious that the deterrent to personal effort caused by the tax must thus have been considerably increased. There can be little doubt that the heavy tax liability resulting from additional work was a serious brake on effort in war-time, and contributed to the spread of voluntary absenteeism. In this respect the division of the reduced rate into two smaller steps should be a decided improvement.

The extent to which a large and sudden rise in the marginal rate of tax will in practice tend to check effort depends on two factors—the extent to which the individual taxpayer can vary his income, and hence his liability to tax, by varying his effort; and the extent to which variations in income are immediately related to variations in tax. Normally most workers have only very limited opportunity of varying their income by varying their effort, unless they are on piece-work; but when there is a heavy demand for overtime the situation is very different. This unfortunate effect of sudden changes in marginal tax rates was thus at its maximum in war-time.

Traditionally, liability to income tax was based on income averaged over three years; the relation between current effort and tax was thus very remote. In the 1920's when tax began to be assessed on the income of the preceding year only, the relation was brought appreciably closer. At the same time the rise in tax rates greatly increased the incentive to regulate annual income so as to maximize income *after* tax. In 1943 a much bigger move in the same direction was made by relating tax to income directly, week by week, under the "Pay as You Earn" system of tax collection on wage and salary earners. In order to appreciate the significance of this it is necessary to consider the combined effect of the various alterations made in the tax for war purposes.

The most important effect of the adaptation of British income tax for war purposes was for the first time to bring very large numbers of weekly wage earners within the scope of the tax. The number of income tax payers must in any case have increased considerably owing to the rise in money incomes due to war employment; but in addition to this, a deliberate extension of the tax was sought, in order to use it as an instrument for the control of mass consumption. Thus, at the same time as the rates of tax were pushed up, its scope was extended by a reduction in the nominal exemption limit and of the personal allowances (these latter were, however, accredited to taxpayers for repayment after the emergency period).[1] As a result of these changes the traditional methods of tax collection no longer sufficed; it was impracticable to collect tax from large numbers of weekly wage earners on an annual or even on a quarterly basis, as had hitherto been the practice; weekly incomes could only be taxed with efficiency and equity by means of weekly deductions.

Faced with this difficulty, the Inland Revenue managed to graft on to the traditional administrative system a method of adjusting tax deductions weekly to the rate which exactly corresponded to the taxpayer's effective liability (taking account both of his earnings and of the reliefs to which he was entitled) for the fiscal year up to the current week. Owing to difficulties in the ranges where manual workers' earnings overlapped with clerical salaries the P.A.Y.E. system of collection was extended to all salaried workers.

Although the system was successful in imposing on weekly wage earners an effective income tax, which lost nothing of its traditional equity, it had two serious objections. In the first place the calculation of liability week by week involved enormous additional work, both for the revenue authorities and for employers, who were required to pay out wages *net* of tax.

In the second place while the worker no doubt had little idea how his weekly quota was arrived at, he soon found that his tax bill varied directly with last week's earnings. From this it was a simple step to discover that un-

[1] Cf. p. 82.

authorized holidays could be enjoyed at the expense of the revenue, idleness being financed by the reduction in tax liability for the year. There can be little doubt that absenteeism was considerably stimulated by this discovery, especially during the later stages of the war. This is a serious disadvantage of the British P.A.Y.E. system, which unlike the large difference between marginal and average rates, is not necessarily a war-time phenomenon. A still greater disadvantage of the system lies in its complication (due mainly to the effort to preserve equity), and the consequent rigidity of tax rates once established.

The calculation by employers of the amount of tax to be deducted from their workers' pay envelopes under the P.A.Y.E. system is based on a system of codes (representing the fixed personal and dependants' reliefs to which the taxpayer is entitled) and a set of tables—calculated separately for each code—taking account of the variable reliefs; codes and tables are supplied to firms by the revenue authorities, but even with their aid the additional work thrown on wages departments makes the method unsuitable as a permanent administrative device, while the time required for calculating and printing new tables and codes apparently makes it impossible to change the rates of tax with less than six months' notice. Thus at the moment when for the first time income tax became usable as an instrument for the control of consumption, and practicable as a tax on the lower income groups, it became in fact too clumsy to be used for these purposes. Since, as we have seen, the extension of income tax at the expense of outlay taxes may have considerable advantages, it is very desirable to discover a simpler method of operating a tax on weekly incomes.

One very considerable simplification of P.A.Y.E. calculations could be obtained by removing the fixed allowances from the income tax system and awarding them separately,[1] most conveniently in conjunction with the social security system, as soon as its extension to the whole nation comes into operation. This change would nominally remove the progressive element from the tax on small incomes, since (as we have seen), below the range of stepped marginal rates progression depends wholly on the operation of the reliefs; but the progressive element would still remain in the reliefs, which could be claimed weekly. The complications of the P.A.Y.E. tables of variable reliefs would still remain, however, even after this reform.

The remaining complications of the P.A.Y.E. system could only be abolished by abandoning the lower (income tax) ranges of the stepped progression, and in fact returning to Pitt's simple proportional tax; this would have the additional advantage of removing all check to incentive due to sudden changes in marginal rates. The drawback to this simplification would be, however, that the rate of progression (which would then depend wholly on the operation of the reliefs) would gradually slacken off as income rose, unless stepped marginal rates were re-introduced by lowering the surtax exemption limit, at the point where the reliefs declined in importance. Since, however, the rate of the proportional tax on wages would need to be low enough to impose no serious check to incentive at the point of first liability to tax, the reduction in the surtax exemption limit would need to be drastic —to something like a level of £500.

To extend the scope of surtax in this way would have several not unimportant drawbacks. The original intention of supertax was to establish a special means of taxing the incomes of the rich, and because of their complicated

[1] Cf. the plan suggested in *The Economist*, 12th January 1946.

structure, a rather elaborate administrative method was evolved ; it would be wasteful to extend this to the main body of income taxpayers if simpler and more economical methods would suffice. The extension of surtax would undo much of the economy of the simplification of P.A.Y.E.—which under a simple proportional system would presumably require no returns of income from wage earners. Further, the abandonment of a fairly high standard rate would (by diminishing the amount of revenue collected at source) both increase the danger of evasion and seriously delay the collection of a large amount of revenue; undoing in this respect most of the advantage of P.A.Y.E. in keeping tax collections in step with changes in the national income.

A solution which would combine the advantages of the old and the new would be to return to the traditional methods of collection for the great body of income tax, but to support the tax with a simple proportional tax deducted from all wages and salaries at a low rate and collected on a greatly simplified P.A.Y.E. system. Personal income tax would then be divided into three sectors—the proportional wage tax, primarily for the lower incomes; normal income tax, primarily for the middle incomes; and surtax, primarily for the incomes of the rich. The standard rate (or, if necessary, rates) of the middle sector could then be set at the point which would be most convenient for the rapid collection of the main body of the revenue, but not forgetting the hardship inflicted on small rentiers in having to wait until the end of the financial year for their refund, if it is set too high. In these conditions it might well be possible to raise, rather than lower, the exemption limit for surtax, without upsetting the progression, and thus to restore it to its original purpose as a tax on the wealthy.

It must be remembered, however, that the standard rate has reference not only to personal income tax but also to the taxation of business profits. In the nineteenth century, when the idea of a progressive income tax was being actively canvassed, it was the effect of the taxation of the wealthy on business prospects which aroused more apprehension than the effect on personal effort.[1] In mid-Victorian conditions it is likely that the two effects were indistinguishable. By his personal effort the individual accumulated savings which he would then apply directly to real investment in his own or a friend's business, unless prevented by the income tax.

If it proves necessary to continue to levy tax on the middle and upper income ranges at anything like the rates established in 1941, the effect of the taxation of the rich will once again have to be carefully considered. Maximum effort is if anything even more necessary in the national interest among the leaders of industry, higher paid officials and professional workers than among the manual workers and clerical ranges. An effective rate of tax which leaves to the worker a quarter or less of the fruits of his efforts can scarcely be a stimulus to first-rate work. At the same time heavy taxation in these ranges increases the incentive to evasion, by charging an excessive volume of personal expenses to the costs of the firm. Thus at high tax levels average rates need to be considered as well as marginal rates; there is a limit above which, in normal times, it would be folly to allow the tax to remain. Under modern conditions, however, the effect of high taxation of the rich has very little reference to the question of investment. Investment now takes place as a result of the decisions of boards of directors and is financed not by the direct application

[1] Cf. pp. 146ff.

of personal savings of the wealthy but very often out of the accumulated reserves of firms. The relevant factor to consider is consequently not the personal tax but the effect of the standard rate on undistributed profits in checking investment and enterprise. This may be felt in two directions, one depending primarily on the absolute height of the tax, the other on the type of investment contemplated.

In order to see the working of the first of these let us take the case of a firm which is considering the installation of new equipment costing £10,000. If the firm can borrow the necessary capital at 5 per cent, then £500 of the interest on the loan (as well as the necessary depreciation quota on the equipment) must be covered before any net advantage accrues from the investment. Even if a net profit of more than £500 is regarded as likely, there is always the chance that less will be realized, in which case the investment will result in a loss, hence the expected profit must be sufficient to compensate for this chance. Let us say that a most probable return of £600 would be considered satisfactory, taking account of the chance of loss. This £600, however, is *net* profit, after tax has been paid. If the rate of tax is 5*s*. in the £, the necessary pre-tax profit for the investment to be worth while must therefore be £633. If, however, the rate of tax is 10*s*. in the £ the pre-tax profit must be £700; investments bearing a probable rate of return of 7 per cent are not too easy to find. High rates of tax must stifle a number of promising industrial opportunities.

Parallel reasoning can be applied to the financing of new investment out of accumulated reserves, except that instead of profit net of interest charges, the relevant calculation is the difference between the expected net profit (after tax) resulting from the new equipment and the receipts (also after tax) which could be obtained by an alternative use of the funds—for instance, in the purchase of securities. It remains equally true that the addition to profits (pre-tax) which must be obtained for the investment to be worth while rises *more than proportionately* to the increase in the rate of the tax.

In practice a firm is not faced with a single expected rate of profit but rather by a range of possible results, which may be pictured as ranged along a curve, similar to the normal curve of error. In respect of risky, untried sorts of investment, where there is much uncertainty as to the result, some chance of a very high return but also a large chance of loss, the curve will tend to be wide and flat. In respect of safe investments, where there is no pioneering element, the chance of loss will be negligible, and the most probable rate of return will be expected with a high degree of confidence; the resulting curve will be narrow and humped.

The effect of an additional tax on profits on a curve of expected returns is to shift the curve bodily to the left, but without altering its shape or the chance of loss. The chance of very high gains which formerly balanced the big chance of loss in the risky investment's curve is thus cut off, and the scales are consequently tipped against it; while the safe investment, being relatively unaffected, will become the more attractive. The discrimination of high profits taxes against "venture capital" is serious for any country that means to keep abreast of modern developments; it is perhaps especially serious in an established industrial country, well supplied with most sorts of industrial equipment, and where consequently new enterprise needs to be especially on the alert. This tax effect has also important cyclical relevance; in depression curves of expected returns tend to flatten out;

many normally "safe" investments pass into the "risky" class.

A high rate of tax on undistributed profits is thus economically undesirable; at the best it cuts down reserves and so hinders the modernization of plant, at the worst it may be a serious brake on enterprise and invention. Yet it is not desirable to exempt undistributed profits completely from taxation, as has sometimes been suggested in the United States. The tax on undistributed profits is a completion of the personal tax; although they cannot use it in consumption, the profits are "income" belonging to the owners of the business (usually the ordinary shareholders), and should be imputed to them on any strict accounting of assets.[1] To free this income from tax would greatly increase the incentive for evasion of the personal tax, by means of bonus distributions. Further, if a zero or very low rate of tax were levied on undistributed profits, an incentive would be provided for the mere accumulation of reserves without any particular stimulus being given to real investment.

The aim of a tax on undistributed profits should thus be to put the smallest possible brake on production, and especially on the modernization of plant, which is consistent with the completion of the personal tax; while if possible creating a positive stimulus to enterprise and invention. This implies that if the standard rate of the personal tax is high, and it is desired to keep the same rate for the impersonal tax for administrative convenience, substantial rebates should be available, not merely for obsolescence and wear and tear (which is more or less the case at present) but also for new investment, research and any project likely to improve productivity per worker. An appropriate way to achieve this aim was pointed in

[1] Cf. p. 287.

the Income Tax Act of 1945 which allows what amounts to a partial exemption from tax on certain types of new investment and on research.[1] Both the scope and the amount of the relief need to be extended considerably, however, if this reform is to make a substantial difference to entrepreneurial planning.[2]

§ 4. *The Taxation of Excess Profits.* The impersonal section of British income tax looks after the routine taxation of profits and completes the personal tax. In times of emergency it may be necessary to impose an additional charge on profits in order to support the necessary control of consumption and investment by other direct means. For additional effectiveness such an emergency profits tax would naturally fall on all and not merely on undistributed profits. Thus an excess profits tax is a convenient, and probably an indispensable, part of war finance.[3] It is not, however, excess profits in the sense of especially high profits which are the proper subject of attack—since these may be due to extra efficiency in war as well as in peace—but rather the increment over normal profits due to the emergency conditions. In wartime this increment will be due, directly or indirectly, to the spending of the government. The natural basis for measuring the taxable excess is therefore the difference between emergency profits and the normal pre-war "standard" experience of the firm in question.

Excess profits taxes properly understood are thus war profits taxes; there is no implication that the profits

[1] *The Economist*, 28th April 1945, contains an account and criticism of the provisions of this and the Finance Act, 1944 (which form part of the same measure). The main drawback is the inadequacy of the relief in a period of rising prices.

[2] For a further development of essentially the same plan, cf. Kalecki, *The Economics of Full Employment*, p. 46.

[3] Cf. Hicks and Rostas, *The Taxation of War Wealth*, *cit.*, Chapter V.

which are taxed are " excessive " in any normative sense ; it is recognized that they are due to circumstances largely beyond the control of the firm making them. Nevertheless the idea that industrial profits are somehow chronically higher than they should be (presumably in relation to some other sort of earnings) has also frequently been present when excess profits taxes have been imposed, and proposals have been made for incorporating them into permanent tax structures. With this idea in mind it has been attempted to measure the excess profits not in relation to the pre-war standard, but in relation to a given return to the capital invested in the business, the permitted percentage being chosen on arbitrary grounds. There are even examples of excess profits taxes being imposed at progressive rates as the profits increase.

Even if this procedure were logically justifiable it leads to a great deal of difficulty in defining and valuing the capital invested, except in the case of assets which have recently been bought new. The capital basis for an excess profits tax thus leads to technical difficulties and anomalies which seriously detract from whatever equity the tax possesses, so that it is desirable to avoid it so far as possible. In fact, however, there is no logical justification for taxing high profits as such, either in war or in peace.[1] On the contrary, wherever there is freedom of entry into an industry the existence of (temporary) supernormal profits is an essential economic indicator that there is room in the industry for more labour and capital ; to tax away the profits of enterprise in such circumstances is to hinder the optimum allocation of resources. It is another matter if the excess profits can be shown to be due to monopoly control, but even then

[1] It is, of course, an illusion to suppose that the shareholders of companies making high profits are themselves exceptionally wealthy.

it is doubtful if a high profits tax is the most effective method of attack.

Thus, so far as normal conditions are concerned, the arguments against taxing reserves at high rates hold with even more force against the taxation of high profits as such; in war-time it is normally possible to find a satisfactory base for an excess profits tax in the relation between pre-war and war-time profits, without requiring any capital valuation, and without including any pseudo-moral principles.

There are, however, some situations in which the excess over the pre-war profit does not give a satisfactory measure of the effect of the emergency on the firm. One of the most frequent is the case of the new firm, which before the emergency had not worked up its full profitability; the use of the pre-war standard would therefore lead to the taxation of normal as well as of abnormal expansion. This case can be fairly easily resolved by measuring excess on the capital basis, because most of the assets will be fairly new.

A more difficult case is presented by industries whose profits habitually fluctuate to an abnormal degree and which chance to have an unlucky pre-war standard; the capital basis is sometimes appropriate here also, but it is more difficult to apply. Still a third trouble arises with industries which exploit wasting assets—such as metal ores—and which may be forced to work the mines faster and more wastefully, as a result of the emergency demand for their products, than would be reasonable in the best interests of the concern. In this case an excess profits tax is in fact taxing capital as well as income. While this may be fully recognized by the government, it is difficult to give compensation on anything but a fairly conventional basis.

From these few examples it is apparent that an excess profits tax cannot easily deal fairly with all sorts and conditions of firms; it must be recognized that compared with a normal income tax it is a pretty crude and inferior affair. So long as the tax needs to be kept in operation it is therefore necessary to allow not only special reliefs for firms in awkward circumstances; but also to give the tax in general more flexibility than would be reasonable for a normal tax.

In Britain the most important element of flexibility has been the provision whereby the calculation of excess is readjusted in each accounting period for the whole duration of the tax up to that date, in exactly the same manner as the liability to income tax under the P.A.Y.E. system is adjusted from week to week over the financial year. This "suspense accounting principle" is a useful safeguard against hardship due to the sudden changes in the direction of government spending which are inevitable in wartime. It is not, however, completely satisfactory, because if prices rise during the currency of the tax (as they are extremely likely to do) the excess of money profits over the pre-war standard seriously overstates the excess in any real sense.

Thus even when all possible reliefs and flexibility have been introduced into an excess profits tax, it does not get good marks on normal criteria of equity. Its bad points are inevitably exaggerated by the very high rates at which it must be imposed, if it is to be effective in its primary purpose of control.

The fact that this rather crude tax has to be levied at very high rates is a more serious drawback in another respect; high rates stimulate evasion, the rough and ready methods of the tax make evasion abnormally easy; and however it occurs, evasion not only lowers the standard of equity still further, but almost certainly damages output. One direction in which evasion may be practised—due to the fact that the tax is expected to be temporary—is by reducing taxable profits through expenditure which has no relevance to the period of the emergency, but is designed to improve the firm's long period position. This is perhaps not so serious (because it does not damage efficiency in the long run) as other more casual methods of allowing costs to run up. The most damaging criticism of an excess profits tax is the way in which it removes all incentive to good management; and bad habits acquired in war-time are not so easily set aside when the emergency is over. For all these reasons it is desirable that the life of an excess profits tax should not be prolonged beyond the minimum period necessary for its primary task of control.

It will be seen from our analysis of profits taxes that the best way of taxing income (whether from work or property) is by means of a personal income tax. The more reliance is placed on the indirect method of profit taxation, the more the principle of ability to pay has to be sacrificed, and the more danger there is that the progress of the economy will be hampered by the failure of enterprise. Since, however, there is a limit to the tax quota which can be taken from earners without checking incentive, progressive personal income taxes are not indefinitely expansible. It is for this reason that countries with a heavy tax bill to meet are forced to rely increasingly on capital taxes.

CHAPTER XIII

CAPITAL LEVIES AND CAPITAL TAXES

§ 1. *The Loss of Satisfaction Due to Income and to Capital Taxes Compared.* Besides taxes on net income and profits, whose case we examined in the last chapter, the other large category of general taxes consists of those assessed on the capital value of the taxpayer's wealth (or total property). Capital taxes share the advantage of income taxes over outlay taxes, that they can be closely adjusted to ability to pay; although it is difficult to adjust them quite so accurately, since like capital does not always yield equal income. There are also several other points in their favour.

The possession of capital gives its owner social and economic advantages—advantages both of security and of opportunity—over and above the income derived from the employment of the capital. It is no wonder that this "capitalist's surplus" as we may perhaps call it was early recognized to be a "proper subject of differential taxation" [1] and was, as we have seen, the subject of the first progressive tax in Britain.

Further, it is recognized that the greatest cause of inequality of incomes is inequality of inherited wealth; a policy of redistribution which does not make substantial use of progressive capital taxes will make but little headway against this factor. Finally, there is the consideration, which we have found to be important, that while high income taxes discourage incentive and enterprise and put a premium on evasion, capital taxes

[1] As suggested by J. S. Mill.

(even recurrent capital taxes paid out of income) are much less likely to have this effect, since the tax base is related to past action and not to present effort.

There is thus a good *a priori* case for capital taxes, especially where rates of income tax would otherwise be very high. Against this must be set one possible drawback which in the past attracted a considerable amount of attention. If capital taxes are not accompanied by a compensatory increase in real investment they may lead to "capital consumption"—a deterioration in the community's provision for the future, relative to its provision for the present. This will only happen if saving, equal in value to the taxpayer's loss of capital, does not take place somewhere else in the community—not a very probable state of affairs unless the capital tax is very heavy. In any case this is a long period consideration; if a serious degree of capital consumption did appear to be taking place it could always be compensated by new public investment. In normal times, in advanced countries at least, there may well be as much danger of over as of under saving.

Although the case for capital taxes would seem to be a good one from the point of view of the economy, we still have to take into consideration the taxpayer's preferences. If he were to be presented with a tax bill of a given present value, extending over the span of his life, how would he prefer to meet his liability? Our analysis of the loss of surplus arising from outlay taxes indicates that he would usually prefer a straight income tax to paying outlay taxes as a condition of enjoying a certain range of goods and services, selected by the government. Would he still prefer a straight income tax to paying over part of his property, while leaving his income relatively intact? This is the question to which we must now turn.

In investigating this question we are primarily concerned with once-for-all capital taxes—capital levies as they are usually called.[1] The unforeseen nature of a levy makes it inevitable that it should mainly be paid by disposing of assets. In all other cases the taxpayer has some opportunity of making provision out of income for his liability; thus the capital tax becomes more or less a species of income tax. The history of genuine capital levies which have actually been carried through according to plan is short; so if this were all with which we were concerned our question might seem rather academic in scope. Death duties, however, at least when imposed at the high rates now in force in Britain, have so much in common with capital levies that they can properly be included in the analysis of taxes paid out of capital.

Since the fact of liability to death duties is known in advance, it is possible for people to "pay" death duties out of income, more or less completely, by insuring the value of their property at death, *net* of the whole, or part, of the death duty liability. For owners of small or moderate estates the whole of death duty liability can be met in advance in this way; but owing to the sharp progression of the rates of tax on larger estates, their owners would not have enough left to support them during life if they attempted completely to discharge their liability in this way. People thus have the opportunity of treating death duties wholly or partly as an income tax; but the statistics clearly show that they do not take advantage of this opportunity; in fact it is very uncommon to insure against death duties. Hence it is quite proper to treat them as a capital levy.

[1] In practice arrangements generally have to be made for taxpayers to meet their levy payments in instalments, as forced sales would otherwise depress capital values unduly, but all the instalments depend on the single valuation.

The taxpayer's preference for a once-for-all levy cannot accurately be compared with his preference for an annual tax until we reduce them both to the same (either capital value or annual value) basis. Various methods of expressing death duty liability as an annual tax have been suggested. Most of them are primarily concerned with calculating the formal incidence of the death duty revenue collected in a particular period from particular income groups; we shall have to examine them later in this connection.[1] No method of expressing a capital levy as an annual tax can be completely satisfactory and free from arbitrary elements or assumptions, since with a tax paid out of capital we are concerned with the future, and the future is always uncertain. For the purpose of estimating relative preferences, however, what we may call the "income stream" method [2] seems to be the most satisfactory.

This method proceeds by expressing the expectation of death duties on an estate (not merely the liability when the present owner dies, but at all subsequent turnovers) as a perpetual stream of equal annual payments, and comparing the size of this stream (i.e., its present capital value) with that of a perpetual income tax.[3]

[1] See Chapter XVI, Section 2.

[2] Cf. N. Kaldor, "The Income Burden of Capital Taxes," *Review of Economic Studies*, IX (2).

[3] The principle of the calculation of the death duty stream is as follows: when someone inherits an estate he inherits with it a certain liability to future death duties. This liability can be regarded as a fixed charge on the estate (similar to a mortgage except that it bears no interest). If we call the value of the estate K and the rate of yield on it i, then the income derived from the property is Ki. If d is the fraction of the capital value payable in death duties, then Kdi is in the nature of a life interest for the present owner. After his death the estate will be worth $(K - Kd)$, and his successor will have a life interest $(K - Kd)di$, and so on, for future generations, with the estate getting smaller and smaller at each turnover. (It is possible, although more complicated, to allow for the fact that successive owners may add to the value of the estate during their lifetime.) It should be noted that

Let us suppose that the taxpayer is confronted with the alternative of a perpetual stream of payments in the form of death duties, which imply a gradual reduction in the value of the estate, and an income tax which leaves his capital intact. There must clearly be *some* rate of income tax which he would prefer to the necessity of handing on a smaller estate to his successor; hence there must be *some* rate of income tax (which we may call the "compensatory income tax") which would cause him an exactly equivalent loss of satisfaction. Is the present market value of this likely to be larger or smaller than the present market value of death duty liability? In the first place let us look at the matter the other way round. Suppose that the taxpayer is offered the choice between paying death duties or paying an income tax with the *same* present market value (which would be of equal value to the revenue authorities); we may call this the "equivalent income tax". Would this be larger or smaller in value to the revenue than the compensatory income tax?

The taxpayer's preference between income tax and death duties depends on the rate at which he discounts his death duty liability in order to estimate its present value to him. Now death duties, unlike any other tax, do not require any personal surrender of either income or capital by the present owner of property. It would seem likely therefore that the taxpayer will discount his future liability to death duties at a pretty high rate—distinctly higher than the market rate is likely to be. This implies

as the value of the estate shrinks, owing to the successive payments of death duties at each turnover, the tax liability on it (in respect of income tax as well as of death duties), is more than proportionately reduced, as it is pushed down into lower reaches in the schedules of progressive taxes. This is some compensation for the loss of capital value due to death duties.

that the estate owner's estimate of death duty value is lower than the value the market (or the revenue) would put on it; by market valuations death duties are undervalued by estate owners. Consequently, the income tax which has the same value to the estate owner (the compensatory income tax) will be worth less to the revenue than death duties (or the equivalent income tax). The government can obtain better value by imposing death duties, than by imposing an income tax which inflicts the same loss of satisfaction on the taxpayer.

Are the taxpayer's reactions to a once-for-all levy to be paid during his lifetime likely to be similar to his reactions to death duties? We can say pretty definitely that they are not. Paying the levy involves some loss of income, but much more importantly it implies a sacrifice of opportunity and security. It is likely that most taxpayers would be prepared to put up with a pretty stiff income tax which would leave their "capitalist's surplus" intact during their lifetime. Consequently, it is probable that the gain to revenue from the compensatory income tax would be higher than the gain from the equivalent income tax (which implies the same benefit to the revenue as the levy).

We may thus conclude that death duties are superior to an income tax, in the sense that the government can raise a given revenue by means of them, with a smaller loss of satisfaction to the taxpayer than by an income tax. In the same sense a capital levy, taken in the lifetime of the taxpayer, is inferior to an income tax. A government which insists on imposing a levy when it might impose an income tax, is throwing away the opportunity of raising a given revenue in a manner which would cause less loss of satisfaction to the taxpayer.

§ 2. *The Economic Effects of Capital Taxes and Levies.* We have seen that it is possible to reduce a single capital payment and an income tax to the same basis, with sufficient accuracy to make a sensible comparison of taxpayers' preferences. The economic effects of death duties can be directly compared with those of an income tax, because death duties are a regular part (and in fact a very stable part) of the revenue. For the economy as a whole their effect is that of an annual tax and not of a once-for-all levy. Although death duties are mainly paid out of the capital of the estates concerned, the annual savings of the community are more than sufficient to absorb any assets that have to be sold in order to discharge liability, without causing any decline in the value of the national capital, so that for the economy as a whole death duties are paid out of income, not capital.

The economic effects of death duties *per se* are thus those arising from the greater equality in the distribution of wealth which is gradually brought about by the operation of the tax. This more egalitarian distribution is in accordance with ideas of social justice, and on the whole, it is not likely to have unfavourable economic repercussions, in that it promotes stability in consumption. It has been common to attribute to death duties difficulties which small businesses have sometimes experienced in raising capital for expansion. It may well be that there is a gap in financial institutions at this point,[1] but if so death duties are only partly responsible; the altered position of the small firm in the economic structure must also be taken into account; and further, the effect of surtax in reducing the private funds available for direct investment.

[1] As was cogently argued by the Committee on Finance and Industry (Macmillan Committee), Cmd. 3897 of 1931.

A more substantial case against death duties can be made of their effect on agriculture. The limited marketability of real estate may lead to losses in capital value, when it has to be sold in order to pay death duties; losses which would not occur in respect of more liquid forms of capital. Only a small part of the undoubted decay in farming capital which has taken place over the last two generations can reasonably be imputed to death duties; and besides, this is eminently a case where full compensation, from the social point of view, could be provided by public expenditure.

The economic effects of a once-for-all levy, imposed in the lifetime of the taxpayers, cannot so easily be stated. They depend to an enormous extent on the particular circumstances of the time and place—on political and fiscal circumstances and institutions, as well as on economic conditions. A levy requires very expensive administrative machinery, so that to be worth while from any but the purely political standpoint, it must be large enough to bring in a really effective revenue. A levy thus amounts to a major surgical operation on the body politic; it will be either a kill or cure, and very different in its effects from the regular dosage or massage applied by the normal tax structure.[1] In most levies that have been attempted or planned, the order of magnitude has been sufficient to swamp most of the effects of normal public finance for the time being.

[1] In a plan for a levy, prepared by the British revenue authorities for the Select Committee on War Wealth, after the war of 1914–18, the number of levy payers was estimated at five times as many as the number of estates on which death duties were paid in any year, in spite of the use of a relatively high (£5,000) exemption limit. The *amount* of capital to be surrendered at the rates proposed was estimated to be thirty to forty times as much as the amount annually surrendered in death duties. Cf. Hicks and Rostas, *The Taxation of War Wealth*, *cit.*, pp. 253–5.

In principle the initial effects of a levy are expected to be deflationary, if only because of the disturbance to business programmes and capital markets caused by the spate of capital transfers which the levy calls for, in order for the levy payers to obtain liquid funds to discharge their liability. For this reason in the immediate aftermath of war, it is common that a levy should be proposed for the purpose of combating the tendency to inflation, which is an inevitable legacy of war finance. In practice levies imposed in these circumstances may not have the desired effect, but rather the opposite ; this was certainly the experience of almost all the countries which attempted levies in the 'twenties.[1] If, as normally happens, loan facilities have to be made available for levy payers to discharge their liability in a form that is manageable for the government, and if in fact a considerable part of the levy is thus paid out of new borrowing, the effect will be anything but deflationary. It is as little likely to be so as a levy actually imposed in war-time.

The main reason why the levies of the 'twenties turned into violently inflationary measures was, however, the failure of governments to impose adequate exchange control, so that capital flight put the governments to the necessity of increasing their own borrowing (either by loans, or more likely by expanding the note issue), at an ever faster rate, in order to cover their current needs. Even with better machinery for exchange control levies are difficult tools to handle ; and it is desirable to be certain, both that the objects they are designed to achieve are really necessary and that they are not attainable by gentler methods.

Capital levies are exceptional remedies, it is only exceptional emergencies which bring them into the fore-

[1] Cf. *The Taxation of War Wealth*, *cit.*, Chapter XXIII.

front of discussion. During the emergency itself to carry through a levy would in any case be impracticable, and it is generally recognized that it cannot safely be used for current purposes, even in war-time. Once the emergency is over, however, a levy can very reasonably be suggested as a means of ridding the country of the millstone of debt which has been accumulated during the emergency.[1] When a levy is advocated as a means of paying off a large part of the National Debt there are really two arguments involved, one that the *capital* of the debt is too large, the other that its *annual cost* is too high.

It cannot be regarded as self-evident that it is desirable to repay a substantial part of even a very large national debt, when we reflect that the destruction of such a large amount of private property must necessarily have very disturbing and deflationary effects at the time when the operation takes place. The question of whether, and when, it is desirable to make an exceptional effort to pay off debt, involves the whole policy of public finance and its relation to the national income; consequently, it is a question which we must discuss more fully at a later stage.[2] The argument for a levy on the grounds of the high annual cost of the debt (in terms of the income tax necessary to finance it) rests on a more substantial basis. The case for the levy is essentially the case against a high income tax, and that as we have seen is a good one.

If the object of a levy is to permit a reduction in income tax, its efficiency must be judged by the extent to which the repayment of debt would cause a net saving in the revenue bill. For a levy of any given structure this

[1] A levy may also be desired as a means of inflicting a tardy justice on war profiteers. A levy which is *confined* to the increment of wealth during the emergency cannot be expected to cover its cost, so that in practice an increment levy is generally accompanied by a general levy on wealth.

[2] Cf. especially Chapter XIX, Section 3.

depends on three factors: first, the rate of interest which has to be paid on the debt (determining the revenue required to service a given volume of debt, and consequently the revenue saved by paying it off); secondly, the extent to which debt interest is subject to income tax, and the capital of the debt is held by income taxpayers (determining the extent to which debt holders will furnish their own interest by their tax payments); thirdly, the extent to which the revenue normally relies on progressive taxation (income tax and death duties), since the revenue from these will be heavily reduced with the disappearance of the debt as a form of taxable property, and its interest as a source of taxable income.

In Britain it so happens that all these factors are now unfavourable for a levy. Interest on the National Debt is subject to income taxes, and as we know, the revenue is very dependent on progressive taxes, so that the loss of future receipts from surtax and death duties would be heavy. Consequently, the repayment of even a large amount of debt (say, 50 per cent of the capital) would permit only a moderate reduction in income tax.[1] In the 'twenties fiscal conditions were more favourable for a levy than in the 'forties, since the average rate of interest on the debt was substantially higher, and the progression of taxation less steep. It is probable, however, that political and psychological resistance to a levy would have been more serious a generation ago than they would be to-day.

With given fiscal conditions and distribution of debt

[1] Figures are not yet available for making a precise estimate relevant to the 1940's. In the *Taxation of War Wealth* an estimate was made on the basis of the 1938 distribution of wealth and structure of income tax; the net saving in income tax did not exceed 6*d*. in the £. In conditions of the 1940's, the continued fall in interest rates and rise in tax progression implies that it would be considerably smaller. Cf. Hicks and Rostas, *op. cit.*, Chapter XXIX.

holdings, the amount of saving in the revenue bill which a capital levy would permit depends on the structure of the levy—the height of the exemption limit and the steepness of its progression. The lower the exemption limit is set, and the milder the progression, the greater will be the reduction in rates of progressive taxes which can be accomplished when the debt service is reduced by the repayment of the principal. This is because a surrender of capital by citizens from whom the government derives only a small part of its surtax and death duty receipts, will not seriously eat into the future revenue from these taxes. Even in British conditions a *proportional* levy might permit a substantial reduction of income tax, of the order of about double the reduction which could be accomplished by a levy whose progression was comparable with the present progression of death duties. A proportional levy might, however, not be in accordance with ideas of social justice. It would be equivalent to a reduction in the progression of the tax structure, from the time of the levy, until such time as capital losses could be made good by new saving.

§ 3. *The Technique of Capital Taxes and Levies.* We have yet to consider the technical problems involved in the assessment and payment of a levy, assuming that conditions are favourable (especially that the levy is accepted by capitalists), and that it has been decided to impose one. So far as assessment is concerned the problem differs only in degree from that of other capital taxes, such as death duties. The fundamental obstacle to all capital taxes—and indeed all property taxes—is the difficulty and expense of finding fair values (normal selling prices) for the property involved.[1]

[1] For a more detailed examination of valuation problems, cf. Hicks and Rostas, *op. cit.*, Chapter XXVIII.

In respect of British death duties indeed a reliable and equitable technique of valuation has gradually been built up. Valuations are made on the basis of executors' returns, checked over by Inland Revenue officials. A substantial proportion of property consists of securities quoted on the stock exchange, for which, in normal times, reliable selling prices can easily be obtained. Professional valuers are available for household effects, antiques, jewellery and the like. More serious difficulties are met with in valuing real estate, but by far the most serious of all are concerned with the values of shares in (or assets of) small businesses. In many cases values are only agreed (and consequently liability determined) after prolonged negotiation between accountants, executors and the Inland Revenue.

Yet valuation for death duties is a relatively simple matter. The number of estates falling in year by year is fairly stable; and in most years capital values are sufficiently steady to ensure that no greater hardship will arise if liability cannot be determined for some little time after the death has occurred. If the methods of valuation employed for some types of property are not always very perfect, at least the owners of the estates are no longer there to complain, and comparison with similar estates is not easy. There is every reason to believe, however, that, by and large, the revenue from British death duties is collected with as much equity and economy as that of any other tax in the structure.

Few of these favourable technical factors will usually be present when valuations for a once-for-all levy have to be made. In the first place the very magnitude of the task implies that experienced valuers cannot be available in sufficient numbers (either for the government if it makes the valuations itself, or for the property owners if they are required to make returns) for the valuation to be carried through within a short period. This is serious because the levy is likely to be imposed in conditions of anything but stable values. Besides enhancing the difficulty of determining fair values, rapidly changing prices cause great inequity between those who discharge their liability early and those who postpone payment as long as possible.

Even when the problems of valuation and assessment have been surmounted, there remains the difficulty (negligible in the case of death duties) of absorbing the transfer of a very large amount of property without necessitating forced sales; and a consequent change in the relative values of different types of property, if not a general fall in values. If levy payers hold war loan in sufficient amounts to cover their liability, the transfer problem is relatively simple; but this is a most unlikely state of affairs; and even then they may not be prepared to part with their most liquid asset. Thus the government will have to make arrangements for a number of alternative methods of payment; and may even have to be prepared itself to take over temporarily all sorts of heterogeneous property, in order to support values in the interests of the community.

In view of these difficulties, when a levy has been decided upon, there is a strong temptation to resort to less exacting methods of valuation and to be content with low standards of collection. Thus, instead of attempting to find market prices, property values may be "presumed" from income—often on the basis of income tax returns which are themselves far from perfect [1]; and in order to

[1] Of this method of valuation the British revenue authorities remarked (in the memorandum referred to above, p. 238): "To call the result a capital valuation would be an abuse of language."

get some revenue in quickly an amount of evasion is condoned which would not be tolerated for regular taxes.

If a levy has to be thus debased in order to carry it through, it can confidently be affirmed that it would have been better not to have attempted it. Acceptance of a lower degree of equity than would be tolerated in other taxes may damage the whole standard of the financial administration; a bungled levy may easily have the reverse of the intended effect, both politically and economically; and serious delays in collection imply a prolonged uncertainty overhanging the business community, which is at least as likely to damage enterprise as an income tax.

§ 4. *Capital Taxes as an Alternative to High Income Taxes.* So long as the main object of the levy is the avoidance of high income tax, rather than a reduction in the principal of the debt (an object with which we are not here concerned),[1] it is desirable to consider first whether it is not possible to lighten the incidence of income tax on enterprise and incentive (at a given rate of tax), by altering the method of assessment. We have seen that there is considerable room for improvement in this respect in British income tax. In principle a still more eligible alternative to the levy would be a small annual tax based on capital values. Although this would doubtless mainly be paid out of income, it should be decidedly less restrictive than a normal income tax bringing in the same revenue since it would only be very loosely related to effort. The obstacle to this alternative in practice is again the expense and difficulty of valuation.

If the capital tax is not to sink below the standard of the rest of the tax structure in equity, not merely would

[1] But see Chapter XIX, Section 3.

all property have to be valued at estimated market prices by death duty methods, as for a capital levy; but valuations would have to be kept in line with economic conditions by periodic revisions—say, every five years. The expense of revaluation has always been the stumbling block with property taxes, even with simple taxes on real estate such as the British local rate. For a tax on total capital the operation would be enormously more complicated, and any failure to carry out revision would lead to much greater inequity. Thus the capital tax must be awarded very poor marks on grounds of economy, or if it is assessed by cheap, rough and ready methods, on grounds of equity.

As with a levy, so with a capital tax, it is only too likely that an easy way would be sought out of the valuation problem; and in practice the tax would come to be restricted to particular forms of property, perhaps mainly to real estate, or where an effective income tax exists, to stock exchange securities. Most actual property taxes were in original intention capital taxes. While there is a place in a tax structure for an annual tax on real estate,[1] to impose an additional levy on a particular form of property for a purpose which it could not achieve, would be worse than useless. Moreover, some of the objects of the capital tax could be achieved by a much simpler method—by introducing (or increasing) the discrimination against income from property which is already a feature of some income taxes.[2]

A high rate of tax progression inevitably gives incentive for evasion in the upper ranges; so far as this is "illegal" there is no remedy for it beyond greater vigilance on the part of the revenue authorities; so far as it is "legal"

[1] See Chapter XV, Section 5.

[2] The "earned income allowance" in British income tax (see p. 213) in practice has this effect.

it must be the endeavour of finance ministers to stop up every possible loophole by gradually improving the structure of the taxes. So far as surtax is concerned the greatest danger lies in the substitution of capital gains for income [1]; in the case of death duties the main trouble is the gradual reduction in the size of the estate before death by gifts *inter vivos*.[2] In principle a promising method of counteracting both these types of evasion would be to extend death duties to cover all gifts and transfers of capital.

To some extent this has already been done in the United States, where realized capital gains are taxed in the Federal income tax, and a small revenue is derived from gift taxes, collected at the same time as death duties. As it has been worked up to the present, the tax on capital gains has been most unsatisfactory. In the first place there is not an equivalent relief for capital losses; but much more important than this is the injustice which may be inflicted on small investors. A company may suddenly decide to distribute a bonus. This may well be to the advantage of the large investor, who will thereby evade surtax; but it has the incidental disadvantage that the small man has to pay a higher effective tax than he would otherwise have paid. This is an illustration of the difficulties which arise when income tax is not confined to true income.

Although a capital transfer tax would be more equitable if the assessment were entirely separated from income tax, the connection between the two taxes would inevitably

[1] Cf. p. 207. A famous loophole only recently stopped up was the process known as "bond washing". Bond holdings were disposed of when the price was high because interest was shortly due, on the understanding that they would be bought back again when the coupon had been detached, i.e., at an "ex div." price.

[2] Gifts within five years of death are now included in the estate for British death duties. This safeguard is hardly yet sufficient.

be close. The rate of the capital tax would need to be adjusted to total wealth, which could most easily be deduced from income tax returns, with the requirement of such additional information as might prove necessary. It would be necessary, for instance, to obtain statements not only of total securities and real estate (as at present) but of all capital transactions during the year. These should be obtained from both sellers and buyers (or donors and recipients), since it would be in the interest of those parting with the capital to supply information.

If this method of procedure proved feasible it would probably be unnecessary to use elaborate valuation machinery. Most of the transactions would be of the type for which stock exchange valuations are readily obtainable; and unless the progression of the tax were very steep (which would probably be impracticable in any case) an exact computation of total wealth would be of secondary importance. Nevertheless, ample provision would have to be made for checking doubtful returns, and the process would be much less simple than the corresponding check for income tax.

It may be doubted whether the revenue from a capital transfer tax would ever be sufficient to permit much reduction in rates of British surtax. The case for it must rest on its power of stopping evasion from surtax and death duties; and the methods which would have to be used for assessing and collecting do not inspire confidence that it would not itself be subject to a high degree of evasion. How urgently additional means for preventing evasion of progressive taxes is required, only the revenue authorities can estimate. It is well to recognize nevertheless that, in spite of the high degree of efficiency which has been achieved, the British system of direct taxes is by no means perfect.

CHAPTER XIV

OTHER TAXES WITH GENERAL EFFECTS

§ 1. *Taxes on Overheads.* When we were discussing the method of tax analysis, we saw that there were some taxes, which, although they were imposed on particular ways of enjoying or spending wealth, were of such transcending importance in the economy as to influence directly the factors determining the size of the national income. Such taxes require a general analysis, in addition to the partial analysis normally appropriate to outlay taxes.

Possible varieties of such "general" outlay taxes are those formally assessed on an important domestic overhead (such as a tax on houses and land), or on consumption in general (such as a non-selective sales tax), on the one hand; on the other are taxes formally assessed on production, either on general industrial and commercial overheads (such as a tax on factories and business premises) or on running costs (so-called gross income taxes and turnover taxes and wage taxes).

We have already noticed [1] that if it is assessed at a high poundage the British local rate will affect building adversely, and so will influence the general tempo of investment in the economy. A similar effect on building is likely to result from any real property tax, except one imposed only on the increment of value of a site due to the increased demand for its services.[2] This is an

[1] Cf. Chapter XI, Section 3.
[2] *Ibid.*, Section 4.

exception which, in settled countries, exists in textbook theory rather than in the real world.

We need not repeat here the analysis of the effect of changes in real estate taxes on the tempo of investment; we have seen that in respect of a tax on house property the adverse effects of a rise in tax can be largely compensated by means of housing subsidies. In the case of industrial and commercial buildings, this particular policy cannot so easily be put into effect, but approximately the same result can be obtained by appropriate rebates in the income tax on undistributed profits for reserves which are applied to specified new building.[1] In Britain, so far as industrial buildings are concerned, any restrictionary effects of high local rates must have been eliminated by the scaling down of rate liability by 75 per cent under the derating provisions of the Local Government Act, 1929.

So far as commercial and office buildings are concerned, there has been no parallel relief. It is tempting to see the effect of high rate poundages in restricting new building on business account in the very extensive transfer which took place in the 1930's, of buildings which had hitherto been dwelling houses, to office and warehouse use. It was this movement apparently which enabled the distributive trades to finance a very large expansion with remarkably little new investment.

In general such a transfer of the purpose of a building is not a movement which the community should encourage. The need for additional dwellings is likely to remain high for a considerable period, and if premises conveniently situated in the centre of towns or in the inner suburbs can be divided and converted to modern housing standards, it is in many ways preferable to further extensions of the

[1] Cf. pp. 225-6.

outer suburbs. On the other side house property is seldom convenient for business purposes. This effect of local rates on building could be counteracted either by inducing firms to build afresh for office and warehouse purposes, by means of appropriate income tax rebates, or by a subsidy for the division and modernization of dwelling houses.

§ 2. *The Incidence of Social Insurance Contributions.* In Britain the most important tax on current outlay is comprised in the social insurance scheme; in considering British conditions it is necessary to distinguish between the employees' and the employers' contributions. Although we have decided that the employees' contribution must be classed as a tax because of its compulsory nature (and is consequently a poll tax on earnings), it cannot have the same effect as an income tax of similar magnitude and income distribution. It is overwhelmingly probable that in the absence of a State insurance scheme the majority of workers would insure themselves voluntarily at comparable rates for the same purposes. Thus the distribution of family outlay can only be altered to a very small extent by the existence of the compulsory scheme.

In so far as the employees' contribution has general tax effects, so long as the scheme was confined to the "under £250" class, they were those of an outlay tax rather than of an income tax of the type familiar in Britain; that is to say, the incidence of the tax was on consumption rather than on saving. This effect was intensified by the fact that the contributions, being uniform, are regressive against income, falling more heavily on the unskilled workers who save less, than the more highly paid members of the scheme. As the insurance scheme is extended to the whole community the incidence will naturally become more like that of an income tax.

Economically the incidence of the employers' contribution is more interesting. To the employer his contribution to social insurance is equivalent to a rise in his wage bill; this rise he will incorporate in his selling prices, so that for the economy as a whole the tax leads to a more or less proportional rise in prices. If for example, we suppose that the employers' and employees' contributions are each 4*s*., we may regard the payments as equivalent to an all-round rise in wages of 4*s*. accompanied by a charge on the workers of 8*s*. Since the funds are distributed in income transfers, however, incomes rise *pari passu* with prices; consequently the net effect on employment and real incomes of a rise in contributions is likely (by the familiar Keynesian analysis[1]) to be zero —there being nothing in the change which is likely to affect dispositions to save or invest.

This absence of important effects of the employers' contribution refers, however, only to the internal situation. The short term effect of a rise in social insurance contributions is to raise British prices relatively to others, and so to cut down exports; at the same time the rise in employees' incomes due to the extra benefits may stimulate imports, so that the balance of payments is weakened, perhaps from both sides. The stimulus to imports is likely to be greater the more closely the system is confined to working-class incomes, since a larger part of higher incomes is probably devoted to expenditure on the services of home labour, and less on additional food and other imports.

[1] Cf. Keynes, *General Theory of Employment*, Chapter XIX.

§ 3. *Other Taxes on Prime Costs.* The other big group of taxes which we have to consider is that consisting of the so-called gross income taxes, turnover taxes and general sales taxes. In the crisis of 1930 taxes of this nature were very widely imposed both in Europe and America, but Britain weathered the budgetary storm by other means. The British war-time purchase tax, however, belongs essentially to the same class of tax, although its general effects are very much damped down by the exemption of food and of utility products.

Whatever they may be called, and whatever the differences of detail, these taxes are essentially similar in effect. They are regarded by producers as additions to costs and are added to selling prices. The loss of producers' and consumers' surplus which eventually results, will be determined in each case by the elasticity of the demand curve facing the producer, in the manner which we have already analysed with reference to partial taxes on outlay.[1] It is not this result, however, with which we are here concerned, but with the effect on the economy of the general rise in prices, and consequent fall in real income, which follows the imposition of the tax.

Whatever the details of the tax, it must impose some check on consumption, and as a result some check on investment, in the whole economy, relatively to that resulting, for instance, from the imposition of a net income tax bringing in the same revenue. This is due to the fact that the incidence is on spending rather than on saving. The check to consumption and investment will be the greater the more temporary the tax—or its new rate—is expected to be (up to the present taxes of this nature have mainly been regarded as emergency measures). If, however, the tax is expected to be very temporary,

[1] Chapter IX.

investment for the remote future may be stimulated, while more immediate opportunities are neglected. In a federal constitution when taxes of this nature are adopted by the constituent States, additional complications and costs may arise through the distortion of production or marketing channels in order to by-pass high tax States. This phenomenon was illustrated in the United States as a result of the State sales taxes imposed for the purpose of supporting local budgets in the crisis of 1930–31.

If the tax is imposed as a sales (or purchase) tax, it probably implies that the revenue is collected from the wholesale or retail stage of the productive process, this constitutes a small improvement on the tax on turnover. In the first place, the later the stage of production on which the tax is assessed, the smaller the opportunity for a " pyramiding " of the tax by adding a fixed percentage to selling price at each productive stage (on an ever-expanding base), in order to recover the cost of the tax from the next purchaser.[1] If attention is not paid to this phenomenon by the administration, the prices of some goods may rise by very much more than the amount of the tax. Secondly, if the tax is assessed only on the merchanting stage, there is much less opportunity for inequity as between small and large firms, due to differences in the degree of integration, than if the tax is assessed on turnover in general. From all this it follows that before attempting to assess the incidence of any particular tax, consideration must be given to its administrative details.

A tax assessed on the merchanting stage of production has the additional advantage over other varieties of general taxes on running costs, that a rebate can be allowed on goods intended for export. Apart from this

[1] Cf. the analysis of the taxation of a monopoly, Chapter X, Section 4.

consideration, taxes of this nature, as contrasted, for instance, with social insurance contributions, tend to stimulate exports (by reducing the home demand for home produced goods), without stimulating the demand for imports—since consumption as a whole is cut down. A general sales tax may thus be of some assistance in strengthening a weak balance of payments.

As has already been said, it is doubtful how far the British purchase tax, with its wide exemptions, can have important general effects, and still more doubtful whether it could have an appreciable effect on the balance of payments in a period of unrestricted consumption; it all depends on the rate at which the tax is imposed on different commodities. In most circumstances as good a result on the balance of payments could probably be obtained from a proportional tax on wage earners' incomes, which would be both more in accordance with ability to pay, and would almost certainly lead to less loss of surpluses. As we shall see later, however,[1] a tax of the nature of the purchase tax may be a convenient weapon to have in reserve for the control of consumption in cyclical conditions, because like all outlay taxes, reactions to it are extremely rapid, while unlike most other outlay taxes it is administratively flexible.

[1] Cf. Chapter XVII, Section 4.

CHAPTER XV

THE THEORY OF LOCAL TAXATION

§ 1. *The Financial Problem of Federalism and Local Government.* Problems of local finance and its relation to national finance are of universal concern to the countries of the world. In many European countries the development of strong local government has been an essential part of the growth of the modern state at some of its most formative periods, dating from the time when the great cities, managing their own affairs to a very large extent, found it in their best interest to ally themselves with the national government in the common fight against feudalism. In the Dominions and in America, national governments mainly came into being as the result of the voluntary union of what were in origin separate and independent settlements ; the form of constitution which emerged was consequently more or less federative, in contrast to Europe where the unified state became the most usual pattern.

In the modern world, in spite of this basic constitutional difference, the problems of central/local finance in a unitary state and in a federation differ in degree rather than in kind. Nevertheless the varying degrees of political unification in different nations—reflecting differences in physical conditions and in social outlook, as well as differences in political origin—imply considerable variations in the relation between central and local financial institutions. Broadly, three main political types, with their corresponding financial arrangements, can be distinguished. Examples of all three have long existed, without there being (at least until recently) any marked tendency for them to change or merge.

At one extreme is the effective federation [1] in which the powers of the member states are very wide—whether or not they actually possess residual constitutional rights—and their tax powers are correspondingly ample. In these conditions national and regional governments frequently have overlapping tax rights, and much competition and confusion may result. With modern revenue pressure, however, it is becoming apparent that the struggle is an unequal one; sooner or later the national government must seek to increase its hold on the tax structure, because it is responsible for the fundamental duty of defence in war-time, and in normal conditions, for the economic well-being of the nation. These are services whose finance must be subject to no obstacles.

At the other extreme is the closely unified state, which is by no means necessarily a dictatorship, but is nevertheless one in which local government has very little independent life of its own. Local authorities may indeed be chosen by popular election, and may nominally possess considerable tax powers, but in practice they are subject to the agents of the central government, and so are not effectively in control of the manner in which the revenue they collect is laid out. Typical of this arrangement is the so-called "prefectorial" system widely established in Europe by Napoleon, and still surviving more or less intact in a number of countries (especially France and Italy) up to 1939. Under the prefectorial system, although the local authorities are democratically elected, they exercise little real power, partly because they are only very intermittently in session, but mainly

[1] Although it is formally a federation, the political and financial institutions of the U.S.S.R. conform more closely to those of a highly unified state than of a federation.

because their decisions and their budgets are subject to veto by the prefect.

Mid-way between these two extremes comes what we may term the Anglo-Scandinavian compromise, a situation in which room is found within the confines of a unitary state for a considerable degree of local autonomy, exercised by local representative bodies, more or less continuously in session. Supreme constitutional powers remain with the central government, and the subordinate governments cannot function outside their permitted sphere, or levy taxes to which they are not specifically entitled. Nevertheless, the line of demarcation between central and local functions is not usually rigid. In Britain, for instance, the local authorities have from time to time considerably increased the scope of their powers through the medium of private Acts of Parliament.

Although these three types of central/local organization have long existed, in the inter-war period they were all subjected to an increasing amount of pressure and criticism, the net result of which has been, in almost every case, to increase the hold of the central government. The most striking example of this process was, of course, the Gleichschalting of Nazi Germany, reflected in a milder form in her satellites; but in the United States and in the British Dominions the strain, first of the war of 1914–18, and then of the unprecedented boom and depression of 1928–31, led to a very remarkable increase in the influence of the national government. The federations have thus been drawing nearer, in fact if not in law, to the British type of organization. At the same time there have also been powerful centripetal forces at work in Britain, whose effect has been intensified by the greater central and regional control found necessary for war purposes between 1939 and 1945.

. This increasing pressure of national governments makes it necessary to examine afresh the questions of central/local relations. Although the Anglo-Scandinavian compromise has behind it an impressive record of the development of social services on the one hand, and of political stability on the other, the basis of local autonomy on which it rests is to-day seriously questioned.

§ 2. *The British Local Authority—Rates and Grants.* The historical development of British local government has resulted in a present central/local financial arrangement which is so singular that it hardly seems possible that it should work satisfactorily. In normal times the greater part of the national Budget is devoted to social expenditure, but instead of itself spending the money provided out of national taxes for this purpose, the central government hands over the revenue to other organizations for disbursement, with no more than general directions of principle as to the way in which they should act. Thus unemployment pay has been under the control of the Assistance Board (which may, however, be regarded as the Ministry of Labour in disguise); National Health Insurance as first established was paid out—together with funds derived from their members—by privately-owned Friendly Societies.

More important than the organization of these social transfers, is the arrangement whereby the administration of practically the whole of the remainder of the social services, and traditionally by far the greater part of public investment, has been in the hands of the local authorities—county boroughs, administrative counties and county districts, in all more than 1,300 separate bodies. From the point of view of local finance this implies that the greater part of expenditure is concerned with social services, but only about half of the funds are derived from local taxation. The difference between the £376 mn. which local authorities were spending on current account in 1938 and the £211 mn. which they raised in rates was bridged by grants from the national Budget.

The roots of the present British local finance system stretch a long way down into history. In the twelfth century local communities were already raising a "rate" to provide local amenities and works—bridges, embankments and the like.[1] By the reign of Elizabeth all parishes were compelled by Parliament to levy a rate for the relief of the poor in their area, and by this time local communities were also carrying out other services for the national government, especially in connection with the administration of justice. Alongside of the growth of central government in the sixteenth and seventeenth centuries the activities of local communities also expanded. The modern development of city government may be dated from the establishment of "Improvement Commissioners"[2] in certain towns in the eighteenth and early nineteenth centuries, by means of private Acts of Parliament.

Parliament gradually took a hand in generalizing by national legislation the powers and duties thus obtained sporadically by local acts. At first as each new service was established on a national basis it was administered by a new series of *ad hoc* local authorities—e.g., the poor law guardians, highway boards, sanitary districts and school boards—but in the second half of the nineteenth century local government duties were gradually concentrated[3] in the hands of general, non-specialized

[1] Cf. Cannan, *History of Local Rates in England.*

[2] Thus the Liverpool Commissioners in 1744 obtained powers to carry out street lighting and cleansing, prevention of nuisances and control of vehicle parking.

[3] The latest of the *ad hoc* authorities to be absorbed were the Poor Law Guardians, in 1929.

local authorities, and the country was mapped out so that it was completely covered by a network of representative governing bodies. Although the number of separate jurisdictions was still large, this concentration of powers achieved a great simplification in local administration.[1] As a result of a further (*de facto*) concentration of function since that date, it is now sufficient for most practical purposes to take account of the activities only of the county boroughs and administrative counties, that is to say, to consider only about 140 different bodies instead of 1,300.

It will be apparent that almost from the first a local body was responsible for two different sorts of activities; those of its own choosing and those placed on its shoulders by Parliament. There was, however, no satisfactory functional difference between the two sorts of activities.[2] Services which enterprising communities took steps to provide for themselves were seen to be good for other places as well, and Parliament naturally wished that they should also be available for those who lived in less progressive—or less wealthy—neighbourhoods. Thus services which were in the first place provided voluntarily and sporadically tended to become universal and compulsory on local authorities.

As we have seen, the local rate was first used by local communities for the improvement of their own neighbourhoods, but following the precedent of the Elizabethan Poor Law, the additional services, when they were made compulsory, were also placed by Parliament upon the local rate. Clearly there was a limit to the possibility

[1] Strangely enough this concentration of functions has never taken place in the U.S.A. where local administration is in the hands of some 175,000 separate authorities, many with overlapping jurisdictions.

[2] Cf. the discussion of the onerous/beneficial distinction, pp. 278ff.

of financing additional services from a single tax—a limit made all the more definite (as we shall see later) by the special characteristics of the rate itself; but since the Treasury jealously reserved [1] for the national Budget the right to all other taxes, it was inevitable that sooner or later Parliament should come to the help of local finance out of its own resources. It is no accident that the first exchequer grant (1825) followed closely the enormous rise in the poor rate due to the Napoleonic wars.

A natural consequence of Parliament's wish to generalize services was that it should also desire to generalize *standards* of service. This policy calls not merely for grants in aid of average rate revenue, but for especially generous grants directed to those areas which are abnormally poor or whose needs in particular directions are abnormally great. Once this policy is accepted, grants tend to become not only larger but more complicated. Differential grants in this sense have been of gradually increasing importance in the education service since early in the present century. They were first given for general purposes in the Block grant, which in 1929 took the place of certain specific grants which had previously been given.

§ 3. *The Political Importance of Local Autonomy.* The sequence of events which we have followed *explains* the distribution of administrative and financial responsibility between the national government and the British local authorities, but does it *justify* either the one or the other? It is natural to ask whether it would not be better (granted that it is not practicable to enlarge the local tax

[1] The period of Goschen's "assigned Revenues" in the second half of the nineteenth century is only an apparent exception, the local authorities had no control over the rates of the taxes which were assigned to them.

base) to abolish the clumsy and perhaps dangerous apparatus of transfer of funds from the national to local exchequers, by transferring instead the administration of the services concerned to central control? During the inter-war period grants in aid from major to minor governments became increasingly important, not only in Britain but in many other countries, especially in the United States and the British Dominions,[1] so that the problem, although most pressing in Britain, is also of general interest. The problem is clearly one which has two sides, political and administrative on the one hand, financial and economic on the latter. Although we are primarily interested in the latter, the two are so inter-related that we cannot ignore political considerations altogether.

We have seen that local communities were already exercising a number of government functions for their own convenience at the time when Parliament began to develop public social services on a national scale. Parliament was thus taking the line of least resistance in putting the administration of the new services under local control; but in fact this policy was largely inevitable in the then state of transport and communications on the one hand, and of the primitive condition of administrative technique on the other.

Local administration has, however, traditionally had a deeper justification than mere technical convenience. In the services concerned with the individual citizen and his family it is clearly most desirable that the administration should possess local knowledge and understanding.

[1] Cf. H. J. Bittermann, *State and Federal Grants in Aid*; Hansen and Perloff, *State and Local Finance in the National Economy*; Report of the Royal Commission on Dominion-Provincial Relations (Canada); the Reports of the Australian Grants Commission are also particularly illuminating in this respect.

This especially concerns the administration of public assistance and public health. For other services, e.g., education and housing, it is equally necessary that the officers concerned should be familiar with local industrial and topographical conditions, if the citizens are to get best value for their money.

Local administration does not, however, necessarily imply local control of the executive officers. With modern communications and the development of the administrative machine it is possible—at any rate in a small country like Britain—for a decentralized national administration to pay just as much attention to personal and local needs as one that is locally controlled. In the inter-war period this was conclusively demonstrated by the success of the Assistance Board. This discovery has largely cut the ground from under the argument that in Britain social services require local control. Indeed there is an *a priori* case for supposing that the local branches of a central department will be more successful in providing uniformly good services than semi-independent local authorities.

From the other side it is argued that with the spread of urban development over the countryside, and the increasing habit of living in one place and working in another which it implies, statutory local authorities no longer have under their charge *communities* in any relevant sense. On the one hand neighbourhoods have ceased to be physically and psychologically distinct; on the other the traditional jurisdictions of the local authorities have become too small for modern life.

There is a good deal of substance in these contentions, and it is not surprising that they should be leading both to an actual extension of central functions and to a demand for the grouping of local authorities into larger "regional" units. It is further evident, on purely economic grounds, that for the successful maintenance of a high level of economic activity, either the national government must undertake (directly or through public corporations) substantial types of investment—for instance, housing and highways—or it must have available much greater means of controlling the timing and intensity of local investment than it has hitherto enjoyed. Thus it is inevitable that the status of local investment in the economy will be modified.

The traditional degree of local independence in Britain is thus threatened from several quarters. The threats are the more serious because they have the backing of the progressive elements in the country, the educationalists, the social workers, and all who put a high value on efficiency. Yet there remains one basic argument in favour of autonomous local government which has at least as good claims to consideration as efficiency. Moreover, it is an argument which the course of history is tending to emphasize rather than to weaken.

The convincing argument for the preservation of local autonomy—and hence for something like the present British local government set-up—is now almost wholly political. Recent history strongly suggests that the power of local initiative is a *sine qua non* of successful and stable democracy. The reason for this is that live local government ensures an active connection between the citizen and the executive. Complexity of political structure is actually a virtue because it multiplies the contacts between the governed and the governing. The danger of destroying these additional contacts was tragically demonstrated in France in 1940. To obliterate all traces of them has been a leading aim in the authoritarian states.

The spirit of democracy is in fact nothing other than the sense of political responsibility in the individual citizen. It is true that the democratic virtues can be fostered by many types of association, both social and occupational (trade unions and even choral societies); but the organization of local communities into associations which are political in the sense of being partly self-governing has a special virtue in promoting a sense of political responsibility. Local autonomy is a training ground for a far wider circle than the few who have ambitions to take a personal share in government.

The political argument for local autonomy is so strong that it is right that it should be given preference even at the risk of some loss of efficiency. It is necessary to consider carefully, however, with what type of autonomy the argument is really concerned. It is essentially an argument for the independence of local *communities*, that is, of groups conscious of common local aims and interests. It is obvious that in Britain such groups only exist on any scale that is administratively relevant in urban communities, although not necessarily only in the eighty-three major towns which at present enjoy the privileges of county boroughs. The political argument for local autonomy, at least in England, is thus fundamentally an argument for the independence of town government. In areas where no administratively convenient self-conscious units exist,[1] the argument for local

[1] The size of the satisfactory local unit probably differs considerably from country to country, according to the type and density of the population. In Scotland community life in rural areas seems to be stronger than in England, and the typical burgh is much smaller than the English town. It is quite possible that in Scotland—or for that matter in France, which is in many ways similar—independent administration of small county areas would work well. In the United States a population unit of 35,000 to 50,000 seems to find most favour (cf. Hansen and Perloff, *cit.*); on English standards this is rather low, cf. the minimum for independent privileges recommended by the Ministry of Health to the Local Government Boundary Commission.

independence is weak in comparison to the high probability of the greater efficiency which would result from national or regional control.

§ 4. *National Standards and Local Inequalities.* There is thus a fundamental dilemma in local government—of balancing the political advantages of autonomy against the economies of large administrative units and the social benefits of uniform standards in the social services. This dilemma, with all the complications to which it gives rise, is far from being a purely British phenomenon. It appears—and in a surprisingly similar form—in every country [1] which does not cut the knot by complete centralization ; it is particularly intractable in the great federations, because it is then on a two-layer basis—federal, state or provincial and local. It is especially important to find a solution in a country which wishes to follow a systematic policy of high employment.

The factor above all which complicates the solution is the disparity between local wealth and needs. In an advanced and well-educated country, like Britain or the United States, there is no reason to suppose that one town cannot produce as able citizens as another for the local council (remembering that we are primarily concerned with urban communities of a certain minimum size) ; or that *given equal financial opportunity* equal administrative and executive ability is not available to all local authorities. Minor differences, in ability and in tastes, are always to be expected, and do no harm. (For instance, if Manchester has a special interest in its education policy and Birmingham in its public health, that is a matter for

[1] Cf. Report of a " Conference on Problems of Reconstruction between the Birmingham Reconstruction Committee and Representatives of Some Cities of the Allied Nations ", Birmingham, April 1944.

congratulation and not for discouragement, so long as other services do not suffer.) There is no reason why such minor differences should have any systematic or lasting bias against the interests of particular citizens.

Unfortunately, however, financial opportunity is not naturally equal; local communities differ enormously in wealth from one another. Just how wide the differences are is not easy to determine. There is no completely satisfactory method of measuring local incomes when communities are interconnected, and many citizens effectively have dual local citizenship. In the United States regional differences can be roughly measured by means of data of income disbursements. In 1938–40 income per head ranged from $199 in Mississippi to $853 in New York State. In Britain no attempt has been made to estimate local income differences from income tax returns; the method of tax collection is not favourable for the attempt. If valuation for rates were made on a uniform basis throughout the country, rateable value per head would provide a very fair indication of relative wealth, but under present valuation practice it would do less than justice to the differences.[1] Some indication of the disparity between wealth and needs can be obtained by comparing rates per head, a calculation which allows for the equalizing effect of grants. Thus the same expenditure per head in 1938 required in Manchester a poundage of between 16*s.* and 17*s.* while in Eastbourne it called for one of only 9*s.*[2]

These rough figures reveal the dimensions of the problem, but give only a small indication of its complexity. Differences in local wealth are partly a matter of whole

[1] Cf. Hicks (J. R. and U. K.) and C. E. V. Leser, *The Problem of Valuation for Rating*, Part II, Chapter II, Section 1.
[2] Hicks (J. R. and U. K.), *Standards of Local Expenditure*.

regions being poor or rich together, or suffering more or less from booms and depressions. They are partly a matter of the decay or rise of particular towns, whose trend is not necessarily in accordance with the regional trend. A particularly intractable form of the problem to-day is the decay of heavily built-up areas near the centres of towns, as compared with the more modern and attractive suburbs. When the city bounds cannot conveniently be extended to embrace the suburban development, even an otherwise prosperous city may be tipped downhill financially. In all these situations the crucial point is that wealth is in inverse relation to needs; so that to finance a given standard of services requires not merely a greater expenditure per head in a poor than in a rich town, but a much more than proportionately higher rate of tax, if the service is to be financed by local resources.

The solution of the local government dilemma thus cannot be achieved by the national government merely handing over sufficient funds to local governments to enable them to reach a satisfactory average standard of performance, but not enough to destroy their initiative (i.e., giving them no incentive to practice laying out their own resources to the best advantage); it is something much more complicated. The solution requires the combination of a carefully adjusted differential grant system and a local tax system which minimizes the work which the grants have to do.

§ 5. *The Characteristics of a Good Local Tax.* Much less attention has been given to the consideration of the desirable properties of a good local tax than of a national tax; yet a little thought will show that they are by no means identical. It is, of course, desirable that a local tax should—like any other—be convenient and certain, fair between persons similarly situated and economical in collection. (This last is especially necessary since minor authorities cannot afford the skilled administration which is available to national governments.) But the position of local finance in the economy differs from that of central finance in several respects, and this affects the type of tax which is required.

Just as there must be a basic difference between the ultimate tax powers of national and subordinate governments, so there is a parallel, almost equally inevitable, difference in their borrowing powers. There is virtually no limit to the debt which a national government may acquire, so long as it retains the confidence of the citizens; the borrowing of subordinate governments on the other hand cannot be allowed to proceed indefinitely. It is not beyond the bounds of probability that a subordinate government which can borrow to an unlimited extent may be able to defy the policy of the national government and even break up the nation.[1] In a less critical situation than this, it is still very undesirable that a subordinate government should be allowed to drift into a position in which it is in danger of default (which might well occur if borrowing powers were unlimited). In a unitary state local default cannot be tolerated (consequently in Britain a fairly tight rein on local borrowing has always been held by some department of the central government, even when the loan was to finance equipment for a trading service). Even in a federation the whole basis of government may be compromised by the default of one of the members.

It follows from this that regional governments should practise more or less the "sound finance" which

[1] Cf. especially the conduct of the Confederate States in the American Civil War.

is proper to private enterprise (which implies incidentally that if a deficit in the whole public sector is required for purposes of economic policy, responsibility for it must be borne by the national government). The first necessity for a local tax is therefore for one that will help subordinate governments to keep their finances on an even keel, in other words for a tax whose yield is reasonably stable in good times and bad. Neglect of this principle brought the services of even first-class American cities to a standstill in the depression of 1930.

The second desirable quality in a local tax is that its base should be localized within the jurisdiction of the taxing authority; only then can local authorities enjoy effective autonomy, because only then can they have effective control over their own budgets. (It will be noted that under modern conditions an income tax fails to satisfy this requirement.) Localization of base, however, gives rise to a new difficulty. Owing to differences in wealth and needs, there is a real danger that a local authority which allows its rate of tax to become abnormally high will drive its taxpayers outside its jurisdiction. Such emigration will land the local authority in question in cumulative difficulties. Its overhead charges are rigidly fixed, and the possible economies in current outlay are strictly limited. This difficulty is especially serious when local jurisdictions are small, because small areas give small opportunities for averaging wealth, and large opportunities for emigration. From this difficulty two important considerations follow.

It is most desirable to have a local tax which does not exaggerate local disparities in wealth. This it will be noted, cuts out for local use progressive income taxes of the British type. Poor authorities could never hope to make both ends meet if they had to get most of their revenue from the few moderately wealthy people who alone would be likely to live within their jurisdictions. Further, the danger of stimulating migration implies that there is a ceiling in relation to income above which it is unwise to allow local tax quotas to rise. Although this is primarily a matter of relative tax rates in one area and another, the higher the general level of local taxation, the greater will be the absolute differences in inter-local tax liability. From these points of view a tax which is proportional, or even moderately regressive, is more appropriate for local purposes than a progressive tax, and should not be unacceptable on distributional grounds as long as liability is reasonably low in relation to working-class incomes.

Finally it is, to say the least, extremely convenient if the local tax can be reserved for local use. Basically the purpose of this is to ensure local autonomy; but on other grounds also it is very desirable to avoid overlapping tax rights between national and regional governments. When revenue needs are urgent, the major government must necessarily override the interests of the regional authority, and this leads to much friction, as well as to confusion in local budgets. In both Canada and Australia there was much heartburning on this account between 1939 and 1945.

Where interlocal differences in tax rates are large, overlapping rights may actually hinder the national government in the performance of its duties by driving up tax rates in some areas beyond the practicable limit (producing, for instance, income taxes of more than 100 per cent). Competitive exploitation of taxes is also a fruitful source of double—or even treble—taxation of the same income or commodity. Finally, competitive exploitation has the important distributional disadvantage that it makes it impossible for the central government to regulate the rate of progression of the tax structure.

In a unitary country it should always be possible to reserve local taxes for local uses, and yet allow local authorities sufficient control over revenue to ensure their autonomy. In a federation some overlapping may be inevitable if regional governments are to cover their legal functions, but it need not be extensive.

§ 6. *The Application to the British Local Rate.* Given these characteristics of a good local tax, we must next examine how far the taxes most frequently used for local purposes are appropriate for their task, and particularly the British local rate and its foreign counterpart the local property tax on real estate. In principle it will be seen that a tax on land and buildings (which is by far the most common of all local taxes) has much to recommend it. The tax base is unequivocally localized, and the yield is usually extremely stable. Stability of revenue is no doubt partly due to the fact that valuations tend not to be kept strictly adjusted to changes in wealth; but fundamentally it is due to the fact that real estate is a highly "illiquid" form of property; its "velocity of circulation" is notoriously slower than that of other forms of property, so that its value is less volatile.[1]

Secondly, land and buildings are much more "important" commodities in consumption than any others which are available for tax purposes, so that a

[1] This stability in yield seems to be much less fully realized in the United States than elsewhere. In the past revenue from the American local property tax has fluctuated enormously with changes in the level of economic activity. This appears to be mainly due to widespread defaults among property owners in depression (perhaps connected with unsatisfactory credit facilities); it may also be due to the relatively greater volume of land sales, and hence greater variations in value, in what is still, from many points of view, a new country.

given revenue can be raised with lower *per capita* taxes than by means of any other outlay tax.[1] Thus subordinate governments can raise a large independent revenue by this means without running their heads dangerously near the ceiling.[2] Finally, a tax on land and buildings is one which it should be easy for the national government to refrain from poaching on; for emergencies, just because of its stable (and consequently unexpansible) yield, it is very little use; for normal conditions there is no lack of tax sources with similar incidence. In the United Kingdom the local rate has always been left to the local authorities[3]; in the United States there has recently been a very marked tendency to leave the local property tax to the local authorities, so that the problem of overlapping jurisdictions and competitive exploitation is now practically reduced to the Federal/State plane.[4]

In spite of these obvious virtues it is common to find the local property tax the object of much criticism and opposition, especially in countries which put a considerable weight on it. Although the weight on the British local rate is not unreasonable,[5] it is not exempt from this criticism, so that we must inquire into its cause and validity.

An obvious objection to real estate taxes as they are commonly practised is the use of out-of-date valuations of the property to be taxed. This is partly due to the limited financial resources of minor governments especially where jurisdictions are small. The tax is not in

[1] Cf. the analysis, p. 171.

[2] This advantage also seems to be less fully realized in the United States than in Britain, perhaps because of the undermining of the American tax base with exemptions, see next page.

[3] The seventeenth-century land tax was essentially an income tax, cf. p. 138.

[4] Cf. the account of the U.S. tax structure, pp. 88ff.

[5] Cf. the estimates of formal incidence, pp. 291ff.

principle " uneconomical ", but it is rather difficult and expensive to determine the base correctly. Valuation is a skilled job, and a thorough revaluation requires the service of expensive personnel for a considerable period. Consequently valuations tend to be scamped, or postponed, until with the passage of time they become quite out of line with each other and with the facts.

Probably the best cure for this difficulty is to transfer the duty of *valuation* (but not, of course, of assessment or collection) to a central body, placing the cost on the national exchequer.[1] This would not only promote uniformity of valuation practice, and so enormously increase the equity of the tax, but would in itself tend towards equalizing interlocal financial opportunities (by removing from local financial shoulders an expense which is especially heavy in small districts), without in any way diminishing local financial autonomy.

Out-of-date valuations are an important cause of inequity in a local property tax, but they are not the only one. In the United States arbitrariness arises from (very varying) attempts to include movable property and even intangibles in the tax; the British local rate in the past went through similar troubles. There is no doubt that it is better to confine this tax to real estate, which can be taxed equitably with relatively simple administrative machinery; indeed many of the advantages of the tax for local purposes depend on its scope being thus limited. A still more important trouble (again illustrated in the United States) is the multiplication of exemptions from the tax, partly with a view to vote catching, partly as a concealed subsidy, e.g., to home owners. The result is to drive up the rate of tax against those who cannot

[1] Cf. Hicks and Leser, *The Problem of Valuation for Rating, cit.*, Part III, Section 2.

claim exemption, and thus (in addition to the inter-personal inequity) to limit the revenue which can be raised, while at the same time making it less stable.

Although the British local rate is not riddled with exemptions, its incidence on different types of property is at present unnecessarily arbitrary. Since 1929 agricultural land and buildings have been given an exemption which would better have been awarded as an open subsidy; shops and offices are burdened in comparison with partially derated industry, the methods of valuing public utilities are arbitrary and uncertain. Finally, in most areas pre-1914 houses are assessed more heavily than those built in the inter-war period, and the whole basis of house valuation has been upset by the effect of rent control.[1] Many of these defects could be very much reduced by central valuation.

Besides objections brought against the practice of existing local real estate taxes, two objections of principle are frequently brought against them. It is pointed out that from the point of view of the local authorities the revenue is inflexible and rigid, while from the point of view of the taxpayers it is regressive against income. The former limitation is especially felt by the larger and wealthier local authorities who have ambitious plans for neighbourhood improvement. Our analysis has shown that this inflexibility is inevitable, and is in fact part of the virtue of the tax, since it is only the other side of stability. Undeniably, wealthy cities would be better off if they were allowed to exploit a progressive local income tax, but if they did so it would make things harder, both for the central government and for their poorer neighbours. Local ambitions cannot be given

[1] Cf. Hicks and Leser, *The Problem of Valuation for Rating*, *cit.*, Part II, Chapter III, Section 3.

free rein without upsetting the balance of the national economy.

Our analysis also shows that moderate regression is not necessarily an objection in a local tax, to some extent it is an inevitable accompaniment of its equalizing properties. All outlay taxes have some degree of regression, that of rates is less severe than of many other outlay taxes.[1] Acceptability of regression, however, only remains so long as the national government retains control over most of the rest of the tax structure (so that the over-all rate of progression can be adjusted), and so long as the rates of the local tax are moderate. This implies that if it is constitutionally necessary for minor governments to undertake duties which are beyond the resources of the real estate tax, they should be given additional sources of revenue before the danger point in the real estate tax is reached.

It would take us too far afield to discuss adequately appropriate extensions in the local tax field ; it is mainly a federal problem and the best solution depends on local conditions, which may differ widely. In a new country there is obvious scope for a tax on land values ; other taxes with reasonably localized sources are entertainments duty and motoring taxes, especially vehicle licence duty. All of these have the advantage that they could be vacated by most national governments [2] without undue inconvenience, that they are not unduly regressive and that they need not involve double taxation or interlocal tariffs against trade and industry.

§ 7. *Equalization through Grants.* A satisfactory local tax

[1] Cf. the estimates of formal incidence in the next chapter.

[2] The proportion which total revenue bears to the national income is also relevant. Where revenue needs are light the obvious advantages of a *proportional* income tax for an upper layer of regional governments are so great that its disadvantages may be overlooked.

greatly facilitates the solution of the dilemma of local finance, but it can never provide a complete solution. Unless the powers and duties of local governments are to be more limited than is desirable on political grounds,[1] exchequer grants will be necessary for equalizing purposes; they may also be needed as a supplement to local resources to prevent the general level of local tax rates from becoming too high. (In addition it may also be desired to award grants to stimulate the expansion of new services, this policy although admirable in itself actually —as we shall see—increases the difficulty of solving the main problem.)

In any grant system there are thus two major policy problems to solve, one concerned with the over-all size of grants in relation to total local financial resources, the other with the distribution of grants between local authorities differently placed.[2] It would take us too far into the administrative field to discuss these questions in detail, but a word must be said on each in order to complete our analysis of the more limited fiscal problem.

The danger of very high grants is that they will lead to irresponsible spending. This is probably less true of an equalizing grant based on some objective measure of

[1] At the same time the existing powers and duties of local authorities should not be regarded as sacrosanct. In Britain, e.g., there is scope for a further transfer of highway services from purely local control, besides perhaps fire brigades and certain hospital services.

[2] Mention should be made here of the traditional method whereby it was sought in Britain to solve both problems at once—namely, by the distinction between *onerous* services (mainly those imposed by the national government), and *beneficial* services (essentially neighbourhood improvements), the former to be grant aided, the latter to be financed wholly from local resources. From the first the distinction was vitiated by the refusal of the central government to make a grant for public assistance, the most onerous and disequalizing of all forms of local expenditure. In a situation in which neighbourhood improvements may be made compulsory, and income redistribution is accepted as a national policy, the distinction loses any precision it once had, or any usefulness as a directive of policy.

needs, and available for general purposes, than of a specific percentage grant for a particular service; the latter may have the effect of seriously distorting local budgets. The natural reaction of central governments to the danger of irresponsible spending is to attempt to increase control, as grants expand. Since this is to destroy local autonomy it should be avoided as far as possible. There is little doubt that a higher standard of good spending could be achieved if the national government were to aim (by precept and practice) at a higher standard of local authority costing and accounting. By these means central departments would have a better effective control without any inevitable increase in day-to-day interference with administration.

At the same time, if a policy of increasing urban local autonomy is followed (as is here suggested on political grounds) a time will come—in Britain at no very distant date—at which some counties can cover only a very small part of their needs out of rates. In those conditions an amalgamation of areas under national or regional control would promote efficiency without sacrificing anything of political value, since there is little local consciousness in county areas, apart from the question of cricket.

Up to the present, the effect of differential grants in securing uniform services in Britain has only been slight. One important reason for this is the extensive use made in the past of specific grants for particular purposes. Percentage grants are disequalizing because only well-off authorities can take much advantage of them, since in accepting the grant they inevitably increase their own responsibilities also. After the grants have been in operation some time therefore the standard of services in poor and rich areas begins to diverge markedly.[1] If,

[1] A striking instance of this was recently revealed in the backwardness of tuberculosis services in Wales.

finally, it is decided to provide adequate differential help, the task of equalizing services will have been made more difficult, and the government will find itself committed to substantial positive grants to the wealthier authorities.

The basic problem of a successful differential grant is, however, the choice of an objective and secure basis for measuring the inequalities in wealth and needs which the grant is required to rectify. Since grants cannot be made very flexible without inconvenience to the central Budget (the British block grant is fixed for five years at a time), this is mainly a long period problem. Short period needs, e.g., the extra costs of depression, must be met in some other way. The British block grant formula is complicated by weights for such factors as the number of children under five and the mileage of main roads in the area. The relevance of the first is doubtful (and could be better allowed for in an education grant), the purpose of the second would disappear with a greater transfer to central management. On every ground it is better to have a simple formula, and once valuation becomes uniform throughout the country a simple and effective measure of relative wealth at once becomes available. It would seem to provide almost everything that is necessary.

These are difficult problems, and it is not possible here to do much more than indicate their existence; but that at least is necessary, because they are of vital importance for the future. The dilemma of central/local relations cannot in any case be avoided; since both the future of democracy and the welfare of the community are at stake, it is worth diligence and patience to discover the right solution.

CHAPTER XVI

THE INCIDENCE OF BRITISH TAXATION AND EXPENDITURE

§ 1. *The Measurement of Formal Incidence.* It is now time to turn to the more interesting arrangement of the revenue figures which we promised ourselves in Chapter V. What proportion of the revenue from different taxes, we have to ask, is contributed by people in different economic circumstances? Or, to look at the question the other way round, what proportion of their incomes do people in different economic circumstances pay over to the revenue authorities in meeting their liabilities to different taxes? Once we have answered this question it is a matter of simple addition to discover the formal incidence [1] of the tax structure as a whole. If we can make a parallel estimate of the formal incidence of public expenditure, we can set the one calculation against the other, and so ascertain how far the incomes which people derive from their share in the productive process (production or nominal incomes) are redistributed through the public finance system into available or consumption incomes—ex tax but cum subsidy—which can be devoted at will to real consumption or to voluntary saving.

The first step in the process is to determine the manner into which the population is to be classed into income groups in order to measure the relative incidence of public

[1] "The proportion of people's incomes which goes *not* to provide the incomes of those who furnish them with goods and services, but is paid over to governing bodies to finance collective satisfactions," cf. p. 158.

finance. Until very recently the distribution of production incomes could only be estimated rather roughly by indirect evidence, except for the small number of the population who belonged to the surtax paying class, concerning whom the Inland Revenue published detailed annual statistics. Since 1938 the official calculation[1] has been extended down the income scale to cover all those within the scope of income tax. It is usual to divide this section of the population into four classes, with annual production incomes respectively of £125 but under £250, £250 but under £500, £500 but under £1,000, and £1,000 but under £2,000. For most purposes it is sufficient to divide the surtax incomes into two classes, at the £10,000 line. The rest of the population must then be swept into an omnibus "under £125" group. We are thus provided with a division of the entire population into seven income classes—which we may conveniently refer to as classes 1–7, beginning with the smallest incomes.

No doubt the broad outline of the distribution of production incomes will be familiar (it is set out in detail in Table IX on p. 300). A situation in which the great majority of the population receive incomes below the average, and a very few make incomes much above it, is familiar in most countries, especially in industrial countries, which offer more opportunities for amassing wealth than agricultural communities. This distribution is a statistical fact which we need not discuss here. There are, however, some statistical difficulties with the composition of the lowest income class of which it is well to take note, because they affect our interpretation of tax incidence.

People with zero or very low production incomes belong

[1] Published in the Budget White Paper.

to two quite different groups; on the one hand are the unfortunates, the unemployed, the disabled and the subnormal, whom we naturally think of as the very poor; but on the other we have to include children, and all who are receiving full-time education (although they may be living in quite comfortable circumstances), the supplementary earnings of wives, and the small incomes of boys and girls starting to earn their living. The inclusion of this second group in the lowest income class implies that the standard of living is less uneven than the distribution of production incomes. It also implies that estimates of tax incidence may tend to give an exaggerated idea of the incidence on genuinely poor families. For this reason there is a lot to be said for taking the two lowest income classes together. The "under £250" group—at 1938 prices—provides a convenient concept of the "working class", considered essentially as manual workers, although not a few manual workers actually received incomes above this level in 1938.

The next step is to discover how figures of tax payments by income group can be ascertained. Of the two big classes of taxes, on the whole income and capital taxes present the simpler problem. So far as income (including surtax) is concerned, for the most part it is merely a question of looking up the scale of effective progression (cf. Chart 2, p. 215) and multiplying by the number of people in each income class. Employees' contributions to social insurance (the only other personal income tax) are even simpler, because for all practical purposes contribution is at a flat rate. Death duties are not so simple. No living person's economic position is made any worse than it was as a result of the tax being paid—except in so far as he may have borrowed on his expectations. It is a question therefore whether we ought to include death duties in a calculation of the distribution of the tax structure ; but since they do imply a redistribution of wealth not merely within classes but between them, when we are considering the incidence of public finance as a whole it would be wrong to leave them out,[1] even though (as we shall see) it is not very easy to distribute them satisfactorily between the income classes.

While the incidence of income and capital taxes can be ascertained directly from the official figures, the incidence of outlay taxes can only be discovered indirectly—by asking people how much of the different taxed commodities they bought during a given period—usually a week—and then calculating the annual tax liability on this rate of consumption. There is an initial difficulty about this procedure ; the information derived from budget studies relates to the consumption of entire households, whereas the income tax figures relate either to separate (unmarried) individuals or to husband and wife ; the two calculations are thus not quite on the same basis. For many purposes household tax payments measured against total household incomes would be the most useful calculation, but unfortunately we cannot quite manage to carry that through for the community as a whole, for two reasons. On the one hand we cannot ascribe the low income members of the first class to their correct levels, on the other we can never really ascertain total family income.

Family budget information is almost universally obtained from the housewife, so that the "income" against which tax liability is measured is essentially the housekeeping money, not even the income of the chief wage earner, still less the entire income of the household. Moreover the housewife is very likely to leave out of her

[1] But contrast a similar calculation to that given below, in J. R. Hicks: *The Social Framework*, where death duties are omitted.

expenditure account large intermittent purchases (such as furniture and clothes) if they do not happen to occur in the week in which the survey is made. For this reason the final calculations tend somewhat to exaggerate the proportion of taxes to income, especially as we move up the income scale.

Besides these difficulties the family budget technique breaks down rather seriously in two directions. First, it is almost useless for estimating the incidence of the big taxes on smoking and drinking. Even if the chief smokers and drinkers in the household can be contacted, they are not likely to own up to the extent of their indulgence. Secondly, the method is really only useful for the working-class income ranges; above the £250 level sufficient housewives are not prepared to make the necessary returns for a small fee; nor is it so easy for them to do so, as their expenditure does not fall neatly into weekly accounting periods, and large intermittent purchases are much more important than at lower income levels. This second difficulty is not so serious as it might seem to be at first sight, since the importance of outlay taxes falls rapidly as we move up the income scale.

It will be seen from these difficulties that there is necessarily a good deal of guesswork about the estimates; they are nevertheless extremely worth making. It so happens that two very detailed calculations of the incidence of British taxes are available for the year 1937 [1]; since the revenue collected in that year did not differ much from that of 1938—which we have used for other purposes—we can assume that the results obtained for 1937 would also represent the situation in 1938.

[1] Shirras and Rostas, *The Burden of British Taxation*, and Barna, *The Redistribution of Income through Public Finance*. The first builds up incidence from the basis of the typical family; the second distributes total revenue collected, among entire income classes.

There is still one more caution before we proceed to the actual estimates. The incidence which is calculated is the average incidence—on the "representative" family or entire income class. In a sense this is right; it is more important for policy to find whether taxes are heavy or light for ordinary normal people than to find that they strike with exceptional weight on families in peculiar circumstances. Some families are especially unfortunate, most families pass through ups and downs. It is not possible to allow for this in the tax structure, the proper place to allow for it is on the expenditure side; although if it is found that a certain tax persistently presses heavily on a considerable body of people, that certainly provides an *a priori* case for examining whether the revenue could not be raised more easily in some other way.

On the other hand there is the question whether incidence averaged over a large group does really represent the typical situation. For most taxes we can be sure that it does so reasonably well; budget studies show a remarkable consistency in consumption within income ranges. For certain taxes, however, particularly those on smoking and drinking, it is evident that differences in taste may make an enormous difference to incidence. For other reasons the incidence of local rates also shows a rather large dispersion round the average. Unfortunately data are rarely sufficient to measure the importance of dispersion adequately.

§ 2. *The Formal Incidence of the British Tax Structure.* Armed with some knowledge as to how much we can expect the estimates really to tell us, we must now examine the different main groups of taxes in order. Turning first to income tax, although most of the work is done by the

Inland Revenue, there is one point for which the official figures do not allow. The effective rates of tax apply only to personal incomes; if we want to find the tax incidence on total private (non-government) income we must also include what the Budget White Paper calls "non-personal" income, the undistributed profits of firms. It is reasonable that this income should be "imputed" to the owners—in most cases the ordinary shareholders—since it is made with their property, although they have not the same rights of disposal over it as they have over the rest of their income. The total of this imputed income in 1937 was £244 mn., and it is estimated to have been distributed between the different income classes at rates varying from about £1 per head in the first two income classes to over £1,900 in the highest class.[1] Since all this income is taxed only at the standard rate, the effect of including the tax on it is substantially to reduce the apparent progression of surtax. Since wealthy people can sometimes influence the proportion of profits which is distributed, and so the tax that they pay, it is very necessary to remember this qualification when estimating the incidence of income tax.

There is not much to say about the formal incidence of employees' contributions to social insurance. Since they are collected at a flat rate they are regressive on the lower incomes; the finance of the social insurance system as a whole is not regressive, however, on account of the exchequer contribution, which must be regarded as having the same progression as the tax structure as a whole. As between the different income classes considered as units, the *per capita* incidence depends on the proportion of workers included in the insurance system. This was

[1] Cf. Barna, *op. cit.*, p. 75. For war years revenue from E.P.T. would also have to be imputed.

roughly the same in the first two classes (with *per capita* contributions of £1·35); in the third class the average *per capita* contribution fell to £0·4, because of the lower proportion of insured workers in the group. The actual average payment per worker over all sections of workers was £4 4*s*.

It will be recalled that in Chapter XIII we discussed the problem of expressing death duties as an annual tax, in order to compare the relative loss of satisfaction to the taxpayer, of future liability to death duties and an income tax. Here we are also in a sense concerned with death duties as an annual tax, since we are examining the revenue of a single year,[1] but our object is rather different. We are not concerned with personal valuations, which require the future to be taken into account as well as the present, but merely with what happened in a single year. We have to distribute actual revenue collected during the year between the different income classes, whose members on their deaths, contributed the revenue.

An ingenious method of doing this has been suggested. First, the distribution of total private property among the different income classes is estimated, on the basis of the property of people who become liable to death duties in the past. Then for each income class an estimate is made of the "risk" of dying—or the number of people in the class who are likely to die—within the year. This is based on adjusted life tables, the greater longevity of the wealthy being largely counterbalanced by the greater age of the higher income classes. This "rate of risk" is then applied to the property of the group, to find how much of it is likely to become liable to death duties during the year; the average *per capita* property in each

[1] Actually in estimating the incidence of death duties it is better to average the revenue of several years, in order to even out the fluctuations caused by the deaths of the very wealthy. Dr. Barna takes the year 1936–38.

class determining the appropriate rate of duty.[1] In this way the proportion of the revenue contributed by each income group is estimated.

The incidence of death duties thus estimated is substantially progressive,[2] the rate of average tax payments rises from less than 1 per cent of total income on the first three income classes to 47 per cent on the highest; 95 per cent of the revenue is contributed by people belonging to the £500 and over classes.

We can now see that, by and large, the income and capital taxes were paid by the " over £250 " income classes, and for the most part by the "over £500". It will be remembered that in the 1930's a married couple with three children only became liable to income tax at about the £500 level. During the war this situation was modified, but it still remained true that the revenue from income and capital taxes was mainly derived from people above the working-class level.

In contrast, the revenue from outlay taxes comes mainly from the "under £500's". Since liability depends on individual consumption this follows from the concentration of the population in these classes.

From the point of view of formal incidence the outlay taxes fall naturally into three groups, distinguished by the way in which the revenue is distributed between the different income classes. The first group consists of local rates on houses, estimated to bring in a revenue of about £125 mn.[3] Secondly comes a group consisting of the small

[1] For a fuller description of the method, cf. Barna, *Review of Economic Studies*, 1941.

[2] Although the total incidence is much smaller than that obtained by the " insurance method ", cf. Colwyn Report, *cit.*

[3] Statistics of the distribution of rate revenue between dwelling houses and other rated property are not prepared, so that to ascertain the precise figure it would be necessary to consult the rate books of local authorities. There is reason to believe that the figure of £135 mn. usually given is too high.

taxes on articles of common consumption and the two big sets of taxes on smoking and drinking—the last two contributing respectively £83 mn. and £114 mn. to the revenue in 1938. Thirdly, we have a group of fairly heavy taxes on not quite so common consumption, mainly motoring (including travel by bus and taxi), with a revenue of £47 mn., and taxes on silks and other imports, with a much smaller revenue.

This classification leaves out of account a revenue of about £173 mn. assessed on the use of factors common to a wide spread of industries, whose incidence it is impossible to trace satisfactorily. The revenue is mainly collected through rates on business and industrial premises (47 per cent) and employers' contributions to social insurance (33 per cent); most of the rest comes from commercial motoring. As will be appreciated this revenue is too large to neglect, even if we cannot make a very satisfactory estimate of its distribution.

The greater part of the revenue in the first two of the above three groups is contributed by the three lowest ncome classes—over 90 per cent in the case of food, drink and tobacco duties and local rates, over 70 per cent in the case of entertainments. In contrast, in group 3 over 70 per cent of the revenue from motor taxes is paid by the "over £500's" while the revenue from silk and other imports comes equally from the classes over and under £500. It is probable that the general factor taxes have a fairly steep regression but not so steep as that of the food taxes, since business rates and employers' contributions (especially for personal services) must pay a considerably more important part in the consumption of the wealthy than of other classes.

These differences of formal incidence between the income classes are of fundamental importance for the direction of policy, for instance, for the control of consumption; but from other points of view other differences in formal incidence are no less important, as we shall see when we examine the components of the different groups of taxes.

Until recently it was impossible to make any close estimate of the incidence of local rates, for two reasons. In the first place the large interlocal variations between both rates and incomes imply that it is necessary to have not one but a number of estimates, and hence an enormously wide collection of budget studies. Secondly, budget studies do not normally distinguish rent from rates, for the reason that most working-class people pay the landlord a *gross* rent which includes their rates, so that it is difficult to get precise information about rates. Owing to the fortunate coincidence of two nation-wide inquiries, both relating to the year in which we are interested—one by the Ministry of Health into the *net* rents of houses of various sizes, the other by the Ministry of Labour into family expenditure in general—this gap in estimates of tax incidence has now been filled.[1]

In respect of rates England (with Wales) is divided into three distinct zones, rate poundages are high in Wales, middling in the north (including Lancashire and Yorkshire) and low in the midlands and south; since rates are high where people are poor, rate incidence follows the same pattern. Over the average of the working-class income groups rates were, at the time of the inquiry, 4, 3·5 and 2·9 per cent of income respectively in the three zones. Cutting across this regional distinction is another, depending on the size of the community; broadly speaking the larger the town the higher the rates, a difference which is only partly compensated by a higher level of

[1] Cf. J. R. and U. K. Hicks, *The Incidence of Local Rates in Great Britain.*

incomes in the large cities. Thus the average working-class rate incidence in London is just as high as in Wales; in three out of the four largest cities it is higher still. At the other extreme, in every part of the country, rural date incidence is much lower than urban, in spite of the relatively low incomes of farm workers.[1]

It follows from the fact that people are poor in highly rated areas, that rates are also more regressive in such areas. The difference between rate incidence (say) in Wales and the midlands is greater for the unskilled worker than it is for the better-paid artisan. As we proceed up the income scale, in every area the incidence becomes less regressive; people clearly take the opportunity of rising incomes to move into more than proportionately better houses. Naturally this greater proportionality of incidence cannot continue indefinitely up the income scale; but it seems to be well established at least up to £500. About 70 per cent of total revenue from rates is estimated *to be contributed by the two lowest income classes,* so that the distribution is rather less regressive than that of food taxes, where the proportion is about 76.

Regional differences constitute one kind of deviation from the average which needs to be taken into account when we are considering rates, but deviations within income classes in the same area are also considerable, and require attention, because the rate—unlike other outlay taxes—is a "domestic overhead"; liability cannot easily be adjusted when a change in private economic circumstances occurs. Most of the cases of very high rate incidence discovered by budget studies are due to temporary causes; they cannot be guarded against except

[1] In Scotland, on the average, rates are very high indeed although the combined rate and rent payment is moderate, because rents are very low. Cf. *Incidence, cit.* pp. 59ff.

by enormously lowering the general level of rates. As has been said, they are a matter for expenditure and not revenue policy. High rate incidence also very commonly occurs where elderly couples go on living in the same houses although they can no longer really afford it, and where there are abnormally large families of young children. These are both persistent causes of exceptional tax burden which could appropriately be lightened by building more houses catering for these especial needs.

We can pass more quickly over the other outlay taxes; they do not give rise to so many complications as rates. Of the two taxes on "necessary" foods—tea and sugar—the latter is by far the heavier, and is also the more important because consumption goes on expanding for a considerable way up the income scale—not so much the direct consumption of sugar but from the purchase of sweets and cakes. This pattern of consumption is even more marked in the case of the "other foods" taxed, where the annual *per capita* tax paid in the third income class is double that in the lowest class.

For none of the food taxes do we have to bother much about deviations from average consumption, but there is another very important factor to consider—the "horizontal regression" of the taxes on large families. This is especially important in the case of the "other food duties" since they are assessed on nutritionally "protective" foods, and things which it is very desirable that children should be able to have plenty of. In contrast, when we are considering the incidence of the drink and tobacco taxes, the main factor of importance is the unevenness of tax incidence due to differences in taste between taxpayers within the same income class.[1] In respect of the motoring duties there is also a fairly wide

[1] This was first emphasized by D. Caradog Jones, *J.R.S.S.*, 1927.

variation in tax incidence due to differences in taste. For the import duties on the other hand, although consumption varies between income classes, it seems to be stable within each class.

It is interesting to try to discover how the typical household in the lower income classes normally (albeit largely unconsciously) distributes its tax payments. An idea of the relative importance of the different taxes can be obtained by comparing average *per capita* tax payments for the most important taxes. These are shown in Table VII, income classes (1) and (2) being amalgamated for statistical convenience. In order to obtain average *family* payments these amounts should be multiplied two to three times; obviously they take no account of deviations from average consumption.

TABLE VII.—AVERAGE TAX PAYMENTS OF LOWER INCOME GROUPS (1937) (£ PER AN. PER CAP.) [1]

Income Class	Rates	Food	Alcohol and Tobacco	Other Articles and Services	Social Insurance
Under £250 . .	2·5	0·99	3·8	0·7	1·4
£250, but under £500	3·9	1·5	5·5	3·6	0·4

Broadly, we may say that an "under £250" family, where the parents smoke but do not drink (which is no doubt a very common situation) pays about 40 per cent of its taxes in the form of rates; in the third group this proportion may rise to as much as 60 per cent. This calculation does not take account of the general factor

[1] Figures other than rates based on Dr. Barna's calculations. Income tax is omitted as it was negligible for families in these ranges at the date in question.

taxes, which as we have seen cannot be distributed with any precision; but however the revenue from them is distributed at least 50 per cent of it must fall on incomes in these three classes; a plausible estimate would seem to be a payment somewhat lower than rates, but (within these classes) with a similar class distribution.

Before we leave the tax side of the account it will be useful to summarize the information by measuring total tax payments against an income scale (Chart 3). As will be evident from our discussion, the tax structure is composed of two quite different sections, one of mildly regressive outlay taxes, the other of highly progressive income and capital taxes. These combine to produce a total structure which is at first proportional or even slightly regressive,[1] but which swings rapidly upwards from about the £500 level.

Probably the most remarkable thing about this structure is the extent to which its shape has been altered within the present generation. Even as recently as 1914 [2] the proportion taken in taxation of even the highest incomes was no more than 10 per cent; the tax structure as a whole was proportional rather than progressive. The beginning of serious progression, together with the rise in the drink and tobacco taxes which took place during the war of 1914–18, at first gave rise to a U-shaped structure, with a long progressive head, a short regressive tail and a decided dip at about the £500 level.[3] This dip has gradually been ironed out, partly by a reduction in the regressive tail, partly by the greater use of outlay taxes on types of consumption which continue to increase up the income scale (e.g., motoring). The finishing touch

[1] Depending mainly on consumption of drink and tobacco.
[2] Cf. Shirras and Rostas, *cit.*, p. 64.
[3] To some extent the dip was an illusion due to the omission of the incidence of local rates, cf. Hicks, *Incidence*, *cit.* Chapter V.

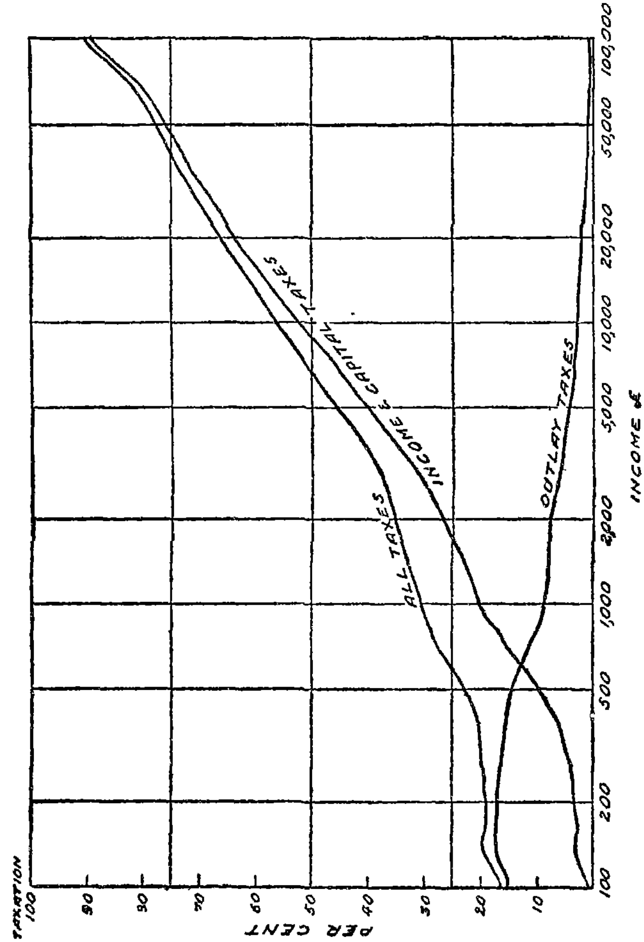

CHART 3. TAXATION AS A PERCENTAGE OF INCOME, UNITED KINGDOM, 1937.

was put to this process in 1941 by the extension of income taxes to cover a large proportion of working-class incomes.

§ 3. *The Incidence of Redistributive Expenditure.* We must now see how far we can set out the formal incidence of the public expenditure structure in a parallel manner. Unfortunately, on the expenditure side we are confronted by an awkward logical difficulty. If we want to make a nice tidy balance sheet we ought to distribute the whole of public expenditure out of revenue between the different income classes, just as we have done for taxation ; but while paying taxes is an individual affair, about one-half of public expenditure goes to provide benefits which are, to all intents and purposes, indivisible. How, for instance, are we to impute the benefits of defence, police, justice and roads, or even of the ordinary expenses of administration, between people in different economic circumstances ? Obviously there is no "correct" way of making a complete allocation of expenditure, although it is always open to anyone to carry out the calculation, according to whatever assumptions he cares to adopt.

On the other hand, the other half of public expenditure has a very definite and socially important distribution between income classes, and it is really this in which we are interested when we talk about the redistribution of income. Since an estimate of partial redistribution, based on the allocation of divisible benefits, will tell us most of what we want to know, and is logically quite unambiguous, it seems better to venture no further than this. Even so we are up against a more difficult statistical problem than on the tax side, as the information respecting the consumption of divisible benefits is much less good than the information concerning the consumption of taxed commodities.

With these difficulties in mind we may proceed to examine the distribution of divisible public expenditure (mainly social expenditure) between the three lowest income classes, just as in the case of outlay taxes.

TABLE VIII.—THE INCIDENCE OF DIVISIBLE BENEFITS (1937) (£ PER AN. PER CAP.) [1]

Income Class	Education	Health	Health Insurance	Assistance and Unemployment	Pensions	Housing
Under £125 .	2·1	1·2	0·7	4·2	5·1	0·4
£125, under £250	3·1	1·2	0·4	0·8	1·1	0·7
£250, under £500	3·7	1·3	—	—	0·3	—

From this it clearly appears that the only services which are progressive with needs are Assistance and Pensions; *per capita* "consumption" of public health services is constant within these ranges; consumption of housing and education services expands as income rises. (The apparent decline in the "consumption" of health insurance as income rises is due to the fall in the proportion of workers included in the system.) The relatively regressive incidence of housing expenditure is clearly marked in the table, but this method of presentation illustrates very inadequately the well-known fact that house building by local authorities in the inter-war period mainly benefited the better off workers.[2]

It will be recalled that public expenditure consists either of expenditure on goods and services or of transfers,

[1] Based on Dr. Barna's calculations, omitting collective services provided privately.

[2] The position can be better appreciated by saying that the chance of a family in class 1 of getting a council house was only 60 per cent of the chance of a family in class 2; the chances were better for the upper half of class 2 than for the lower. Cf. Barna, *op. cit.*, p. 171, and M. E. A. Bowley, *Housing and the State*.

and that the transfers can in turn be divided into income transfers (of sums of money) and outlay transfers (of rights to consumable goods, at less than cost price) Over the whole of these divisible benefits income transfers (50 per cent) were by far the most important; expenditure on goods and services (43 per cent) was next in importance, leaving outlay transfers a mere 7 per cent. During the war these proportions were materially changed, mainly owing to the fall in income transfers in a state of full employment. The main outlay transfers were in respect of the education services and health insurance; the distribution of the other categories of expenditure is immediately apparent from the types of the services.

We are now in a position to bring together the available information on both sides of the account, in order to ascertain the extent of (partial) redistribution of income, this is shown in Table IX. The important columns to consider are (i) The initial distribution of nominal or production incomes (received + imputed) in each class, (ii) The total amount of revenue derived from each class, (iii) the distribution of divisible benefits and (iv) the resulting distribution of free or available consumption incomes—ex-tax but cum-subsidy. The residual revenue, after partial redistribution is allowed for, amounted to nearly £600 mn., out of which was financed almost wholly by the "over £250's" the indivisible remainder of government expenditure, including the service of the National Debt. A striking result of this policy was that in the two lowest income groups *per capita* production incomes of £54 and £69 respectively, were changed into consumption incomes of £59 and £64. Redistribution policy thus resulted in a levelling up of the incomes of the very poor, nearly to those of the next group.

The result of the estimate can be seen more concisely

TABLE IX.—Income Distribution and Redistribution (U.K.), 1937[1]

Income class	No. of Persons in Class (Thous.)	Total Incomes of Class (£ mn.) (i)	Taxation (£ mn.)			Divisible Expenditure (£ mn.)			Consumption Incomes (iv)
			Income and Capital	Outlay	Total (ii)	Social Transfers	Expenditure on Goods and Services	Total (iii)	
Under £125 .	21,800	1,176	30·6	209·4	240·0	238·6	108·5	347·1	1,283
£125, under £250	18,750	1,290	37·3	208·8	246·1	64·7	84·3	149·0	1,193
£250, ,, £500	4,816	646	31·3	100·3	131·6	2·7	23·5	26·2	540
£500, ,, £1,000	1,209	351	49·3	47·4	96·7	—	2·3	2·3	257
£1,000, ,, £2,000	451	277	61·4	28·4	89·8	—	1·5	1·5	189
£2,000, ,,£10,000	258	447	161·8	31·8	193·6	—	1·3	1·3	255
£10,000 and over	22	223	150·2	8·6	158·8	—	0·2	0·2	64
Totals . .	47,300	4,410	521·9	634·7	1150·6	306·0	221·6	527·6	3,781

[1] Based on Barna, *op. cit.*, p. 215. The classification of taxes is that used throughout this book, and differs slightly from Dr. Barna's practice. Collective services provided by private enterprise, e.g., charities and insurance, are omitted.

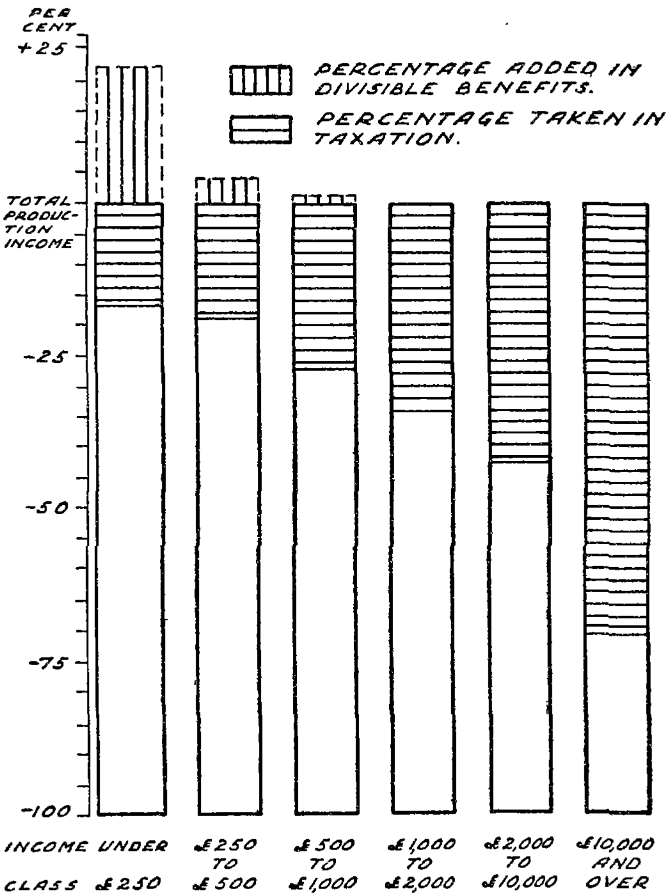

CHART 4. REDISTRIBUTION OF INCOME, U.K. 1937, BY INCOME CLASS.

by charting the percentage additions and subtractions from production incomes in each class (Chart 4).

It would be of very great interest if we could set this estimate against the situation in other countries, but so far data are lacking for a detailed comparison. It may well be that in a country where the overall needs of the exchequer are smaller (e.g., in Sweden) a higher degree of *net* redistribution may be obtained. On the other hand, in the United States in 1939 income and capital taxes amounted to only 4·2 per cent of personal incomes (as against 11·2 per cent in Britain), while social transfers (excluding social insurance) amounted to only 2 per cent (as compared with 5·5 per cent in Britain),[1] so that light revenue needs are not necessarily correlated with high transfers.

These calculations relate to the pre-war world. Detailed estimates of war-time public finance cannot yet be made; but it is possible from the figures of revenue collected to draw some tentative conclusions, some of which have relevance to the post-war world.

In the first place we can say that (with the big exception of the duties on smoking and drinking) outlay taxes lost their old importance during the war. Rate poundages remained stable (or in a few places even declined), so that against the higher incomes of war-time—on the average almost doubled—the formal incidence of rates was roughly halved. Revenue from food, motoring and protective duties decreased absolutely, and became so small in relation to war-time incomes that even with the additional of some £100 mn. of revenue due to the purchase tax [2]

[1] Cf. J. R. Hicks and A. G. Hart, *The Social Framework of the American Economy*, p. 229.

[2] It is difficult to predict what the figures of the incidence of the purchase tax will reveal when they are available for examination, owing to the enormous difference of the rates of tax on different commodities. It would not be surprising to find that the distribution between income classes was similar to that of the silk duties, see p. 290.

the incidence of all these taxes taken together was smaller than in 1938. For all these commodities and services restriction of consumption was not brought about by taxation, but by rationing and scarcities. On the other hand, even at constant prices, the importance of the tobacco duties was doubled, while that of the alcohol duties increased by about 50 per cent.

The more important fiscal changes of the war were on the side of income and not outlay taxes; as a result of them the tax structure became decidedly more progressive. In 1941 changes in the structure of income tax for the first time not merely brought a large section of the working class within the scope of progressive taxation (by lowering the exemption limit and restricting the allowances), but subjected them immediately to a "reduced rate" as high as the "standard rate" of a few years previously. The income scale of the war-time tax was shown on Chart 2, p. 215, and we have already discussed the adverse effects of the changes on personal incentive, a consideration of increasing importance with the return of the economy to normality and one that has so far only been partly mitigated by tax concessions. A further cause of increased progression in the tax structure during the war was the total removal by 100 per cent E.P.T. of industrial incomes in excess of the pre-war level. Finally, the effect of these changes was enhanced by the rise in prices—the income tax paying population as a whole moved up the scale of progression.

Against the greater progression of the tax structure must be set certain additions to redistributive expenditure. Subsidies to stabilize the prices of essential foods and fuel —whose incidence must be similar to that of the essential food taxes—rose to about £240 mn. per annum; substantial additional pensions were also granted. The public finance system itself thus became a greater leveller in war-time than ever before, but this change was small in relation to the levelling effects of rationing. The more striking war-time changes in the formal incidence of taxation and expenditure were no doubt mainly temporary in nature, but it will be very surprising if the war-time experience does not establish a precedent for a far greater degree of net redistribution than has yet been achieved.

§ 4. *The Effective Incidence of British Taxes.* All that we have said so far relates to formal incidence; but in order to pass judgment on a tax it is the effective incidence—the social and economic situation caused by the presence of the tax, relative to the situation without it—that we must consider. We have seen that the chief additional factors to be taken into account in deducing effective incidence are first, the loss of surpluses due to the tax—determined mainly by the height of the tax, and in respect of outlay taxes by the elasticity of demand; secondly, the restriction of effort and enterprise due to the revenue being raised in one manner and not in another.

We may start our inquiry with outlay taxes, since on the basis of our previous discussion it would seem that in principle they are most open to criticism. It is unfortunately the fact that very little can be said with precision concerning the effective incidence of British outlay taxes, because of the paucity of statistical demand studies. It is probable that further research, even on the scanty data available, would throw considerably more light on the subject.[1] In the meantime we can make some progress by general observation and inference.

[1] A beginning has been made in respect for the demand for tobacco, beer and spirits, all heavily taxed commodities, by J. R. N. Stone, "The Analysis of Demand", *N.I.E.S.R.*, 1945 (see below). It will be recalled that in the U.S.A. much greater progress has been made in

Family budget studies all agree in showing that the demand for food is one of the most inelastic items in consumption; and that this is especially true of articles of universal consumption, such as tea, sugar and wheat. It is therefore evident that a *small* tax on these commodities is relatively innocuous, apart from distributional effects, and they are not likely to be serious. This conclusion is in sharp contrast to nineteenth-century ideas, at least in respect to the taxation of bread. The difference is mainly accounted for by a real change in habits, due to the rise in the standard of living. The demand for the commodities covered by the British "other food taxes" is however much less inelastic. Since these are assessed on vitamin rich and nutritionally "protective" foods the loss of surplus should be considered not merely in terms of loss of satisfaction, but in terms of health also.

The demand studies relating to tobacco, beer and spirits all suggest a fairly low price elasticity of demand—in every case the estimate is less than unity, in the case of tobacco only 0·5.[1] The income elasticity in each case is complicated by a trend movement—the demand curve for tobacco was moving strongly to the right throughout the inter-war period, giving rise to a cumulative upward trend of about 3 per cent per annum; the leftward movement of the demand curve for spirits resulted in a cumulative downward trend of about the same amount. The trend of beer consumption was less definite; it would be consistent with the figures to assume a slight downward movement which would be in sympathy with

the statistical investigations; research has been carried out both by the government departments concerned and by private committees of experts. Cf. p. 74.

[1] Cf. Stone, *loc. cit.* It is not impossible that the demand for the leaf (on which tax is assessed) was considerably more elastic than this. The manufacture of tobacco gives exceptional opportunities for substitution and quality changes.

the trend of the consumption of other intoxicants.[1] On grounds of loss of surplus, apart from other considerations (especially in respect of the rates of tax), these taxes were not unreasonable. The downward trend of alcohol consumption may, however, presage an increase in demand elasticities.

The local rate presents a more difficult problem, because we have to take account not only of the initial period of operation of a change in poundage, when the effective incidence is necessarily on the occupier, but also of the longer period when the effect of the change spreads to the "supply curve" of existing houses and to the production of new ones. In general the demand for house room shows as low an elasticity as any item in the family budget. In poor and declining areas, however, there is a strong tendency for local migration, and if landlords want to keep their tenants they must be prepared to lower the supply price of existing houses (i.e., the rents). The further this movement proceeds the more the effective incidence of rates spreads to the landlords. This factor is a considerable mitigation of the high formal incidence of British rates, especially in Wales and the big cities of the north, where we may assume that most of the incidence of rates is on the landlords.

The duties on private motoring, on silk and rayon and on non-food imports (e.g., cameras, watches, films and the like), must be awarded considerably less good marks in respect of demand elasticity than the taxes so far discussed; the loss of surpluses is consequently higher, and the effective incidence of the taxes has a wider spread. It is no defence of such duties that they fall on "semi-luxuries" since these are amenities of which all would

[1] This might account for the rather surprisingly slight income elasticity of demand revealed by the correlation analysis.

like to consume more. At present, as we have seen, the greater part of the revenue is collected from the income tax paying classes; a transfer of the revenue to income tax would make little difference to their liability and the reduction of the duties would enable consumption to spread down the income scale.

In general British outlay taxes are assessed at very high rates, both absolutely and relative to those usual in other countries. The high rates of British taxes are often concealed because they are assessed on the specific and not on the *ad valorem* method. Most of the import duties, however, are assessed *ad valorem* at the fairly high rate of 33⅓ per cent; the purchase tax with its 66 and 100 per cent rates soars still higher. A rough indication of the height of specific taxes can be obtained by estimating the relation of revenue collected to total expenditure on the taxed articles. For the taxes on smoking and drinking, even on the average, this is very high—nearly 60 per cent for spirits, 50 per cent for tobacco and over 40 per cent for beer.[1] The percentage of tax in the selling prices of particular commodities belonging to these groups is naturally very much higher than this. Again in respect of petrol, tax accounted for 50 per cent of the selling price under war-time conditions. It will be seen that several of these taxes are equivalent to *ad valorem* taxes of more than 100 per cent.

An official study [2] of the relative heights of outlay taxes in the United Kingdom, the United States and Canada, under war-time conditions, attempted to get over the difficulty of comparing specific and *ad valorem* taxes, by expressing American and Canadian taxes on a specific

[1] Cf. Barna, *op. cit.*, p. 162, and the proportions derived from Shirras and Rostas, *cit.*, Table 43.

[2] Cf. "Excise Taxes: U.S.A., Canada and U.K.," Treasury Department (U.S.A.) *Division of Tax Research*, 1945.

basis; the results are striking. Tobacco duties in the U.K. range from \$0·3 to \$6·8 (excluding the astronomic duties on cigars), compared with a Canadian range of \$0·2 to \$0·7, and still lower rates in the United States. Spirits and beer were taxed in the U.K. at \$23 and \$28 respectively, compared with an average of \$8·9 in both the U.S.A. and Canada. In respect of sugar the British tax was four times as high as the Canadian, and eight times as high as the American. It should also be remembered that the majority of American local sales taxes are assessed at quite low percentages—such as 5 per cent or even 2 per cent, which compares favourably with even the lowest rates of British purchase tax. (The American taxes are, however, much wider in scope.) Thus even if demand elasticities are the same in all three countries, the British taxes imply a more than proportionately higher loss of surplus.

The main exception to the rule that the rates of British outlay taxes are higher than those of most other countries is the local rate. Unfortunately, comparable American data are not available, and the rates at which the local property tax is assessed vary enormously from place to place. It is apparent from the *per head* liability already given, however, that rates of tax are considerably higher than those of the British local rate [1]; the *per capita* payment of the American tax was nearly double that of the British. In absolute terms the British local rate at about 33 to 35 per cent of the total cost of house accommodation was fairly but not exceptionally high on British tax standards. Nevertheless, there can be little doubt that the local rate was on the average in the inter-war period high enough to exercise a substantial check on the building of new houses and on the conversion and

[1] See p. 90.

modernization of old ones. This was especially true during the period of rising rate poundages immediately prior to the outbreak of war.

In absolute terms again the British taxes on motoring do not appear exceptionally high on British tax standards; the proportion of tax in total consumption costs is estimated to have been roughly the same as the local rate (33 to 35 per cent). It is not possible to make an exact comparison with American or Canadian tax standards, since the main method of motor taxation in North America is by a sales tax expressed as a percentage of the manufacturer's price—in the U.S.A. for private cars a flat 7 per cent, in Canada varying from 25 to 29 per cent according to the type of vehicle.[1] This tax is accompanied by state and local excises on gasolene, but these again are but a small fraction of the British tax. In addition to the high British vehicle duties and petrol tax, the effect of the high purchase tax on new cars must also be taken into account.

Nobody now doubts that British motoring taxes have led to the production of an insular type of car, which gives the British motorist a less powerful engine than he might have for the same cost under a different (but equally heavy) method of taxation; while at the same time the combined effect of the peculiar method of assessment of the vehicle tax (on a notional horse-power) and the high rates of licence and fuel taxes has been to make the British car unsuitable for export to most countries. In an effort to remedy these defects, especially in respect of exports, it was decided in 1945 [2] to abandon the horse-power basis in favour of a straight tax on engine capacity. This change removed the main obstacle to the

[1] Rates in 1945. Cf. Excise Taxes, *cit.*
[2] Operating from January 1947.

development of engine power. This was, however, only one of the objections to the old horse-power tax; almost equally undesirable was the manner in which its finely graded rates encouraged the multiplication of models, and thus led to a failure to achieve the economies of large-scale production. A finely graded cubic capacity tax has no advantage over a finely graded horse-power tax in this respect.

On the other hand a broadly graded tax directly encourages concentration of the most powerful model within each grade; it can therefore be used to stimulate model simplification. Thus in respect of private motor cars a three step tax should stimulate the production in sufficient quantities of three sizes of car to realize the economies of scale; at least two of these (the small and the medium) should be competitive in export markets; although American producers would probably retain advantages in the production of the largest cars.

It is worth paying attention to this possibility, not merely for the sake of the motor industry but as a particular application of the theory of taxation in conditions of monopoly.[1] The failure to realize the economies of large-scale production through the excessive multiplication of products and models [2] is the cause of some of the most serious social losses which can be laid at the door of market control. It is a general problem that runs all through industry, not merely in the field of finished products, but even more seriously perhaps in the field of parts and components. There is a high probability that the situation could be materially improved by the application of well-chosen taxes or subsidies; probably

[1] Cf. Chapter X, Section 4.

[2] Cf. Kaldor, "Market Imperfection and Excess Capacity", *Economica*, 1935, pp. 47ff.

quite low rates would be sufficient to tip the scales in favour of greater standardization.

As long, however, as British chancellors cling fanatically to their revenue from motoring taxes, the dice will be loaded to some extent against British car exports. On the other hand it would be wrong to reduce motoring taxes merely to please the motorists, or even to stimulate exports, since a substantial reduction in motoring taxes could not fail to have important repercussion in the distribution of passenger and freight traffic between rail and road transport. The socially correct rates of motoring taxes can only be determined in relation to the optimum allocation of traffic of different sorts between different forms of transport; railway obligations and rates are as much part of the picture as motoring taxes.

The optimum allocation of traffic between different sorts of transport presents an interesting and difficult, but by no means necessarily insoluble, problem in the economics of the social advantage. Until the theoretical problem has been solved it is not possible to say what the correct level of motor taxation should be. At the same time there is not much doubt that some reduction, even from the overall levels of 1938, would be an improvement from every point of view.

In view of the high rates to which British outlay taxes have now been driven by the needs of the revenue on the one side, and by their own limited scope on the other, it is at least questionable whether the traditional British policy, established by Huskisson and developed by Peel and Gladstone, should not now be reversed in favour of a greater use of low rate taxes embracing a wide field, Our earlier analysis suggests that the loss of surplus due to high rates of tax, even when demand elasticity is low, may be so considerable that a change to low rate taxes would be an improvement, even if the elasticity of demand for the commodities taken separately were somewhat greater. The possibilities of group elasticity being smaller than individual elasticity would also be considered.[1] From this point of view—as well as from others which we shall consider later [2] the attractions of a general purchase tax imposed at a low uniform rate deserve careful examination. The incidence of outlay taxes, however, cannot be satisfactorily discussed in isolation from the effects of the high rates to which the needs of the revenue have also driven income and capital taxes.

At 1938 rates of tax we found that the principal check to incentive in the personal income tax was due to abnormally large differences between marginal and effective rates of tax—and hence abnormally high taxation of the marginal effort—at particular points in the income scale. This factor became very much more serious after 1941, when the initial marginal poundage was raised to 6*s*. 6*d*., a reduced rate higher than the full standard rate of only a few years previously. There is no doubt that this sudden impact of tax on a new class of income taxpayers was a serious mistake, more especially when in 1943 its effect was reinforced by a system of P.A.Y.E. tax collection which directly related tax to effort.[3] It would have been better if the division of the reduced rate into two sections, introduced by Mr. Dalton after the end of hostilities, had been made in 1941.

High *marginal* rates of tax can be avoided by manipulating the tax schedule—but only so long as the effective rates of tax remain moderate. This ceased to be the case in British income tax after 1941, and since

[1] See Chapter X, Section 6.
[2] See p. 328.
[3] See Chapter XII, Section 3.

the needs of the revenue are not likely to decline substantially or rapidly, the situation which has to be faced is one of high *effective* rates, continuing indefinitely; thus the marginal rate is bound to remain high. The most serious effect of these rates on incentive and effort will probably be found in connection with the earned incomes of the managerial and professional classes, most of whom could increase their incomes, and hence their contribution to the social output, by increasing the effort which they put into their work. With the growth in the size of the business unit—both in private enterprise and in nationalized industry—the relative importance in the economy of this class is increasing. It is vital in the interests of the community that they should be given the maximum incentive to personal effort. Some relief could be obtained by increasing the value and extending the range of the earned income allowances; but this could hardly work more than a minor improvement.

A parallel, though perhaps somewhat less intractable problem, is posed by the high standard rate on undistributed profits. Relief from the emergency level of this tax is urgently required. It could be applied either generally, by cutting the rate free from the personal tax, or more discriminatingly, by extensive rebates on the types of outlay of business reserves which it was desirable to encourage.

Most of the revenue lost by these income tax reliefs would naturally have to be made up in some other way. The most eligible substitute both for the present progression of the personal tax and for the high standard rate on undistributed profits would be an increase in death duties. As we have seen, a capital tax imposes no restriction on current enterprise and effort; further, there is strong reason to believe that, per £ of revenue collected, death duties imply a substantially smaller loss of surplus than income tax.[1]

So far as the lower income groups are concerned, our analysis shows that relief from the present incidence of the British tax structure should be in the main in the opposite direction (that is to say away from outlay taxes and towards income tax). During the war the problem which had hitherto baffled the British revenue authorities, of collecting equitably an income tax on small incomes, was solved in principle by the P.A.Y.E. method of collection. The main justification for the collection of a substantial amount of revenue from outlay taxes was thus removed. Although the first method of P.A.Y.E. was open to objection because of the close relation of tax to effort, this difficulty could be overcome (as we have seen)[2] by the substitution of a low proportional tax with separate allowances for the present composite tax-cum-relief.

There is little doubt that a low proportional income tax would be a preferred substitute for some of the very high rates at which British outlay taxes are assessed, especially for the present tobacco duties.[3] In view of the drastic rise in employees' contributions to social insurance, due to the expansion of social security benefits, it is worth considering whether it would not also be a preferred alternative to the traditional regressive method of uniform contributions.

These conclusions relate, however, almost exclusively to the incidence of individual taxes, considered as members of the tax structure. According to the accepted policy of the British government in 1938 no other considerations

[1] Cf. Chapter XIII, Section 1.

[2] Cf. pp. 219ff.

[3] In respect of the alcohol duties, however, it must be remembered that revenue is only one of the aims sought by the taxes.

were formally required. The effects of different taxes and of different tax structures on the size of the national income had, however, long been recognized by economists. Even in the pre-war situation the possibility of using tax changes to improve the level of economic activity would have required our attention. With the assumption by the government of responsibility for the level of economic activity the position of the revenue in the whole field of public finance assumes a new importance.

PART III

PUBLIC FINANCE IN THE NATIONAL ECONOMY

CHAPTER XVII

PUBLIC FINANCE AND THE LEVEL OF ACTIVITY

§ 1. *The Contribution of Public Finance to Employment Policy.* Already in 1938 in Britain about a quarter of total private income was paid over to government authorities for the finance of public services. As we have seen nearly half of this was disbursed in ways which deliberately altered the initial distribution of incomes. We now know the manner in which this redistribution was brought about, but we have not yet discussed the policy which lay behind it.

It will be recalled that in Chapter VII we defined the aims of economic policy in terms of the pursuit of two optima: first the production optimum, a position in which economic resources are so allocated that the production of one good cannot be increased without reducing the output of another; and second, the utility optimum, a position such that the satisfaction of one member of the community cannot be increased without reducing the satisfaction of another, after making due allowance for compensation out of the proceeds of any adjustment.

Our previous investigations have shown that within the scope of present taxes and subsidies, considered individually, there exist a number of ways in which a better approximation to these optima could be obtained than at present, e.g., by raising revenue by taxes that cause a smaller loss of surplus, or by stimulating reallocation of resources to bring prices nearer to marginal costs. Our present problem is to examine how the public finance system as a whole, in relation to the resources of the community as a whole, can be directed so as to secure and maintain the highest possible level of economic activity, in order to raise the standard of living.

The most obvious application of economic policy consists of public action to raise the level of employment when there are unemployed resources. In such conditions there can be no doubt that the larger national output will register improved allocation, while as larger national income it will increase satisfactions all round. This is so obvious that a systematic economic policy has come to be regarded as primarily a full employment policy. This attitude unduly narrows the issue ; it is not the employment which is the end of policy, but the real income which results from it. Full employment of resources is compatible with economic organizations which are by no means optimum ; and on the other hand by striving for a very high level of employment instability may be generated.[1] We must therefore examine how a "full employment" policy should be interpreted in order to give the best results.

Experience has shown that in industrial countries unemployment may originate in three different ways. First, it may be the result of frictional delays in making inevitable readjustments in a world of change ; secondly, it may be the mass unemployment caused by the failure

[1] In the absence of strict control of labour movement (as in war-time) a situation of "more jobs than men" may give rise to an unmanageable turnover of labour.

of demand in the trough of a slump; thirdly, it may be the "long unemployment" which persists even at the top of a boom, and which in Britain it took over two years of the urgency of war to liquidate. The causes of this last variety are more complicated, but fortunately the number of people involved is much smaller than in the mass unemployment of a slump. Methods of reducing frictional unemployment are relatively simple—in the nature of the case it can never be completely eliminated. If remedies can be found for the other two types, we can be sure that of itself frictional unemployment would be a minor social evil; it is a problem which can most appropriately be dealt with by the established method of insurance, so that we may neglect it here.

For dealing with the other two types of unemployment it is evident that two different sorts of policy are necessary, on the one hand a cyclical policy of filling up the troughs (and perhaps flattening down the bumps a little); on the other a long-term policy of raising the whole level of activity. The cyclical policy can be conceived in various degrees of completeness, starting from the minimum degree of action (which must be agreed by all) in which policy is confined to seeing that the activities of public authorities do not themselves aggravate the fluctuations of the private sector. At the other extreme we can imagine a policy so complete that any further reallocation of resources would seriously interfere with the individual's freedom of choosing his occupation, spending his income and other liberties which most people would be sorry to see sacrificed.

The content of the long period policy must naturally differ according to the diagnosis of the cause of long unemployment. It is possible that it may be mainly a back-log remaining from a previous slump which the subsequent boom has failed to sweep away completely; this was undoubtedly an important cause of the persistent unemployment in Britain during the boom of 1936. On the other hand long unemployment may have deeper implications, of international maladjustment, or of a chronic internal tendency for the accumulation of cash balances to be preferred to the accumulation of goods, after a certain stage of satisfaction has been reached. Even when the cause of the unemployment has been correctly diagnosed there remains to consider the degree of action which is desirable; there is no sense in using a sledgehammer to crack a nut.

Whatever the origin of the unemployment, and the policy appropriate, that policy will be the more effective the greater the care taken to absorb the newly employed in situations where their marginal product is high. This implies some responsibility for the distribution of labour between occupations and areas.[1] Further, satisfactions can be increased if policy results in an improvement in the quality of the factors of production. This points, in respect of labour, to further development of public health, housing and education services. In respect of capital it points to measures both for facilitating private investment and for increasing public assets. If there is reason to fear a chronic preference for cash balances this can be counteracted by gradually raising the level of consumption, the increase being brought about partly by a greater redistribution of income and by education and propaganda to introduce consumers to new satisfactions of which they are perhaps not yet conscious (e.g., better

[1] It must not be interpreted as a universal mandate for "taking the work to the worker", since due attention must be paid to the social costs of maintaining inconvenient locations on the one hand, and of sacrificing additional areas of agricultural land on the other, before the best policy can be determined.

ways of employing leisure). An excess demand for cash balances also suggests a need for investment designed to open up new opportunities and so to increase the productivity of industry. Such investment can often most effectively be carried out by State action or encouragement.

It should be borne in mind that these are objectives of economic policy, and that public finance is only one of the instruments for carrying policy into effect. The particular applications of policy to public finance is our immediate task, but it may first be convenient to sum up the present stage of our discussion by distinguishing three levels of policy, according to the degree in which it is considered that State action is required. The lowest stage consists of the mere filling up of troughs, a policy which in theory hardly goes further than avoiding deepening them, although in practice it may be very much more complicated. The second stage aims at taking up any permanent slack in the economy, but without interfering further with the private sector. We may now distinguish a third stage which aims considerably higher, at a net redistribution of resources with a conscious striving after the optima in this manner.

What degree of State action is decided upon will differ according to the ideology of the community, its relative valuation of freedom and efficiency; and also upon its state of development, e.g., the extent to which private effort is able, or willing, unaided, to make the fullest possible use of available resources. In many parts of the world, not least in Britain, there has been a revolution of ideas as to what is right and necessary, within the course of scarcely more than half a generation. It is worth considering briefly the stages in the conversion of British public opinion—both private and official—since they serve to explain present hopes and to throw some light on future policy.

In Britain the government has always recognized some responsibility for action in times of distress, and action has traditionally taken the form both of "assistance"—income transfers—and "public works"—additional public investment. Thus after the Napoleonic wars, poor rates were levied which were high even on modern standards, and dating from the same period (1825) a stone was recently discovered [1] recording the completion of a programme of road construction as a piece of relief work. Further there has always been a tacit recognition by the central government that it was unreasonable to exact more than a formal balance of the Budget in bad times; such economy as was possible was practised in the public services, but tax rates were not increased sufficiently to compensate for the fall in revenue; hence the Budget was formally balanced by a more or less frank use of book-keeping devices.

This charitable policy was, however, conceived only in terms of the relief of unfortunate ~~individuals~~ by the more fortunate, through a temporary redistribution of income. In practice it could hardly amount to more than this, since any favourable secondary (multiplier) effect of the expansionary policy was likely to have been at least neutralized by the unfavourable effect of the degree of budget balancing deemed necessary. The famous "Treasury View" of the effects of public works was based on just such experience as this. According to this *post hoc ergo propter hoc* argument, additional outlay in depression *could* effect no general improvement, since it merely resulted in the public sector spending money

[1] During excavations for precisely the same purpose in the 1920's, cf. *Final Report of the Unemployment Grants Committee*, 1933.

which would otherwise have been spent by the private sector.[1]

The economic analysis undermining the basis of this argument and demonstrating the positive utility of an active expenditure policy was already taking shape in the 1920's. It was based partly on a resumption of pre-war investigations of the trade cycle[2] (prompted originally by the crisis of 1907), partly on a more general realization of the implications of the enlarged public sector left by the war of 1914–18. Although it seemed that this was mainly due to the war, this was really only true of the monetary side; in the fields of social expenditure and socialized industry, in terms of constant money, the expansion represented hardly any acceleration of a process which had been going on since the early 90's.

To the big changes in prices and incomes brought about by the war can also be traced a new preoccupation with the fortunes of the economy as a whole, a point of view which bore fruit at the end of the 20's in Keynes' analysis of Saving and Investment in the *Treatise on Money.* Discussion of these matters was enormously, and successively, stimulated first by the boom of 1928–29—which, however, had the effect of concentrating attention on monetary policy and the control of interest rates[3]—and later by the depression of 1930–32. This, by emphasizing the need for assistance and public works, redirected atten-

[1] A typical statement of the "View" is quoted in U. K. Hicks, *The Finance of British Government*, p. 218.

[2] Especially D. H. Robertson, *Industrial Fluctuations*, 1915. The first fruits of the resumption of activity were Part VI of Pigou's *Economics of Welfare* (1920)—itself a development of the corresponding part of *Wealth and Welfare* (1912)—and Lavington, *The Trade Cycle* (1922).

[3] D. H. Robertson in *Banking Policy and the Price Level* (1926) was again a pioneer in the discussion.

tion to the field of public finance, and at last produced an effective answer to the Treasury view.[1]

To this fabric of research and discussion there is still one more strand to add. At the end of 1935 Keynes' *General Theory of Employment Interest and Money* shed new light on the whole problem of economic activity by relating saving to income (instead of as hitherto only to the rate of interest). From Keynes' analysis it followed that the total of incomes formed an index of economic activity; and thus his theory, which at first sight seemed to be mainly an analysis of the *deflationary* effects of the multiplier in depression, became within four years the foundation of a policy which rigidly controlled the economy against *inflation* and directed it to the single purpose of winning the war. A new importance was thus given to calculations of the national income, which had previously been regarded as having mainly social interest, a demonstration of the distribution of wealth and poverty. It was now shown that a systematic economic policy could be firmly based only on estimates of the structure of the national income. The Consolidated Income and Expenditure accounts of the Budget White Paper,[2] as a directive of policy, derive from the General Theory.

Official British opinion lagged some way behind the demonstrations of the economists. Public policy in the depression of 1930–32 was reactionary, even on 1921 standards. Abroad, however, in Australia and New Zealand, more conspicuously in Sweden, and later in the

[1] Of which the first statement was R. F. Kahn's "The Relation of Home Investment to Unemployment", *E.J.*, 1931. Already in 1929 in Sweden Professor Lindahl was exploring the applications of public activity to an anticyclical policy (*Penningpolitikensmedel* (1929)). The first detailed analysis was Myrdal's work of 1934 (see p. 129), but these works were not available in English.

[2] Cf Chapter VI, Section 3.

New Deal medley of the United States, positive steps were taken by public authorities, both to expand public activity to compensate for the temporary decline in private activity and to improve the productive capacity of the economy. Formal recognition of the acceptance of systematic economic policy in Sweden was signalized by the adoption in 1938 of a new budgetary system, expressly designed both to give the flexibility required by an anticyclical policy and to integrate into the public accounting system a long term programme for the increase of public assets.[1]

In Britain the decisive first step in official conversion was the establishment early in the war of an economic and statistical secretariat attached to the Cabinet.[2] This led to the publication (with the Budget of 1941) of the first White Paper on the National Income and the Sources of War Finance, containing the first Consolidated Account of the public and private sectors of the economy. The basing of war policy on the White Paper calculations did not, however, itself indicate any official change of heart in respect of normal policy. That a considerable change of heart had nevertheless taken place was apparent when an agreed White Paper on Employment Policy[3] was published in 1944.

The White Paper on Employment Policy registered a further important step in the process of establishing a systematic economic policy, since it implied that the British government, irrespective of party, accepts responsibility for positive measures to mitigate slumps.[4] Although the

[1] See pp. 370ff.
[2] See p. 41.
[3] Cmd. 6527 of 1944.
[4] *Loc. cit.*, p. 16, "The Government are prepared to accept for the future responsibility for taking action at the earliest possible stage to arrest a threatened slump."

policy recommended formally went no further than the filling-up-troughs level, several of the suggestions put forward (e.g., purchasing for stock by central and local governments, varying terms of hire-purchase contracts), would in practice lead considerably further. In two respects, however, the White Paper recommendations went less far than British experience had shown to be necessary in the inter-war period.

In the first place the White Paper's (almost fanatical) avoidance of borrowing to finance additional outlay in the slump would severely limit the effectiveness of any action taken; in the second, and much more important, there was a complete absence of any reference to the need for public action to raise the general level of activity, or of any suggestion that the State might take steps to increase the productivity of the economy.[1] If the policy was intended to apply only to the early post-war years there was some justification for putting forward this limited programme, since the immediate danger was of shortages rather than of unemployment resources; but as a long run policy its scope was clearly inadequate.

The desirability of a systematic public finance policy is thus now universally accepted in Britain. Further than this, it is not too much to say that with the Employment White Paper the British Government assumed responsibility for the level of economic activity in the economy. This extension of the formal commitments of the White Paper was explicitly accepted by the Labour Government with the complete approval of the Opposition. Up to the present, however, in any actual depression, public action has not even graduated to the most primitive

[1] The need for any such increase received only passing reference (para. 78) and it was concluded that the unassisted efforts of private enterprise would provide all that was necessary.

level of anti-slump policy. We have therefore little in the way of precedent to help us in estimating the relative practicability of forms which policy might take in Britain. The possible lines of attack are three: on the revenue side the amount of revenue collected and the composition of the tax structure may be appropriately varied; on the expenditure side the amount and direction of public outlay can be similarly varied; finally, the relation of revenue to expenditure can be varied in order to bring about a deficit (or an over-balance) as an end in itself.

§ 2. *The Attack from the Revenue Side.* Our previous analysis of tax incidence will enable us to set out the general principles directly. A rise in rates of income and capital taxes will tend to check saving, and will thus be expansionary (presuming that the revenue is quickly disbursed), except in so far as the expansion may be frustrated by a fall in private investment due to the effect of the higher taxes. Conversely, a fall in the rates of income and capital taxes will tend to increase saving, but can be made to stimulate investment if the fall is concentrated on funds allocated to reinvestment and research. A change in the rates of these taxes will not affect consumption appreciably unless the major working class income groups fall within the scope of income tax.

On the other hand a rise in the rates of outlay taxes, especially the duties on drink and tobacco and the purchase tax, will check consumption. *Mutatis mutandis* a fall in the rates of purchase tax will tend to expand general consumption, because the outlay comes within the housewife's purview; a fall in the rates of drink and tobacco duties are less likely to do so. Finally, a rise in the rates of employers' contributions to social insurance, not accompanied by an increase in benefits,[1] will increase costs and prices, and thus tend to check additional employment and hence consumption ; while a fall in employers' contributions not accompanied by a fall in benefits will tend to expand consumption and employment.

Thus for the control of consumption variation in rates of outlay taxes is the most effective means (in the absence of a workers' income tax) ; for the control of investment most direct use can be made of the income tax on profits. Many combinations of these effects are naturally possible. Thus employers' contributions to social insurance during the depression could be entirely remitted or even replaced by a subsidy to wages ; the outlay being financed by a rise in death duties or in the tax on rentier incomes. For implementing a long run policy ingenious combinations of devices can easily be imagined, but for a cyclical policy there is a further complicating factor to consider.

The essence of success in an anticyclical policy is speed of reaction to the measures taken. Owing to the operation of the multiplier, unless boom and depression are attacked before secondary effects have developed, the flattening process requires much heavier artillery than would otherwise be necessary. Consequently, since consumption can be influenced more quickly than investment (because the planning period is shorter), the first attack must be launched against consumption. Outlay taxes must thus be the first weapons to be brought forward ; the brake or accelerator on consumption begins to be effective on the very day the change of tax rates is announced ; whereas as we have seen a change in income tax only doubtfully affects consumption unless the

[1] In these circumstances the contributions would be equivalent to a simple tax on running costs

mass of wage earners are included in the system; and under present P.A.Y.E. methods of collection, several months' notice is necessary before a change can become effective.

Of the outlay taxes, pride of place must be awarded to the purchase tax since the rates of duty can be adjusted at any time by Treasury order, subject to confirmation by the House, whereas changes in most other taxes require legislation. The only drawback to sudden changes in purchase tax is the embarrassment which may be caused to retailers if when rates are lowered they find themselves with large stocks acquired at the higher rates.[1] Still easier to vary are the rates of contribution to social insurance, because no complications of this nature would occur.

In the White Paper on Employment Policy it was calculated that a practicable variation in the rates on social insurance contributions, at the higher levels which would have ruled under the Beveridge proposals for social security, would have made a difference of about £2 mn. a week, which as we have seen would mainly fall on consumption; it would not be unplausible to assume a similar variation from a change in purchase tax rates. Assuming the value of consumption at about 50 per cent above the 1938 level this would amount to a total difference in consumption of between 3 and 4 per cent, either way; a useful, but hardly a decisive variation.[2] Variations in income taxes and other anticyclical measures on the revenue side would intensify the effect as they were

[1] The revelation of the enormous stocks habitually carried by retailers and wholesalers, on which the country lived happily for the first two and a half years of war, suggests that this may be an important consideration in normal times.

[2] The slightly higher rates of the National Insurance Act, 1946, do not materially alter this conclusion.

successively brought to bear on the situation [1] but it seems evident from these figures that on the best guess that can be made of the composition of the future tax structure, an attack on the revenue side alone would be insufficiently powerful as an anticyclical policy.

§ 3. *The Relation between Revenue and Expenditure.* All this assumes that tax rates are varied appropriately in boom or slump ; so far this has never occurred in Britain. It is perhaps safe to assume that in future they will at least not be varied in the wrong direction in a boom. If they are varied in the right direction in a slump, and if, as should be the case, a normal standard of public services is maintained, a sizeable deficit will inevitably develop. This in itself will have a stimulating effect ; personal tax liability will be lower (certainly absolutely, perhaps even in proportion to income) ; while at the same time the government borrowing to cover current needs will increase the liquidity of the monetary system.

An induced deficit of this nature provides a beautifully simple method of stimulating expansion ; its effect is immediate, and its operation requires neither planning nor additional staff ; but there are two important reasons why it is not well to rely on it. In the first place when departments are allowed, and even encouraged, to go on spending in the knowledge that a deficit is to be incurred, there is a serious danger of the weakening of financial control. To some extent this can be guarded against by better accounting methods in the public departments, and by a budgetary system which expressly provides for deficit finance.[2]

[1] If the main working class income groups were included in the scope of income tax of course the matter might be different ; effective use might then be made of deferred credits on the war-time model. In the four years 1941–44 £800 mn. was accumulated by this device.

[2] See Chapter XX, Section 1.

Secondly, and perhaps more important, there is no guarantee that the stimulus of an induced deficit will be applied where it can be most effective. So far as the salaried classes are beneficiaries, the effect is likely to be counteracted by an increased demand for cash balances. At the best it is essentially only consumption which is directly stimulated, and this is likely to transmit only a weak and temporary impulse to investment; because a considerable expansion can be met by allowing stocks to run down, perhaps no further back in the productive process than the retail stage. So far as investment is stimulated at all it is more likely to be confined to "safety first" expansion of repeat orders for existing equipment, which will do little or nothing to increase the efficiency of the system.

Thus although an unplanned, induced deficit is a simple method of achieving expansion, its effects are likely to be considerably below the best that could be achieved *for a given deficit*, if a systematic policy were applied on the expenditure as well as on the revenue side.

§ 4. *The Attack from the Expenditure Side.* The propositions which we set out on the revenue side can be paralleled on the expenditure side. An increase in public expenditure will always tend to have an expansionary effect; even if the additional public outlay is covered by revenue, tax liability will be partly met out of saving; so that the total demand for goods and services will be increased. This proposition is no doubt more true to-day than it was when the Treasury View was first put forward, and when the general level of capital accumulation was probably lower than it is now. Secondly, we can say, a deficit-financed outlay will be more expansionary than one financed out of revenue, because there will be no contraction in consumption due to higher tax rates; also the new government borrowing will have an expansionary effect in the money or capital market, or in both. The problem therefore is to determine which kinds of expenditure will be most beneficial, both for anticyclical and for long run policies.

For this purpose it is convenient to regard the national output as absorbed by six outlets: C (i) necessaries bought by consumers; C (ii) non-necessaries bought by consumers; P (i) necessaries bought by the government; P (ii) non-necessaries bought by the government; I gross private investment (new investment, maintenance and depreciation); E exports. All experience shows that the most fluctuating elements in this total are I and E. However successful public policy may be in stabilizing the economy in future, there is no hope that fluctuations in these two factors can be entirely eliminated.

A large part of the fluctuations in I is due to the "bunching" of renewals of fixed capital, caused by a previous bunching of new investment (or renewals).[1] Re-equipment after the war will eventually give rise to a more serious peak of renewals than the British economy has yet experienced, both in respect of producers' and of consumers' capital goods; it would be over-optimistic to suppose that this can be surmounted without a severe strain on the economy, or that the phenomenon will not continue to recur in the more remote future. Similarly, in respect of exports, it would be impracticable to hope that Britain, her international position weakened by the war, will not be affected by fluctuations in other economies; even if she can keep her own internal economy running on an even keel. The main task of anticyclical policy must

[1] For a simple analysis of this type of fluctuation, cf. J. R. Hicks, *The Social Framework*, pp. 77ff.

thus be to induce compensating variations in the other streams of national output when fluctuations in I and E appear.

It will be readily agreed that variations in the *necessary* purchases of consumers must be avoided as far as possible; it is just this objectionable feature of past depressions that we want to eliminate in future. In any case it is clearly easier for the government to vary its own outlay than to influence the private sector in the right direction. We must therefore examine the composition of P (i) and (ii) from this point of view.

Public expenditure on necessaries may be classified as (*a*) routine services, (*b*) long run plans of development which have been given high priorities. The volume of expenditure under (*a*)—if the services are efficiently run—must be considered as fairly rigidly determined by administrative considerations; indeed it has been the difficulty of varying this element which has largely been responsible for the virtual deficits of past slumps. In the past the (*b*) category which was directly under the control of the national government has been confined to a small part of road construction, and to telecommunications development—if we exclude expenditure on armaments.

There has always been, however, a much wider spread of services which the national government could influence at second-hand—the remainder of road construction, the education, public health and housing services of local authorities, as well as the local trading services, and a still wider circle of public corporations and privately owned public utilities which were to some extent within the orbit of the government's influence. In the future we may look for both a very considerable expansion of investment which can be influenced at second-hand as well as a marked extension of direct action by central departments[1]; but there are other types of public activity, more or less closely related to these, which it is most desirable should be developed, because in them lie some of the best hopes of increasing the efficiency of the economy.

We may envisage " necessary public expenditure " of the future as including, in the first place, accepted schemes for regional social betterment which are beyond the scope of individual local authorities—the rehabilitation of a depressed area, for instance, or the building of a satellite town. Similarly, in the field of industry a number of large-scale reorganizations are required, and cannot be carried through without a very heavy amount of new investment—coal and cotton immediately come to mind. Whether the industries concerned are nationalized or not, it may well be easier for the government to carry out the new investment itself and lease equipment to firms or local authorities, rather than establish the additional controls which would be necessary if the work were carried out locally by means of exchequer grants. A third type of activity would consist of really large-scale public works, parallel in their own way to the T.V.A. experiment in the United States, the nucleus of which might be such things as a Forth-Clyde canal or a Severn bridge and barrage.

Important as this type of public expenditure is likely to be in the future, it does not really offer much help as a cyclical stabilizer. If preliminary costing and statistical investigation show that a project clearly falls within the criteria of policy, then the work should be undertaken and carried through, at a pace and in an order, dictated primarily by technical considerations. If a project does

[1] The transfer of further 3,685 miles of main road to central control by the Trunk Roads Act, 1945, is symptomatic.

not clearly fall within this " necessary " classification its claim to inclusion should be very seriously examined. There will, of course, always be some projects on the margin of worthwhileness, but even these cannot conveniently be proceeded with intermittently according to the state of trade. The Reports of the war-time Committee on National Expenditure are conclusive as to the waste caused by intermittent investment and the changes of plan which it entails.[1]

The fundamental difficulty of projects of this nature is, however, that they require a long period of planning and of preliminary work, such as site preparation. Very different amounts of labour are required at different stages of the process, and it is particularly difficult to forecast just when the maximum demands for labour and materials will be reached, so that they can be timed with the down turn of a cycle.[2] At the same time the varying demands of the projects for inputs constitute them, *per se* de-stabilizers rather than stabilizers.

It thus appears that however important large public works may be in the future, their main contribution to welfare will consist in the manner in which they succeed in increasing productivity and satisfactions as part of a long-term programme. There remain as eligible stabilizers consumer and public expenditure on non-necessaries; particularly of types which do not call for the production of much new fixed capital.

The scope for direct public action in this field is not very extensive. It would include small social betterment schemes of a type which can mainly be carried out by labour, and purchases for stock (e.g., of equipment for

[1] See pp. 68ff.

[2] For an exhaustive discussion of these difficulties applied to past public investment, cf. Bretherton, Burchardt and Rutherford, *Public Investment and the Trade Cycle*.

use in collective services—school and house equipment, for instance). In view of this relative paucity of variable government expenditure it is very desirable to explore further methods of influencing consumer expenditure on non-necessaries. The authors of the White Paper on Employment Policy do not recommend the purchase by public authorities of goods for resale to the public, because of the uncertainty imparted to private merchanting. This difficulty would also be encountered in a policy which used purchases and sales of commodities (food and raw materials) by government departments, as part of a stabilization policy. In respect of finished consumers' goods the difficulty might be got over if the goods were hired and not sold, a plan that would tie up with the White Paper suggestion of varying hire-purchase terms.[1] If the goods in question were chosen so that they served definite educational or social purposes (e.g., household equipment or baby furniture) considerable good might result.

It emerges from our discussion that it is considerably easier to plan and carry through a long-period programme of national improvement than it is to operate successfully an anticyclical programme. On the other hand schemes of a much lower order of objective excellence may be justified in a slump, when resources would otherwise be idle, than as parts of a long period programme, when priorities have to be considered on the basis of the whole activity of the economy. Expert calculation of the respective net benefits of big rival schemes of national improvement can never be an easy matter, but obviously some device for scientifically determining priorities must be developed.

On the other hand the existence of a long-period pro-

[1] See p. 325.

gramme for raising the general level of activity will at the same time mitigate the violence of fluctuations; and the operation of an even moderately successful stabilizing policy will tend to raise the average level of productivity.

Thus in principle the new responsibilities assumed by the British government are not merely capable of fulfilment, there is considerable choice of policy available for the attainment of the desired ends. Before the policy can be made fully effective, however, there are a number of technical problems which urgently call for solution. To the discussion of these—so far as they impinge on the field of public finance—we must now turn.

CHAPTER XVIII

PLANNING PUBLIC INVESTMENT

§ 1. *The Planning of Local Investment.* In the past it has been almost universal experience that public finance in depression has been the reverse of helpful. Perversity in fiscal policy is clearly far from being wholly due to the fact that governments did not accept responsibility for an appropriate policy, because countries which intended to fill up the trough in the early 30's found it extremely difficult to put an appropriate policy into effect. One of the main reasons for this was the absence of machinery for preparing plans in advance and of finance for putting them promptly into effect at the right moment.

In Britain, between 1940 and 1942, effective machinery was developed for planning and putting into effect public policy, and also controlling the private sector. For this purpose the government built up a fact finding and plan-making nucleus round the Cabinet Offices and the Central Statistical Office, in conjunction with the manpower control exercised by the Ministry of Labour and National Service. This nucleus is available for use in peace-time also, but it is only the beginning of the machinery necessary for a systematic economic policy. The war-time machine was reasonably effective, but only for its own purposes and for functioning in an atmosphere of controls that would not be tolerable in normal times. Clearly the organizational experience gained in war-time has some permanent value, but it would be strange if the war-planning machine could be converted to normal use without drastic alteration and extension.

The degree of planning and control of the economy which is desirable as a long-run policy is a matter of political opinion and so lies outside our field. In Britain a position which is now widely accepted however (and which therefore can conveniently be used as a starting point), is that the national government should assume responsibility for achieving and maintaining a high level of economic activity, without itself undertaking a major part in actual production. This policy implies two conditions. In the first place it is the duty of the government to do its best to provide a favourable *milieu* in which private enterprise can function to the best of its ability, but without any more direct interference by government agencies than is implicit in the provision of advice and guidance (based on information supplied to the government) as to the probable course of economic development, internal and international. The second condition is that the government should so direct the activity of the public sector as to compensate, and if need be to supplement, the activity of the private sector, so as to secure that the economy as a whole works at the highest possible level of activity.

The details of the precise forms of public activity by which this dual policy should be implemented, and of the precise relation of the volume of public and private activity respectively, are matters of great practical importance, but from the point of view of the machinery of planning they are of secondary interest. On the one hand the problems are very similar in kind at any level of public/private relationship short of the complete absorption of the private sector by the public; on the other, even at the lowest level of activity by the public sector, a considerable extension of planning machinery, beyond anything that now exists, is required in order to implement a systematic policy.

Many of the problems of planning are purely administrative; with them we are not concerned. Again the plans will not bear the expected fruit unless they can grow in a congenial monetary climate; with monetary policy as such we are equally not concerned. Nevertheless in discussing the economic and fiscal aspects of policy we cannot avoid poaching in these fields to some extent, because all three are inevitably closely related, and all must play their part in a systematic policy.

A very common obstacle to making public activity an effective factor in policy has been the circumstance that the main types of relevant public expenditure have been controlled by regional governments, the national government itself doing little or nothing at first hand. This has severely hindered the realization of a concerted policy in the public sector, both in respect of planning and of execution. In Britain this division of function in the public sector must in any event have been an important limiting factor in policy. In the United States the policy of the State and Local Governments in the early 30's was wholly perverse, and seriously aggravated the catastrophe. This was only partly compensated by the fact that after 1933 the policy of the federal government operated in the right direction, because the feverish activity of the New Deal administration matured too late to be of much importance during the slump. (Nevertheless the federal agencies established at that time would strengthen the hands of the federal administration on another occasion.)

Sweden surmounted the technical difficulty of division of function with more success than most countries which attempted a positive anticyclical policy in 1930–32, because the national government was already in control of important investment opportunities; but even there delays in execution, due to the division of function, were a limiting factor. Australia has perhaps succeeded best so far in developing a concerted policy in the public sector, an achievement which is the more remarkable because she is a federation. The Commonwealth chances to be organized in a manageable number of not too dissimilar States, and by an accident of past history,[1] a joint council was already in being at the moment when it was decided to attempt a common anti-cyclical policy. The Australian Loan Council, on which the States are equally represented, has authority to determine which of the schemes put forward shall be adopted, and also to arrange for the necessary finance. In Britain some parallel body is also required, but much additional machinery at the lower stages of planning is also necessary.

The fact that a large proportion of public investment is undertaken by regional governments is likely to increase the difficulty of achieving a concerted policy for the public sector in three different ways; first, in the willingness of minor governments to bestir themselves in the interests of the whole economy; secondly, in respect of their ability to make effective plans; and thirdly, in respect of the time which elapses at the various stages of preparing, passing and executing plans.

We have seen that in most countries regional governments labour under a fairly rigid limit to their total expenditure. British local authorities are probably more conscious of this than regional governments abroad, because of the narrowness of their tax field and

[1] The necessity of finding some means of surmounting the debt crisis of those States which had borrowed beyond their means and were threatened with bankruptcy. The Loan Council is primarily a State body, although the Commonwealth government is represented on it. This fact may possibly lead to trouble in the future with the expanding importance of the Commonwealth government, especially in the field of monetary policy.

their consequent heavy reliance on grants. Subordinate governments thus usually feel that they must watch their step very closely in relation to the local revenue position. The result of this limitation is to cause them to react to the economic situation with at least as violent waves of optimism and pessimism as those which afflict private enterprise. Since minor governments do not normally build up liquid reserves (and are often legally prevented from doing so), if anything, their reactions to the state of economic activity are even more intense than those of the private sector.

This phenomenon was recently illustrated in Britain in a most interesting way. In 1938 the Ministry of Health, tardily converted to the desirability of forward planning, requested local authorities to prepare comprehensive " Five Year " plans. With rising rate poundages and a general feeling of uncertainty, the result was virtually zero. In 1945 local authorities were once again requested to forecast their capital expenditure for a period of years. The result, in the atmosphere of post-war optimism and full local coffers, was a flood of schemes in themselves sufficient to keep the whole economy occupied for years, oblivious of the calls of private enterprise and of the central government on the national resources.

Even if this psychological (or more basically financial) difficulty can be overcome, there remains the technical problem of getting workable plans prepared. One reason for the poor response to the Ministry's suggestion in 1938 was the fact that very little help in planning was offered, and no incentive whatever was given to incur the very considerable expense of working out detailed plans. The schemes submitted in 1945 were many of them more in the nature of " homes for heroes " dreams than based on professional plans drawn up in a form in which they were ready for implementation in a national policy.

The inability of most local authorities to maintain large technical staffs is a very real difficulty in planning the public sector. After the war of 1914–18 it took about six years before effective local housing departments were developed, yet the technique of estate planning was largely a "repeat operation" once the first batch of houses had been erected. For the all-round development which is now desired much larger and more diversified technical staffs are needed. If, however, funds for investment are scarce, funds for planning (which may never result in something the ratepayers can see) are still more scarce. The result is that central departments do not get the plans in the form they require them, and must examine all local plans carefully on technical grounds. This causes frustration and delay to the larger local authorities which can command adequate staffs, without doing anything to raise the general standard of plan preparation.

In Britain (and in most other countries) it will continue to be necessary to make use of local investment as an important part of the policy of the public sector, even if the direct opportunities for investment by the national government are considerably increased. The British local authorities may lose some of their former investment opportunities (e.g., highways) to the central government, but on the other hand they are likely to gain some (e.g., grammar schools, hospitals and some housing) from the private sector, so that in the immediate future local investment is likely to expand considerably. It is imperative therefore to develop better machinery for systematic local planning.

The first step towards achieving this aim is to find a means of inducing and enabling all local authorities (not merely the largest county boroughs) to undertake effective preparation of definite investment schemes. This implies that they must have equal access to trained staff without straining their finances. The cost of plan preparation is a more serious item than is usually allowed for. In the U.S.A. where the war has shown that the technique of surveying, site preparation and the like is considerably more advanced than in Britain, the average cost of planning has been estimated at some $3\frac{1}{2}$ per cent of the total cost of schemes.[1] When the plans have been worked out, further means of passing them and classifying them in order of priority need to be developed; and finally, administrative machinery and immediate finance are required for putting the plans into operation.

It seems clear that these three stages of preparing the local plans, correlating them and putting them into operation, require that the process should be at every phase a co-operative undertaking between the local authorities and the central administration (mainly the Ministry of Health). Only if officers of the central administration are fully conversant with the local plans from an early stage, can the plans be given correct priorities and passed quickly into execution. From the side of the local authorities, the skilled technical staff of the central administration can supply the advice and technical guidance with which all but the leading authorities have been—inevitably—under-equipped in the past.

Before the Ministry of Health can play its part effectively in this co-operative venture it requires, however, drastic internal reorganization and expansion. A strong statistical department, concerned with the real content of local finance rather than with numerical totals, is long overdue. Additional strength in the technical staff

[1] Cf. Hansen and Perloff, *cit.*, p. 222.

of surveyors, architects and cost accountants is no less necessary. Even when these reforms have been carried through there will still be an important bottle-neck in the necessity for passing the plans of anything up to 1,000 local authorities through a single office. It would therefore be extremely desirable if the Ministry of Health could take a leaf from the book of the Ministry of Labour and develop a really strong regional organization, staffed by technical officers in continuous contact with the London office on the one side and with the local authorities of their region on the other.

If these internal reforms of the Ministry were carried through, and a strong regional organization established, it is possible to visualize the co-operative process of planning proceeding somewhat as follows [1]: Regional Investment Councils would be instituted consisting of representatives of all local authorities in the area, and the regional staff of the Ministry of Health. The larger authorities (County Boroughs, say, exceeding 300,000 inhabitants, and County Councils) would have permanent seats on the Council; the smaller authorities would occupy the remaining seats in rotation.[2] It is essential to the scheme that all grades should be directly represented; indeed it is the weaker authorities which are most in need of help from the scheme. At the same time the presence of the Ministry representatives should ensure an atmosphere of reality and urgency which has often been lacking in joint councils of local authorities sitting by themselves.

[1] The line of ideas put forward in this section was evolved in discussion with Mr. H. Hartley, who has undertaken to examine more carefully their administrative implications.

[2] The parallelism with the organization of U.N.O. is not accidental; basically the problem posed is the same—of giving due weight to the interests of "nations" of very varying size and wealth, in a co-operative organization.

The regional investment councils would meet regularly; in the first place they would discuss broadly the relative merits of schemes put forward locally. They would then authorize the promoters of those schemes which were provisionally accepted to proceed to detailed planning and scheduling. It would be the duty of the regional organization of the Ministry of Health to see that adequate technical staff and finance for planning were available to the authorities concerned. When the plans were completed they would be finally examined by the Council in order to determine provisional priorities for the region —provisional because it might on occasion be necessary for priorities to be reshuffled on national grounds.

The next stage of planning the public sector would necessarily take place on the national plane; but the establishment of a national system of priorities for local investment need no longer give rise to delay. The bottleneck would already have been broken by the decentralization of the Ministry of Health, and by official co-operation in the plans from the earliest stage. The Ministry would determine its priorities for submission to the central planning body of the public sector on the basis of its own regional officers' reports.

§ 2. *The Integration of Sectional Plans.* Local investment is only one of the strands in the fabric of public investment policy, although it may well be the most important. However close the integration of local planning, the national government's influence will still be indirect; it may suggest, but it cannot force, schemes on local authorities without weakening their autonomy. The more the government can fill out the policy of the public sector by activities more directly under its control, the more flexible that policy will become. From this point of view there are two types of investment to consider, first, that of the nationalized industries; secondly, the trading activities of government departments. In both of these directions there are likely to be considerably greater opportunities in the future than in the past.

The most obvious avenue for direct action by the national government is that of the nationalized industries. In the past this avenue has been practically closed for policy purposes, not only because of the small range of nationalized industries, but also because of their constitutional relation to Parliament. They were either (like the Post Office) too closely related to the fortunes of the Budget, or (like the Central Electricity Board) too remote from Parliamentary control to be even as closely integrated with policy as the investment of the local authorities. Thus the Post Office is under the control of a Minister of the Crown, responsible continually to Parliament [1]; the Post Office Estimates come within the Budget almost on the same footing as the Estimates of the Supply Departments. Although Commercial Accounts have been drawn up since 1933, the old-fashioned Budget accounts come much more effectively within the purview of Parliament. At the opposite extreme the public corporations established in the inter-war period (such as the Central Electricity Board) follow a virtually independent line, so that they are almost as little controllable as to policy as the old-fashioned Public Boards (e.g., the Port of London Authority) composed of representatives of consumers.

It is to be hoped that with the newer nationalized industries a middle way between these extremes will be found, whereby Parliament can maintain regular and effective contact with the finances of the industries

[1] Cf. p. 6.

(conducted according to the best contemporary accounting technique), but yet leave them free of the leading strings of direct ministerial guidance. It is only by leaving the day-to-day running of the concerns to the judgment of the boards, that the country can realize that increase in productivity which is the main justification of public ownership.

From this it follows that it is only in so far as the nature of the nationalized industries makes them suitable helpmates in a national investment policy that they can be used for that purpose without damage to the concerns themselves, and so to the community. Fortunately their nature is such as to suggest that they can be drawn upon as instruments of policy fairly freely without damage to their commercial prospects, at least for the immediate future. Both coal and transport urgently call for large amounts of new investment; civil aviation and telecommunications still require much development, and for some at least of this an anti-cyclical timing policy would not be inappropriate. The success of guaranteed loans to the railways in stimulating new investment at the close of the 1932 slump [1] suggests that a good deal of appropriate activity in these industries might have been forthcoming without the process of nationalization, but it cannot be denied that the effect of public policy on investment in the public utilities can be more direct, without damage to the concerns, under public ownership.

In the past the direct investment of the public departments was almost wholly confined to the Defence Departments. On more than one occasion battleships have been economically effective public works, and they will no doubt serve the same purpose in the future; it goes without saying, however, that the Defence Departments

[1] Cf. U. K. Hicks, *Finance of British Government*, *cit.*, pp. 72 ff.

cannot be relied on as an instrument of policy. Their investment, even more than that of the nationalized industries, is dictated by technical considerations which can only be interfered with at the country's peril.

During the war, however, certain supply departments (e.g., the Board of Trade, the Ministries of Supply, Works, Food and Agriculture) developed what were in effect powerful trading organizations. So long as suitable accounting methods can be evolved, activities of this sort could usefully find a permanent place in the economy; it is evident that this is the intention of all parties. Thus the Employment White Paper expressly advocated departmental forward purchases [1]; the Ministries of Supply and Works are already authorized to provide materials for house building and equipment. This new departure promises to be of very great importance for the policy of the public sector of the future, because it is more directly under the control of the government than any other form of public investment. At the same time it should not be overlooked that investment in working capital may have less favourable multiplier effects than investment in fixed equipment.

These then are the strands out of which the fabric of policy for the public sector must be woven. The final stage of the determination of policy must necessarily be at Cabinet level, but the Cabinet will no doubt rely on independent advice (for instance, from the National Investment Council) as to the plan as a whole, just as it will rely on the separate reports of the policy of the different parts of the public sector, sponsored by the appropriate departments.

The plan for the public sector must, however, be drawn up in relation to the situation of the whole economy

[1] Cf. p. 325.

(including external considerations) ; this requires a continuous reference to the intentions of the private sector. The channels of contact opened up during the war, the statistics collected by the C.S.O. and by the Ministry of Labour, and their interpretation in the Cabinet Offices, have provided enormous new opportunities for the government to make an informed judgment on the state of economic activity ; these channels of contact need to be still further broadened and deepened. The Employment White Paper indicated a number of directions in which additional information is required on the lines already developed ; separate committees have investigated more closely the figures of production and distribution which should in future be available.

In the first place, it is agreed that an Annual Census of Production, with results available in the succeeding year, is a basic necessity. This should include information on stocks and work in progress, as well as on quantity and value of output, and so far as possible, a detailed breakdown of cost items. Secondly to supplement the Census, and increase the flexibility of policy, a sample monthly investigation of production, consumption of materials, stocks and orders in hand, taken from the leading firms and trade associations, is also recommended. Thirdly, more detailed figures of the distribution of manpower, and of hours worked, are suggested, including forecasts of intended investment and the labour force implicated. Finally, more information is asked for concerning the composition of, and movements in, the foreign balance.

This new statistical information was deemed to be necessary for the foundation of policy for the public sector even at the lowest, trough-filling level of public activity. It would be even more necessary for a more ambitiously planned public sector, since the effects of errors would be magnified. To provide these statistics will be no simple matter, either for the firms who have to make the returns or for the statisticians who have to present and interpret them. The magnitude of the task can be realized when it is remembered that in the inter-war period there was considerable boggling at a quinquennial Census of Production (which was much less detailed than what is now asked for), and that the results were only available after very great delay. On the other hand the statistical difficulties should not be exaggerated. In the past Britain has lagged seriously behind the United States in the collection of industrial statistics ; it is only to be expected that there will now be much leeway to make up, whatever the level of policy to be put into force. It is to the interest of the private sector to co-operate as fully as possible in providing them.

Thus set out, the process of determining the volume of public activity and of integrating the various strands of the public sector into a concerted policy for the whole economy looks formidable, but it is not in principle impracticable. Adequate planning machinery at all stages is necessary for the formulation of a systematic policy, but in order for the plans to be implemented and bear due fruit, adequate finance is equally necessary ; to this matter we must now turn.

CHAPTER XIX

LOAN POLICY AND PUBLIC DEBT

§ 1. *The Provision of Funds for Local Investment.* In considering the financial aspect of the additional public expenditure necessary for maintaining the economy in a state of full activity, there are three sorts of problems which require attention; first, those concerned with the provision of adequate funds for immediate use on any project which has been scheduled for commencement; secondly, those concerned with the process of raising the necessary loan funds; and thirdly, the effect on the economy of an increased accumulation of public debt.

The first is mainly a technical problem, but it is of considerable practical importance, and in the past the difficulties have not been successfully overcome. Difficulty arises essentially from the division of function in the public sector. The government can immediately put central departments in possession of any funds they need for direct investment, but it is not so easy to finance indirect operations—those of the local authorities or of private firms who are working for a department on contract. During the war this problem was solved by means of a system of progress payments. It is worth investigating whether something of this apparatus could not be adapted to peace-time use, and extended to cover payments from the Ministry of Health to the local authorities. Without some such arrangement an important factor in the delay of putting local investment into effect cannot be eliminated.

Whatever arrangements are made for the provision of immediate funds, sooner or later local investment will require the raising of long-term loans, and in this field there are many unsolved problems. In the inter-war period British local authorities borrowed extensively to finance fixed investment, especially house building; the costs of this were, however, considerable, and differed markedly between authorities differently placed, so that development was also uneven.

There are certain inherent difficulties connected with local borrowing which need to be overcome, if local investment is to play its full part in a national policy. In the first place the expansionary effect—which should in principle be fully as great as if the investment were undertaken directly by the central government—only partially accrues in the area where the investment takes place. The authority incurring the loan only benefits to a small extent by an increase in rateable value, the greater part of the effect of the expansion accrues to the central government in the form of increased income tax revenue. As against this, the greater part of the local debt will probably be held externally to the area, so that interest payments will entail an external transfer. Thus the natural effect of borrowing is to raise rate poundages, it is consequently a luxury which local authorities cannot equally afford.

The final control of the amount of debt which a British local authority may acquire is fixed by the Ministry of Health. Hitherto the criterion used in giving permission for new borrowing has been a fairly crude comparison of the capital of the debt in relation to rateable value. This method has succeeded in keeping local borrowing well within the limits of safety, except in the special case of the few towns (such as Merthyr) which have been losing population heavily in recent years. In other respects the policy has not been very successful, in that it has done little to secure that local authorities were able to make the best use of the opportunities open to them.

In the nineteen-twenties there was a sharp contrast between the terms on which the larger and wealthier local authorities could raise funds in comparison with their smaller and poorer neighbours. The larger cities and counties had unfettered access to private savings through the stock exchange, except for the over-all limit imposed by the Ministry, which in their case was largely formal. The terms of stock exchange issues were little if any stiffer than those available to the national government (at one period in the 'twenties local stock actually stood higher than that of the national government). In contrast, the smaller authorities were forced to borrow at second-hand from the central government through the Public Works Loans Board, an organization which financed itself directly from the stock exchange, but on terms no more favourable than those available to the larger local authorities,[1] so that it was compelled to charge its clients a higher rate than they would have had to pay if they had been able to make use of direct methods.

The combined effect of the extra cost of borrowing through the P.W.L.B.[2] and of the effective limit imposed by the Ministry of Health, was to put the smaller authorities at a decided disadvantage. This was enhanced by

[1] The borrowing policy of the Public Loans Board itself was not always fortunate. All its stock was issued at 3 per cent whatever the rate of interest; in the 1920's some stock was actually issued at 57. in flagrant contravention of the rule that public authorities should not borrow under par, because such loans are difficult to convert. This has proved eminently true of Local Loans stock. For details of the loan transactions of British local authorities in the inter-war period, cf. U. K. Webb (U. K. Hicks), "Local Public Debt in England and Wales", *Economica*, 1935.

[2] Some small towns actually found it preferable to borrow at second-hand from their larger neighbours instead of relying on the P.W.L.B,

the reluctance of private investors to take up mortgages except in the larger cities, and their desire to avoid especially any area where rates were already high. (This was mainly due to an entirely misconceived transfer of notions of commercial risk from private enterprise.) This discrimination in borrowing opportunities was one of the main reasons why towns in poor areas remained shabby and old-fashioned after others had modernized themselves. While it is obviously undesirable that towns which are no longer expanding should be encouraged to encumber themselves with a large amount of debt which they may have difficulty in servicing, these arrangements tended merely to give them bad value for such loans as they did raise.

In the 1930's the free access of the larger authorities to the stock exchange was greatly curtailed through the necessity for obtaining Treasury sanction for a public issue; a sanction that was not infrequently withheld in the interests of the national finances. In partial compensation for this some (but not all) of the larger local borrowers were able substantially to lighten their debt charges by converting issues which had been raised at high rates of interest in the early 'twenties. This relief was not open to the clients of the P.W.L.B., which on the contrary, owing to its own inability to convert, was forced to impose fairly heavy fines for premature repayment of mortgages.

By the end of the inter-war period the loan facilities available to local authorities were in the aggregate less good than they had been at the beginning; without any progress having been made towards equalizing opportunities or towards relating control to economic, as opposed to narrowly financial, considerations. During the war the control of the Treasury over the capital market became (through the Capital Issues Committee) virtually complete. Since the needs of the Treasury in the 1940's and even the 1950's are not likely to be less than they were in the 1930's, there is little prospect that the local authorities will recover the freedom of access to private savings that they once had. Conditions of control similar to those of war-time seems likely to continue indefinitely.

It may well be that in the long run the interests of public policy as a whole, and even of the local authorities themselves (except for the few largest and wealthiest), will be best served by concentrating all access to long-term capital in a single body. This would avoid competition on the capital market which might be embarrassing to the Treasury, especially in the post-war decade; while if funds were made available to all local authorities, without discrimination, when once their schemes had been passed for execution, much delay and heartburning would be avoided.

The constitution of the central Council responsible for primary borrowing for public investment needs, however, to be very carefully considered. It needs to be broadly based if it is to be something more than a continuation of war-time Treasury control (exercised through the Capital Issues Committee). Clearly it must be closely related to (if not actually identical with, as in Australia) the body responsible for examining investment plans and advising the government as to their priority. The Council must always recognize that in recommending to the government particular schemes for execution, they should have in mind economic rather than financial considerations; finance should be the handmaiden of policy and not its master. Finally, the economic considerations which are relevant in determining policy are those of the economy as a whole, and not of any particular part, however importunate.

This financial machinery should enable a concerted policy for investment for the whole public sector to be put into effect. It should also eliminate the tendency for uneven development which marred the local investment of the inter-war period. Since local authorities would often be making their investment as much in the national interest as in their own, it would not be unreasonable for the exchequer to make special grants in aid of debt service in particular areas. In general, however, the position of declining areas can be more efficiently safeguarded by a greater control of the actual investment than by making it difficult for them to borrow. As an additional safeguard against a worsening of a local economic outlook during the currency of a long loan, it would be worth exploring whether some method could not be evolved of insuring future debt service; thus relieving both the national and local exchequers of anxiety for the future, and also incidentally improving the status of a weak local authority as a borrower on short term.

In a sense the problem of local debt in the 1940's and 50's should be an easier one to solve than that of the 20's, because of the much lower level of interest rates. This is no doubt the foundation of the Employment White Paper's conclusion that: "It is unlikely that a growth of indebtedness of local authorities would involve an intolerable burden on rates." Unless some such machinery of loan finance as we have discussed is evolved (or alternatively the volume of local investment is held lower than it should be in the national interest), this conclusion is likely to prove over optimistic.

§ 2. *The Effect of the Process of Borrowing.* It is commonly taken for granted that the assumption by the government of responsibility for maintaining the level of economic activity implies a heavy volume of deficit finance and a rapidly mounting public debt. This is by no means inevitable; in the post-war decade, while deficits may well be incurred, their effect is likely to be embarrassing to policy (as tending to inflation) rather than helpful. Even in the longer period we have seen that there are a number of ways in which economic efficiency could be increased and enterprise stimulated without any recourse to deficit finance—e.g., by reduction of the repressive effect of income tax, by expansion of output where it has been reduced by monopolistic control and in general by a better application of science to industry. On the other side it is equally a mistake to suppose that incurring a deficit is in itself a sufficient directive of policy. Neither a balanced nor an unbalanced Budget is "a crime against society" (as declared by one member of Parliament in the debate on the Finance No. 2 Bill of 1945); either may be the correct policy, according to the economic circumstances.

There are, however, a number of reasons for supposing that the undertaking which all parties in Britain have given for maintaining the level of activity, will in practice lead to a fairly rapid expansion of the public debt. For the first time in British history the National Debt is likely to grow in time of peace as well as in time of war. In the first place, the maintenance of full activity in an economy which is no longer expanding, may ultimately require fairly frequent Budget deficits on current account. It is a mistake to view the policy required too exclusively in terms of long-term investment, it is equally important to secure a proper balance between present and future.

Budget deficits on current account do not necessarily cause a permanent rise in the public debt. There is much to be said for a policy which aims at repaying some at least of the new borrowing when conditions improve. In Sweden the whole of the additional debt incurred on current account in the depression of 1930 was in fact subsequently cancelled. It cannot be said, however, that this result is very probable, and it would be false policy to endeavour to pay off debt if economic conditions did not call for a budget surplus.

In the second place, while a number of the new assets acquired will ultimately cover their costs (indirectly in the form of tax receipts or directly in the form of trading profits), many others, equally eligible on welfare grounds, will not do so. Even some of the most urgent industrial investments, e.g., the sinking of new coal shafts, will not result in an early increase in profits. For these reasons, long-term investment is also likely to lead to a considerable expansion of the public debt.

There is also a third probable cause of the expansion of debt, also in relation to long-term investment, which is more subtle, but of which it is important to grasp the significance, because it concerns a form of deficit finance which may well be particularly paying to the community.

Many of the public utilities (some already partly socialized, others scheduled for nationalization) are characterized by very high overheads in relation to running costs. Gas, electricity, rail transport and telecommunications are the typical "increasing return" industries, which require that output should be pushed to the point where price equals marginal social cost,[1] even when this implies a working loss. There may sometimes be situations in which (owing to a limitation of the local market or to the large size of the minimum unit of investment) the optimum output policy will result in a

[1] Cf. Chapter X, Section 5.

profit.[1] Usually, however, the marginal units cannot be expected to cover their costs. This is precisely why the optimum output is unlikely to be reached under private ownership; under public ownership there should be no inhibition against reaching optimum output, but it will lead to a deficit.

In addition to all these situations in which it would be wrong *not* to incur a deficit, it would be optimistic to suppose that once the obligation to an annual budget balance is removed, and more especially as the field of public control over industry expands, deficits will not sometimes be incurred on less legitimate grounds. Even if a watertight system of accounting for the new types of public activity can be evolved (a question which we must discuss in the next chapter), it is inevitably more difficult to keep a tight hand over costs in the absence of the convenient profit check. It must be remembered also that once the State has put its hand to the plough (taken over a firm or industry) it is much more difficult for it to turn back and cut its losses than it is for a private firm saddled with indefinite prospects of loss. It is just in those industries which find it most difficult to keep their heads above water in the choppy sea of private enterprise, that the pressure for nationalization is likely to be greatest, both from the side of management and of labour.

For all these reasons it seems inevitable that the public debt will tend to expand fairly rapidly over the next two decades. The problem of launching smoothly on the money and capital markets a substantial amount of new public debt, on top of the abnormal conditions created by six years of war borrowing, is not an easy one. To

[1] Cf. Meade and Fleming, "Public Output Policy in State Enterprise", *E.J.*, December 1944.

discuss the monetary problem in detail is obviously outside our field, but we cannot neglect it entirely, since it impinges directly on investment policy.

In principle the government has, broadly speaking, a choice of three methods of financing a deficit or raising a loan. It can borrow on fairly long term, at a rate probably in the neighbourhood of about $2\frac{1}{2}$–3 per cent; it can borrow at short term (of the order of three to six months), at a rate of interest which is some fraction of 1 per cent; or, finally, it can borrow at zero rate of interest by printing additional notes. In the first alternative private investors—both individuals and firms—are largely concerned; in the second it is mainly a question of relations with financial institutions; in the third of relations with the Bank of England.

Obviously the second and third methods of borrowing are preferable from the narrow budgetary point of view; the average rate of interest on the debt is much lower, and the tax charge less, for a given debt. The market rate of interest is also probably more directly under the control of the authorities than the longer rates. On the other hand the creation of large amounts of new money or near money tend to increase the liquidity of the system in an awkward manner. There is some danger of setting up an inflationary pressure of expenditure, which it might only be possible to control by the direct rationing of the means of investment, in the war-time manner. This would be a sad hindrance to incentive in the private sector.

On the other hand the course of the less expansionary long-term borrowing may not be altogether smooth. Since 1932 it has been possible continually to force down interest rates—long and short—by the simple process of glutting a virtually closed system with credit. During the war this policy was continued with impunity, although at the cost of a rising volume of liquidity. It is not so certain that it will be possible to continue the process of forcing down, or even of keeping down, long-term rates in this manner, essentially because of the inability of the system to absorb indefinite amounts of long-term bonds without having its liquid position substantially strengthened.[1] Further, with a continuous need for borrowing, even an austere and successful use of bonds does not eliminate the danger of over liquidity, because with the passage of time, long- and medium-term debt is continually turning into short-term debt. In the 1920's excess liquidity was an embarrassment to the monetary authorities right down to the big conversion operation of 1932.

The worst problems of monetary control will naturally be concentrated in the reconstruction period ; if once this can be safely surmounted, the more effective methods of control now available will ease the situation as compared with the 1920's. At the same time the greater reliance on short-term borrowing between 1939 and 1945 (as compared with 1914–18) makes the situation in itself more difficult.

Whatever the future course of interest rates, no one doubts that it will be possible for the authorities to hold the long-term rate at a level well below the average of most earlier periods. This will be of real assistance to private enterprise (especially for very long-term investments) as well as to the Budget. The increased difficulty of controlling private investment, if interest rates are kept perpetually on the floor, must not be left out of account, however. Even a moderate low interest policy, carried on irrespective of the economic situation, implies a revolution in monetary management, which has not

[1] Cf. " The Short Bond Problem ", *Economist*, 24th November 1945.

hitherto been put to the test. It implies the abandonment of the economic functions of the rate of interest, first as a sieve for determining investment priorities, secondly, as a rapid means of checking inflationary over-investment (i.e., pressure to invest in a situation of full employment).

It will no doubt be agreed that the usefulness of the rate of interest for determining investment priorities is much less than it used to be, owing to the growth of internal financing. It is not therefore of no importance at all, especially in relation to the trying out of new inventions. The decision not to use the rate of interest to check inflation is more serious. Although like other purely monetary measures, the working of interest rate policy was somewhat rough and clumsy, it had the virtues of quick reaction, and of complete absence of any private wire-pulling element. On many occasions the threat of a rise in rates was sufficient to check over-investment, so that the real damage to expectations cannot have been large.

The great difficulty of refraining from the traditional use of interest rate policy is to find alternative controls which will work as smoothly, quickly and equitably, without stifling enterprise at least as thoroughly. The writers of the Employment White Paper were clearly aware of this. They advocated an eventual return to a more or less traditional interest rate policy, but only after the difficult period when the war debt was still being digested by financial institutions.[1] This seems to imply an acquiescence in the continuation of something like war-time controls over that period, which would appear to be

[1] The distribution of war borrowing alone makes a condition of high liquidity in the short-bond market inevitable up to about 1960, cf. *Economist, loc. cit.*

a disproportionate sacrifice in the interests primarily of a low debt charge.

The extent of the monetary difficulty depends, however, to an enormous degree on the volume of new debt thrust on the system. As we have seen, for the purpose of maintaining the level of activity it is very unlikely that, once the immediate effects of hostilities have been overcome, a deficit will be required for some years, perhaps not within the post-war decade. By good management it should therefore be possible to steer safely round the difficult corners in the reconstruction period, after which the problem will become very much simpler.

§ 3. *The Effect of Increasing Debt.* In a country which has a public debt charge as large in relation to its national income as that with which Britain emerged from the war, an addition to the debt from whatever cause cannot be regarded with complete indifference; even if (as must be supposed) the new debt is all held internally, and so poses no new transfer problem, and exerts no new pressure on the balance of payments. In one sense the presence of a large debt has an expansionary effect, even after the period of borrowing is over and the new money has ceased to give rise to additional incomes. For financial institutions (as we have seen) it tends to increase the degree of liquidity and so can be the basis of extended lending; for borrowers, additional long-term debt provides extended collateral for loans.

On the whole, however, a large public debt is on balance a depressing factor in the economy, especially if it consists mainly of long-term bonds held outside the narrow range of financial institutions. A large internal debt implies a large race of rentiers; the receipt of a steady rentier income deadens the incentive to work and reduces the stimulus to enterprise.[1] Of far greater importance than this, however, is the effect of the taxes which have to be raised in order to service the debt; this factor is especially serious in Britain in view of the many other new calls on the revenue, and the very high rates of tax already established. Even if the additional debt interest were to be financed by a proportional personal income tax (which would avoid additional direct pressure on business and yet be not inconsistent with distribution policy), the total rates of tax on the salary incomes would be at a level which would seriously impede incentive. This is a difficulty which cannot be solved by juggling with marginal tax rates, because the average rate itself is so high.[2]

The most serious aspect of an indefinite prospect of new borrowing is thus the taxpayer's reaction to footing the bill. In view of the seriousness of the British situation it is worth inquiring what methods are available for lightening the charge of the debt. The natural methods of reducing the cost of public debt are conversion to a lower rate of interest and repayment of the principal; in current British conditions neither of these methods offers much hope of relief. Short-term debt leaves no room for conversion, on the contrary it will probably need funding from time to time, thus raising the debt charge; long-term rates are already so low that a conversion could not effect much economy. Nor is there much prospect of reducing the principal. Tax rates are already too high without attempting to force a large Budget surplus, even if economic conditions made it possible. As we have seen,[3] for a country with high progressive taxes, the gross saving of a capital levy is largely swallowed up in future revenue losses.

[1] Cf. Meade, "Mr. Lerner on the Economics of Control", *E.J.*, 1945.
[2] See p. 222. [3] Cf. p. 241.

A more promising expedient is to develop sources of public revenue outside the tax system, especially the profits of public enterprise. In Britain, since this is a source of public income which has scarcely been touched in the past, there should be considerable scope in this direction; especially in view of the prospective expansion of public ownership. This is a policy which has been very popular in Sweden, partly because it facilitates the accumulation of a surplus during times of high activity which can be applied to investment during a slump without complicating the main Budget; but also explicitly as a means of keeping the rates of the progressive income tax within bounds. The policy has been followed so successfully that in 1941 the revenue from Swedish State enterprises covered the service of the national debt twice over.[1] In Britain the addition to the revenue would be smaller (per £ of net profits), because the government already takes a larger share of the profits of public enterprise in income tax.

In Britain, as we have seen,[2] policy has hitherto been opposed to the realization of net profits in public enterprise. This may be partly due to the nature of the traditional trading services, although there is little evidence that output has in fact been pushed to the optimum point. In some cases a pricing difficulty has arisen through the high cost of supplying the small consumer, so that selling prices which brought in a profit would be regressive on small incomes. This difficulty can usually be surmounted by the use of a two-part tariff, consisting of a fixed charge graduated with income and a low standard running charge.

We are not here concerned with the central problem of

[1] Cf. Hansen, *Fiscal Policy and Business Cycles.*
[2] Cf. Chapter V. Section 3.

price and output policy in public enterprise, which belongs to the field of public economics rather than of finance, but it is necessary for our purpose to notice one further reason why in practice large profits are not likely to be available for general revenue purposes, even from the expanded field of nationalized industry. The temptation to serve non-economic as well as strictly economic ends in public enterprise is very great. There is, for instance, inevitably a strong pressure to make productive units carry on their backs unproductive units,[1] for whose existence there may be no justification beyond the argument that to shut them down would cause local unemployment. Thus although the extension of public enterprise opens up a possible new source of revenue in relief of taxation, it would be optimistic to suppose that the relief will be very substantial.

There remains one final method whereby the depressing effect of a large public debt can be indefinitely avoided. The burden of a given debt charge in money terms depends on its relation to the money national income. If the economy is subjected to a continuous credit inflation, the national income in money terms can be made to expand *pari passu* with the growth of the debt, so that the proportion never rises, whatever the rate of new borrowing. A policy of continuous inflation may prove exceedingly tempting to a hard-pressed government; it is not one, however, on which a self-respecting economy should allow itself to embark. It implies a continuous discrimination against all with fixed incomes, rich and poor, charities and friendly societies as well as banks and insurance companies.

[1] This sentiment was aptly illustrated in plans put forward for hydro-electrification in Scotland. The prospectively profitable Tummel-Garry scheme was advocated not for its contribution to an increase in productivity, but because it would be made to cover the deficit on unprofitable distribution in remote highlands and islands.

Unless the rate of inflation is very slow (which may well be insufficient to float off the debt), it will end by destroying savings, and this, as European experience in the 1920's amply demonstrates, seriously jeopardizes the internal stability of a nation. In the case of Britain it would also have international repercussions which could not be ignored.

It appears from this discussion that the problem of British public debt can neither be lightly brushed aside nor easily escaped ; at the same time the present position is by no means too serious. In 1944 the service of the National Debt (of the central government) required a sum equal only to 4·9 per cent of the national income at factor cost ; this was only 0·7 per cent more than 1938 proportion. It is true that the burden of the new war debt must be expected to rise slightly as the national income total sags from its 1944 maximum, nevertheless it is evident that a properly conducted economic policy is at present in no serious danger of frustration on account of the burden of debt.[1]

[1] For alternative quantitative estimates of the position, cf. Beveridge, *Full Employment in a Free Society*, Appendix C (by N. Kaldor).

CHAPTER XX

THE FUTURE OF PUBLIC ACCOUNTING

§ 1. *The Purpose of Budgetary Reform.* In our earlier examination of the British Budget (in Chapter VI) we saw that the traditional method of presenting the accounts serves two purposes; first, it aims to show that the lay-out of revenue and expenditure is in accordance with the decisions of Parliament; secondly, it certifies that (in all normal circumstances) current expenditure is properly balanced out of current revenue. According to nineteenth-century conditions expenditure by the central government was essentially expenditure on current goods and services, or on transfers—apart from the Post Office which always received somewhat different accounting treatment —so that in practice the question of accounting for capital expenditure within the Budget never came up.

According to the policy which is made necessary by the British government's assumption of responsibility for the level of economic activity in the economy, the relation between expenditure and current revenue is not of less but of greater importance in the Budget. A proper level of economic activity can only be achieved and maintained if this relation is "correct". Instead of always being correct if it is an exact balance, however, it may need to be a deficit, an overbalance, or an exact balance, according to economic conditions. Attention has recently been concentrated on this relation between expenditure and revenue because of its enormous importance; unless the balance is correct, the policy on which everything has been staked will fail.

If information on the correct relation between revenue and expenditure were the only thing it was necessary to ascertain from the public accounts in order for them to be a satisfactory instrument of policy, then there would be little point in continuing with the cumbrous machinery of the traditional Budget ; it would be much simpler to change over to the White Paper type of account, in which the factors determining the working of the whole economy are set out, and which consequently includes the necessary information for determining the correct relation between revenue and expenditure. This is virtually the practice which was followed in war-time. Although the Estimates were presented in summary they did not receive their customary discussion, and they covered only a small part of total expenditure by the central government—no more than the basic routine of civilian administration. Such check on the system as it was possible to exercise was based on the White Paper accounts.

For normal purposes, however, control of expenditure merely on the basis of the White Paper accounts would be altogether insufficient. The need for Parliament to assure itself as to the lay-out of expenditure and revenue is no less than under the old system ; rather it is greater, since the knowledge that a deficit is to be incurred is an invitation to administrative slackness in the spending departments. Further, as we have already seen, the accounting method used in the public departments is no longer efficient for its purpose ; it is attuned to reveal dishonesty but not incompetence.[1] With the expansion of the public sector this is a situation which should no longer be tolerated.

There is thus a double problem to be solved in British budgeting and public accounting ; first, the reform of the

[1] Cf. p. 106.

traditional Budget so that it becomes an efficient instrument for the control of expenditure; secondly, the further development of national accounting along " White Paper " lines, in order to determine the correct balance between revenue and expenditure, and hence the place of the public sector in the economy. This double problem must present itself in a more or less parallel form in any country whose government accepts responsibility for the level of economic activity.

The first country to attempt to adjust its budgetary method to a systematic economic policy was Sweden. The Swedish budgetary reform of 1938 has attracted so much attention that it is necessary to examine it briefly, in order to grasp its purpose and to assess its applicability to the British problem. We have seen that in essence the traditional Budget (in Britain, and in most other countries, many of which deliberately copied the British method) was based on ideas proper to a personal account—an extension of the idea of the King's private and personal account. As is natural in a personal account, no attention was paid to questions of profit and loss, and no distinction of capital account attempted.

The Swedish Double Budget [1] is an attempt to regard the public sector not as a person but as a firm or business concern. Accordingly the account is divided into a " Current Budget " corresponding to the profit and loss account of a firm, and a " Capital Budget " which is parallel to the capital account of a firm. The Swedish government was led to adopt this particular method as a direct consequence of their experience in the depression of 1930–32. Having most earnestly attempted to put

[1] For a description of the principle, and of alternative methods of presentation, cf. Lindahl, " Balancing the Budget ", in *Studies in the Theory of Money and Capital*, and Myrdal, *op. cit.*

into operation an anti-slump policy for the public sector, they realized acutely the force of " fiscal perversity " of public authorities. The new policy, however, is not merely directed against the trade cycle; it is coupled with a long period aim of expansion of public capital assets. The current Budget is to be over- or under-balanced from year to year, according to economic circumstances, thus acting as a cyclical counterpoise; but since a value is put on the public capital, the Budget as a whole will be balanced, in the same sense as the accounts of a firm would be balanced, even if in a particular year it was spending more than it received, in order to expand its capital equipment.

This budgetary method is especially appropriate in Sweden where a large proportion of public investment is undertaken directly by the national government, and the State already possesses considerable real assets. Although the public sector remains as self-regarding as under the old method (having merely changed from being a person to being a firm), in practice the new method ensures that public policy will have positively favourable effects on the economy as a whole. It will be seen that imputing a value to public capital assets is an ingenious method of circumventing the chronic deflationary tendency of public authorities, who on the old system regularly finance long-term investment (e.g., roads, schools, hospitals, etc.) from current revenue, but, because no value is put on them in the accounts, insist on raising taxes in a slump in order to cover current expenditure. At the same time the long-period policy of capital formation is expansionary in tendency.

It was soon found in Sweden that the traditional method of public accounts would not stand up to the new weight thrown upon it, since it did not provide any proper basis for putting values on capital formation and depreciation. Unless it is possible to measure these magnitudes on a true economic basis the more ambitious Budget may become a snare and a delusion. Capital values that cannot be checked may become a convenient cloak for official shortcomings. Departmental accounts can only be checked if they themselves are in the form of profit and loss and capital accounts. Hence it is no accident that Sweden has become a pioneer, not only in the method of budgeting but also in the method of public accounts.

From this summary of the Swedish reforms it will be seen that the goal of Swedish policy which lies behind the Double Budget is something different, and more limited than the policy which has now been assumed in Britain. The British public sector can no longer be self-regarding, because it is required to be a supporting and compensating factor in the economy. The correct policy for the public sector can only be ascertained from the accounts of the whole economy. This wider aim also implies that British policy cannot—and should not—be thought of in terms only of public capital formation, as is mostly the case with Swedish policy. Deficits on current account may also be needed; the distribution of public expenditure between current goods and services and long-term investment is one of the questions which has to be settled against the background of the economy. Hence, whereas the Swedish Budget *as a whole* is always likely to be balanced (taking into account capital values), the British Budget is very likely not to be.

It is thus evident that the Swedish solution will not solve the whole of the British budgetary problem. On the other hand the White Paper does in principle provide the type of account which is necessary for the policy which Britain is attempting, but it needs to be accompanied by an account similar in kind to the traditional Budget, that is to say, a detailed exposition of revenue and expenditure, in order to ensure that public resources are laid out to best advantage. It is therefore to the discussion of these two forms of account that we must turn our attention.

§ 2. *The Accounts of the Public Sector.* Since 1941 two documents, the Financial Statement (containing the Budget Accounts) and the White Paper on National Income, have been presented to Parliament—they come out together but are almost entirely unrelated. This want of relation is partly a temporary accident; when the two accounts have been subjected to a certain amount of extension and rearrangement it will be possible to relate them more closely to each other, both in the Chancellor's speech and in popular understanding. This process is obviously very desirable, but at the same time the two accounts must always remain distinct in kind in several important respects.

In the first place the two documents refer to different periods—the Financial Statement to the financial and the White Paper to the calendar year. This is partly due to technical causes; accounts of the Budget form can be presented within a few weeks of the end of the period to which they refer; accounts of the White Paper form require some months of preparation. This difference in time is of no great hindrance in planning. Since the White Paper accounts come out with only a lag of three months they are close enough to the present to be a reliable guide to the future. (Nevertheless, if the Central Statistical Office could manage a rough estimate for the final quarter of the financial year it would be very useful.)

There is also a more fundamental difference between the two accounts. The Budget accounts are a highly accurate record of transactions, even in this, their first form, correct almost in terms of shillings. The White Paper accounts are a set of estimates—more or less rough (as is revealed by the extent of subsequent adjustments as more evidence comes to hand). Their purpose is as different as the kind of information which they provide. The Financial Statement is Parliament's check on its past actions, every line of the picture is carefully engraved by hand. The White Paper is no more than an outline sketch, drawn in a broad and bold style, but on a much larger canvas, and of a much more profound subject. Thus the two accounts are in every sense complementary. That is not to say that the correct scope for each account has yet been finally determined ; as we shall see, a certain amount of give and take between them would be an improvement. In the first place it should be asked whether it is not desirable to extend the scope of the Budget in order to take account in it of the extended responsibilities of national policy.

We have seen that the central government is very differently placed in respect of the planning and execution of the activities of the various divisions of the public sector. The national government is not, and cannot be, responsible for the accounts of the local authorities. Their political autonomy demands that in the last resort these should be their own concern, although the content will naturally be modified in various ways by Parliament's decisions—e.g., in respect of grants and borrowing facilities. In a similar way the activities of the nationalized industries must be dictated by business, non-Parliamentary policy and their accounts drawn up on commercial lines. The division of function in the public sector thus implies that whatever additional accounts are necessary in order to cover adequately the whole field of the public sector, the Budget in its present sense as the account of the finances for which Parliament is completely responsible—of the revenue which it votes and the expenditure which it sanctions—should remain one of the instruments of national accounting. Budget reform in the narrow sense is thus more a question of rearrangement than of extension of scope.

For accounting purposes the Budget may be considered as consisting of two sets of documents—the Estimates, presented to Parliament before Easter, and the Financial Statement, presented on Budget night in April. The Financial Statement contains a summary of the Supply Estimates compared with the corresponding lay-out in the previous year. This summary is of great importance (or might be made so) since it gives an admirable opportunity for admiring the wood, with the trees themselves removed into the background of the Estimates.

According to the latest normal practice the summary of expenditure and estimates in the Financial Statement was set out in three tables; *A* Grants for Local and Other Services, *B* Pensions, Insurance and Unemployment Assistance, *C* all other Services. Unfortunately this summary missed being an informative account because the breakdown was not functional. Thus, although the income transfers were segregated in Table *B*, benefits were not distinguished from wages and salaries. In Table *A* there was no means of distinguishing grants made to local authorities and to the private sector for similar purposes (e.g., health and hospital services). More important still there was no functional distinction of grants between consumption, capital investment and subsidies to production (although with the aid of the Estimates it would have been possible to discover the truth). In view of the greatly increased scope of subsidies to production and consumption it is especially desirable that these should be clearly set out. Further, many of the items in Table *C* paralleled those of Table *A* and could more properly have been classed with them.

Finally, there was an urgent overriding need throughout the account to distinguish between expenditure on wages and salaries and expenditure on goods bought from the private sector; and between items on capital and on current account. It is possible, however, that some of these items could more conveniently be shown in the White Paper than in the Financial Statement. This is a question to which we shall have to return later.

A functional rearrangement of the Financial Statement summary of expenditure suggests a similar rearrangement of the Estimates; there is no doubt that they could be made very much more informative by a better breakdown, especially by distinguishing more clearly between wages and salaries and purchase of goods. As we have seen, however, tinkering with the Estimates is a dangerous game, because it weakens Treasury control, which is now more than ever necessary; consequently it is a matter for gradual reform rather than for any immediate action.

With the adoption of the new policy, the capital account, and with it the account of the deficit (which is part of it) becomes of outstanding importance. The Financial Statement gives a long and careful record of transactions in the National Debt during the period, but since this deals only with changes in the nominal composition of the principal, it is useless for discovering the true deficit. The basis for the analysis of the deficit is, however, already present in the accounts; but it is necessary to look for it in the White Paper and not in the Financial Statement. It would be much more convenient if this information were related, with the rest of the details of expenditure to the financial year.

The White Paper contains a table entitled "Central Government Expenditure and the Sources from which it was Financed"[1]; this could well be made into a detailed analysis of the deficit and of its lay-out. The left-hand side of this table is divided into three parts: (i) Finance from ordinary revenue, i.e., taxation and income from property; (ii) finance from government resources, i.e., internal borrowing by the exchequer, (iii) finance from borrowing, i.e., from the private sector. We are not concerned with (i) which has nothing to do with the deficit; it merely repeats information given elsewhere, and if this account were confined to the deficit it would naturally disappear.

The second part of the table records changes in the totals of the following items: (i) The Social Insurance funds and Local Loans fund; (ii) the exchequer balance at the Bank of England (including the Exchange Equalization Account); (iii) capital transactions included in revenue; (iv) issues to sinking funds (a negative item if the issues are positive); (v) issues under various long-term agreements and guarantees. This part is thus a summary of the change in the government's own account, in a wide sense. The third part of the table analyses the changes in actual (not nominal as in the Financial Statement) amounts of the various forms of public borrowing, including changes in the note issue. By the addition of these two parts of the table the size and structure of the deficit is at once apparent.

To complete the account of the deficit in the way we have suggested, the right-hand side of the table needs more drastic alteration. It would no longer exhibit total outlay, which again is mainly a repetition of information available in other tables. In order to "balance" the

[1] Table 35 in Cmd. 6623 of 1945.

deficit in a financial sense, an account is needed which sets out all the expenditure which does not come under normal revenue. It would contain three parts: (i) subsidies, distinguishing those awarded to consumption, to production or given in the fulfilment of guarantees; (ii) the result of trading activities by the different departments, shown separately; (iii) sums devoted to long-term investment. The amounts devoted to trading activities would naturally reappear in the separate accounts of the services and industries, where they would be given real content by a detailed account of the items purchased by their aid. Subsidies would appear in the accounts of the departments concerned, in the Estimates and again in the Appropriation Accounts.

In this way there would be a double entry or check against the whole of the deficit. Unless some such account is available in future it is difficult to see how Parliament can keep a proper watch over deficit finance, a failure which would jeopardize the success of the whole policy.

From this discussion it will be seen that reform in the method of *presenting* the public accounts is urgently needed; but of itself it could do little unless it were accompanied by a parallel reform in the method of *keeping* the accounts. With the extension of the government's responsibilities there are in effect three different accounting problems to consider, first, the accounts of the ordinary Supply Departments (at present, it will be remembered, conducted on the penny cash book principle) [1]; secondly, those of the direct trading activities of government departments (activities which started during the war, but for which no satisfactory accounting method could be evolved in the rough and tumble of war finance); thirdly, those of the nationalized industries,

[1] Cf. pp. 105ff.

which on the analogy of either the Post Office or of the Central Electricity Board, will be required to adopt business methods.

In respect of the Supply Services there should be a definite, if gradual, process of modernizing accounting methods, so that it is possible for a revising body—the Public Accounts Committee, an *ad hoc* committee on expenditure, or for that matter a head of department, to ascertain total departmental costs and to break them down in a significant manner. Only thus can multiplication of the expenses of management, the great danger of the public service, be guarded against. It has long been realized that this reform is necessary; and it will be a long business to carry it through. In the meantime a beginning might be made with the reform of the accounts of self-contained sub-departments (e.g., the Medical Services of the Forces).[1] A few beginnings of this nature would have an important moral effect, and would be the best means of convincing laymen and civil servants of the need for reform.

The trading activities of the central departments present a most difficult and awkward problem in public accounting. Whether they work to a deficit or not (which is a matter of policy), their functions are purely economic and consequently call for business accounting methods; any attempt to retain the penny cash book method must lead to hopeless confusion. It is essential for the taxpayers to know the extent of the profit or deficit for each type of trading; a full profit and loss account must therefore be available and should be completely segregated (e.g., in respect of salaries) from the non-trading activities of the department concerned. Although it would obviously be impossible to make a current disclosure

[1] As recommended by the Committee on National Expenditure, 1917-20.

of government transactions in markets, it is essential that full details should eventually be made known (as was done in the case of the Exchange Equalization account, where current information was similarly impossible).

This publicity is necessary in the interests of the tax-payers, but no less so in the interests of the traders in the private sector. The great danger of government transactions in commodity markets has always been the uncertainty which it creates (and hence the upset to price expectations). This uncertainty is due on the one hand to the large scale of government operations, and on the other to the fact that public authorities cannot be counted on to react to price changes in the same way as business firms. If, however, the story of government transactions is eventually made available in detail, it should gradually become possible for traders to accustom themselves to the effect of government intervention, and by making proper allowance for it, contribute to that steadiness in prices which is the main justification of the intervention.

To provide this necessary information it is necessary that the accounts of public trading activity should be drawn up with great accuracy. Unfortunately the problem of accounting properly for changes in stocks is one which has never been satisfactorily solved in the business world; it consequently remains one of the darkest spots in the national accounts. Here is a chance for the public sector to lead the way, in showing not merely the changes in the value of the stocks (which depends on prices and is of little economic importance) but also the value of the change in stocks, which depends on real quantities.

The accounting of the nationalized industries presents a more normal professional problem, since the accounts for each industry will no doubt be self-contained and will be closely parallel to those of any other industrial firm. There are several points, however, which call for especial care. Since some of the units will be working, from time to time at least, on a planned deficit policy, and there is always the possibility that others may make an unintentional deficit, especial care should be taken to exhibit this clearly, and also the source from which it was financed (e.g., from taxation *via* the Estimates, or from borrowing *via* the Consolidated Fund). Secondly, since the units of control will probably be rather large, it is especially necessary to show a breakdown of costs which will show clearly the share of wages and management. Thirdly, an effort should be made to illuminate more successfully than has been done in private enterprise the true value of changes in capital—both in fixed assets and, once again, in stocks.

It should be the case that the accounts of nationalized industry are drawn up to satisfy a vigilant and inquisitive body of citizens, and not (as happens too often in private enterprise) to put to sleep a body of impotent and perhaps indifferent shareholders. In this field also the public authorities can perform a double service to the community, if public accounting methods are always pushing ahead of the best professional technique instead of, as in the past, lagging behind it. It naturally follows that our discussion of public accounting methods applies with equal force to the activities of those parts of the public sector which lie outside the direct control of the national government, that is to say, to social insurance and the local authorities.

New accounting methods, appropriate to the new activities of the public sector, will only be partially effective unless they are backed up by efficient expert and Parliamentary examination of the new information available. For this purpose a considerable amount of new machinery for the control of expenditure is required; the matter is the more urgent, since it seems that Parliament has not yet woken up to its responsibilities in this direction. Thus the progressive and inquisitive Committee on National Expenditure was replaced within a few months of the end of hostilities by the—admittedly useless—Estimates Committee. Early in 1946 power was requested, and granted almost without opposition, for the Post Office to suspend the compilation of its Commercial Accounts.[1] It is hard to picture any body of shareholders in private enterprise agreeing to such an enormity as this.

It would take us too far into administrative problems to discuss in detail what this new machinery of control should be, but we must at least face up to the problem in outline. It will be apparent from our earlier discussion of the control of expenditure that machinery of three types will be required. First, it would be useful to have an extra-Parliamentary examination of the activities and accounts of the nationalized industries, in order to provide a "freely tendered, independent second opinion [2]" on policy; secondly, a detailed examination by Parliamentary Committee is called for, parallel to the work of the Public Accounts Committee on the Budget accounts. (If these examinations are to be effective it goes without saying that the committees must be provided with ample expert staff.) Finally, a reform which permits a more rational distribution of the short time which can be spared for the control of expenditure in Committee of the Whole House becomes an urgent necessity.

[1] The excuse given by the Assistant P.M.G. was that: "The continued heavy amount of national service work being done by the P.O. made it impossible for the staff to devote their energies to compiling exact accounts."

[2] *Economist*, "Unplanned Investment", 26th January 1946.

A necessary first step would be the enlarging of the Comptroller and Auditor-General's Department, and its strengthening by the addition of economists and statisticians. For the proper conduct of the nationalized industries an entirely new apparatus would seem to be unavoidable. What is required is a body of experts and technicians—economists and statisticians, engineers and accountants. This body might properly be charged with three duties; first, a running supervision of the industrial units, carried out by periodic and unanticipated inspections (in the manner which has been found so beneficial in Russian industry); secondly, supervision of the compilation of very full annual reports and accounts, of each industry separately, for presentation to Parliament (preferably at the same time as the Financial Statement and the White Paper); thirdly, a periodic (say, quinquennial) full-dress report on the industries, taken in turn, with recommendations as to policy. For this last purpose additional outside opinion might be called upon. This sounds a formidable programme, but it is difficult to see how Parliament can fulfil its duty as the nation's watchdog if any less full information is available to it.

Within the House the abolition of the Estimates Committee would free Members' time for the re-establishment of something more like the war-time Committee on National Expenditure. Its reports should be immediately published, and where possible, time should be allowed for their discussion in the House. In addition it would seem desirable to establish a new committee, including some of the House's own experts, for the special purpose of examining the reports and accounts of the nationalized industries.

It is hardly possible to suppose that the House as a whole could spare much more than the traditional seventeen days for considering the control of expenditure, but it is more than doubtful whether the House can continue with its present cavalier treatment of the Estimates, using them merely as pegs on which to hang attacks on the government's weak places. As we have seen, from the point of view of technical control, Parliament's policy in respect of the Estimates is nearly useless, and in view of the thoroughness of Treasury control, it is also largely unnecessary. It would be a better allocation of the time of the House if discussion of the Estimates in the old manner were cut down, say to twelve days, and the remainder used to put in some really hard work considering the information available on the nationalized industries and the trading activities of government departments.

§ 3. *The Accounts of the Nation.* The machinery which we have been considering covers only the activities of the enlarged public sector; this is the biggest job for Parliament—as distinct from the Government. Parliament will not be fulfilling its duties, however, unless it is also prepared to understand and make intelligent criticisms of the policy for the economy as a whole recommended by the Cabinet. The main basis for this criticism will be the account of the affairs of the nation presented in the Budget White Paper. It is to be supposed that in future this will be supplemented by the annual reports of the bodies responsible for advising on loan and investment policy. Since the Budget White Paper has hardly yet passed out of the formative stage it is difficult to predict to what degree of perfection it may be brought when the additional statistics requested by recent Committees [1] are available.

[1] See p. 349.

Prior to the number issued with the Budget of 1945, the White Paper fell into two parts, not very well bound together. First came a series of unconnected tables, dealing with particular aspects of the economy (e.g., distribution of consumption, of income and of manpower). This was followed by the series of Main Tables, leading up to the Master Table of the whole account—the estimate of the National Income (product), both at market prices and at factor cost, and of its distribution between consumption and investment.

With the 1945 issue the Report took an enormous step forward in integrating the information provided and in emphasizing the principle that the calculation of the affairs of the nation is based on a series of related accounts, fitted together like a jigsaw puzzle (so that a re-estimate of one must be balanced by consequential adjustments in the others). In this way the whole is made to present a significant description of the structure and working of the economy.

The description of the affairs of the nation which is summarized in the Main Tables of the White Paper is built up out of three strands; (i) the structure and activity of the private sector, (ii) the structure and activity of the public sector, (iii) the relations between the two. For none of these is it yet possible to draw a completely satisfactory picture.[1] Especially great is the need for additional information concerning the distribution of manpower; without this the Factor Cost calculation of the National Income remains largely barren as an instrument of policy, because it implicitly assumes universal constant costs in production. No less important is the need for a direct estimate of investment, both in

[1] For a more detailed statistical examination of the contents of the 1945 White Paper, cf. Gilbert and Jaszi, *E.J.*, December 1945.

stocks and durable equipment. Obviously an estimate based only on conventional business allocations to depreciation may be seriously misleading when summed over the whole economy. In respect of the public sector the capital formation account must continue to be even more unsatisfactory than that of the private sector so long as systems of public accounting fail to make a proper distinction between capital and current items.

In many ways the most important shortcoming of the present account is its inability to disentangle satisfactorily the two sectors of the economy from each other. This is partly due to the inadequate distinction in the public accounts between wages and salaries and goods bought from the private sector, which we have already noticed. If once the two sectors can be successfully divided it should be possible for the Central Statistical Office to draw up a profit and loss account for the whole private sector. Besides its intrinsic importance, this would provide a much more accurate check than is at present available, in respect of saving and real capital accumulation.

Once these gaps in the statistics have been filled—as they will no doubt be filled—the Cabinet will have before it a scientific basis for a comprehensive plan, which will in principle enable it keep the economy in a state of full activity without resort to direct control over the private sector or to authoritarian planning of the whole. In 1939 the mere idea of such an instrument of policy would have seemed chimerical; to-day it is on a fair way to being achieved. The idea has not, however, lost any of its fascination by greater familiarity; on the contrary its possibilities appear greater as its outlines become better recognized.

The British economy stands to-day at the cross-roads between the old and the new systems. In finding her way along the new path it must be realized that Britain has once again to rely on her own wits; there are no international precedents. To have launched the new policy at a moment when the national capital is depleted by war, and labour exhausted and in short supply, is heroic. The essential decision has been taken, however, the structure is fast going up, and there can be no turning back. It will remain an empty shell, a useless encumbrance, and perhaps even a danger to the public, unless we are prepared to put hard work and some very hard thinking into the job of furnishing the house.

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