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THE CAMBRIDGE ECONOMIC HANDBOOKS

General Editors

J. M. KEYNES (Lord Keynes) 1922–1936
D. H. ROBERTSON (Sir Dennis Robertson) 1936–1946
C. W. GUILLEBAUD 1946–1956
C. W. GUILLEBAUD, MILTON FRIEDMAN 1956–

PUBLIC FINANCE

BY
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INTRODUCTION 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:

> "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.

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

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 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. GUILLEBAUD

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 Publ Finance. Three of the outliers are so important that they c for brief comment.

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

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

The third omission will probably be found, under prese conditions, the least forgiveable. Economists will look vain for an adequate treatment of international fiscal relatio Here above all it seems to me that fiscal consideration can usefully be discussed in isolation from the other factors whi go to make up the international situation, and from the oth instruments of policy—monetary and exchange action on t one side, direct controls on the other—by which a nati

endeavours to keep its feet in the world economy. Had I once entered this territory there would have been no practical stopping place.

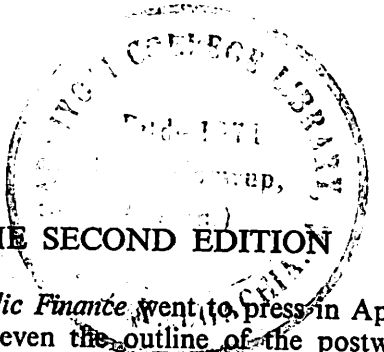
A first draft of this book formed part of the course for the School of Special Studies in Economics in the University of Liverpool. I am much indebted to Mr. Henry Hartley, Lecturer in Public Administration in Manchester University, for advice on the parts of the book which border on administration. 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.





PREFACE TO THE SECOND EDITION

THE first impression of *Public Finance* went to press in April 1946, too early to foresee even the outline of the postwar world. In 1949 I was able to take advantage of a new impression to record a few of the already great changes that had taken place in the short space of three years. Now after close on ten years it is high time to undertake a more extensive revision, especially as it begins to be clear which of the war and immediate postwar changes have become permanent features of the British economy. It is evident that the major developments of social expenditure have come to stay, more especially the National Health Service and the extension of social insurance to the whole nation. On the other hand the abolition of controls, allocations and rationing have now made the economy in some ways more like that of the prewar world than that of 1946–49. All these changes are reflected in the system of public finance, so that wherever possible I have compared the situation as it was in 1953 (the latest complete year available) and 1938. In Chapter XVI in particular I have tried to indicate the consequent changes which have taken place in the distribution of incomes and in their redistribution through progressive taxation and social expenditure. But the data for a complete survey comparable with those made for 1937 are not yet available.

Over recent years no change has been more significant than the continuing process of strengthening and expanding the Treasury to enable it to perform the important new tasks of fiscal policy. The seal has here been set on the new organization of the departments responsible for the preparation of general economic policy by the transfer of the Economic Section from the Cabinet Office to the Treasury. I am very

grateful to the courtesy of the Treasury officers who ha
overseen my account of these matters. The fruits will
found partly in Chapter III, concerned with the administrati
set-up, and partly in the final chapter. Although the Budg
does not yet itself formally reflect the immense progress whi
has been made in the art of national accounting, in the statisti
on which it is based and in its applications to policy, the ne
outlook is already apparent in Budget speeches. It is perha
even possible to discern the direction in which budgetar
reform will develop at the next stage.

In view of the now far greater importance of *Public Finan*
in the National Economy, as a matter of normal life and n
merely in a transitory phase of emergency, I have rewritt
the whole of Part III which is concerned with such matte
In Chapter XVII I have treated those aspects of fiscal poli
which are concerned with stability at a high level of empl
ment, dealing separately with the problems of inflation a
unemployment, since neither their analysis nor their treatm
is symmetrical. Chapter XVIII contains new matter co
cerned with the part which fiscal policy can play in promot
growth. I have been led to this partly through the n
emphasis on increasing productivity which has been neces
tated in Britain by reason of her balance of payments di
culties, partly on account of the many new problems w
which public finance is being confronted in respect of t
development of the backward countries of the world. Wh
I would be the last to suggest that either the problems of th
countries or the means of meeting them are homogeneous
seems to me that a number of problems can nevertheless be u
fully treated in a general discussion, both in respect of the r
of fiscal policy in promoting development without inflation,
in the use of the budget as an instrument of policy in the m
primitive economies.

Finally the revival of the monetary instrument of con
in the autumn of 1951 puts the whole question of debt mana
ment, treated in Chapter XIX, in a new setting. It is no
be hoped or expected that the new monetary policy will

fiscal policy from its now established position of pre-eminence as a means of implementing economic policy. Rather we should now look forward to a world in which the two instruments can cooperate to enable the nation to make the best use of its economic resources.

URSULA K. HICKS

Oxford,
JULY 1955

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PUBLIC FINANCE

PART I

THE PUBLIC ACCOUNTS

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 consists of those who are dependent on incomes derived from the production of goods and services destined to satisfy (directly and 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 is 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 most directly 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 pa
for out of taxes—compulsory transfers of private incomes
governing bodies for the express purpose of arranging for t
collective satisfaction of wants. The fundamental differen
between this and the market method of finance is that there
no relation between the tax liability of any individual and t
share of collectively provided services which he will be able
enjoy. Nor, save in very exceptional circumstances, can t
revenue from any particular tax be regarded as paying for a
particular service. Taxes are paid into a pool; entir
separate decisions govern the distribution of revenue betwe
the public services.

Workers in the first, "private enterprise", group are org
ized in a great number of different ways. At one extre
they may work on their own, with only the assistance of th
families, as many farmers do; at the other they may work
a giant firm, employing tens of thousands of workers. Wh
ever their size, all these organizations have this in comm
they are independent units, and all, the one-man firm and
big company alike, are motivated by the principle of incent
or profit. The goods and services which are produced
conditioned by the continued receipt of more satisfact
incomes than could be secured by producing other goods
services.

The public service is also organized in groups—the dep
ments of the central government and of the "local authoriti
(the corporations of large towns and the councils of coun
small towns and rural areas). In this case, however, the gro
are not independent, they work as parts of central and lo
governing bodies, and in the last resort all are subject
Parliament. Their activities are not in process of continu
adaptation to the anticipated demands of consumers, as is
case with the private enterprise groups. On the cont
what they do, and largely the way they do it, are prescribed
the previously expressed decision of the bodies whose serv
they are, and ultimately by Parliament. Their work can
be varied when these bodies decide to alter their policy.

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 nationalized industries (public corporations) and trading activities of the departments of the central government and of the local authorities, which provide 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 in the last resort 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. Again the British Transport Commission, established in 1948, was designed to take over both the railways (operated by large companies subject to much control and regulation) and road transport which mainly consisted of small independent units. From 1954 the B.T.C.

was shorn of this latter function, road transport returning to private enterprise. Similarly, civil aviation is being developed partly by the publicly owned Airways Corporations, partly by private companies operating under licence.

There is, however, a significant difference between the independence of the private firms producing services of the latter 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 form of semi-public enterprise made its appearance in Britain. Prominent examples were the Central Electricity Board and the London Passenger Transport Board. These "public corporations"[1] were bodies controlled by boards of directors, with similar rights and duties to directors of privately owned companies, but appointed by the government. This form of organization was the prototype of the nationalized industries established between 1946 and 1950. The essential difference between the public corporation of the 1930's and these later creations is that the latter are closely related to a sponsoring Ministry (the Ministry of Fuel and Power or the Ministry of Transport), and are subject to direction by the Minister, who also answers for them in Parliament. The new type of public corporation is thus much more closely integrated with public policy than were the corporations of the 1930's; but in matters of day-to-day organization of production and sales they function as much as possible along the lines of a private enterprise company. They thus also differ from the old form of nationalization, typified by the Post Office,

[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".

services which are conducted almost as if their functions were purely administrative.

The public corporation form of organization 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.

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 reason that policy decisions in this field are mainly determined within the industries on economic rather than on political or social grounds. The problems which public enterprises have 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.

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 to account not only the activities of governing bodies but also of all organizations whose policy is subject to some degree of public control.[1]

[1] For the sake of completeness we should include here the public credit organizations, although their problems belong mainly to the field of

§ 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 thus 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, securing the best application of limited means to secure given ends, the ends in this case being given not by the demand of consumers on the market, but by policy determined by representatives of the people sitting in the governing bodies, 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 formerly followed a *laissez-faire* tradition, as of countries (such as Sweden and the western democracies) where there has long been a tradition of public ownership. One of the most striking and universal phenomena of recent years has been 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 in 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 a 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. During the war these numbers expanded enormously and are unlikely ever to fall back to the 1938 level. 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 tinplate and steel 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 borrowing to war periods, when the necessary expenditure exceeded what could be extracted from the incomes of citizens by means of taxes; public enterprises, however, frequently borrow 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 States 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 other taxes of a more special nature. It is therefore with

[1] The largest item of public borrowing to finance investment (fixed capital formation) is for the construction of houses by public authorities.

monetary policy and not of public finance. Those which are concerned with the implementation of public finance policy are organizations for supplying long-term credit—for public investment (Public Works Loans Board) and for approved private investment function performed by several organizations sponsored jointly by 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 before the Bank was nationalized.

taxation and its problems that we shall be mainly concerned on the receipts 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 public can only be based on party considerations; on the contrary 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 this has been done it is the duty of the adviser on public finance to show what types of public outlay, and what types of taxes, are most appropiate for attaining the ends laid down.

Although public finance is the servant of policy it has often an importance which has 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 importance 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 and 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 political liberty have been fought. The struggle for the existence of Parliament centred on the financing of Edward's wars. The freedom of the House of Commons was won on the question of Charles I's Ship Money, and its dominance finally confirmed against the power of the House of Lords as a result of the struggle for the Finance Act of 1911.[1]

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

3. The State and the Individual. The State is part of the organization of a nation. What then, we must inevitably 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 or users. 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 has 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 has been likened to 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 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
uncomfortable to exist in a "stateless" condition. Failu
pay one's "subscription" (taxes) to the State is punishe
imprisonment.

The compulsory nature of obligations to the State give
to important questions of social justice. For instance, th
nothing objectionable in having a golf club subscription w
is uniform for all the members, because membership is vo
tary, those who think that it is too high will simply not
but to impose uniform taxes on all citizens irrespective of
incomes is recognized as being very unfair indeed. An
portant part of public finance is concerned with questions o
proper distribution of tax liability between citizens with d
ent incomes.

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

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

Although in a democracy the club concept of the
remains useful from some points of view, as a comprehe
account of the relation between the State and the indivi

ow appears altogether too narrow and passive. The internal
unctions of the government, for instance, can no longer be
onceived in terms of "holding the ring" between different
nterests, and of providing "amenities" of the type of street
ghting and cleansing (which were the typical examples of what
as regarded as "beneficial expenditure"). The concept of the
roper sphere of the State's activities must be extended in two
mportant directions.

In the first place it is rapidly coming to be accepted that it
the business of the State to ensure that every citizen can
njoy the primary necessities of life—sufficient and correct food,
dequate shelter, and health and education services commen-
rate with his needs. It is now widely held that the State
ould ensure this minimum by itself buying or producing and
istributing the means of satisfying these primary wants,
herever it is apparent that the field is not being adequately
vered by private enterprise. In the second place it is now
ld to be an overriding duty for the State—which alone can
ndertake the task—to secure the maximum level of economic
tivity and of social welfare which the resources of the econ-
my permit. These two extensions of the concept of the
here of the State imply a new and more intimate relation
tween the State and the individual, both in his capacity of
oducer and of consumer; they also imply a considerable
pansion of the types of public activity.

The State thus tends to figure more definitely as a producer
d employer. Production is still mainly of services, but the
portance of goods, both for current use and as permanent
sets, is rapidly increasing. Houses were but one—and the
st—example of the sort of capital goods which can usefully
produced by the State to supplement the output of private
terprise. As the capital equipment of a nation increases,
d consequently the profits which can be derived from produc-
g further units tend to decline, an extension of public
vestment may well be the most fruitful method of raising the
oductivity of the economy. We shall have to consider this
estion and its bearing on the future organization of public

finance when we have completed our investigations into different parts of the system.

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

There is one complication, however, about regarding State as a giant firm. The functions of government distribution of expenditure and the collection of taxes, ar the monopoly of the national government, but in almost countries are divided between a major central government minor local units. (This suggests that the analogy of a ho company and its satellites would really be more appropri

Just what relations are established between the ce government and the local units differs greatly from co to country. In the United States there exists a reg government (the State of California) of such importance it has a jurisdiction of 240,000 sq. miles and a populati over 10 millions; the State legislature being a major go ment for a large number of local authorities. The government of California exercises wide independent powers and in most aspects of internal administration frame its policy without regard to other jurisdictions. other extreme we might instance a French Commune of hundred souls, which for all major policy decisions is depe on the central government, but yet still possesses a di

mmunity life of its own. In Britain, in spite of the fact that he national government is unitary and not federal, the collec- ve importance of the local authorities is by no means negligible, ot merely in carrying out policy, but also in framing it.

Notwithstanding the wide powers which may sometimes be joyed by minor governments, the central government of a ountry must always retain pre-eminence both in general and financial policy. This is inevitable, since the national overnment is charged with decisions which are vital to the xistence of the nation, decisions relating to war and peace, and l relations with other nations. Internally also the pre- minence of the central government tends to increase as the ope of public activity expands; for a systematic economic olicy concerted action, directed by the centre, is an essential e-requisite. Thus the finance with which we shall mainly be ncerned is that of the central government; but we must not low it to monopolize our attention completely. Local thorities make an indispensable contribution to democratic ganization. The best method of integrating their policy and lances with those of the central government, without sacrific- g their independent life, presents one of the major problems 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 important 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 in a modern state starts with a given expenditure plan, and the authorities adjust their "income" (revenue) by means of taxes and other resources, to match expenditure.[2] 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 be a choice, another, set by the proportion of their incomes which they 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 estimates and appropriation accounts of the central government and the financial statements of the local authorities; but in order to arrive at a comprehensive picture it is necessary to group the services in some sort of functional manner.

The first systematic discussion of public expenditure in Britain was contributed by Adam Smith in the *Wealth*

[1] The only true incomes of public authorities are those derived from property and trading.

[2] In poor and undeveloped countries where the raising of taxes is a difficult matter it may still often be necessary to plan the budget from the revenue side.

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 which the State could play in providing collective ser which might be desired by all, but would yet be beyond scope of private enterprise. Smith's balanced position complete answer to the charge that a rigid interpretati *laisser-faire* has been part of the British tradition.

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

Adam Smith was much impressed by the burden of d expenditure and with the way in which it was tendi increase in his day. This was largely due to the trou times in which he lived; the same complaint was freq heard in the inter-war period. Actually in time of defence expenditure has not tended to consume a larg portion of the resources of the British economy. In the war period, before the beginning of rearmament in amounted to about 2·8 per cent of the net national (including war pensions); this represented about 15 per

[1] For an account of the development of British public expend cf. U. K. Hicks, *The Finance of British Government, 1920 to 193* and *British Public Finances, Their Structure and Development, 19* (1954).

he total outlay of the State excluding national debt interest. y 1944 defence expenditure had, however, risen to some 80 er cent of total public outlay. After 1945 it quickly declined nd was back to under 7 per cent of the net national income by 950, only unhappily to rise again with rearmament consequent n the Korean crisis. In 1953 defence expenditure amounted about 9 per cent of the net national income.

The "second duty"—of internal justice—is also partly a atter of defence. Peaceful and law-abiding citizens require otection from their more unruly neighbours. The final ercive power of the State over all classes of citizens is as ndamental for the stability of the community as its defence gainst external enemies. The maintenance of justice between tizens in the complications of modern life requires, however, much more extensive mechanism than the mere apparatus of olice, law courts and prisons. The cost of making and ministering laws, the work of Parliament and of the depart- ents of the central government—especially the Treasury and e Home Office—and the administrative work of the local thorities must all be included. It would be more accurate -day to describe the second duty as that of civil government, very important object of which is to see that full and equal stice is done, in all respects, between one citizen and another. The "second duty" thus defined has two aspects, one pro- tective, the other administrative. The scope and cost of the ministration have increased enormously since the eighteenth ntury, *pari passu* with the growth of the public sector, vertheless the protective side (police, justice and fire services) ll accounted for more than half the outlay on civil govern- ent in the inter-war period. It is important to notice that hile the finance and execution of the "first duty" are wholly business of the central government, responsibility for the econd duty" is shared between the central government and local authorities; the greater part of the costs falling on ntral finances but the greater part of the work being carried t by the local authorities. The outlay of the State on il government in the inter-war period amounted to about

6 per cent of total public expenditure.[1] In spite of its pr
importance the "second duty" is no longer one of the
calls on the community's resources.

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

In Smith's day the greater part of public efforts "to fa
the commerce of the society" took the form of a compl
system of protection, drawbacks and bounties design
forward the interests of particular groups. Smith regarde
type of public activity with scant favour, and it was large
to his influence that in the following generation a great
the apparatus was swept away. On the other hand
was a keen advocate of public works of the type of
construction, which he conceived as operated on a comm
basis (by means of tolls); and which, as he rightly perc
would greatly increase the productivity of the economy.

§ 2. Expenditure for Economic Ends. In modern cond
State expenditure for economic ends also consists of
services to private enterprise on the one hand and b
to the community at large (for instance through the soc

[1] Excluding interest on the National Debt.

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

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.[1] The State is 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 relatively 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, first as a result of dislocations and changes due to the 1914–18 war; later in attempting to mend depression conditions. Subsidization and protection of particular industries, especially agriculture and shipping, was an important contribution to international political tension in the 1930's. In Britain expenditure of this nature grew from about £30 mn. in the later 1930's to a maximum of £99 mn. in 1947. Thereafter it gradually declined, reaching £48 mn. in 1953.

In Britain the socialized industries—apart from the Post

[1] 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 fee.

Office services—grew up under local rather than national control, and were somewhat hampered in development by the awkward distribution of local jurisdiction—determined largely by historical accident. The first step nationalizing the local trading services was taken by establishment (in 1926) of the Central Electricity Board co-ordinate the production (but not the distribution) of trical current. In addition to the orthodox trading ser some local authorities own more adventurous enterpris Doncaster's race course and Colchester's oyster beds favourite illustrations. Probably many more local author would be prepared to venture in other directions if they c obtain the authorization of Parliament without undue exp and delay.

Traditionally the only important trading service of British central government was the Post Office, but it is in the present century that control over the telephone was complete; other telecommunications were added in although the extension had virtually been agreed on d the war. Broadcasting on the other hand has from an date been a national service, controlled by a public bo The central government has also long operated a additional enterprises, small but efficient, ranging from Stationery Office to a stake in the public house business ke as the "State Management Districts" of the Carlisle n bourhood. The years 1946 to 1949 saw the establishme the great nationalized industries: in 1946 the Airways Co ations (the Bank of England was also nationalized in year), the National Coal Board in 1947, the British Trans Commission and the British Electricity Authority in 1948 the Gas Council and Area Boards in 1949.

Although there are considerable differences from co to country, broadly speaking the same sorts of industry tended to get nationalized everywhere, namely, those w in time of emergency it is vital for the State to control, su the postal services, broadcasting, and the road system (in many respects deserves to be classed as a trading ser

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 nationalized 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 established. It cannot be assumed *a priori* that public operation will secure maximum efficiency.[2] 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

[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*.

[2] 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 has been the way in which the prosperous telephone services are made to carry the unremunerative telegraph services. This is a form of economic waste which may be a particular temptation to public service.

private enterprise measure (of maximizing the differ
between costs and receipts). Only if a systematic enquir
been made, based on objective policy criteria and statis
investigation, can it be determined in any particular ca
which direction the balance of social advantage lies.
nomic expenditure of other types should also be subject
periodical statistical check of efficiency, since if they do
lead to an increase in productivity their right to exist is
questionable.

§ 3. Social Expenditure in the Modern State. Social exp
ture has for some generations now absorbed by far the l
share of British public outlay in normal times. The co
has a long tradition of social service. Even in the
nineteenth century expenditure on poor relief was
relatively to the national income, although it declined to
the middle of the century with the rise in Victorian pros
and the rigours of the "New Poor Law"; by that
however, other social services were beginning to suppl
its efforts. Before the middle of the century exchequer
were given towards education services; public educatio
State service dates from 1870. Public Health services
started before the middle of the century (when they were
stimulated by the effect of a devastating cholera epid
they were greatly extended in the early years of the p
century, again as a result of the 1914–18 war. A still fu
expansion took place after 1945.

Social insurance and old age pensions were introduced
the Liberal Administration of the first decade of the pr
century; they expanded in the inter-war period;
was not until the legislation of 1946–48, implementing
"Beveridge" Report[1] of 1942 that social security was w
into a nation-wide system. House building by local auth
started as a tiny trickle just before the war of 1914–18;
late 1920's it had expanded to a major national se

[1] Report of the Interdepartmental Committee on Social Insurance and Allied Services.

ltogether public authorities built one in four of the inter-
ar houses. In the years immediately following the second
orld war the "industry" of house building may almost
e said to have been "nationalized"; between 8 and 9 of every
0 houses were erected by public authorities, and a higher rate
f building was reached than had ever been attained in the
nter-war period. The early 1950's saw the gradual revival
f private enterprise building but without, initially at any rate,
ny appreciable decline in the activities of public authorities.
t can safely be asserted that already in the inter-war period
ritain was providing social services on a more generous scale
han any other country; yet they fell short—and still do so—of
he complete abolition of want which was the goal of the
everidge proposals.

The present British social services can be roughly classified
nder three heads: (i) education, (ii) public health (including
ousing and health insurance) and (iii) income supplements, in
he form of transfers in cash or kind from the incomes of other
itizens, through the tax system. These three headings now
over a large variety of services. Under education, for
stance, we should include the provision of schools and
chnical colleges, the payment of grants to certain schools,
olleges and the universities, the payment of salaries to teachers
nd administrative staff, the award of scholarships and main-
nance grants to pupils, the provision of ancillary services,
hool meals and medical service, and finally the provision
f libraries, museums and picture galleries. Considerably
ore than half education expenditure is, however, absorbed
y the public elementary schools.

The first public expenditure on health was in the provision
f collective services such as street cleansing, sewerage and the
ovision of parks and baths.[1] As the nineteenth century wore

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

on, public medical services were widely provided for such
fortunate members of the community as paupers and lun
but there was no general personal health assistance by p
authorities until the establishment of health insurance an
other social reforms implemented by the Liberal governm
of the first decade of the present century. Further ser
were established in the inter-war period for special cases
as maternity and the treatment of tuberculosis and ve
disease. Finally the National Health Service with fr
highly subsidized) treatment for all according to their n
and a national organization of hospitals, started operatio
1949. With these personal health services should be gro
the expenditure on nutritional foods, especially milk, d
buted free to nursing mothers and children. These start
any considerable scale only in the second world war, but
now become an established and most important part of
provision for the nation's health. Of even greater impor
than these during war time were the general food subsidie
their maximum these absorbed over £400 mn. or 4 per cent
national income. As food became more plentiful they
gradually scaled down, but in 1953 outlay (as measured
trading losses of the Ministry of Food) still amounted to
£200 mn. Although the general food subsidies were recog
as an effective method of underpinning the consumption
very poor, they were a very costly method of doing so
most of the expenditure went to subsidize those who could
afford to pay market prices for their food.

The remaining supplements to personal incomes are n
given in the form of cash "grants to persons". Except
are the tea and tobacco cards of old-age pensioners
rent and food vouchers which may be provided th
national assistance. Unemployment expenditure varies
the state of trade, but *per capita* payments have progres
approached the level of unskilled wages. *Per capita* pa
payments also show a continuous tendency to rise, as we
secular expansion due to the ageing of the population.
the new social security system of 1948 additional be

ecame available, such as children's allowances and payments
t marriage and death.

During the 1930's the public social services (including war
ensions, which have a similar social effect) required an annual
utlay of about £500 mn. Of this, roughly one-quarter went
education, one-quarter to health services (including housing
xpenditure not covered by borrowing), while the remaining
alf consisted of supplements to personal incomes (social
ansfers); of this, roughly half went on public assistance and
nemployment payments, and half on pensions of various
rts. Social expenditure had thus come to be more important
a provision of incomes than as a provision of services. By
53 total outlay on social services had risen to over £2,500 mn.
rise of roughly 350 per cent in real terms). Owing, however,
the high level of employment a smaller proportion
presented supplements to personal incomes.[1] The rise in
ensions payments, however, was not far from making up the
ference.

Economic expenditure is the administrative and financial
sponsibility of the central government; but the local authori-
s have traditionally been Parliament's agents for the pro-
sion of the social services. Since the extension of social
curity to the whole nation and the establishment of the
ational Health Service, however, central agencies have become
ectly responsible for more than 60 per cent of social expendi-
re. For many years before this local services were heavily
sisted by an elaborate system of exchequer grants, built up
rtly with a view to stimulating local activity, partly in order
make things easier for the less prosperous neighbourhoods.
e shall have to examine the policy implications of this
paratus at a later stage.[2]

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

[1] See Chapter XVI, especially Section 4.
[2] See Chapter XV, especially Sections 2 and 7.

services and nationalized industries. The postal service normally, operated to bring in a positive profit (tot about £11 mn. in the 1930's, but which since the war has lower in real terms), this the Chancellor invariably regar available in support of general revenue. In the eight century road expenditure was made self-balancing by device of tolls; a similar result was in principle obtained inter-war period, during the independent life of the Road (which came to an end in 1937), vehicle duties and fuel principle being set against road expenditure. In pr however, the revenue collected was largely applied to ge purposes. The system of tolls is still much used in Am and there are strong arguments in its favour if it succe getting roads built which would otherwise seem to thro heavy a charge on the taxpayer, although in the end would more than pay for themselves in increased spe transport.

The idea of making the social services self-supporting has been abandoned. Fees are indeed charged for a few se (e.g. for prescriptions and apparatus under the national service); the house rents charged in the inter-war peri some authorities were almost sufficient to constitute h a trading rather than a social service. By and large, ho it is accepted that the social services should be provided in order to bring about a more equal distribution of consu incomes.

The only type of public outlay which we have n discussed consists of payment of interest on the National To the government this appears as just another demand public purse, absorbing revenue which might more u have been devoted to social or economic development, however, is a misleading way of looking at the debt co In the first place the interest is not a burden on the r commensurate with the outlay required, because i payments are subject to taxation. Britain's high ra

[1] For discussion of the economic significance of the National D Chapter XIX.

urtax ensure that the national debt is self-supporting to a not negligible extent.

A more important reason why we should not regard 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 om our discussion that Adam Smith's list of the "Duties the Sovereign" is still not inappropriate as a classification public expenditure. In order to appreciate the importance the public services in a modern economy it is necessary to ve them a statistical content. The relative importance of the ifferent services is best realized by referring them not merely each other but to the total resources of the community. It also necessary to have regard to their development over time, d to their variation with good and bad economic conditions. able I illustrates these movements by showing the relation of e main types of British public outlay to the national income[1] the "normal" years (which are used as the bases of statistical ries) 1913, 1924, 1938 and 1948, in a bad year 1932, and ally in 1950 and 1953.

[1] The net national income, at factor cost here used, is not a wholly isfactory measure of the output of resources since it contains an bitrary element of depreciation of fixed equipment, but it is the only one ailable over the whole of our period. The purist should note that social nsfers are included with other social expenditure while they (with other nsfers) are excluded from calculations of the national income in order avoid double counting. If we exclude them from social expenditure 1953 its percentage would be reduced from 16 per cent to 7 per cent.

4

TABLE I.—THE MAIN TYPES OF BRITISH PUBLIC EXPENDITURE (ON CURRENT ACCOUNT) AS PERCENTAGES OF THE NATIONAL INCOME (AT FACTOR COST).

Year	Defence	Civil Government	Social Expenditure	Economic Expenditure	
				General	Roads
	%	%	%	%	%
1913	3·6	0·9	5·5	0·006	1·0
1924	3·2	1·3	10·3	0·2	1·4
1932	3·1	1·7	15·8	0·5	1·5
1938	7·8	1·5	13·0	0·6	1·4
1948	7·5	3·0	14·0*	0·9	0·4
1950	6·9	3·0	14·0*	0·6	0·6
1953	9·0	3·0	16·0	0·4	0·6

* Including food subsidies, 18%.

The dominance of social expenditure is strikingly demonstrated by this table; the greater importance of economic services than the expenditure suggests should, however, be borne in mind. In contrast to other economic expenditure road development has been allowed to stagnate; it can be doubted that the neglect of the roads in the face of the expansion of motoring is an important factor in the accident rate, which all deplore. It is interesting to observe the very much higher level of defence expenditure in compared with 1913, and further, the extent to which the of a third world war has caused it to rise since 1950.

It should be noted that all services registered an expansion relative to the national income, in the depression years. This illustrates the rigidity of public outlay, due to the 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 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 contributed to intensifying the depression. Fiscal policy 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 in principle favourable to the implementation of a high employment policy, for which they are the most relevant factors.

It will be seen that the expansion in the public sector which the table illustrates has been practically continuous throughout the inter-war period; it evidently does 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 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.[2]

[1] In Part III.

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

CHAPTER III

THE MAKING OF FINANCIAL POLICY

§ 1. The Sovereignty of Parliament. Policy is propo
the Cabinet, but must be agreed by Parliament before
be implemented. Our interest is not in the politica
which determine policy, but in the financial means
by Parliament to carry it into effect, including the polic
governs the choice of means. Success in public f
depends on a judicious balance of stability and flexib
stability because unnecessary change is costly and loos
established threads of control; flexibility because in a
of change public finance needs to be kept appropriate
situation. We have to enquire how far these two qu
emerge from the financial apparatus which has been dev
in Britain.

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

We can, in fact, distinguish three degrees of Parliam
control over the public finances. One part of public
diture, and the balancing revenue, lies entirely outside
mediate jurisdiction of Parliament (being under the con
the local authorities); a second is reviewed by Parliament
is agreed without debate; the remainder is submitted to
ment in great detail and debated at considerable leng
is obviously this third section which is most fully
control and most amenable to adjustment, but even th
hands of Parliament are to some extent tied by past co

nd by the nature of the services. Public finance never starts
ith 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
mportance of these three degrees of Parliamentary control.
n the year 1953 the Cabinet presented to Parliament expen-
iture plans on current account amounting to £4,274 mn.
evenue was planned to produce £4,368 mn., of which £4,177
n. was to come from taxes, leaving a planned surplus of £94
n. as a contribution towards investment or reduction of
nflationary pressure.[1] Of this expenditure total £674 mn. was
be charged directly on the "Consolidated Fund",[2] that is to
ay it belonged to the second degree of control, to be reviewed,
ut not debated, by Parliament.

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

The remaining expenditure plan was divided into three parts,
,365 mn. for the supply of the defence services, £2,190 mn.
r civil expenditure and £45 mn. to cover the cost of tax
llection. Detailed estimates of the distribution of the first
o were submitted and duly discussed. In principle all this
penditure came under the third degree of Parliamentary

[1] Cf. the Balance Sheet on p. 88.
[2] For the significance of the Consolidated Fund cf. pp. 47, 48.

control; it was within the power of any member to sug
change of plan during the debates.[1] In fact, however, P
ment was pledged to pay over to the local authorities
of about £420 mn. from it, a much larger sum (about
mn.) was required to finance the various types of pens
and to support the social insurance funds. In addition,
estimated that over £440 mn. would be required to fu
undertakings of the National Health Service. Thus the
dom of action implied in the debates on the estimates,
as these sums were concerned, was rather of the natur
reminder to Parliament that it could if it liked take st
alter the arrangements, than as having any relevance f
year in question.

In addition to their Parliamentary grants the auth
which thus received them collected taxes independen
Parliament (the local rate and contributions to social ins
respectively), to complete the financing of their activities
the average, Parliamentary grants covered about 40 per
the expenditure of the local authorities on current ac
Nearly 90 per cent of these grants were allocated to
services whose conduct was broadly under the cont
Ministers responsible to Parliament (such as the Mini
Education); the remainder was awarded as an "Equali
grant in support of the general revenues of local auth
below the average in wealth; the local authorities them
determined its distribution between services. Their poli
however, inevitably deeply affected in the long run
presence of these substantial grants.[2]

In a similar manner Parliament resigned control of th
paid over to the national insurance fund. Its oper
however, followed "predestinate grooves" the broad
of which had been laid down by Parliament, and

[1] So long as the change did not involve a charge on public fu
p. 51.

[2] The precise proportion of grants to independent resources,
specific to block grants, differed considerably from one auth
another, but the degree of control by Ministers varied cons
less.

onsequently be altered by legislation. Thus in practice the
ubstantial sums paid over by Parliament to the local authorities
nd to the social security system passed out of current Parlia-
entary control, and belonged essentially only to the lowest
rder of control.

We may sum up the situation by saying that Parliament
ominally controlled the outlay of about 80 per cent of the
tal current public expenditure, but at the most 30 per cent
f this was subject to effective discussion. Of this, some part
g., defence expenditure) was too technical to be usefully
ebated by laymen, and further parts were fixed by long-term
ngagements. These proportions exclude trading activities.
n the other hand, about 85 per cent of the taxes collected was
oted by Parliament. As compared with the 1938 situation the
ntral government had extended its control more over ex-
enditure than over taxation.

These proportions are, of course, substantially above those
ntrolled by the central government of a federation, such as
e United States. Moreover, the opportunities for flexibility
e rather greater than appear. Greater adaptation to changes
the level of economic activity might be incorporated by
atute into the policy of the social security system, and (less
adily) by agreement into that of the local authorities. These
e matters to which we shall have to return at a later stage
Part III). On the whole, however, the British financial
stem is distinguished for stability rather than for flexibility.
bstantial changes in public outlay, other than in defence
penditure, have been the result only of legislative changes.
Stability is not a merit in itself, but only so far as it conduces
the most effective distribution of public outlay. An
amination of the machine which produces the annual plan
financial policy (loosely known as "The Budget") will
able us to estimate the probability of this.

2. The Treasury. The centre of policy in the British system
government is the Treasury. In the later Middle Ages the
bit grew up of giving the post of Treasurer to the chief

Minister of the Crown. A very notable holder of the
was Lord Treasurer Burleigh, Queen Elizabeth I's great
(the first of many members of the Cecil family to hold
office under the Crown). Since 1714 the Treasurer's
always been "put into commission", i.e. a number of
Commissioners are appointed to form a nominal
Treasury to share between them the business of the
This is for practical purposes a fiction, however, since
the Board of Trade (but unlike the Board of Admiralty
Board of Treasury never meets. The continued
of the Treasury in policy is shown by the fact that the
Minister now always assumes the title of "First Lord
Treasury" and the members of the Government are
referred to collectively as "the Treasury Bench".

The Chancellor of the Exchequer, the chief financial
of the Crown, is the Second Lord of the Treasury. His
are to advise the Cabinet on financial matters, and to
the government's financial policy in the House of
The most important occasion on which he does this is
introduces the Budget,[2] the financial plan for the
other occasions on which an explanation by the
called for are becoming increasingly frequent as the
of public finance in the economy increases.[3]

The Chancellor is now assisted by two Ministerial
Since December 1947, in addition to the Financial
there has been either a Minister of State for Economic
or an Economic Secretary. Both advise the
general financial and economic policy, but the
Secretary is responsible, under the Chancellor, for
administration and procedure among other things,

[1] For the history of this device cf. pp. 47ff.

[2] The first recorded use of the word in its technical sense
be in a pamphlet in 1733, cf. Miss D. M. Gill, "The Treasury
English Historical Review, 1931.

[3] The traditional function of the Exchequer—from which
its name—the tallying of tax collections, is now under the
of Exchequer and Audit, presided over by the Comptroller
General, cf. pp. 50ff.

Economic Secretary (or Minister of State) deals principally with overseas financial questions. Other Treasury Ministers include the Parliamentary Secretary, who is assisted by five Junior Lords Commissioners; they are known as "Government Whips" and their duties are almost entirely political.

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.

For many years the Treasury has been undergoing a gradual, but most significant, process of modification. During the 1939–45 war there was a great extension of government intervention in economic affairs. Much of the work of co-ordinating the war-time economic controls was carried out under the direction of the Lord President of the Council, or by other Ministries, while the Treasury duties were greatly increased as the scale of government expenditure grew and the problems of external finance became more pressing. The Central Statistical Office[1] and the Economic Section were established in the Cabinet Office at the beginning of the war, and took part in the work of co-ordination organized under the Lord President. For some time after the war the main responsibility for economic co-ordination continued to lie with the Lord President, but as the apparatus of direct controls over the economy was gradually dismantled, budgetary and monetary policy—additional responsibilities of the Treasury—assumed increased importance as instruments of general economic policy. In 1947 the Chancellor of the Exchequer added to his older functions the responsibility for general economic co-ordination. At the same time the newly created Central Economic

[1] See below, pp. 332ff.

Planning Staff was transferred to the Treasury. In 1953 the Economic Section of the Cabinet was also transferred to the Treasury.

It will be seen from the above account that the Treasury has expanded its activities widely beyond its traditional role as financial watch-dog. Although the necessity of organizing the economy for total war was the occasion of the great extension of the role of the Treasury, the changes of the post-war years are of even greater significance in the sense that they reflect a permanent reorientation in public opinion concerning the responsibility of the government for a national economic policy. The stages in this process are reflected in the growth of Treasury personnel: from some 400 at the beginning of 1940 to 800 at the end of the war and 1,350 at the beginning of 1950. From this position, it is safe to say, there can be no fundamental return. Governments of different complexion may differ in future lay more or less stress on the degree of control and planning they feel to be desirable. In fact the dismantling of controls from 1951 has implied some reduction in Treasury personnel also. These variations, however, are not likely to be more than minor; the policy which lies behind the new responsibilities of the Treasury is a matter of public opinion rather than of party, and is accepted in principle by both the major parties.

We shall be further concerned with these matters in Part II. It is worth noting here, however, that even at its expanded size the British Treasury is a small department compared with the central finance Departments of comparable countries. This is because it is essentially a nucleus, co-ordinating the activities of a diverse collection of outlying agencies (such, for instance, as the Exchange Fund). By this means it has been found that the traditional advantages of direct communication and personal contact can substantially be retained even in the complicated circumstances of the present day.

According to the new organization the Treasury is divided into five parts: Supply, Establishments, Home Finance, Overseas Finance and Economic Affairs, corresponding

[1] For the significance of these changes, see below, pp. 332–3.

functions of watching over the activities of the other spending Departments; of supervising the general organization of the Civil Service; of preparing the details of internal financial policy; of dealing with external financial policy and of co-ordinating and formulating general economic policy.

The Supply Divisions of the Treasury discharge the traditional function of controlling expenditure other than on staffs. Each is responsible for a group of Departments whose financial activities it supervises, advising and helping on the preparation of Estimates and on the layout of expenditure. We shall have some more to say about this work presently.

The Establishments Divisions deal with all personnel questions relating to the Civil Service and the Armed Forces. Some control the numbers and grading of staff employed by individual departments. Others handle general questions such as pay, recruitment, manpower, policy and superannuation. 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 Home Finance Divisions are concerned with the preparation of the Budget, fiscal policy, the management of the National Debt, promotion of savings and banking and currency questions. They also cover the control of capital issues and the provisions of loans for local authorities.

The Overseas Finance Divisions fall into two groups. One is concerned with various general aspects of the balance of payments problem, such as export policy, import programmes, exchange control and so on. The other is concerned with the commercial and monetary relations between the United Kingdom and individual countries.

The sections of the Treasury dealing with general economic affairs comprise the Central Economic Planning Staff, the Overseas Co-ordination Section and the Economic Section. They are responsible for Economic Surveys and other general studies of economic trends at home and abroad. The Economic Section forms the staff of the Economic Adviser to

the government and is responsible for giving general adv
economic matters. The Central Economic Staff and Ov
Co-ordination Section, which have more specifically ad
trative functions, are responsible for the co-ordinati
various aspects of economic policy, particularly such a
cern other economic departments besides the Treasur
work includes the formulation of national investment
and the co-ordination of British policy in trade negoti
and in certain international economic organizations.

§ 3. The Annual Financial Routine. The above compris
main equipment for preparing financial policy. By
following the annual routine of preparing the plans
penditure and revenue, and passing them through Parli
we can watch the machinery at work.[1] The Financi
in the United Kingdom begins on 1st April; formal
preparations begin some six months in advance of it
mencement, when (about 1st October) the Treasury s
the various Departments a request for the submission
mates of expenditure for the coming year. In actual
is not the beginning of the Estimates, which may almost
to be in continuous preparation; as each item of expe
takes place, minutes on it constitute the first stage in p
the corresponding item next year.

The official opening of the financial, as of the Parliam
programme occurs on the reassembly of Parliament
new session, an event which now takes place in the a
At the opening of Parliament the Queen's Speech (prep
the Cabinet and submitted to Her Majesty by the
Secretary) briefly reviews the work of the session just co
and outlines the business of the new session—the leg
which it is hoped to enact and a rough idea of the
which it will be necessary to raise, both to cover routi
vices and to provide for any new legislation which m
been passed in the previous session. It is significant

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

ritish constitution that while the general policy plans are
mmunicated to both Houses together, the Commons are
dressed alone when it comes to matters of finance.

The Queen's Speech is followed by an Address from both
ouses in reply to Her Majesty (this is also prepared by the
abinet). The most significant thing about the Address is the
pportunities which the debate gives—on the one hand for the
pposition to criticize the general policy of the government,
the other for the government to gauge the strength of the
pposition. When the Address is carried without amendment
e government is in a very strong position.

At this stage in the financial year one further piece of
utine machinery is set up. Expenditure and revenue debates
not take place as formal sittings in the House of Commons,
th the Speaker in the Chair; instead they are conducted in
ommittee, but in Committee of the whole House, presided
er by a specially elected Chairman. The same Chairman
esides irrespective of whether the House is considering
penditure (when it is said to be in Committee of Supply) or
ation (when it is said to be in Committee of Ways and
eans). At the time of the Debate on the Address these
ommittees are formally set up and their Chairman selected,
though the machinery does not begin to function until some
me later. The purpose of this rather odd Committee
rangement is to allow greater freedom in debate—for
stance, as to the number of times a Member may speak
the same Motion—than would be permissible under the
anding Orders of the House when the Speaker is in the
air.

The next stage in the financial year is the consideration of
Estimates by Parliament. These will have been submitted
the Treasury by the departments of the central government
out mid-December, and provisionally approved by the
easury before the end of January; they are brought before
House about the middle of February. The Supply
imates are presented in a number of separate volumes for
Defence Departments, the Civil Service Departments and

the Revenue Departments respectively. Together they co
thousands of pages. From the point of view of polic
Civil Estimates are the most interesting, since a
part of Defence expenditure is technical, and a further
part (e.g., war-service pensions) is subject to long
undertakings.

The Defence Estimates are introduced to the Hou
Commons by the respective Ministers responsible fo
departments, but the Financial Secretary to the Tre
undertakes much of the work of passing the Civil Esti
through the House of Commons. The Estimates are gr
in "Classes" relating to the different Ministries—thus C
is now entitled "Local Government and Planning, Ho
Health, Labour and National Insurance"—and coverin
work of the respective Ministries. Each Class is divide
a number of "Votes"—1, 2, 3, etc.—these usually refer
same type of expenditure every year, for convenience of
ing outlay. Each Vote is in turn divided into Heads, A
etc., and each Head into Subheads, A1, A2, A3, etc.,
the expenditure is finally broken down into quite small
occasionally as low as £10, more commonly in sums o
or so. Thus the plan of the lay-out of intended expen
is extremely detailed, but, as we shall see later, owing
peculiar organization of public accounts, the details
practice not very informative.

A major responsibility of Parliament during the spri
early summer is the consideration of these Estimate
Parliament also has a great deal of other business to att
—new legislation, the discussion of current events and
to Members' questions. It has therefore been agreed t
Estimates can only be allowed twenty-six Parliamentary
for consideration (with provision for three extra days if it
absolutely unavoidable). These "Supply" days
arranged almost any time that Parliament is sitting,
February and the end of July, when the Estimates

[1] The number was raised from 20 in November 1947 to allow
the discussion of problems raised by the nationalized industries.

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

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

Since the time of Pitt, Budget speeches have been among
he most important made in Parliament. In Victorian times,
nce the statistics were not printed, the speech was largely
tour de force illustrative of the Chancellor's memory;
might occupy several hours, and some Chancellors hardly
eigned to make use of the notes provided for them by the
reasury, preferring to produce everything from their own
eads. Although there is now much more for a Chancellor
say in his speech, the process has been enormously shortened
y making available to Members a printed Financial Statement
mmarizing both expenditure and revenue for the year which
as just ended and the Estimates for the year just opening.
ven so, Chancellors are wont to make the most of their
pportunity, and to attempt to give the speech an individual
avour in the tradition of a Peel or Gladstone, or even a
hurchill or Snowden.

We need not linger here over the plan of the Budget Speech,
hich invariably follows traditional lines, because we shall

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

have to discuss at some length at a later stage the pri
on which it is based. The information given in resp
expenditure is inevitably very summary, since the acco
period will only have ended a couple of weeks earlier,
fact it does not add a great deal to the weekly summa
expenditure and revenue published throughout the
consequently, this part of the speech does not arouse a
deal of interest. The Budget properly so-called consists
details of the taxes which it is proposed to levy during th

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

Since 1941 further statistical information of a very imp
nature concerning the country's finances has been
available to Members and to the public, at about the time
Budget. The important items of this are: (i) the Eco
Survey (which first appeared in 1947), setting out the
economic situation, both internal and external, as it appe
the government's statisticians and economists, (ii) the
nary estimates of national income and expenditure (whi
1952 have been followed some months later by a "Blue
containing much more detailed and diverse information
(iii) the account of the country's balance of payments w
rest of the world. Increasing use of this economic infor

made by Chancellors in their budget speeches, and there is
o doubt that they are leading to a much better understanding
f the real economic situation and of the effect on it of public
xpenditure and taxation. We shall be further concerned with
hese matters in Part III.

Several days are usually allotted for the discussion of general
conomic policy after the Budget has been introduced. The
louse then goes back to general business, this time interspers-
g Ways and Means debates with the remaining supply days
nd other matters. When all the financial resolutions have
een agreed to in Ways and Means, the Finance Bill is brought
and must be passed through all its stages before the end of
uly. It contains all the revenue changes, and from time to
me a certain amount of general legislation concerning the
etails of tax administration.

Any of the Estimates which have not previously been passed
e taken on the last two supply days, and passed *en bloc*,
that by the end of July the whole of the financial programme
r the year will have been agreed to. It is embodied finally
only two Acts—the Finance Act covering taxation and all
atters relating thereto; the Appropriation Act authorizing
e application of revenue to the purposes stated in the Esti-
ates. Thus, little more than four months after the opening
the financial year, all the vital arrangements for its transac-
ons will normally be complete.

It will have been noticed that we have been concerned so far
ly with the activities of the House of Commons; before the
inance and Appropriation Acts become law they must also
passed by the House of Lords and receive the Royal Assent.
here is now no danger of any serious hitch in the Lords, and
e Royal Assent is completely automatic. The last occasion
which the Lords attempted to assert an independent policy
curred in 1909, when the Upper House refused to pass the
inance Bill authorizing revenue for the new social insurance
nds. The Lords' opposition was recognized to be against
e social rather than the financial policy in question, so that
important constitutional issue was involved. As a result

of this attempt to frustrate the policy of the governme
Lords were eventually forced to accept the Parliament A
1911, whereby a Money Bill, passed by the Commons
presented to the Lords at least a month before the end o
session, becomes law, whether the Lords agree to it or n

A simplified version of the Budget technique is follow
the more important Local Authorities, the Finance Com
usually playing a more or less parallel role to the Treas
the preparation and co-ordination of the estimates of the
ent Committees of the Council. Thus for each main
body in the country, the year's financial plan comes befo
elected representatives of the citizens in a single, fairly s
consolidated account.

The consolidated account is an essential first step in en
an efficient lay-out of resources on the one hand, a
efficient control of expenditure on the other; but it is
no more than a first step; in itself it is no guarantee of effi
in either direction. We have only to consider what s
control can be exercised by a Committee of more th
members which only allows itself twenty-six days to co
thousands of pages of estimates. That it cannot be a
of technical detail is quite evident; it is hard to believ
even the broad lines of policy are really clear to many Me
It is therefore not surprising that Parliament has been oc
for centuries in devising means of checking its own fi
actions.

CHAPTER IV

THE CONTROL OF EXPENDITURE

1. The Consolidation of the Public Accounts. The financial
an which is embodied in the annual Appropriation Act and
inance Act is the joint product of the Treasury, the Cabinet
nd Parliament (putting the partners more or less in the order
which their contributions are made). This co-operation is
ecessary, first, to see that the plan *as submitted to Parliament*
satisfactory, in that it provides for an efficient transfer of
ivate resources to the public sector and for their distribution
accordance with the government's policy; secondly, that the
an *as it leaves* the House of Commons really expresses the
shes of the House; and, thirdly, that the plan is *put into*
ecution in accordance with the decisions of Parliament.
These three conditions need to be distinguished, but they
ust all three be fulfilled. A not-so-good measure proposed
Parliament may be improved as it passes through the House;
the other hand an initially coherent measure may be torn to
eces or distorted beyond recognition by bright ideas during
bate, unless some means of ensuring self-restraint are avail-
le. Needless to say even good measures will fail unless
rried out according to intention.

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

taken to see that the three conditions are fulfilled in re financial measures.

Parliament, as the ultimate authority, has to do its assure itself that the three conditions are faithfully carr but by its very nature it works under a grave disabili Parliament is essentially a dual-purpose assembly. On hand it is a legislative body in control of the executive, with the making of new laws and with the duty of see existing laws are working in accordance with intent the other hand it is a forum for the discussion of and international issues, and for the ventilation of grievances. Neither of these two duties can be di with, or even markedly curtailed, without damag democratic institutions; but it is obvious that the of the second duty severely limits the time available first, and so makes success more difficult. When we reflect that membership of Parliament is not a whole- and that most members have their own businesses to a the importance of the time factor becomes still more a

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

It now seems clear that not merely the *Cabinet* evolution is related in every school history book), bu Treasury and the organization of the national finan started in their modern careers as the result of a series but very inconspicuous, developments which took p tween the accession of Charles II and the death of Que It is interesting to reflect that if the Pilgrim Fathers h a couple of generations later these changes might co have been embodied in the United States constitutio would then probably have assumed a considerably form from the one which it has now developed.

In early Stuart times the "Executive" consisted of the "King Council", that is to say, the King's advisers were outside rliament, in the manner of the Executive of the United States. e Treasury as a body emerged from this set up when Charles departmentalized[1] the executive, with the double purpose of aking it more effective and at the same time more obedient his will. Under a succession of extremely able officers, osen for their financial and business abilities,[2] and under the idance of Lord Godolphin, who held the supreme financial st under the Crown in many ministries and during four gns, the Treasury soon attained the leading position among departments. Decisions came to be taken there; the l-fashioned Council found itself effectively by-passed and dually sank into insignificance. When before the end of the enteenth century the transfer of the King's Ministers to rliament took place (and the Executive and Legislature were ited as "The King in Parliament"), the Cabinet being a mmittee of Heads of departments, the Head of the Treasury turally became the leading Minister.

From the Restoration the attempt to finance any consider- le part of the public services out of the revenues of the yal Estates had been abandoned (the inadequacy of these d been at the root of much of the trouble under Charles I). e support of the Royal Household and similar expenses re then put on a "Civil List", later merged in the Consoli- ed Fund. At the extinction of the life revenues granted to arles I and James II the whole of Supply Expenditure ame dependent on Parliamentary grant. It was then pos- le for the Treasury Lords to prepare Ministerial directions, responding to the modern Estimates; but already from

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

[2] Especially Sir George Downing, appointed Secretary to the Treasury, 7, who gave his name to Downing St.; from the fortune which he umulated was founded two generations later, and by a series of ac- nts, Downing College, Cambridge. At least equally important was Wm. Lowndes, after whom Lowndes Square is called, Treasury Clerk, 9, secretary to the Treasury, 1695–1724; his family motto records his in devising "Ways and Means" of raising taxation. See *Dict. Nat.* g.

1667 the way had been prepared for this step by the ins
of the Treasury that the departments should furnish
accounts of their transactions with the Exchequer. Fr
period also dates the distinction between the two f
functions of Parliament—on the one hand to "Appro
supplies, on the other to find adequate "Ways and Me
cover the appropriations.

The next considerable step forward in the consolida
the public finances was the work of the younger Pitt.
rightly been called the Father of the Budget, because h
duced the practice of laying the whole financial year
gramme before Parliament in a single whole—on the o
the Estimates for all Departments, on the other th
revenue estimated to be required to cover them. Pitt a
the foundations of a consolidated accounting system, b
transferring the accounts of all departments to the B
England. Modern practice, whereby the Estimates
penditure, and of revenue changes, are each passed in
Act, is essentially a development of Pitt's reforms; s
the single Exchequer Account at the Bank of Engla
bank balance of the Consolidated Fund), whereby all
ments to the government, and all out-payments to
Departments pass through the hands and are under the
of the Paymaster-General.

These three forms of consolidation are of the
importance for the orderly conduct of the nation's f
The device of the Consolidated Fund enables the T
very simply to keep a watch over the departments, an
it possible for the Cabinet to ascertain at any time
how things are going, simply by examining in- a
payments of the Fund. The single Finance Act goes
way to ensure that Parliament will agree on the n
taxes, and will do so in plenty of time. For policy th
Appropriation Act is still more important, since i
guarantee that Parliament has really had the opport
considering the entire annual lay-out of public fun
whole.

This degree of consolidation was not achieved without
onsiderable difficulty. The post of Paymaster-General was
reated in 1834; the single Finance and Appropriation Acts
ate from the 1860's, and were mainly the work of Gladstone,
ho ranks with Pitt and Godolphin as a financial administrator.
he improvements were due, however, as much to the deter-
ination of the Commons to prevent the Lords from spoiling
eir plan, by throwing out essential parts (which was easy so
ng as it was presented in instalments), as to any anxiety to
view the plan as a whole.

2. Departmental Control. For the routine supervision of
e Executive, Parliament relies more than ever to-day on the
reasury. The operation of Treasury control is a continuous
ay by day process, all proposals for expenditure on new ser-
ces or extension of existing services requiring Treasury
pproval before they are put in hand. The submission to, and
tailed examination by, the Treasury of the annual Estimates
rve to crystallize each Department's expenditure into a
cture of twelve months' cash requirements, and thus super-
pose on the "running" control a more sharply defined
short-term" control once a year. The two forms of control
e complementary: in sanctioning any new expenditure the
easury is mindful of its effect on the current year's budget,
hile the examination of a particular year's Estimate provides
e opportunity for a comprehensive review of the whole of a
epartment's activities and the general trend of its expenditure.
Most of the Civil Departments publish detailed annual
ports which provide Parliament (and the public) with a
rther record of performance (the Reports of the Ministries
Labour and Education are particularly noteworthy). The
efence Estimates (in time of peace) are accompanied by eight-
ar comparisons of expenditure for different purposes; they
o contain departmental reports similar to those of the civil
nistries. Treasury sanction is required for the application
savings on one Subhead of a Vote towards an excess on
other Subhead of the same Vote (technically known as

virement). Any important alteration in the form of th
mates would not be made unless agreement had been r
between the Treasury, the Estimates Committee and the
Accounts Committee.

A parallel system is used to check expenditure as i
place. The Department of Exchequer and Audit p
over by the Comptroller and Auditor-General keeps
stantial staff (over 300) of auditors continually at w
departmental business. In respect of those departmen
derive all their moneys from the Consolidated Fund,
is a simple matter; but some have additional in-pay
for instance, the court fees and fines collected by the
the check is then more complicated. All such "App
tions-in-aid", as they are called, have to pass thro
Paymaster-General; they cannot be retained in the depa
In the same way unexpended balances of funds w
Parliament have to be returned to the Paymaster-Gener
end of the financial year.[1]

The office of the Comptroller and Auditor-General d
from a series of reforms extending from 1832 to the G
era; the Auditor-General is an "officer" of the H
Commons, with status similar to that of a judge.[2] H
are to enforce the regulations which govern expenditur
detect and report any waste or irregularity which occu

[1] The expenditure accounts of the British Government co
three editions: (i) The Financial Statement, issued with the B
The Finance Accounts, issued in the following autumn. These
contain details of revenue collected, national debt operations, a
the civil list, and sundry other accounts; they differ from each oth
in detail; (iii) The Appropriation Accounts, issued some eighteen
later for the civil and defence supply departments, in which are
all adjustments between the Consolidated Fund and the Depar

[2] That is to say he can be removed only by petition of both
The Comptroller and Auditor-General is thus the ultimate gu
the public purse (and not the Paymaster-General, who is a mem
Government). This was brought out very clearly in the final
troversy of 1909–11, when there was some little danger of a stopp
public services, since the Comptroller and Auditor-General would
continued to authorize expenditure if Parliament had failed
Budget. The episode is excellently described in Sir A. Cha
Politics from Inside.

xpenditure accounts are drawn up in an exactly parallel
rrangement of Votes, Heads and Subheads as the Estimates;
henever there is a discrepancy, however small, between
upplies voted and sums disbursed, elaborate explanations are
rovided. Important discrepancies are often commented upon
the Auditor-General's Report which prefaces the Appro-
riation Accounts.

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

The first form of the Standing Order (now S.O. 78)[1] on
ich this most important provision rests, dates from 1713.
nfortunately the state of Parliament's records in the seven-
enth century make it impossible to discover its origin, but
e may safely regard it as a further legacy from the great days
Godolphin and Lowndes. It is completely effective in
eventing either government back benchers, or members of
e Opposition, from wrecking the balance of a financial plan
trying to go "one better" than the government, a habit

In its present form, which dates from 1866, S.O. 78 reads: "This
use will receive no petition for any sum relating to the public service,
proceed upon any motion for a grant or charge upon public revenue,
ether payable out of the Consolidated Fund or out of money to be
vided by Parliament, unless recommended from the Crown." Cf.
nings, *op cit.*, p. 250.

which is the source of endless trouble in countries which 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 and there should be no dark corners in the government's expenditure. On the revenue side it was formerly the custom to provide adequate opportunities for debate even if no tax changes were proposed, by making the income tax and one other tax (usually that on tea) renewable only from year to year. The decisive factor now is the annuality of the income tax, without which the public services could not be carried on.

In practice, however, the supply debates do not enable 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, as by avoiding a division on the Vote in question. 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 last two supply days come round, only a few of the Estimates will have been considered at all. The time necessary for the remaining two days to be spent by members walking in and out of the division lobbies, passing Votes 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 Government.

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; indeed, 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.

Parliament debates the Estimates piecemeal, Vote by Vote, members being able to raise any topic whatever concerned with the Department whose Vote is under consideration. This traditional practice led to difficulties when it was desired to raise a subject common to a number of departments. By an ingenious modification of procedure devised in 1942[1] this difficulty has now been surmounted. The common subject it is desired to debate (for example wage policy in the public services) is named in the terms of the motion brought before the Committee of Supply with a token vote set against it. There follows a list of the Votes of the particular departments concerned, with a token vote (of say £10) against each, the total of these being the figure appearing in the Motion. Thus a notional common Estimate is produced which provides the necessary peg on which to hang a Committee debate.

Parliament has long been conscious of the inadequacy in 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,[2] still another of the Gladstone reforms. It is a committee of fifteen members, drawn from the different political parties roughly in proportion to their

[1] After Sir H. Williams had drawn attention to the inadequacy of the existing procedure.

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

representation in the House (in accordance with the practice for select committees). In order to ensure critical attitude the chairman is a member of the Opposition it is usual, and obviously convenient, to choose Financial Secretary to the Treasury in the preceding Parliament.

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 Committee, however, does not lie so much in the attention which Parliament pays to its findings as in the examination witnesses from the departments. The procedure is chairman to sit at one side of the table, the Treasury representative at the other, with the representative of the victim between them. It is not surprising to find that the important effect of the committee's work is considered the feeling of "wholesome dread" which it inspires departments.

By means of the double check of the Department and the Public Accounts Committee, tradition of financial integrity and probity has been among public servants. It can confidently be stated country in the world wastes less of its substance malversation in the public services.[1] All this is excellent as it goes, but its effectiveness as a check on the allocation resources is severely limited in two ways. In the first to make a detailed examination of expenditure only has taken place is apt to be like shutting the stable door the horse has escaped; in the second place the type of over the Executive which Parliament secures methods seldom rises above a fairly elementary

[1] The audit arrangements of local authorities are different. their accounts are audited by District Auditors appointed by the of Health (now the Ministry of Local Government and Housing) of the accounts of a number of boroughs are audited by firms of tants. The Report of a Departmental Committee on the Accounts Local Authorities published in 1907 (Cd. 3614), pointed the standardization of accountancy methods.

ane.[1] Waste of public money is likely to occur in more ubtle ways than through the occasional dishonesty of minor ivil Servants.

In order to meet the first of these difficulties Parliament has ied various plans to ensure a more thorough examination of penditure by submitting programmes as well as accounts to lect committees. A Select Committee on the Estimates[2] was ppointed for each of the Sessions 1912–14, and again from 21 to 1939. There is general agreement that these early timates Committees were largely ineffective.[3] They showed tle initiative in developing a technique of investigation. oreover they attempted to examine the Estimates between eir release by the Treasury and their consideration in mmittee of Supply, a process for which there is no adequate terval. Throughout further, they were hampered by the sence of a secretariat such as was provided for the Public counts Committee by the staff of the Department of chequer and Audit. There is evidence, however,[4] of increased effectiveness just before their appointment ceased on the tbreak of war in 1939.

Ever since the Crimean War, the abnormal expenditure due war has aroused Parliament to a realization of the need for ecial watchfulness. Both in the Crimean and in the Boer ars, Select Committees on National Expenditure were ppointed, but their duties were conceived mainly in terms of

Some years ago, however, the Comptroller and Auditor-General de history by detecting a flagrant piece of inefficient buying of telephone ipment by the Post Office. This discovery may well have been due to more effective method of accounting now used in some of the Trading partments as compared with the Supply Departments, see p. 56.

For an excellent summary history of these cf. the Eleventh Report of Select Committee on National Expenditure for the Session 1943–44, on ich also see pp. 57ff, also Chubb, *The Control of Public Expenditure*.

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

Cf. Chubb, *op cit.*

detecting fraud in the execution of war contracts. In t
of 1914–18, extraordinary as it may appear, no watch w
was kept over expenditure (apart from the Public Ac
Committee) from 1914 when the Estimates Committee
(owing to the suppression of the Estimates for security re
until 1917. A Select Committee on National Expenditu
then appointed, and re-appointed sessionally until 1920
possessed much wider terms of reference than previo
mittees. It was charged with three separate duties,
examine current expenditure (of any type) and to re
Parliament on the possibility of economies consiste
policy; secondly, to examine and make recommendati
the form of the Public Accounts, and on the system of
within the departments and by the Treasury; thi
examine Parliamentary procedure in relation to Sup
Appropriation, with a view to making control more eff

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

The mistake of leaving the national finances un
during war was not repeated in 1939; within four m
the outbreak of war a new Select Committee on N
Expenditure was appointed, and continuously reappoin
1945. The terms of reference were, however, narrowe
1917; the Committee was empowered merely to
current expenditure, and in respect only of "services

[1] Cf. Chapter VI, Section 1, and Chapter XX, *passim*.

nnected with the war". In spite of these hampering re-
ictions—more hampering than they would have been in 1917
cause of the more permanent nature of many war works, and
eir greater adaptability to civilian use—the Committee
cceeded in taking a broader sweep in its investigations than
y previous body. It developed a useful technique of work-
through sub-committees which enabled it to save time,
thout endangering the co-ordination of its programme.
ove all it managed to break through the obstacles to examin-
subjects common to a number of departments, and issued
orts on such subjects as contract procedure, design and
pply of stores, competitive bidding for personnel and the
mination of waste generally.

The Committee on Expenditure Arising out of the War was
uptly terminated at the close of hostilities, and a new
imates Committee was appointed in its stead. It was very
n evident that this was no mere reincarnation of earlier
imates Committees, but rather the direct heir of the war-time
mmittee. Firstly the new Committee continued the war-time
ice of working through sub-committees, obtaining sanction
expand its numbers to thirty-four to enable it to establish
en sub-committees (of which one is a "steering Committee"
rged with the drawing up and allocation of programmes);
sub-committee system enables the Estimates Committee to
ke ten times as many investigations as the Public Accounts
mmittee. Secondly it abandoned the attempt to examine
Estimates between the Treasury and the Committee of
pply, interpreting "Estimates" as synonymous with
rrent expenditure". Thirdly, it continued the practice of
mining particular programmes or projects as a whole,
er than ploughing steadily through the Estimates of selected
partments. Thus for the first time a sort of continuing
k on expenditure was established at the legislative level.
lthough the new Estimates Committee is much more effec-
than its predecessors there are inherent difficulties in the
mination of public expenditure "ex ante" which are not
ent in its examination "ex post". In the first place the

criticisms of the Public Accounts Committee can
because it is in a sense in the position of a tribunal;
Committee cannot attempt to play this role for fear of
ing the responsibility of the executive officers co
There is a similar difficulty in respect of the relation
Committee with the House of Commons: a Select Co
must be extremely careful not to usurp Parliament's
by pronouncing on policy, as can easily occur
examination is directed to programmes which ar
process of being carried out.

The new Estimates Committee has profited greatly
the provision by the Treasury of a secretariat and of
to service the two Financial Select Committees; but
at a disadvantage as compared with the Public
Committee, since there has been no preliminary sur
ground at the administrative level, such as the wo
Department of Exchequer and Audit in examining the
There is thus no automatic source of Agenda for the
Committee, as there is in the Report of the Comptr
Auditor-General for the Public Accounts Commi
these circumstances it is much more difficult to ensu
ground has been effectively covered.

The work of these committees show that inefficient
of resources in the public service can be traced again
to particular weaknesses. These are intensified by
and tumble of war finance, but they are present none
more normal conditions. It is therefore worth
briefly one or two of the most common forms
emphasized by the committees.

Overlapping of similar services supplied by differ
ments is one of the most potent causes of the
getting less than full value for its outlay. The
on National Expenditure found many examples of
departments, for instance, were responsible for
This is a problem which in normal times has b
relevance to the work of the different committee
authorities. Notorious examples were the devel

or law hospitals into auxiliary general hospitals, and the
mpetitive provision of post-primary education by county
horities and by authorities for elementary education only.
is overlapping is a weakness which is likely to become
nsiderably more prominent among central departments and
ionalized industries as their functions are extended—for
tance, into the field of direct provision of housing and
ated consumers' goods.

Overlapping services are sometimes due to carelessness in
ial planning; departmental functions and powers are in-
ficiently defined; and over-zealous officers extend the work
their departments in unforeseen ways. Overlapping is often
remely hard to prevent, especially with developing services,
ce their ultimate status cannot easily be determined. In
of this, additional statistical information is still required as
oundation of systematic planning. There would also seem
be a place for permanent machinery to review, and if neces-
y to redistribute, departmental functions, once overlapping
hown to have occurred, without paying regard to established
erests.

Another frequent cause of waste, apparently endemic in the
blic services, is the penny-wise pound-foolish policy of
nting salaries and materials, and so getting less than the best
ue for a given expenditure. One example of this frequently
phasized by the Committee on National Expenditure was
tendency for departments to entrust initial investigations
junior officers who were insufficiently qualified or experi-
ed; the plan thus had a rickety foundation from the start.
ere is often a hesitancy on the part of public departments to
ur heavy initial expense, even when it is justified; partly
doubt this is a relic of the time when control meant cutting
wn; partly it probably arises from the fear that the represen-
ve bodies for whom they work will take alarm at a big bill
h nothing tangible to show, and decree a change of policy
ore the project is complete.

This difficulty is closely related to one of the commonest
ms of waste—alterations of plan after the work has been

started. Alterations may become necessary either
planning at the outset failed to take proper accoun
relevant factors—this again is largely a statistical ma
because circumstances change before the project is co
This latter consideration is especially important in w
and is one of the main reasons why war-time expendi
not be closely controlled; but it should have very m
relevance to normal times. Whenever a change of
made, direct waste is caused because expenses ha
incurred for what is now useless; indirect waste is
follow because of the difficulty of checking costs and
contracts, once the original agreement has been abo
There is urgent need in these and related directions fo
more thorough investigation than has yet been attemp

§ 4. A Comparison with American Practice. The m
demerits of the British constitutional practice in re
finance can best be appreciated by comparison.
Parliamentary procedure has been widely (but not
wisely) imitated abroad. The Dominions follow
practice so closely in many respects that comparisons
them and the mother country are less informative tha
be expected. It is a testimonial to the workabilit
British system that it can be transplanted successfully
different political and economic climates. The mos
nating comparison is with the United States, since the A
system has the same heritage and general backgr
the British, but has developed on independent lin

[1] When dealing with the control of expenditure, reference s
be made to the work of *ad hoc* extra-Parliamentary Committees
in times of especial excitement. In the inter-war period the m
tant of these was the (May) Committee on National Expendit
somewhat alarmist report on the state of the national finan
summer of 1931 precipitated the withdrawal of foreign bal
London, which led to the collapse of the gold standard. Th
such committees is, however, of only minor interest from the po
of policy, since they are charged with "economy" in the narro
cutting down expenditure; thus the terms of reference of the
mittee bade it make recommendations "for effecting forthwith
cable and legitimate reductions in the National Expenditure

merican financial machinery now controls the largest public
penditure of any democracy in the world. Essential parts
it date only from 1921, but it already functions with much
the prestige of tradition.

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

Thus, the whole American procedure is plainly a relative
the British system, but identities of nomenclature conceal
portant differences of substance, apart from fundamental
stitutional differences which affect the whole set-up. The
eral upshot of these differences is that opportunities for
estigation by members of the legislature are better than
der the British system, but control over expenditure is less
cient, and the prospects of successful plan carrying very
ch worse.

n the first place the procedure for the passing of the
mates of expenditure and revenue is less unified and con-
trated in the United States than in Great Britain. Instead
a single Appropriation Bill and a single Finance Bill,
enditure and taxation are gradually determined in a series
eparate measures. Moreover, neither of the main British
guards against failure to pass the year's financial pro-
mme as planned is operative in America. In the first place
open to any member of Congress to propose (and carry)

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

additions to expenditure or reductions in taxes; secondly financial arrangements must be agreed to separately in the Senate. This may give rise to enormous delay and to friction. The separate Appropriation Bills make it hard for Congress to view the year's programme as a whole and differences tend to drag out the annual budget routine; it is difficult to clear one year's transactions before the new year is well on its way, thus causing confusion in accounts 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. To it are attached the important Departments of State, as well as the Bureau of the financial offices such as the Treasury and the Bureau of the Budget. The President chooses his "Cabinet", but they are by themself the members are administrative officers. Thus the President knows everything that is going on, but has no legislative power. On the basis of his administrative knowledge the President may indeed make suggestions to Congress as to what legislation ought to be done—for instance, the Budget Message may contain 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 requires.

A second although less significant difference also arises from the American passion for checks and balances. In Britain the majority remaining in power so long, but only so long, as it has the confidence of the Legislature, as happens in practice. In America all three bodies, the President (and his Cabinet) and the Senate, retire automatically at short periods and have to be re-elected. The President's election occurs every four years, Congressional elections every two, but as only one-third of the Senators retire on each occasion, there is greater continuity in the Upper House than in the Lower. Owing to this electoral system it may 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 th
may set its machinery in motion while the House
deliberating, but in respect of Ways and Means, in or
the Lower House should have the first word on tax is
accordance with British tradition), the Senate postp
discussions until the House has completed its delibe
(This respect for its British heritage does not, of course,
the Senate from turning the House Bills inside out
does receive them.) If everything goes smoothly th
process of Hearings, committee sessions and House di
occupies some eight or nine weeks, but the time allo
the final stage of discussion on the floor of the House
short, perhaps not more than a week.

Secondly, in order that Congress may have a relia
for action, the Administration collects and publishes v
fuller information on the activities of the Executive
available in Britain. The Treasury Department is
excellently complete Monthly Bulletin of public
Most items are reported with a lag of only a few week
American Estimates are also more informative than th
although perhaps not quite so detailed. Opposite eac
the Budget Statement is a record of actual expenditur
term of years, as well as the estimates for the year in pro
the year which is being planned for. These details are,
available to the general public as well as to members of C

Finally, the Administration collects from the busin
munity (by means of frequent censuses of production
investigations) much fuller and more up-to-date info
on economic activity than is available in Britain, eve
government planners. This difference is as much du
attitude of the business community as to the zeal of the
stration. The situation in Britain has improved re
in recent years, but has not yet caught up with the A
standard. This is a matter with which we shall be co
in Part III.

It will be apparent from this brief survey, that the Br
American systems are so to speak complementary, one

here the other is strong, and vice versa. In the United States, part from fundamental difficulties arising from the principles f the constitution, which presumably are not amenable to teration, at least in the near future, the most pressing need ould appear to be for better contacts between Congress and e Executive, so that the Legislature is enabled to find out rectly what the Administration is doing. With the increased tivity of the public sector inaugurated by the Roosevelt gime and extended in the war and post-war periods this has come a matter of urgency. During the war period some provement in this respect was almost inevitably made. One ample was the work of a Special Senate Committee appointed investigate the National Defence Programme (the War vestigation Committee) which performed services corre- onding to those of the British Committee on National penditure. This Committee has been highly constructive, d by the employment of a large staff of expert statisticians d economists has exposed waste and inefficiency in many anches of the Administration. Projects for more permanent ntacts have been discussed,[1] but, as in Britain, reform comes more difficult to achieve as control becomes a less essing need. The successful handling of the minor recession 1953 gives ground for hope that *de facto* if not *de iure* a tter understanding between Congress and the Executive r the implementation of a national economic policy has been ached.

[1] Cf. the Reports to Congress of the Hoover Commission on the ganization of the Executive Branch of the Government, especially the ask Force" Reports (Appendices).

CHAPTER V

THE PUBLIC REVENUE

§ 1. The British Tax Structure in 1938 and 1953. The proposals which are presented in the Budget in April, sequently debated by the House in Committee of Means, are not an autonomous plan in the same sen estimates of expenditure. The total revenue req determined by the total bill to be met (which by that be more or less decided); its distribution between the possible sorts of taxes has not usually aroused any political controversy. On only two occasions in the period were politics deeply involved in revenue discuss 1924 when Snowden repealed the "breakfast table" the interests of the working-class family, and in 19 Neville Chamberlain induced the House to return—af ninety years—to a general protective tariff. On the these occasions the loss to the revenue was a mere 2 on the second, although the initial difference was s eventual effect, even in crude terms of revenue collec quite substantial.

Although party issues are not usually very influ determining the choice of taxes, from the point of economic welfare it is most important that the ri should be chosen. Economists have always recogni and throughout the nineteenth century it was this public finance which monopolized attention. More with the expansion of the public sector, other probl thrust their heads up with urgent claims to attentio must not allow them to obscure the view of the fun tax issues. Accordingly, we shall be occupied for m time in Part II with questions of the choice of tax

urpose of the present chapter is to serve as an introduction that study by familiarizing us with the relative importance f the different taxes in current fiscal practice.

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

It will be useful to examine the distribution of revenue etween different taxes as it was in 1953 compared with a rmal pre-war year (Chart I). A major war inevitably leaves aftermath of enormously increased revenue requirements. he interest on the new debt requires heavy taxes to cover it; d apart from that war, is a stimulus both to the development the social services and to the enlargement of the functions the public sector in other directions. Apart from changes the level of prices it was inevitable that post-war tax rates ould settle nearer to the war-time than to the pre-war level. In the chart the distribution of revenue between the different rts of taxes (the tax structure) is shown for the two years spectively. This, of course, is not the only, nor even the ost interesting, way in which we might arrange the revenue. more interesting arrangement would show how much of the venue from each tax is derived from families in different onomic circumstances. It will be more satisfactory, however, postpone an examination of this latter arrangement until we ve discussed the relative merits of the different types of xes; accordingly we shall return to it at the end of Part II.

It will be seen from the chart that with the single exception the purchase tax in 1953, the types of taxes used, and even oadly their relative importance, were very similar in the two ars, although the totals are so very different. This similarity largely inevitable, because fiscal changes only come about owly, and moreover, tax experiments are abnormally hard carry through in war-time, with depleted administrative

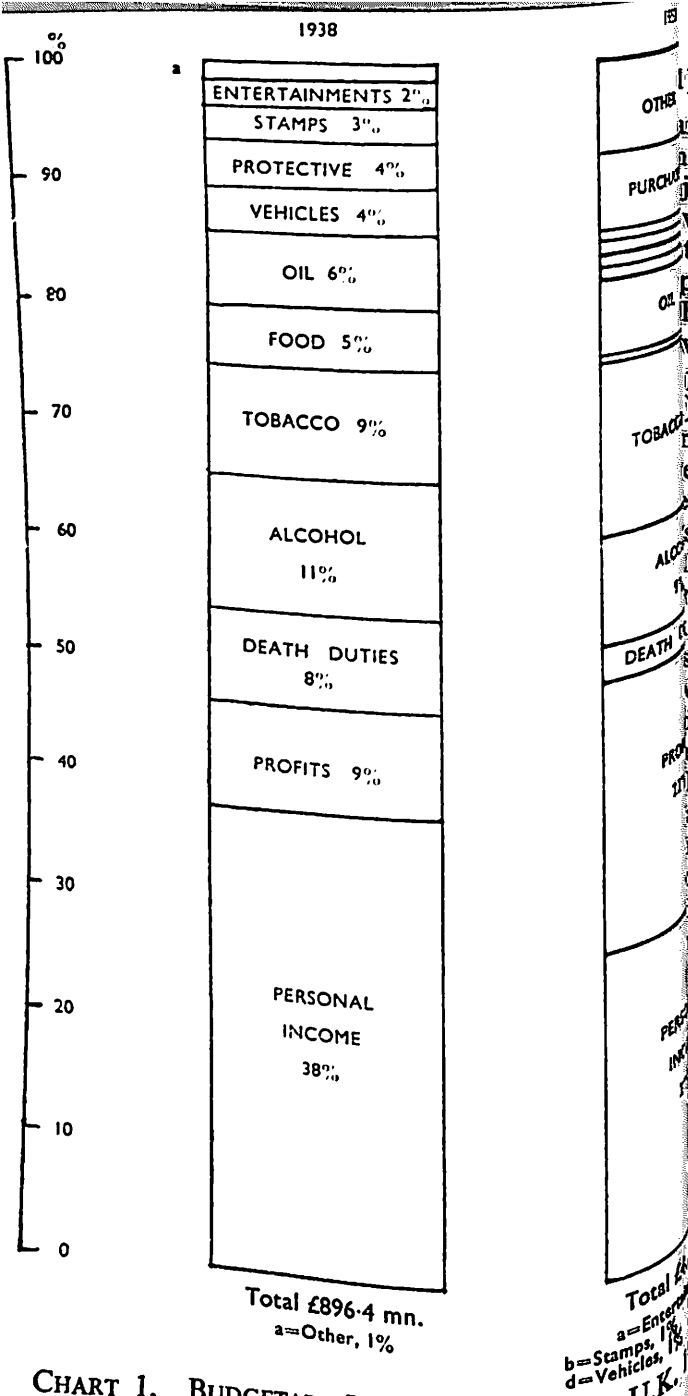


CHART 1. BUDGETARY TAX REVENUE IN THE U.K.
(Percentage Distribution)

ffs. It is thus very important to have a normal tax structure ich will stand up to exceptional strain with only minor justments. In the war of 1914–18 Britain had a decided vantage in this respect over both her Allies and her enemies, t owing to fiscal reforms abroad in the intervening years, her periority in 1940 was less marked.

In 1938 70 per cent of the revenue of the British national vernment was derived from only four groups of taxes[1]: personal (net) income tax, (ii) taxes on (net) business profits,) duties on alcoholic liquors and (iv) duties on the con- mption of tobacco. In 1944 the proportion of the revenue e to these four groups had risen to over 85 per cent; E.P.T., special war-time profits tax, was an important factor in s rise. By 1953, however, these four groups of taxes were l contributing practically three-quarters of the central tax enue. This was accounted for by the continued high ation of profits and personal incomes and by the conspicu- s rise in the rates of tobacco tax.

We must now turn to examine briefly the kinds of taxes of ich the "rungs" in our "tax ladders" are composed. e first three hang closely together; they are the taxes llected by the Inland Revenue Department[2] and constitute at are usually called "direct taxes".[3] What is important m the economic point of view is that liability to these taxes ends on the general economic position of the taxpayer, l not on the amount of his expenditure on particular mmodities.

n normal times the most important member of this group he personal income tax, which although nominally two es (income tax and surtax) in practice forms one continuous

[1] For further details of the composition of the pre-war British tax cture cf. Shirras and Rostas, *The Burden of British Taxation*, and Barna, *Redistribution of Incomes through Public Finance*. For tax changes ng the inter-war period cf. U. K. Hicks, *The Finance of British ernment*, cit., and since that period, *British Public Finances, their cture and Development 1880–1952*.

[2] So also are Stamp Duties and a few minor duties of which the most esting is the seventeenth-century Land Tax (cf. p. 121).

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

levy on all incomes above a low minimum exemptio
The personal income tax in Britain (and now in mo
countries also) is the principal *progressive* tax, that
liability forms an increasingly larger proportion
incomes than of small. Death duties are also prog
with the value of the estate—indeed in Britain th
the first progressive tax to be sanctioned by Parli
They are paid when a property passes at death, and
directly on the value of total property owned
deceased.

In the years which we are considering there were
of profits taxes in operation. The first was the no
on the undistributed profits of firms, which is collec
the personal income tax as part of "Schedule D
second consisted of taxes on total net profits (befo
bution). In 1938 only one of these latter, the
Defence Contribution (N.D.C.) was in operation;
flat 5 per cent of the profits of industrial firms. Durin
when "E.P.T." (Excess Profits Tax) was added, it and
operated alternatively, according as current profits
were not, in excess of normal earnings.[4] After the w
of E.P.T. in December 1946, the N.D.C. was re
"Profits Tax". The rates were more than once increa
in addition, a discrimination in favour of retained p
introduced.

At the height of the war, in 1944, five-sixths of th
derived from income and profits taxes came from
"impersonal income". By 1953 this proportion had
tially declined, but it is noteworthy that impersona
continued to make a relatively higher contribution th

[1] For details of the structure of British income tax, see Ch
Section 2.

[2] See Chapter VIII, Section 4.

[3] "Profits from Businesses, Professions, etc." It is only
(with the issue of the White Papers on National Income and E
that the revenue from this tax can be separated from that of
income tax.

[4] For the details of E.P.T. cf. Chapt. XII, Section 4, and at gre
in *The Taxation of War Wealth*, by J. R. and U. K. Hicks and

e war. At a later stage we shall have to examine the
onomic implications of this change.

The other taxes in the structure were traditionally designated
ndirect"; with a few exceptions they are collected by the
oard of Customs and Excise. For the most part these taxes
d to be *regressive* with income; that is to say, the smaller the
come, the larger the proportion which tax payments bear to
By far the most important of these taxes, which fall on
rticular ways of spending or holding wealth, are (as we have
eady noted) the taxes on the consumption of alcohol and
bacco. Before the war the liquor duties group brought in
larger revenue of the two, but during the war this situation
s reversed, a change which was consolidated by the rise
the rates of tobacco tax in the early post-war years. In
ntrast, rates of taxes on drink have tended to be lowered
her than raised in recent years, due to falling demand.
1938 about 60 per cent of the liquor revenue was derived
m beer, and nearly all the rest from whisky; in 1944 the beer
portion had risen to over 80 per cent; by 1953, with whisky
ce more available, the pre-war relation had been restored.
e immense tax potential of these groups of taxes was first
bloited in the war of 1914–18,[1] since when rates of tax have
ny times been raised.

n the 1930's, as will be seen, duties on food were by no
ans negligible; they were of three main types. First came
time honoured taxes on tea and sugar, last relics of the
reakfast table" duties successively removed in the 1920's;
he second group were a number of duties imposed under the
ttawa" Commonwealth agreements of 1932, typical of these
e taxes on dried and canned fruit. Finally there was a
cial kind of tax intended to boost wheat prices for the
tish farmer. The wheat "levy" was collected from millers
l paid over to farmers. This last is not included in the
rt since it fell outside the budget, a device adopted to spare
he darts of free trade criticism in Parliament.

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

In the inter-war years most of the food duties had to them an "imperial preference" rebate, fixed on basis, which implied that produce from the Dom Colonies enjoyed a substantial advantage in the Brit As time went on the food duties also came to contain element of protection for the British farmer. Th levy was frankly designed for this purpose; it wou sliding scale, reminiscent of the old Corn Laws, and faded out as the world price rose. Even more interest case of sugar. In Victorian times this was wholly product and bore a straight revenue duty. On the int of sugar beet as a British crop at the time of the first a demand for a subsidy arose. In itself sugar beet is submarginal crop, but its merits as an item in an imp rotation on the one hand and as a strategic reserve on were so warmly pressed that it was deemed worthy measure of protection cum subsidy. The require had to be all the higher as the protective element in th duty became seriously eroded by imperial preferenc

In the post-war period the scene has substantially First of all the heavy subsidization of basic foods period, and continuing through the reconstructio made such of the tax element as remained largely in The importance of the specific duties progressively the value of money fell, and this finally reduced th imperial preference almost to vanishing point. Thi increasing extent quantitative control (already grow 1930's) has come to take the place of protective d guaranteed prices to British farmers of specific subsi to these three elements that the substantial fall in t from food duties is due. Only in the case of sug semblance of the pre-war situation retained. So substance of the old imperial preference is secured b guarantee, extending over a term of years, to buy a q all Commonwealth sources at a protected "negotiat outside this quota a further amount qualifies for th of imperial preference, so that only marginal supplie

on unprotected world markets. This system is mainly of efit to certain West Indian islands whose basic crop is ar. Needless to say it has been found possible to work in ethod of continuing to protect British beet sugar.

he wheat levy is of some interest finally, as an example of x whose revenue is "earmarked" for a particular purpose, is thus not available for general revenue needs. The marked tax is an apparently plausible device, which in ctice is very awkward. Even if initially the funds are opriate for the purpose, there is naturally no guarantee they will continue to be so after a lapse of time. For- ely, this is now generally realized by British chancellors.[1]

ext in importance come the taxes on motoring, in respect which, in addition to the vehicle and driving licence duties, ly the whole of the tax on hydrocarbon oils is collected. torists—both private and commercial—are thus taxed by methods, an "overhead" in respect of the type or category he vehicle, and a "running cost" charge, according to the consumed. In every country motoring taxes are tending rovide an increasing source of revenue, and there is usually such dichotomy of charge (which has a sound logical s), but it is probable that in no country are the rates of sorts of taxes so high as in Britain.

ext in interest, although not in fiscal importance, are the aining protective duties. These fall into two groups, first duties imposed in the early 'twenties, either for strategic ons, or on such "infant industries" as rayon (a tax which obvious reasons had to include silk), or motor cars and ssories[2]; and secondly, those imposed on the advice of the rt Duties Advisory Board, established to implement the ectionist regime in 1932. Many of these protective duties evied on the raw materials and semi-finished products of

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

[2] Viz. "McKenna" (1915), Key Industries (1921), Silk and Artificial 925), Duties (which include nylon and all similar fibres).

industry, and were originally designed to promote
recovery from the depression of 1931. While they
helped the industries concerned, and thus raised the
of employment, the policy behind them and the Ottaw
ments first brought the British revenue authorities in
conflict with other countries, particularly with the Un

We may pass very rapidly over the remaining
taxes. Stamp duties are mainly collected on property
especially of stock exchange securities, so that
considerable importance during stock exchang
Other stamp duties are those levied by the 2*d.* stamp
and receipts. Entertainments duty is payable on
fees over 6*d.*, and is graduated fairly steeply on the

Of more interest than these is the war-time pur
first imposed in 1940 with the primary purpose
consumption. In spite of the exemption of food and
goods, and the scarcity of other commodities in war
chase tax brought in a revenue of about £100 mn.
during the war. After the war this rapidly increased
the level of £300 mn. The principle behind the
chase tax has all along been that as large an
(relative) progression as possible should be embo
In the first place its coverage is highly selective; in
all food and children's clothing have always been
Secondly the qualities of goods bought mainly by
earners have been very largely exempt, to start with
"utility" scheme, which during the war and some
wards gave a guarantee of solid quality as well as
price; since 1952 the so-called "D" scheme has
stituted for the utility system. The characteristic
that goods under a certain price (fixed separately
category) are exempt from duty, purchase tax bei
only on the excess over the "D" limit. This, it
introduces a greater measure of progression than ex
the utility system. Finally, by means of differen
tax (at one time ranging up to 100 per cent) an effo
made to tax more heavily goods of a "luxury"

ch as a luxury cannot satisfactorily be defined this element
he tax has worked with some peculiar results.[1] Differential
es have also been used, perhaps with more effect, to "steer"
mand away from goods, such as electrical equipment, where
was especially urgent to curtail demand.

Taxes of the nature of British purchase tax (usually called sales
es) are now a normal feature of the tax structure of most
ntries; but elsewhere their coverage tends to be wider and
ir rates lower than in Britain. Such taxes are especially
ractive to the regional governments in a federation because
their superficial administrative simplicity and productive
enue. They are not, however, a good sort of tax in
ctice. They fall directly on family budgets, so that unless
coverage is very carefully controlled they tend to be very
ressive. If they are imposed (as sales taxes) at the retail
ge, collection is expensive and it is difficult to prevent
sion. On the other hand, if they are imposed at earlier
ges in the process of production and distribution (as gross
nover or gross income taxes) the burden tends to be exag-
ated through repeated "marking up" of price to cover tax
each stage, so that the ultimate weight on the consumer is
ggerated. These disadvantages must be set against certain
oretical advantages (which we shall have to examine in
apter IX), which may be expected to accrue if the coverage
arefully chosen and the rates kept low. They imply that
normal times, when the tax is not required to fight an
lationary pressure they should be used only very moderately.

All the taxes (except the wheat levy) which we have so far
cussed are budgetary taxes, but there are also two other
portant members of the British tax structure of which we
st take notice—the "rate" levied by local authorities on the
upiers of buildings and land (other than agricultural land),
contributions to social insurance.[2] The fiscal importance

[1] Thus picture postcards bear the maximum rate.

[2] The net revenue of the Post Office is also sometimes regarded as a
the question turns upon how far it should be regarded as the normal
t of a trading service, or as a monopoly charge. Chancellors, as we
e seen, appear to regard it simply as a tax.

of the local rate has long been declining relative to the revenue of the central government, but it is still a very important tax, with a yield second only to income tax (£2,111 mn. in 1938 and £436 mn. in 1953); some 60 per cent of the yield comes from domestic property, and most of the rest from factories and offices, since factories were excused three-quarters of their liability under the Local Government Act of 1929.[1] At a later stage we shall have to devote a good deal of attention to the tax, since it is the pillar of local government finance.[2]

From the inception of the services, social insurance in Britain has been financed by a tripartite arrangement of contributions from employers, beneficiaries and the general revenue, contributions being paid at first into a separate fund for each service. With the extension of the social security system to the whole nation (by the National Insurance Act 1946) the various funds were consolidated into one. There is undoubtedly a genuine "insurance" element in the beneficiaries' 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 economically it must be so regarded. We should thus call the beneficiaries' contribution a poll tax, that is to say, an equal per head levy, at rates which vary with sex, and to some extent with age. The employers' contribution is related to other taxes on factors (e.g., the 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. Any straightforward comparison of *per capita* revenues is 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 position, 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.[1]

The most interesting international 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 traditionally been a highly protectionist country; secondly, the fact that its constitution is federal and not unitary causes a substantially different distribution of resources between major (federal) and minor (state and local) governments from what we have found in Britain.

Traditionally its monopoly hold on customs revenue was 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, largely catching up with British rates of tax during the second world war. 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.

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

[2] See Chapter XV, *passim*.

[1] For instance the local property tax in the United States.

Table II compares the distribution between sou
total tax revenue in the two countries in 1938 and 19
U.S.A. has traditionally been a low tax country, but
years its revenue needs have been expanding rapid
1953 at 25 per cent of the gross national product
revenue was still substantially below the British level,
gradually overhauling it. The lower level of taxatio
U.S.A. is essentially due to the fact that the social se
still less developed than in the U.K.; but since the
second world war there has been a rapid expansion
will no doubt continue.

TABLE II. PERCENTAGE OF TOTAL TAX REVENUE FROM DIFFERENT SOURCES. 1938 AND 1953.

	U.S.A.		1938
	1938	1953	
	%	%	%
Customs and Excise, Sales (less motor fuel)			24
Personal Income Tax	21	14	32
Profits Taxes	10	36	7
Gift and Inheritance (capital taxes)	12	24	6
Motoring (Fuel and Licence)	4	1	7
Social Insurance	10	4	5
Property (Rates)	10	6	17
Other	32	10	2
	1	5	
	100	100	100

Comparing the total position of the revenue in
countries, the two most striking changes which are
to both countries are the rise in the taxation of profits
to personal incomes on the one hand and on the
decline in the importance of the local rate and its
counterpart the (almost completely local) tax on pro
greater part of the revenue from which is derived
and buildings. The first of these changes can be re
to some extent a relic of the war, when in both countr
profits taxes carried the taxation of profits to very hi
the necessities of the Korean war implied that pro

uld remain high, while the continued high level of economic
ivity ensured that this could be done without too serious
nomic repercussions. The decline of the local tax on land
buildings is in both countries related to the stickiness of
d values relative to other prices in a period of inflation, and
consequent difficulty of keeping valuations in line with
e values. In the U.K. this difficulty has been exaggerated
the persistence of rent control and the inability of any
ministration so far to devise a system of valuation which
uld reconcile post-war values with pre-war rents.

Comparing the changes in the two countries, those in the
S.A. are clearly dominated by the great rise in the importance
income and profits taxes; this is a most interesting develop-
nt. On the other hand in the U.K. these taxes, after
minating the tax structure during the war, have become less
portant relatively to taxes on outlay. In both countries
se trends have continued over the most recent years; the
50 figures would tell the same story but in a less accentuated
nner. One underlying cause of the now relatively small
ation of outlay in the U.S.A. is that, in spite of some very
h rates of duty, the American tariff does not bring in a very
ge revenue, because the volume and range of imported goods
alike low, especially of finished goods. Another relevant
erence is the extremely high taxation of tobacco in the U.K.
en if the Americans wished to tax smoking as heavily as the
tish they would run into formidable technical difficulties,
to the great importance of domestic tobacco growing.

Table III compares in somewhat more summary form the
nges in the sources of the different layers of government, and
the change in the central share of each source; in the U.K.
re has of course been no change in this respect. The extent
which the U.S. federal government has been gaining on
rest is most significant, and once again the movement is
tinuing; in 1950 the share of the federal government had
yet reached 70 per cent. That this is mainly due to the
wth of income and profit taxes is clear, and here again
trend is unbroken. It is also significant that as social

TABLE III. *Relative Tax Resources of Different Layers of Government, U.S.A. and U.K. 1938, 1953.*

Tax	U.S.A.						U.K.			
	% of Revenue accruing to Federal Government		% Distribution of Tax Revenue between Sources				% Distribution of Tax Revenue between Sources			
			Federal		State		Central		Local	
	1938	1953	1938	1953	1938	1953	1938	1953	1938	1953
Customs, Excise, Sales:										
Alcohol and Tobacco	77	70	18	4	7	5	22	22	—	—
Other	21	20	10	8	19	22	10	10	—	—
Motoring (fuel and licence)	19	23	5	2	31	28	9	7	—	—
Personal Income, Profits, Gift, Inheritance	80	96	53	77	18	17	49	48	—	—
Land, Buildings and Property										
Social Insurance										

penditure rises the federal share of the revenue, through cial security contributions, also rises. With a few notable ceptions the federal government has traditionally been more ive than the states in this sphere.

Turning to sources of state revenue, it will be seen that the ee major sources remain, as they were before the war, ises (in practice sales taxes), motoring taxes and income and ofit taxes. Of these the income and profit taxes lost some ound during the war: on the one hand state treasuries were ll supplied relative to the expenditure they could undertake; the other federal income and profit taxes (which usually rank a cost for state assessments) were so high that the revenue m state income taxes was low and uncertain. On this account re was during the war some slight decline in the competitive ploitation of the same tax sources by different layers of vernment—always a difficult problem in a federation.

This position has been reversed in the most recent years and trend appears to be moving in the opposite direction. rd pressed by the fall in property tax revenue on the one nd and the rising costs of social services, especially education, the other, cities in some states have also been permitted to se local income taxes; in other states they are now engaged knocking at the doors of federal constitutions for enabling wers. As things stand at present, however, the changes in distribution of local revenue sources as compared with -war have been minor. The most interesting feature is the pansion of miscellaneous sources, such as parking meters, nces and other small taxes; this is in itself a reflection of financial stringency in which many American cities are now ding themselves.

Taking all in all, however, the dominating feature in both ntries has been the growth in the public sector, as reflected the rise in tax revenue relative to the gross national product, l with it the concentration of influence in the hands of the tral government. The significance of this development for success of a national policy of economic stability hardly ds emphasizing.

Tax structures broadly similar to those of Britain and the United States are now to be found in most advanced industrialized countries. Income taxes with some degree of progression are now almost universal, although the majority date only from the 1914–18 period.[1] Heavy duties on the taxation of alcohol and tobacco is also very common, although in no country do both sources appear to be exploited as in Britain. Britain also makes more use of inheritance taxes, and as we have seen of inheritance taxes, and as we have seen of inheriting taxes, countries. More backward countries have to rely largely on customs duties, although recently many of them are experimenting with income taxes. Such countries are at a disadvantage in an emergency since the revenue is less flexible than one largely derived from income. Finally, for local purposes, the use of a tax on buildings is very common. Although this is an ancient and rather a primitive sort of tax, it has, as we shall see, a number of conveniences for purely local use.[2]

§ 3. Other Sources of Revenue. In normal times an alternative source of public revenue for current needs is income from public property including trading services and interest on loans and investments. In Britain, at first owing to the small amount of public property, later to the output policy followed in the socialized industries, this has provided only a very modest supplement to taxation. In 1938 the national government derived an income of £17 mn. from its property; by 1953 this had risen to £26 mn., but over 70 per cent was composed of interest on loans (many of them to authorities overseas). In 1938 the income of local authorities amounted to £117 mn., of which £16 mn. was due to interest on the investment of superannuation and pensions funds, and to rents on municipal estates. The net profits of trading services made a very small contribution.

[1] Since the war the U.N. organizations E.C.E., E.C.L.A. and E.C.A.F.E. have published some useful comparative tax statistics.
[2] Cf. Chapter XV, Section 5.

...leed. By 1953, consequent on the nationalization of the ...or local trading services the *net*[1] revenue must have been ...l less.

...he slight use of trading profits as a source of revenue in ...tain as compared with some other countries (notably ...eden) is largely to be explained by the nature of the industries ...ich have been socialized.

...n industries which have an inherent tendency towards ...nopoly, such as fuel, power and transport, there has been ...atural reluctance to extract a monopoly profit from con...ers. Indeed the desire to avoid such exploitation has been ...important factor in determining nationalization.

...he third source of public finance in 1938 was borrowing by ...central government; but this was entirely due to the fear ...mminent war. Except for emergencies such as war, public ...owing by British governing bodies has been restricted to ...needs of long-term investment. When faced with serious ...ergencies central governments have always borrowed freely; ...y have the right to do so whenever the requirements of public ...enditure exceed what can reasonably be expected from the ...ome of the citizens; and they can borrow quite safely be...se they have unlimited tax powers, so that (unless there is a ...ger of a revolution) the means to service the debt can always ...found, and in the last resort they can avoid national ...kruptcy by depreciating the currency. In respect of minor ...ernments (the local authorities or the constituent states of a ...eration) the position is substantially different. For them ...borrow freely for current needs, however urgent, may put ...n in danger of bankruptcy, a situation which should never ...llowed to arise.[2]

...he advantages of borrowing to finance long-term invest...t have also generally been recognized in the past. By ...ns of loan finance the equipment can be enjoyed by the ...mmunity at a much earlier date than if it had to be paid ...out of current income. British local authorities have

[1] Not given separately in *National Income and Expenditure*.
[2] Cf. p. 237.

sometimes made less use than they might of these
through concentrating on the additional cost of
interest, rather than on the additional benefit of
investment. This is a question which we must
later stage. In the past the borrowing of the Brit
ment for investment purposes has been practically
the Post Office services, apart from the activities of
Works Loans Board,[1] which is really engaged in
investment.

The restrained borrowing policy of the British
in the past has on the whole been sound sense.
government which abuses its powers by allowing
deficits to develop in normal times runs the danger
weakening the technical control of expenditure, and
door to all sorts of abuses in the civil service. If
ment is also unable to control the monetary situation
the danger of heaping up a burden of debt interest
chronically embarrass the Budget, and lead to
which requires a repeated depreciation of the
French fiscal history since the Napoleonic wars
several examples of the evils of this rake's progress.

Under modern conditions the situation is
different. It is now realized that in times of under-
the most effective way of sustaining the national
the government to spend more than it taxes, thus
borrowing; while in times of full employment and
pressure it should tax more than it spends. With
technique of national income accounting, the
finance of the government, exercised through budg
or surpluses, has become an important instrument
Borrowing up to the amount required for national
correct policy which need cause no alarm. These
which we shall have to discuss at length in Part III.

[1] Cf. Chapter XV, Section 5.

CHAPTER VI

THE BALANCE SHEET OF THE PUBLIC SECTOR

The Budget Accounts and Their Significance. Now that
have looked at the way in which the State distributes its
ources over different services on the one hand, and gets
mmand over the necessary funds on the other, the next step
o consider the two sides of the account together in the form
complete budget. "The Budget" usually so-called is, as
have seen, the account of the activities of the central
vernment, presented by the Chancellor of the Exchequer on
dget Night. It is, of course, not a complete account of the
blic sector of the economy. In the inter-war period it came
rt of covering the total expenditure of public authorities on
rent account by about a third. By 1953, however, it had
n to about four-fifths. The Budget is concerned primarily
h outlay on current account, and with the revenue to cover
Certain capital items are, however, given in an annexed
le of the "Financial Statement" set apart "below the line".[1]
considering the accounts of the whole public sector we
e to include as well two other sets of budgets—those of the
ial insurance system on the one hand, and of the local
horities on the other. Of the latter there are in all about
00, but for most practical purposes it is sufficient to take
account the activities of the eighty-three county boroughs
the sixty-one statutory counties in England and Wales,
the parallel bodies in Scotland and Northern Ireland,
ause a great part of the activities of the smaller county
horities are effectively controlled by the county councils.
ven with these simplifications it is evident that it is a
plicated business to put together an account of the entire

[1] For the significance of this see below p. 348.

public sector. A few years ago it was only possible
rather roughly, and after a lag of about two years
period to which the accounts related. This was
much too late to be of any relevance for the direction
With the beginning of the series of Estimates of the
Income and Expenditure (the first of which, it will
bered, was presented with the Budget of 1941), the
has been greatly improved. We now have not mer
accounts for the public sector, but also an account of
economy (which, as we shall see later, is of first rate
for the direction of policy). It is still necessary, ho
wait for several years before the details of the activit
authorities are available.

The Chancellor's Budget is confined strictly to the
of the year just ended and the estimates for the
beginning, although the Financial Statement also
list of total expenditure and total revenue collect
series of years. The general accounts of local auth
not kept on any uniform plan (from which it follow
tally that the returns which they make to the central g
are also not very uniform). There is no opportunity
ing local estimates except in so far as individual co
choose to give them publicity in the local press.

The traditional reason for the central government
knowledge of the intentions of the local authori
course, that their spending plans are to a considera
their own affair; and in the local rate they possess an
dent source of revenue which enables them to some
least to give expression to their individual preferen
budget of the central government is, however, link
budgets of the local authorities by means of the
grants from which a considerable part of their exp
financed. In a similar manner the budget of the
government is linked with the budget of the National
Fund, by means of the exchequer contribution to the

In order to find our way about the public accounts
convenient to start with the Chancellor's Budget;

ith the help of the National Income Estimates), we can
oceed to the "balance sheet" of the whole public sector.
nally, again with the aid of the Estimates, we can extend the
count to the whole economy. We shall thus have an oppor-
nity of comparing the relative magnitude of the public and
ivate sectors, a comparison which is of obvious importance
the direction of policy.

The art of budgetting is a two-way looking process; the
ns for the future must be grounded on the experience of
past. This end is provided for by the arrangement of the
dget Speech, which is traditionally divided into three parts,
st a presentation of the revenue and expenditure accounts
the year just ended; secondly, a forecast of the extent to
ich the Estimates for the year just beginning (which will
eady have been before Parliament for several months) would
covered—or more than covered—at existing rates of tax;
d finally, a recommendation of adjustments in taxes,
culated to bring about the desired balance at the end of the
r.

The method of presentation of the accounts of the central
vernment is most clearly seen in the Budget Estimate which
pears at the end of the Financial Statement. It will be
eresting to look at the plans presented to Parliament in April
38 and in 1953, the years whose revenue and expenditure
have already examined. Since the account is just a sum-
ry of the estimates for expenditure and revenue placed
inst each other, we need not comment in detail on the
arate items. (See Table IV.)

As we have seen, 1938, like 1913, was reckoned as a statistical
e year, subsequent movements in economic series being
asured from it. Unfortunately, on account of the inter-
ional tension, it was not a very normal year, and this is
ected in the Budget by the provision of £90 mn. estimated
be covered by borrowing, and the £10 mn. reserved for
oreseen contingencies. In a more normal year, such as
53, there would have been no mention of borrowing in the
dget, and there would even have been no allowance for

TABLE IV. BUDGET ESTIMATES FOR THE FINANCIAL YEARS 1938–39 AND 1953–54
(TO NEAREST MILLION £s.).

Estimated Revenue	*1938*		*1953*		*Estimated Expenditure*	*1938*		*1953*	
Inland Revenue					National Debt	230		615	
Income Tax	341		1,782		Payments to N. Ireland	9		48	
Surtax	62		127		Miscellaneous Cons. Fund	3		10	
Death Duties	88		160				242		673
Stamps	24		52						
Profits Tax, etc.[1]	1		315		*Supply Services*				
		537		2,436	*Defence:*				
Customs and Excise					Army	86		526	
Customs	228		1,044		Navy	94		330	
Excise	116		680		Air Force	73		498	
		344		1,725	Departmental[3]	—		143	
Motor Vehicles	62		69		Other	—		139	
Total Taxes		917		4,230			253		1,636
Post Office	11		2		*Civil Votes*				
Crown Lands	—		—		Administration	53		282	
Sundry Loans[2]	1		25		Social Services	332		1,462	
Miscellaneous[6]	5		111		Economic[4]	41		172	
	11				Cost of Tax Collection	14		44	
					Margin for Supplementaries	10		—	
					Total Supply	—	450		1,960
TOTAL REVENUE		945		4,368	Total Expenditure	945			4,269
					Estimated Surplus[5]				99
							945		4,368

NOTE: This account has been slightly rearranged from the presentation in the Financial Statement in order to make it more

ntingencies, because Chancellors are expected to provide actly for all possibilities at the beginning of the year,[1] in order make Treasury control over the accounts as complete as ssible.

It so turned out that in 1938 tax collections were £16 mn. ow the Estimate, but as defence expenditure did not mature rapidly as had been anticipated, total outlay was £123 mn. ow the Estimate, so that a surplus was realized. This was an unsatisfactory piece of budgeting in view of the many predictable factors in that uneasy year. In 1953 revenue s returned exactly as estimated, but tax receipts were £53 mn. ow the Estimate, the total being made up by an increase in liscellaneous". On the other hand, the outlay total was mn. above the Estimate, so that the surplus was rather less n had been planned. The divergence from the estimates s, however, relatively small in relation to the magnitude of figures involved. At the same time it must be realized t this arrangement of the accounts bears little relation to nomic realities, being in fact a historical survival. The e surplus or deficit can (as we shall see later) by no means read off from the traditional arrangement of the Budget. normal times British estimates of revenue and expenditure e been correct to within a few hundred pounds, a result ch is a striking tribute to the efficiency of the financial inistration. It is an achievement which can best be appreci- l by remembering the many centuries which have gone to perfecting of the technique,[2] and by observing the diffi- ies experienced by other countries in attaining even this ree of proficiency.

udgeting, as it has long been understood in England, is most countries a comparatively recent innovation. By the e that the smoke of the 1914–18 war had cleared away, the ernments of most countries had indeed come to present

n fact in 1953 a substantial surplus was budgetted for in order to teract inflationary pressure.

t has been claimed that there were "traces of an organized financial m in England at a surprisingly early date"—e.g. in the ninth century r King Alfred. Cf. F. M. Stenton, *Anglo-Saxon England*.

some sort of annual statement of taxation and public
ture, but in many cases it was far from complete.
U.S.A., in spite of the enormous improvements in
control which have recently been made, it is as we h
still the custom to present no consolidated finance b
enue is only available as Congress successively bring
the point of agreement on the necessary taxes. This
inevitably weakens the financial administration; it
to a considerable amount of at least short-term bo
where tax revenue ought to be available.

A much more serious weakening—which is still by
rare—is a failure to collect (because of tax evasion), o
even to plan for (because of the weakness of the gov
sufficient tax revenue to cover the current expendit
had already been agreed upon. Governments in
predicament are accustomed to bundle all the
expenditure—whatever its nature—into an "extraord
"capital" budget, which for the foreseeable future a
had to be covered by borrowing, probably from the
bank. If "double budgetting" of this nature become
there is a risk of undermining confidence both in the
institutions whose stability is threatened by the gov
importunity and even in a political system where gov
cannot keep their affairs in order.

In the inter-war period, however, another kind o
(or rather divided) budget was adopted in some co
notably Denmark and Sweden—in which separate a
capital expenditure was taken in an annex to the
budget. This kind of budgetting is not merely ver
from the chaotic state of affairs where the "capita
is little more than a cloak for weakness or incompet
also a considerable improvement on the traditio
system, because it is capable of being used as an inst
policy, which the British budget in its traditional fo
At a later stage we shall have to discuss the applicatio

[1] Cf. p. 61.
[2] Cf. Chapter XX, Section 2.

d other, improved budgetary techniques to British conditions.
e need for budgetary reform arises essentially from the
anged purpose for which the accounts are now required.
The primary purpose of the traditional British Budget is first
the Estimates) to record the agreement of Parliament to a
rticular lay-out of public revenue (arranged for in the Finance
:t), and later (in the Appropriation Accounts), to certify to
rliament that the revenue has been provided and applied
agreed. The necessity for Parliament to assure itself in
tail on these matters is a survival from the days when kings
re liable to divert to their own uses monies provided by
rliament for the public services. In fact, Parliament now
ies on the Treasury to see that all is in order; and the detailed
m of the Estimates, on which the Budget is based, is really
enable the Treasury to carry out its traditional process of
ntrol.

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

t is not merely the method of presentation of the public
ounts which is a survival from conditions which have
sed away, the trouble goes considerably deeper. The
ual method of accounting used reflects a stage of economic
political development when accounting technique was
minated by practices appropriate to personal or family
enditure. In order to facilitate the traditional method of
asury control, the accounts of government departments are
t on a strictly cash basis; only those payments which have
ually been made during the relevant period figure in the

[1] Cf. p. 52.

accounts. Other transactions which may have been
in the accounting period, and which properly belong
unrecorded so long as cash has not been paid over.
accounts are thus merely a cash record, not a true ex
account; thus they do not provide an accurate
government activity during the year, and are hardly
in technique to that of a penny cash book.

Moreover, in the Estimates, expenditure is groupe
ject not by service. To take an example at rando
Class VI, Vote 1, Head A (General Administration o
of Trade), was divided as follows: A1, Salaries,
Travelling and Incidental Expenses; A3, Special
A4, Telegrams and Telephones; A5, Expenses unde
stuffs (Import Regulations Acts, 1920–24). (The
looks suspiciously as if it had been put there for
better pigeon hole.) On this method of accounting
to impossible to compute the total cost of any
service. For instance, if we want to find out the
services provided by the local Employment Exchange
start by finding the cost of the salaries of the
separately accounted for under Class VI—but we
for the cost of the time of the central staff taken up
tion with this service, which can be by no means negli
cost of the buildings and furniture, and purchases
and other stores, are merged with the cost of simila
used by other departments—mainly under "Common
in Class VII—so that we cannot isolate them prop

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

This obstacle to an intelligent control of expenditure was
cutely realized by the Committee on National Expenditure
hich sat during the 1914–18 war. As a result of their
peated expostulations some improvement was made in the
counting methods of the trading services. The Post Office,
cluding the telephone and telegraph services, brought
accounts more into line with those of a business firm.
reconciliation account was then drawn up to square these
ith the Estimates. An interesting experiment was also made
the advice of this Committee in the arrangement of the
my accounts. Instead of the traditional "subjective classi-
ation (e.g. petrol for the forces wherever consumed), an
jective" or modified unit cost system (e.g., the cost of man
d hours in military hospitals) was tried for a few years.
fortunately this eminently intelligent experiment proved too
bitious for the time. We must not, however, linger over
ese questions here, since we shall have to pay considerable
tention to them in Part III.

One of the continuing shortcomings of the traditional
dget is that it fails to distinguish the different types of
penditure according to their economic significance. Ex-
nditure on current account may consist of the purchase by
blic authorities of goods and services, the services of civil
vants and other employees, the goods used in collective
nsumption (e.g., in schools) or in the trading services.
ternatively, it may take the form of a transfer from the
comes of one group of citizens to supplement the incomes
another. Such transfers are of two kinds, payment of
tional Debt interest to the owners of war loan and other
vernment stocks, and social transfers, e.g., pensions and other
yments made as part of general social and economic policy.
It is highly desirable to be able easily to distinguish these
o forms of public outlay in the accounts, because the first—
penditure on goods and services—generates new incomes
ectly, whereas transfers do not, although, of course, additional
comes may later be generated if the recipients spend the
ditional income while the transferers would have saved it.

The failure of the Budget adequately to segrega
and capital items should also be stressed. The C
Budget as traditionally arranged may well inclu
items on both sides of the account. On the expend
a considerable proportion of the cost of roads and s
is really new investment financed out of revenue
revenue side, there is included both interest and repa
capital, while the Miscellaneous item was notorious
the past to bring out the desired answer irrespect
character of the payments included. Even in mo
situations it has tended to include a number of capi
In the past the failure to distinguish capital from cu
was of secondary consequence, but immediately
economic policy is adopted it becomes of first rate im
These again are matters with which we shall be co
Part III.

In view of these deficiencies of the traditional Budg
surprising that the necessities of war finance calle
source (the White Paper on National Income and Exp
of additional information on both these heads,
giving much further information on the whole st
economy. British national income accounts, ho
not capable of integration with the Budget because
to a different accounting period: the calendar year a
financial year. In spite of the great progress that
made since 1941 in adapting the public accounts as
ment of policy much still remains to be done.

§ 2. The Consolidated Account of the Public Se

National Income and Expenditure accounts set out a
of each component of the Public Sector: the Centr
ment, the National Insurance Fund and the Local
but so far they have not presented a consolidated
all public authorities taken together, although of c
the national insurance fund revenue and expenditu
consolidated with the central government accounts
clearly of interest to ascertain what contributi

thorities as a whole made to the national income and its
listribution, and what the final result of their activities was,
terms of contribution to or subtraction from the aggregate
pply of savings in the economy. Let us try, therefore, to fill
s gap in respect of the two years which we have been dis-
ssing, 1938 and 1953. In respect of 1953 almost every step
be estimated directly by re-sorting the figures in the Blue
ok; but for 1938, for which fewer figures are available, we
st rely on the number of sources, drawn up on bases and
periods which are not strictly comparable. There seems
reason to suppose, however, that the result which we can
tain is seriously wide of the mark.

n order to consolidate the separate accounts it is necessary
eliminate all payments between one authority and another,
order to avoid double counting. Thus from the account of
central government on the revenue side we must subtract
taxes paid by local authorities, from the revenue account
the insurance fund we should deduct the contributions of
central government in respect of the armed forces. From
account of local authority revenue we must similarly
luct payments from the central government; grants on
rent account and payments in lieu of rates on Crown lands;
using subsidies from the central government and interest
eived from other local authorities. On the expenditure side
the respective accounts we must make consequential
luctions. Most of these adjustments can be made quite
ply; the main exception is the outlay taxes paid by local
horities to the central government, in respect of petrol,
icle licences and other taxed commodities which they con-
ne. Since there are no figures for these we must just remember
t the revenue side of the consolidated account will be some-
t inflated on account of incomplete consolidation.

One further point arises. The revenue account of a public
hority is not quite the same thing as a current account in an
nomic sense, because it contains items which are in fact
nsferred to capital account or reckoned in the capital ac-
nt of some other sector. The chief items involved are, on

the revenue side death duties, and on the expend
payments in respect of war damage and refunds
profits tax to firms, and capital grants to local a
Since the figures (at least for 1953) are taken from the
of the Central Statistical Office and not from the
form of government accounts, they do take into ac
transactions which properly belong to the year, irre
whether payment has actually been made or not.
balancing item in the account, the net figure of saving
authorities is economically correct so far as the
allow.

The result of the estimate is shown in Table V. Pe
most notable phenomenon in the account is the
stability (or rigidity) of the position of the local
when compared with either the central gover
the national insurance fund, both on the revenue
expenditure sides. In the case of the insurance
expansion[1] is, of course, due to the extension of soci
to the whole nation. The central government has
all along the line, although in a number of items tran
some other sector, rather than new services, are
Thus the increase in income from property is largely
of interest payments from local authorities who
borrowed from the private sector. Of central expen
goods and services the major item (£1,545 mn.) is
for by defence, in one way or another; the other
is the £441 mn. which the national health service cost
the transfers the largest item is the £625 mn. for
of the national debt; other substantial items are £
national insurance benefits and £427 mn. of other
assistance and grants to persons. Grants abroad
mainly outlay under the Colonial Development an
Acts; before the war outlay of this nature was neg
It will be seen that in 1938, on this reckoning, a
deficit was realized, in spite of the fact that the budg

[1] In terms of constant prices the 1953 figures should be de
2¼ times.

TABLE V. CONSOLIDATED CURRENT ACCOUNT OF BRITISH PUBLIC AUTHORITIES IN 1938 AND 1953 (£mns.).

Incomings	*1938*	*1953*	*Outgoings*	*1938*	*1953*
1. *Tax Receipts*			1. *On Current Goods and Services*		
Central Government .	773	4,030	Central Government .	455	2,352
Social Insurance .	109	526	Social Insurance .	14	32
Local Authorities .	211	436	Local Authorities .	355	737
	1,093	4,992		824	3,121
2. *Income from Property*			2. *Transfer Expenditure*		
Central Government .	22	177	Central Government .	312	1,385
Social Insurance .	neg.	48	Social Insurance .	136	524
Local Authorities .	49	102	Local Authorities .	23	47
	71	327		471	1,956
3. *Current Grants from Abroad*	—	105	3. *Current Grants Abroad*	—	56
			Net Expenditure of Public Authorities	1,295	5,133
			Net Saving by Public Authorities	−131	291
Total Revenue .	1,164	5,424			

an apparent surplus. This result was due to prepa
defence rather than to economic policy, although
of unemployment would have merited a sizeable
an overt policy of compensatory finance had been
In 1953 on the contrary a substantial surplus wa
and this was intentional, as a contribution towards
of a potentially inflationary situation. The surp
have been considerably smaller, however, had it
for the grants of the American government unde
Aid.

One final word of explanation: the saving thus sh
in the sense that it is a consolidated figure; it is, how
in the sense that depreciation has not been deducted
public authorities do not charge depreciation excep
trading services (in respect of the central share o
"Blue Book" gives a nominal depreciation figure
in 1953). Both central departments and local
possess a number of fixed assets which have to be
and it is arguable that this would be better carrie
fact depreciation was budgetted for upon them.
question which we shall have to discuss along
problems of budgetary technique, in Part III (Chap

§ 3. The Public Sector in the National Economy. rounded picture of the relative importance of the pu
in the national economy it is necessary to take into
tion the capital account also. This is illustrated
for 1938, 1944 and 1953. Capital formation is sh
that is to say both the maintenance of existing ass
formation of new fixed assets are included. To g
plete capital position it would be necessary to take in
also changes in stocks of raw materials and se
products. This is not possible for the earlier years
for 1953 the figures are less reliable than those relat
assets. Fortunately, from the investment point of v
changes are normally considerably less important th
in fixed capital formation.

ABLE VI. THE PRIVATE AND PUBLIC SECTORS OF THE BRITISH ECONOMY.

	1938	*1944*	*1953*
vate Sector			
sonal Expenditure on Consumption	4,153	5,216	11,076
vate Gross Capital Formation[1] .	550	224	1,016
lic Sector			
olic Expenditure on Current Goods nd Services (Public Consumption) .	814	5,221[2]	3,074
olic Gross Capital Formation at Home	235	63	1,317[3]

[1] Including the cost of acquisition and transfer of property.
[2] Excluding outlay financed through lend-lease and similar arrangements.
[3] Including the public corporations.

The effect of the war is very evident in both accounts. At height of the war *net* investment was negative in both tors; it has been estimated that *net home* investment was gative to the extent of £202 mn. in the private sector and of 2 mn. in the public sector in 1944. In the private sector the investment of 1944 followed a previous disinvestment of 30 mn. spread over the previous four years. Even this does t give a complete picture of the internal capital position cause it makes no allowance for the deterioration of house- ld goods and domestic capital of all sorts. It is necessary o to take into account the sacrifice of foreign assets due to war. In 1938 this already amounted to £70 mn. (of which, wever, £55 mn. represented the sale of gold which had been uired over the preceding few years.) By 1944 foreign investment had risen to the large sum of £655 mn., and the ocess continued steadily year by year until 1947; it was only 1952 that a steady rate of new overseas investment appears have been re-established.

In the private sector it will be observed that expenditure on nsumption in 1953 was broadly similar to that of 1938, asured in stable prices. In 1944 it was, of course, sub- ntially lower in real terms. On the other hand capital mation in real terms was smaller in 1953 than in 1938. is is largely accounted for by the difference in house building,

which was still booming in 1938, but which in 193
beginning to emerge from the fetters placed upo
reconstruction period. In the 1930's the low level o
development, hampered by poor profit prospects
pression, was already giving rise to concern. Sin
variety of methods of stimulating investment th
rebates (which we must examine in Chapter XIX)
tried; but the position cannot yet be said to be
factory.

Relatively to the private sector, the public sector
know, been rapidly expanding. The increase in p
capital formation is of even more significance th
public consumption, because it is more permanent in
In the near future private gross capital formation
pected to rise with the increase in private enterpris
it is to be hoped that industrial investment will al
On the other hand public capital formation is unlik
in view both of the needs of the nationalized indus
the large programme of slum clearance which is co

PART II

THE THEORY OF TAXATION

CHAPTER VII

THE ART OF PUBLIC FINANCE

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

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

The fact that public authorities exist for the satisfaction of wants of the citizens puts public finance firmly into the

field of economics. This implies that its study (and its successful conduct) presupposes a knowledge of the of the economic system. It is further clear that it to the field of *applied* and not to that of *pure* economics finance is an art, it is concerned with actual proble analysis is to have any practical application, at a stage, a particular economic set-up must be postul both the means to be used, their effects, and in so even the ends to be pursued, depend on the type of the

Thus, as we have seen, in a predominantly a community little use can be made of the income ta an apparently identical income tax may have very effects in a community where the typical business small family firm, and where consequently investment derived from private savings, and in a community typical business unit is large, and markets more or less listic. Most important of all such differences concerned with the optimum size of the public sector to the rest of the economy. In one situation the int nation may be best served by a small public secto private enterprise to invest freely on expanding ma another stage of its development the same nation m to enlarge its public sector enormously if it is to take of the less obviously profitable methods of imp standard of living, which may constitute its be progress. This is a question to which we shall hav in Part III.

From these few examples it is clear that the public finance to the other subjects usually includ nomics calls for very careful consideration. The the economist to the community cover two qui services. In the first place he must be able to working of the system, in the second place, on the analysis, he should be able to offer advice for its im Thus the discipline of economics can be divided into tinct processes. In the first place there exists wha call the positive sector, the business of which is to de

onomic institutions of the society (for instance, the organ- ation of industry) and to analyse the causal sequence of the actions of these institutions to economic and other stimuli. is part of the discipline may be described as the anatomy d physiology of economics.

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

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

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

A second and more fundamental part of positive public nce consists in the analysis of the actual process by which es (or subsidies and transfers, which are merely negative es) of particular types work through an economic system. s analysis is necessary to discover the economic conse- nces of fiscal changes, and only if the process is carefully ed is it possible to judge the relative merits of alternative

means of reaching a given end, and so to choos
method. It is convenient to refer to this analysis as
of Taxation, or Tax Incidence, although it is also
with certain types of expenditures. We shall be
with this type of analysis in Part II. It should be
it is essentially a "one thing at a time" process mad
by general economic analysis, in the sense that wh
studying the effects of a particular fiscal change
changes in the economic set-up which are not,
indirectly, due to it. The entire new set-up can
change must, however, be examined.[1]

The third and final part of positive public fin
which we shall be concerned in Part III) consists in
of the combined effects of the entire system of pub
on the national income; it embraces the fiscal polic
authorities in the fields of current expenditure,
taxation and borrowing. This analysis is clearly
foundation for a systematic policy of high econom
and for the direction of social policy; but a knowl
theory of tax incidence is an equally necessary
order that the means selected for bringing about th
of activity shall be satisfactory from other points
well. It will be seen that the theory of tax incid
sponds in the field of public finance to the theory of
industry in general economic analysis, while the
public finance in the national economy is related to
economic theory of business activity.

§ 2. The Choice of Policy. The positive side of pu
however, cannot long be kept apart from the nor
The analysis of the working of taxes or expenditur
end in itself, but merely a step in the process of s
best policy. On the normative side public finance
itself to be merely a department of economics.

Just as positive finance is concerned with a partic
ment of economic analysis—the effects of the finance

[1] For further discussion of this point, see pp. 10

ublic authorities—so normative public finance is concerned
h judgments on particular types of economic policy, those
ch are, or may be implemented by, programmes of ex-
diture or of revenue collection; the ends which are sought
his manner cannot, however, differ in any way from those
ght by other types of economic policy, and may more
veniently be implemented by different means than by public
nce.

he policy which is adopted by a nation—such a policy, for
ance, as is reflected in the annual financial programme
ch we have been examining—is composed of a number of
nds; some of these have a non-economic, legal or psycho-
cal basis—for instance, the desire for legal equality, satisfied
Adam Smith's second duty, or arrangements to secure
gious freedom. The greater part of policy, however, is
cerned with the satisfaction of wants which are similar in
l to those satisfied (or which could be satisfied) through the
ket mechanism; in this sense they are individual economic
ts, although they may more conveniently be provided on
llective basis.

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

objective criteria for all that part of policy which is
with the satisfaction of economic wants by pub
With the current expansion of public sectors this p
of urgent topical importance, but unfortunately it ha
far too little attention. In order that our analysis
be left floating in the air, but be made to yield defin
sions, we cannot avoid attempting to state the criteria
however briefly and inadequately.

Remembering that the final end of policy is the s
of wants, an obvious first stage in our quest is to st
means of satisfying wants—production, output
maximized. Clearly if production, with a given
resources, is not maximized, however the product is d
satisfaction is less than it should or might be. The
tion of output, the "production optimum", is thus
with the allocation of resources; the condition for
tion of output is that with any given system of p
should be impossible, by reallocating factors, to
output of one product without diminishing that of anot
criterion is perhaps not much more than a prec
stating the oft-quoted maximum condition of eq
returns to factors, but it has the decided advantag
independent of any particular system of price we
may be given to the products, so that it is of general
So far there is no logical difficulty, although
consider the problems set by such complications a
lities, external economies, and complementarity of
implementation of a policy of reaching the producti
clearly sets many problems of a technical nature.
stage in the pursuit of the economic absolute is a
complicated. Among production optima we hav
the set-up which will maximize *satisfactions.* And
up against the difficulty of comparing one person's s
with those of another. The most plausible way
tangle of incomparability of utilities is by the route

[1] For a more precise, but essentially similar definition c
melson, *Foundations of Economics*, Chapter VIII, especially

tion. If a particular redistribution of products will make the
st individual so much better off than he was that he can
mpensate the second man and still remain better off [1] than
was initially, then both must agree that the change would be
improvement. The maximization of satisfactions, the
tility optimum", may hence be formulated precisely, in a
anner parallel to the production optimum. *Utility is*
ximized when it is impossible to increase the satisfaction
nprove the position) *of one individual without diminishing the*
tisfaction of another, after full allowance has been made for
mpensation.

The utility optimum clearly takes us up to a higher stage in
fining the course of policy, because it brings us into view of
final goal, which is real income and not real output. It
es so by eliminating the degrees of freedom which would
herwise exist in the organization of production. Something
in to the utility criterion has been sought in the form of
ui-marginal social net products; the concept of social net
oduct, however, contains too many unmeasurable quantities
the basis of actual policy. Both the production and utility
tima in the form just stated are capable of being brought
o relation with statistical and econometric enquiries, and
are capable of becoming practical directives of policy.
It is obvious, but should perhaps be emphasized, that both
teria need to be interpreted in a dynamic sense; the produc-
n that is to be maximized is not this year's or next year's, but
the present value of a future output stream, discounted at
atever rate defines an acceptable compromise between the
rtal nature of the individual and the immortality of the
mmunity. The utility optimum must similarly be conceived
realized by a stream of satisfactions through time. Some
the increase in satisfaction which will signalize progress
vards the optima will take the form of a better provision for
nts already conscious, and probably already partly satisfied;
re is also, however, a large field for the development of
nt-consciousness, which will lead eventually to higher levels

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

of satisfaction. In this field public authorities ca
important role.

§ 3. The Implementation of Policy. Having defined
of policy, we must now attempt to see how they can
to the actual direction of policy. Starting with an
a going concern (as we must do) we have a given
potential supply of factors, i.e., the labour and cap
or shortly obtainable through production with exi
ment, or by exchange. The first condition, re
the production optimum, is that these factors sho
and continuously employed. We must then use
optimum to discover just in what way they should
used.

In any economy there are always likely to be a
number of schemes which are potentially eligible fo
within the scope of the utility optimum, in the sens
would severally increase satisfactions and still leav
over cost, after compensation had been paid for
factions. By estimating for different schemes
magnitude of these surpluses, a definite and objectiv
priorities can in principle be established. Given
statistical data of costs, it should be possible to do
reasonable degree of accuracy. In practice diffi
arise—for instance, owing to discontinuities where
mum outlay is large—but for the most part it should
to make marginal adjustments which are small fro
of view of the whole economy, although they ma
from the point of view of a single unit of control.[1]

When the matter is put in this way the important
public finance must play in the attainment of the
once apparent. The production optimum can only
with a technically correct allocation of factors;
there are many reasons why it is often difficult to
allocation. For instance, monopolistic control of
impose an obstacle; again an inadequate educatio

[1] For further discussion of planning difficulties cf. Chamb

y prevent the best use of the nation's talent. Technical
tacles of this nature are very amenable to treatment by fiscal
ns, through the use of particular taxes, or the development
particular types of expenditure. Again, on the plane of the
tion of public finance as a whole to the economy as a whole,
al policy can be directed both to making the public sector
supporting and balancing factor in the economy, and to
uencing the activities of the private sector in a direction
ropriate to the criteria of policy.

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

hus some revising agency (for which the government must
ultimately responsible) is required to take into account
n determining policy programmes those "community
cts" of individual actions which are not apparent to the
vidual. (For instance, the backwash of *A*'s actions on *B*
not be taken account of by *A* because they lie outside his
ate accounting system, either considered as the utility
unts of the consumer, or the production accounts of the
.) In the productive field effects of this nature have long
recognized as a type of "external economy" (or *mutatis*
andis dis-economy), but so far policy has almost entirely
d to take them into consideration. In the field of con-
ption "community" or "neighbourhood" effects of this
re are less important, and up to the present much less
ntion has been paid to them.[1]

Many of the functions of the State in thus revising and
grating policy, whether they are actually performed by the
slature directly or by an agency (e.g., the judiciary acting
er legislative direction), are closely related to fiscal policy.
rder for them to be carried out to the best satisfaction of

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

the community it is clear that the government must
real wishes of the people as faithfully as possible.
lie within the field of economics to discuss the pre
political organization which will satisfy this con
appropriately, any more than it does to determine
of the remaining non-economic strands which go
the fabric of policy. Since the economist has
responsibility in the implementation of these other
policy it is necessary for him to be conscious of their

Some of the non-economic strands of policy are
importance for the life both of the individual and of
indeed they take us beyond the utility optimum
in which we have defined the maximization of
That this is so is shown by the willingness of
society to lay down their lives in order to secure
families and descendants the sort of system of
approve. In policy of this nature must be
fundamental physical and psychological needs
Smith had in mind as pertaining to the "First
Duties of the Sovereign". For policy of this nature
be no question as to whether resources can be spared
must take precedence over the realization of
optima of policy.

Besides these fundamental needs of man in
are also other psychological and social needs which
less fundamental are deeply engrained in the ideals
ticular societies, and of which consequently the economist
be aware when he is advising upon policy
although again he must take as a datum the ideological
enshrined in the policy. An example of such a
policy which is peculiarly strong in Britain is the
justice, expressed in the present generation by a desire
redistribution of income, but traceable in tax ideals
far back into history.[1] The economist has an important
to perform in respect of this policy; he is responsible
reporting to the community on progress, *e.g.*, on

[1] Cf. Chapter VIII.

any particular measures of redistribution (or the general
ce of redistribution) on the production and utility optima
spectively. Policy of this type if carried to extremes may
nceivably conflict with the pursuit of the optima; armed with
economist's report it is for the government to take the
sponsibility for deciding between conflicting ends. Still
her types of policy, even those desired by majorities, may
nflict more seriously with the pursuit of the optima (we might
ke as an example the determination to establish an industry
which conditions are unsuitable). Policy of this nature
ds to be measured very carefully against our criteria. It is
fortunately within the power of majorities to inflict lasting
mage on an economy by the pursuit of ends for which the
eans are not available.

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

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

Of these three methods of implementing policy, public finance
pears to be the most powerful and generally useful where it

can be properly applied. On the one hand, in no
the scope for direct controls cannot be large witho
of infringing essential liberties; on the other, fiscal
the advantage over monetary policy that it can
just at the point where stimulus or pressure is require
monetary policy inevitably goes bludgeoning all
economy.

Further, whereas monetary policy can only op
indirect effects, fiscal policy can be turned at will e
direct production of satisfactions, or to their indire
tion through the stimulus or control of the output of
sector. Thus the adoption of particular ways
revenue may in itself lead to an expansion of incom
(for instance, by promoting industrial efficiency) or
reflexion of preferences on the market (for instance,
prices nearer to marginal costs); while at the sam
expenditure of revenue promotes progress towards
(for instance, by the dynamic development of
optimum, through better housing or education).

Although it is only the modern development of
analysis which now enables us to formulate the
policy precisely, in a crude form they can be sho
been present in the minds of the framers of British f
from the seventeenth century, from the moment w
ment finally got full control of the revenue. Until
the nineteenth century, however, pursuit of the o
almost wholly conducted on the tax side. This was
because the greater part of the revenue was requir
satisfaction of the fundamental (non-economic) ne
community, which as we saw must take precedence
wants. Thus until quite recently the ideals of pub
were comprised in the theory of tax incidence;
Gladstone era it was not even realized that the ta
could, and should, be treated as a unity from the po
of policy.[1]

Once it became possible to think in terms of a co

[1] Cf. p. 131.

ructure, instead of in terms only of its components taken
eparately, a broader outlook was conferred on policy. It
egan to be perceived that the tax structure might itself be used
s an instrument of policy. Since, however, the main emphasis
ontinued to be on the theory of tax incidence, the principal
dvice that the nineteenth century had to offer on the policy
f public finance was that the public sector should be kept as
nall as possible. In the mid-nineteenth century, the age of
pidly expanding population and markets, this was sound
conomic sense. The opportunities for pioneering by private
terprise were enormous, and no assistance from public sector
as required to secure a high level of activity. Nor would it
ave been possible for the public sector, with inadequate
ansport and an undeveloped civil service, to take an active
art in policy.

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

The modern analysis of the effects of public finance as a
hole, and hence of the place which fiscal policy might play in
e economy, followed quickly on the development of the
eory of business activity, associated especially with the
mes of Wicksell and his pupils in Sweden, and slightly
ter of Lord Keynes and others in Britain; the new theories
ere first applied in detail to public finance in Sweden in
34.[1]

The practical application of the new analysis depended,
owever, on the emergence of two new factors in the situation,
st the expansion of the public sector in national economies
ue both to the growth of trading services and other forms of

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

public investment and to the development of the soc
vices); secondly, the availability of a better techni
monetary control, once the rigid gold standard of th
teenth century had been abandoned. Without this
change the new orientation of policy would have
danger of frustration on the monetary side.

CHAPTER VIII

TAX IDEALS

I. The Principles of British Taxation. When the finance
inister of a country is choosing the taxes to go into his budget,
hat considerations ought he to have in mind? This is
ually the first aspect of public finance to attract attention,
cause it is a matter that affects every citizen. In England
: can trace a long tradition of opinion on tax ideals. Before
: pass to the economic analysis of the operation of particular
xes it will be useful to see what general principles have lain
hind the levies actually imposed from time to time.
There are, broadly speaking, three different types of question
ich a finance minister might be supposed to put to candidates
· the Budget before admitting them. In the first place he
ght ask what (if any) other purpose they were capable of
ving besides providing revenue for the satisfaction of public
nts. Secondly, he might question them about their distri-
tional effect, what classes of the people might be expected
contribute most of the revenue. Thirdly he would have
put them through an efficiency test, to ascertain which were
: most economical and effective methods of raising a given
enue, or which taxes were most appropriate for serving
ier given purposes.
The taxes selected by British Parliaments have usually been
uired to give fairly specific answers to these questions, at
st from the sixteenth century. The answers may be stated
:he form of three principles. In the first place the primary
'pose of the revenue should be to finance the public services,
isequently those taxes should be chosen which would be
st efficient for this purpose. Nevertheless, it is permissible
certain circumstances to choose some taxes whose main
ect is to serve an agreed subsidiary aim, such, for instance,

as improving the balance of payments on international
or hindering some undesirable form of consumption
ture. The second principle is that the citizens should
in accordance with their ability to pay, a criterion which
take some account of family circumstances as well as
Thirdly, taxes should be universal, imposed without
of person between citizens similarly placed.

In terms of the policy aims which we were discuss
last chapter the first of these principles can be relat
productional criterion. The productive optimum in
circumstances can only be reached if the most efficient
used; a country which tries to make its revenue serve
subsidiary purposes at once is almost certainly de
chance of attaining the optimum. The second p
concerned with the question of social justice; but
related to the utility criterion. The precise interp
"ability" inevitably gives rise to differences of opinio
is really at stake is the relative weighting which should
to the various factors on which ability may be said
This question cannot be settled objectively, so that
pretation of the principle must remain a matter o
matter that is for Parliamentary decision. The int
put on the second principle has naturally varied wi
of economic and social development.

The third principle is also related to ideas of so
by way of Adam Smith's Second Duty, since it is
with equality before law. It is characteristic of
outlook that a great deal of attention should have
to this point, and taxes which were otherwise acce
often condemned or even abandoned if they could n
satisfactory in this respect. The third principle is
cerned, though not very obviously, with the effi
which otherwise does not figure very prominently in
discussion. The connection, however, was made
Adam Smith's formulation of the principles of tax

In his chapter on the Public Revenue, Adam Sm
ward four canons or maxims of taxation, which

me which perhaps they hardly deserved, since they appear
have been mainly a reflexion of contemporary opinion.
he second and third canons (the first is merely a restatement
f the distributional principle) lay down respectively that taxes
ould be certain and not arbitrary, and that the time of collec-
on should be suited to the convenience of the taxpayer—
rtly a question of equality again but partly also of efficiency.
he fourth canon, concerned with economy, is much more
teresting and it is worth quoting it in full: "Every tax ought
be so contrived as both to take out and to keep out of the
ockets of the people as little as possible over and above what
brings into the public treasury of the State."

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

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

Now, after more than a century of efficient fiscal adminis-
ion, it may seem that the principles of taxation which we
e just listed are so self-evident as hardly to be dignified by
name of ideals. They have not always been very well

[1] See Chapter X, Section 3.

observed, however, even in this country, and
different principles have often held sway. In th
every country it is easy to find occasions when
has been distorted to serve particular interests, fo
the field of foreign or industrial policy. The net
has been more often than not to damage total
interests of particular groups. In Adam Smith's
British tax structure was full of levies and subsi
had been imposed at different times with the
benefiting particular interests. It was largely on
that it so lamentably failed to provide sufficient
finance the Napoleonic wars.[1]

In France at the same date the tax structure
much greater extent against Adam Smith's
notorious that under the *ancien régime* the taxes
levied on the poor, the rich and aristocratic being
exempt. A very common way in which the
revenue between different classes of the commu
distorted is by exempting State employees from
thus constituting them a privileged class. When
it is common to find their privileges backed
exemption from the jurisdiction of the ordinary
history of Germany, and even of France, pro
illustrations of the evils to which such
lead.

Another common fiscal privilege has been the
interest on the national debt from income tax.
States this has traditionally been the arrang
to-day so much of the debt of the constituent Sta
that American millionaires can escape no small
rigours of surtax by investing in public funds.
tax structure has not always been entirely free
weakness,[2] but on the whole it is true to say th
has steadily set its face against fiscal privileges

[1] Until the introduction of the income tax. See p. 124
[2] In the war of 1914–18 certain war loans were issued
Hicks, *The Finance of British Government*, *cit.*, Chapter X

inst legal privilege. The fact that national debt interest
the salaries of public servants were made subject to
ome tax by Pitt, on exactly the same basis as other sorts of
ome, ensured that when the income tax became a permanent
ture of tax structure it would contain no privileges of this
ture.

The Development of Tax Ideals. It is one thing, however,
lay down principles; it is quite another to carry them into
ctice. To what extent can the taxes imposed from time
time in Britain be said to have conformed to the ideals?
would take us too far afield to attempt more than the briefest
vey,[1] but even this will serve to illustrate the considerable
ount of attention devoted to the tax principles, more
ticularly to the principles of equitable distribution.

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

In the sixteenth and seventeenth centuries tax revenue was
ived from two sources, a variety of partial taxes on ex-
diture, and a general tax on wealth. At the beginning of
period most of these partial taxes were on imported goods,
according to current theory, lay outside general distribu-
al considerations, because they were regarded as paid by
porters, and earmarked for naval expenditure. As the
ds of the revenue increased and the customs duties were
ltiplied, their theory could no longer be plausibly main-
ned, and the distributional aspect of taxes on imports had
be considered. For the most part it was aimed to con-
trate them on "nice and delicate things", such as silk, wines

In this field much research still remains to be done. For the earlier
od W. Kennedy, *English Taxation, 1640 to 1799*, is invaluable. New
it on the first income tax was thrown by A. Hope Jones, *The Income
in the Napoleonic Wars*, and on its further development by F. A.
hab, *Progressive Taxation*.
The medieval Xth and XVth were in intention proportional to wealth.
t taxation of the poor could raise a storm at an early date is apparent
n the poll tax episode of 1381. Cf. also the unbroken development of
basis of the local rate (Cannan, *History of Local Rates*).

and tobacco, from the taxation of which the poor
be expected to derive much hurt.

The chief interest of distributional theory was
general tax on wealth. This had been reformed by
under name of "The Subsidy". Liability was fixed
£ on income, or alternatively at 2*s.* 8*d.* on the capi
the source of income. The tax was considered to fa
the rich or "the middle sort". A gradual process
exempting the poor is discernible and appears to have
plete by the accession of Elizabeth. Unfortunately,
service was incapable of maintaining the intention
sidy, and before the end of the century contributions
"stereotyped" (tied to conventional assessments).
of this was a progressive fall in the amount of revenue

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

This second deterioration of the general tax on w
it necessary for further reform to be attempted in
William III when the needs of the revenue once ag
pressing. The new "General Aid" was again in
proportional tax "according to yearly profits". In
was assessed in three ways, directly on salaries,
respect of income from moveable property by

[1] It should be noted that throughout English tax theory
connotes the manual working class, and not the recipients

rcentage on the capital value, and finally, in respect of income
m real estate by collecting tax from the tenants, who stopped
out of the rent.[1] It soon became apparent that it was still
yond the powers of the authorities to collect tax on income
m personal property, so that in fact the Aid became a Land
x. Throughout the eighteenth century it remained an
portant source of revenue; and it is still paid (but has no
ger any fiscal importance) on certain old houses in respect of
ich it has never been redeemed by a capital payment.

t seems clear from these efforts that in the sixteenth and
enteenth centuries it was the intention of the legislature to
se an important part of the revenue by a general tax pro-
tional to ability to pay; from contemporary writings it
uld seem that it was customary to pay some attention to
nily circumstances as well as to wealth.[2] The fact that what
erged was a partial tax on income from real property was
partly to the relative ease with which income from this
rce could be assessed and the tax collected. At the same
e land remained by far the greatest source of income until
ne way through the nineteenth century, so that the greater
t of the receipts of an effectively general tax would also have
ne from land. The partiality of the tax does not seem to
e been a source of serious complaint until well on in the
hteenth century.

There is no doubt that these "general" taxes were mainly
d by the wealthy, and the poor were virtually exempt. The
lt of sixteenth- and seventeenth-century policy was to fix
doctrine that income was the proper standard of equitable
distribution.

n the later seventeenth and early eighteenth centuries the
in on the exchequer of long periods of war required the
covery of another source of revenue. This was found in
imposition of taxes on home-produced goods known as

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

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

excises.[1] During periods of exceptional strain (
the Commonwealth and again in the Marlbo
excises were freely imposed on commodities which
bought by the poor (especially beer, leather
first accepted because of the dire needs of the
then condoned because of their impartiality, it was
that after all the excises were not distributionally
because rich households made larger per head
taxed commodities than poor families. Only
clearest brains perceived that the excises were still
unless the rich bought *proportionately* more
which was not very likely.

A more serious argument in favour of taxes
consumption was derived from Locke's political
which became fashionable in the eighteenth cent
forward the concept of the State as a voluntary
the sole purpose of providing for the primary
Since all must share these wants it was just that
contribute to their satisfaction, no matter how
station. This view was never universally accepted
ment (which consisted mainly of landowners) the
lively interest in the welfare of the poor, the
most members' tenants belonged, and a consequ
to tax them.[4]

The view that tax contributions should be
accordance with ability to pay was thus never
overthrown, but for a large part of the eighte

[1] The use of the term "excise" in this restricted sense
from 1643, when both the type of tax and the name were
the Dutch. In the United States the more general use
viously 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
forward a "functional" view of the State, according to
should be exempted from taxation on account of the
which formed a sufficient contribution to the body politic

[4] The Parliamentary storm which arose over Walpole's
to substitute excises for the degenerated General Aid
titude. On grounds of the utility criterion Walpole's plan
it sounds, cf. Chapter X, especially Sections 3 and 6.

flame burnt less brightly than at any other period of our
al history. Nevertheless, about the middle of the century,
en the strain on the revenue was eased, the taxes imposed
re in fact less regressive. Excises on commodities in general
were reduced to very low rates, and greater reliance was
ced on high-rate taxes on luxury goods. The eighteenth
tury approved of such taxes not merely because distribution-
they were more acceptable but also because they regarded
m as to some extent optional; the manner in which he
uld make his contribution to the revenue might in some sort
left to the discretion of the taxpayer. Only an age of light
enue needs could have failed to realize that services cannot
paid for by optional taxes.

owards the end of the century, when the needs of the
enue were once more expanding, new taxes were again
uired. This time the choice fell on a series of external
ications of wealth, such as the number of hearths or windows
houses. Such things were easy to assess, and ownership
ht be assumed to be roughly proportional to wealth. These
es undoubtedly represented a return towards the old
lition. The small houses were completely exempt; and the
dow tax was even assessed at slightly higher rates as the
ber of windows increased.

t the end of the eighteenth century there set in a period
evere financial strain similar to that which had occurred
entury previously. Once again tax ideals were thrown
rboard in a scramble for revenue. Excises of all sorts were
oduced, and continued in operation throughout the
oleonic wars. They were once again condoned as a war
ssity, but it is not improbable that they served something
he same function during the war as the purchase tax of
), in restraining consumption which would have been in
petition with the war effort.

he imposition of the new excises on top of the hearth and
low taxes, the remains of the "optional" taxes, and various
r remnants from earlier ages, reduced the tax structure to
tmost confusion. Owning mainly to the degeneration of

the old taxes, up to 1797 the revenue was never
cover more than a minimum satisfaction of
collective wants and the interest on new war borro
persistent prejudice against the inequity of gener
wealth (as they had so far been imposed) pre
solution from being found, until Pitt finally succe
suading Parliament to return to the general taxation
in the form of an income tax.

Pitt's income tax of 1797 was enormously more
any previous general tax. It produced revenue ab
tion, and what was still more remarkable, instead o
ting after a few years in the manner of all prev
taxes, the longer it was in operation the more rev
duced. This was no doubt partly due to the ris
incomes during the war, but it also revealed a n
in the revenue authorities.[1]

Like the earlier general taxes, the income tax ai
at an impartial proportionality in distribution;
definite cognizance of family circumstances by
rebates, and the lower incomes were assessed at
rate. Returns of income were not compulsory,
tions had to be made in order to claim these
These returns were a substantial aid to correct
and still more important, they formed a precedent
compulsory returns, which as experience has abund
are a *sine qua non* of an equitable and effective inco

In spite of its greater efficiency, the generality o
tax was still suspect. It did not succeed in catchi
incomes adequately, and the main burden still fe
This was one reason, perhaps the main reason

[1] The main explanation of the new efficiency was that fo
the government succeeded in training a reliable and effec
collectors. The nucleus of this specialist organization was
secretly preserved by Somerset House during the suspensio
all this it seems to be to Addington rather than to Pitt that the
be given. Cf. Hope Jones, *cit.* and Shehab, *cit.*

[2] There were also loud outcries against the inquisitorial po
tax collectors; this would mainly affect the profit incomes, a
that they were not so undertaxed as the landlords believed

position which it aroused, and which led to its suspension
ly in the reconstruction period. Although the first income
vanished in 1816, and every effort was made to obliterate
traces, few people believed that it would not return. The
or had once more been opened wide on the old tradition
axation in accordance with ability. None of the Victorians
ously questioned its validity, although they inherited from
eighteenth century the partially contradictory principle
t all should contribute to the expenses of government. It
nly in the most recent period that these two ideals have
n successfully reconciled.

The Subsidiary Aims of Taxation. Once the income tax
gone, the tax structure inevitably sank back into something
its eighteenth-century distribution. Thus, in 1828, over
per cent of the revenue came from Customs and Excise,
r a quarter being derived from duties on food and non-
holic drinks, and a considerable part of the rest from excises
bricks, glass, hides and other commodities which certainly
cted wage earners. This tax structure probably bore at
t as heavily on the poor as that of the late seventeenth and
y eighteenth century, but it differed from it in an important
nner, in respect of the subsidiary aims to be achieved by the
enue. It will be convenient to turn aside to discuss the
nge of opinion in this respect before proceeding to trace
modern development of the distributional ideal.

rom the middle of the seventeenth century an increasing
re to serve economic ends by differential import and export
ies is discernible. At first the main objective was to encour-
the import, and discourage the export, of raw materials
ch might serve to stimulate employment at home. Gradually,
direct protection of home industries and the encouragement
xports came to attract more attention. In the eighteenth-
ury period of revenue ease Parliament was able to experiment
differential duties designed to reach the "productional
mum" by favouring particular interests. As usually
pens, many of these attempts over-reached themselves.

A striking example of an unlooked-for consequ
encouragement of industry by the State was the
home production of alcohol of an import duty.
eenth century the protection afforded to the ma
spirits[1] resulted in such an enormous increase of
fall in prices, that the spread of gin drinking among
class alarmed and shocked the whole country. (It
as the phrase went, of "drunk for a penny, dea
tuppence".) The result of this fiasco was the inaug
now traditional British policy of drastic excises on
with the express purpose of reducing consumption.
1828 a third of the revenue was derived from alcohol
(the latter duties had also something of a sumptuar
As we have seen, this policy has been continued w
mission right up to the present day, not, as must
edged, without considerable advantage to the reve

Of greater economic importance were the duties
imports, with the purpose of protecting the balan
ments. It would seem that in the latter half of the
century a severe strain was felt on the exchanges
fested itself in a series of crises, and in high and
interest rates. The causes of the pressure were c
they were compounded partly of the strain of succ
partly of the weakness of the Dutch exchange (
gradual impoverishment of that country) and the
efforts of Dutch nationals to repatriate funds hithe
in England.

The customs duties with which the eighteen
attempted to meet this trouble were clumsy and
inefficient. Adam Smith viewed the tax structure
with great disfavour, and no doubt he was right.
(in effect) that the innumerable duties and subsidi
distorted the allocation of resources, and so by
approach to the productional optimum. In princi

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

o in favour of tariff reduction, but during the war period
e state of the exchanges did not allow of any relaxation;
leed the suspension of cash payments by the Bank of England
nalled the final collapse of the balance of payments.

Not long after the end of the war, however, Huskisson was
le to effect an enormous simplification of the tax structure
thout any appreciable loss of revenue. This was a reform
tirely in line with Smith's doctrine; but it also paved the
y for the later reduction of duties on the path to free trade.
vertheless the repeated exchange crises of the early eight-
nth century, and their obvious relation to abnormal food
ports (consequent on bad harvests at home), reveal that the
lance of payments remained precarious until near the middle
the nineteenth century. It is probable that the most
portant economic effect of the Corn Laws was their restric-
n of imports.

From the 1860's the balance of payments was never in serious
nger until after 1925. The Victorians, accustomed to
pidly expanding markets and to an unprecedented rate of
pital accumulation, looked back incredulously at an age
hich had thought it sensible to multiply customs duties, and
en to attempt to prevent the export of coin. In our own
nes, faced again with a deterioration in the balance of pay-
nts, we may look more kindly on an age when governments
d to meet a very difficult international situation with what-
er clumsy and primitive weapons lay to their hands.

Although the successive repeal of protective duties (culmi-
ting in that of the Corn Laws in 1846) led eventually in the
cumstances of the mid-nineteenth century to a substantial
crease in the national income and in the standard of living,
ntailed for the time being a serious loss of revenue, which
oner or later would have to be made good. Reluctantly it
s realized that this implied the return of the income tax.
us it was that in 1842 the income tax came back, on the
ict understanding that it was a temporary reserve for
ergencies. It was soon perceived, however, that many of
e old objections to it had lost weight. Partly owing to the

increased skill of the Inland Revenue, partly to
morality of the business world, the assessments co
be accused of partiality. Gladstone continued to
his days to affirm that the income tax was only tem
the fact remains that when he might have abo
refrained from doing so.

§ 4. The Acceptance of the Progressive Principle. T
that a substantial part of the revenue should be raise
of a tax which paid prime attention to ability to p
firmly and finally established. The remaining ste
preting "ability" as satisfied only by progressive t
delayed for a few more decades. Sir William
progressive death duties of 1894 was the first ste
new road, but the tax structure as a whole remai
proportional up to the second decade of the twentie
Yet the concept of progressive taxation, and the
bringing about a more egalitarian distribution
through public finance, were no more than logical
of the traditional tax ideals. It is possible to trace
emergence of the modern outlook from at least an
in the nineteenth century.

Up to the end of the eighteenth century the
idea (if we can call it such) was confined to the (very
attempts to lighten the tax burden of the working
choice of excises falling outside the range of wa
purchases, and the exemption limits of the hearth
taxes, are illustrative of these attempts. In the "re
on small incomes of the early income tax, it is perh
to detect a small further step; historically it did
the first link in the chain of a fully progressive in
This tenderness for the poor was based on h
grounds, and was not supported by logical argume
there was a total failure to produce any argument
stand up to Locke's contention that all should c
the expenses of the State.

[1] Cf. p. 184.

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

On the whole Adam Smith reflected the eighteenth-century
int of view in being relatively uninterested in distributional
estions,[1] yet it is evident from other parts of his book that he
s extremely interested in welfare problems. It is probable
t in his view progress towards the "productional optimum"
hich would be fostered by a reduction in restrictive duties)
uld improve the lot of all more rapidly than conscious
listribution. Among his contemporaries, however, there
re already some who demanded that taxation should be used
remedy the inequality of riches as much as possible by
ieving the poor and burdening the rich".[2]

By the middle of the nineteenth century such a leading
nomist as Mill was prepared to support progressive taxation
long as the object could be obtained without taxing "in-
stry and economy". He was apprehensive of the effect of a
gressive income tax on investment (a very real danger in the
ys of small scale private business), but he was in favour of the
cation of economic surplus (Ricardian rent), and also of

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

Lord Kames, *Sketches of the History of Man*, quoted in Cannan's
tion of the *Wealth of Nations*.

progressive inheritance taxes. The first of these t
natives was immediately recognized as being eco
admirable. Since pure surplus arises as the result
outside the control of the individual (such as the
demand for his labour or for the use of his propert
have no incentive to reduce his output if the surplu
away. Unfortunately, the revenue to be gained fr
on pure surplus is in most circumstances negligible i
to the costs and difficulties of assessment and collect

Largely owing to Mill's support, the progressive in
tax became law in 1894. By that time it is clear t
degree of progressive taxation had become generally ac
Many Liberals would probably have been prepared
gressive income tax almost immediately.[2] The chang
look owed much to the marginal analysis of the 'seve
its demonstration that an accurate interpretation of
must take account of the fall in the marginal signi
money as income rises, so that even an "equal sac
income called for progressive rather than for pro
taxation.

A few years after Harcourt's death duties had be
duced Edgeworth was arguing[3] not for "equal sacri
for "minimum aggregate sacrifice"—which strictly
would have implied the confiscation of all income
defined level. Since both these principles required
personal measurement of utilities, they were not c
providing an objective criterion for the direction
(such as is provided by the modern utility criterion)
theless, the general acceptance of the principle of th
bution of incomes through public finance—which was
the way by the end of the nineteenth century—owed
the contemporary discussions of the economists.

[1] Cf. Chapter XI, Section 4.
[2] Harcourt actually prepared a scheme for a progressive inc
1894, but withdrew it, as he thought it would be going a little
Parliament, cf. A. G. Gardiner, *Life of Sir William Harcou*
Chapter XVI.
[3] *E.J.*, 1897, reprinted in *Collected Papers*, Vol. II.

At the beginning of the twentieth century it would not
ave taken a very well-informed prophet to foretell that the
ext substantial strain on the revenue would see the establish-
nent of the progressive income tax. The occasion came with
he Liberal Budget of 1909,[1] which called for large additional
unds (to finance additional naval expenditure as well as new
ocial services). Thus supertax[2] finally found its way into the
ax structure; in 1913 it yielded £3 mn., by 1920 this had
lready jumped to nearly £56 mn.

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

This discovery finally made it possible to resolve the dilemma
etween the principles that all should contribute to the expenses
government (on political and moral grounds), and that the
or should be exempt (on humanitarian and utility grounds).
Britain to-day working class families do contribute to the
sts of government; in respect of income tax it is a fully
nscious contribution. Nevertheless on a balancing up of
uses and minuses there is a net redistribution[3] in favour of
e lower income groups. By appropriate alterations of the
x and expenditure policy the redistribution can be adjusted
whatever extent, or in whatever direction, is required by
e criteria of policy.

[1] It was the rejection of this budget by the Lords which led to the
ssing of the Parliament Act of 1911 (see p. 44).
[2] The name was changed to surtax by Mr. Churchill in 1929.
[3] Cf. Chapter XVI.

CHAPTER IX

THE METHOD OF TAX ANALYSIS

§ 1. The Classification of Taxes. A necessary first step in tax analysis is classification; before we can begin to trace the operation of particular taxes through the system we must divide them into convenient groups. In Chapter V we found that income tax and death duties are commonly referred to as "direct taxes"; most of the other taxes in the British tax structure are regarded as "indirect". The direct-indirect distinction has been by far the most common one in 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 the same way in other countries, which have different institutions or different 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 assessed for each taxpayer, so that the relation between the taxpayer and the revenue authorities is in principle 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 some official collecting agency, for others, however, it is convenient 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 purchased, such as the tax on a packet of cigarettes or a ticket at the cinema. What is really being taxed in this case is the packet of cigarettes (which cannot pay a tax)

njoyment of the consumer in satisfying his want of a smoke. he enjoyment of goods which are not consumed in a single use, s cigarettes are (for instance motor cars or wireless sets), annot, however, be taxed by making the merchant or manu- acturer an unofficial tax collector, unless the government is ontent to collect tax only once in the lifetime of the goods, amely, when they are first sold. Consequently, for this class f goods the revenue authorities need an official tax collector, ho will collect a yearly sum during the lifetime of the goods, r the right to use them. The British revenue authorities, turally looking at things from their own point of view, like regard as direct all those taxes which are either individually sessed on the taxpayers or collected from them by an official ency.[1]

It is clear, however, that there is no essential economic fference between a tax on the enjoyment of smoking and a x on the enjoyment of motoring, while, on the other hand, great gulf separates a tax assessed on total income or capital, om a tax which is paid as a condition of satisfying a particular nt, such as smoking. It is largely immaterial in the latter se whether the taxpayer meets his liability by means of a gle payment (as he must do in the case of a single-use good) in the form of an annual right to use (as will probably be quired in the case of a durable-use good). Again it is im- terial—from this point of view—whether the tax is assessed a main component of the finished article (e.g., tobacco) on a subsidiary component (e.g., the oil or labour used in nufacturing processes); in both cases the tax will have to paid before the smoke can be enjoyed.

There is thus a fundamental economic distinction between es on income (including taxes on the capital from which ome is derived), on the one hand, and taxes on outlay— er for outright purchase or for periodic right to use—on other. This distinction is of universal validity, and does not

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

depend on national institutions. Its true impo
however, only recently been recognized, because
calculations of the national income and of its
among the citizens that it derives its significance
calculations have only comparatively recently be
recognized, and used as planning directives.

The national income (or national output) is not
simple concept. There are, in fact, two fundamen
of the national income,[1] both of which are set out in
Paper, because both are of significance, although fo
purposes. In the White Paper these concepts
respectively the National Income (Output) at Factor
the National Income at Market Prices. The first is
tive, technical concept; the different commodities
in the national income are valued according to the
the factors of production which have gone to
the relative prices of the factors are taken to represe
at which the various factors are capable of being
substituted at the margin, so that the cost of a co
taken to represent the amount of the nation's reso
have gone into making it. The national income at
is thus a measure of the technical potential of the
resources.

The national income at market prices on the othe
subjective or welfare concept. It reduces the diffe
modities to a common measure not according to their
according to their marginal utilities. The relative
different commodities and services which people buy
the relative satisfactions which the members of the
derive from the components of the national income
ticular set of prices. The product prices which cons
to pay in the market are made up of the factor c

[1] The same distinction holds good for the *Gross Nati*
which is merely the national income (or output) before de
fixed assets and stock adjustments have been made. In
difficult problems surrounding the estimate, and even the
depreciation, the "G.N.P." rather than the net national inco
to be used in policy formulations.

utlay taxes which have to be paid before the satisfactions can
realized. (Some market prices may be less than factor cost
ecause the government awards a subsidy; this makes no
fference in principle, the subsidy is merely a tax in reverse.)
ence the difference between the factor cost calculation and
e market price calculation consists of outlay taxes, less
arallel (outlay) subsidies.[1]

The market price calculation of the national income is thus
measure of the satisfaction which consumers derive at a given
t of prices; and as concerns us more directly in public finance,
hen a statistical calculation is made of the distribution of the
ational income among the different income groups in ac-
rdance with their share in it, the outlay taxes which are paid
a condition of this share have to be imputed as accurately
possible between the different income groups, in accordance
ith the outlay of their incomes between different types of
nsumption. In Chapter XVI we shall be examining the
sults of calculations of this nature.

The distinction between income and outlay taxes is thus of
eat economic and social interest; but it does not bring out
ite fully the distinction which we need for analytical pur-
oses. Let us recall a point which we reached in Chapter VII,
hen discussing the subject-matter of public finance. Just as
general economics there are some problems which can best
approached from the standpoint of the individual firm or
dustry (by means of a "partial equilibrium" analysis), and
hers which call for a general analysis of spending, saving and
vestment, the factors which determine the size of the national
come, so in tax analysis it is convenient to make a similar
stinction even at the stage when we are working out the
eration of particular taxes, and before we come to considera-
ns of the combined effect of public finance in the economy.

[1] It should be noted that subsidies can be divided on an exactly parallel
sis to taxes, into those which give better value for a particular sort of
tlay, by enabling consumers to purchase the product at less than factor
st, and those which provide a general subsidy to *income*, e.g. pensions,
ually called social transfers. For further discussion of this point see
apter XVI.

We can thus make an analytical distinction betw
taxes in which all or nearly all of the working out p
place in a particular corner of the economic field (
industries concerned with the manufacture and sale o
and tobacco), and *general* taxes which impin
on the phenomena which determine the size of th
income.

It should be emphasized that this analytical di
essentially one of convenience, not of logic. In
partial analysis is appropriate and sufficient for ne
lay taxes, while for income taxes it is completely in
but there may be some outlay taxes which are of
cending importance in the economy that they requi
analysis; or they may require one if we are interes
period problems when the operation of the tax will
beyond the confines of the markets first affected.[1]
form of analysis may conceivably be appropriate
tax under different social conditions. Thus it woul
perfectly logical for an economist of the early
century to apply a general analysis—such as Ric
have given—to a tax on bread, emphasizing its pro
in driving the worker below the margin of subsisten
to-day we should regard a tax on bread as not
different from a tax on tea, in which we should cert
concerned with changes in the size of the national

§ 2. Searching for the "Taxpayer". The proble
fication thus leads directly to the method of analy
past it has been customary to set out on the proces
the operation of a tax through the economic syste
starting point of the party who is in contact with
officials. For instance, in the case of a tax on sm
the tobacco manufacturer who pays the duty on
leaf as he withdraws it from bond; in the case of
purchase tax it is the wholesaler, since it is on this
productive process that the revenue authorities ha

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

ost convenient to pounce; in the case of an income tax,
wever, the process of analysis can only start with the tax-
yer, the owner of the income, since he alone is concerned.
Following this method of approach an elaborate theory of
ax shifting" has been built up.[1] To take a simple example,
would be necessary to say that the tobacco manufacturer
ifts the tax to the wholesaler, who shifts it to the retailer, and
ally to the smoker. The object of this analysis has been to
scover whether the price of the finished article is raised by as
uch—or more—or less than the amount of the tax. It
lects the view of the revenue official rather than of the econo-
st. It is certainly not the way the Chancellor of the
chequer looks at the matter, since he regards himself as
king smokers, nor is it the view of the smoker himself, since
fully realizes he will have to pay the tax as the price of his
dulgence.

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

Finally, it has sometimes been attempted by analogy to
velop a parallel theory of the shifting of income tax by
empting to trace changes in product prices which might be

[1] Cf. especially E. R. Seligman, *The Shifting and Incidence of Taxation.*

due to income tax payers trying to hand on the tax
know, it is only outlay taxes, and not income taxes,
included in the prices at which goods exchange on the
consequently the search must be vain. More than
fundamentally misconceived; the operation of inco
on the level of incomes, not on the level or prices.[2]

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

§ 3. Formal Incidence and Effective Incidence. Re
steps in our discussion, it will be seen that we are
in economics with two concepts of the falling of ta
payers, or as it is called, the incidence of taxes.
place there is the statistical calculation of the way in
revenue collected from any particular tax over a gi
(usually a year), namely, the difference between the
and the market price of the product on which the tax
is distributed between the citizens (for convenience
according to their income levels); or, alternatively,
portion of people's incomes which goes *not to*
incomes of those who furnish them with goods a
but is paid over to governing bodies to finance
satisfactions. The result of this calculation may be
Formal Incidence of the tax—or if we add up the
of the revenue from all taxes, of the tax struc
calculation of formal incidence is of great social

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

[2] This is not to deny that in certain circumstances—
regarded as exceptional—such for instance as a sellers'
complacent monetary policy, income tax may be "shifted"
raising their selling price to cover *estimated* liability to
or more plausibly by raising wages to compensate workers
personal income tax rates.

onnection with questions of the distribution—and redistri-
ution—of income; it is also of economic importance to the
overnment when planning the national output in order to
aintain a high level of economic activity, since it assists them
predict for instance whether the reaction to a given tax change
ill mainly take the form of a restriction of consumption or of
reduction in saving. These are questions which we shall
ave to discuss in Part III, especially in Chapter XVII.

Important as it is, however, the calculation of formal
cidence tells us nothing directly of the taxpayer's reaction
a change of tax, and its consequences; it is precisely with
ese questions that the second concept of incidence is con-
rned. In order to discover the full economic consequences
f a tax we have to draw and compare two pictures—one of the
conomic set-up (distribution of consumers' wants and incomes,
d allocation of factors), as it is with the tax in question in
peration; the other of a similar economic set-up, but without
te tax. It is convenient to call the difference between these two
ictures the *Effective Incidence* of the tax. It will be seen that
must often be a very complicated picture; and moreover, since
th situations cannot exist together, one of the pictures must be
ypothetical, established by reasoning and not by observation.
The establishment of effective incidence thus calls for a
stematic chain of reasoning, based on observation of such
ctors as demand, cost and marketing conditions (in the case
outlay taxes), and as the distribution of income and wealth,
e degree of industrialization and the typical size of the firm
the case of income taxes). Wherever possible the reasoning
ould naturally be supported by statistical evidence, but owing
the complication and interrelation of many of the factors
ncerned, statistical evidence can hardly be more than a
pport for the deductive process. It is only when this chain
reasoning has been carried through in respect of each
tegory of tax that we can be in a position to state which
kes are to be preferred, and which avoided, from the point
view of the criteria of policy.[1]

[1] For further discussion of these distinctions see Chapter XVI.

CHAPTER X

THE INCIDENCE OF PARTIAL OUTLAY TAXES

§ 1. Types of Outlay Taxes. If we were to take a [illegible] at the tax structures of the world, at any time we [illegible] everywhere a large number and considerable variety [illegible] taxes on outlay in force; if we took a look into [illegible] should find, if not a still larger number, at least [illegible] 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 [illegible] in primitive conditions where elaborate revenue machinery is out of the question; this is especially true if they are [illegible] on imported goods of a type which cannot be produced [illegible] More recently advantage has been taken of the fact that they yield revenue extremely quickly—it begins to flow [illegible] day the tax is imposed—to check inflationary pressure.

In spite of these conveniences, on the whole the [illegible] of outlay taxes relatively to income taxes is tending [illegible] for the reason that their income distribution is less [illegible] on modern standards; as we shall see later, [illegible] always more or less regressive measured against [illegible] Nevertheless outlay taxes are still a considerable [illegible] tax structures, and they have a not unimportant [illegible] in the combined fiscal planning of the future. [illegible] it is necessary to trace their effective incidence with [illegible] in spite of the complications into which the [illegible] inevitably lead us, complications which are only [illegible] to the varieties of tax which may be imposed, and [illegible] importantly to the differences in demand, cost and [illegible] conditions, which exist in the industries whose [illegible] convenient subjects for taxation.

In the first place it will be convenient to look briefly at the [illegible]fferent forms which outlay taxes may take. Partial outlay [illegible]xes may be imposed either on single-use goods (i.e., those [illegible]ed up in a single process of consumption or production) [illegible]d on services, or on durable-use (capital) goods, used either [illegible] consumption or production. They may be imposed on an [illegible]olated commodity (e.g., tea), on a group of closely related [illegible]mmodities or on a wide range, as in purchase tax. Taxes im-[illegible]sed on the use of capital goods may take several different [illegible]rms. They may be assessed on the value of the goods—[illegible]her on capital or on annual value—or alternatively they [illegible]ay take the form of an annual licence to use the goods—[illegible]her for any purpose of which they are capable (e.g., wireless [illegible]ences) or for a particular purpose (e.g., liquor licences for [illegible] sale of intoxicants).

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

Liability to a tax assessed on the use of particular goods [illegible]urally varies with the quantity of goods used; it may also [illegible]y with the quality of the goods, or with their price. When [illegible] rates of tax are expressed as proportions of the selling [illegible]ces of the goods, the tax is described as *ad valorem*; when [illegible]loes not so vary, but is expressed as so much per lb. or per [illegible]rel, it is known as *specific*. Specific taxes may, however, [illegible]graded with the quality of the product, as for instance British [illegible]tor vehicle duties used to vary with the size of the engine. [illegible]pecific taxes are much easier to administer than *ad valorem* [illegible]es, which may require a very expert revenue department if it [illegible] question of converting prices from the currency of another [illegible]ion. Owing to the endless possibilities of rate manipulation [illegible]ere this has to be done, *ad valorem* taxes are in favour as a

protective measure; indeed they are the cause of m
administrative friction which arises between nati
tariffs. Specific taxes are rather less productive o
than *ad valorem* taxes, and also tend to be rather mo
sive, but this disability can largely be eliminated by
of grading. It is worth noticing that when a gener
prices takes place, the real rates of specific taxes are
while those of *ad valorem* taxes are automatically adj
considerable part of the rise in the rates of British
between 1914 and 1931 can be regarded as a com
adjustment in specific taxes.

In the United States the typical partial outlay
valorem; in Britain the specific type has been
and is still the most usual. A very wide use is
grading, however. The new protective duties of the
period, both those introduced in the 1920's and th
came in with the big change of policy in 1931, are
the *ad valorem* method,[1] so also is the purchase
local rate, which brings in more revenue than any
tax, also belongs to the *ad valorem* group, althou
valuation practice does not lead to a very close corre
between rents and rateable value.

§ 2. The Incidence of Taxes under Perfect Competi

general sequence of the operation of a partial tax
is that first, the selling price of the product is in
the tax, this leads to a restriction of demand, so that
later production must also be cut down. In the co
on single-use commodities the analysis can usually
to following the ramifications of this process; in
taxes on capital goods, however, there is an additi
of events to consider, due to the fact that capital
immediately be adjusted to a change in the rate of
present chapter we may avoid this complication by
our attention to taxes on single-use goods.

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

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.

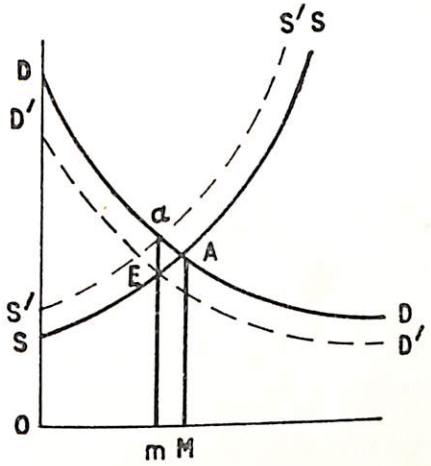


FIG. 1.

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 Ea 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

[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. 151.

reduced from OM to O*m*, and the price raised from MA
The analysis can be applied in reverse (by lowering the
curve or raising the demand curve) to fit the case of a s

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

As between margins of spending and saving, the re
depend, to an important extent, on the distribution
consumption of the taxed (or subsidized) product bet
different income levels. When most of the consumptio
from the lower income groups, which is normally
since they comprise most of the population, the reac
will largely take place at the expense of consumption
an important part of the demand comes from the w
the tax may be paid out of saving to some extent.

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

The real objection to such taxes "on production in

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 "co
of the optional nature of outlay taxes is an illus
illegitimate to compare the "inconvenience" to th
of a tax which he does not have to pay with the inco
of one which he cannot get out of. The correct co
is between the relative damage to consumers and pro
the sense of their loss of satisfaction, consequent on

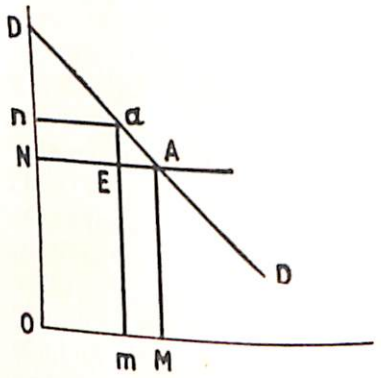


FIG. 2.

given revenue by
methods. If we make
parison we shall find
eighteenth century
may be quite misleadi
In order to conc
the essential factors,
with a situation in
are constant (Fig. 2),
ing our previous ass
of perfect competi
absence of closely re
ducts or factors.
tax is imposed an
of the commodity is consumed, at price MA.
of amount E*a* is imposed, it will bring in a reve
but there will be a loss of consumers' surplus eq
triangle *a*AE,[1] in the sense that if the governme
compensate taxpayers for their loss of satisfaction
revenue, there would not be enough to go round.

There is thus an initial grave objection to partic
outlay on welfare grounds, in that they cause a net
between taxpayers' loss and revenue's gain, a flagra
of Adam Smith's principle of "economy" correctly
There is thus, on welfare grounds alone (e.g.,

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

istributional questions), an *a priori* case against partial outlay
xes. Marshall and Edgeworth would have regarded this as a
ase *for* income taxes, but we shall see later that this argument
less convincing when the rate of income tax is high.

Clearly some outlay taxes will cause a greater loss of surplus
an others; we must therefore investigate more closely on
hat the loss of surplus depends. If we assume that the
iangle *a*AE is rectilinear (as is reasonable for a small tax),
ne loss of surplus—the area of the triangle—is equal to half the
eduction in the amount consumed, multiplied by the tax per
nit of commodity; while the revenue collected is equal to the
ate of tax multiplied by the amount spent on the commodity,
ost-tax. We can see further that the loss of surplus will vary
elatively to the revenue collected—in the same proportion as
alf the change in amount consumed bears to the total con-
mption after tax:

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

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

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

ence, 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
should be possible to estimate the magnitudes concerned
ith a fair degree of statistical accuracy. In practice, however,
e situation will often be complicated by the fact that marginal
osts are not constant; and we have therefore also to take
count of the elasticity of the supply curve, and of the loss of
roducers' surplus (e.g., the amount which would be needed
compensate the owners of the factors of production

employed in this industry for loss of earnings, if the ... were to be cut down, and they were forced to tra... where). In this case (cf. Fig. 3 where rising marginal ... shown), the loss of surplus (aAE) is:

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

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

From this analysis it follows that for a given rev... loss of surplus will b... the larger is the elas... either demand or su... either is completely ... the loss of surplus fal... and there is no tend... substitute any other ... the taxed commodity, ... lay tax becomes equi... a lump sum taken ... taxpayer or an inc... which has no effect ... willingness to work ... ordinary circumstanc... ever, there will be so... surplus. This loss will also vary (this time inversely) ... amount spent on the article, i.e., its importance in con... For to raise a given revenue from an "unimportant" ... dity, very high rates of tax may be required; with any ... elasticity of demand or supply the loss of surplus will ... From this analysis it follows further that if any ... commodity can be found whose supply or demand is co... inelastic, it will minimize loss of surpluses to raise ... much as possible, of the revenue by means of it.[1] A... either of the elasticities is very low, although not a...

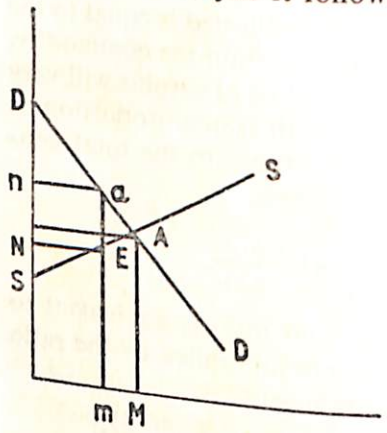


FIG. 3.

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

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.[1]

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 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.

[1] 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. 182.

If the monopolist is maximizing his profits (as we
pose) he must be making marginal revenue equal to
cost. Hence any tax which increases the cost which
incur in order to put the marginal unit on the
cause him to reduce his output and raise his price.
the short period this is equally true of a tax which
overheads and of one which falls on his running co
extent to which consumers will suffer depends on
polist's ability to increase his selling price without
total profits on the one hand, or attracting rivals and
ing his monopoly power on the other. A great
results is possible, due both to the monopolist's
power of manipulating his costs, and to his con
market. As Edgeworth pointed out many years
the drawbacks to taxing a monopoly is the uncert
surrounds the result.

If we assume that the demand curve facing the
is a straight line, and that the marginal costs of the
are constant, it is clear from general monopoly the
price of the taxed commodity will be raised by *half*
of the tax, whereas under competitive conditions
raised by the whole amount of the tax.[2] There see
particular reason, however, to assume a demand
this nature. If there is some concavity in the dem
price will be raised by an amount greater than
concavity is such that the marginal revenue curv
demand curve are parallel over the relevant range,
price will be equal to the tax, as in competitive con

If, however, we assume that the demand curve is
concave but of constant elasticity (which, at least

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

[2] The situation can easily be visualized by interpreting the
cost curves in Fig. 2 as belonging to a monopolistic condi
paring the result with the analysis accompanying Fig. 2,
analysis cf. J. Robinson, *The Economics of Imperfect Compe*

hanges, would seem to be quite as probable as a straight line
emand curve with constant slope), we get a much more
erious result. The ratio between price and marginal cost will
en be constant; since marginal revenue is necessarily less
an price, this must mean that the slope of the marginal
evenue curve is *less* than the slope of the demand curve, so
hat the price will rise by more than the tax—as is indeed
therwise evident, for price is now equal to marginal cost
excluding or including tax) plus a fixed percentage; after the
ax is imposed, the percentage is reckoned on a larger base
gure. This hypothesis[1] seems to be consistent with observed
onduct of producers; it is just such an addition of a fixed per-
entage to profits at each productional stage, to cover the tax,
hich leads to the phenomenon of "pyramiding" of taxes
ssessed on the early stages of the production process.

The economic importance of the monopoly analysis, how-
ver, does not depend on the existence of a few isolated
onopolists who may be able to exert pressure on the com-
unity for limited periods, but on the vast intermediate field
etween the pure competition and the pure monopoly of the
extbooks. An important extension of the competitive
nalysis which we made above (cf. Fig. 3) shows that taxation
f a monopolized[2] industry, when it leads to further restriction
f an already restricted output, is more damaging to the
ommunity than taxation of industries where competition
revails.

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

[1] For some unexplained reason Mrs. Robinson in the passage quoted
bove 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
situation of "imperfect competition" (in the sense that there is free entry
nto the industry, and changes in output are brought about by changes
n the number of firms), although the price is greater than the marginal
ost of the firm, it is the average cost of the firm which is the effective
narginal cost of the industry, and this is not less than the price.

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

When we are considering a situation in which many elements are present we have to be on the look-out possibility of pro factor relationship, which is usually ne in conditions of pure tion. This circumst have an extremely bearing on the ques optimum allocation between different in The fundamental of monopoly is that factors to be employ a way that the soc

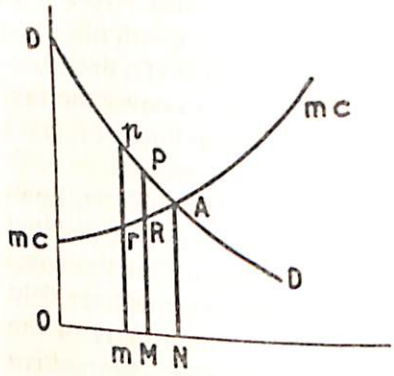


FIG. 4.

is less than it might be. Instead of factors being in such a manner that in every use the value of the unit of output is just equal to its cost, under mo selling price of the product exceeds the cost of the the industry, by a more or less considerable amount tension of output in the industry might well result in of this gap, and a consequent increase in the social but such an expansion will not take place as the economic forces alone, because (owing to the sloping demand curve), with every unit sold, profit Public action which tends to close the gap by bringing an expansion of output will usually thus be a social ment.

The fact that the reorganization of industry in this would increase the social output indicates that the so

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 ent) 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
petition. If in any industry there is a gap between
and marginal cost, an extension of output in that
usually be a social improvement[1]; but unless the
rest of the economic system is working under
that price equals marginal cost, there may be a
between the private and true social costs of the
consideration, so that action should not be taken
its output until the true social cost curve has been
so that the correct target for the expansion can be

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

[1] The social cost curve of an industry which it is desired
contract may also have to be adjusted to allow for externa
Thus an expansion in one industry may lead to an expansion
mentary industries, which were such that in them price
excess of marginal cost. In this case the social cost
lower than the private cost curve of the industry in
case of "Marshallian" external economies, depending on the
monopoly elements somewhere in the system, although the
consideration may be working in conditions of perfect
External economies which depend on effects falling outside
accounting system of the firm (cf. p. 109) may occur in
universal perfect competition; an appropriate adjustment
cost curve of the industry under consideration must also be
are present.

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 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 solation; new taxes should also be considered in relation to hose already in existence. A policy of industrial reorganzation 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.

Fortunately we can continue to apply the rule that we have established in this case also. The tax which will cause least disturbance to consumption and production is that which from the taxpayer's point of view is as nearly as possible similar to a lump sum to be taken from him. Where a group of commodities is being taxed this implies that the rates of tax should be so adjusted that consumption is cut down by the same proportion for each commodity. It is probable, however, that some members of the group of commodities which it is proposed to tax are related to each other, either in consumption or in production, it may be as substitutes for each other or as complements (a rise in the price of one reducing the demand for the other). In this case we have to take into consideration not only the elasticity (of demand or supply) of any good taken in isolation, but also its "cross" elasticity in relation to its close substitutes or complements. If the goods are very closely

related the cross elasticity between them may be m
tant than the straight elasticity of either considered i

If a group of products or factors are related in s
that a tax of the same rate raises the price of all th
of the group by the same proportion (as might app
be the case with an *ad valorem* tax on products prod
conditions of perfect competition), the group can be
an economic unit from the fiscal point of view.
that if we can find such a group of products or fac
the elasticity (either of supply or demand) for the
whole is very low, it will not merely do no harm to
taxed field to cover the whole group; it will actual
the loss of surpluses if as much of the revenue as
raised from the group. This consideration shou
tially widen the field in which partial outlay taxes c
acceptable on welfare grounds.

Further, our equations on pp. 147–48 have show
a given elasticity of demand, the loss of surplus d
the amount spent on the commodity increases.
is an *a priori* probability that the extension of a ta
member of a group to another will decrease the loss
as compared with a policy of raising the same reven
taxation of the single commodity. This may well be
if the members of the group are not so closely relate
can be considered as a unit; it all depends on th
between the elasticity of demand for the group
elasticity of demand for the single product.

If the article originally taxed has an elasticity nea
one of the group has a positive elasticity, then the
demand for the group as a whole will be positive
extension of the tax field would be a mistake. O
hand if we have two commodities which are *close*
in the sense that a fall in the price of either sets up
adjustments which are more at the expense of the
than of other things in general, the elasticity of
the group of two *must* be less than for either
separately, so that the extension of the tax to cov

e a benefit. This will be true by a fairly large margin even if
ne relation between the two commodities is rather looser than
e have been supposing.

This analysis holds good wherever the industries concerned
re working under conditions of competition[1]—either perfect
r imperfect—where consequently there is no substantial gap
etween price and marginal cost for the industry as a whole.
, however, conditions of monopoly (including oligopoly)
revail, we have to remember that there is a pre-tax loss of
rplus (the consumers of the commodity are in a sense already
xed), so that the post-tax loss of surplus will increase at a
ster rate. There is thus an *a priori* case against either
tending the tax field to cover a commodity produced under
nditions of monopoly, or to raising the rate of an existing
x on a monopoly. Consequently, the other arguments in
vour of the change would have to be very strong in order
r it to be desirable.

7. International Complications. So far we have ignored the
ssibility that taxes may be imposed on goods imported from
road, and that exports may be restrained by taxes or en-
uraged by subsidies. We must clearly take some account
re of these possibilities, since it is on single-use goods that
ch taxes and subsidies mainly fall. Nevertheless, although
e questions raised by international fiscal measures are of
ormous importance, there is not a great deal that needs to be
id about them at this stage of our analysis, for two reasons.
In the first place fiscal policy is only one of the means

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

available for carrying international policy into e
agreements between governments, and internation
and exchange policy, have to be considered alongsi
discuss fiscal policy in isolation is not usually satisf
the second place taxes on imports can rarely be
apart from the fiscal policy of which they form a p
when they are of the Victorian "revenue only" ty
though an import duty may initially have the limi
protecting only a small range of home industry (e.g
of the development of an "infant industry", or of
mentary with established industries), it is notorious
for governments to resist the extension of protectio
import duties tend to be considered as part of a
as indeed the word "tariff" implies.

British experience in the inter-war period is a go
of the typical sequence of events.[1] Starting at the
of the period with a limited range of "key ind
"McKenna" duties, which owed their origin to war
protection spread in various directions in the midd
(under Mr. Churchill), and finally became a "syst
(under Mr. Chamberlain). The discussion of tari
belongs to the field of the combined effects of pu
on the economy, rather than to the analysis of part
of raising revenue with which we are concerned in
our investigations.

Outlay taxes on internationally traded goods
margins of consumption and production, and of s
exactly analogous manner to internal taxes of the
We have as usual to take account of the degree of
in the industries concerned, and to be on the look-o
or product relation. The operation of an interna
however, differs in some respects from that of
duty.

In the first place some of the productional mar
are affected by the tax will be abroad, beyond th

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

e control of the country imposing the tax, and of whatever
enefits its public finance policy may bring about. In one
ense this implies that only a part of the loss of surplus con-
equent on the tax falls on nationals; but, on the other hand,
specially in the long period, the taxing country may injure
self by damaging its customers abroad.

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

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

What the effects of any particular tax or subsidy will be on
he terms of trade and on the balance of payments depends on
he relative cost and demand conditions in the countries
oncerned. Generally speaking, a tax on imports improves
he terms of trade and strengthens the balance of payments; a
ax on exports improves the terms of trade while a subsidy on
xports will tend to weaken them, but may strengthen the
alance of payments. All of these effects may be neutralized
r reversed if the taxes or subsidies provoke retaliation.

The classical British case for free trade was tacitly founded
n two arguments, first on the universal truth that under

conditions of perfect competition and full employ
international tax or subsidy would hinder the
allocation of resources between nations and regi
secondly, on the purely local argument that as Brit
duties must inevitably mainly fall on goods of wor
consumption, or on raw materials (since these bet
accounted for most of our imports), import duties
increase the cost of British manufacture relatively
other countries, either by increasing the cost of raw
or by forcing producers to raise wages.

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

In the world of to-day the conditions under which
would automatically secure an optimum distribu
resources no longer fully hold; it is often only to
that the international allocation of resources has alre
distorted by monopoly elements or political action
other hand, under modern conditions, there are so
in which a country can benefit itself by imposing imp
above all when there is unemployment at home, and
these will necessarily lead to a contraction of world
It is possible for instance that some import duties

[1] For a discussion of the use of import duties in developing
see below p. 302.

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 GOOD

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

More rarely partial taxes are levied on income
derived from a particular type of property (as from
diamond mines in South Africa). Partial income
sort are naturally classed by administrators as direct
would not normally be among the taxes whose rev
to make up the difference between the "factor cost"
"market price" calculations of the national income.
less their effective incidence is that of outlay taxes
of income taxes.

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

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

From the point of view of incidence the use of these taxes
or local purposes adds an additional complication. Local
axes are inevitably levied at different rates in different districts;
that the possibility of evasion of high rates of tax by removal
a lower taxed area is always open to the taxpayer; this
nds to enhance already existing disparities of local tax levels,
nd may have far-reaching effects on the distribution of pro-
uctive resources.

The general operation of taxes on durable-use goods is
milar to that of other partial taxes. A rise in tax causes an
crease in market price, this leads to a fall in demand, and
ter to a readjustment of supply, and a tendency for factors
transfer to other occupations; conversely a fall in tax

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

causes an expansion of demand and a consequent
factors. Owing, however, to the durable nature
erty, and partly also to the length of time req
production of new units of output, the effect of
on supply takes some little time to become
tax-induced change in the annual rate of con
demolition of buildings, for instance, makes
difference to the total buildings in existence;
in analysing the early stages of the operational
supply may be taken for all intents and purposes

When a tax is imposed on a single-use good
adjustment is on income account; indirectly the
of the equipment used in the production of the taxed
fall as a result of the tax, but how great the
depends on a number of factors—apart from
demand—on the life of the plant, for instance,
extent to which it is specific to the taxed line of
Per £ of revenue collected, the effect on the capital
particular type of capital instrument will prob
very large.

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

A further complication arises from the fact that
being consumed by their owners, goods of long
hired out for use by others, either in produc

consumption (in either case from the point of the owner they
re then employed in the productive process). A single piece
of property of long life, such as a house, may be subject to a
uccession of leases during its lifetime, and alternatively it may
e subject to several different kinds of leases at the same time.
There may be thus a large number of people whose position
s directly affected by the tax change, although they may not
ll feel the effect simultaneously—for instance, a rise in local
ates cannot be of any immediate interest to the holder of a
99 years ground lease in the early years of its currency.

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

The possibility that a property tax may be assessed on
omeone other than the owner is obviously an additional
omplication which may or may not be present, so that it will
e convenient to discuss this part of the operation before we
ome to the more general analysis of property taxes. In
rder to simplify the analysis we may confine our attention in
he first instance to a tax on property used for consumption
such as the British local rate on dwellings),[1] and further we

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

may assume for the present that the supply of hous
—as it must be in any case in the short period.

§ 2. Local Rates and the Adjustment of Net Rents

moment of the change in tax it is clear that the
Scotland the landlord and tenant jointly) must bear
of any rise in rates; equally, after a fall in rates
will not be able to alter a rent contract unfavour
tenant during the currency of the lease; but after
the question arises whether tenants with their sm
and smaller reserves are in a position to force landlo
rents after a rise in rates, or to withstand a rise in
rates have fallen.

It is obvious that landlords are normally in
financial position than their tenants, and, further,
given hostages to fortune by the fact that they are fi
houses. They will have to incur heavy costs—in
convenience—if they choose to move out. There
circumstances in particular (as we shall see) in wh
will be extremely loth to make a move, and will
put up with a considerable rise in gross rents (rents
before doing so. The superior strength of landlord
however, necessarily put them in a position to exa
polistic pressure; there are normally few houses
unique that appropriate alternatives cannot be
Families do not generally intend to remain indefi
same house; family circumstances and incomes
time goes on, and in fact it appears that most
move fairly frequently.[1] In London it was said
average the whole population used to move every
The position becomes clear if we reflect that a
is for the ratepayer equivalent to a fall in real inco
ments for house accommodation are now larger in
his money income than he would wish; he will want

[1] Where there is a large amount of rent control in the econ
there is a wide difference between controlled rents and
market rents mobility may be seriously impeded.

is budgetary equilibrium as soon as opportunity offers, either
y obtaining a reduction in the net rent, or by moving into
naller quarters. Thus when rates have been rising, tenants
king out new leases will insist on lower (net) rents. There
no reason to suppose that landlords will be able to find
milar tenants who will be satisfied with the old rent, since the
pending power of all tenants will have been reduced. Hence
ndlords will have to acquiesce in a fall in rents.

The rent adjustment need not necessarily take the form of a
irect money concession; an equivalent effect may be obtained
y an alteration in the amount or quality of the repairs and
ther services performed by the landlord.[1] It is important
notice also that the change in tax does not affect all property
qually. After a rise in rates a landlord may not be able to
nd a similar tenant at the old rent, but he may succeed in
nding a tenant with a larger income who previously lived in a
igger house. Thus a rise in rates will affect large houses more
an small. The rents of small houses may still tend to fall,
spite of the movement of demand in their favour, because
ousing expenditure can also be reduced by taking in lodgers.
A change in rates will also tend to affect old and new prop-
ty differently. Normally new houses are preferred to old,
that a change to new houses would be stimulated by a fall
rates, and *vice versa* for a rise. In Britain during the inter-
ar period this tendency was largely offset by the fact that the
ew houses were cheaper to run (and easier to manage without
ervants), and further that they were often relatively under-
alued for rating purposes[2]; but in principle a fall in rates
ould stimulate the demand for new houses relatively to old.
The extent to which the net rents of houses (or more broadly
he conditions of letting) will be adjusted after a change in tax
ffers according to the type of district where the change takes
lace. The adjustment of net rents which tenants as a body
re able to extract from landlords as a body may be greater

[1] A change in this respect may follow immediately on the change in
tes 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*.

than the rise in rates (in declining districts it is likely
or it may be the same or it may be less. In expanding
rents may continue to rise in spite of the rise in
amount of the change in rent is no criterion of the
which landlords are being forced to share the
after a rise in rates. The only measure of this is the
between net rents[1] as they become after the rise,
would have become if there had been no rise in
if there is no difference between these two can we
tenant has been forced to bear the whole costs of
A declining area is one from which populati
moving, consequently at any moment there will be a
families who value the costs of removal lightly.
it in mind that they will move shortly in any case,
provocation will tempt them to accelerate the
sequently, landlords will be in a weak position
reduction in rents. In an expanding area on the
alternative accommodation is hard to come by,
will be abnormally reluctant to leave the houses
These local differences in tenants' and landlords
are intensified by the fact that the rate is a local
in amount from place to place. Declining areas
high rates, and the high rates provide an incentive
leave, and thus hasten the decline. Expanding areas
low rates, and although the cost of providing public
new housing estates is initially heavy, it is normally
within a short period by the increase in rateable
There is thus an important local difference in the
which, after a rise in rates, readjustment can be
landlords by tenants. In declining areas a great
be, in expanding areas probably very little. Thus
in expanding areas rents will be a little lower than
otherwise have been, but probably not very mu
declining areas rents will be low, not only because
prospects of the district make it unattractive, but
high rates are continually forcing them down.

[1] Or more strictly, net letting conditions.

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

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

Property owners are affected by a change in tax, not merely
respect of the rents they can obtain, but also, and perhaps
ore importantly, by the adjustment of capital values[1] to the
w situation. A rise in rates will cause an immediate fall in

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

the value of house property relative to other form
ment; it is as if an additional ground rent had be
on the property (and *vice versa* for a fall in rates).
a rise in rates, investment in houses becomes re
attractive until equilibrium is restored—usually
in the demand for house room relatively to the
declining areas this point may be almost indefinitely

Home owners are thus doubly penalized by a
Not only must they bear the whole cost of read
income account for so long as they own the hou
value of their property is also diminished. Whe
to sell the house its value will be less than it would
otherwise because of the discounted value of add
expected rates. Once again the actual change in
be more, or less, or exactly the same, as the pres
the future rate charge, according to the type
Conversely home owners gain doubly from a
rates—on income account as occupiers, and on cap
as owners.

§ 3. Local Rates and the Volume of Building. So
concentrated on the operation of the tax in the p
it becomes possible for the supply of houses to
so that the values (and rents) of existing houses
only by the change in the tax and not by alter
number of houses as a result of the tax. A
stimulates new building because it raises the net
are prepared to pay for houses (to live in themse
to others). Houses which before it would not
profitable to build now become profitable. Fo
the same reason, a fall in rates stimulates repair
houses.

As the new houses are built, they add to the supp
and their competition brings rents down. Thus
phase there may be some tendency for landlord
from a fall in rates, in the following phase (logically
temporarily successive, since both may proceed sim

he advantage is transferred back to tenants. In the same way,
art of the advantage got by home owners from a fall in rates
ill be lost to them when the increased pace of building
iminishes the value of their property.

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

Consideration of reactions through new building therefore
einforces the conclusions already reached. In a declining
rea where for other reasons the effective incidence is more
kely to be shifted on to landlords, there will in any case be
ttle new building for private profit. Changes in rates can
herefore have little effect on new building, and the conclusion
nat the effective incidence will be mainly on the landlord
:ands.

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

The local rate—or any similar tax on real estate—is thus
om one point of view a tax on building, and a reduction in
ne tax will have the effect of a sort of housing subsidy. If the
im of policy is to get new houses built, however, a subsidy
aid only on them is much more effective and more economical
revenue than a reduction in rates (brought about, for
stance, by the transfer of some rate-borne services to central
nds). The greater part of a reduction in rates must go to
enefit directly the tenants (or landlords) of old houses; the

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stimulus to new building is confined to the opport
to builders of new houses to get a share in these be

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

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

For the producer the rates which he has to pay
head. In the short run they will probably be
profits (at least this would be the economically
cedure); but in the longer period rates are one of
must be covered in selling price. The producer ha
natives of charging additional rates into price, or of
his energies elsewhere. Which course he follows
on similar considerations to those which determine
when confronted with a new tax on a single

onsiderations of relative elasticities of supply and demand, the
egree of monopoly and the ease with which specialized factors
ncluding his own abilities) can be transferred.

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

4. Other Property Taxes. In so far as franchise taxes are
nposed on the letting value of property their operation is
actly similar to that of the taxes on real estate we have
ready considered, except for the fact that the main effects
e localized in the particular part of the economic field
ncerned. Demand, and hence production in that line, will
e restricted in the event of a new tax, and stimulated in the
ent of a tax reduction, analogously to a change of tax on a
ngle-use good. There is, however, the possibility that
ability to franchise taxes may be based on an estimate of

profits (deduced from past receipts); in this case the
of the tax will approximate to that of a selective
on property; if the tax is not expected to be
current rates there will be some attempt to adjust
of profits over time, so as to minimize the total
have to be paid.

The incidence of taxes on less durable goods
"licence" duties on motor vehicles) differs
corresponding taxes on real estate by the smaller
effect of changes in capital values. Thus the
tax on private pleasure cars corresponds to the
on home owners; there is an analogous tendency
tax to cause a shift in demand from bigger or
smaller cars, and for a reduction in tax to stimulate
for expensive cars. The precise formula
liability is assessed is of very great importance in
since manufacturers will naturally adjust their
maximize the net attractiveness (satisfaction in
prospective purchasers. Similarly, the operation
duties on buses and taxis follows that of
leased property—the lease being considered as
short contracts rather than a single durable one;
the operation of licences on such vehicles as lorries
vans is analogous to that of buildings owned
production, but in every case without
respect of capital effect.

Before we leave the incidence of taxes imposed
capital goods themselves there is one further point
As we have seen, the British local rate is assessed
to rents, that is to say it is based on *annual* value.
other countries the corresponding tax is based on
price of the property, that is on the *capital* value.
fundamental distinction of principle here, although
the difference it makes either to valuation or to
often not very great. Annual values take the
and have no thought for the values of tomorrow;
however, take into account not merely the

property commands but also the market's expectation of
future rents which can be foreseen from the expected develop-
ment of the property or the neighbourhood, allowing of course
for the probability that these expectations may not be realized
for some time and so must be discounted accordingly.

Where properties are not normally rented it is obviously
inevitable that the tax base should be capital and not annual
value. In a developing country this is a positive advantage
since the expectation of increasing value is probably consider-
able and should by all means be included in the tax. Generally
speaking, however, capital values are more difficult to assess
correctly than annual values; property which has recently
been sold may easily not be a good guide for the true present
value of other properties in the neighbourhood. For this
reason an element of judgment enters into the valuation which
is absent from annual valuation, at least where there is no
widespread rent control, and this leads to uncertainty and loss
of objectiveness.

A variant of the capital value base is what is known as the
taxation of site values. This method seeks to base the tax on
the capital value of the site alone, either ignoring the buildings
or other improvements which have been made upon it, or
attempting to value them separately and tax them at a lower
rate. Two possible purposes may be sought by site value
taxation. In the first place since liability to tax will not be
affected by the character of any building which is put upon it,
there is no fiscal deterrent to putting up the type of building
which holds out the biggest prospect of return; this may or
may not be a larger building than if the tax had included the
building, but there is some *a priori* likelihood that it will be
better or larger than if it had been subject to tax also.
Secondly, site value taxation (supposing the valuation is carried
out correctly) will secure for the revenue the increment of value
of the site due to the expansion of the neighbourhood, an
increment which is, so far as the individual property holder is
concerned, "unearned". Site value taxation is thus based on
the theory of "economic rent" or surplus, which accrues to the

owner of a factor (such as land) of which the total
fixed, as the demand expands for the products which
in question helps to produce. The virtue of such a
it has no adverse effect on productivity, so long as
assessed on true economic surplus.

This increment of value will also be secured by
valuation based on the full capital value of site and
but since the results of the owner's enterprise are the
included in the tax it will not be without production

The difficulty about site value taxation lies on
the actual valuation. Only vacant sites are sold
even then improvements are often incorporated in
all other cases it is the unit of site and improvem
comes on the market and consequently it is only in
this that market evidence is available. Once a b
been erected on a site there is no objective means of
the respective contribution of site and building to
the whole; even if they can be logically disentang
is by no means certain. There is thus a chronic
market evidence on which site valuations can be ba
implies an element of arbitrariness in the valuation
above that which as we have seen is encountered
capital valuations. In respect of these last the va
is merely to interpret the judgment of the market;
he is assessing the value of a built-up site a much gr
of the imagination is required, and appeal from his
is virtually impossible.

In site valuation not only must the valuer foresee
development but he must postulate when it is like
place; an error in this can make a substantial di
the present discounted value of the site. If the er
of over-optimism on the part of the valuer, much
may be inflicted on the taxpayer who is effectively
income which he has no means of earning. In
seems that those countries which have been most
with site valuation taxation (New Zealand and Den
tended to set their valuations with a very generous

but by this means of course the revenue potential may be seriously reduced, over and above the reduction due to the narrowing of the tax base by the omission of the improvements.

In view of the difficulties of site value taxation and of their pressing needs for revenue, developing countries will probably be well advised to content themselves with taxing expected development values within full capital valuations. If it is desired to encourage particular types of development this can be arranged through reduced rates of rebates.[1]

If it is attempted to change over to a site value tax in a country which is already developed and where the population is more or less stationary, the costs and difficulties of valuation on the one side, and the windfall gains which will accrue to the owners of large and expensive buildings on the other, will probably be found to outweigh the productional advantages which would accrue, especially as these would only fully accrue if the tax is assessed on true economic rent alone. If the new tax were in substitution for a tax on the value of the complete unit, whether annual or capital, there would also be a substantial loss of revenue to be faced, which it would be difficult to make up in such a country through the inclusion of expected development values. 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 such a tax in Britain is that "there is no money in it".[2]

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".[3] If it can be taxed, the tax has a double virtue. First, it secures for

[1] Cf. J. R. & U. K. Hicks, *Taxation and Finance in Jamaica.*
[2] Cf. Edgeworth, *Collected Papers*, Vol II, Sections U and V.
[3] Cf. p. 130.

the community the increase in the value of the prope
is due to the expansion of the local community and
exertions of the owner; and secondly, since the incre
value is "unearned" by the owner, the tax can have
tive effect on enterprise. In order to obtain this result
it is necessary to estimate the value of the site in its
"unimproved" state (as originally provided by nature
tax only the increment in value due to community

In new countries where it has been possible to
selling value basis for undeveloped sites, and where
ment has been taking place rapidly, considerable use
made of taxes of this nature.

CHAPTER XII

GENERAL TAXES ON NET INCOME AND PROFITS

§ 1. The Welfare Effects of Income and 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 the income stream from casual capital receipts is not usually a difficult one; there are, however,

[1] Probably from the economic point of view the best definition of income is the sum which the owner can consume in any period without diminishing his total wealth (capital), cf. J. R. Hicks, *Value and Capital*, p. 172. In many circumstances this would include some capital gains. As we shall see later (p. 216 below) there are great administrative and technical difficulties in working an effective and equitable general tax on capital gains, with adequate compensation for losses. On the other hand the effective taxation of total capital (including gains made during lifetime) by means of inheritance taxes is both simple and equitable.

always a few borderline cases which may give tr
instance, where income is normally derived from
capital transactions (as the income of the stock-jo
such a case as this it is perfectly correct to tax capi
income. Difficulties of another type arise because
times within the power of taxpayers to substitute
for income (e.g., by arranging to receive bonus
butions in lieu of dividends, from firms in which
controlling interest). Such capital gains are truly
should be subject to income tax, but it is not alw
detect them, and much of the evasion of surtax
place is probably of this nature. This type of
cannot suitably be guarded against by the extension
tax to cover capital gains in general[1]; but means
particular methods of substituting capital gains for
usually be found, within the framework of the inc
a diligent revenue department.

The process of determining the costs to be
reducing gross income to net gives rise to m
difficulties. In practice "personal" costs are de
revenue authorities in a quite conventional manner,
they include a limited allowance for occupational
costs (such as tools supplied by the workman, li
premiums and mortgage interest on a dwelling h
they exclude the cost of acquiring a professional
The costs to be allowed to a business firm for the
section of British income tax are also settled in a co
manner; those acceptable to the revenue authori
necessarily those which an accountant or an econo
consider appropriate, and this may make a given
more onerous than it need be. This is an import
which we shall have to return later.

The most serious technical difficulties in assess
tax probably arise in distinguishing between co
and personal income in the case of the small
indifferent accounting methods often used by such

[1] Cf. pp. 216ff.

cause their owners in many countries to escape a not in-
considerable 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 account-
ing. 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

[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.

with the effects of the disbursement of revenue. We ... that the expenditure out of the revenue from an ... tax can only be isolated for separate discussion in ... an earmarked tax, so that the whole question of the ... of revenue must await the general discussion of pub... in the economy. Nevertheless, our analysis must now ... general in the sense that we can no longer confine our ... to changes in particular markets, but must discuss ... of taxation on the general phenomena of consump... investment, the factors which determine the size of the ... income.

The classical (or rather Victorian) case in favour ... taxes as compared with outlay taxes (see p. 147) ... assumed that when the taxpayer is confronted with ... of paying a certain revenue by a particular partial ... by a general income tax, his initial liability in both ... is zero. In these conditions it is right to assume that ... prefer an income tax. In the first place by this alone ... distribution of outlay will not be disturbed. Secondly ... the rate of income tax[1] to bring in the same re... almost certainly be lower than the rate of the ou... will have less effect upon him. It is unlikely indeed ... be conscious of any shift in his relative preference for ... leisure as a result of paying the income tax, and so ... sustain no loss of surplus.

The conclusion that an income tax entails no loss ... rests fundamentally on a neglect of the costs of ac... income—the wear and tear to the individual, and the ... disutility of work—so that it is only strictly true of ... income from work so long as the rates of tax are ... and more particularly when the taxpayer has no ... of varying his income by varying his effort. In this ... are no substitution effects and the income tax appro... a "lump sum" tax which we have seen to be "ideal" ... productional point of view. Nevertheless, in ma... stances it is true that there will be a gain in satisfa...

[1] On account of its "importance", see p. 148.

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 the lower income groups to spend more, while not seriously preventing the higher income groups from spending as much as before. The opposite of this is of course that high and progressive income taxes tend to check saving, both by seriously curtailing the incomes of large savers and by taxing the large spenders less heavily. In order to appreciate the dangers in each 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 £2,000, assessed at rates that increase fairly rapidly on successive increments of income. Administratively British income tax is thus effectively three separate

[1] Apart from complications concerned with "reduced rates", and with reliefs" or "allowances", see pp. 185, 186, 188ff.

taxes, but economically it consists of two taxes on
gressive personal income tax, with a low exemption
a proportional tax on business. The first two of
administrative elements are the direct descendan
original income tax; the third is the successor to th
of the Liberal government of 1910, when, however, th
tion limit was £5,000.

Liability to the two personal elements of the tax
coming within the surtax range is determined at one
on the basis of a return of total income made by the
soon after the beginning of each financial year; but the
tion of income tax and surtax takes place in two op
surtax being due a year in retard of income tax. On
hand a large part of the personal and impersonal re
income tax (as distinct from surtax) is collected to
very simple device. The total profits of firms are ta
standard rate, and dividends are then distributed
holders net of this amount of tax.

This "deduction at source" constitutes a first app
to discharge of liability to the personal tax; each
position is subsequently adjusted, with reference to
income and the reliefs to which he is entitled, by m
additional payment or a refund, according as his
of tax is below or above the standard rate. This
collection is an important safeguard against evasi
the taxpayer failing to return the whole of his in
property; if the standard rate is fairly high it also
a large part of the revenue is collected in this pain
with a very brief time lag.

British income tax has always attempted to take
the taxpayer's ability to pay, not merely in respect of
but of his needs also. Some small allowances w
a feature of Pitt's income tax, and the necessity o
return of total income in order to claim them was
used as a method of reconciling the taxpayer to di

[1] Three if the taxpayer is also taxed currently under P.A.Y.E.
pp. 189ff.

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 and other dependants, in addition to a "personal" allowance for the taxpayer and his wife. Further, a percentage allowance, up to a certain maximum amount, is given on income from work, thus constituting a discrimination against rentiers; this form of allowance has also been extended as an "age relief" to old-age pensioners in the lower income tax groups.

As a result of these reliefs, 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 1953–54 with a statutory exemption limit of £125, a married couple with three children were virtually exempt from tax if their income did not exceed £600; in 1938 this point was reached at £500 but in pre-war pounds a much higher exemption limit was implied. 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 reliefs 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 now usually adopted for progressive taxes). In the "income tax" range (below the surtax exemption limit), there have traditionally been two such steps, known respectively as the "reduced rate" and the "standard rate". (A second reduced rate was added in the second Budget of 1945 and more recently a third.) The progression of the surtax range is now achieved by means of eleven steps.

When these stepped or marginal rates of tax are averaged over the whole of the taxpayer's income the progression of

[1] Cf. p. 124.

his tax liability proceeds in an almost smooth curv
income expands. The position is illustrated in Chart
the curves A, A′, B and B′ represent the marginal and
(or effective) rates of tax in 1953–54 respectively for
person with all investment income and for a marrie
with three dependent children. For comparative purp
A′ curve for 1938 is also included.

Since the marginal curves rise throughout their le
average curves necessarily lie below them, but as
increases the curves approach asymptotically—since
definite limit (100 per cent) above which the margin
cannot rise. Even when this point is near to being
(as it has been since 1941) it is still possible to make
more progressive by introducing the maximum rate at
income level.

§ 3. The Effect of High Tax Rates on Incentive and Ef

It is not possible to say in general whether a taxpayer
harder or less hard as a result of a given change in
We can, however, postulate that where a change
marginal earnings more than average earnings his
likely to be stronger because the effect is more direc
mediate. A large gap between marginal and average
tax tends to be disincentive because marginal effo
relatively highly. The difference between marginal
rates of income tax at different points on the income
assumes considerable importance. It will be seen
gap is especially large first, where liability to income
and secondly where liability to surtax begins. The
these points is clearly the more important from the
view of incentive; but here the situation has been co
improved in recent years by the multiplication of
rates", keeping the marginal and average curves close
than they used to be.

In respect of relative changes in marginal and
rates, due to alterations in the structure of the tax, the
which the reliefs are given is important. The per

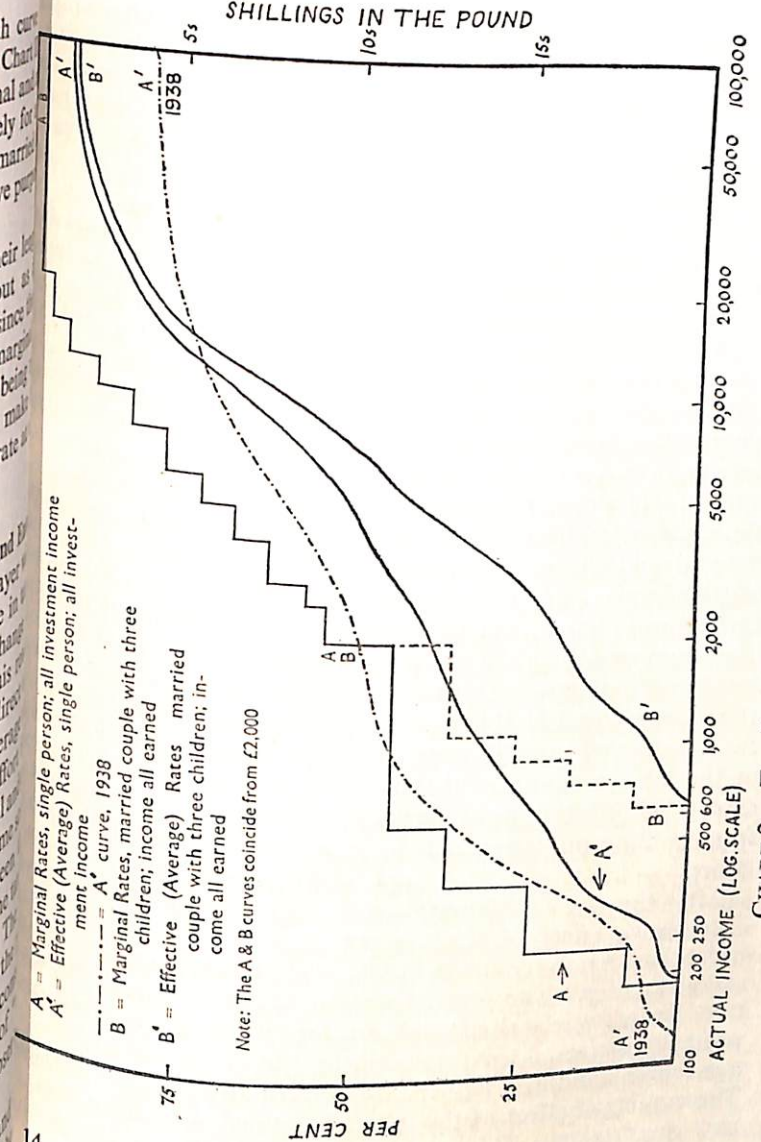


CHART 2. THE STRUCTURE OF BRITISH INCOME TAX 1953–54

dependants' rebates, being flat sums, impinge only on
rates; the earned income and age reliefs on the other
being percentages, affect marginal rates and are equiva
straight reduction in the rate of tax, which is especially
at the lower range of liability. These latter reliefs thus
double purpose: in addition to the distributional
discriminating against investment income, a rise in
is likely to be definitely incentive. Both these aims
better served if the earned income relief were conti
the surtax range; as things are now it is the small and
large property owner who is discriminated against
course it comes to death duties.

As compared with the pre-war situation British
has substantially altered in character. In the 1930's,
3·8 mn. taxpayers it was essentially a middle and upper
impost, while only the wealthy came within the surtax
With the first effective war budget the exemption
lowered and the reliefs reduced; by this means
became a mass tax to which large numbers of wage
earners were liable, while with the fall in the value
large numbers of middle incomes came within the surtax
In spite of reductions from war rates, in the early
16 mn. were found liable to tax, while many more
cases were provisionally assessed. This change in the
of the tax was quite deliberate; it was a means of
saving" aimed to prevent the recipients of bulging
from bidding up prices, and to set resources free for
effort.

After the war inflationary pressure still continued
disincentive effect of income tax on weekly wages
which had barely counted in war conditions, now
serious matter. The process was therefore reversed
tion limits were raised and all the reliefs have
peatedly increased. At two-ninths the earned income
age reliefs stand at a higher rate than in any previous
The combined effect of the reliefs has thus come to
new importance. This is enhanced by the P.A.Y.E.

by which since 1943 tax has been collected from all wage and salary earners. In order to appreciate the significance of this we must examine briefly the principles under which P.A.Y.E. operates.

A system of "current with-holding" (to use an American phrase) became a necessity with the inclusion of weekly wage earners in the tax, since they could not be expected to carry the necessary cash balances for half-yearly or even quarterly payment. For administrative convenience the system was extended to salary earners, although for the upper ranges of these tax withheld would probably only represent a payment on account of total liability. P.A.Y.E. is based on current earnings, so that tax payments proceed as nearly as possible in step with changes in the national money income, and a good stabilizing effect is thus obtained. Liability is averaged every pay period over the whole financial year to that point. Thus the basis is annual and not merely pay period income; this implies that incomes which fluctuate within the year pay no more tax than the same income received regularly, an important point for piece workers. It also implies that at the close of every pay period the taxpayer is brought into equilibrium with the revenue authorities; in all ordinary circumstances when the end of the financial year arrives he will owe the revenue nothing and be owed nothing. The system is thus equitable in a very high degree.

P.A.Y.E. is, however, disincentive in several respects. The crux of the matter is the way in which the personal (dependants') reliefs are treated: they are assumed to accrue regularly through the year at the rate of one fifty-second per week. Thus in any week when earnings fall below average there is a possibility that the taxpayer will not have received the full reliefs to which he is entitled. They will then be set against accrued tax liability; in a sense they are treated as a "loss" to be carried forward, if need be to the end of the financial year. The combined effect of the adjustment to a lower average rate when income falls and of the accruing reliefs is to provide a species of "holiday with pay" for the

absentee. If work ceases completely during the fina
he may qualify for substantial repayments, lasting
weeks. This result has much to recommend it from
of view of equity and stability of effective dema
clearly carries with it serious disincentive possibi
the other hand, in any week in which work exceeds
additional tax will immediately be charged; thus
is in danger of being disincentive whenever earning
considerably.

In addition to this drawback the administration of
is far from simple. The weekly accrual of reliefs
a separate "table" for each week in the year, while
combinations of reliefs require the calculation of
payer's liability according to a particular "code".
system began the Inland Revenue has taken the
of "coding in" also on the one hand other costs
taxpayer may be entitled to deduct (such as mortg
or insurance premia), and on the other certain item
erty income which are frequently encountered in
income groups (such as war loan interest and imp
from an owned and occupied house). In process of
than 170 different codes have been delineated.
manipulating codes and tables, so as to calculate
liability, falls on employers, a social cost which is
negligible. Moreover, such is the complication of
ing codes and tables after a change in tax that the
only be made effective after a lag of at least
Thus the usefulness of current with-holding as
measure is partly sacrificed to administrative conv
In view both of its disincentive effect and of its co
there is an obvious *a priori* case for the reform
Whatever change might be made, however, the
features of the system which it would be a pity to
annual basis of liability and the maintenance of
close equilibrium between the taxpayer and
authorities. Even within these constraints severa
reform are conceivable. One method would be

simpler system, after the manner of that in operation in the U.S.A., where family reliefs are standardized as a series of flat ($500) sums, and tax is deducted weekly according to the weekly average of anticipated annual income. This, it is claimed, has no disincentive effects, and is apparently acceptably equitable, notwithstanding that the financial year normally ends with substantial repayment of overwithheld tax.

An alternative which would be simple to administer and which would wholly eliminate the disincentive effect of the gap between marginal and average rates would be to charge the first £x of income (x being of the order of £500) at a flat percentage rate; reliefs could be given as percentage deductions which would be more equitable than the present system. A very neat solution through such a "simple tax" could be obtained if it proved possible to combine with the income tax, on the one hand contributions to social insurance, and on the other the social insurance benefits such as family allowances which are at present given twice: as positive social security payments and as negative income tax rebates. This amalgamation would lead to substantial administrative saving. Moreover, if the contributions to social insurance were transmuted into percentages from the present flat sums the sting of the loss of progression at the lower end of the income tax scale through the abolition of the reduced rates would be largely removed. Since, however, many workers regard the traditional method of social security contribution not as a tax but as an insurance premium, entitling the contributor to benefit as of right and not of subsidy, it would not be easy to get agreement for this solution.

Strong as the *a priori* case is for the reform of P.A.Y.E., there are arguments on the other side also. It is by no means certain how far the potential disincentive effects are in normal circumstances actual. It is in the nature of the case impossible to obtain statistical verification, although well-substantiated casual instances have never been lacking. There is no doubt that the willingness to work was at its lowest immediately after the war: war weariness, the abundance of

money in relation to the goods available in the shop
negligible chance of being fired for absenteeism, con
P.A.Y.E. to create an inherently disincentive sit
more normal times the opportunities open to mos
salary earners to vary their income by varying their
not very extensive.

Moreover, the seeming complications of the co
have in fact been turned by the Inland Revenue in
administrative simplification. Once the correct cod
identified (and it is in almost every case in the
interest to see that this is done correctly), no return
need be obtained from the vast majority of taxpay
the "simple" American system does require every
file returns every year. Further, mechanical ingen
supplied firms with P.A.Y.E. machines which can
by unskilled clerical labour. Thus the arguments
form of P.A.Y.E. are on the whole not so pressing as
a few years ago. This should not blind us to the
of the system, more especially as it applies to ear
the weekly wage level, the assessment of part of who
by P.A.Y.E. makes it almost impossible for the
estimate his outstanding liability.

Although the lower income ranges are probably
sensitive to the *form* of income tax, in the middle
ranges high rates of tax may be disincentive w
impinge on marginal or on average rates. The re
likely to take the form of reluctance to put forth
effort, or perhaps to undertake further training w
carry with it a higher salary, than of absence from
of work; it is none the less damaging to the natio
on that account. More obviously tax rates which
is considered reasonable lead to multifarious form
evasion, for instance through expense accounts,
which can be checked by the revenue authoriti
inflicting hardship on legitimate needs.

Most of all high tax rates on the upper income r
than any other factor, have almost put an end to

savings and have sometimes provoked dis-saving, at least in the short run; but for this high death duties must also share responsibility. The decline in personal savings is serious from two points of view. Voluntary savings assist a programme of public investment by setting free resources which would otherwise have to be obtained by a budget surplus if inflation is to be avoided. Loaned to private firms personal savings may still provide an important source of "venture" capital for expanding new enterprise. This is a form of investment which cannot be financed from within the firm when it is itself young and small.

Under modern conditions, however, the effect of high taxation of the rich has, in general, very little reference to the question of investment. Investment takes place as a result of the decisions of boards of directors and is normally financed not by the direct application of personal savings of the wealthy but 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 p
be £700; investments bearing a probable rate of
7 per cent are not too easy to find. High rates of
stifle a number of promising industrial opportunities.

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

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

The effect of an additional tax on profits on a
expected returns is to shift the curve bodily to the
without altering its shape or the chance of loss. The
very high gains which formerly balanced the big chan
in the risky investment's curve is thus cut off, and the
consequently tipped against it; while the safe
being relatively unaffected, will become the more
The discrimination of high profits taxes against
capital" is serious for any country that means to keep
modern developments; it is perhaps especially serio
established industrial country, well supplied with m
industrial equipment, and where consequently new

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, but also for new investment and for research. This is the more necessary in a period of rising prices, when depreciation allowances for income tax, based on the original cost of the equipment, may fall very far short of the sums required for replacement. Dating from the Income Tax Act, 1945, an ingenious method has been worked out which serves both these purposes. This

[1] Cf. p. 267.

is the system of "initial allowances" whereby a
part of the total depreciation allowance (at one perio
as 40 per cent) has been made available in the first
life of the equipment. In the long run this conce
stitutes not a reduction of tax liability, but merely
free loan from the exchequer. Where a substantial
of investment is being undertaken it results, howe
postponement—sometimes the almost indefinite pos
—of liability to tax. Changes in the rate of initial
have also been discovered to be an important factor
the rate of capital formation by firms; they can
useful stabilizer; but this is a matter to which we
to return in Part III.

§ 4. The Emergency Taxation of Profits. Tradi
taxation of business profits in Britain has been who
in income tax; in most other countries the income
confined to personal incomes, while a separate com
imposed on incorporated business. The British sy
least three definite advantages over this practice.
place the integration of personal and impersonal ta
taxation of undistributed profits at the "standard
it simple to tax property income "at source" by
tax at standard rate on dividends and similar payme
a large amount of revenue is collected quickly
possibility of evasion. For personal taxpayers
holding is a first approximation to their eventual
American terms it constitutes a "100 per cent cred
it. Final settlement involves either a further pay
taxpayer of the right to claim a refund, accor
correct effective rate of tax is above or below
rate.

Secondly, it will be seen that no double taxation
profits occurs; thus it is easy to calculate what
buted profits are really bearing and to make
adjustments for depreciation and so on in a rati
Thirdly, in principle there is no difference between

of incorporated and unincorporated firms; thus there is no
hindrance to incorporation, such as is often encountered
abroad. For the small firm this is an important reinsurance
against a number of risks. There is no doubt that for all
normal conditions this system of profit taxation is more
efficient and more equitable than any other.[1]

In times of emergency, however, it becomes necessary on
grounds of stability, and perhaps also on grounds of equity,
o impose further taxation on profits as an additional safeguard
against either firms or their shareholders spending the proceeds
when it is essential that they should be saved.[2] In the war
of 1914–18 this problem was dealt with by the imposition of
n Excess Profits Duty levied on the difference between war and
re-war profits, or in exceptional cases, where no reliable
re-war standard was available, on the excess over a standard
eturn on the "capital employed" in the business, measured
y a valuation of the assets.[3] This form of emergency tax-
tion was adopted partly because it was widely felt that very
igh profits were being made out of the war at other people's
xpense. This was indeed the case, but it was largely the result
f the low level of pre-war taxes (there is a limit of tolerance
the speed with which taxes can be raised) and of the absence
f an effective system of the physical control of investment.
artly also it was felt that the excess profits were wholly due to
overnment orders so that to tax them away would not damage

[1] It is argued by those who give a very high priority to the redistribution
f income through public finance that an additional profits tax is desirable
order to tax more highly the larger property incomes than would be
ossible through income tax alone: effectively to impose a more than 100 per
nt tax on disposable incomes. In assessing this policy it should not be
erlooked that the small property income will be relatively more damaged
an the large. Further, in view of the poor productional arguments for
e high taxation of undistributed profits, such a policy is doubtfully
lvisable as part of a normal tax structure.

[2] As income tax is at present operated, with a lag of a year between the
claration of the profits and their taxation, a separate profits tax could
t more quickly and so more usefully. There is little doubt, however,
at profits could be taxed more expeditiously within the income tax
thout too great disturbance to the administration.

[3] For details of excess profits taxes in both wars, cf. Hicks, Hicks and
ostas *The Taxation of War Wealth*.

enterprise. In the war of 1939–45 an Excess Pro
tougher in nature and higher in rate than the old E.P
imposed at a much earlier stage in the war; after
operation the rate was raised to 100 per cent.

There is no doubt that in the special conditions in
were imposed E.P.D. and E.P.T. both proved powe
ments of forced saving and so broadly fulfilled their
They were, however, fundamentally clumsy and
with hindsight in another emergency better means of
their aims might well be found. This is especially
of the great experience gained in operating physical
in the second world war and immediate post-war
making it unnecessary to rely so heavily on fiscal
future emergency.

Excess profits taxes are bad because tax falls
directly on the margin of effort and enterprise than
with a percentage tax on total profits; even in wa
is important. They are bad taxes also because
high premium on cost inflation in order to achieve
excess, a practice which is all too easy to achieve in
and scurry of war orders. Habits of bad manage
extravagance acquired in war-time are not easily
times return to normal. These results of an excess
are the greater because the tax is known to be
expenses incurred during the war to improve the p
the war carry a very high premium.

In the lesser emergency of a cold war an exc
tax is not practicable. Exceptional profits must
relatively more to energy and enterprise than to
orders, so that the disastrous marginal effect of
profits tax becomes intolerable.[1] Nevertheless s

[1] This was demonstrated by the good sense of Parliament
1937 substituted a flat percentage tax on total profits (N.D.C.)
profits tax first proposed by the Chancellor (Mr. Neville
to preserve stability in the rearmament phase. In sco
circumstances in 1952 the Conservatives found themselves
impose an Excess Profits Levy in order to fulfil an election
had the good sense to make it as short and as mild as possible

additional quick-acting impost on profits may be called for. In these circumstances there is no doubt that the answer is a straight percentage tax on all profits. Further, in view of the bad effects of an excess profits tax in any circumstances, and of the less extensive stabilizing work which it would need to do in a future emergency (because of the availability of other means), it is highly probable that the best solution for a major emergency also would be to rely wholly on a tax on total profits, rather than use it (as was done with N.D.C. in the second world war) merely as an additional safeguard where profits did not qualify as "excess".

Since 1947, however, there has operated in Britain a separate tax on total profits which has certainly not generally been regarded as temporary; moreover it has been continued during a period not all of which could claim to be even a minor emergency. We must, therefore, briefly examine its *raison d'être*. The first purpose of the post-war profits tax was mainly to gather revenue; it was clear that without some alternative the immediate loss of over £400 mn. accruing from the discontinued E.P.T. would have seriously disrupted the budget, and it was almost certainly impracticable to make this good out of income tax alone. Before long, if not from the first, two additional purposes were found for it.

The new profits tax differed from its predecessor N.D.C., not only in having a wider coverage, but also in being assessed at different rates on distributed and retained profits—or rather it was assessed at a single rate on distributed profits, with a "non-distributional relief" on retained profits. As time passed, this differential was several times expanded, until it reached 40 per cent (rate on distributed profits 50 per cent, and on retained profits 10 per cent). This differential served two purposes: in the first place it discriminated still more heavily against property income than a flat percentage would have done; in the second place the accumulation of reserves was encouraged, a policy that was further supported by a voluntary "dividend freeze".

We have seen reason to doubt the validity of this first

purpose on productional grounds, while the mere acc
of reserves is only an indirect stimulus to capital fo
the sense that firms may feel a greater propensity to i
they find themselves liquid than when they have t
Against this must be set the greater unwillingness o
vesting public to buy securities when only very smal
can be expected. The direct stimulus to capital
given through the initial allowances is certainly mo
if the purpose is to increase the rate of investm
decisive argument against attempting discriminatio
distributed and retained profits is, however, the lia
accumulates on the firm over the course of years for
ment of non-distributional relief whenever it is
distribute anything in excess of the current year
(as may often be desirable both in the interests of
of general economic stability). It is of course inc
the Inland Revenue should claim the repayment of
otherwise a firm could effectively evade the higher
completely.

It seems clear, therefore, that a profits tax whi
discrimination between distributed and retained pro
an excess profits tax, only practicable over a stric
period; without this provision the post-1947 profits
have lost much of its attraction. This discovery ne
dismay because, as we have seen, in all normal circ
its productional effects and most of its distributi
could be obtained better through the traditional m
single integrated income tax.

[1] For a good account of the complications to which the
of profits tax gives rise see *The Economist*, Nov. 1951, especi

CHAPTER XIII

CAPITAL LEVIES AND CAPITAL TAXES

1. Income and Capital Taxes Compared. Besides taxes on
et income and profits, whose case we examined in the last
hapter, the other large category of general taxes consists of
ose assessed on the capital value of the taxpayer's wealth (or
tal property). Capital taxes share the advantage of income
xes over outlay taxes, that they can be closely adjusted to
bility to pay; although it is difficult to adjust them quite so
curately, since like capital does not always yield equal income.
here are also several other points in their favour.

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

Further, it was pointed out that the greatest cause of
equality of incomes was inequality of inherited wealth[2]; a
olicy of redistribution which does not make substantial use
progressive capital taxes will make but little headway
ainst this factor. Finally, there is the consideration, which
have found to be important, that while high income taxes
courage incentive and enterprise and put a premium on
asion, capital taxes (even recurrent capital taxes paid out of
come) are much less likely to have this effect, since the tax
se is related to past action and not to present effort.

There is thus a good *a priori* case for capital taxes, especially
here rates of income tax would otherwise be very high.

[1] As suggested by J. S. Mill.
[2] Cf. Dalton, *The Inequality of Incomes*.

Against this must be set one possible drawback w
past attracted a considerable amount of attention.
taxes are not accompanied by a compensatory incr
investment they may lead to "capital consumption"
oration in the community's provision for the futu
to its provision for the present. This will only
saving, equal in value to the taxpayer's loss of
not take place somewhere else in the economy—
probable state of affairs unless the capital tax is
In any case this is a long period consideration;
degree of capital consumption did appear to be
it could always be compensated by new public in

Although the case for capital taxes would seem
one from the point of view of the economy, we
take into consideration the taxpayer's preferences.
to be presented with a tax bill of a given present v
ing over the span of his life, how would he prefer
liability? Our analysis of the loss of surplus arisi
lay taxes indicates that he would usually prefer
income tax to paying outlay taxes as a condition o
certain range of goods and services, selected by the
Would he still prefer a straight income tax to pay
of his property, while leaving his income relativ
This is the question to which we must now turn.

In investigating this question we are primarily
with once-for-all capital taxes—capital levies o
usually called.[1] The unforeseen nature of a lev
inevitable that it should mainly be paid by disposa
In all other cases the taxpayer has some opportunity
provision out of income for his liability; thus the
becomes more or less a species of income tax.
genuine capital levies which have actually been car
according to plan is short; so if this were all w

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

vere concerned our question might seem rather academic in
cope. Death duties, however, at least when imposed at the
igh rates now in force in Britain, have so much in common
vith capital levies that they can properly be included in the
nalysis of taxes paid out of capital.

Since the fact of liability to death duties is known in advance,
is possible for people to "pay" death duties out of income,
nore or less completely, by insuring the value of their property
t death, *net* of the whole, or part, of the death duty liability.
or owners of small or moderate estates the whole of death
uty liability can be met in advance in this way; but owing to
he sharp progression of the rates of tax on larger estates, their
wners would not have enough left to support them during
fe if they attempted completely to discharge their liability in
his way. People thus have the opportunity of treating death
uties wholly or partly as an income tax; but the statistics
learly show that they do not take advantage of this oppor-
unity; in fact, it is very uncommon to insure against death
uties. Hence it is quite proper to treat them as a capital levy.
The taxpayer's preference for a once-for-all levy cannot
ccurately be compared with his preference for an annual tax
ntil we reduce them both to the same (either capital value or
nnual value) basis. Various methods of expressing death duty
ability as an annual tax have been suggested.[1] No method
f expressing a capital levy as an annual tax can be completely
tisfactory and free from arbitrary elements or assumptions,
nce with a tax paid out of capital we are concerned with the
uture, and the future is always uncertain. For the purpose
f estimating relative preferences, however, what we may call
he "income stream" method[2] seems to be the most satis-
ctory.

This method proceeds by expressing the expectation of death
uties on an estate (not merely the liability when the present
wner dies, but at all subsequent turnovers) as a perpetual

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

stream of equal annual payments, and comparing
this stream (i.e., its present capital value) with
perpetual income tax.[1]

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

The taxpayer's preference between income tax
duties depends on the rate at which he discounts his

[1] The principle of the calculation of the death duty stream
when someone inherits an estate he inherits with it a certain
future death duties. This liability can be regarded as a
on the estate (similar to a mortgage except that it bears no
we call the value of the estate K and the rate of yield on it i, the
derived from the property is Ki. If d is the fraction of the
payable in death duties, then Kdi is in the nature of a life
present owner. After his death the estate will be worth $(K-Kd)$
successor will have a life interest $(K-Kd)di$, and so on, for
tions, with the estate getting smaller and smaller at each
is possible, although more complicated, to allow for the fact
owners may add to the value of the estate during their lifetime
be noted that as the value of the estate shrinks, owing to
payments of death duties at each turnover, the tax liability
of income tax as well as of death duties) is more than
reduced, as it is pushed down into lower reaches in the
gressive taxes. This is some compensation for the loss of
due to death duties. Cf. Kaldor, *loc. cit.*

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 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 "capital-ist'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 I

have seen that it is possible to reduce a single capi
and an income tax to the same basis, with sufficien
to make a sensible comparison of taxpayers' prefere
economic effects of death duties can be directly com
those of an income tax, because death duties are a re
(and in fact a rather stable part) of the revenue.
economy as a whole their effect is that of an annual
of a once-for-all levy. Although death duties are
out of the capital of the estates concerned, if the ann
of the community are more than sufficient to absor
that have to be sold in order to discharge liabili
causing any decline in the value of the national cap
economy as a whole, death duties are paid out of
capital.

If death duties do not cause capital consump
economy as a whole their main economic effects
arising from the greater equality in the distributio
which is gradually brought about by the operation
This more egalitarian distribution is in accordance
of social justice; on the whole it is not likely to
favourable economic repercussions, and in an
which there is danger of oversaving it would tend
stability in consumption. On the other hand the
of death duties in the upper ranges of wealth has
so high in Britain (reaching 80 per cent of the
that the process of the break up of property has
perhaps dangerously, accelerated from the point of
social provision of savings.

The effect of death duties in accelerating the
landed estates was early noticed, because the
illiquid nature of the property, and the consequent
as a result of forced sales to pay death duties,
least responsible for the decay of farming capital
place in the inter-war years. It must be admitted
that much of this decay would probably have
dependently due to the low prices ruling for

products. This aspect of the effect of death duties is perhaps less important in the 1950's, partly because most large estates have been turned into limited companies, thus restricting the incidence of death duties to the individual shares, partly because the state now takes a big hand in assisting owners to maintain their productive farm capital.

A more substantial case against death duties at their present level is the difficulty which small firms may be put to, not only in the raising of new capital (which is essentially a function of the decline in personal saving and hence only partly the responsibility of death duties), but actually in maintaining existing capital intact. When a director who is also a large shareholder dies, the firm may not hold sufficient liquid funds for the executors to discharge his liability without selling some of the productive equipment employed in the business, a process that may obviously disrupt the firm's whole economy. This hardship could be much mitigated if the revenue authorities were empowered to accept death duties in instalments.

The economic effects of a once-for-all levy, imposed in the lifetime of the taxpayers, cannot easily be foreseen. They depend to an enormous extent on the particular circumstances of the time and place—on political and fiscal circumstances and constitutions, 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 economic; 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

[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 in 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.

swamp most of the effects of normal public finance time being.

In principle the initial effects of a levy are expec deflationary, if only because of the disturbance to programmes and capital markets caused by the spec transfers which the levy calls for, in order for the l to obtain liquid funds to discharge their liability reason in the immediate aftermath of war, it is com levy should be proposed for the purpose of com tendency to inflation, which is an inevitable lega finance. In practice levies imposed in these circ may not have the desired effect, but rather the oppo was certainly the experience of almost all the coun attempted levies in the 'twenties.[1] If, as normally loan facilities have to be made available for levy discharge their liability in a form that is manageab government, and if in fact a considerable part of t thus paid out of new borrowing, the effect will be a deflationary. It is as little likely to be so as a levy imposed in war-time.

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

Capital levies are exceptional remedies, it is only emergencies which bring them into the forefront of During the emergency itself to carry through a levy any case be impracticable, and it is generally recogn cannot safely be used for current purposes, even in

[1] Cf. *The Taxation of War Wealth*, *cit.*, Chapter XV

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 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

[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. Chapter XIX.

which the revenue normally relies on progressive
(income tax and death duties), since the revenue fro
will be heavily reduced with the disappearance of thi
a form of taxable property, and its interest as a
taxable income.

In Britain all these factors are now unfavourable fo
Interest on the National Debt is subject to incom
and, as we know, the revenue is very dependent on p
taxes, so that the loss of future receipts from surtax
duties would be heavy. Consequently, the repayme
a large amount of debt (say, 50 per cent of the capi
permit only a moderate reduction in income tax.
'twenties fiscal conditions were more favourable for a
in the 'forties or 'fifties, since the average rate of inter
debt was substantially higher, and the progression o
less steep.

With given fiscal conditions and distribution of
ings, the amount of saving in the revenue bill which
levy would permit depends on the structure of the
height of the exemption limit and the steepness of its
sion. The lower the exemption limit is set, and the
progression, the greater will be the reduction in
progressive taxes which can be accomplished when
service is reduced by the repayment of the principal
because a surrender of capital by citizens from
government derives only a small part of its surtax
duty receipts will not seriously eat into the future
from these taxes. Even in British conditions a
levy might permit a substantial reduction of incom
the order of about double the reduction which
accomplished by a levy whose progression was
with the present progression of death duties. A

[1] In *The Taxation of War Wealth* an estimate was made on
the 1938 distribution of wealth and structure of income tax,
in income tax did not exceed 6*d.* in the £. In conditions
the continued fall in interest rates and rise in tax progression
would have been considerably smaller. Cf. *The Taxation of
cit.*, Chapter XXIX.

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]

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. This is a further difficulty (in addition to that discussed on p. 207 under which the small firm labours in respect of death duties. 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

[1] For a more detailed examination of valuation problems, cf. Hicks and Rostas, *op. cit.*, Chapter XXVIII.

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 estates is not easy. There is every reason to believe, that, by and large, the revenue from British death duties is collected with as much equity and economy as that of any tax in the structure.

Few of these favourable technical factors will be present when valuations for a once-for-all levy have to be made. In the first place the very magnitude of the task is likely to mean that sufficient experienced valuers cannot be available in sufficient time (either for the government if it makes the valuations or for the property owners if they are required to make them) 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 values 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 large amount of property without necessitating forced sales and consequent change in the relative values of different kinds of property, if not a general fall in values. If levy payers can borrow on their property to pay the levy, they may be able to meet it by selling a war loan in sufficient amounts to cover their liability; but this is a transfer problem is relatively simple; but this may involve 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 provide itself to take over temporarily all sorts of 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

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 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),[2] 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 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 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.

[1] Of this method of valuation the British revenue authorities remarked in the memorandum referred to above, p. 207); "To call the result a capital valuation would be an abuse of language."

[2] But see Chapter XIX.

If the capital tax is not to sink below the standard of
of the tax structure in equity, not merely should all p
be valued at estimated market prices by death duty
as for a capital levy; but valuations should be kept in
economic conditions by periodic revisions—say, e
years. The expense of revaluation has always
stumbling block with property taxes, even with simp
land and buildings such as the British local rate. Fo
total capital the operation would be enormously m
cated, and any failure to carry out revision wo
much greater inequity.

In British conditions it is unlikely that a capital
property tax would improve the tax structure; bu
stances may well differ elsewhere. In Scandin
Germany the wealth tax has been found a useful
collecting tax from the proprietors of small
especially retail traders, where income tax is often
The difference appears to lie in the first place in
greater proportion of very small businesses (as
with Britain), and secondly, in the smaller
incorporation (making it more difficult for the
authorities to determine net income). In turn, this
is no doubt partly due to the traditional use of
corporation tax.

As with a levy, so with a capital tax, it is only too
an easy way would be sought out of the valuation
and in practice the tax would come to be restricted to
forms of property, probably mainly to real estate,
an effective income tax exists, to stock exchange
Most actual property taxes were in original intent
taxes. While there may be a place in a tax structure
annual tax on real estate,[1] to impose an additional
particular form of property for a purpose which it
achieve would be worse than useless. Moreover, s
objects of the capital tax could be achieved by a mo
method—by introducing (or increasing) the disc

[1] See Chapter XV, Section 5.

against income from property which is already a feature of some income taxes.[1]

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 revenue authorities; so far as it is "legal" 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 death duties are concerned the main trouble is the gradual reduction in the size of the estate before death by gifts *inter vivos*.[2] In the case of surtax the greatest danger lies in the substitution of (tax free) capital gains for income. There are a number of ways in which this can be done.[3] In a small director-controlled company profits may be retained in excess of what can usefully be employed in the business in order to distribute them later as capital bonuses. More generally, in times of rising values, especially of real estate or stock exchange securities (which may, of course, be no more than the reflexion of an autonomous fall in interest rates), investors tend to buy and sell property not for the annual return which it will give them but for the far larger capital gains, of which they can be virtually certain. In principle a promising method of counteracting these types of evasion would be to extend death duties to cover all gifts and gains on the transfer of capital.

In economic principle there is a plausible case for taxing capital gains, since in many, perhaps most cases, they fall within the definition of income as that which can be spent without injuring the capital position of the owner.[4] In this sense capital gains are part of "disposable income" as truly

[1] The "earned income allowance" in British income tax (see p. 185) in practice has this effect.

[2] Gifts within five years of death are now included in the estate for British death duties. This safeguard is hardly yet sufficient.

[3] Cf. p. 180. A famous loophole was the practice 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.

[4] See above p. 179.

as the normal income stream, and add as much to the
power of the owner. In the United States where the
sensitiveness to economic power (which carries with it
of political power also), the taxation of capital gains
many to be an indispensable completion of the person
tax; other countries have also experimented with
taxes. It cannot be denied that in the absence of
gains tax very high rates of income tax may be
control excess spending in a period of inflationary

The fiscal difficulties of an equitable tax on
(which should logically give symmetrical relief for
however, formidable and it is doubtful whether they
effectively be surmounted. The economically correct
tax a capital gain would clearly be when it occurs
practice gains can only be taxed when they are
which may be some considerable time later; thus
much of its potential compensatory force and
equity. Again, in practice, it is not feasible to give
relief for losses because they can too easily be used
of tax evasion.

There is the further difficulty that by no means
gains are advantageous or desired by the recipients.
liquidations or bonus distributions which are to the
of the large shareholder,[1] anxious to avoid the high
surtax, may damage the small shareholder whose
steady income and who finds himself suddenly pitched
a high surtax range as the result of an unwanted "
most awkward aspect of this difficulty occurs
generally rising prices or falling interest rates, when
no transfer of property can be made without realizing
in money terms, although in real terms it may actually
a loss relative to the change in other economic categories
as wages.

In view of all these difficulties governments have
fought shy of treating capital gains as on all fours

[1] Assuming that capital gains are taxed at a lower rate
income, as is usual.

normal income stream. The rate for the capital gains tax has been set well below the upper surtax ranges, thus inviting to surtax evasion. Relief for losses is usually very meagre. An attempt is sometimes made to distinguish between unwanted and planned gains by setting a much higher rate of tax where the asset has been held only a short time. None of these devices, however, is more than a palliative.

It is thus at least arguable whether the addition of a capital gains tax is of benefit to the tax structure. Again much depends on circumstances: the political and economic importance of wealth in the economy on the one hand, and the expertize of the revenue authorities on the other. It is clear in any case that the theoretical advantages of a capital gains tax can only be very imperfectly realized in practice. In Britain most of the trouble of undue retention of profits in a director-controlled company has been avoided by giving the Inland Revenue power to tax excess reserves at surtax rates, according to the several interests of the proprietors, just as if they had been distributed. The strongest apparent case for a capital gains tax is to deal with inflationary pressure; but here also lies the greatest danger of inequity and hardship. In many, perhaps most, situations in which there is a rapid rise in prices or fall in interest rates (as there was in Britain in the years immediately after the second world war), which gives rise to widespread and conspicuous capital gains, they are more properly considered as evidence of faulty economic policy outside the fiscal system and can presumably be dealt with by more appropriate means.

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 discus
method of tax analysis, we saw that there were so
which, although they were imposed on particular
enjoying or spending wealth, were of such transc
portance in the economy as to influence directly th
determining the size of the national income. So
require a general analysis, in addition to the partia
normally appropriate to outlay taxes.

Possible varieties of such "general" outlay taxes,
formally assessed on an important domestic overhea
a tax on houses and land), or on consumption in ge
as a non-selective sales tax), on the one hand; on
are taxes formally assessed on production, either o
industrial and commercial overheads (such as
factories and business premises) or on running costs
gross income taxes and turnover taxes and wage tax

We have already noticed[1] that if it is assessed
poundage, the British local rate will affect building
and so will influence the general tempo of investme
economy. A similar effect on building is likely to
any real property tax, except one imposed only on the
of value of a site due to the increased demand for
This is an exception which, in settled countries, exc
book theory rather than in the real world.

We need not repeat here the analysis of the effect
in real estate taxes on the tempo of investment; we
that in respect of a tax on house property the advers

[1] Cf. Chapter XI, Section 3.
[2] *Ibid.*, Section 4.

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 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

[1] Cf. p. 196.

conditions it is necessary to distinguish between the em
and the employers' contributions. Although we have
that the employees' contribution must be classed a
because of its compulsory nature (and is consequen
tax on earnings), it cannot have the same effect as a
tax of similar magnitude and income distribution
overwhelmingly probable that in the absence of
insurance scheme the majority of workers would insu
selves voluntarily at comparable rates for the same
Thus the distribution of family outlay can only be
to a very small extent by the existence of the co
scheme.

In so far as the employees' contribution has ge
effects, so long as the scheme was confined to the "und
class, they were those of an outlay tax rather than
tax of the type familiar in Britain; that is to say, the
of the tax was on consumption rather than on sav
effect was intensified by the fact that the contributo
uniform, are regressive against income, falling mo
on the unskilled workers who save less, than the
paid members of the scheme. When the insuranc
was extended to the whole community (in 1948), the
naturally became more like that of an income tax.

Economically the incidence of the employers' co
is more interesting. To the employer his contr
social insurance is equivalent to a rise in his wage bi
he will incorporate in his selling prices, so that for t
as a whole the tax leads to a more or less proportio
prices. If, for example, we suppose that the emp
employees' contributions are each 4*s.*, we may
payments as equivalent to an all-round rise in w
accompanied by a charge on the workers of 8*s.*
funds are distributed in income transfers, however
rise *pari passu* with prices; consequently the pro
employment and real incomes of a rise in contributo
(by the familiar Keynesian analysis[1]) to be zero—

[1] Cf. Keynes, *General Theory of Employment*, Chapter

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.

§ 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 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 low-priced articles.

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

[1] Chapter IX.

on consumption,[1] and as a result some check on in
in the whole economy, relatively to that resulting, for
from the imposition of a net income tax bringing in
revenue. This is due to the fact that the incidence is
ing rather than on saving. The check to consump
investment will be the greater the more temporary
or its new rate—is expected to be. If the tax is exp
be very temporary, investment for the remote future
stimulated, while more immediate opportunities are
In a federal constitution when taxes of this nature are
by the constituent States, additional complications
may arise through the distortion of production or
channels in order to by-pass high tax States. This p
was illustrated in the United States as a result of the
taxes imposed for the purpose of supporting local
the crisis of 1930–31, and, as we have seen, has co
an ever-increasing scale since.

If the tax is imposed as a sales (or purchase) tax, it
implies that the revenue is collected from the
retail stage of the productive process, this constitu
improvement on the tax on turnover. In the first
later the stage of production on which the tax is as
smaller the opportunity for a "pyramiding" of
adding a fixed percentage to selling price at each
stage (on an ever-expanding base), in order to recov
of the tax from the next purchaser.[2] If attention
to this phenomenon by the administration, the pric
goods may rise by very much more than the amou
Secondly, if the tax is assessed only on the mercha
there is much less opportunity for inequity as be
and large firms, due to differences in the degree of
than if the tax is assessed on turnover in general.
this it follows that before attempting to assess the

[1] Unless we assume conditions of overfull employment and
when this, or virtually any other tax which falls upon the
by workers as a lever to raise wages. For discussion see
XVII.

[2] Cf. the analysis of the taxation of a monopoly, Chapter

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 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.

[1] Cf. Chapter XVII.

CHAPTER XV

THE THEORY OF LOCAL TAXATION

§ 1. The Financial Problem of Federalism and Local Government. Problems of local finance and its relation to [illegible] finance are of universal concern to the countries of the [illegible] In many European countries the development of [illegible] government has been an essential part of the growth [illegible] modern state at some of its most formative periods, [illegible] from the time when the great cities, managing their own [illegible] to a very large extent, found it in their best interests [illegible] themselves with the national government in the common [illegible] against feudalism. In the Dominions and in America, [illegible] governments mainly came into being as the result [illegible] voluntary union of what were in origin separate and [illegible] dent settlements; the form of constitution which emerged [illegible] consequently more or less federative, in contrast to [illegible] where the unified state became the most usual pattern [illegible]

In the modern world, in spite of this basic contrast, [illegible] difference, the problems of central/local finance in a [illegible] state and in a federation differ in degree rather than [illegible] Nevertheless the varying degrees of political unification [illegible] different nations—reflecting differences in physical [illegible] and in social outlook, as well as differences in political [illegible] imply considerable variations in the relation between [illegible] and local financial institutions. Broadly, three main [illegible] types, with their corresponding financial arrangements [illegible] be distinguished. Examples of all three have long [illegible] without there being (at least until recently) any [illegible] tendency for them to change or merge.

At one extreme is the effective federation[1] in which [illegible]

[1] Although it is formally a federation, the political [illegible] institutions of the U.S.S.R. conform more closely to those of a unified state than of a federation.

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). 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 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
Britain, for instance, the local authorities have from
time considerably increased the scope of their powers
the medium of private Acts of Parliament.

Although these three types of central/local organiza
long existed, in the inter-war period they were all
to an increasing amount of pressure and criticism,
result of which has been, in almost every case, to
hold of the central government. The most striking
of this process was, of course, the Gleichschaltung
Germany, reflected in a milder form in her satellites
the United States and in the British Dominions the
wars has led to a very remarkable increase in the
the national government. The federations have
drawing nearer, in fact if not in law, to the British
organization. At the same time there have also been
centripetal forces at work in Britain, whose effect
intensified by the greater central and regional co
necessary for war purposes between 1939 and 1945.

This increasing pressure of national governments
necessary to examine afresh the questions of co
relations. Although the Anglo-Scandinavian comp
behind it an impressive record of the development
services on the one hand, and of political stability on
the basis of local autonomy on which it rests is to-day
questioned.

§ 2. The British Local Authority—Rates and Grants. We have seen, in the last quarter of the nineteenth century
expansion of social expenditure which has led to its
by far the largest part of public outlay in normal circ
had definitely begun. Hardly any of this outlay
made by the central government; in the 1930's
authorities were responsible for the administration
two-thirds of the total. Most of the rest was looked
separate bodies, such as the social insurance funds
Assistance Board; these might, however, be regarded

less as agents of the central government. The explanation of this somewhat odd distribution of functions is partly historical, partly fiscal. The "new" social services: education, public health and, later, housing, naturally followed the precedent of poor relief—the one major service inherited from an earlier age—in being a local responsibility.

Once they had been established on a nation-wide basis these services grew rapidly, the main financial burden falling initially on the local rate which was already sustaining the heavy cost of poor relief. From the 1890's the growing burden on rates led to a gradual, although often grudging, expansion in exchequer grants to local authorities, especially for education; but it was not until the end of the first decade of the present century that any real change of policy took place. The schemes which were then established for old-age pensions, health and unemployment insurance were all managed by centrally appointed agencies, entirely outside the orbit of the local authorities. This new policy served not only to remove assistance of the elderly, the sick and the workless, partly at least from the stigma of pauperism (which carried with it political disabilities up to 1918), but also to relieve the pressure on the rates without the supposed "danger" of giving a grant for poor relief.

Thus the administration of the greater part of the social services remained the responsibility 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 the funds are derived from local taxation. The difference between the £916 mn. which local authorities were spending on current account in 1953 and the £436 mn. which they raised in rates was almost wholly[1] 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

[1] Grants=£411 mn., other local income (gross)=£186.

amenities and works—bridges, embankments and
By the reign of Elizabeth I all parishes were co
Parliament to levy a rate for the relief of the poor i
and by this time local communities were also carryi
services for the national government, especially in
with the administration of justice. Alongside of
of central government in the sixteenth and
centuries the activities of local communities also
The modern development of city government m
from the establishment of "Improvement Commiss
certain towns in the eighteenth and early nineteenth
by means of private Acts of Parliament.

Parliament gradually took a hand in generalizing
legislation the powers and duties thus obtained spo
local acts. At first as each new service was estab
national basis it was administered by a new servi
local authorities—e.g., the poor law guardians
boards, sanitary districts and school boards—but i
half of the nineteenth century local government
gradually concentrated[3] in the hands of general,
ized local authorities, and the country was mapped
it was completely covered by a network of se
governing bodies. Although the number of
dictions was still large, this concentration of powe
a great simplification in local administration.[4] As
a further (*de facto*) concentration of function
date, it is now sufficient for most practical purp
account of the activities only of the county bo
administrative counties, that is to say, to consider
140 different bodies instead of 1,300.

[1] Cf. Cannan, *History of Local Rates in England*.
[2] Thus the Liverpool Commissioners in 1744 obtained
out street lighting and cleansing, prevention of nuisances
vehicle parking.
[3] The latest of the *ad hoc* authorities to be absorbed were
Guardians, in 1929.
[4] Strangely enough this concentration of functions has
in the U.S.A. where local administration is in the hands
separate authorities, many with overlapping jurisdictions.

It will be apparent that almost from the first a local body
as responsible for two different sorts of activities; those of
s own choosing and those placed on its shoulders by Parlia-
ent. There was, however, no satisfactory functional differ-
ce between the two sorts of activities.[1] Services which
terprising communities took steps to provide for themselves
ere seen to be good for other places as well, and Parliament
turally wished that they should also be available for those
ho lived in less progressive—or less wealthy—neighbourhoods.
hus services which were in the first place provided voluntarily
d sporadically tended to become universal and compulsory
local authorities.

As we have seen, the local rate was first used by local
mmunities for the improvement of their own neighbour-
ods, but following the precedent of the Elizabethan Poor
w, the additional services, when they were made compulsory,
re also placed by Parliament upon the local rate. Clearly
ere was a limit to the possibility of financing additional
rvices from a single tax—a limit made all the more definite
s we shall see later) by the special characteristics of the rate
elf; but since the Treasury jealously reserved[2] for the
tional Budget the right to all other taxes, it was inevitable
at sooner or later Parliament should come to the help of
cal finance out of its own resources. It is no accident that the
st exchequer grant (1825) followed closely the enormous rise
the poor rate due to the Napoleonic wars.

A natural consequence of Parliament's wish to generalize
rvices was that it should also desire to generalize *standards*
service. This policy calls not merely for grants in aid of
erage rate revenue, but for especially generous grants
ected to those areas which are abnormally poor or whose
eds in particular directions are abnormally great. Once this
licy is accepted, grants tend to become not only larger but

Cf. the discussion of the onerous beneficial distinction, pp. 244ff.
The period of Goschen's "assigned Revenues" in the second half of the
eteenth century is only an apparent exception, the local authorities had
control over the rates of the taxes which were assigned to them.

more complicated. Differential grants in this sense
of gradually increasing importance in the educa
since early in the present century. They were fir
general purposes in the Block grant, which in 19
place of certain specific grants which had previously

§ 3. The Political Importance of Local Auto

sequence of events which we have followed explain
bution of administrative and financial responsibi
the national government and the British local au
does it *justify* either the one or the other? It is n
whether it would not be better (granted that it is no
to enlarge the local tax base) to abolish the clumsy
dangerous apparatus of transfer of funds from the
local exchequers, by transferring instead the adm
the services concerned to central control? In fact
has been going on in Britain since early in the pre
Not only did the policy of the "break up of the
dating from the Reports of the Royal Commissio
lead to centrally-controlled and financed old-age
health and unemployment insurance, but the
accelerated in the 1940's by the substitution
assistance for poor relief, and by the absorption of
the health services of the local authorities in
health service in 1948. During the inter-war per
aid from major to minor governments became
important, not only in Britain but in many other
especially in the United States and the British D
so that the problem is of general interest. It is
which has two sides, political and administrative
hand, financial and economic on the other. Alth
primarily interested in the latter, the two are so
that we cannot ignore political considerations alto

[1] Cf. H. J. Bittermann, *State and Federal Grants in Aid*
Perloff, *State and Local Finance in the National Economy*
Royal Commission on Dominion-Provincial Relations
Reports of the Australian Grants Commission are also
luminating in this respect.

We have seen that local communities were already exercising
number of government functions for their own convenience
t the time when Parliament began to develop public social
ervices on a national scale. Parliament was thus taking the
ne of least resistance in putting the administration of the new
ervices under local control; but in fact this policy was largely
nevitable in the then state of transport and communications
n the one hand, and of the primitive condition of administra-
ve technique on the other.

Local administration has, however, traditionally had a
eeper justification than mere technical convenience. In the
ervices concerned with the individual citizen and his family
is clearly most desirable that the administration should
ossess local knowledge and understanding. This was
pecially held to be desirable for the administration of public
ssistance and public health. For other services, e.g., edu-
ation and housing, it is equally necessary that the officers
oncerned should be familiar with local industrial and topo-
raphical conditions, if the citizens are to get best value for
heir money.

Local administration does not, however, necessarily imply
ocal control of the executive officers. With modern com-
unications and the development of the administrative machine
is possible—at any rate in a small country like Britain—for
decentralized national administration to pay almost as much
ttention to personal and local needs as one that is locally
ontrolled. In the inter-war period this was conclusively
emonstrated by the success of the Assistance Board. This
iscovery has largely cut the ground from under the argument
hat in Britain social services require local control. Indeed
here is an *a priori* case for supposing that the local branches
f a central department will be more successful in providing
niformly good services than semi-independent local authori-
es.

From the other side it is argued that with the spread of
rban development over the countryside, and the increasing
abit of living in one place and working in another which it

implies, statutory local authorities no longer have
charge *communities* in any relevant sense. On the
neighbourhoods have ceased to be physically and
logically distinct; on the other the traditional juris-
the local authorities have become too small for mo

There is a good deal of substance in these conten
it is not surprising that they should be leading
actual extension of central functions and to a dem
grouping of local authorities into larger "regional
is further evident, on purely economic grounds,
successful maintenance of a high level of econom
either the national government must undertake
through public corporations) substantial types of in
for instance, housing and highways—or it must ha
much greater means of controlling the timing
of local investment than it enjoyed in the inter
Thus it is inevitable that the status of local inves
economy should be modified.

Local independence in Britain is thus threatened
quarters. The threats are the more serious becau
the backing of the progressive elements in the
educationalists, the social workers, and all who put
on efficiency. Yet there remains one basic argum
of autonomous local government which has at le
claims to consideration as efficiency. Moreover,
ment which the course of history is tending to emp
than to weaken.

The convincing argument for the preservati
autonomy—and hence for something like the
British local government set-up—is now almost wh
Recent history strongly suggests that the pow
initiative is a *sine qua non* of successful and stable
The reason for this is that live local governments
active connection between the citizen and the
Complexity of political structure is actually a virtu
multiplies the contacts between the governed and the
The danger of destroying these additional c

ragically demonstrated in France in 1940. To obliterate
ll traces of them has been a leading aim of authoritarian
tates.

The spirit of democracy is in fact nothing other than the
ense of political responsibility in the individual citizen. It is
ue that the democratic virtues can be fostered by many types
f association, both social and occupational (trade unions and
ven choral societies); but the organization of local communi-
es into associations which are political in the sense of being
artly self-governing has a special virtue in promoting a sense
f political responsibility. Local autonomy is a training ground
or a far wider circle than the few who have ambitions to take
personal share in government.

The political argument for local autonomy is so strong that
is right that it should be given preference even at the risk of
me loss of efficiency. It is necessary to consider carefully,
owever, with what type of autonomy the argument is really
ncerned. It is essentially an argument for the independence
local *communities*, that is, of groups conscious of common
cal aims and interests. It is obvious that in Britain such
oups only exist on any scale that is administratively relevant
urban communities, although not necessarily only in the
ghty-three major towns which at present enjoy the privileges
county boroughs. The political argument for local auton-
ny, at least in England, is thus fundamentally an argument
r the independence of town government. In areas where no
ministratively convenient self-conscious units exist,[1] the
gument for local independence is weak in comparison to the

[1] The size of the satisfactory local unit probably differs considerably
m country to country, according to the type and density of the popula-
n. In Scotland community life in rural areas seems to be stronger than
England, and the typical burgh is much smaller than the English town.
is quite possible that in Scotland—or for that matter in France, which
in many ways similar—independent administration of small country
as would work well. In the United States a population unit of 35,000
50,000 seems to find most favour (cf. Hansen and Perloff, *cit.*); on
glish standards this is rather low, cf. the minimum for independent
vileges recommended by the Ministry of Health to the Local Govern-
nt Boundary Commission.

high probability of the greater efficiency which would result from national or regional control.

§ 4. National Standards and Local Inequalities. The... a fundamental dilemma in local government—of ... political advantages of autonomy against the ... large administrative units and the social benefits of ... standards of social services. This dilemma, with all ... plications to which it gives rise, is far from being ... British phenomenon. It appears—and in a ... similar form—in every country[1] which does not ... by complete centralization; it is particularly intract... great federations, because it is then on a two-... federal, state or provincial and city or local. It is ... important to find a solution in a country which ... follow a systematic policy of high employment.

The factor above all which complicates the ... disparity between local wealth and needs. In an ... and well-educated country, like Britain or the U... there is no reason to suppose that one town cannot ... able citizens as another for the local council (re... that we are primarily concerned with urban comm... certain minimum size); or that *given equal financial* ... equal administrative and executive ability is not ... local authorities. Minor differences, in ability ... are always to be expected, and do no harm. (For ... Manchester has a special interest in its education ... Birmingham in its public health, that is a ma... gratulation and not for discouragement, so lo... services do not suffer.) There is no reason why ... differences should have any systematic or lasting ... the interests of particular citizens.

Unfortunately, however, financial opportu... naturally equal; local communities differ enormo...

[1] Cf. Report of a "Conference on Problems of Reconstruc... the Birmingham Reconstruction Committee and Represent... Cities of the Allied Nations", Birmingham, April 1944.

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 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 give only a small indication of the complexity of the problem. Differences in local wealth are partly a matter of whole 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.

[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*. 17

The solution of the local government dilemma that ... be achieved by the national government merely handing ... sufficient funds to local governments to enable them ... a satisfactory average standard of performance, but not ... to destroy their initiative (i.e., giving them no incentive ... practice laying out their own resources to the best advantage). ... it is something much more complicated. The solution ... quires the combination of a carefully adjusted differentiation ... system and a local tax system which minimizes the work ... the grants have to do.

§ 5. The Characteristics of a Good Local Tax. Much ... attention has been given to the consideration of the ... properties of a good local tax than of a national tax, ... little thought will show that they are by no means ... It is, of course, desirable that a local tax should ... other—be convenient and certain, fair between ... similarly situated and economical in collection. (The ... especially necessary since minor authorities cannot ... skilled administration which is available to national ... ments.) But the position of local finance in the economy ... from that of central finance in several respects, and ... the type of tax which is required.

Just as there must a basic difference between the ... tax powers of national and subordinate governments, ... a parallel, almost equally inevitable, difference in the ... ing powers. There is virtually no limit to the debt ... national government may acquire, so long as it ... confidence of the citizens; the borrowing of ... governments on the other hand cannot be allowed to ... indefinitely. It is not beyond the bounds of probability ... a subordinate government which can borrow to any ... extent may be able to defy the policy of the national ... ment and even break up the nation.[1] In a less critical ... than this, it is still very undesirable that a ...

[1] Cf. especially the conduct of the Confederate States in the Civil War.

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 is proper to private enterprise (which imples 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
exaggerate local disparities in wealth. This, it will
cuts out for local use progressive income taxes of
type. Poor authorities could never hope to make
meet if they had to get most of their revenue from
moderately wealthy people who alone would be like
within their jurisdictions. Further, the danger of
migration implies that there is a ceiling in relation
above which it is primarily a matter of relative tax
area and another, the higher the general level of local
the greater will be the absolute differences in inter
liability. From these points of view a tax which is
or even moderately regressive, is more appropriate
purposes that a progressive tax, and should not be
able on distributional grounds as long as liability is
low in relation to working-class incomes.

Finally, it is, to say the least, extremely convenient
tax can be reserved for local use. Basically the purp
is to ensure local autonomy; but on other grounds
very desirable to avoid overlapping tax rights betwee
and regional governments. When revenue needs
the major government must necessarily override the
the regional authority, and this leads to much fricti
as to confusion in local budgets. In both Ca
Australia there was much heartburning on this
between 1939 and 1945.

Where interlocal differences in tax rates are la
lapping rights may actually hinder the national g
in the performance of its duties by driving up tax rat
areas beyond the practicable limit (producing, fo
income taxes of more than 100 per cent). C
exploitation of taxes is also a fruitful source of doubl
treble—taxation of the same income or commodity
competitive exploitation has the important distribu
advantage that it makes it impossible for the central g
to regulate the rate of progression of the tax struct

In a unitary country it should always be possible

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 given revenue can be raised with lower *per capita* taxes than by means of any other outlay tax.[2] Thus subordinate governments can raise a large independent revenue by this means without running their heads dangerously near the ceiling.[3] Finally, a tax on land

[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.

[2] Cf. the analysis, p. 148.

[3] 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. In some states also a low ceiling to the property tax was deliberately written into the constitution.

and buildings is one which it should be easy for the
government to refrain from poaching on; for exam
just because of its stable (and consequently unexp
yield, it is very little use; for normal conditions the
lack of tax sources with similar incidence. In the
Kingdom the local rate has always been left to
authorities[1]; in the United States there has recently
very marked tendency to leave the local property
cities and local authorities, so that the problem of
jurisdictions and competitive exploitation is now
reduced to the Federal/State plane.[2]

In spite of these obvious virtues it is common to
local property tax the object of much criticism and
especially in countries which put a considerable
Although the weight on the British local rate is not
able,[3] it is not exempt from this criticism, so that
inquire into its cause and validity.

An obvious objection to real estate taxes as they
monly practised is the use of out-of-date valuation
property to be taxed. This is partly due to the limited
resources of minor governments, especially where
are small. The tax is not in principle "uneconomic
is rather difficult and expensive to determine the base
Valuation is a skilled job, and a thorough revaluation
the service of expensive personnel for a considerable
Consequently valuations tend to be scamped, or
until with the passage of time they become quite
with each other and with the facts.

Probably the best cure for this difficulty is to
the duty of *valuation* (but not, of course, of assess
collection) to a central body, placing the cost on the
exchequer.[4] This would not only promote uniformity

[1] The seventeenth-century land tax was essentially an income tax, p. 121.

[2] Cf. the account of the U.S. tax structure, pp. 78ff.

[3] Cf. the estimates of formal incidence, pp. 260ff.

[4] In the U.K. this was done by the Local Government Act, p. 242.

valuation practice, and so substantially 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 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 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 crown property and public utilities are arbitrary and uncertain. More serious than these anomalies (because about 60 per cent of rate revenue is derived from them) is the situation concerning the valuation of dwelling houses. Since there was no provision for regular revaluation, although valuations were properly based on free market rents, as was legally required, on the eve of the first war serious differences had already arisen depending on the date of valuation. These differences were then frozen by the rent control of the first

world war. When (in 1925) provision was made for quinquennial revaluation the position had been complicated by the tendency for valuers to value the by analogy with the controlled rents of old houses size, rather than seek a current (and of course higher) market rent. Since in addition the tended to be smaller than old houses of similar accommodation, this practice gave rise to a situation new houses were generally undervalued relatively to this it arose that whole areas might be substantially valued relatively to others, depending primarily on of small new houses within their boundaries. serious matter, since from 1929 rateable value per to be one of the elements on which the amount of exchequer contribution to local revenues was based.

Probably only valuation by a central authority straightened out the intra- and inter-local valuation which had accumulated by 1939; it was therefore an improvement when valuation was (by the Local ment Act 1948) transferred to the Inland Revenue. time, however, the total rent control of the second had once more frozen relative values in the accidental into which they had drifted; at the same time it had once more frozen relative values in the traditional nitely postponed the day when a return to the traditional of valuation (the free market rent) could be made. quagmire no government has yet been able to devise which would once more place the valuation of houses on terra firma.[1] In respect of grants the situation now even more serious, since (as we shall see) the erosion grant of the Local Government Act 1948 depends to a greater extent on uniform valuation. This erosion of the local rate is a melancholy factor in the situation has to be borne in mind; at the same time it can be said to destroy the basic arguments in favour of local tax.

[1] The Rating and Valuation Act 1953 may provide a first step; it is yet too early to say.

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 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] Regression, however, only remains acceptable 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 may be scope for a tax on land values; other taxes with reasonably localized sources are entertainments duty and motoring taxes,

[1] Cf. the estimates of formal incidence in the next chapter.

especially vehicle licence duty. All of these have the
that they could be vacated by most national g
without undue inconvenience, that they are not
gressive and that they need not involve double
interlocal tariffs against trade and industry.

§ 7. Equalization through Grants. A satisfactor
greatly facilitates the solution of the dilemma of lo
but it can never provide a complete solution.
powers and duties of local governments are
limited than is desirable on political grounds.
grants will be necessary for equalizing purposes
also be needed as a supplement to local resources
the general level of local tax rates from becomin
(In addition it may also be desired to award grants
the expansion of new services, this policy althoug
in itself actually—as we shall see—increases the
solving the main problem.)

In any grant system there are thus two major pro
to solve, one concerned with the over-all size o
relation to total local financial resources, the o
distribution of grants between local authorities
placed.[3] It would take us too far into the

[1] The proportion which total revenue bears to the na
also relevant. Where revenue needs are light the obje
of a *proportional* income tax for an upper layer of regiona
are so great that its disadvantages may be overlooked.

[2] At the same time the existing powers and duties of
should not be regarded as sacrosanct. In Britain, e.g.,
a further transfer of highway services from purely local
perhaps fire brigades which were a national service during

[3] Mention should be made here of the traditional m
was sought in Britain to solve both problems at once
distinction between *onerous* services (mainly those impose
government), and *beneficial* services (essentially neighbo
ments), the former to be grant aided, the latter to be finan
local resources. From the first the distinction was vitia
of the central government to make a grant for public ass
onerous and disequalizing of all forms of local expenditure
in which neighbourhood improvements may be made
income redistribution is accepted as a national policy,
loses any precision it once had, or any usefulness as a direc

ld to discuss these questions in detail, but a word must be
id on each in order to complete our analysis of the more
nited fiscal problem.

The danger of very high grants is that they will lead to
esponsible spending. This is probably less true of an
qualizing grant based on some objective measure of needs,
d available for general purposes, than of a specific percentage
ant for a particular service; the latter may have the effect of
riously distorting local budgets. The natural reaction of
ntral governments to the danger of irresponsible spending
to attempt to increase control, as grants expand. Since
is is to destroy local autonomy it should be avoided as far
possible. There is little doubt that a higher standard of
od spending could be achieved if the national government
re to aim (by precept and practice) at a higher standard of
cal authority costing and accounting. By these means
ntral departments would have a better effective control
thout any inevitable increase in day-to-day interference with
ministration.

At the same time, if a policy of increasing urban local
tonomy is followed (as is here suggested on political grounds)
time will come—in Britain at no very distant date—at which
me counties can cover only a very small part of their needs
t of rates. In those conditions an amalgamation of areas
der national or regional control would promote efficiency
thout sacrificing anything of political value, since there is
tle county consciousness in most areas, apart from the
estion of cricket.

Up to the second world war, the effect of differential grants
securing uniform services in Britain was slight. One im-
rtant reason for this was the extensive use made of specific
ants for particular purposes, especially for education. Per-
ntage grants are disequalizing because only well-off authori-
s can take much advantage of them, since in accepting the
ant they inevitably increase their own responsibilities also.
fter the grants have been in operation some time therefore
e standard of services in poor and rich areas begins to diverge

markedly.[1] If, finally, it is decided to provi
differential help, the task of equalizing services w
made more difficult, and the government w
committed to substantial positive grants to th
authorities.

The basic problem of a successful differenti
however, the choice of an objective and secure basis
ing the inequalities in wealth and needs which
required to rectify. The first major attempt in B
"Block Grant" (General Exchequer Contributio
This worked through a complicated formula o
population by factors presumed to allow for
poverty or exceptional needs: low rateable valu
high percentage unemployed, large number of chil
and in rural areas, sparsity of population per
The grant was fixed for five years at a time, an
which had the advantage of certainty both fo
and for local budgets, but the disadvantage of
As an equalizer this grant proved a very weak inst
was partly because the grant (and especially th
element in it) was small both relatively to other
of which were definitely disequalizing), and e
relation to the great disequalizing force of publ
expenditure during the depression. It was also p
some of the wealthy authorities were eligible for
tial grants under it.

In 1948 a much more equalizing grant was subs
was based (apart from a nominal weighting for
sparsity) squarely on the difference between rateab
head in the area and the national average, and
"needs" of an area as determined by its expen
grant, moreover, is adjusted from year to year
local expenditures are known. Further, grants

[1] A striking instance of this was revealed in the backwa
culosis services in Wales in the 1930's.

[2] A committee investigating in 1953 recommended the
moving three-year average: it does not seem likely that this

ly to areas with less than average rateable value per head.
principle this grant should be very equalizing; it provides
tually similar opportunities for the poorest authorities as
e richest enjoy from their own wealth; it will not of course
sult in equality of rate poundages unless the poorer authorities
e restrained in their outlay, but it should result in rate
undages roughly proportional to expenditure.

As a result of this Equalization grant, and in conjunction
th the transfer of public assistance to central responsibility, in
t a complete equalization of standard of basic services has
obably been attained. That the new grant has not proved
many feared) an overpowerful stimulus to expansion is
obably because on the one hand its scope is still narrow in
ation to other grants, and on the other expansion still gives
e to uncomfortable pressure on the rates in poor areas.
e principles of this grant have much to recommend them on
unds of simplicity; but it will be seen that for its equity it
ns very heavily on standardized valuations. Until the
uation problem has been solved many anomalies in its
rking must necessarily persist.

These are difficult problems, and it is not possible here to
much more than indicate their existence; but that at least
necessary, because they are of vital importance for the
ure. The dilemma of central/local relations cannot in any
be avoided; since both the future of democracy and the
fare of the community are at stake, it is worth diligence and
ience to discover the right solution.

CHAPTER XVI

THE INCIDENCE OF BRITISH TAXATION AND EXPENDITURE

§ 1. Formal Incidence and Effective Incidence. We have seen the convenient word "incidence" has been ... tax problems with a number of different meanings ... has led to no little confusion. There are, however, ... meanings which are of particular interest for ... purpose, and concerning these there need be no ... We have distinguished these as *formal* and *effective* ... respectively. In the present chapter our main ... the former; it will be as well, however, to recall ... basis of the distinction before we proceed.

The formal incidence of a tax records the allocation ... different income groups of the revenue actually ... during a particular accounting period. The formal ... of income and profit taxes is determined directly ... income groups of the producers of the income ... owners of the property (including bondholders) ... accounting terms disposable income=product ... less income taxes. The formal incidence of estate ... (if we wish to include them in the estimate) is ... found by taking the gross value of estates passing ... the period, relating the properties to the income ... the former owners, and on this basis dividing ... collected.

We are not concerned, in formal incidence, with ... economic repercussions of these taxes were, ... ducers might have worked harder or less hard ... had been different, whether capitalists might have ... or less had their net dividends been larger, or ... elderly may have taken to reduce the value of ...

before death. These questions belong to the field of effective, not of formal incidence.

In respect of outlay taxes in similar manner, the task of formal incidence estimation is solely that of determining the income distribution of the revenue actually collected during the accounting period: the amount of tax which, aggregated over the year, each smoker (for instance) has paid as a condition of buying his cigarettes. The old concept of "shifting" of tax, from the tobacco manufacturer, through various stages to the consumer, is not relevant here because we are not inquiring into the economic repercussions of the tax: whether (for instance) if smokers reduce their consumption, manufacturers decide to "bear" part of it themselves, by acquiescing in a reduction of their profit margins, or what the retailers' reactions are if they find an unwanted accumulation of stocks on their shelves. These inquiries again belong to the field of effective incidence. Although it is highly desirable that empirical investigations into effective incidence should be made, and much too little has yet been attempted in this direction, it is evident that estimates of effective incidence cannot form the basis of unambiguous and precise aggregative statistical estimates, since at bottom they must depend on the particular assumptions on which the analysis is based, and the assumptions appropriate in one time and place may be completely inappropriate for another, so that inter-temporal or inter-local comparisons are misleading.

In contrast the method of estimation of formal incidence can be applied at any time or place to give unambiguous results, the accuracy of which will depend only on the accuracy of the primary data on which they are based (such as collections of consumers' budgets) and not on the choice of particular assumptions. Having in this way determined the formal incidence (or income distribution) of the revenue tax by tax, we can if we like add the formal incidence of all taxes to obtain the formal incidence of the tax structure on the whole economy. In principle we can do the same for public expenditure—or at least for those parts of public expenditure which provide

benefits which are divisible between persons (as
services such as police and defence are not) and s
to different groups.[1] If we then confront the tw
we can discover the formal net effect of public
income distribution.

It is important to emphasize that any such esti
only a very limited real content; for economic ju
policy decisions the important factor is not the f
dence, but the economic adjustments which are m
sequence of it. The sum total of these constitu
incidence. Normally the process of adjustment pass
a number of stages. When a tax is paid, co
resources is in the first instance transferred from
to the public sector; accompanying the payment th
in almost all circumstances, a change in income d
the part of the private sector on which the tax fa
most heavily, will have lost command over resour
to other parts.

The additional resources now available in the p
may be employed in the purchase of goods a
(which may be either on current or on investme
or they may be employed abroad. Alternatively
be transferred to other public authorities or fo
private sector, possibly to the same, but more likely
pockets from whence they came. This again will
changes in income distribution.

The changes which occur at the various stages in
will lead to changes in output since they imply
demand; these in turn are likely to lead to
investment, while the changes in income distr
tend to alter directly the relation between curre
and saving. These are the processes which
watched and evaluated by those responsible for
economy running at a high level of activity with
national product; we shall be concerned with pro
nature in Part III; our present task is much more

[1] For a discussion of this point see below, p.

The question of income distribution and redistribution
hrough public finance early aroused great interest in Britain,
ar in advance of other countries. The first estimates of the
ncome distribution of the tax structure related to the year
903–04. Interest in the effects of social expenditure were grow-
ng throughout the first decade of the present century, as witness
uch a book as Professor Bowley's "The Division of the Pro-
uct of Industry" (1911). In the middle 1920s the (Colwyn)
ommittee on National Debt and Taxation expanded and
rought up to date these estimates. Later additional inform-
tion, especially relating to consumers' expenditure, became
vailable, and this facilitated the making of the most detailed
stimates of formal incidence which have yet been possible; for
he first time also it became possible to include the important local
te in the estimate.[1] For the first time also tentative estimates
ere made of the formal incidence of public expenditure.
Since that time the practice of social accounting and of the
rmulation of a general economic policy based upon it, has
reatly improved the relevant statistics, especially in respect of
itial income distribution. It is thus possible already to
nprove markedly the accuracy of the income and capital side
f the tax estimate. While some new information is also
vailable concerning the distribution of consumer expenditure,
o such comprehensive data as were used in the 1930's are as yet
vailable for the post-war world. An estimate has, however,
een made of the formal incidence of taxation and expenditure
lating to the year 1948–49[2] which is some help in bringing
e figures up to date, besides being of considerable historical
terest, as illustrating the pattern of income redistribution at
e height of rationing and progressive taxation. (In that year
e Special Contribution, based on investment income of the
revious year, was levied in addition to the normal income and
rofit taxes.)

[1] Cf. F. Shirras and L. Rostas, *The Burden of British Taxation*; T. Barna, *e Redistribution of Income through Public Finance*; and J. R. and U. K. icks (with C. E. V. Leser), *The Incidence of Local Rates in Great Britain.*
[2] Cf. A. M. Cartter, *The Redistribution of Income in Post War Britain.* 18

§ 2. The Distribution of Income. In virtually all ... income distribution resulting from the production ... tends to conform to a similar pattern: the vast major... citizens have incomes below the average, a small num... incomes substantially above it. The British version ... distribution is summarized in Table VII for 1938 ... Now that a number of calculations are available ... countries it is apparent that the degree of inequality ... not exceptionally great, rather the contrary. It may ... that in no other country is the initial distribution of ... so equal, unless it be one of the Scandinavian coun... the U.S.A. the initial distribution of incomes is also ... egalitarian, and this is broadly true of all developed ... ized countries. It seems to be well established that ... and underdeveloped countries income distribution ... very much more uneven.[1] These countries have also ... power of influencing the final distribution of income ... public finance than developed countries with well-de... tax and social security systems.

An attempt has been made in Table VII to allow ... change in the value of money between 1938 and 19... assumed that an income of £500 in the later year w... similar bundle of goods as an income of £250 in 193... not strictly true, but it is a convenient approxima... fact, as the result of the Korean inflation, the value ... had fallen rather more than this by 1953, so that ... in the later year are in the Table somewhat inflated ... to 1938. In practice this makes little difference; it ... from the composition of each group that we ... concerned with the same sort of people in the £500 ... 1953 as those in the £250 group in 1938 and so on.

The changes are just what we should expect ... economic grounds. The numbers in the top group ... relatively (and slightly in absolute terms also, esp...

[1] Cf. "The Distribution of Income in Ceylon, Puerto Rico, ... States and the United Kingdom", by T. Morgan; *Econ...* Dec. 1953.

remember the overvaluation of 1953 incomes just mentioned). The numbers in the third group have expanded considerably and in the other two slightly. The fall in the number of upper incomes can easily be explained, mainly by the smaller distribution of dividends and by the cumulative effect of death duties. The expansion of the lower reflects the better employment position. The lowest group of all includes of course many part-time workers, and the extension of employment among women is one of the factors accounting for its expansion.

TABLE VII. THE DISTRIBUTION OF PERSONAL INCOMES IN 1938 AND 1953.

Income Class (£)		Numbers in Class (th.)		Average Income before Income Taxes (£)	
1938	1953	1938	1953	1938	1953
Over 1,000	Over 2,000	289	285	2,667	4,000
500–1,000	1,000–2,000	539	790	669	1,322
250–500	500–1,000	1,890	6,575	334	652
Under 250	Under 500	15,300*	17,650	169	283

* Unofficial Estimate.

Thus, over the period there has been a general evening up of the initial distribution of incomes; other factors outside the public finance system have also contributed to a greater equalization of spending power. In particular rent control benefits the lower income ranges more than the upper, because a larger proportion of them live in rent-controlled houses. Table VIII shows the difference which income and surtax made to this initial distribution of incomes. It will be seen that in 1938 the top group parted with 30 per cent of their incomes in income and surtax; the second group also made a substantial contribution of over 11 per cent, but the contribution of the two lower groups was very small. By 1953 the situation had

altered materially: the top group, besides being s
less well off, now parted with 66 per cent on th
(individually of course with much more, since this g
the progressive range of surtax); the second group
with 20 per cent, while the third group lost 8 per c
the extension of income tax down the income sc
lowest group, although the total contribution was s
had greatly expanded.

True disposable income depends also on the m
(or income transfers) made through the social s
similar provisions. In 1938, due to the great imp
unemployment pay and public assistance, all but a

TABLE VIII. THE FORMAL INCIDENCE OF INCO

Income Class (£)		Average Income After Taxes (£)		Perc
1938	1953	1938	1953	19
Over 1,000	Over 2,000	1,823	2,104	30
500–1,000	1,000–2,000	597	1,069	11
250–500	500–1,000	323	606	3
Under 250	Under 500	169	276	0

percentage of these transfers accrued to the lowe
group. In the later year, due to the fall in unemp
relative importance of money transfers had fallen
still mainly accrued to the lowest income group
basis of the 1948 estimates it seems that virtually
pensions, 87 per cent of family allowances and 59
other transfers, including educational grants, acc
"under £500s" in that year; the percentage addi
disposable income was 11 per cent, while the
received a contribution of 1 per cent only. It do
likely that these relations can have altered much by

[1] For further discussion of this point, see below p

The other important redistributional tax is of course death duties; in recent years the redistributional element in this has considerably increased; the progression has been steepened and the exemption limit raised, thus cutting out a large number of small estates. Death duties were, as we have seen, the first progressive taxes to be introduced; but for many years their rates remained moderate and the effect on income distribution was negligible. They gradually crept up, and in 1930 were drastically increased. Already by 1938 the largest estates paid 50 per cent, but an estate of £200,000 still paid the comparatively moderate tax of 25 per cent. The present rates, progressive up to 80 per cent on the whole estate, were established only in 1949, so that sufficient time has not elapsed for their effect on incomes to have worked out (for this reason the 1948 estimates understate the position in 1953). These confiscatory rates not only break up estates directly, but lead indirectly to greater equalization of incomes through gifts *inter vivos* and trusts. They also tend to capital consumption and abstention from saving; this gives rise to further equalization, although probably at the cost of some productivity. Finally the inflationary price rise has substantially increased the burden of death duties. An estate of £200,000 in 1953 had a real value of between £75,000 and £100,000 in 1938, and on this basis the rate of tax had risen by more than 40 per cent.

3. The Formal Incidence of Outlay Taxes. The formal incidence of outlay taxes can only be discovered by asking people how much of the different taxed commodities and services they purchased over a given period, usually a week, and when samples of several weeks have been taken, expressing these as yearly rates. Finally the total revenue collected during the year in respect of the different taxes must be allocated to different income groups on the basis of this information. The family budget method is full of difficulties and the results inevitably contain a good deal of guesswork; they cannot be regarded as being on all fours with estimates of the

income distribution of income taxes. This by
detracts from the importance of attempting to
estimates.

The first difficulty is that the tax "unit" differs
the two types of tax. The income tax family consists
of the single person or married couple, although
is gradually improving which enables dependent
allocated to the standard of living which they
For most outlay taxes in contrast the tax family
those who pool their expenditure for food, furniture,
perhaps clothes. For the all-important taxes on
tobacco on the other hand the unit is strictly
here in particular the family budget method
down completely. Information is obtained from
they rarely know either the whole income of the
consumption of drink and tobacco by the several
Even if the chief smokers and drinkers can be
are unlikely to own up to the extent of their
has been found that there is always a serious
the consumption implied by the revenue
consumption admitted by taxpayers.

There is a further difficulty in respect of
chases, such as clothes and furnishings, which
correctly recorded by the weekly method.
important in 1937 since few of them were taxed;
of the purchase tax has altered the situation.
reason that so much larger a percentage of their
consists of intermittent purchases of this nature,
inquiry method works even less well in the
range.

Finally there is the problem of the local rate,
from every other British tax in that the
markedly—before the advent of the Equalization
differed very markedly indeed—from area to
federation of course such interlocal variation is
a number of taxes, especially sales taxes; for this
very difficult to obtain meaningful and inclusive

formal incidence in federal countries. Only very exceptional inquiries provide sufficient information for making separate area estimates of rate incidence; normally budget studies throw up only a single figure of gross rents (rents plus rates) which are useless for the purpose. Fortuitous circumstances—the coincidence of two inquiries—produced the necessary information for 1937 but it may not again be available for many years. While this is regrettable the greater equalization of rate incidence, due to the greater equalization of poundages on the one hand and to larger incomes in the formerly highly rated areas, together with the decline in the importance of rates in relation to other outlay taxes, makes the problem of estimating the formal incidence of rates of somewhat less importance than formerly.[1]

The investigations of 1937 pointed pretty clearly to a pattern of incidence by which outlay taxes fell neatly into three groups: (i) the vast majority falling on mass consumption, including taxes on essential foods (tea, sugar), drink and tobacco, and local rates; (ii) a group of taxes on not quite so common consumption, including duties on silk and rayon, cameras and so on, the motoring taxes (fuel and licence duties) and taxes on the less essential and luxury foods; (iii) a substantial revenue derived from taxes falling indirectly on consumption through the production and marketing processes, such as local rates on business premises and motoring taxes on lorries, buses and delivery vans.

In the first group in 1937 over 90 per cent of the revenue was derived from the (prewar) "under £500s", and something over 80 per cent from the "under £250s". In the second group incidence was more evenly divided between the under and over £500s—in respect of silk and rayon it seems to have been divided about 50/50; in the case of motoring taxes as much as 70 per cent may have come from the over £500s. It is not possible to determine the incidence of the third group with any precision; it no doubt lay between that of the first and second, probably nearer to that of the first.

[1] For further discussion of this point see below, p. 263.

As we have seen the 1948 estimates are not based
independent data; it is interesting nevertheless to
the picture which they reveal with the pre-war situation
two stalwarts, taxes on drink and tobacco, continue
80 per cent of the revenue as derived from our lowe
(under £500 in post-war conditions). It must
remembered, however, that 80 per cent of the popu
be found in this group. Apparently a rather small
age of the revenue than in pre-war conditions was de
the next group up the income scale. This perhaps
well substantiated decline in smoking among young
the middle income groups. The food taxes had
largely faded out through being assessed at unit
ad valorem rates[1]; indeed many had been replaced by
The incidence of these we must examine later. Both
Betting tax and the much increased Entertainments
showed a somewhat less regressive incidence; for
ments 50 per cent of the revenue was derived from
£1,000s and 72 per cent from the under £500s; for
figures were respectively 69 per cent and 77 per cent.

The 1948 incidence of motoring taxes is of historic
only, due to the inavailability of cars and to the
of petrol rationing. The result of these factors was
the percentage derived from the higher income groups
£1,000) to a mere 18 per cent in place of the pre-
cent. Considerable interest attaches to the
purchase tax for which there was no pre-war parallel
greater part of the revenue has been derived from the
clothing, durable consumers' goods and a variety
articles, including cosmetics, taxed at rather high
none of these was the incidence highly regressive,
one hand to the exemption of utility goods from tax
other to the *ad valorem* rates of tax. The average
of the tax as a whole shows 53 per cent derived from

[1] Consequently as prices rose their effect gradually declined
have occurred also in respect of the taxes on drink and tobacco
rates not been repeatedly raised. See also Chart 1, p. 65.

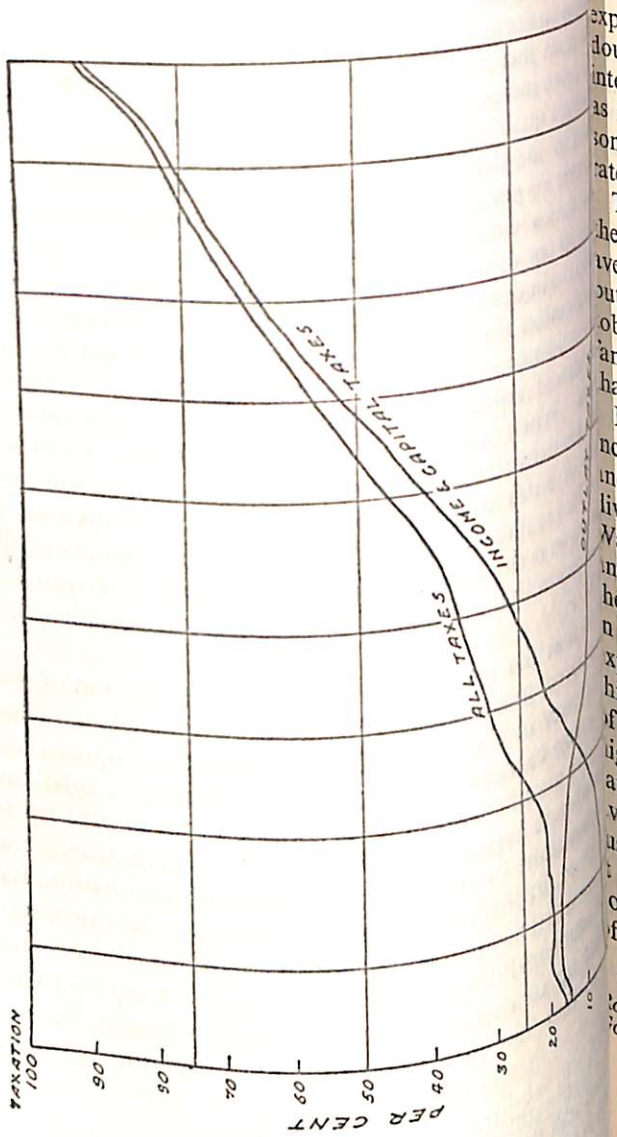
£1,000s and 38 per cent from the over £500s. This significant movement towards the reduction of the regression of outlay taxes was thus on the average less than the increase in regression due to the great increase in the taxes on smoking with their highly regressive incidence.[1] As we shall see, however, there is an important qualification which needs to be made here.

Returning to the firmer figures of 1937 the situation was that while over 90 per cent of the revenue from income taxes and death duties came from the over £500s (in pre-war conditions), 90 per cent of the revenue from outlay taxes was derived from the under £500s. There was thus a quite different income distribution for the two sorts of taxes: a persistently progressive incidence of income and capital taxes and, on the whole, an almost equally persistent regressive incidence of outlay taxes. When combined the tax structure showed a progressive incidence ranging from 17 per cent on the very low income of £100 to over 90 per cent on an income of £100,000. This is illustrated in Chart 3. The waviness of the income tax curve is the reflection merely of the proportionality for short ranges which results from the reduced and standard rate "bands".[2]

It appears that the lower end of the outlay tax curve was slightly regressive, presumably because the variety of expenditure was narrower in the lowest income group, many of these would be young earners and single individuals. From this point the curve assumed an almost proportional course up to about £500 when it began to drop sharply. There are several possible explanations of this range of relative proportionality. In the first place, in the pre-war situation the consumption of certain common articles (such as tea and sugar, apart from that used in confectionery) appears to have expanded parallel with rising income up to a point of about £500 when it became stabilized, so that tax as a percentage of income dropped

[1] Presumably the substitution of the less regressive "D" scheme operating in 1953 must still further have reduced the regression of purchase tax as compared with the operation of the utility scheme in 1948.

[2] See above, p. 185.



sharply. More important, because the revenue is so much larger, in the relatively free market conditions of 1937 expenditure on house room, and hence rate payments, tended to expand fairly regularly with income. As income rises, and no doubt as the size of the family increases, people tend to move into bigger houses, thus leaving rates as a percentage of income as high as (or even a little higher than) before. There was some indication in the 1937 data that proportional ranges of rate incidence were repeated higher up the income scale.

The figures on which the curves are based are averages for the whole economy. In respect of most taxes deviations from average consumption within each income group are not large; but this is not so in respect of the consumption of drink and tobacco. The result is that for non-smoking or drinking families the regression of outlay taxes is very much smaller than appears from the average.[1]

In respect of the local rate also deviations from the average incidence are very important, between one part of the country and another. In conditions of the 1930s the country was divided very clearly into three rate zones: high poundages in Wales, middling poundages in the North, including Lancashire and Yorkshire, and low in the Midlands and South. Over the average of weekly wage-earning income groups rates were, in 1937, 4 per cent, 3·5 per cent and 2·9 per cent of family expenditure respectively, in the three zones. Cutting across this regional distinction was another, depending on the size of the community: broadly speaking the larger the town the higher the rates, a difference which was only partly compensated by a higher level of incomes in the large cities. Thus the average rate incidence in London on these income groups was just as high as in Wales; in three out of the four largest cities it was higher still. At the other extreme in every part of the country rural rate incidence was lower than urban, in spite of the relatively low income of farm workers. Generally

[1] This point was first investigated by D. Caradog Jones, *Journal of the Royal Statistical Society* 1927; cf. also U. K. Hicks, *The Finance of British Government*, p. 275.

speaking, however, higher urban rates implied standard of local services; consumers were, so to spe more of the product, and for the most part this suited them.

The income distribution of the 1937 tax structu markedly from that of earlier calculations.[1] In 19 whole curve was proportional or even slightly regr £1,000; by 1913–14 the progressive head had begun following the introduction of supertax; but th combined incidence was less than 10 per cent of inco cost of the first world war brought the high point t 50 per cent; during the 1920s it ran at about 4 rising again in the early 'thirties to over 50 per cent scientious but largely mistaken endeavour to b budget in depression. In the meantime through th regressive "tail" had been rising, to something cent (if rates had been included it would have been 17 per cent); leaving a decided "dip" at about th where total incidence fell to only some 6 per cent.

As can easily be seen from Chart 3, this dip was declining effect of outlay taxes as income increa income tax was still negligible in the lower ranges as the dip was not a statistical illusion it may well economically beneficial, taxing relatively lightly a the population which is particularly important from of view of productivity. There is no doubt, how current calculations exaggerated the importance partly through the omission of the local rate, w proportional incidence in this range, partly th assumption of an even distribution of the incidence smoking and drinking within each income group. seen from the Chart, with the lowering of the exemption limit and the inclusion of the local rate in any case virtually disappeared by 1937.

Unfortunately we do not have sufficient info

[1] For a description of earlier calculations cf. U. K. Hicks, *of British Government, 1920–36, cit.*, p. 270.

redraw the curves for the 1953 situation; but there are several things we can say about their course with reasonable assurance. In the first place, owing to the additional pressure on the revenue, due to the cost of the second world war, the continuing necessity for defence expenditure and not least the expansion of welfare expenditure, both curves have shifted up substantially. A maximum incidence of outlay taxes of 17 per cent before the war would now read about 24 per cent; in 1948 income taxes as a percentage of personal incomes had reached 73 per cent on all incomes above £20,000; by 1953, as we have seen, they averaged 66 per cent from £2,000.

Secondly it seems probable that the "dip" at the crossing of the two curves has finally disappeared, due to the greater coverage of income tax (mainly the result of inflation) and to the presence of purchase tax with its relatively mild regression. The local rate has not only declined in relative importance, but its incidence has become more even between one area and another, both through the operation of the equalization grant and through the rise in employment and incomes in the formerly most highly rated areas. Rate incidence in London may well now be considerably higher than in Wales. Broadly speaking, the combined effect of the increase in the taxes on drink and tobacco, of the purchase tax and of the decline in the importance of food taxes and of local rates, has been to shift incidence from the family to the single individual. The same tendency has been at work in income tax through the increased rebates for children and other dependants; it has of course been further reinforced by means of direct family allowances for the second and succeeding children.

4. The Incidence of Divisible Expenditure and the Redistribution of Income. We have still to consider the income distribution of public expenditure, other than money grants to persons (income transfers), which we have already set against income taxes. First, however, we must note a logical difficulty which does not occur on the tax side. If we want to make a nice tidy balance sheet of the redistribution of income through

public finance we ought somehow to distribute the whole public expenditure on revenue account between the different income groups, as has been done on the tax side. But while most taxation[1] is an individual or family affair, about one half of public expenditure goes to provide benefits which are to all intents and purposes indivisible. How are we to impute the benefits of defence, justice, police and roads, or even the ordinary expenses of administration, between people in different economic circumstances? Clearly there is no rational way of doing so; some writers have given their readers a choice of a number of methods, but none of them has any logical precedence over the others. It seems better to be satisfied with distributing only the expenditure which is divisible, in the sense that the benefits can be ascribed to particular groups. But so we are up against a much more difficult problem than on the tax side, since the information concerning the "consumption" of divisible benefits is less good than the information concerning the purchase of taxed commodities.

Divisible expenditure other than money grants takes different forms: (i) the provision of goods and services, for instance through the system of public education, the national health service, or the houses provided by local authorities, (ii) rights to the consumption of certain goods and services below cost, such as subsidized foods. These latter can be regarded as "outlay transfers", exactly parallel to certain taxes in reverse. According to the 1937 calculations, while income transfers were progressive with needs (formed a higher percentage of income as we moved down the income scale), this was not true of benefits conferred by the social services by outlay transfers, so far as the lowest income groups were concerned, although over the whole income range all such expenditure was of course progressive with needs.

Table IX shows the income distribution of the three divisible expenditures among the three lowest income groups

[1] Some difficulty arises over taxes on undistributed profits, which are usually imputed to the owners of the property although not forming part of disposable income.

in 1937, in *per capita* amounts. It will be seen that in each case the not so poor benefited more than the very poor. It was a well-known fact that in the inter-war period house building by local authorities mainly benefited the better-off wage earners.[1] In the 1937 situation income transfers accounted for 50 per cent of social expenditure, provision of goods and services for 43 per cent and outlay transfers a mere 7 per cent. It is possible that these last (school meals, cheap milk and so on) were also progressive with needs, but if so they would have been less sharply so than income transfers.

TABLE IX. THE INCIDENCE OF DIVISIBLE EXPENDITURE 1937–38.

(Other than Grants to Persons)
(£s per an. per cap.)

Income Class	Education	Health	Housing
Under £125	2·1	1·2	0·4
£125 but under £250	3·1	1·2	0·7
£250 but under £500	3·7	1·3	—

In the post-war world the relative importance of the different types of divisible expenditure has altered considerably. In the full employment economy the decline in assistance and unemployment benefit implies that income transfers are less important and less progressive with needs than they used to be; on the other hand, with the food subsidies there has been a great increase in outlay transfers. Table X shows a parallel estimate to that of Table IX for 1948. It will be seen that—strangely enough—housing was the only one of the four services which was progressive with needs through the three income groups. In the case of education, while the £250 to

[1] Or to put it another way, the chance of a family in the lowest income group getting a council house was only 60% of the chance of a family in the next group; the chances were better for the upper half of this group than for the lower; cf. Barna, *op. cit.*, and M. E. A. Bowley, *Housing and the State*.

£500 group received nearly twice as much per head as the groups below them (no doubt due to their taking greater advantage of secondary education services) the third group still received a greater benefit than the lowest group.

Both the health service and the food subsidies were apparently *regressive* with needs throughout this range. In the case of the former this may have been due to ignorance of the services available, or to a reluctance to seek advice; in the case of the latter it was no doubt due to inability to take up the whole of the ration. This illustrates the wastefulness of general food subsidies as a method of income redistribution: they confer their benefits indiscriminately on those who do not need them. On the other hand in one sense the food subsidies did benefit the very poor more than others. Since food occupies a larger place in their family budgets than in those of the better off; the percentage of income set free by receiving their food below cost was correspondingly large. In 1948 the general food subsidies (excluding the welfare foods) were at their maximum of £390 millions; by 1953 they had declined to just under £200 millions. The cost of the health service, however, continued to expand; in 1948 (before it had fully got into its stride) it cost £240 millions; by 1953 it had climbed to just under £500 millions, and was thus substantially the largest item in divisible benefits. Thus, by and large, over the field of divisible benefits (other than money transfers),

TABLE X. THE INCIDENCE OF DIVISIBLE EXPENDITURE, 1948–49.

(Other than Grants to Persons)
(£s per an. per cap.)

Income Class	Education	Health	Housing	Food Subsidies
Under £250	5·2	8·5	3·8	14·7
£250 but under £500	10·7	13·3	2·9	22·8
£500 but under £1,000	8·8	14·1	neg.	25·4

pre-war pattern persisted, with the very poor tending to benefit less than the not so poor.

If we now attempt to put together the results of taxation and social expenditure we can get in a formal sense an estimate of the redistribution of income through public finance. An estimate of this has been made for 1948 on a base comparable to the estimates of 1937, and is quoted in Table XI. It will be seen that the lowest income group received a smaller net addition to production incomes (personal factor incomes) in

TABLE XI.* THE REDISTRIBUTION OF INCOME IN 1937–38 AND 1948–49.

Income Class (£ th.)		Numbers (mns.)		Redistribution (per cap. £s.)		Disposable Income as % Personal Factor Incomes	
1937	1948	1937	1953	1937	1953	1938	1953
<·125	<·25	21·8	20·5	+12·6	+39·0	117·4	112·2
·125–·25	·25–·5	18·8	20·8	+5·4	+22·2	101·1	96·8
·25–·5	·5–1	4·8	5·6	+2·2	−24·9	96·9	85·6
·5–1	1–2	1·2	1·4	−33·0	−142·5	85·5	76·0
1–2	2–5	0·5	0·5	−115·0	−735·0	76·0	64·7
2–5	5–20	0·3	0·1	−565·0	−4380·0	59·7	42·5
>10	>20		·005	−7375·0	−37450·0	27·1	17·3

* From Cartter: *The Redistribution of Income in Post War Britain*

later year than in the earlier, but that relatively the larger incomes lost substantially more.

The main factor at work in the change has of course been the greater weight of taxation over the whole structure, due partly to the war and its aftermath, including persisting defence expenditure, but mainly to the social expenditure programme itself. A programme of this magnitude must necessarily be financed to a considerable extent by the income groups who benefit from it. Within their ranks, however, a simultaneous process of lateral redistribution is continually taking place:

from the healthy to the sick, from those of working age to the
elderly and from the single and childless to the parents of
young families. Thus estimates of redistribution by income
omit a most important aspect of the phenomenon. Neverthe-
less it will be remarked that in spite of the great increase in
non-divisible expenditure the difference between the additions
to the lower incomes and the subtractions from the higher
were greater in 1948 than in 1937. In this sense the pace of
redistribution had quickened. It must again be emphasized
that the results of income redistribution thus obtained are
formal, illustrating only the position at the moment of paying
taxes or receiving benefits, and can tell us nothing directly about
the economic process whereby these phenomena percolate
through the economy. They do, however, render the task of
tracing effective incidence easier by pointing the direction
where inquiries should start.

PART III

PUBLIC FINANCE IN THE NATIONAL ECONOMY

CHAPTER XVII

PUBLIC FINANCE AND THE LEVEL OF ACTIVITY

§1. Public Finance and Fiscal Policy. The last chapter introduced us to one aspect of the effects of public finance as a whole. We must now turn from distributional considerations to productional effects. The two of course are not unrelated since the pattern of consumption, and to a considerable extent also the type and volume of investment, are largely determined by the distribution of disposable incomes.

Fiscal policy is concerned with the manner in which all the different elements of public finance, while still primarily concerned with carrying out their own duties (as the first duty of a tax is to raise revenue), may collectively be geared to forward the aims of economic policy. These we may define as stability at a high level of employment on the one hand, and on the other the steady increase of productivity so as to obtain the maximum growth from the available resources.

In discussing fiscal policy we thus need to consider all types of public outgoings and incomings: on the one hand expenditure on current goods and services, loans, transfers, fixed capital formation and purchase of stocks; on the other, tax revenue and public income from property, borrowing and debt management. It is important for fiscal policy that all these elements should be kept in proper relation to each other. Indeed balance is the heart of fiscal policy, above all the

relation of current outlay and true revenue items in the Budg
since this denotes (as we shall see later) the contribution of
government to the saving or dissaving of the economy. It
this magnitude which needs to be adjusted in order to balan
the nation's economic budget. This is a much more fund
mental account than the Chancellor's budget.

Now that fiscal policy has been developed as an establish
economic function of government, every country is anxious
gear its public finances in pursuit of the twin aims of stabi
and growth; but their relative importance is very differen
regarded from one country to another. A poor and backw
country will strive to put most of the emphasis on grow
especially if, as may well be the case, its population is expan
rapidly. Nevertheless it cannot afford to neglect stabi
considerations. The process of development has an inherent
inflationary bias in that additional incomes are distributed
those engaged on the new works, without there being, to s
with, any additional consumers' goods to satisfy the
demand. Hence such a country will be wise to season
expansion with stiff taxes and other contractionary pay
finance measures, if it is to escape balance of payme
difficulties and even a danger of an unmanageable inflation

On the other hand a country whose natural resources h
already been developed to a high degree, and especially
whose population is not expanding rapidly (so that the cha
in tastes and techniques which inevitably occur cannot e
be absorbed in a tide of rising demand), will tend to concen
on stability, on keeping its already developed resources
employed. At the same time if it neglects the means of gro
—a sufficient allocation of resources to new investm
including research into new processes—there may be a dan
that it will subside into the sort of stagnation that seemed
have overtaken most of the developed countries in
1930s.

In the present chapter we shall be primarily concerned w
fiscal policy to secure stability; in the following we
consider briefly fiscal means to promote growth. The

aspects are, however, inextricably linked. A steady rate of expansion will tend to reduce the violence of such fluctuations as occur; a successful full employment policy will provide an atmosphere which is congenial for growth.

The idea that public authorities should have some responsibility for economic stability is by no means new in England, although it was not formally acknowledged until 1944. Enterprising Governors of the Bank of England realized from early in the nineteenth century that the Bank's credit policy could contribute, far from negligibly, to stability, by lopping off the tops of speculative booms by credit restriction and by filling up depression troughs by an easy money policy, notwithstanding that the Bank's primary duty was concerned with international rather than with internal stability. The part that public expenditure could play in promoting growth was (as we have seen) emphasized by Adam Smith and his contemporaries when England was just setting forth on the path of development, and when she was consequently in urgent need of just those economic and social "overheads" (such as roads and schools) which are the prime need of developing countries to-day.

At a later stage in the nineteenth century, when these overheads had been provided and growth seemed to be sufficiently assured by unaided private enterprise, the emphasis in British policy shifted to the attempt to remove the fiscal obstacles to growth. In particular, much thought and discussion was devoted to ways and means of exempting saving from income tax. As time went on and the rapidly expanding stage of the British economy passed away, this somewhat negative fiscal policy became economically inappropriate, while on the other hand the growth in wealth and social consciousness made it increasingly unacceptable on distributional grounds.

A necessary prerequisite for the correct orientation of a policy of economic stability, or compensatory finance, in modern conditions was an adequate economic analysis of the real (as distinct from the monetary) forces underlying industrial fluctuations. The first steps in providing this analysis in Britain were taken (most notably by Professors Pigou and

Robertson[1]) in the years just preceding the first world war. It seems to have been the crisis of 1907 which first aroused interest in this direction. Still greater stimulus to thought was provided by the prolonged under-employment of the 1920s and the chronic unemployment of the 1930s, which appeared to contemporaries no less a depression than the famous one years of 1870–90. It is to the 'twenties and 'thirties that we owe the fundamental theory of compensatory finance.

Outside Britain the most interesting development in the analysis of fiscal policy was in Sweden, where a group of young economists (especially E. Lindahl and G. Myrdal[2]) brought up in the general or macro-economic approach by their teacher Knut Wicksell, were groping for a comprehensive and rational policy of compensatory finance. The Swedish contribution was notable for emphasizing from an early stage three points which later experience has shown to be vital: (1) the importance of establishing machinery to ensure that in future depressions public authorities would not act "perversely", by taxing more and spending less, as they had done in the past, and would be likely to continue to do unless special measures were taken; (ii) the importance of the formation of additional assets in the public sector, both as a means of promoting growth in the economy and for their steadying effect; (iii) the need to gear the system of public accounting and the arrangement of the budget so as to make it appropriate for the additional responsibilities of fiscal policy.[3]

Meanwhile in Britain the economic analysis of fluctuations was making steady progress. The first important landmark in the new approach was Keynes's *Treatise on Money* (written in the late 1920s). This drew attention to the cyclical importance

[1] Pigou's *Wealth and Welfare* (the forerunner of *The Economics of Welfare*) was published in 1912; D. H. Robertson's *Industrial Fluctuation* in 1915.

[2] Lindahl's *Penningspolitikens medel* was published in 1929, Myrdal's *Economic Effects of Public Finance* (also in Swedish) in 1934; credit must also be given to the Swedish government, whose Royal Commission on Unemployment was the direct cause of the Swedish studies of the 1920s.

[3] For the significance of this see below, pp. 339ff.

of the relation between saving and investment, especially the propensity of both private and business capitalists in depression to fail to sustain the level of incomes in the economy by increasing their cash balances instead of spending or investing as usual. At this stage of analysis, however, the propensity to spend or save, and hence the level of incomes, was related primarily to the rate of interest. Policy was thus directed to the monetary rather than to the fiscal instrument. By saturating the desire for liquidity through an easy money policy it was confidently hoped that recovery would be brought about. This approach was characteristic also of Swedish contemporary thinking.

The direct contribution which public expenditure could make to recovery was first explicitly expounded by R. F. Kahn in the summer of 1931.[1] The idea that public expenditure could should be used in depression as a palliative to unemployment was of course not new; relief works have been used from time immemorial, but on humanitarian and moral rather than on economic grounds. The Victorian attitude to such works, enshrined in what was known as the "Treasury View", was that public works could have no beneficial economic effect. Either the works produced would be economically useless or they would merely represent an anticipation of what would have been done later in any case. The new approach, however, demonstrated that the additional incomes distributed on the works in a given period would not merely serve to sustain demand, but would have "Multiplier" effects, depending in volume on the degree of "leakage" out of the new incomes through expenditure on imports or through saving. Moreover this favourable effect would be quite independent of what might happen when the completed works came into use.

§2. The Principles of Compensatory Finance. The next stage in theoretical development completed in principle the analytical foundation on which modern fiscal policy is based. This was marked by the publication of Keynes's *General Theory of*

[1] In the *Economic Journal*, "The Relation of Home Investment to Unemployment".

Employment at the end of 1935. The analysis was fundamentally a further development of that of the Treatise and the Multiplier, but it differed significantly from the former in relating the level of activity to the level of effective demand and saving to the level of income, rather than to the rate of interest. This shift in emphasis had two implications for policy. In the first place the operative factors were shown to be those which were directly amenable to fiscal policy rather than to credit control; this was not to deny that low interest rates might be advantageous, on distributional and budgetary grounds, if they certainly always on economic grounds. In the second place it became clear that the responsibilities of fiscal policy might extend beyond the bounds of a self-regarding policy for the public sector (such as would be implied in the avoidance of "fiscal perversity") to the correct alignment of the level of money incomes in the whole economy.

The preoccupations of the 1930s were wholly with the problems of under-employment, due to the generation of insufficient incomes to ensure full capacity usage of factors. In these circumstances no particular precision in public policy was called for. The greatest expansion that could in practice be brought about was unlikely to run into any international difficulties of shortage of supplies once the gold standard had been abandoned. In fact, at this stage the technical obstacles to "inflation" were formidable, and no great success was achieved by fiscal policy in the 1930s by any country. There was, however, a growing understanding and acceptance both of the principles and of the means of compensatory finance.

In depression, it was realized, in addition to an easy money policy (which would promote growth as well as recovery) there must be a fiscal policy of refraining from increasing rates merely for the purpose of achieving a balanced budget. The accompanied by a definite programme of expenditure. This programme could, of course, be financed out of taxation, but it was convincingly demonstrated[1] that it would be more

[1] Cf. the "models" set out by N. Kaldor in Appendix C to Lord Beveridge's *Full Employment in a Free Society*.

effective to pay for it by borrowing, since the taxes would have a contractionary effect which would itself need to be compensated.

This position was, however, by no means universally accepted. The Coalition White Paper on Unemployment of 1944, which set the seal on the official acknowledgment of responsibility for fiscal policy, carefully refrained from stating that deficit finance in the general budget might be required, although it was prepared to allow one on the budget of the Unemployment Insurance Fund. Another school of thought considered that a specific expenditure programme was unnecessary; it would be sufficient to allow a deficit to develop spontaneously by refraining from raising tax rates. There would seem to be no good reason, however, why advantage of both sides of the budget should not be taken in gearing fiscal policy for recovery.

Even more than the Treatise, the General Theory was born of depression; superficially from the policy point of view the main difference between the two was the increased emphasis now put on fiscal rather than on monetary policy. In fact, however, the way had been opened for a more fruitful approach, which would make it possible to determine in principle not merely the right direction for policy, but also the correct quantitative degree of government action that would be required to maintain full employment at stable prices. The mechanism for this[1] lay in confronting an estimate of the total resources available with an estimate of the probable demands upon them for consumption and investment, in the public and private sectors taken together. The estimates were to be based on calculations of the national income, arranged as an integrated system of accounts, in the sense that an alteration in one figure could not take place without requiring a corresponding adjustment somewhere else.

The difference, if any, between the two estimates thus confronted constituted a "gap" which required to be filled by

[1] As explained most clearly in Keynes's "Britain's Income and Economic Potential", *Economic Journal*, December 1939.

public policy: either by direct action or by such indirect action as would cause the private sector to take the necessary steps to fill it spontaneously. It was especially important (although this was not noticed until Keynes himself pointed it out in the article just referred to) that the "gap" might be in either direction: too little demand or too much demand, in relation to available resources. The new method of determining the correct amount of government action was thus of general application, either to deflationary or inflationary conditions.

The simple aggregative approach on which the first "scientific" compensatory finance was based served well enough in war-time, when economies, especially the British economy, were exceptionally amenable to direct controls as a support to fiscal policy. In more complicated situations it has been found to be over crude and static as a reliable basis for policy direction. In order to forecast with any degree of accuracy the movement of economic factors it is necessary to break down the aggregates into the budgets of their component sectors: broadly speaking consumers, households, firms, public authorities, and the outside world. The more specific sectors these in turn can be broken down into, the easier it becomes to see the machine working as the wheels go round and so to foretell its course.

In recent years, notably from 1952[2] in Britain, remarkable progress has been made in this sort of "Social Accounting," as it has come to be called. We shall have to discuss it further at a later stage. The technique of the process is by no means yet fully established and the statistics behind fiscal policy may be expected to improve year by year. The essential revolution has, however, taken place; well-founded quantitative estimates increasingly take the place of unreliable hunches. Once or later the right statistical questions are asked, sooner or later the statistical answers to them can be made available, and the way is opened for an ever-increasing knowledge of the working of the economic system. The system of social accounting is not tied to any particular form of policy; in itself it has no policy implications. It is merely a means to a better performance of whatever type of policy a country desires, and it is powerless unless appropriate and flexible means of policy implementation are also available. To these we must now turn.

[1] It is convenient also to distinguish separately firms that are public corporations.

[2] Signalized by the publication in that year of the first of the annual "Blue Books", greatly expanding the information hitherto available in White Papers on National Income and Expenditure.

§3. The Means of Compensatory Finance: Attack from the Revenue Side. When discussing the instruments of compensatory finance it is useful to distinguish at the outset between automatic stabilizers, which are "built in" to the system of public finance, so that in the course of their ordinary operation they have a counter-cyclical effect, and those which have to be applied as a result of a policy decision. The first have two advantages: that they come into operation immediately in the manner of a thermostat, and secondly that they call for no decision, the necessity for which is in itself an acknowledgment that something is wrong and which consequently may have an adverse effect on confidence. The most obvious of these automatic stabilizers is the unemployment insurance system, including public assistance. Funds are regularly accumulated in times of good employment and decumulated in depression. Another, which is not so easily recognized as such, is the practice of reckoning the depreciation on fixed assets and stocks for tax purposes on the original cost of the equipment or of the longest held stocks respectively. In times of rising prices this practice results in taxing more than true profits while as prices fall tax liability is less than true profits.

The trouble about these automatic stabilizers is that their effect is weak relatively to what might be accomplished by a major policy decision. Very often, however, their effect can be strengthened in a manner which calls for hardly any action. Thus the rates of social insurance contribution can be raised in time of boom, and lowered in times of slump, or even, as has been more than once suggested, substituted by a *per capita*

subsidy on the employment of labour. A counter-cyclical movement of this type was written into the Unemployment Insurance system by the Unemployment Act of 1934, under which the Statutory Committee responsible for rates of contribution and benefit was directed to balance its budget over the course of a complete cycle. This provision was dropped when the insurance funds were amalgamated in 1946, it must be acknowledged that the notion of a budget balanced over a cycle (originally a Swedish idea[1]) is not very practicable since it presupposes a degree of regularity which few cycles exhibit. The use of an anti-cyclical device of this type was also strongly advocated by the 1944 Report. With the inclusion of the whole nation in the insurance system it could now be a much more powerful instrument than it would have been in the 1930s.

In a similar way the terms on which depreciation allowances are given can be varied according to the state of activity. The institution of "initial allowances"[2] whereby a large proportion of the cost can be written off in the first year of the life of an asset, instead of at a constant rate over its whole life provides a very simple way of doing this. A quick write-off of the major part of the total cost of a fixed asset (at one time 40 per cent was allowed in the first year), stimulates investment both by reducing vulnerability to changes in prices and economic outlook during the life of the asset, and by postponing liabilities to tax, if a succession of investments is being undertaken. Variations of this device can also be used as a longer-term stimulus to investment (see below, p. 305). On the other side, experience in 1952, when initial allowances were temporarily withdrawn and private investment was substantially cut back, suggests that the device is even more useful as a boom than a depression stabilizer.[3]

When we turn to more powerful measures which can be

[1] As part of the Budgetary Reform of 1938.
[2] First in 1945, see above, p. 196.
[3] The impact effect of the announcement of the withdrawal of initial allowances was, not unnaturally, to accelerate investment.

taken deliberately it will often be found that one will be more useful for fighting an inflation, another for promoting recovery. On the whole it must be expected that additional taxes will be more useful against inflation than tax concessions will be in promoting recovery. In certain circumstances it is conceivable that additional taxes might even promote recovery.

In discussing the means of fighting inflation it is desirable first to distinguish the type of the phenomenon, since the usability and effects of particular tax devices will not be the same in all circumstances. Thus we may classify: (i) a situation of actual war; (ii) a situation where inflationary pressure is primarily due to the impact of defence expenditure impinging on conditions of fairly full employment (a cold war); and (iii) an investment boom resulting from exogenous causes such as the sudden exploitation of a new technique, or merely a spate of simultaneous replacement of a large amount of industrial equipment.

Such a bunching of investment has been a common experience in the past and there is no reason to believe that it will not occur again in the future. It goes without saying that much more experience and empirical investigation is required before anything like a mature judgment on the relative merits of different devices can be formed. Here we can do no more than indicate the most obvious lines of attack. It must be borne in mind that in no circumstances need fiscal policy bear the whole burden of preserving stability. In war-time it is probable that the heaviest work will be undertaken by direct controls; in other circumstances credit control can play an important, if probably subordinate, part.

Anti-inflationary tax policy in actual war conditions is not difficult to define. We can say at once that capital taxes, such as death duties, will be of very little use indeed, because they do nothing to transfer current resources to the government, and because they have little or no effect on current consumption. Indeed a rise in death duties may, in the short run especially, actually stimulate spending. In war-time shipping difficulties are likely to limit the use of outlay taxes as

instruments of control; in a country that relies on importe
raw materials this is as true of excises as of customs duties.
Main reliance must therefore be placed on income and profits
taxes. In war-time the normal danger to incentive of a sharp
rise in personal income tax is much reduced owing to the
strong desire to end the war. Moreover progressive personal
tax has itself a built-in stabilizer; as prices rise the effective
exemption limit is lowered while the progression becomes
stiffer in real terms.

Under the British system of taxing undistributed profits
mainly within the income tax a rise in the standard rate will
also impinge on "impersonal" incomes. It will no doubt
addition be desirable to exert a further pressure on profits, and
one that operates more quickly than income tax, payable on
the previous year's profits. In modern wars it has been cus-
tomary, both in Britain and other comparable countries, to
meet this need by an excess profits tax; but we have argued
above[1] that this is not really desirable on economic grounds in
any circumstances, both because the intensity of the marginal
effects is dangerously disincentive, even in war-time, and
because the desire to avoid taxable excess leads to inflated
costs and other bad habits of management. Moreover it will
in any case be desirable to have some additional tax to meet
the case of firms who have no taxable excess, in the manner of
the National Defence Contribution between 1939 and 1945.
Nor should it be necessary in future to resort to an excess
profits tax, at least on economic grounds, since the main
burden of price stability can now be taken by direct controls.
It seems therefore that in a future war an additional tax on
total profits would be sufficient. This perhaps constitutes the
argument, although not a very strong one, for retaining a
separate profits tax in the normal structure; if so, in quiet
conditions its rates should be strictly moderate.

In spite of the limited usability of outlay taxes in war-time
where a commodity is not amenable to rationing (such as
tobacco) or where equitable rationing is difficult (such as

[1] See pp. 198ff.

petrol) a stiff rise in rates may be a useful support of direct controls. In addition a highly selective purchase tax will assist to direct consumer demand away from scarce commodities. By and large, however, the control of consumption in war-time will normally be the task of rationing and other direct controls.

When we are once again faced by an old-fashioned investment boom the problem also should not be difficult, in view both of the greatly expanded size of the public sector, which must be trusted not to act perversely, and of the many new weapons now available, not least the better facilities for forecasting. In fact the difficulties are more likely to be political than economic; so long as there is any unemployment Parliament will be reluctant to admit the existence of boom conditions. The implication of this psychology may be a continued bias in an inflationary direction; but it is just here that the revival of credit control can play as especially useful part; changes in interest rates do not call for Parliamentary action and they operate much less discontinuously than fiscal changes. So far as strictly fiscal measures are concerned the application of a selection of those appropriate to the more severe conditions of the cold war would probably be sufficient. To this more difficult problem we must therefore turn.

Although as regards the means at our disposal we are now much better equipped for fighting severe inflationary pressure in time of peace than ever before, in one sense the situation is less favourable: the rates of many taxes are now so high that any increase brings with it a danger of recoil in the opposite direction. Thus it has been widely argued that a rise in purchase tax is useless as a measure of control because it will immediately lead to rises in money wages. Carried to its logical conclusion this argument leads *ad absurdum*: both to raise and lower taxes will be inflationary. It has been similarly argued that a rise in workers' income tax will be transferred to consumers *via* higher wage rates leading to higher prices. For these results to occur very special assumptions must be made concerning credit policy; too easy money will allow

demand to expand in money terms *pari passu* with the rise in
tax liability so that no contractionary effect occurs. If the
taxes are to have their correct effect therefore credit policy
must first be attended to. More serious, because more
difficult both to assess and to deal with, is the possibility that
output may decline through the disincentive effect of a rise in
personal income tax, especially at the weekly wage-earner level.
In this case, in spite of tax measures, the inflation will be kept
going by a shortage of goods. Apprehension on this account
led to a steady process of raising the exemption limit of British
personal income tax, by various devices, onwards from 1945.

In spite of the fact that income tax has a built-in stabilizing
effect it must be admitted that out of war conditions it is by no
means an ideal[1] stabilizer. By taxing saving it penalizes
directly those who refrain from drawing on the available
supplies of goods, while giving no reward to those who do their
best to increase them. Thinking along these lines (especially
the former) economists have, as we have seen, long searched
for a means of exempting savings from income tax. The
present reliefs for particular forms of saving, such as life
insurance and house mortgage interest, are the sole fruits of
these efforts.

More recently it has been suggested that the right solution
would be an Expenditure Tax. This would differ from even
the most comprehensive sales tax in that it would be assessed on
progressive rates on cumulative total expenditure over the year.
If it proved practicable it would in a sense be more flexible than
income tax, since there would in principle be no limit to the
rate of progression that could be charged, whereas an income
tax must inevitably become proportional some way short of
100 per cent. In fact, owing to the narrower base of the

[1] It has been argued that if capital gains are included in income, the
tax is a much more powerful stabilizer. In principle this cannot be denied,
but it is just in conditions of inflationary price rise when many of the profits
gains represent no real gains (sometimes even real losses), that it is most
difficult to operate the tax equitably. Further the stability achieved is
not so great as might appear at first sight, since the gains can only be
taxed when they are realized, not when they are made.

expenditure tax (due primarily to the exemption of saving),
rates would have to be very progressive indeed if the revenue
were to be comparable with present income tax revenue. A
progression up to 400 per cent on total expenditure would be
by no means ruled out.

The advantage of an expenditure tax as an anti-inflationary
device would largely turn on the extent to which it encouraged
saving. While it is clear that there would be an immediate
premium on not spending, this would disappear the moment
the savings were spent; and if they were spent within a single
year the premium would be considerably more than swallowed
up by the heavy progression of the tax. It must indeed be
questioned whether "ability to pay" can be as well measured
by outlay as by income; too often expenditure, especially
heavy expenditure within a short period (which would attract
the higher rates of tax), reflects exceptional needs rather than
exceptional ability, needs such as the unavoidable purchase of
a house when moving employment, or the supplementary
expenses consequent on illness. To a limited extent, it is true,
certain types of expenditure considered socially desirable, or
shown to have been due to a personal emergency, might be
exempted from the tax. The wider the range of exemptions,
however, the higher must be the rates and progression on the
remaining expenditure.

In a minor way all outlay taxes follow the Expenditure Tax
in penalizing spending, but having little or no adverse effect on
saving; they are thus on *a priori* grounds good inflation
fighters, especially where the demand for the taxed goods is so
inelastic that there is no escape by substitution. In British
conditions so far taxes on tobacco have proved ideal.

No anti-inflationary fiscal devices can be fully effective which
impinge only on consumption; it may be even more necessary
to cut back investment. We have already seen the importance
in this respect of varying the terms of depreciation allowances;
but something more drastic might be required. In the Korean
boom the Swedish government experimented with an expendi-
ture tax on investment, the revenue being reserved for future

development of the industries concerned; there may be some thing to be done along these lines. However, it is just here that credit control is at its most useful. Experience in 1952–3 demonstrated that holding of commodity stocks is still very sensitive to money market conditions. Now that many producers' goods are bought on hire purchase (especially in agriculture) a stiffening of hire purchase terms, including mortgages, might be even more effective than the same measure applied to consumers' durables.

The part which tax changes can play in sustaining effective demand in depression is, as we have seen, not likely to be very powerful. It is doubtful how far a relaxation of personal income taxes would be translated into additional spending in the short run. Nor, since demand tends to be inelastic, would relaxation in tobacco or alcohol taxes be likely to have much immediate effect. If a general expenditure tax were in operation its relaxation might have a powerful effect; a similar although much smaller effect could be obtained by a relaxation of purchase tax rates, were it not for the difficulties caused to retailers who would be selling goods at lower tax rates than they had bought them for. This difficulty does not exist when tax is levied at the retailing rather than the wholesaling stage, and must be set against the great administrative advantages of collecting from a small number of wholesalers rather than an enormous number of retailers. For the main instruments for fighting depression we must, however, turn to the expenditure side.

§ 4. Attack from the Expenditure Side. It is particularly on the expenditure side that the great increase in the size of the public sector should facilitate the maintenance of a high level of activity. Further, we need not expect again to be faced with such a complex of unemployment as plagued the British economy in the 1930s. It is nevertheless desirable to distinguish between different types of unemployment, since all are likely to occur in some measure in the future. Unemployment in an industrial country can broadly be divided into three types: frictional, cyclical and secular (or long period).

Frictional unemployment is merely that which inevitably arises in a world of change and imperfect foresight, when one industry or firm declines and another expands. Some little time must usually elapse even when conditions are good, before workers who have been laid off find re-employment elsewhere. It was precisely for this problem that the employment exchanges were established; for many years conservatism and unfamiliarity militated against their full usefulness being realized; but the experience of war and post-war labour shortages seems to have broken down earlier inhibitions; this, together with better education and better statistics, make it unlikely that of itself frictional unemployment need be a serious problem. This hope is supported by the very low levels of unemployment which have been attained in recent years.

Secular unemployment may be regarded as aggravated frictional unemployment. Where large industries are declining, as cotton was in the inter-war years, so great a number of workers become redundant that they cannot quickly be reabsorbed. Their standard of living and their industrial skill deteriorate as the months of worklessness stretch into years; prolonged part-time working has almost as serious effects on productivity and morale. In the 1930s the hard core of the unemployment problem was thus the "long unemployed",[1] largely concentrated in the areas of the country where whole industries had fallen on evil days. These men had been thrown out of work by the collapse of the post-war boom of 1919–20, and before they had found satisfactory new jobs the slump of the early 'thirties was upon them. A solution was eventually reached by the passing out of employment of the older workers and the reabsorption of the others in the labour scarcity of the second world war. The danger that frictional unemployment may lapse into secular is endemic in any economy which is not rapidly expanding; but here again we should start in a better position than in the 1930s. There is now no backlog of long unemployment; for those who are not quickly reabsorbed into their own or similar jobs much better facilities exist for training

[1] Cf. *Men Without Work*, written for the Pilgrim Trust.

and resettlement, and much better understanding of the ad
vantages which these offer.

In spite of the efforts of semi-public organizations[1] in th
1930s to induce these firms to open factories in the declin
areas, and in spite of the rate and rent concessions offered
new factories by some local authorities, by and large, new wo
for the unemployed could only be found by migration to m
prosperous areas. This led to formidable social and econo
problems for those left behind, as well as to financial proble
for the local authorities, who strove to supply normal lo
services out of an ever-dwindling rate fund. Since the end
the war, policy was been substantially reoriented. The Loc
tion of Industry Act (1947) gives statutory authority wh
includes the direction of industry to what are now known as
Development Areas. More extensive fiscal concessions a
available, and considerable experience has been gained
locating new factories in formerly declining areas.

There are, however, limits to the benefits of a policy of taki
the work to the workers. Migration and inconvenie
location usually imply additional production and transpo
costs; these are a social as well as a private loss and must b
set against the social and economic loss of continuing dep
So long as "direction" could be implemented by the allocatio
of scarce materials, including bricks and mortar, "voluntary
migration of firms could be counted upon. Now that this
no longer the case a government might put itself in an awkw
position if it has used the statutory powers to the full and
migration had resulted in bankruptcy. However, in this fie
especially success breeds success. The development areas no
offer both much better living conditions and a wider lo
market than they did in the 1930s.

The prospects of redeploying workers who have beco
redundant ultimately depends on the rate of expansion of
industries, and so on the rate and application of techno

[1] Such as the Special Areas Reconstruction Association, and
Nuffield Trust. For an account of their work cf. U. K. Hicks's *Finance
British Government*, *cit.*, Chapter XIII.

inventions. Fiscal methods of stimulating this belong to the discussion of the next chapter. Again, however, there is reason to believe that we are better placed than we were in the 1930s. It should be emphasized, however, that while new techniques are important, their effectiveness depends entirely on their productive use, and this is the joint responsibility of the public and private sectors of the economy.

By far the most important type of unemployment in modern economies has been cyclical; this was the typical problem of all countries in the 1930s; we can have no assurance that we shall not again have to fight it, perhaps at very short notice. It is in this direction that the responsibility of fiscal policy is greatest, but fortunately it is in this sphere that its weapons are most appropriate. The essence of success in fighting cyclical unemployment is speed; it is vital to support effective demand before it seriously flags and the multiplier in reverse has had time to work out its evil effects. Timing is, however, also the most difficult aspect of policy implementation. Not only is it difficult to recognize when, and how much, action is called for, but after the need has been diagnosed, and appropriate expenditure set on foot, in most cases a considerable time elapses before the works make a useful contribution to the demand for labour. In the 1930s even those countries which started earliest and tried most earnestly to fight the slump by public expenditure (such as Sweden and Australia) only got their works to a useful point long after the worst of the slump was over.

In the acceleration of public works obstacles and delays may arise in three directions: first there is the time required for planning and blue prints; secondly the necessary contracts may require much time for completion, especially if they are concerned with land purchase, and finally in the majority of projects the demands for resources expands only gradually, so that it is a matter of months or even years before the peak demand for labour and materials is reached.[1] Many

[1] Cf. Bretherton, Burchardt and Rutherford, *Public Investment and the Trade Cycle*.

suggestions for telescoping these processes, such as the "shelf" of ready planned projects, have been made. While pre-planning can clearly save delay, if the plans have been worked out some little time previously they will still probably require considerable revision before they are ready for execution. Works requiring little land usually show a quicker reaction than others; certain types of defence expenditure are therefore especially useful as reflators. Thus orders for army uniforms helped to fight the textile recession of 1949.

There is clearly no way of overcoming these timing difficulties completely; but the position is probably somewhat better in Britain to-day than it was in the 1930s. Under the Town and Country Planning Acts local authorities are obliged to draw up twenty-year plans of land use in their areas; these plans have to be revised every five years, so that they can never be very out of date. While not themselves blue prints for action, works the existence of these plans should both save time and remove uncertainty. Secondly, local authorities have before them a number of urgent investments not requiring extensive land purchase (and in any case this has been made easier by the same Acts). Among these are the Medical Centres (one for every 10,000 of the population), without which the full benefits of the National Health service cannot be realized, many new and additional schools, and in the background the ever-present need for slum clearance.

On the financial side also a number of former obstacles have now been removed. In the 1930s a serious difficulty was that while the outlines of policy were determined centrally, detailed planning and execution and much of the necessary finance was a local responsibility. So far as current account expenditure is concerned (which would include planning costing and no doubt some of the actual outlay at the site), the situation has been considerably eased by the fact that for sub-average authorities the Equalization Grant (of 1948) is adjusted upwards for every rise in rate poundage.

A further difficulty was that formerly for capital expenditure the smaller and poorer authorities were in practice compelled

to borrow from the Public Works Loans Board, which, concerned primarily with its own solvency, of necessity charged rather high rates. Through a completely mistaken transference of ideas from the private sector, such authorities were regarded as a bad risk by trustees seeking mortgage investments; this simple method of raising funds was therefore closed to them. At the same time stock exchange loans were beyond their means, even had investors there taken up a more sensible attitude.

From 1946 all authorities were required to borrow only from the Public Works Loans Board; the dice were thus no longer loaded against the small and poor areas. Moreover the policy of the Board soon showed itself to be completely changed. No longer bound by considerations of its own financial soundness, it was used by the government as an instrument for providing local authorities with loan funds at subsidized rates (mainly for Housing). While this is not necessarily desirable, it is clear that a new means of assisting local authorities to take up projects is now available. More recently the right of local authorities to borrow directly from the private sector has been restored, although subject to the direction of the Capital Issues Committee so far as stock exchange issues are concerned. At the same time the new facilities offered by the Public Works Loans Board have not been withdrawn. Hence for projects which fall within the range of national policy long-term finance should no longer be an obstacle.

The importance of seeing that local authorities take rapid and consistent action in incipient depression is, however, no longer so great as it was in the 1930s; through the expansion of its own investment, including that of the nationalized industries, the central government can now take an important direct part in compensatory finance on the investment side. Like the local authorities the public corporations must have development plans; in fact all have large projects ahead and all are subject to Ministerial direction, so that their timing can be determined, so far as it is economically desirable to do so. Their borrowing is also strictly controlled.

Viewed from the angle of compensatory finance, however, the investments of the public corporations probably have only a limited usefulness. Many of the programmes (such, for instance, as new power stations and new coal mines) only gradually work up to a substantial demand for labour and often require years, not months, for completion; moreover they cannot be accelerated and decelerated without much more economic loss than would occur from the similar treatment of a road or housing programme. This is not to imply that the fact that more than half of the capital formation of the British economy is now concentrated in the public sector does not open up important new potentialities for compensatory finance.

In one respect, however, the situation would probably be more difficult than it was in the 1930s. Then, thanks mainly to the exceptionally favourable terms of trade, there was no need to apprehend balance of payments difficulties for any feasible expansion of public outlay. This situation may never be repeated, nor indeed is it very desirable that it should be, since the impoverishment of our customers, due to the unfavourable terms of trade with which they were faced, was an important factor in the intensification of depression.

Even in this sphere, however, there are new grounds for hope: on the one hand the assistance of the international financial institutions (the Monetary Fund, the International Bank for Reconstruction and Development and their agencies), on the other hand there are improved possibilities of maintaining overseas effective demand by government commodity purchases for stock. With the more difficult balance of payments position, however, it is clearly the more necessary that compensatory action should take place before depression has taken hold, so that the amount of action required, and the consequent pressure on the balance of payments will alike be moderate.

CHAPTER XVIII

FISCAL POLICY AND GROWTH

§1. The Opportunities for Fiscal Policy. In the last chapter we were primarily concerned with compensatory finance; but measures which stimulate recovery, especially on the investment side, will also tend to stimulate growth. The adoption of a quick write-off of new capital assets and the maintenance of long-term interest rates at as low a level as is consistent with stability, as part of a normal programme, will help to create an atmosphere congenial to growth. We have consequently now to consider here measures which are specially designed to stimulate the long-period expansion of the gross national product in real terms.

At the same time it must be remembered that some of the measures undertaken primarily on social grounds, but with an eye also to the cyclical maintenance of effective demand—such as a more equal distribution of disposable incomes—may in conditions of full employment be inimical to growth, because they tend to expand consumption at the expense of saving, and hence of investment, both directly and through the repercussions of the high progressive taxes which accompany them. To some extent, to be sure, this anti-saving bias in the private sector can be compensated by an increase in "saving" in the public sector through budget surpluses; but if these in turn are not to have a further effect on the volume of private savings they must be secured by taxes which are not highly progressive. Hence the mere existence of full employment is by no means necessarily favourable to growth.

The emphasis on the state's part in promoting economic growth, which is now so striking and universal a feature of policy, is of recent origin, or perhaps it would be more accurate to say revival, because we have seen that it already existed in

eighteenth-century Britain. In the developed countries especially in Western Europe, this new interest is compounded of the fear of a return to the stagnation of the 1930s and anxiety concerning the balance of payments *vis à vis* the dollar in the face of the apparently amazing increase in productivity on the North American continent. Although in the U.S. economy the process of growth seems for the time being to be sufficiently assured by private enterprise, in fact something like a revolution in the position of the state has occurred, to an extent that is not generally realized. Vast sums are currently spent by Federal agencies, such as the RAND corporation (*R*esearch *and D*evelopment), primarily on research, much of which is "fundamental" in the sense that it is geared to the general improvement of the efficiency of technical processes, rather than to the solution of specific problems. Nor does the state's share end with research; definite orders are placed by the government, for instance for prototypes of aeroplanes and so on, which otherwise could not be undertaken by private enterprise on the same scale.

A similar part is played by British government departments, although on a smaller scale. Further, in both countries (and in others also) atomic research is primarily being developed as public enterprise, notwithstanding that its object is economic as well as military. Government research projects are also undertaken by firms and in universities, thus making funds available to wider groups of research workers. The universities in particular are now much more ready than formerly to accept public money for research work, presumably because they are satisfied that conditions which might hamper the research worker will not be attached to the grant. This itself is an indication that the nature of the work is general rather than particular. The fact that these new directions of public expenditure were originally motivated by defence needs is in practice of little relevance to their contribution to general economic development. In fact progress may actually be speeded by the fact that defence expenditure is commonly more readily agreed to by legislatures than outlay on research with

a vague mandate for the improvement of economic efficiency. The fruits of this new activity of the public sector may be found in the extremely rapid growth in the discovery and application of new materials and techniques which has taken place since 1940.

The new emphasis on growth, and on the part which public activity can take in it, is even more striking in the poor and backward countries than in those we have been discussing. Here it is compounded of a new consciousness of backwardness due to extended contacts with other ways of life during the war, of new opportunities on the financial side due to the swing in the terms of trade since 1940 in favour of primary products, and in many cases on the political side by a greater freedom and greater urge to develop. In many tropical countries also an improvement in the gross national product, especially on the agricultural side, is a sheer necessity in order to maintain the pre-war standard of living, since the improvement in tropical medicine and insecticides has removed former brakes on population growth.

The change in the attitude of the richer countries *vis à vis* the more backward is hardly less important. The part which the former are now prepared to play, either directly or through the new international agencies,[1] is in strong contrast to the neglect of the backward countries in the 1930s, although perhaps not (in terms of scale) in relation to several periods of the nineteenth century and the first decade of the twentieth century. The fact that the motivation for this assistance is partly political again has little relevance to the types of development assisted or to its benefit to the developing countries. The fact that substantial assistance may be available does, however, strongly affect the fiscal policy of the developing countries, since practically none of them possesses sufficient reserves to take full advantages of their existing resources. On the one hand they are concerned to gear their public finance (and especially their taxes) so as to attract outside capital, but

[1] Such as the International Bank for Reconstruction and Development, the U.N. Technical Assistance Administration and the Colombo Plan.

on the other it must be shaped so that their own nationals are induced to forsake their accustomed ways and to undertake new and often strange processes of production. It is equally necessary that fiscal policy shall ensure that the recipients of rising incomes (due to development) will not cash in the whole of their surplus in improving their own standards of living, but will tighten their belts sufficiently to allow the process of development to gather momentum. Space does not allow us to examine in detail the special problems of the developing countries; but many of the difficulties which they face are of general application.

Fiscal policy is capable of contributing to growth in four different directions. First there is the part which public expenditure may play, either directly or on behalf of private enterprise; secondly comes the choice of revenue adjustments which must be made both to provide funds to cover the outlay and to preserve stability in what (as we have seen) is an inherently inflationary process. Thirdly within the field of fiscal policy fall the problems concerned with providing the necessary loan funds for capital formation, and for the management of the debt incurred. Finally there are a number of important organizational and planning problems to be solved if the best use is to be made of the limited resources available. These problems lie on the borderline between administration and fiscal policy, and so partly at least outside our field; but some aspects (especially those concerned with the organization of the budget and with inter-governmental financial relations) are closely tied to fiscal policy. In the present chapter we shall be concerned with the first two of these aspects of fiscal policy; in the two remaining chapters we shall deal briefly with the others.

§ 2. Public Expenditure for Growth. Broadly speaking there are two ways in which public expenditure can contribute to the expansion of the gross national product. In the first place the state is responsible for providing the basic economic foundations in the form of "overheads" of an economic or social nature

without which existing resources cannot be made fully available or put to their best uses. In the second place public expenditure can increase economic productivity directly, both by providing assistance for the establishment of new industries and the introduction of better agricultural methods, and by itself undertaking production and trading, especially of a type not hitherto attempted in the country. Into this category would fall the research work of the government and its agencies, applied to the special local conditions of the economy. These applications of public expenditure to development are general for all types of countries.

Although the basic economic overheads, such as the transport system, have long been established in developed countries such as Britain, this is by no means the end of the story; technical change calls periodically for replanning. Thus the British road system has fallen seriously behind that not only of the U.S.A. but also of a number of less wealthy countries in Western Europe, because no serious attempt has been made to catch up with arrears since 1940, much less to build a modern system of through roads which the growth of road traffic has shown to be necessary. Nor have any effective steps as yet been taken to forge the essential links in the traffic system, such as the Severn Bridge. The railways themselves also call for drastic reorganization before they can become efficient in their still important although reduced role. The road system is a matter in which (as we have argued earlier) it should not be difficult to establish objective priorities for development (time saved per unit, multiplied by the number of units, on alternative stretches of road). Nor need there be any serious financial problem if the sensible plan (now used by most other countries) of charging for the use of newly built highways is adopted. This is partly a budgetary question to which we shall have to return later.

In most underdeveloped countries inadequate transport systems, both road and rail, are serious obstacles in the path of growth; a further trouble very commonly encountered is the inadequacy of port facilities, leading to delay in clearing both

exports and imports. These bottlenecks tend not only to reduce overseas income, but also make it more difficult to preserve internal price stability. The optimum solution for a really underdeveloped and largely uncleared country, including a correct balance between road, rail, water and air transport, is by no means easy to determine. No simple calculation of relative cost and benefit will meet the case and considerable must be taken of the particular local situation, in respect of such factors as type of terrain, amount and distribution of rainfall, road metal available, and so on. On the other hand many obvious improvements are usually available, and within their limited sphere it should be possible to establish objective priorities, without delaying the course of the major decisions. What is required above all is a greater awareness of the importance of economic overheads in advance of any large scale development, if full advantage is to be taken of industrial and agricultural improvements as they occur.

Parallel with the need for the extension of economic overheads in underdeveloped countries is the need for a greater provision of social overheads, especially in the direction of education and public health, but here, in a sense the financial problem is easier. In the first place there is much awareness of the desirability of such developments, greater local demand should (and often does) imply greater local willingness to pay the bill, thus tapping additional sources of revenue. For the most part also the installations call for less heavy capital equipment than economic overheads (this is not true of general hospitals). The fiscal problems in the field of social overheads are hence primarily those of control and of such an allocation of priorities as will best improve the national product. Social overheads commonly raise powerful local vested interests whose votes are frequently important. With their more limited resources it is especially important that poor countries should avoid "open-ended" expenditure, such as contracts with professional agencies for services the development of which they cannot control. As we have seen it is all too easy for rich developed countries to overtop the bounds of economic wisdom

in the social services, sacrificing the benefit of the many to the special favour of the few; for underdeveloped countries the danger is still greater.

Concerning the provision of overheads of all sorts there is, however, the fundamental financial difficulty that their direct contribution to fiscal potential is negligible while their beneficent indirect effects are likely to be realized only slowly over a long period, through the expansion of the national product. The provision of social overheads indeed in the short run not uncommonly creates more difficulties than it solves, for instance by hastening the break-up of an existing social structure before the new economic structure is ready to absorb the labour set free. This strengthens the argument for watchfulness and caution; the cost in terms of alternative use of resources needs to be constantly weighed.

Economic overheads and true economic development often merge into each other. The touchstone of the latter is that the works pay for their keep in the sense of making no net call on the revenue, either for current outlay or for the service of the debt incurred in providing them. In addition they should be expected, when they are fully in operation, to provide a surplus of saving for further development, thus contributing to a dynamic process.

On the borderline of economic overheads and economic development are the provision of the basic conditions for the improvement of productivity in industry and agriculture, especially electric power, flood control, drainage, irrigation and other methods of soil preservation and enrichment. These services are true development, but like overheads they yield their full fruits only over a long period; this is especially true of major works which commonly take some years to construct. Such works should not, therefore, be neglected; in general they offer the best hope of a permanent increase in the productivity of factors. As well as such major works there are likely to be many more minor works available which will raise productivity more quickly in the short run, but in the long run less effectively. There is often a tendency to push ahead with

these because they call for less belt tightening. No harm can result from this so long as the minor schemes have been fitted into a definite programme of development. If the small projects are preceded with haphazard, however, funds are apt to be frittered away without securing the best use of resources.

The basic problems in the field of public expenditure for development (especially in backward countries) are two: (i) the extent to which industrialization should be encouraged for its by-products (in terms of habits of regular work and technical skill), apart from the value of its net product, and (ii) the extent to which the state should take a direct responsibility in indus- trial and agricultural projects, in preference to giving its aid and support to private enterprise. These involve matters of general policy which lie quite outside our field, but at bottom they ultimately turn on economic and fiscal considerations.

It should continually be borne in mind that an industry which does not cover its costs without subsidy detracts rather than adds to the national product; it would be more proper to regard it as a type of social service, which should consequently be integrated with the social rather than the economic pro- gramme, and reckoned as an additional charge on the revenue. In very many cases also the potential marke twhich the industry might serve (within any reasonable planning period) may well be too restricted for economical working of even a single plant. Where a large potential market is available, but local know-how is lacking and overseas capital hard to attract, there is a strong case for state operation or participation, since in that way the availability of technical advice and training may be improved.

The least controversial field for public expenditure for development is in improving the technical conditions for the establishment of industry and for raising the productivity of agriculture. Under this heading we may include such things as the provision of capital funds on reasonable conditions, in the quantities required by firms making a start, the provision of information, suitable sites, legal assistance in the acquisition of land and so on, so that the special local risks may be minimized, and the undertaking of technical research into the

adaptation of machinery appropriate for local conditions of climate and labour skill. None of these need entail a heavy net cost on the revenue, since they can be recouped from the beneficiaries over a period in most cases.

Experience of developed countries, not excluding the United Kingdom, suggests that services of this kind can most appro- priately be undertaken by public authorities, more or less directly under government departments. Examples are the finance corporations set up in the 1930s and strengthened after the end of the war, to ensure a supply of funds for small firms[1]; this sort of assistance is even more urgently required in back- ward countries, and indeed many of them are already supplying it. Similarly the "trading estates" which were established in Britain first by private enterprise (as at Slough and Trafford Park) and later by public corporations in the Development Areas, go half-way to meet the entrepreneur by providing him with site and factory on rental basis, with public utilities laid on. In underdeveloped countries the obstacles which stand between a willing entrepreneur and adequate production conditions are still more formidable, and may be greatly complicated by such factors as tribal systems of land tenure. Trading estates would seem to be especially appropriate for meeting these difficulties.

Even in developed countries again it has been found that equipment designed for one set of physical conditions is almost useless in another. Thus the coal mining machinery eagerly imported into Britain from the U.S.A. after the war was found to be largely unusable in British geological conditions. This sort of experience is almost certain to be repeated in tropical climates with unskilled labour. In the agricultural sphere the work that needs to be done in this direction, for instance in soil diagnosis, appropriate use, selection and breeding of seeds and stock, and the adaptation of farm machinery, is even more important, since of all development food production must come first.

[1] In order to fill the "gap" diagnosed by the (Macmillan) Committee on Finance and Industry.

2 I

§ 3. The Contribution of the Revenue Side. The revenue side of public finance has a heavy responsibility in the successful promotion of growth. The additional need for taxation which government-sponsored development implies can probably in any case not be met without some additional burden. In the developed countries, as we have seen, tax rates are already so high that any increase runs the risk of exerting an effect contrary to the one intended, for instance by reducing incentive or (if credit policy is not on the alert) by stimulating inflationary price rises. In an underdeveloped country the tax structure is likely to show signs of strain at much lower rates of tax, due to the inexperience and lack of education both of taxpayers and tax collectors, as well as to difficulties due to the undeveloped types of business organization. Indeed it is characteristic of a backward country that the state succeeds much less well in taxing such wealth as is available than in a rich country.

The business of the revenue during a process of development is twofold: on the one hand it must find the funds to finance the necessary contribution of public expenditure in the ways we have just examined; at the same time it must exercise a sufficient restraint on the economy to eliminate anything above mild and controllable inflationary pressure. In addition to these primary purposes the revenue itself can serve to stimulate the process of development. While the extent to which it can do this is often exaggerated, it is obvious that the necessary taxes should be geared so as to minimize risks and disincentives, especially for intending entrepreneurs. These three objectives do not by any means necessarily lead to the same choice of taxes. Constraint needed to preserve stability may damp enterprise; over-eagerness to encourage industrialization may lead to an undue sacrifice of revenue.

The major problem of the revenue is concerned with the [illegible] two of the above objectives. It can be, and frequently has been, argued that a small degree of inflation actually greases the wheels of development. Resources are transferred thereby from fixed income receivers to the government; the revenue is buoyant and [illegible] enterprise.

a process appears much simpler and less painful than that of raising sufficient revenue to avoid the upward drift. Attractive as this argument is, it is not a safe one for countries who are in earnest about development.

To begin with, the process of transfer of resources to the government is not nearly so effective as it would be in a more developed country because the taxable fixed income receivers are few; moreover such savers as there are may well be discouraged by the fall in the real value of their savings. Unless ample reserves are somehow available to counteract the tendency for prices to rise by importing additional consumers' goods, there is a grave danger of balance of payments difficulties. It is the more difficult to diagnose the position correctly because reactions tend to be slower than in a developed country with rapid communications, so that a substantial inflationary potential may be built up before the danger is realized.

The responsibility of the revenue for preventing inflation from getting out of hand is also much greater than in a more developed country, because the other instruments of control are much weaker. Direct controls are difficult to work and seldom equitable. Normally speaking, poor countries are financially dependent on some richer or larger neighbour and do not have a developed system of financial institutions. Thus, even if a reserve bank is available, it is not likely to have much power of control, which calls for both banking habits on the part of the business community and at least some provision of banks with extensive interests in the country. In one sense indeed the absence of financial institutions implies that the sort of speculative boom (in commodity stocks and stock exchange securities) which has so often interrupted the smooth course of development in the more advanced countries is not likely to occur. Its counterpart, however, is the speculative land boom, with savings leaking away from industrial development and subscriptions to government loans into mortgages and luxury building. In the next chapter we shall touch on methods of public borrowing which may help to avoid this difficulty;

the surest method, however, is to ensure that the tax structure can take it. We must therefore consider carefully what part in this process different taxes can play.

The traditional taxes for financing development are import duties. In certain conditions they may aid in all three of our objectives: additional revenue can usually more easily be collected through the customs than in any other way; the revenue will tend to come out of the pockets of just those elements in the economy whose incomes have most advanced; and finally new industries can be fostered behind the shelter of tariff walls, which may both stimulate local capitalists and attract outside firms anxious to retain their markets.[1]

The usefulness of import duties in a process of development, however, is often much exaggerated. It is by no means certain that the duties will impinge where the additional incomes are situated; if they are imposed on luxuries the fraction of the economy affected may be too small to ensure control; if they are imposed on articles of mass consumption they may be found intolerably regressive; the margin by which the lowest incomes can be repressed is pitifully small. The difficulty arises essentially from the smallness of the middle class with easily taxable consumption habits. Again, infant industries notoriously tend to be Peter Pans, and before deciding to support them with a high tariff the government would do well to inquire whether any of the obvious conditions for success exist, such as cheap power, indigenous and low-cost raw material or large potential markets. If this is not the case the only argument in their favour is the external economies of skill, training and urbanization which they may promote. Poor countries cannot afford to pay too high a price for these.

This is not to deny that import duties can be a major aid to development; as a shelter for infant industries they are in many case much to be preferred to any system of guarantees

[1] The favourable effect of import duties on the terms of trade, so much advertised in developed countries, is rarely likely to be important in underdeveloped countries because they are unable to influence world prices.

monopolies which will neither produce so much revenue nor give as good a guarantee of efficiency as a moderate tariff. In most cases it will be necessary, however, to support the import duties with excises, which will be more or less usable and useful according as excisable commodities are manufactured locally. Almost everywhere duties on tobacco can bring in a large revenue and alcoholic liquors are usually dependable. In very many cases the revenue position could be improved also by ensuring that service charges, especially for postal services and harbour dues, really cover their costs, even if this implies some lowering of service standards. British standards (for instance of postal delivery) are by no means necessary in more primitive conditions.

A variant on the use of import duties to promote development is the imposition of export duties, normally on primary commodities. During the boom of 1951–52 a number of developing countries used these to great effect. In conditions of world boom it is not only natural that primary producing countries should make the most of the favourable terms of trade which fortune has handed them, but it is actually desirable that they should do so from the world point of view, since stability is thereby aided both in the importing countries, who will thereby be restrained from bidding against each other, and perhaps to some extent in the exporting countries also.

But export duty revenue of this type is likely to be short-lived; in the longer run the attempt to exploit inelastic demands inevitably leads to the expansion of alternative sources of supply or of substitute commodities. It is therefore not safe to count on such revenue for the finance of any continuing service.

Export taxes will also contribute to stability in the exporting country, especially as they impinge directly on those sections of the economy which are reaping the greatest advantage from the export boom. An alternative method of achieving the same result is by means of government agencies or marketing boards which buy from producers at fixed prices and sell direct to foreign importers, thus imposing on producers as much forced

saving as may be necessary to preserve stability. This is in principle a superior method to export duties, because the buying price can be simply adjusted; to approach the same flexibility an export duty would have to be imposed at *ad valorem* rates on a sliding scale. The basic problem, so far as the home economy is concerned, is to choose a buying price or rate of tax which will preserve stability without impeding enterprise. This, however, is a general problem of price control and not confined to export taxes. If export taxes are carefully used in this manner they can contribute intermittently very useful to development, providing a fund out of which the import of additional consumers' goods to counteract the tendency for prices to rise can be financed, quite apart from their direct usefulness in paying for the import of capital goods.

The alternative method to customs duties, both of preserving stability and of promoting the development itself, is through personal income and profits taxes. As we have seen, personal income taxes are not ideal cyclical stabilizers, because at the high rates now usual in developed countries they may have serious effects on incentive. This argument has much less force in primitive conditions, where rates of tax are normally substantially lower and the coverage much narrower. There is little doubt that income taxes could be much further pressed in developing countries, and, further, as the now developed countries found before them, it is along this path that the ultimate solution of their revenue problems must be found. The fundamental obstacle in the development of effective income taxes is normally the want of an expert and reliable inland revenue department. Aid with building up this service should be given very high priority in requests for technical assistance. It is only if he has confidence in the equity of the assessment and collection of tax that the taxpayer can be made to contribute adequately.

The taxation of the profits of the small firm (which is likely to be the predominant form of business organization) will naturally fall within the scope of personal income tax, which indeed it will provide some of its worst headaches. More

developing countries have, however, a certain number of sizeable companies operating within their areas, which are likely to be partly at least owned overseas. The encouragement of the establishment of large-scale companies is in many ways a most desirable objective of development policy, both because they offer the best chance of increasing the national product and raising the level of employment, and because they are exceptionally easy to tax. For this very reason there is a temptation to exploit the company, especially the foreign-owned company, by high profits taxes. If this is done, however, the establishment of new enterprise, both foreign and locally owned, may thereby be discouraged. The government is thus on the horns of a dilemma between getting more revenue by an easy route, and one in which the foreigner largely pays, and taking measures to encourage what may be the most effective way of expanding the national product.

In fact policy is frequently biassed by the type of output that is in question. Mining concerns tend to be mainly foreign-owned and are unsuitable for local development with their heavy demands for capital and skilled labour; they are usually heavily taxed. On the other hand, where there is some prospect of a general industrial development in which local capital can be induced to take part, governments tend to favour rather than to exploit, even though the concessions offered to industrial enterprise may imply a substantial loss of revenue. This issue raises problems which are common to the process of growth in developed as well as in backward countries, although they are usually more acute in the latter.

As we have seen, tax concessions allowing a quick write-off of fixed equipment, especially when supported by substantial "initial" allowances, have proved a most useful method of promoting capital formation in recovery. This method is even more useful in the special conditions of uncertainty (concerning labour efficiency and other costs on the one side, and markets on the other) which beset a firm trying to set up in a backward country. The question is whether such stimulus (which implies no ultimate loss of revenue) is sufficient or whether it

should be supplemented by further attractions. Several lines of approach are possible. In the first place an indefinite carry-forward of losses may be allowed (in place of the traditional limited period only). Secondly a choice of depreciation methods—either the "straight line" or "reducing balance" method may be allowed to the firm.[1] Thirdly, carry-back of losses as well as carry-forward may be allowed; fourthly a special "investment allowance"[2] may be granted on top of the depreciation allowances; and finally a complete "tax holiday" for a defined period may be granted. Many variations and combinations of these devices can be imagined.

In judging these baits to entrepreneurs a distinction must be made at the outset between those which do and which do not entail a net sacrifice of revenue. There can never be any objection to the latter; they represent merely an intelligent gearing of the tax to promote growth. The former are more or less suspect according as revenue is hard to come by and concessions are wasted by covering those who do not need them. In most cases a better result could be obtained by a general reduction in rates, the effect on the revenue of which can more easily be estimated than the result of special concessions.

Carry-forward of losses is a normal concession to industries with fluctuating profits; little or no loss of revenue is involved even if the carry-forward is made indefinite (as it has been in Britain for some years). Carry-back raises a more difficult problem since it implies the repayment of revenue already collected. If this is justified at all it would seem to be rather as a cyclical stabilizer in a developed country (which can easily resort to deficit finance) than as a stimulus to development. Choice of method of depreciation entails no loss of revenue and has every justification as a factor in risk reduction; in some

[1] Under the straight line method a fixed percentage of the original cost is deducted year by year until the entire cost of the equipment has been recovered by the firm; under the reducing balance method the percentage is applied year by year to the written down and not to the full original cost of the equipment.

[2] As introduced in the British budget of 1954.

industries or circumstances a complete write-off within a defined period may be more attractive than a quick write-off of the major part of the cost of new equipment, and *vice versa*.

To allow the depreciation allowance to blossom into an investment allowance is another matter. Here revenue is definitely sacrificed, and it must consequently be asked whether the stimulus is at least commensurate. It should be noted that the main additional stimulus to capital formation of the investment allowance is felt only at the end of the "revenue" life of the equipment, which is very likely to be too far ahead to play an important part in planning.[1] Poor countries will therefore probably be well advised not to waste revenue on investment allowances.

There remains the "tax holiday" for a definite period. Apart from a possible psychological effect when it is first introduced, this device provides little stimulus to the pioneering firm for whom it is intended; it is unlikely to make important taxable profits within the relevant period, which cannot usually be set at more than five years. On the other hand the very successful firm will be enjoying a quite unjustified immunity. The crux of the problem, however, turns on the tax arrangements after the holiday period has expired. If the customary tax on profits with depreciation allowances is then imposed (so that five-year-old machinery is effectively treated as new) then substantial revenue may be sacrificed. If, however, this is not done the firm may be worse off than if the straight line method of depreciation with indefinite carry-forward of losses had been allowed, instead of the tax holiday. In the case of firms owned abroad the whole situation is immensely complicated by the taxes imposed by the country of origin. This is too specialist a subject for us to be able to enter into it in detail here; although it is a factor of such importance that it may well be decisive in the decision to

[1] It is true that if the "reducing balance" method is used there will be a small additional stimulus in the second year, since that year's depreciation quota will be calculated on full, not written down, original cost.

establish a plant in an undeveloped country.[1] If no double taxation agreement exists between the two countries, the firm may be seriously deterred by having to pay the two taxes aggregatively. Even if such an agreement exists, so that the firm pays the whole of the tax of the country with the lower rate, and the balance to the country with the higher rate, since the underdeveloped country is likely to have the lower rate the concessions it offers may be in vain; the firm must still pay its home rate of tax, and in addition face the extra hazards inherent in investment abroad.

When all is said and done, however, it is very doubtful how far tax concessions in their own right really succeed in promoting development. In Britain the rehabilitation of the depressed areas made virtually no progress under the rate concessions of the 1930s; the real change came only with the "direction" of firms thither (with the bait of the scarce commodities, bricks, mortar and steel) in conditions of high activity. In the backward countries the things that decisively swing the balance for the foreign investor are economic prospects in the widest sense, political security, including security of tenure, and reasonable facilities for the repatriation of dividends, and if necessary capital. The services which the government of a backward country can offer through its expenditure to promote development are likely in the long run to be more helpful than the taxes it refrains from collecting.

[1] The situation may also be different according as the foreign firm sets up a subsidiary or a branch in the underdeveloped country. From the point of view of the latter the subsidiary is preferable, since it is easier to ascertain the taxable profits; the home country by the same reasoning will probably prefer to encourage the establishment of branches abroad.

CHAPTER XIX

BORROWING POLICY AND DEBT MANAGEMENT

§1. The Significance of the Public Debt for Credit Policy. As we saw at the outset, in modern conditions there are available three methods of implementing a general economic policy of stability and development: the fiscal instrument, the monetary instrument and the method of direct control. Outside of war and major emergency conditions (due perhaps to some natural disaster) the last must be regarded in a free society as a *pis aller*, indicating in part at least the inadequacy of management or misuse of the other instruments, both of which have the merit of preserving freedom of choice and enterprise in a way which direct controls make difficult.

During the second world war direct controls played a most important part in the belligerent countries, in none more than Britain, at the same time the fiscal instrument fell into the background (this situation was tacitly recognized by the omission of the Chancellor of the Exchequer from the War Cabinet), while the monetary instrument was almost entirely directed to minimizing the budgetary charge of the war debt and was not applied to the purpose of control. The fiscal instrument came to the forefront with the deliberate anti-inflation budget of 1948 (which as we shall see in the next chapter marked a most important stage in the technique of budgetary development). A decisive although tentative return to the monetary instrument as a support of general economic policy was made in Britain in the autumn of 1951, and at about this time by other countries whose policies had followed a broadly similar trend. It was only in the autumn of 1954, however, that it began to appear as if the monetary instrument might be fully restored to something like its traditional importance.

Monetary and credit policy as such cannot be regarded as falling within the field of public finance, more especially that part of it which is concerned directly with preserving external stability. This remains true even although the institutions responsible (in Britain the Bank of England and the Exchange Equalization Account) are now publicly owned and formally subject to Treasury direction. Nevertheless there is one aspect of the monetary instrument which lies so close to the field of public finance that it cannot be neglected, namely that part connected with borrowing policy and the management of the public debt. Since the creation of the vast debt of the first world war (when the capital sum of the national debt rose tenfold) an indissoluble link has been forged between public finance and credit control. Borrowing and debt management on this scale affect the whole economic background of a country. Debt management is a public responsibility which cannot be shirked, because (owing to the structure of the debt) it calls for specific decisions of re-financing at frequently recurring intervals.

This public responsibility is, however, also a public opportunity; in fact it provides an important new instrument of control. The basis of this is that since the borrowing of the first world war (in Britain; in the U.S.A. this situation was only reached in the second world war), public debt has dominated the financial markets. Treasury bills have so much exceeded any other short instrument of indebtedness that their rate of interest (or more strictly discount) has set the pace in the money market, while long-term government debt (war loans and the like) has similarly dominated the capital market. Although this revolution had been achieved in Britain by 1920 when the borrowing process of the war was complete, more than a decade elapsed before the public authorities were able to turn their responsibility into an opportunity.

By the middle 1930s, however, the Treasury was unofficially recognized as the arbiter of monetary policy, exercised through debt management. The Bank of England voluntarily regarded itself as under Treasury direction ten years ahead of its formal nationalization in 1946. Thus the act of nationalization added in practice surprisingly little to the working of the control instrument. That was already assured by the pre-eminent place of the Bank itself among British financial institutions, and in particular by its close physical and personal contacts with the commercial banks, themselves made more amenable to control since a series of important amalgamations carried through in the early 1920s had produced the dominance of the "Big Five". The "hint from Headquarters" was already effective in their operations long before it came to be formally inspired by the Treasury. Nevertheless nationalization has undoubtedly strengthened the hands of the authorities in wielding the instruments of control, it has added something to their armoury in the way of control over hire purchase terms, and the revelation of details of certain deposits with the banks, which can materially add to the effectiveness of policy.

It is our business in the present chapter to discuss the ways in which the (in a sense) fortuitous presence of a large public debt has within the present generation put into the hands of the government a new instrument of control which can be integrated with the more strictly fiscal instrument on the one side and with the traditional monetary instrument on the other. This new situation is in some ways strangely reminiscent of that earlier revolution in British monetary affairs marked by the establishment of the Bank of England at the end of the seventeenth century, which carried British arms to victory against Louis XIV. How much it will be desired to use debt management as an active instrument of control in the future is a matter of speculation; the situation has been changing fast over the last few years. Further, the importance of a debt policy, and with it to some extent the effectiveness of the instrument, is probably at a maximum in the decade following a period of heavy borrowing, because it is then that the process of refinancing gives the greatest opportunities. Nevertheless for the most part time cannot undo the change which has taken place in the control centre of the nation's monetary affairs.

§ 2. The Structure of the Debt. The traditional attitude to a large public debt has been that every effort should be made to pay off as much as possible from the moment that the need for new borrowing ceases. This attitude was partly based on an analogy with private debt, on the consideration that the "dead weight" debt was similar to a private consumption loan, against which there would stand no assets for its support. It was also partly based on the fear—probably largely imaginary in respect of internal borrowing—that the presence of a large debt might hamper future borrowing, and partly on the far from imaginary fear that the real burden of paying the money interest would increase to an intolerable extent if there were to be a general fall in prices (rise in the value of money).

In modern conditions the capital sum of the national debt is of negligible economic importance; the significant factors are on the one hand the internal structure of the debt and on the other the bill for debt interest, or more precisely the additional taxes that have to be raised to meet it. These we shall examine below. It follows, however, that the reduction in the capital of the debt is no longer of economic significance. The process of repayment is almost wholly deflationary; the effect of the budget surpluses out of which alone it can be achieved far outweigh any expansionary effect of the release of funds for the purchase of other types of security. Debt repayment thus falls into place as a method by which an additional disinflationary push can be given when this is required on grounds of general economic policy.

Apart from quantitatively minor exceptions (and apart from the note issue which is in effect non-interest bearing debt), under modern conditions the public debt can be divided into three categories, according to the length of time before it becomes mature and repayable: short-term or floating, medium-term and long-term. Typical of the short-term debt is the Treasury bill issue, currently running at about £3,400 mn. out of a total floating debt of about £4,500 mn. The Treasury bill has a life of only three months, but in the same category of short-term debt must also be included the advances

which the Treasury takes from time to time from its bankers (the Bank of England) or from government departments who have spare cash to invest. Such borrowings are known as Ways and Means advances because like the tax revenue (which it will be remembered is debated in the Committee of Ways and Means) they provide the means of covering current expenditure. These advances are in a class by themselves, since they are entirely internal transactions and their terms are not revealed. They thus only indirectly affect market conditions. As well as these, it is now customary to include in the same category of short-term debt, bonds which are reaching maturity, either because they have been issued for a short time only or because their term has nearly run. These have been very plentiful in the post-war decade, since much of the war borrowing between 1939 and 1945 was in the form of 3-to-4 or 5-to-7 year bonds. Nevertheless in spite of the presence of these other short-term securities the money market continues to be dominated by the vast Treasury bill issue.

These short-term securities all belong to the same category because they appeal to the same classes of lenders: those who need to hold in their portfolios a certain proportion of liquid or "quick" assets, which they can consider as "near money", in other words those whose need for liquidity may be sudden and unpredictable. They include commercial banks, foreign and Commonwealth governments, banks and currency boards, and some firms. By far the most important holders, however, are the London Discount Houses, collectively often referred to as the "Money Market", whose business it is to trade in quick assets. The discount houses thus have a unique interest in short-term interest rates. The British commercial banks are also in a special position in this respect, since they aim to keep a more or less steady (roughly 30 per cent) proportion of their liabilities in respect of deposits in the form of quick assets. Finally, within the public sector there are a number of government agencies which also have need of short investments, less ephemeral than Ways and Means Advances. Especially important among these is the Exchange Equalization Fund,

which trades sterling bills for gold and foreign exchange, the National Debt Commissioners, who keep the portfolios of the savings banks, and the National Insurance Fund, which in times of full employment has large sums to invest.

At the other end of the scale from money market securities is the long-term debt, running for a period of years (roughly ten or more) and in many cases not redeemable at all or only at the option of the government. The demand for this type of security is substantially different. Long-term debt is necessarily less liquid than short, because when the maturity date lies far in the future there is always the possibility of capital loss from a rise in interest rates, if the securities should have to be sold at short notice. The demand side in this long-term market is made up of insurance companies and other financial institutions, including Building Societies and the commercial banks (once their demand for quick assets is satisfied, and especially if the demand for advances to the public is slack), and of trustees, both private and corporate (such as the trade unions). Again there are some government agencies which have some permanent demand for long-term securities, although for the most part they seem to hold them for relatively short periods.

In between the money market and the market for long-term securities there is a less clearly defined demand for medium-term government securities, bearing interest rates which are also intermediate. The demand side now consists almost wholly of financial institutions who find it convenient to bridge the gap which would otherwise exist in the maturities of their portfolios. During the war, however, when most of this medium-term debt had its origin, it had a wide appeal to personal investors who were very willing to tie up their [illegible] incomes for a short period of years if reasonably remunerative rates were offered.

If there were free markets in all these types of securities the price (or rate of yield) of each would at any moment accurately reflect relative supply and demand. When markets are subject to influence by public authorities these "natural" prices may

appear only as tendencies which the authorities may wish to encourage or alternatively seek to curb, or even (although with some difficulty) reverse. In reasonably quiet times there tends to be a fairly well defined "structure" or scale of interest rates, running from the low yields of Treasury bills to the highest yields of the "longs"; but the relative positions of the different maturities are by no means stable in detail. Apart from any difference which may occur on the supply side, the relative demands for different maturities is continually fluctuating; the result is recurrently to put one maturity out of line in the structure. Normally this will quickly be compensated through the action of the financial institutions whose interests straddle markets, and who are extremely quick to take advantage of a slight difference in yield. The authorities can also take advantage of these temporary shifts in demand whenever they have need to issue new securities. It is one of the arts of public borrowing to probe where demand is keenest at any moment.

On the supply side also, and even apart from any positive action by the authorities, the structure of the debt is continually shifting, as the efflux of time turns long debt into medium, medium into short and short into mature. Hence after a long period of borrowing, such as during a war, there ensues a period of rapidly recurrent need for refinancing. The efflux of time makes medium and long-term debt more liquid, more like money and so tending to have a more expansionary effect. The process of refinancing gives an opportunity for continuing this trend or readjusting it, as may be required in accordance with general economic policy.

3. The Aims of Policy. During a period of rapid expansion of the debt the traditional aim of policy was to ensure that the floating debt was not increased more than could be helped, for fear that the creation of so much "near money" would lead to an unmanageable inflationary potential which might jeopardize the future borrowing of the government. This was the policy which dominated the borrowing of the first world

war. But with the skill in credit control evolved during the
1930s together with some additional means (such as control
over bank advances) used during the second world war, this
danger need no longer be considered serious, at least under war
conditions. Consequently between 1939 and 1945 policy was
directed to two quite different purposes: on the one hand to
minimize the budgetary charge for servicing the debt, and on the
other to arranging a convenient spacing of maturities so as to
ease the process of refinancing after the war. In both these
aims policy was extremely successful; it was inherent in the
however, that the relative size of the floating debt was enor-
mously increased.

When war borrowing is over, debt management becomes a
process of refinancing; some further factors need then to be
taken into account. On the one side the government has a
chronic (although very fluctuating) need for short-term
borrowing to bridge the gaps in the flow of revenue, which
tends to be concentrated in the last quarter of the financial
year. This need may cut across a movement which would be
desirable on grounds of general control. On the other side,
while the Treasury itself has no special requirement for which
long-term borrowing is needed, a number of public authorities
do require long-term finance: the local authorities, especially
for housing, the Public Works Loans Board, which largely
finances them, and the nationalized industries for their invest-
ment programmes. These needs may on occasion also conflict
with desirable movements on grounds of general economic
policy (this was especially true during the period of the great
nationalizations). Debt raised for such purposes has a sub-
stantially different economic significance from "dead weight"
war borrowing, but from the point of view of the lender
public, one gilt-edged security is a perfect substitute for another
of like maturity, so that on the demand side the two types of
long-term borrowing may get in each other's way.

For the most part these constraints on the authorities' free-
dom to conduct debt management in accordance with general
economic policy are not serious, and they have consequently

almost complete liberty in the use of debt management as an instrument of control. They are faced, however, with three objectives, all worthy in their own right, but which require to be reconciled. First there is the desirability of minimizing the budgetary charge of the debt; secondly there is the considera-tion that low interest rates are conducive to a high rate of capital formation, so necessary for growth; and thirdly there is the desirability of using the monetary instrument to support fiscal policy in the process of compensatory finance. These objectives will not by any means necessarily lead to the same type of policy, consequently it is necessary to consider the relative importance which should be assigned to them. What this should be depends naturally on the particular economic circumstances, but there are also some general considerations to note.

When a large programme of borrowing, such as is necessary to finance a war, is on hand, it is of prime importance to minimize the future cost of the debt by keeping interest rates as low as possible. There need be no apprehension of inflation-ary effects of such a policy, because of the existence of direct controls (for instance of bank deposits) on the one hand and of the very limited opportunities for people to dispose of their incomes in other ways than by lending to the government.

In contrast the aim of minimizing the cost of servicing a debt which has already been acquired, although important, is by no means necessarily decisive for policy. If the debt is held internally and is subject to taxation (the interest to income and surtaxes, the principal to death duties or other capital taxes), a substantial part of the cost of servicing the debt will be covered by the taxation of debt holders on their holdings. In fact the situation is not quite so good as this, since, as is evident from our discussion of the demand side, the debt is largely held by institutions who pay income tax only at the standard rate. It is still true, however, that the net budgetary charge of the debt in modern conditions is not very great; it follows that a substantial reduction in the principal (as by a capital levy) would enable only a small reduction to be made

in tax rates, perhaps not more than a few pence on the standard rate.[1] When tax rates are very high even this may be quite important. In general, however, the aim of maintaining stability in the economy must take precedence over the aim of minimizing the budgetary charge of the debt in a programme of debt management.

The effect of the level of interest rates on the process of capital formation has given rise to much controversy, into which we cannot enter here. It is, however, generally agreed that its real importance is confined to very long-term investment, involving land and buildings, and becomes progressively less the shorter the life of the assets for which the loan is undertaken. Since the stimulus of long-term investment is an important factor in growth, this consideration is probably sufficiently important to justify a policy of keeping the long-term interest rates as low as is consistent with maintaining stability in the economy, but can hardly be said of itself to constitute a major aim of policy. On the other hand there is some evidence that savers are sensitive to long-term rates of interest, so that from the point of view of encouraging saving it is undesirable that interest rates should be kept very low. This is especially true when the greater part of capital formation is likely to be financed internally.

As an instrument of control (both internal and international) the most important aspect of management probably lies in the movement of short-term rates, especially those relating to Treasury bills and advances by the commercial banks. Traditionally stability in the money market was maintained by the influence of the authorities on the price of bills, exercised either by directly varying the supply available to the money market by buying or selling them against cash (cheques on the government account at the Bank of England through Open Market Operations), or indirectly, once a tightness had been induced in the market, by forcing the discount houses to resort to their liquidity at the penal Bank Rate. Terms of bank lending could also be influenced (although indirectly and not always satisfactorily) by this means, through the conventional relation which the banks maintained between bank rate and their rates for loans and deposits. It was also customary for long-term gilt-edged rates to move in sympathy with money market rates to some extent.

Thus a successful dose of rising Bank Rate would be disinflationary all along the line of interest rates. If, however, to start with conditions in the money market were very easy and the government had difficulty in avoiding new borrowing itself, to be successful the contractionary movement might have to be so persistent as to run the danger of a serious deflationary potential before the desired tightening was effected. This situation was very troublesome in the late 1920s.[1]

4. The Technique of Control through Debt Management. In the 1930s the need of credit policy was entirely expansionary. It was imperative to reduce the whole level of interest rates, both from the view of compensatory finance and capital formation and from that of the increased cost of the debt service due to the steady fall in prices in the late 1920s. In the 1920s the finances both of firms and of public authorities had alike been hampered by the high interest rates resulting from the clumsy borrowing of the first world war. In fact during the 1930s a technique of debt management was evolved (or perhaps more accurately stumbled upon), which was extremely successful in lowering interest rates and keeping them low. It was essentially this technique, elaborated and supported by new direct controls, which was the basis of borrowing policy in the second world war. This was a brilliant example of the achievement of the objective of minimizing the budgetary charge during the period of borrowing. Since the technique would seem to be available for use at any future time when it

[1] Cf. *The Taxation of War Wealth*, *cit.*, Chapter XXII, and discussion pp. 209–10 above.

[1] Due primarily to the fact that, owing to a clumsy arrangement of maturities, the money market was flooded by £2,000 million of war loan which reached the short bond stage simultaneously; cf. U. K. Hicks, *The Finance of British Government*, *cit.* Chapter XXII.

becomes necessary to use the monetary instrument for expansion, it is worth examining it briefly.

It would appear that the technique was first developed in the later 1930s, when market conditions were tending to push rates up more than was desired by the authorities. The obvious way of meeting such a situation would be to expand the note issue through Treasury borrowing at the Bank of England. By this means the commercial banks would find that their cash holdings at the Bank had gone up and would be stimulated to buy additional Treasury bills or even bonds (depending on their liquidity position), thus causing rates to drop. This was essentially the policy followed in 1932, which led to the successful conversion of the big block of 5 per cent war loan to a $3\frac{1}{2}$ per cent basis; it was followed again during the war and the early reconstruction period on a considerable scale.

Circumstances might arise, however, in which the condition of the exchanges would not permit of a simple expansion of this nature; it was then that the new technique of "departmental intervention" proved useful. The basic principle is that the authorities estimate the demand for a particular type of security (especially Treasury Bills, where the weekly tender can be foreseen with a high degree of accuracy), and supply the market with just so much as will balance supply and demand at the rate at which they are aiming. The technique depends for success on the authorities being able to satisfy their remaining needs for finance from internal resources. For instance the National Debt Commissioners, who manage the funds of the Savings Banks, may be receiving a flow of new savings which they will be anxious to invest. These are made available to the authorities to take up whatever form of security is to be operated on. In conditions of rising employment the Insurance Fund will also have a continuous inflow of a special kind of forced saving; other government departments which have funds to invest can also be brought into play. The investments thus made are in the interests of debt management, and not those of the institutions concerned, which might well prefer a different balance in their portfolios.

With the aid of departmental intervention the Treasury bill in the later 1930s was kept down to the unprecedentedly low level of a fraction of 1 per cent. This led to repercussions which affected the whole structure of interest rates, since both the discount houses and the banks had a strong incentive to expand their holdings of bonds (once their demand for quick assets was satisfied) in order to maintain their profits, sadly diminished by the very low bill rates. This result of departmental intervention is especially likely to be important when the demand from the private sector for bank advances is slack, as it was in the 1930s.

In such a situation the desired level of interest rates, especially of the bill rate, can be attained without any additional credit creation. In fact all that is happening is that saving which is being provided in the private sector is directed into particular channels, chosen by the authorities. These conditions may not, however, always be realized, in which case interest rates can only be forced down by some species of credit expansion. By and large, however, the tightness of the control and the success of the method are reflected in the fact that the Treasury bill rate was to all intents and purposes a "managed" rate from the early 1930s to 1954, when it was decided gradually to work back to the use of the price mechanism to fix the rate, in order that fluctuations in demand, which might be a guide to policy, would be quickly reflected in it. Another indication of the operation of the policy is that throughout the period of the managed rate the gap between the market rate and the less easily controlled longer rates was abnormally large.

During the period of war borrowing not only were both the conditions for departmental intervention especially favourable but additional controls were also available. Bank advances were restricted by direction and the banks' recurring excess liquidity was tied up for six months at a time through frequent demands for compulsory lending by (so called) Treasury Deposit Receipts. Further, a new means of directly influencing long-term rates was evolved: a particular broker (known as the Special Buyer) informally stood ready at all times to buy

back government debt from holders, so that they could never find themselves uncomfortably illiquid. The result of this policy was that, since the risk of capital loss was removed, long-term debt became effectively as liquid as short, demand for it tended to rise (because of the higher return it yielded), and long-term rates tended to fall even faster than short. This was the principal means by which the aim of minimizing the budgetary charge of the debt was so brilliantly achieved. In addition, to support the Special Buyer, the surplus funds of the departments were used not only for short-term accommodation but also effectively as "underwriters" for new issues (in fact the City nicknamed the National Debt Commissioners "the Public Stag"). It was in this way that the authorities were able to take full advantage of the slight variations in demand for maturities of different lengths, which, as we have seen, do normally exist.

War conditions for debt management effectively continued over the early months of the reconstruction period, up at least to the end of 1946. Although the rate of saving by the public began to decline almost immediately after the end of hostilities, so long as shortages, both of consumers' and of producers' goods, were acute, the volume of saving remained sufficient to keep the departments liquid. These conditions were used by the Chancellor (Dalton) to force down interest rates still further, by an intensification of war-time methods, until a 2½ per cent rate for long-term securities was almost established, as compared with the 3½ per cent rate of the war period.

The policy, however, met with increasing resistance and balance of payments difficulties. After the early months of 1947 a given decline in rates could only be achieved by an ever expanding degree of credit creation, which, recognized as an inflationary potential of large and perhaps unmanageable dimensions, helped to shake the confidence of investors in the government's ability to continue the policy. Thus, in spite of the powerful controls which the authorities could still exercise on the one hand, and of the strong vested interest which had been built up in favour of high capital values and low interest

rates on the other, the policy was gradually and tacitly abandoned.

The period in which the monetary instrument was used primarily to lower interest rates to the neglect of compensatory finance came to an end at about the time that Sir Stafford Cripps took over from Mr. Dalton in the autumn of 1947, although the change in monetary policy was not explicit; the Special Buyer continued his activities on a modified scale and there was no positive attempt to use the monetary instrument as a means of compensatory finance until 1951. On the other hand, after 1947 there was no more forcing down of interest rates by the deliberate creation of additional credit. In contrast the new Chancellor set out on a deliberate course of disinflation by fiscal means, striving for the first time out of war conditions to measure the "inflationary gap" and to close it by his budget policy.

The tentative revival of the monetary instrument of control as a support for fiscal policy took place only in the autumn of 1951, when for the first time for twenty years (excepting for a short precautionary movement in the first months of the war) Bank Rate was raised, while at the same time the excess liquidity of the market was drastically reduced by the issue of longer-term stock. Later the Special Buyer was withdrawn from general availability, to be used only to smooth out particular kinks in market supplies such as must always occur when big concentrations and disbursements have to be made on public account (such, for instance, as the preparation and payment of the periodic disbursements of the Milk Marketing Board). The effect of this tightening was immediately visible in the reduction of holdings of commodity stocks, swollen out of all proportion by the Korean demand acting on the excess liquidity created in the 1940s.

It was only gradually and tentatively, however, that the revived monetary instrument was put into operation in Britain. It had become so rusty and conditions had changed so much over the course of twenty years that no one could be sure how it would work. Moreover in 1951 many, even most, of the

war-time controls over consumption and commodities were still in operation. In these circumstances it would have been in any case impossible for the price of money (as represented by the short-term interest rate) to resume its full traditional role, either as an instrument of control or as an indicator of tendencies. Gradually, however, as the process of decontrol gathered momentum it became both possible and desirable to work towards a fuller restoration of the monetary instrument, including an active use of bank rate policy. For this to be practicable, however, the policy of keeping Treasury Bill rates artificially low by market rationing would have to be suspended, so that the twenty-years-old wide gap between Bank Rate and market rates could be narrowed to a point where Bank Rate could be made effective.

By the end of 1954, from a gradually attained pinnacle of almost wholly controlled interest rates there had been a descent to a position in which they could in principle move almost as freely as in the 1920s or even before 1914. How far it will be possible or desirable to maintain this freedom is a matter for the future.

It should be noted, however, that Britain has been by no means unique in following this sequence, first of learning to force down interest rates in the hopes of stimulating recovery from the depression of the early 'thirties, secondly of intensifying these methods for the purposes of war finance, and thirdly of gradually (and with considerable difficulty) disentangling the artificial situation which had been built up, in order to return to a flexible monetary instrument. Not merely the sequence but the timing of the different stages has been similar in most countries with developed monetary institutions amenable to management; only the precise means differed from country to country, according to the local organization of the money market and banking system. (For instance in the United States, in place of the informal Special Buyer, Federal Reserve Banks gave a formal undertaking that they would always buy back government debt at fixed prices.)

As a result of this process large programmes of war

borrowing were everywhere carried through at a surprisingly low budgetary charge, but everywhere again excess monetary ease, the result of prolonged credit creation, provided fuel for the Korean boom. All countries again found considerable difficulty in retreating from ultra low long-term rates to a position in which all rates could become flexible again, without giving rise to unmanageable capital losses. In all the problem had been more or less completely solved by 1954, but only at the cost of some further inflation in order to ease the transition to freedom.

Although a great deal of the machinery has now been dismantled, the methods of interest rate control through debt management evolved during the 1930s and 1940s would seem to be a most useful permanent addition to the effectiveness of the monetary instrument of control, giving it much greater flexibility than was possible in a simple regime of bank rate and open market operations. With the development of the more precise fiscal instrument, credit control is perhaps not likely ever to be used again as a major instrument, as it was in nineteenth-century England. It must be recognized, however, that in spite of its imprecision it has several inherent advantages which are not shared by fiscal policy, apart from its possible effects on the external situation, with which we are not here concerned.

In the first place credit policy can operate almost continuously, and if desired by small and gradual steps, whereas in respect of the fiscal instrument there is always a danger that attempted flexibility will be at the expense of effective control of expenditure. Secondly a movement in market rates impinges immediately and directly on a sector of the economic process which is especially sensitive to this particular price, because it is an important factor in stock holding. This was well understood in the nineteenth century and was demonstrated again in 1951–52. It seems unlikely that any conceivable fiscal change would be so effective on this sector of the economy.

An effective use of the monetary instrument, however, is

really only open to advanced countries where banking habits are widespread and well established, and where autonomous financial institutions exist. Even then it can only be enjoyed to the full in countries which are not financially dependent on their larger neighbours. (Such dependence is a matter of size and economic structure; it has no necessary connection with political dependence.[1]) The majority of countries which are now starting on a process of development are therefore at present unable to make much use of the monetary instrument; many of them will never be able to do so. India is a striking exception to this generalization.

As banking habits develop, however, and as the non-monetary sectors recede before the advance of the exchange economy, it should be possible for such countries to make some use of local credit control. As the experience of the Dominions (and especially Canada) demonstrates, this does not necessarily call for the establishment of an independent reserve bank. Much more necessary conditions are the presence of commercial banking units which will follow a policy of some local independence (so that the flexibility of local bank money is secured), and probably some flexibility of the currency supply. An important contribution can also be made by issues of government securities to the local public.

The process of development calls for large capital sums, and while the greater part of these must probably be borrowed abroad, it is very much to the economic and fiscal (as well as the monetary) interest of the developing country that as much as possible should be raised at home. This will both eliminate the need for external transfer in servicing the debt, and will provide an outlet for additional incomes which might otherwise tend to move into consumption. It is desirable that the citizens should both acquire habits of thrift as they rise from poverty and that they should become accustomed to lend to the government. If additional incomes are saved, but deposited in the banks rather than lent to the government, this is still

[1] Cf. the dual dependence of New Zealand on Australia and Britain demonstrated by C. G. F. Simkin, *Fluctuations in a Dependent Economy*.

useful since resources will not be diverted to consumption and the banks are very likely to welcome the opportunity of lending to the government locally (so long as they have confidence in its integrity) rather than sending their funds overseas to one of the world monetary centres.

There may be savers, however, who will merely hoard their incomes in the form of currency. The government should use every means in its power to collect the savings of these, and other potential savers, into its own coffers, by providing suitable means of attracting small savings and attractive means of attaching larger ones. During the war the belligerents learned a great deal about "selling" government securities to the public, especially savings certificates which could be purchased gradually by means of stamps. Indian experience in this field suggests that even where the margin for savings is small, there is a substantial potential source of funds to be garnered in this way, especially if savings groups can be organized (voluntarily) among groups of workers in factories, mines, offices, or it may be on estates and plantations.

As regards lending in larger amounts, through the purchase of bonds, in many countries there appears to be a substantial potential market if the government is prepared to offer reasonably attractive terms. How much it would require to offer would often depend on the extent to which fiscal and other controls had reduced the attractiveness of other openings for savings, such as real estate mortgages. Thus fiscal and monetary policy can be used to support each other even in relatively underdeveloped conditions. It might well be worth the government's while to offer fairly attractive terms in order to inculcate the habit of lending to the government.

For such a policy to be successful two things are above all necessary. In the first place the local bond issues must be well advertised, through banks, lawyers, the local press or whatever media suggest themselves. In this respect also the developing countries have much to learn from the advanced countries. Secondly, and much more fundamental, for success it is essential that the local property owners should not only have

political confidence in the government but should be enthusiastic for development and have confidence in the ability of the government to carry it through. To promote this attitude many devices are available, such as the tying of a particular loan to a particular project (as British war loan drives were nominally tied to the purchase of battleships, Spitfires, and so on). In this, as in many other aspects of development, the passport to success is a continuing alertness on the part of the public authorities.

CHAPTER XX

THE BUDGET AS AN INSTRUMENT OF POLICY

1. The Budget and Planning. Of late years few words have been more bandied about in popular discussion than the word "planning"; it has been made to cover a multitude of sins, methods and wishful thinking. This being so it seems desirable to avoid its use altogether as far as possible. It will make for clarity in later discussion, however, if to start with we distinguish briefly the principal meanings which have been given to planning, so as to isolate those which have reference to fiscal policy.

The simplest application of the term planning is in connection with land use, physical planning in the sense of the Town and Country Planning Acts. This is a perfectly legitimate and important use of the term; but it has little or no fiscal policy significance, so that we are not concerned with it. Next comes the integrated comprehensive period plan first made famous by the Russian Five Year Plans. This again is primarily planning in a physical sense. It is concerned with the lay-out of resources to reach specific economic and political ends, but on account of the very comprehensiveness of the plans it is possible to proceed universally by the method of direct resource allocations, virtually without the intervention of fiscal policy.

The planning of the controlled and directed economy of wartime in Britain and some other countries bore some resemblance to the comprehensive type of planning; it was also concerned with the layout of resources to gain a mainly political end, although at the same time it was used (especially in Britain) to further certain social aims (such as better nutrition and greater equality of disposable incomes) as a by-product. War-time planning, however, was not in any sense long-period; the

exigencies of defence made it essential that output should be flexible, which implied a large hand to mouth element in the planning process. Much more fundamentally the planning of the directed economy in what was still fundamentally a private enterprise organization, working in a free society, was inevitably different from the comprehensive plan of an authoritarian country. Although it was essential that policy should try to balance the national accounts as a whole, actual direction was confined to the war effort and services ancillary thereto.

Out of the directed economy of war-time there grew, in Britain and in several other countries of Western Europe (most notably Norway and the Netherlands), the semi-controlled (but not directed) economy of the reconstruction period. This was at first thought of as a planned economy, and persistent efforts were employed to develop the methods used during the war for permanent use. This, however, was planning in quite a new sense. Comprehensive physical allocation of resources was abandoned, although direct controls and allocations were retained in particular sectors. Persisting scarcities made this inevitable for some time in any case. In Britain the controls were used deliberately to reach the special objectives of policy cencerned with the establishment of the welfare state.

Other countries, notably the U.S.A. and Canada, whose economies had also been largely controlled and directed during the war, more rapidly returned to a free enterprise economy at the end of it. (They were in any case much less hampered by war damage and scarcities.) But in an important sense the technique of planning was not abandoned, since they continued to use the elaborate statistical mechanism of national accounting built up for the equilibration of the war economy, and to use it both to steer the private sector in the direction required for full employment, and to tailor the public sector so that it would take up any slack or compensate for any tightness in the economy as a whole. This is the direction in which Britain has been moving of late years. Controls and allocations have been progressively abandoned, partly as a matter of policy,

partly due to the gradual replacement of scarcity by relative abundance.

It may be questioned whether the steering of a fundamentally private enterprise economy in this way should be regarded as planning, however large the public sector may be (and as we have seen in Britain public investment now slightly exceeds private investment). Nevertheless, whatever the term used, the preparation and implementation of a general economic policy fixes a wide gulf between an economic organization of this type and the unorganized economies of earlier eras, not excepting those countries which attempted—with sadly inadequate instruments—a counter-cyclical policy in the 1930s. In the U.S.A. the growth of the federal government sector since 1940, and the expansion of its influence throughout the economy; through social expenditure and research on the one side and direct taxes on the other, have been little short of staggering.[1] The policy implications of the new situation have hardly yet been fully realized.

There is one final type of planning which needs to be distinguished before we leave the question of classification: the periodic development plan, designed to increase productivity in one or several specific directions. Such was the Monnet Plan in France, and such are the development plans of the British nationalized industries. The five (or ten) year plans of developing countries are similar in kind, although they normally have a wider range. These section plans need to be carefully fitted into general economic policy if they are not to disrupt the balance of the economy. Where they are small relative to the whole (as is the case with the British nationalized industries), they constitute just one aspect of securing a general balance of investment, and need pose no particular problems of control. Where, however, they are large relatively to the total economy, plans of this type require (as we have seen) special fiscal measures to counteract their over-expansionary effects; they also call for a modification of normal budgetary technique, as we shall discuss later.

[1] See above, p. 80 and p. 292.

In Britain the mechanism that was set up to plan the war economy was remarkably simple, almost makeshift. The very extent of controls (which under the circumstances were willingly accepted), made a complicated planning organization unnecessary, even if there had been time to set it up, while a great amount of the statistics required was produced as a by-product of the controls. Most of what the planners needed to know was thus easily available. From the point of view of policy, however, there is one important aspect of war-time planning which needs emphasizing[1]: the mechanism (quite naturally in war conditions) was organized round the Cabinet and was hence outside the Treasury. The Lord President of the Council became the Minister responsible for the Central Statistical Office and the Economic Section.

The framework on which economic policy was built during the war was of course not revealed, but it seems to be closely reflected in the method of planning set out in the first Economic Survey published in 1947. Within the overriding objective of full employment, if possible at stable prices, there were to be sets of budgets: (i) for the major industries, including objective targets of manpower and output, in the manner of war-time targets of planes or tanks, (ii) for the main economic factors: consumption, investment, exports and imports, consolidated in the national income and expenditure accounts, and accompanied by a manpower budget, and (iii) a special set of calculations concerned with the vital bottlenecks in supply, above all steel, fuel and power and supplies of foreign exchange. On the basis of these, as drawn up by the Central Statistical Office and Economic Section, Ministers would then make their final decisions in line with the government's policy. It should be noted that the whole planning process was internal to the government, in contrast to the mechanism of some other European countries, notably the Netherlands.

The troubles of 1947: the fuel crisis in the spring and the balance of payments crisis in the summer, soon indicated that more formal planning machinery would be required, once the

[1] See above, p. 35.

ne of the war-time controls had been removed, above all the rection of labour. The necessity for this was apparent when became vitally necessary to cut back investment. It was then und that virtually no information was available of the plans nd progress of investment in different parts of the economy. also became immediately obvious that without either rection of labour or the use of wage incentives (which were compatible with the wage freeze adopted in the interests of ability) there was no means of attaining the manpower rgets, or hence the output targets.

Out of this virtual impasse came a number of experiments in anning organization, designed especially to secure a stricter location of resources and thereby better control over the hole range of investment. A hierarchy of permit giving encies arose, through the central economic planning secreiat, the Ministry of Supply and the Board of Trade; if new oney was required also through the Capital Issues Committee, eing under directives from the Treasury. At this stage the ew machinery was still developing mainly outside the Treasury, eaving the traditional Treasury control of departments to nction in the old way, so far as it was able to do so. This was eviously a situation which could not endure satisfactorily. ther the new side of government policy would absorb more nd more, and the Treasury be left with a diminishing control ver the public sector, or the new machinery would have to be rought over to the Treasury and integrated with the traditional achinery; it was probably inherent in the British tradition hat the second alternative would finally triumph.

When Sir Stafford Cripps succeeded to the Chancellorship n the autumn of 1947 he was already Minister in charge of conomic affairs; it was only natural that he should double he role with the Chancellorship; but in fact this apparently ortuitous event quickly determined the issue. Although requent changes between 1948 and 1953 show that the process was still experimental, the Treasury was gradually shaping itself to absorb the new economic responsibilities of government within its embrace. On the one side the expansion of

Home Finance[1] made possible budgeting (in conjunction with an Investment Programmes Committee) which took account of economic circumstances and trends in a way that had no pre-war precedent. (In fact before the war nobody could rightly say from what dark corner of the Treasury the budget really emerged.) On the other hand the expansion of Overseas Finance[1] made room for an organization whose special business it was to look after the balance of payments and the statistics which lay behind it. The seal was set on these developments by the transfer in 1953 of the Economic Section from the Cabinet Office to the Treasury, the Head of the Section being given (as we have seen) the title of Chief Economic Adviser to the Government.

Thus the central interpretation of economic statistics—ever growing both in volume and accuracy—now takes place within the Treasury. The fruits of experience can be observed in the changed content of the Economic Survey on the one hand, and of the National Income and Expenditure Blue Book on the other. The Survey has long ceased to talk of targets based mainly on wishful thinking; it has become a document of contemporary economic history; but the history it records is based on much more detailed and accurate statistics. Due to the fact that the Economic Survey is published ahead of the budget, it naturally cannot contain explicit forecasts in any detail; it would seem, however, that for internal use it has become a real foundation of policy formation. The Blue Books not merely contain vastly more information than was ever available in the old White Paper, but it is organized in a manner which is much more meaningful for forecasting.

The first concept of a general economic policy, through national income accounting, set out by Keynes in 1939, and continued essentially unchanged through the reconstruction period, was, as we have seen, in terms of aggregate supplies of factors on the one hand and aggregate demands on them on the other. These two aggregates being confronted, an inflationary

[1] See above, pp. 36ff.

deflationary) gap would be revealed, which it was the first object of policy to fill. This approach, although useful as a first approximation, was both too static and too aggregative to provide an adequate basis for forecasting. It is only when the individual sectors can be taken apart and broken down into their components (both functionally, as for instance between consumption and saving, and organizationally, as between demands on resources), that the tendencies of the immediate past can be observed with sufficient closeness to form the basis for judging the next moves. This is now being attempted in the tables of inter-sector analysis and especially in the new tentative input/output table.

At the same time the end of rationing and the gradual return to a more free economy, together with the revival of the monetary instrument of control, and the greater knowledge which the new statistics supply, can contribute to bring about a simplification in the central planning machinery. Allocations of raw materials are no longer rational in a world of sufficient plenty for the price mechanism to work. On the other hand the new freedom requires a wider outlook and increasing vigilance. The recurrent balance of payments crises in the post-war world were largely due to causes outside the control of Britain; but it cannot fail to be observed that the early Economic Surveys were strangely unconcerned with the over-seas situation. Again it can fairly be argued that the crisis of 1951 was aggravated by the excess of quick assets in the money market which was an aftermath of the era of forced cheap money; this aspect of the economic situation had not then been integrated with policy.

What seems to be called for in the new situation is rather a close and continuous co-operation of all departments and agencies concerned with the factors which determine national income and outlay, under the aegis of the Treasury, than specific planning committees with limited range. All of this, however, in turn implies a substantial alteration of the position of the budget in the economy. To the problems of gearing the budget to its new tasks we must therefore turn.

§ 2. The Functions of the Budget. The budget is the account of the moneys for which the legislature is responsible. In Britain it covers, as we have seen, that part of public outlay on which the House of Commons has the final say, through the Committee of Supply, and the final criticism through the Estimates Committee and the Public Accounts Committee. But with the new responsibilities of the public sector the traditional cash record is not sufficient to bring out the economic significance which is required. In a sense this new need is supplied in the accounts of the various parts of the public sector presented in the Blue Book. These accounts, together with those which have only internal circulation, may be satisfactory for government planners; but from the point of view of Parliament and the outside public it is still the budget that counts, especially since the budget alone can be explicitly forward- as well as backward-looking in any precise way. It is therefore ultimately necessary that the budget should be properly adjusted to fit into its new place, while not abandoning its old purposes.

Traditionally the main importance of the budget was to assure Parliament of accountability control. In its backward-looking aspect it was first to demonstrate that the monies voted for the several public services had been allocated to those purposes, secondly that the funds allocated had either been spent on the services or handed back to the Consolidated Fund. In its forward-looking aspect the Budget recorded the planned amounts to be spent on different services and the revenue which would be required to cover them. The whole process was complete in the Estimates, the Finance Act and the Appropriation Act, finally reported upon by the Comptroller and Auditor-General. The Account was important both in detail, where it was the business of the Treasury, the Comptroller and Auditor-General and the Public Accounts Committee, and in aggregate, where it was the business rather of the Chancellor, the Cabinet and the Committees of the whole House.

Merely for the convenience of Members, and without any statutory authority, there grew up the practice (unknown in other times) of summarizing the results and estimates of expenditure and revenue in the Financial Statement. This would be a most important document, since it gives the only opportunity of seeing the wood for the trees which is directly related to the financial year and which is effectively forward-looking. It is therefore highly desirable that in addition to its traditional role it should reflect the economic significance of the government's performance and policies as closely as possible.

For effective accountability control the two most vital of the characteristics of the budgetary system are first, that the account should be truly comprehensive, and second that there should be an annual clearing of the decks (in an accounting sense) between the Departments and the Consolidated Fund. These are the two things which the British budgetary procedure was especially designed to secure. No funds which are the responsibility of Parliament were to be left out, nor concealed "agency" or "extraordinary" budgets. Expenditure which Parliament regarded as appropriate to be financed out of loan was, however, segregated "Below the Line"—as can be seen in any Financial Statement. In fact, except in war periods, only a few items appeared, intermittently, below the line, such as the cost of telephone extension.

Annuality was especially carefully looked after. Appropriations were for the single accounting period only, and any funds not spent, together with outside receipts by a Department ("Appropriations in Aid") had to be handed back at the end of the period. The all-important income tax was voted only for the year. Although naturally expenditure and tax collection were continuing processes, special powers were taken annually to regularize these for the period until the budget was passed. These precautions and practices continue broadly intact to-day, although as the scope of public activity expands the result becomes somewhat less exact. In practice, many Departments, especially those with trading or production activities, must be allowed to hold working balances if their operations are to proceed smoothly.

Even in the formative stage of budgetary practice (in the second half of the nineteenth century) Parliament evinced a proper interest in another aspect of budgetary organization, which we may call *functional*. This seeks to show not merely the aggregate of outlay but also a breakdown between different types of services. Very considerable interest was shown by the House of Commons in the relative totals, especially as concerned defence. The functional classification was looked after, although only in a very broad way, in the arrangement of the Estimates, which were, and are, published serially on a departmental basis, departments whose business is similar being grouped together. When the Estimates are all brought together in the final "balance sheet" of the Financial Statement this arrangement is preserved. Further, the Financial Statement contains a series of expenditure tables, summarizing in some detail proposed outlay in different directions: grants to local authorities, central contributions to social services, and a number of other headings including colonial, commonwealth and foreign services.

The information given in these tables has become more informative and better organized over recent years. There is still no means, however, of telling, even from the detailed Estimates, how much any particular service costs which is spread over a number of departments or administered together with other services. For this to be possible much more extensive rearrangement of the accounts, and even of the method of accounting, would be required. Yet from the point of view of functional efficiency these are just the sort of costs which should be capable of ready check and comparison. To this point we shall have to return later.

There remains to consider one further classification which is required of the budgetary system: by economic category. With the beginning of compensatory finance in the 1930s a breakdown of the budget into the leading economic categories, at least so far as current/capital and goods and services/transfers are concerned became a virtual necessity. Without these the expenditure effect of public policy could not be judged.

The first country to manifest any interest in the economic classification of the budget was Sweden, which established a fairly comprehensive reorganization of the budgetary structure on a current/capital basis in 1938. This was a most interesting experiment, although from the point of view of later needs it scarcely went far enough.

With the start of quantified compensatory finance within the framework of national accounting (in Britain only a few years later), not only was something like the Swedish reform desirable, but further economic breakdowns were also required, in order to isolate the true surplus on the current budget on which the system of control fundamentally turns. In Britain the process of providing this more detailed economic breakdown grew up entirely outside the framework of the Financial Statement, just as the organizations providing the statistical and economic foundations for policy decisions grew up outside the Treasury. The Chancellor's budget consequently remained unreformed and without formal relation to the economic classification which is provided by the Central Statistical Office. In the next section we must discuss the possibility of bridging the gap which thus arises between the foundations of policy and the budget account in which it is enshrined.

3. The Budget and the National Accounts. We have seen that the traditional arrangement of the British budget, and the simple cash accounting on which it was based, were designed purely for accountability control. So far as ordinary administrative departments are concerned, where there is no question of maintaining or improving assets and independent appropriations in aid (such as fees and fines) are negligible, the system is admirably appropriate for its purpose. It is very understandable that the Treasury is most anxious that nothing should be done to disrupt it. But for the further purposes with which policy is now concerned it is much less than adequate.

Where departments have jobs to perform (as distinct from services to administer) a simple cash record does not have the

same significance. Further, for such departments it is highly desirable that there should be a form of accounts which will enable a check to be made on efficiency, as well as on accuracy. This category includes not only actual trading departments, for which indeed the need is obvious and widely recognized, but also a considerable variety of semi- or pseudo-trading departments, such as hospitals, Royal Ordnance Factories and Dockyards, departments concerned with road development and works. Secondly, and even more important, fiscal policy, whether concerned with stability or growth, calls for an accounting system which will enable a fully economic classification of revenue and expenditure to be made, in order that the central government sector can be consolidated with the rest of the national accounts. The problem of budgetary reform is to devise a system which will give weight to these later considerations in addition to accountability control.

Taking first the problem of gearing the budget to fiscal policy in the widest sense: the first and most fundamental need here is to reveal clearly and accurately the true surplus or deficit on current account, consistent with the definitions of saving in other parts of the economy, because this magnitude measures the contribution of the central government to saving or dissaving in the economy, and hence (according to prevailing economic conditions) its expansionary, contractionary or stabilizing effect. The current surplus is of especial importance in the budget of the central government because in the last resort public policy in revenue and expenditure has to act as the balancing factor in the national accounts. We must examine this central group of problems in some detail below; in the meantime there are subsidiary problems which also need to be considered.

An important aspect of compensatory finance is concerned with budgetary flexibility to meet a change in economic circumstances which may occur in the course of the financial year; this cuts straight across annuality. The Swedish budgetary reform scheme attempted to solve this problem by

proposing to vote provisionally at the beginning of the financial ear alternative budget plans, one for existing circumstances, e for a deterioration in conditions; such a plan would, owever, hardly be less rigid than a single budget. It seems ear that such provision for flexibility as can be made without rupting accountability control, must be made within the dinary budget framework. How far it is possible to go the direction of flexibility varies (paradoxically) inversely ith the tightness of annual control; the better this is the reater the liberties that can be safely taken, and the greater e assurance that they will only be taken when real need ises.

In Britain there have recently been a number of successful mall examples of flexibility of this nature. The acceleration orders for army clothing to stem the textile recession of 1949 as already been mentioned. Similar liberties with the timates have more than once been taken to assist sudden mergencies in the Colonies. Expenditure of this nature can financed in the first instance from the Civil Contingencies und (which also finances the early stages of new services fore they receive their normal Vote in the Estimates). bsequently emergency expenditure of this type must be mbodied in a Supplementary Estimate, where the need for it ill be fully discussed. On the revenue side purchase tax tes can be changed at different times of the year. Even ith these opportunities for flexibility, however, so far as cal means are concerned, main reliance must be placed on the tomatic stabilizers. This points again to the need for making ull use of the continuously flexible monetary instrument.

A somewhat similar problem, also cutting across annuality, posed by the need, in modern conditions, to budget for rojects which may extend over a number of years. In the .S.A. these have led to great difficulty (for instance in respect the finance of foreign aid or farm supports). It appears to necessary to get Congress to vote the entire appropriation the beginning of the programme, hence in that year appropriations enormously exceed outlays, whereby the clarity of the

budget balance is upset; while even then in subsequent years there is no assurance that Congress will not go back on the appropriations it has already made in principle. It seems probable that Cabinet government of the British type makes this problem less intractable. Once Parliament has accepted a programme, in general it is satisfied to accept year by year the estimate of the outlay upon it which is expected to be made during the year. It is evident, however, that estimates of this nature cannot be subject to the same degree of accuracy and hence the same checks as administrative estimates.

Continuing programmes have greatly increased in numbers and importance in recent years, for instance the road development programme, capital development in the health services and the expansion of the telephone service. The defence production programme also implies some very long term commitments, especially on the development side. Nevertheless the continuing programmes with which the British government is concerned are still only of moderate importance relative to the whole. In the budgets of colonies and other developing countries this is usually not the case, and it would seem desirable to adjust the budget organization to take account of this fact, for instance by recording each year progress on the schemes involved, together with original and revised estimates to completion. In order that the legislatures may appreciate the fiscal implications of the developments it is also wise to set against each the cost of the co-operating labour and materials of a recurrent nature required for full operation.

While the solution of these special problems is an increasing requirement for fiscal policy, the central problem remains that of gearing the budget so as to record as nearly as possible the correct current account surplus/deficit. For this to be reasonably accurate two things are necessary: (i) that the accounts should record amounts payable or receivable as well as actual cash transactions, which may be fortuitous and subject to manœuvre between accounting periods; (ii) that there is an effective separation of current and capital items, the latter consisting of funds available for investment and investment

lays, loan and borrowing transactions, transfers on capi
count and other non-recurrent receipts or payments.
It is recognized that difficult problems of definition ari
der all these headings. Cash transactions are definite ar
enable to exact check; as soon as a receivable/payable (c
crual) base is admitted an element of judgment enters, and th
me degree of precision in control is not obtainable. Again
ny items lie on the border of current and capital; judgmen
in enters into their classification. This is especially true
the outlay side, and more particularly where the final outlay
made not by the Department for which it is appropriated, but
some other authority or agency. Nevertheless, while it is
voidable that there should be some untidy margins of
ssification, a form of accounting has been worked out and
ternationally agreed, which on the whole makes these dis-
ctions satisfactorily. Before we examine this, however,
ere are two further matters of classification which require
ief mention.

If we are interested (as we must be) not merely in the crude
gnitude of the budget surplus/deficit, but in its deeper
onomic significance, it is necessary that the items, especially
the outlay side, should be distinguished according as they
present the purchase of goods or of services from the private
ctor on the one hand, or transfers on the other, and of these,
ose that are on social account from payments of national
bt interest. Secondly it must be possible to tell whether the
penditure inpinges in the first place at home or overseas.
ese two distinctions—of which the former is normally the
ost important—are necessary in order to be able to gauge the
fect of the outlays on spending, saving and the balance of
yments.

We may now examine a summary of a form of accounts
hich is suitable for the budget of a public authority and which
kes proper account of all these distinctions, besides being
awn up on an accruals basis. It is in fact virtually identical
form with that used for the accounts of public authorities by
e Central Statistical Office in the Blue Book.

I. REVENUE (INCOME, CURRENT) ACCOUNT

Incomings	*Outgoings*
1. Tax Revenue	1. Expenditure on goods and services
2. Property income (including trading surpluses)	2. Current grants and subsidies
3. Current grants from overseas	3. Current grants overseas

Balancing item: Current surplus/deficit

II. CAPITAL (INVESTMENT) ACCOUNT

1. Current surplus deficit	1. Gross fixed investment
2. Capital Transfers (including gifts from abroad)	2. Stock adjustment
3. New Borrowing	3. Capital transfers and gifts
4. Repayment of loans to authority	4. New Lending
	5. Loan repayments by authority

Balancing item: Change in liquid assets

The first part of this account covers all transactions on current account, so that the balance represents the true contribution of the authority concerned to saving/dissaving in the economy; it is accordingly carried down to the investment account for disposal in replacement of stocks and fixed capital, new investment, lending and increase of liquid resources. The second part covers all transactions on capital account; it will be observed, however, that—apart from gifts and transfers (which in the capital account are of minor importance)—the account falls into two parts, one dealing with real investment, the other with financial transactions. It is often useful to divide the account into two accordingly; if the "real" transactions are put first the balancing item to be carried down appears as "funds available for lending" (or requiring to be borrowed); if the financial account is put first it then appears as "funds available for investment". In any case the final balancing item must represent the change in liquidity, which in the case of a national government would appear as a rise in the balance of the government at the central bank, or if the accounts of the

ral bank are consolidated with those of the government, ld record the change in the country's holding of gold and rnational money.

the account given above, investment is entered *gross* of reciation, and no item corresponding to depreciation is wn. It is therefore suitable only for departments where a' mmercial depreciation policy is not followed and where acement of assets (if any) is provided out of taxation or er extraneous receipts. Even if there are real assets which ire maintenance this may arise because (as in the case of Ministry of Works) there are no receipts out of which reciation can be provided, or because the accounts of a ding or semi-trading department are being kept as if it were administrative department.

Where assets are only a minor matter within departments ch are fully accounted for within the budget, it is probably unnecessary encumbrance to provide specifically for reciation in the current budget, especially if a practice is owed of normally taking trading and semi-trading activities of the full scope of the budget (as explained below). In a eloping country, however, while assets are being built up, item will tend not to be small in relation to the whole. It en desirable both in the interest of good financial practice of stability to provide for depreciation specifically, as well urrent maintenance, out of taxation. It will also make for eady rate of development if a fixed charge for new investnt is made on the current budget, which can either be carried wn directly to the development budget or to an independent velopment Fund.

It is sometimes objected that a commercial depreciation icy cannot sensibly be applied to assets that have no ertainable market value. This, however, seems to be going o far. In the Swedish budget fixed assets are regularly preciated, the assets being divided into categories according their expected useful life, and appropriate depreciation riods and rates chosen accordingly. It is of course essential the interests of accountability control that when the periods

have been once chosen and applied they should not be varied. Formal depreciation goes far to ensure both that sufficient taxation will be levied to cover necessary maintenance and that assets will be renewed when they fall below standard.

The budget account which we have just examined is essentially an administrative record of transactions and commitments. So far as the central government is concerned it has developed straight out of the personal account of the sovereign, just as the first business accounts were indistinguishable from the private accounts of their owners. As business enterprise developed, however, this form was found not to record effectively the economic position of the business; consequently a slightly more complicated form has been evolved which differs from the administrative account in showing (i) how the trading income is *made* (essentially the difference between sales and purchases), (ii) how it is *divided* between contractual payments (interest, etc.) and taxes, capital maintenance and net profits, and (iii) how the net profits are *applied*: to investment, to remuneration of the owners (in the case of private enterprise), and to reserves. Comparing one year with another, the change in the capital position of the business can then be read at a glance. This type of account is briefly summarized below:

I. OPERATING (PRODUCTION, TRADING) ACCOUNT[1]

Receipts	*Payments*
1. Sales	1. Wages and Salaries
2. Subsidies and other transfers	2. Purchases of Goods and [Services
	3. Rent
	4. Taxes (excluding income taxes)
	5. *Less* Increase in Value of Stocks and Work in Progress
	6. Provision for Depreciation

Balancing item: Net Operating Surplus

[1] For the construction of an account of this nature, see J. R. Hicks, *The Social Framework*, 2nd ed., Chapter XIX.

II. APPROPRIATION (INCOME AND EXPENDITURE) ACCOUNT

Receipts	*Payments*
Net Operating Surplus	1. Interest and Dividends
Provision for Depreciation and Stock Adjustment	2. Income and Profits taxes
Interest and Dividends receivable	
Income earned abroad	

Balancing item: Undistributed income before appropriating for depreciation and stock maintenance (= gross saving)

III. CAPITAL (SAVING/INVESTMENT) ACCOUNT

Gross Saving	1. Replacement of Fixed Assets
Capital Transfers (net receipts)	2. New internal capital formation: (a) fixed, (b) increase in stocks and work in progress
Loans (net change)	
Additions to Tax and Interest Reserves	3. Net purchase of financial assets
	4. Net Investment Abroad

Balancing item: change in cash

This account is essentially the same as that used in the Blue ook for the public corporations. It must at once spring to nd that it would be almost equally appropriate for other pes of government activity: the trading operations of the inistry of Food and other Ministries, the Post Office, and th a little adjustment to the road programme[1] and the inistry of Works and Buildings.[2] If it were used further for

[1] For such an adaptation cf. J. R. Hicks, *The Problem of Budgetary eform*, p. 29.

[2] This would imply charging rents to Departments for the buildings ey occupy. Coupled with a proper depreciation policy this might well d both to more care of buildings (especially requisitioned buildings) by e occupants and to more adequate maintenance.

Royal Ordnance Factories, and above all for the hospitals,[1] it would not merely be a more effective check on the disbursement of funds than the present but would point the way directly to a diagnosis of relative efficiency between the establishments. The fact that no commercial profit is expected to be made does not affect the adoption of a commercial form of accounting, where it is relevant. Rather it serves to demonstrate the true dimensions of the subsidies implied.

It is a matter of judgment how far commercial type accounting should be extended to public authorities and agencies which have jobs to perform, in contrast to services to administer; but since in such cases accountability control on a cash basis cannot be effective, there is a strong case for extending it to borderline cases. Whenever an authority is thus given commercial accounts its net results are all that need be entered in the budget; so long as the detailed accounts are readily available there need be no diminution of the comprehensiveness of the budget.

We must now return to discuss the present arrangement of the budget in the light of these considerations. From 1948 to 1954 the Chancellor's budget was (as we have seen) displayed in two arrangements: "Conventional" and "Alternative". The conventional form is divided into "above" and "below" the "line"; this, as we have seen, implies only a legal distinction. Above the line expenditure ties in with the organizational

[1] Perhaps nowhere is the simple cash account more inadequate than in respect of the National Health Service. (i) No distinction is made between the employment of officers on ordinary Ministry of Health business at headquarters and on the Service; (ii) owing to the unsatisfactory classification between income and capital account total outlay may vary substantially and fortuitously, on account of what is really investment and disinvestment; (iii) appropriations in aid, e.g. for prescriptions and other charges are exceptionally large (which always limits accountability control), and in addition, since their amount cannot be known in advance, the Estimate on the Vote may be very wide of the mark; (iv) the hospitals undertake a variety of trading and semi-trading operations which call for commercial accounting: paying patients, board and lodging for staff, production and sale of vegetables. In these circumstances accountability control could not be made worse by abandoning the cash method; it would almost certainly be greatly improved, while the account would then acquire some economic significance.

sification of Departments in the Estimates; below the line set out in order the nominal amounts of loan transactions which the central government is responsible. This is ntially the account which the Treasury and the Public counts Committee use for accountability control, and could y be altered if they were to change their methods very stantially.

The alternative classification was merely a rearrangement of figures. The "overall" totals were identical; but the important above the line (in this arrangement called evenue items") surplus differed—sometimes by many llions of pounds. This was because the alternative classiation was at pains to empty out from above the line all pital items. Thus on the receipts side repayments of capital Sundry Loans were sent below the line, and the greater part "Miscellaneous" was revealed as consisting of non-recurrent ceipts; on the expenditure side a new, and frequently very rge, entry appeared: "capital items in civil expenditure". sentially, however, the two accounts were only a juggling th the same figures; the alternative classification current rplus was not necessarily much nearer to the economic truth an that of the conventional arrangement.[1] It was exceedingly uddling for Parliament and the public to be presented with o quite different surpluses on the same budget; further, the ernative classification no longer tied up with the Estimates. nally both arrangements were of course pure cash accounts, so at they could not be integrated with the government accounts ranged for social accounting purposes in the Blue Book. The alternative classification had, it will be seen, no special nction or sanction. In practice chancellors had to build eir budget speeches on the one hand round the conventional assification, because it tied in with the Estimates, and on the her round the National Income White Paper, because it was earest to the economic truth, although it related to a different

[1] In particular the item "Capital items in civil expenditure" was criticized by the Committee on the Form of Government Accounts (Cmd. 7969) as containing many items which were very dubiously of a capital nature.

accounting period. The question arises whether it would not be possible without a great upheaval to substitute an alternative arrangement that would infuse a real economic meaningfulness into the Chancellor's budget. There are three directions in particular in which the alternative classification was lacking. In the first place the distinction between current and capital items on the expenditure side was not satisfactory in itself (probably because it is applied at too late a stage in the accounting process), while at the same time it sacrificed such functional classification as the conventional form retains. Secondly, there was no breakdown between goods and services and transfers (this applies equally to the current and the capital accounts). Finally there is the matter of cash accounting.

When social accounting began the accounts of the Departments were of course wholly directed to the cash basis and traditional classification; this is one of the reasons which made the early steps of the C.S.O. so difficult. This, however, is no longer the case; for its own purposes the C.S.O. has to keep the needs of social accounting continually before the Departments. They are learning to think in social accounting terms all the way through, not merely at the final stage. The time would thus seem to be ripe for an alternative classification which would have the same types of breakdown as the corresponding tables in the Blue Book. The question of cash accounting would be more difficult; but here also things are not too hopeless.

The most significant differences between the Financial Statement accounts and those of the Central Statistical Office, apart from the categories in which the accounts are presented, are: on the expenditure side the difference between issues from the exchequer and what the Departments have actually disbursed by the end of the year, and, on the revenue side, between tax revenue actually received and estimated to have accrued on the year's working. Trading operations, it is agreed,[1] would in any case be better removed from the

[1] Cf. Report of the Committee on the Form of Government Accounts, *cit.*

inistrative accounts, and (as we have argued above), semi-ing departments would do better to follow them in many s. Reforms which would bring the Financial Statement line in a new alternative classification in these respects ld seem to be by no means impossible. They would not go whole way in producing a complete accruals account of the vities of government departments, especially those concerned production. There is as yet no direct means of estimating k in progress on government account available even to the O. Nevertheless such an account would be a very great provement, and would provide an estimate of the current ount surplus which would have a solid basis in economic nificance. If we then had (as recommended by the Com-tee of the Form of Government Accounts) a quarterly tement of national income and expenditure (however gh), which would bring the White Paper accounts into line h the financial year, at least a footbridge would be built which the outside expert could walk warily but safely enough make the economic implications of the government's policy ar to the public in a way which is just not possible at present. An elaborate machinery for the rational conduct of economic licy has been slowly and painfully built up over what will on be a period of two decades. However imprecise its ults may have been in certain conditions, no one can reason-y doubt that we should have been much worse off without it. the modern world of intense international economic com-ition it is the economist's business to press for the progressive nement of the machinery in general and of the budget in rticular. Only thus can fiscal policy reach its full poten-lities in promoting the twin aims of stability and growth.

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