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With an Address by
RT. HON. LORD HOUGHTON PC, CH

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'. . . tax avoidance . . . is not a moral issue. Tax evasion is different . . . but only when it is breaching the moral laws and not the tax laws.'

* * *

Dr Bracewell-Milnes

'. . . tax avoidance and evasion may serve the public weal by reducing public expenditure or increasing the yield of tax. Tax avoidance and even evasion may be a form of public service, in consequence if not in motive.'

Dr Clark

'. . . a government which has departed from justice is nothing but large-scale gangsterism. Social justice means respecting the rights of groups. It certainly does not mean an attempt to create equality, or the transfer of income from one section to another by arbitrary decision, or legislation conferring special favours on any section.'

Professor Elkan

'If people were today asked in a referendum whether the present allocation between the private and public sectors was that which they would choose if they could start from a clean slate, with all that it implies in taxation and borrowing, only a minority would say "yes".'

Professor Pearce

'Complaints that 60 per cent for the government share of GNP might be too high were met . . . by the suggestion that [it] could be reduced to 50 per cent by eliminating items paid to and received from nationalised industries, and by reforming the basis on which debt interest is included in public sector accounts. The public must not be misled by this sophistry. As long as the question is what proportion of GNP is spent or redistributed by committees the answer remains *"more than 70 per cent"*.'

Professor Prest

' . . . there can be no question about the UK's enormous distinction in [the] international comparison . . . of personal income tax . . . it is [this] system which has done much to foster the feelings about penal servitude.'

Professor Rowley

'The self-seeking citizen will engage in political participation [to resist coercion by taxation] only if the expected benefits exceed anticipated costs . . . the more important instruments are six: (i) voting, (ii) pressure-group formation, (iii) social movements, (iv) individual economic adjustment, (v) revolution, and (vi) migration.'

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Preface

The *IEA Readings* have been devised to refine the market in ideas by presenting varying approaches by economists and others to a subject in a single volume. It is hoped they will be of special value to teachers and students of economics as well as to non-economists who want to know what economists are thinking and writing on the subject that concerns them.

Readings 16 has grown out of a Seminar with the same title, held in London on 6 January 1977. Six economists specialising on aspects of the subject were asked to write papers of some 2,500 to 3,000 words and to present their substances in 20 minutes. The subject of each paper was to be amplified and extended by two commentators, each of whom was allowed five minutes to yield a text of some 500-750 words. The commentators were also mostly economists, with one or two specialists in law and history and with a political balance between a Conservative Member of Parliament speaking as an economist interested in taxation and a Labour GLC councillor speaking as an historian engaged in local government. The day was completed by an address from a speaker with the unique experience as a former General Secretary of the Inland Revenue Staff Federation and a Minister concerned with spending departments in the Cabinet of a recent government. The result is a stimulating collection of authoritative and thoughtful analyses of the subject.

The opening paper by Professor A. R. Prest of the London School of Economics is a general review of the structure of British taxation that fastens on its main characteristics, in particular whether it should be considered penal and 'eccentric'. Professor Prest ends on a sombre note: it has taken a long time to reach the *impasse* and it will take a long time to escape from it. In two comments Mr Geoffrey E. Wood of the City University, as a theoretical economist, questions the purpose of the tax system—whether it is to permit economic stabilisation or to raise finance for public goods and services—and Mr Alun Davies, as a lawyer specialising in tax matters, is strongly critical of the effect of taxes on investment and enterprise and no less of its incomprehensibility.

The second paper is by the distinguished economic veteran and pioneer thinker Dr Colin Clark, formerly of Oxford and for some years lost to Britain since he went to Monash University, Melbourne. Dr Clark extends his early post-war proposition that inflation would become irrepressible if taxation exceeded a given proportion of the National Income. He reproduces an historic document, extracts from a letter from J. M. Keynes dated 9 March 1945, in which Keynes said he would be strongly 'disposed to agree [that] 25 per cent taxation is about the limit of what is easily borne . . .' Dr Clark considers the extent to which the three criteria of the tax system—whether it is socially just, economically efficient and administratively practicable—are compatible and concludes they are not.

The comment by Mr Nigel Lawson, MP, doubts whether UK taxes bear more harshly on the poor than on the middle incomes and argues that it is not possible to assist the poor without a poverty trap. Mr Lawson points to the illogical attitude that reward for harder work is regarded as 'just' but to tax the higher reward is 'social justice'. He also thinks that inflationary pressures are caused by high government spending rather than high taxation, though he agrees that Dr Clark's relationship between taxation and inflation is well founded, particularly if the proportion of government spending is rising, as it has been in Britain especially since 1973.

The second comment, by Professor T. W. Hutchison, wonders whether the 25 per cent proportion had last been reached before World War II, and that if it is to be reduced there will have to be targets both for maximum tax rates and for tax totals. In Britain the difficulty is that government spending is decided before tax (or other) revenue is assessed. He thinks there may be more hope of resistance to taxation because the recently accelerated inflation has moved the middle-income majority into higher tax bands.

The third paper, by Professor Walter Elkan of the University of Durham, examines the relationships between the spending and taxing functions of government. The traditional view was that taxes were designed to pay for government services. Professor Elkan doubts whether public opinion will support the contemporary division between public and private sectors of the economy. (There is support for this view in the IEA studies, reported in *Choice in Welfare, 1970*, of public reaction to alternative state and welfare services in terms of their comparative costs.) Professor Elkan thinks that the choice of the public is virtually defunct because expenditure is divorced from taxation. Although there seems to be wide post-war support for egalitarian public expenditure, there is also increasing public resistance to the expanding government and bureaucracy required to provide it. Public choice has been eroded because the electorate does not feel that government is able to prevail over group interests.

The comment by Professor Alan Peacock of the University of York discusses the conflict between the traditional role of government expenditure in supplying services and its more recent objectives in redistributing income and aiming at economic stabilisation. He thinks it desirable to lower the expectations of voters about the capacity of government to achieve its ambitious objectives and that some economists are to blame for encouraging these claims.

In the second comment Mr Michael Moohr of Buckingham University College wonders whether the traditional view of government spending is still applicable. He thinks it could still apply if account is taken of time-lags: there is evidence, seen in the changed attitudes among politicians in the two main parties, of a delayed public reaction against high taxes. Interest lies rather in the reasons for the change in public attitudes. The public may be opposing not so much big government as the big prices it is being asked in high taxes. Government is no longer keeping its promises to ensure economic growth, full employment, high-standard welfare services, etc.

The after-lunch address by Lord Houghton was a magisterial review of taxation as seen from the Cabinet Room and a government department by a man who had spent his working life in or around the Inland Revenue and the world of taxes. He explains how the demands of administration can triumph over equity or other principles, and how it explains the confusion and anomalies in what seems the illogical taxation of some benefits and not of others. Party politics explains further irrationalities in the taxation objectives of economic management, redistribution of wealth, and the pursuit of ideology. Party politics also explains the resistance to reduction in the high marginal rates of personal taxes. Party politics, added Lord Houghton, comprise not only pressures but also pendulums, such as the Conservative/Labour alternation on the computerisation of PAYE.

These observations remind the student of social policy that there has also been alternation of Conservative/Labour policy on minimum income guarantees cum tax credits. Lord Houghton's brief account provokes the observer to wonder about the intriguing disappearance of the whole idea since Labour came to office in 1974. If Labour in the late 1960s was in favour of a minimum income, and the Conservatives in the early 1970s were in favour of what they called tax credits, and both were variants of a reverse income tax, why is it that we now have neither? If one form or other of reverse income tax would benefit the poor, are the poor being sacrificed to party politics? Does agreement between the two main parties not only deprive the voter of a choice but also end up with a vacuum?

Further anomalies, says Lord Houghton, are explained by the objective of 'fairness' or equity: allowances and reliefs are clarified with explanations to make them seem fair 'to the most fastidious taste', not least the inclusion of a wife's income on her husband's tax return which Lord Houghton firmly declares should be abolished. He also meets the objection that this would induce husbands to avoid tax by transferring assets to their wives by the assertion that British husbands are too mean and, even if they are not, separation of husband and wife's earnings is desirable for the economic independence of the married woman.

On company profits Lord Houghton says that, although normally all Western countries impose over 50 per cent tax on profits, Britain is probably exceptional in tolerating the 'nonsense' of taxing stock appreciation as if the goods had been sold.

Lord Houghton finally remarks on enforcement of the tax laws. He refers to his public warnings against over-zealous enforcement and to his differences with Lord Salmon about the recommendations of a minority of the Salmon Commission that the Inland Revenue be required to undertake functions that would in effect make them a branch of the CID or the Director of Public Prosecutions.

He says there are no ethical or moral laws in taxation, that tax avoidance is not a moral issue and that tax *evasion* is a moral rather than a legal issue. The economist would say that the difference between avoidance and evasion was legal and moral more than economic because, whatever the state of law or morals or ethics, both avoidance and evasion can affect the GNP in a similar fashion. There can be a difficult choice if the legal/moral and economic consequences diverge and if tax avoidance/evasion leads to an increase in the GNP and thus makes available resources for desirable purposes such as increased expenditure on welfare in general and the poor in particular. Not least, Lord Houghton ends with the thought-provoking conclusion that if tax avoidance/

evasion reflects resistance to bad laws there is the recent precedent of the resistance to the Industrial Relations Act of 1971.

The fourth paper, by Professor Charles K. Rowley of Newcastle University, is a tightly-argued and in places ironic application of the new economic theory of public choice to the six ways in which resistance to taxes can be expressed: by voting, by forming pressure groups, by social movement, by individual economic adjustments, by revolution and, in the last resort, by emigration. In his highly suggestive and stimulating discussion Professor Rowley also briefly touches on the economic theory of clubs in its application to the structure of taxes.

In the first of two comments, Dr Malcolm R. Fisher of Cambridge develops Professor Rowley's explanation of the theory of clubs in a discussion of the effects of taxation on mobility in the international labour market, and, in the second, Dr George Psacharopoulos of the London School of Economics sharpens the analysis by asking why, given existing British taxes, emigration is not even higher. His explanation is that British taxpayers hang on in the hope that the political party managing the British tax system may change and that they are less concerned with immediate than with lifetime income. He also emphasises the differences in international incomes as well as in taxes.

The fifth paper, by Dr Barry Bracewell-Milnes of Erasmus University, Rotterdam, discusses the economics of tax avoidance and evasion. He questions conventional attitudes to both, and goes further to discuss the damage to the economy that can be done by measures of anti-avoidance. The comment by Professor Dennis Lees of the University of Nottingham identifies the Inland Revenue as a 'producer-group' in the government bureaucracy that violates the precepts laid down by Adam Smith for an acceptable tax system. He also remarks on the unquantified effort in industry that goes into the detailed calculation of net income after tax in influencing individual decision between work and leisure: 'Minimising tax payments and maximising social benefits is a mass activity'.

Finally, in more philosophical vein, Professor Ivor F. Pearce considers the stages of changed attitudes to work and tax down the centuries. He sees this process as a consequence of the change from necessary government in the provision of public goods to over-government in the provision of services that government does not have to provide and the public has not indicated it wishes to have provided. He questions the recent Civil Service recalculation of the proportion of government spending in the GNP from 60 per cent to a lower figure and maintains that, if all the relative elements are included, the figure is probably as much as 70 per cent. He examines the structure of British taxes in the light of principles laid down by John Stuart Mill and finds it wanting. He declares the ultimate incongruity to be the taxation of social benefits.

In the first of two comments, Mr John Flemming of Oxford points to the trade-off between equity and efficiency and to the theory of the second best to explain imperfections in tax structures. He also wonders whether the scope for moral hazard in insurance makes the financing of welfare in the private sector less efficient than by government. Professor Pearce briefly responds to these remarks.

In the second comment, Mr Douglas Eden, speaking as an academic and a GLC Labour councillor with social democratic sympathies, calculates that the proportion of GNP handled by government is of the order of two-thirds and nearer Professor Pearce's figure than the recent Civil Service recalculation. He argues that individual emancipation requires independence from the state which cannot be secured if taxpayers are 'locked into' a high-taxation and high-spending system that subjects them to the patronage of 'state and trade union politicians and bureaucrats.' The restoration of the will to independence, he concludes, is more important than discussion about the details of tax reform.

The Institute is grateful to the 18 contributors for the thought they gave to their material and to Graham Hutton for the gracious way he presided during the day and for the wise observations he made during the proceedings.

March 1977 ARTHUR SELDON

PART I

1. What Is Wrong with the UK Tax System?

A. R. PREST
London School of Economics

THE AUTHOR

A. R. PREST was born in 1919. He graduated at Cambridge in 1940; PhD, 1948. He held a Rockefeller Fellowship in the USA in 1948-49 and then taught at Cambridge, where he was a Fellow and Bursar of Christ's College, and University Lecturer in Economics. In 1964 he was appointed Professor of Economics and Public Finance and in 1968 Stanley Jevons Professor of Political Economy at the University of Manchester. Since 1970 he has been Professor of Economics (with special reference to the Public Sector) at the London School of Economics. He is a member of the IEA Advisory Council.

Professor Prest is the author of many books including the following on taxation/public finance: *Public Finance in Theory and Practice* (1960); *Public Finance in Underdeveloped Countries* (1962); (ed.) *The UK Economy* (1966); (ed.) *Public Sector Economics* (1968); (co-author) *Self-Assessment for Income Tax* (1977). For the IEA he has written *The Future of Purchase Tax* (Hobart Paper 8, 1961; 2nd edition with a Postscript, retitled *Reform for Purchase Tax,* 1963); *Financing University Education* (Occasional Paper 12, 1966); *Social Benefits and Tax Rates* (Research Monograph 22, 1970); *How Much Subsidy?* (Research Monograph 32, 1974).

COMMENTATORS

GEOFFREY E. WOOD: born 1945, educated Aberdeen Grammar School, University of Aberdeen (MA, First Class Honours in Economics, 1967) and University of Essex (MA in Economics, 1968). Lecturer in Economics, University of Warwick, 1968-75; Lecturer in Banking and International Finance, City University, since 1976. Publications: (with Gordon Pepper) *Too Much Money . . .?* (Hobart Paper 68, 1976); contributed articles to *Southern Economic Journal, Journal of International Economics, Scottish Journal of Political Economy,* etc.

ALUN DAVIES: Executive Director (responsible for taxation affairs) of Rio Tinto-Zinc since 1965. Chairman and member of several committees of institutions in UK and Europe dealing with taxation. Publications: *Render unto Caesar* (1966); contributor to the national press.

I must start by confessing that I had some difficulty in choosing a title for this paper. My first thought was something like 'Is the UK over-taxed?', but it might be thought that any paper with such a title which consisted of more than a single three-letter word would be regarded as wasteful of space. The next idea was 'What is right with the UK tax system?', but this too did not seem to merit a lengthy exposition. As an alternative, I wondered about 'What is left of the UK tax system?', but if emphasis is placed on the last word in such a title there would again seem to be some paucity of subject matter. So, *faute de mieux,* I arrived at the title you have in front of you.

Many people have covered many reams of paper in giving vent to their expertise or their emotions, or both, on this subject and it would be pointless to survey even a fraction of these denouncements. I shall adopt a course at the other extreme; I shall take a single recent quotation about the British tax system and concentrate my analysis on that—on the principle that one peg is normally as good as another for coat-hanging. The single quotation is:

> 'Britain has become saddled with the most eccentric and most penal tax structure of any developed country'.

The source is the recent Conservative Party publication *The Right Approach,*[1] and, although one must obviously allow for a measure of political and perhaps even poetic licence in such a statement from such a source, it is nevertheless an extremely strong and far-reaching proposition, if it can be justified. I propose to ask whether it can be justified, taking 'penal' first and 'eccentric' later.

Are British taxes penal?

We need not spend too much time debating the exact meaning or etymology of 'penal'; I propose to treat it as synonymous with 'punitive' or 'severe'. The first test of the proposition is to examine measures of the overall importance of taxation in the UK compared with other developed countries. Some new figures have recently

[1] Conservative Central Office, London, 1976, p. 40.

become available.[2] We find that in 1974 the ratio of tax revenue to GNP in the UK was 35·6 per cent, compared with an average of 39·2 per cent in industrialised countries in Western Europe; indeed the UK occupied 11th place out of 13 in this league table. It is perfectly true that the UK ratio was higher than those in the USA, Canada, Australia, New Zealand, Japan; but it was far below those in the three Western Scandinavian countries (all around 45 per cent or so). So it might seem that the proposition about the most punitive system does not pass this first test. It would, however, be far too precipitate to reach any such conclusion, for at least two main groups of reasons: first, such conventional comparisons are misleading in themselves; second, in other respects the UK scores much better (if that is the right word).

Conventional overall tax/GNP ratios are misleading for several reasons. First, the concept of tax yield is a matter for argument. If, for instance, the concept of taxation is broadened to include the Friedman inflation tax, the UK tax total would increase proportionately more than would that of most other countries in the Western industrialised group. Second, the tax figures may or may not be comparable; thus the UK still continues to give child income tax allowances, thereby reducing income tax yield, whereas Denmark and West Germany have gone over entirely to cash transfers. Implementation of the new child benefit proposals will automatically raise the UK position in the league table, in the same way as the introduction and subsequent abolition of investment grants a few years ago first increased and later reduced the tax/GNP ratio. Third, the GNP figures themselves may be suspect. Ever since the time of Adam and Eve, it has been difficult to obtain a full account of agricultural output from farmers; and when marginal income tax rates are very high the propensity to conceal income of any kind or from any source increases in a non-linear way. Now the UK has one of the smallest agricultural sectors in Western Europe, relative to GNP; hence, the proportional under-estimation of GNP and therefore the over-estimation of the tax/GNP ratio are both likely to be less than in the other countries. The very high UK marginal rates of income tax, to which we shall

[2] K. Messere, 'Tax Levels, Structure and Systems: Some Intertemporal and International Comparisons' (paper presented to the International Institute of Public Finance Conference, Edinburgh, September 1976). Also *Revenue Statistics of OECD Member Countries 1965-74*, OECD, Paris, November 1976.

come shortly, may have an opposite effect insofar as concealment of income on that account will be *pro tanto* greater; but one has heard rumours that some nationals of some other Western European countries have little to learn in such matters. Finally, there are more far-reaching reasons why these conventional calculations of tax/GNP ratios are unlikely to be an adequate guide. I have developed them at length elsewhere:[3] to single out one reason only, the total to which tax revenues should be related ought to include transfer payments, at least to the extent that they are taxable, and not be limited to a GNP concept.

So we can conclude that the tax/GNP ratio measure is not sufficiently watertight to refute with certainty the proposition about the penal nature of the UK tax system. However, this is a purely negative conclusion. Are there any more positive arguments to bring into consideration?

Burden of UK income tax

The main answer[4] is to be found in comparisons of personal income tax. First, the UK relies more heavily on this tax than do most other countries in Western Europe: 35·2 per cent of total tax yield as opposed to an average ratio of 30·0 per cent in 1974; and fourth in the league table of personal income tax/'total' tax yield ratios. Second, the UK has unique claims to fame when one examines the structure of personal income tax rates. It was reported in Parliament on 25 March 1976,[5] that the UK basic rate of tax of 35 per cent was higher than the lowest rate in any other Western country, even allowing for the impact of heavy local income taxes. Even in Sweden the total was no more than 30 per cent, central plus local. At the other extreme there are the minimum rates of 5 per cent in France and 7·8 per cent in Canada (including Provincial income tax). When asked in June 1976 about top marginal rates on earned income, the Treasury did rather better; they discovered two other

[3] 'Government Revenue, the National Income and All That', in R. M. Bird and J. G. Head (eds.), *Modern Fiscal Systems*, University of Toronto Press, Toronto, 1972; also my 'Public Activities in Perspective, a Critical Survey', paper presented to the International Institute of Public Finance Conference, Edinburgh, September 1976.

[4] A fuller account would embrace Capital Transfer Tax and Development Land Tax, but I shall largely omit these for reasons of space.

[5] *Hansard*, Written Answers, cols. 247-8.

countries with rates about equal to those in the UK and two with higher rates still—though some of the gilt came away from the gingerbread when it had to confess that the latter were Algeria and Egypt.[6]

So there can be no question about the UK's enormous distinction in this international comparison, more especially still if one adds on the surcharge on investment income. Nor can it be claimed that the UK is generous in fixing tax thresholds or the range of other allowances and deductions. Over the last 20 years the income tax threshold for a married couple has fallen from 51·9 per cent of average earnings (more accurately, earnings of full-time male manual workers in manufacturing industry) to 30·8 per cent.[7] And other countries are often more generous in the deductibility of interest payments, social security contributions, and so on.

No doubt other examples of the punitive nature of UK taxes can be found, perhaps especially in Capital Transfer Tax. And there are other respects, like VAT, in which UK taxpayers are treated relatively lightly by Continental standards. But all in all, it is the personal income tax system which has done most to foster the feelings about penal servitude.[8]

Are British taxes eccentric—anomalous?

The second prong of the attack on the UK tax system was the charge of eccentricity. Two rather different notions here must be examined separately: first, that of unusualness, oddness or anomaly; second, amiable harmlessness. There is no difficulty in making the first charge stick: it is only a matter of deciding which examples to select from an enormous range of possibilities. I shall restrain myself and refer to two only: National Insurance contributions and their relationship to income tax; and the withholding of income tax from employee incomes.

The first point about National Insurance contributions is that their applicability is on different lines from income tax, e.g. with

[6] *Hansard*, 14 June 1976, Written Answers, col. 24. Tanzania was later added to this list: *Hansard*, 2 July 1976, Written Answers, col. 358.

[7] *Hansard*, 27 February 1976, Written Answers, cols. 389-90. The reply on 25 March 1976 also shows that the UK threshold in 1975-76 was lower than in the great majority of the other 12 countries listed.

[8] Barry Bracewell-Milnes, *The Camel's Back*, Centre for Policy Studies, 1976, discusses these matters further.

different exemption levels, with a ceiling for employees but not for employers, and so on. Secondly, the authorities play two very different tunes about them depending on which suits their interests at any given time. Thus when the Chancellor announced his 2 per cent increase in employer contributions in July 1976 it was argued that, apart from immediate short-run effects, they would result in additional prices of end-products. But when there was an official pronouncement on whether self-employed people should qualify for earnings-related state pensions, the clear implication was that employer contributions reflect themselves in the level of employee emoluments.[9] Perhaps too many people have it both ways in too many cases today to worry any more; but this illustration would seem a particularly blatant example of double-think.

When we contemplate the interrelation between income tax and National Insurance contributions and benefits we can savour the true delights of *ad hoccery*, in much the same spirit as the famous remark attributed to Talleyrand about the delights of the Ancien Régime in France.[10] Thus, short-term benefits are taxable if received by widows but not if received by others; retirement pensions are taxable, but it is apparently laid down under the new state pensions scheme that those unfortunate enough to have to give up work early (e.g. because of industrial injury) would not be taxed on what are really premature pensions available before retirement age; attendance allowance is non-taxable but mobility allowance is taxable. When questioned on the last point, the Government's answer was that mobility allowance, in contrast to attendance allowance, was mainly paid to people at work and that if a benefit was taxed, lower-income people gained relatively to higher-income people.[11] Neither reason

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[9] *The Times,* 10 and 16 August 1976. The inter-departmental working group seems to have accepted the DHSS contention that the comparison between self-employed and employed people's National Insurance contributions must allow for the employer as well as the employee element in the latter case. But one can only maintain that employer contributions fall on employees in any direct sense and thus add to benefit entitlement if such contributions are deemed to be at the expense of wages.

[10] Lytton Strachey, *Portraits in Miniature*, Chatto & Windus, London, 1931, p. 98.

[11] *Hansard,* Written Answers, 19 December 1975, col. 828. Further discussion is in N. A. Barr, S. R. James and A. R. Prest, *Self-Assessment for Income Tax*, Heinemann, London, 1977, for the Institute for Fiscal Studies and the Institute of Chartered Accountants in England and Wales.

carries the slightest conviction. If the principle is to tax people at work, then, for example, their disability pensions should be taxed; if the principle is to claw back from higher incomes, why are any of these benefits tax-free?

The rot seems to have started in 1949 when short-term benefits were taken out of the taxable category. This led to part of employee National Insurance contributions being made non-deductible for income tax. And subsequently, by a particularly dubious sleight of hand, the remainder of the employee contribution was made non-deductible. Thus the UK is now certainly in an atypical, and maybe even unique, position where no employee contributions are deductible but many benefits are taxable.

It is thought that these details are correct; if they are not, I must beg indulgence. After all, it is commonly said nowadays that only three people understand the full complexity of these matters; and they disagree.

Another unusual feature of our tax arrangements is the system of income tax and capital gains administration. By and large, the UK authorities perform services for taxpayers in areas where they are left to fend for themselves in most other countries. I refer, of course, to the absence of any elements of self-assessment whether at the coding, interim tax-paying or final settlement stages of income tax. Closely allied with this aspect of the UK system is the method of withholding tax from employees. With the sole exception of Ireland, the UK is unique in operating tax withholding on a cumulative basis. This means that tax liability in, say, the 20th week of the tax year depends on (a) the difference between the cumulated total of pay and that of allowances up to and including week 20, and on (b) the cumulated total of tax paid up to and including week 19; rather than on the pay and allowances for week 20 taken on their own, i.e. the non-cumulative system found everywhere else. Many consequences flow from this seemingly entirely technical difference in arrangements.

Are British taxes eccentric—harmless?

The second notion in eccentricity is that of harmlessness. We can quickly see that this characteristic cannot be associated with the UK tax system. A vast amount has been written on the disincentive effects of the system, especially income tax. It is well-recognised, both in economic theory and in the light of many attitude-to-work surveys, that it is extremely hard to come to any firm conclusions about disincentives to work.[12] Nevertheless, there can be little doubt that we are trying very hard and with a degree of effort which is uncommon in this country today to construct a system that maximises discouragement.

Many tell-tale signs suggest we might even be succeeding. To take one example and hence run the risk of generalising from the particular, the LSE lost five out of some 50 teaching staff in the Economics Department to North America in the summer of 1976—not solely due to tax reasons, but unquestionably they played some part. Another proposition is that the cumulative withholding system is a very suitable, even if not quite perfect, instrument for financing strikes in that it does provide for tax repayment *during* a tax year, quite unlike the usual non-cumulative system.[13] Nor should we confine any mention of disincentives to work effects; the heavy reliance on taxes on income rather than consumption, not to mention the Capital Transfer Tax chickens which have yet to come home to roost, must be expected to take some toll of the willingness to save. And there are many other topics, such as the effect of our tax-mix on entrepreneurial risk-taking, which must also be brought into account in any complete assessment.

Nor is it solely a matter of confining oneself to the often-argued incentives case. Another harmful aspect of our tax arrangements is its very large public sector manpower requirements. It was stated in evidence before a Parliamentary Committee in May 1976[14] that Inland Revenue manpower had expanded rapidly in recent years and was in danger of increasing even further; and that whereas UK Inland Revenue administration costs were about 1·75 per cent of the amount of tax collected the US figure was no more than 0·5 per cent. One reason for a difference of this magnitude is the much larger use of computers in the USA; but that is far from the only explanation.

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[12]E.g., C. V. Brown and E. Levin, 'The Effects of Income Taxation on Overtime: the Results of a National Survey', *Economic Journal*, December 1974.

[13]It was also conceded in Parliament in late 1975 that if a man became sick or unemployed after 39 weeks of employment the combination of National Insurance benefits and PAYE refunds would make many people with widely varying family sizes and incomes better off in the last quarter of the tax year if not working. (*Hansard*, 10 November 1975, cols. 540-546.) In late 1976 the position was no better: *Hansard*, 18 November 1976, Written Answers, cols. 736-740.

[14]Reported in *The Times*, 6 August 1976.

The insistence on official coding and assessment for income tax rather than self-coding and self-assessment is another major contributory factor.[15]

'Dangerous lunatic' or 'harmless idiot'?

Another sense in which the adjective 'harmless' is entirely inappropriate is the growth in complexity of our tax legislation. Thus consolidated income tax legislation in 1976 would take up three times as much space as in 1952;[16] and the 1976 modifications to Capital Transfer Tax added more than 50 per cent to the volume of legislation which had only been incorporated in statutory form in the preceding year. Such developments are costly for all, whether law-makers, officials, taxpayers or their advisers.

One could go on for a very long time in this vein. Suffice it to say that there are many oddities in our tax arrangements but that we cannot take refuge in the comforting thought that such idiosyncracies are harmless. So in this sense the charge of eccentricity is really too mild; one might perhaps hesitate to go quite as far as saying 'dangerous lunatic' but this is a more apt metaphor than that of 'harmless idiot'.

Reasons and solutions

In conclusion, I should like to address myself to two further questions. They are both wide-ranging and both demand very extensive treatment; so what I say cannot be more than perfunctory and superficial. Nevertheless, I must say something. The first question is: How and why did we get into such a mess? And the second is: What can be done about it?

On the first question there are many, many reasons, just as there are for the corresponding larger question for the economy as a whole. One reason is that genuine mistakes were made, the consequences of which could not reasonably have been foreseen at the time: the choice of withholding system in 1943 is one example. Another is that the tax system has seen many a change which was in the nature of an after-thought—or, more accurately, an after-without-thought. This is especially true in social security. Purely short-term and insubstantial reasons have governed major tax decisions on far too

[15] N. A. Barr, S. R. James and A. R. Prest, *op. cit.*, contains extended discussion.
[16] *Ibid.*

many occasions, for instance the VAT changes of 1974 and 1975. And there have been notorious instances of whole new taxes, pre-eminently Selective Employment Tax and Capital Transfer Tax, which have been introduced with a total disregard for the necessity of adequate discussion both within and outside the Civil Service.

Lying behind many of these mistakes there is, I think, a deeper reason for many of our present tax ailments. This is the all-pervasive emphasis on the equity aspects of our tax system, both in the horizontal and vertical sense. Thus it is frequently argued that a US-type income tax system would be unacceptable in the UK because it tolerates a degree of rough inequality of treatment of taxpayers in similar circumstances. And any demonstration that the net cost of reducing top marginal rates of income tax to West European levels is peanuts in revenue terms, and mini-peanuts in terms of resource usage, is bound to promote howls of rage at the (*sic*) 'unfair discrimination in favour of the over-privileged'.

What can be done?

This argument leads me to my second and last topic: how do we get out of the mess? Clearly, the distribution argument has to be faced head-on. Unless one is prepared to stand up and say that some re-distribution by fiscal (or for that matter other) measures is unjustifiable, or that the trade-off with incentives and output is not worthwhile, there is very little hope of making any impact whatever. Needless to say, the re-distribution arguments which are patently untrue or only half-true must be exposed as such. Thus for instance, one must allow for the fact that consumption taxes catch future consumption at the time at which it takes place as well as current consumption, so the presumption that they strongly favour better-off people with higher savings ratios loses some of its sting. It will also be easier to make tax reductions at some points if one does not have to make increases at others. In other words, reducing public expenditure or its rate of increase gives more freedom of manoeuvre to the tax technician. But even when all the myth demolition and hatchet work about taxation and distribution has been done, there is undoubtedly a major battle to be fought on this front which cannot be avoided any longer.

Another proposition is that it ill becomes those who condemn others for short-sighted and over-hasty legislation to emulate them when they have a chance. In other words, we require a *minimum* of additional legislation in the immediate future. Desirable as some reforms might seem to be to some (e.g. the conversion of the donor-based Capital Transfer Tax into a donee-based Accessions Tax), this is a strong argument against such changes. Similarly, it is no good thinking that short-term National Insurance benefits can be taxed at the drop of a hat, however much one might wish to make such a change. Given our present tax arrangements, there are formidable administrative obstacles to such a desideratum.

This bring us to the real dilemma of policy. If we leave things as they are, the consequences are highly undesirable and become more so as time passes. If we try to reverse or change legislation on a massive scale immediately, we shall create a whole host of further problems. No doubt one can try to square the circle by arranging for some short-run alleviation (e.g. some degree of indexation in the tax system) whilst preparing for more extensive long-run changes. But I find that the sombre note on which I must end is that we have been a long time getting into the present mess; and we shall be a long time getting out of it.

COMMENTS

The Purposes of British Taxes

GEOFFREY E. WOOD
The City University

Professor Prest's paper has demonstrated very clearly that the UK tax system—complex, rich in anomalies, and expensive to administer—plainly needs to be reformed.

Once that is agreed, the next question is, of course, what should be done? It can be answered at all adequately only after one has considered what purposes the tax system serves. I should like to examine three purposes I consider particularly important in determining the kinds of reforms we should carry out.

1. Economic stabilisation

The first role of the tax system I wish to look at is that of promoting economic stabilisation. A fundamental question in tax reform is what the main tax base should be, and a major consideration in answering it is how actively the government wishes to stabilise the economy. Is it to attempt to 'fine tune', or, at the other extreme, is it to remain highly stable so as to impart to the economy a certain inertia against cyclical fluctuations? A 'fine tuner' would not choose to have income as the main tax base. The reason is that consumption depends primarily not upon current income, but upon a weighted average of past, present, and expected future income—what was called 'permanent income' in Milton Friedman's pioneering work.[1] Because income tax changes affect only current income, but consumption depends on permanent income, before a change in income tax can have a significant effect on consumption it must be very large indeed. A 'fine tuner' would prefer, for example, value added as a tax base, or perhaps even an expenditure tax, as advocated by Nicholas Kaldor.[2] Changes in either of these taxes, particularly if expected to be temporary, would have a very marked effect on consumption expenditure.

If one thought that the best way the government could stabilise was to remain stable itself, one could very well advocate wealth as a basis for taxation. It has been very persuasively argued by John Flemming[3] that a wealth tax could produce a very considerable yield and provide a substantial redistribution of wealth without interfering with incentives. But there can be no doubt that a wealth tax could not be used for 'fine tuning', principally because the relationships between changes in wealth and changes in expenditure, at any rate in the UK, are still known only very uncertainly.

To summarise my first point, then, when we are considering tax reform we should consider what the main base of our taxation system should be, and a major (though of course not the only) determinant is how activist government economic management is to be. The two questions are inextricably interlinked.

2. Providing goods or services free

The second role of our tax system is that of raising finance to provide goods and services without any charge to their user. Much of the

[1] *A Theory of the Consumption Function,* Princeton University Press, 1957.

[2] *An Expenditure Tax,* Allen and Unwin, 1955.

[3] J. S. Flemming and I. M. D. Little, *Why We Need A Wealth Tax,* Methuen, 1974.

taxation raised for that purpose is completely unnecessary, because the goods and services thus provided are not, in the main, public goods,[4] which by their nature cannot be paid for by charges to their users. Most of the goods and services financed by tax revenue in the UK could be financed by charging those who consume them. The case for charging users was summed up with admirable clarity in the Layfield Commission Report,[5] in the following words: 'What people will pay is the best guide to what they want.'

The argument thus summarised is, I think, very persuasive. If we accept it, and move to a system of charging for goods rather than financing them from tax revenue, the reduction in the amount of money raised by taxation could be large. (An indication of the scope for saving by this means is given in a recent *Hobart Paper*[6] by Ralph Harris and Arthur Seldon.) It would be easier to move to a system which strove less hard to be fastidiously fair as between individuals, and which could therefore be simpler and cheaper to administer. It would also mean that, if we wished, we could reduce the sharp progressivity of our income tax structure. To whether we should consider doing this I turn below.

Now of course there are objections to charging rather than taxing. Public goods can be provided only by taxation; that limits the scope for charging. A second objection is that the free market may not fully take account of spillover effects, either beneficial or harmful, from private consumption, and so lead to consumption that is either too small or too large when the full value of the consumption is taken into account. That is, however, a very weak argument for government provision of goods, because of course governments are not perfect, and we may eliminate one imperfection at the cost of introducing a larger one. Further, many of these external effects can be brought into the scope of the market mechanism by legislative changes, and thus 'internalised'.

The most basic objection to the use of charging is that there may be poor people who could not afford goods we think desirable; that the distribution of purchasing power may not be 'fair'. That in itself

[4] The concept of public goods is discussed most fully and clearly in R. A. Musgrave's *Theory of Public Finance*, McGraw-Hill, 1959, Chapters 1 and 3.

[5] Report of the Committee of Inquiry into Local Government Finance (the Layfield Committee), Cmnd. 6453, HMSO, 1976.

[6] *Pricing or Taxing*, Hobart Paper 71, IEA, 1976.

is no argument for providing goods free; rather, as has been shown by many economists,[7] it is an argument for giving the poor money so that they can spend as they wish. It does, however, raise the third role of the tax system which I should like to consider—redistribution.

3. **Redistribution**

Most countries in the West have some degree of progression in their tax structure. The major objection in the UK is not to progression itself, but to its steepness. Progression is often asserted to have gone too far in the UK, in the sense that the benefits believed to accrue from making income distribution more equal are thought to be outweighed by losses of output arising from the harmful disincentive effects.

As Professor Prest notes, the evidence for this view is inconclusive. First, briefly to consider the theory, it is very straightforward to construct models where, on the imposition of taxes, the pre-tax income distribution adjusts itself so as to leave the post-tax distribution unchanged. If we examine the evidence on the effect of taxation on work effort, no clear picture emerges. Professor G. F. Break[8] has recently written a survey of work on tax incidence, in the course of which he examined both results gathered by surveys and the results of econometric studies. He found that the results of a very large body of research were quite inconclusive; there was no clear evidence that progressive taxation either did or did not affect work effort. There is a wealth of anecdotal evidence to the effect that it does, but we should not trust such evidence. The Radcliffe Report (to draw an example from another department of economics) is an example of conclusions being based on anecdotal evidence, and the process of demolishing its conclusions was well advanced only a few years after it was published.

I would therefore approach my conclusions with a plea for further research on the effect of taxation on work effort (and saving). Until we have rather more clear-cut results, a central part of our discussions

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[7] A classic and lucid exposition of the argument can be found in Professor Lionel (now Lord) Robbins, *The Economic Problem in Peace and War*, Macmillan, 1947.

[8] 'The Incidence and Economic Effects of Taxation', in *The Economics of Public Finance*, Brookings Institution, Washington DC, 1974.

on tax reform can be based on no more than well-informed guesswork. That, of course, is not to say that we should for the moment do nothing.

Indeed, it rather provides us with an agenda for tax reform. As Professor Prest very wisely remarks in his conclusion, in our reforms we must avoid the haste which has undoubtedly been a major contributor to getting us into our present mess. Reform must proceed slowly and carefully. Pending some measure of agreement on the effect of taxation on work effort, we should concentrate our reforms on such matters as simplifying the tax system and removing obvious anomalies, on moving (with compensation for those harmed) to a system of charging for goods rather than providing them from tax revenue, and on reconsidering what the appropriate tax base is. That, it seems to me, is an agenda for a good few years. Further, whatever are one's views on redistribution—for economics can at best tell us what the consequences of changing income distribution are; it can never usurp the political and moral judgement of what it ought to be—all would surely agree that the desired redistribution should be brought about by a straightforward and readily comprehensible system rather than by dodging through a maze.

Revenue or Politics?

ALUN G. DAVIES
Rio Tinto - Zinc

When Professor Prest said that one of the things which is wrong with UK taxation is its penal nature, he might have added the two pieces of conclusive evidence. Firstly, the marginal rate of income tax on earned income, 83 per cent; and the marginal rate of income tax on investment income, 98 per cent.

The rate of marginal tax on earned income has no equivalent in the developed world, and if in parliamentary answers the Inland Revenue researchers are driven to quote Algeria and Egypt as two countries with higher rates than the UK, they might have added that in these two countries revenue collection is a joke industry, and that their marginal rates remain uncollectible and uncollected.

The UK marginal rate on investment income is expropriatory.

The traditional phrase 'investment income' has in the time of the present Government been changed into the more opprobrious and pejorative 'unearned income', with the implied connotation that what you have not earned, the Government can morally expropriate, which it does. I have never seen, incidentally, any substantial explanation of what has in practice happened to tax collection when the marginal rate is expropriatory. Rationally, when yield is negative, there should be no revenue-yielding investment, and in any event the natural law that each action is followed by an equal and opposite reaction is probably true in the fiscal world also. Perhaps the present universal evasion and avoidance of taxation at all levels is the obvious reaction.

Penal marginal rates—'a political arquebus'

The existence of capital gains tax and capital transfer tax, with their relative lack of loopholes, at the highest combined rates in the developed world is merely a footnote in the capital field to the penal marginal rates in the income tax. Not only is the UK tax system at at its upper margins eccentric; it is, as a collecting machine, highly inefficient. This only serves to emphasise that true British marginal rates are not for collection, but merely a political arquebus directed at a minority in order to highlight what is called the doctrine of equality, itself merely a fiscal weapon to satisfy the politics of envy.

There is no effective tax yield in national terms on the highest incomes and there is no virtue in investment terms in saving for income yield. One of the most persistent developments in the last decade has been the government policy of closing every tax loophole possible. In economic and psychological terms, this has been a national disaster.

There is no rhyme or reason in the complexity and 'overkill' of our Income Tax Acts. Complexity is probably a universal characteristic of income and capital taxation, but a complexity which results from an attempted Revenue overkill that is seeking in advance to counter any wriggling by the taxpayer out of the tax net has made of UK tax law a paradise for tax consultants and has made the Revenue more skilled in the mediaeval theology of tax interpretation than any similar bureaucracy the world over.

Tax legislation—'a mad hatter's race'

Perhaps the saddest aspect of our tax system is the way in which tax laws are brought into being. Between April and July there is a mad hatter's race in the Committee of the House of Commons to get the new tax laws on the statute book within the statutory 4-month period allowed between the Budget and the Royal signature of the Finance Act. It is scarcely believable that laws of such complexity should be subjected to a system of parliamentary discussion which, owing to the operation of the timetable, forces legislators and Ministers to discuss the most complicated tax clauses throughout the night.

The subject matter which they discuss is hardly intelligible in broad daylight and must seem monstrously unintelligible at 4 a.m. Those of us who have to try and understand the cogitations of the night in the cold light of our offices find it difficult to avoid the conclusion that there must have been a conscious effort on the part of the parliamentary draftsmen to make tax legislation as incomprehensible as possible both to the bureaucrats and to the ruled.

2. The Scope For, and Limits Of, Taxation

COLIN CLARK

THE AUTHOR

DR COLIN CLARK was born in 1905 and educated at Winchester and Brasenose College, Oxford. He graduated in the Universities of Oxford and Cambridge. In 1953 he was appointed Director of the Institute for Research in Agricultural Economics, University of Oxford. From 1969 to 1976 he was Research Fellow at Monash University, Melbourne.

He has been economic consultant to the Governments of Ceylon, India and Pakistan, and Financial Adviser to the Treasurer of Queensland, Australia. Labour parliamentary candidate in 1929, 1931 and 1935. He is a member of the IEA's Advisory Council.

Dr Clark is the author of many books including the following on taxation: *The National Income, 1924-31* (1932); *National Income and Outlay* (1937); *Welfare and Taxation* (1954); and, for the IEA, *Taxmanship* (Hobart Paper 26, 1964, 2nd edition 1970); and a paper on reverse taxes (Hobart Paper 73, 1977).

COMMENTATORS

NIGEL LAWSON: born 1932, educated Westminster School and Christ Church College, Oxford (1st class honours PPE, 1954). Since 1974 Conservative Member of Parliament for Blaby, Leicestershire. Member of the House of Commons Expenditure Committee and the Select Committee on the Wealth Tax. 1956-72 on the editorial staff of national newspapers including the *Financial Times, The Times, Sunday Times, Evening Standard, Sunday Telegraph.* Editor of the *Spectator*, 1966-70.

T. W. HUTCHISON: born 1912, educated Tonbridge School and Cambridge University. Since 1956 Professor of Economics, University of Birmingham. Previously Lecturer (1947-51) and Reader (1951-56) at the London School of Economics. Visiting Professor, Universities of Columbia (1954-55), Saarbrucken (1962), Yale (1963-64) and Dalhousie (1970). Publications: *The Significance and Basic Postulates of Economic Theory* (1938); *A Review of Economic Doctrines 1870-1920* (1951); *Positive Economics and Policy Objectives* (1964); *Economics and Economic Policy in Britain 1946-1966* (1968); for the IEA *Markets and the Franchise* (Occasional Paper 10, 1966), *Half a Century of Hobarts* (Hobart Paper 'Special', 1970), *Keynes & Pseudo-Keynesians* (1977 forthcoming).

It was in the December 1945 issue of the *Economic Journal* that I published an article, still read with a mixture of interest and incredulity, indicating that the safe limit of taxation was 25 per cent of net national income, and that taxation above that rate generated inflationary pressures. (Note that this figure referred to net national income, as it was then customary to measure it, after a deduction for depreciation, but measured at market price: the corresponding proportion of Gross National Product as now measured would be about 23 per cent.)

When I wrote this article I was an official of the State Treasury of Queensland. At the risk of arousing further incredulity, I must add that the idea of attempting to measure the safe economic upper limit for taxation was suggested to me by a Labour politician, Edward Hanlon, at that time State Treasurer of Queensland. Vast schemes for the post-war expansion of public expenditure were being adumbrated all over the world, but Hanlon had strong doubts. Unlike many politicians, he was a reader of history, from which he had formed the conclusion that great empires had collapsed through excessive taxation.

Keynes agreed with the 25 per cent limit

Now I must provoke even stronger incredulity by adding that Keynes agreed with my conclusion, in a personal letter[1] written in March 1945, which apparently had escaped inclusion in the official files in Cambridge from which the new collection of Keynes's writings is being prepared.

The idea was based on work originally done by Keynes on the movements of the French franc exchange rate in the 1920s. Keynes concluded that the level which the franc exchange would ultimately reach would depend

> 'not upon speculation or the balance of trade, but by the proportion of his earned income which the French taxpayer was willing to hand over to the French rentier'.[2]

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[1] [Reproduced in the panel on p. 23—ED.]

[2] Quoted by Lord Keynes in the *Nation and Athenaeum* (9 January 1926) as having been written by himself 'more than two years ago'.

It should not be, but apparently is, necessary to point out that the figure of 25 per cent was not distilled out of some strange theoretical reasoning, but was a strictly empirical conclusion. The method was to analyse, on the limited and imperfect evidence available for a number of countries in the 1920s and 1930s, the ratio of total tax collections (including municipal) to national incomes, and (allowing for time-lag) the appearance of inflationary pressures—usually mild in comparison with those which now confront us. Again it should not be, but is, necessary to point out to a generation of economists who often seem to lack logical precision, that excessive taxation is certainly not claimed as the sole cause of inflation. Extreme inflation is often associated with low taxation, as much Latin-American experience shows. Indeed, a country which decides to meet a substantial part of government spending not by taxation but by borrowing will be in a much worse inflationary plight. So there are many examples of countries under varying degrees of inflationary pressure, but all with taxation at a low proportion of national income. What cannot, so far as I know, be found is a country with taxation exceeding 25 per cent of net national income which is *not* faced with some degree of inflationary pressure.

Time-lags and forms of taxation

In analysing the tax-inflation relationship the first precaution, which many have neglected, is that a time-lag of a year or two must be allowed before rises—or falls—in the tax-income ratio take effect. It is also a mistake to assume a direct linear relationship between the tax proportion and the rate of inflation. Much will depend—though this question so far has been little analysed—on the *forms* in which the total tax burden is imposed. To take a theoretical example: a poor people that could not afford to remain idle might be provoked to increased production by a ruthless government imposing heavy taxation on the necessaries of life. Conversely, some forms of taxation, whether on incomes or on goods, are believed to have the effect of discouraging effort by both labour and management.

The principal reason why inflation is taking place, at any time, is as a consequence of inflation which had already occurred in the recent past. It is like asking why an object is on fire: the fire started somewhere else, and has spread to it. It is generally believed that the principal mechanism by which the inflationary spiral is kept turning is a rise in the price of consumption goods leading to increased money

Treasury Chambers,
Great George Street,
London, SW1.
England
9th March, 1945

My dear Colin,

Your letter of January 10 with a revised version of your article has just arrived. Many thanks for it. Since our previous correspondence, however, I have ceased to be editor of the *Economic Journal* and am, therefore, passing it on to Roy Harrod who is succeeding me as Joint Editor along with Austin Robinson.

Obviously, as you would agree, this statistical inference is rather precarious. Nevertheless, as a practical proposition I should be strongly disposed to agree . . . [that] 25 per cent taxation is about the limit of what is easily borne . . .

Yours ever,
Maynard Keynes

wages, leading in turn to further increases in prices, etc. I am inclined to doubt this view. I think that the principal mechanism turning the spiral is the rise in price of capital goods, which compels business (subject to a time-lag) to charge higher prices in order to be able to earn a gross margin sufficient to replace its assets at the new high replacement costs. This view was first developed by the remarkable Swedish pioneer, Erik Lindahl.

We can see a few more detailed mechanisms by which high taxation (accompanied by government spending) may affect prices and money wages. Critics often say that if government expenditure is fully matched by taxation it has a neutral effect on demand. What they forget is that the government spending is *now*, whereas reducing personal disposable income ('take-home pay') by taxation affects consumption with a substantial time-lag. If government expenditure is constantly increasing in relation to private expenditure, this effect is accentuated.

But, apart from the question of time-lags, if taxation is carried too far, people begin paying it regularly out of income which they would otherwise have saved, rather than by reducing their consumption. In his famous criticism of the 'Report by the Colwyn Committee on National Debt and Taxation',[3] Sir Dennis Robertson said that the Committee had missed the essential point of the whole question, which was to estimate the supply function of business enterprise. At the rates of taxation of the 1920s this was not, he thought, significantly affected. But he would be willing to revise his judgement if he saw 'businessmen playing golf on Wednesdays'. Were he to come back now he would see such evidence, not only on golf courses, but in premature retirement, movement of domicile abroad, long weekends, long holidays, and other evidence of significant discouragement of business effort and enterprise.

More direct evidence of the effects of taxation on money wages is becoming available. Some equations proposed by Professor J. D. Sargan[4] suggest that in the long run labour receives a *post-tax* real wage rising in approximate proportion to productivity. A detailed study of recent movements in money wages by industry in Canada[5] shows changes in personal income tax rates as a statistically discernible variable among the determinants of money wages.

The theory of the effects of taxation and government spending has an interesting corollary. In a time of extreme depression the right policy might be to increase both taxation and government spending. This might have been the right policy in the 1930s. But let us hope that such a situation will not recur.

Conflict of criteria: what is 'social justice'?

There are three criteria which a statesman should have in mind in designing a system of taxation: its effects on social justice, on economic efficiency, and its administrative practicability. Unfortunately they frequently conflict.

On a different definition, Professor F. A. Hayek[6] denies that there

[3] *Economic Journal,* December 1927.

[4] 'Wages and Prices in the United Kingdom: A Study in Econometric Methodology', in P. E. Hart, G. Mills, and J. K. Whitaker (eds.), *Econometric Analysis for National Economic Planning*, Butterworth, London, 1964; criticised by S. G. B. Henry, M. C. Sawyer, P. Smith, 'The Models of Inflation in the United Kingdom: Evaluation', *National Institute Economic Review,* NIESR, August 1976, p. 67.

[5] C. J. Bruce, 'The Wage-Tax Spiral: Canada 1953-1970', *Economic Journal,* June 1975.

[6] *The Mirage of Social Justice,* Vol. 2 of *Law, Legislation and Liberty,* Routledge & Kegan Paul, London, 1976.

is such a thing as 'social justice'. It is true the phrase is sometimes erroneously used. But, used correctly, it is only the counterpart of the just dealings which ought to prevail between individuals and between groups or classes, defined in various ways. Thus the present laws of rent control (which apparently no political party seriously proposes to alter) are a flagrant act of injustice against the owners of rented property, who do not constitute a 'class' in the sociological sense but are a class of persons and institutions by economic categorisation. And social justice certainly does not necessarily mean the will of the majority. Minorities are often treated with grave injustice. The majority of taxpayers now own their homes. This ownership gives them an income on which they do not pay tax, out of which to house themselves, whereas their fellow citizens have to pay rent out of their after-tax incomes. The majority, who are, in this case, on balance generally considerably richer than the minority, are determined by every means to oppose the re-introduction of Schedule A, under which, in the past, owner-occupiers had to pay tax on the imputed net income (less mortgage interest paid) from their houses.

A government which ignores social justice comes under the terrible condemnation of Saint Augustine—*remota justitia quid sunt regna nisi magna latrocinia*—'a government which has departed from justice is nothing but large-scale gangsterism'. Social justice means respecting the rights of groups. It certainly does not mean an attempt to create equality, or the transfer of income from one section to another by arbitrary decision, or legislation conferring special favours on any section. It is however the right and duty of the state to use public funds to relieve real need, when it cannot be relieved otherwise. This concept should be broadly defined.

> 'By necessities as I understand not only the commodities which are indispensably necessary for the support of life',

wrote Adam Smith,

> 'but whatever the custom of the country renders it indecent for creditable people, even at the lowest order, to be without.'[7]

As the general wealth of society advances, the number of these 'conventional necessaries' increases. In other words, extreme inequalities must be prevented.

To use government policy in an attempt artificially to create equality is one thing. It is quite a different matter to say that, to

[7] *The Wealth of Nations*, Random House, New York, 1937, p. 821.

meet public expenses necessarily incurred, the proportionate levy on high incomes should be greater than on low, in other words that taxation should be progressive. The debate on this subject, which began 100 years ago, has still not been concluded.

Modern tax systems regressive: unjust to rich and poor

It is however generally agreed that taxation should not be regressive, i.e. fall with more relative severity on the incomes of the poor than of the rich. It is true that regressive tax systems were taken for granted in the past. There has been a tendency to close our eyes to the evidence, which has become apparent in several countries during recent years, that our present-day tax systems, all indirect taxes having been taken into account, while steeply progressive at the higher end, are regressive at the lowest levels of income, and impose the minimum rates of taxation on the middle incomes. That present-day taxation falls with exceptional severity on the middle incomes is a piece of cant used by politicians eagerly seeking the votes of the politically uncommitted middle. Once again, a majority—this time the middle-income voters—is using its political power to behave unjustly towards the rich at one end of the scale and the poor at the other.

My own view is that tax progression is justified, but only to a limited degree, with the 50 per cent maximum marginal rate. At present levels of public spending no rational tax system is possible. But when public spending has been reduced to a reasonable proportion of the national income, tax progressivity requires that as much as possible should be collected in direct, not indirect, taxation. Here, unfortunately, the claims of justice conflict with the claims of economic efficiency, and some compromise will be necessary. In introducing VAT, Parliament attempted to mitigate its regressive effect by exemptions and special rates. These ideas conflict with the principle of administrative practicability, adding enormously to the burdens both of business and of tax collectors.

If we act on the principle of 'equality of sacrifice', and the marginal utility of money declining with increasing income, what we know about the shape of the marginal utility function still indicates 50 per cent as about the correct figure for the maximum marginal rate of taxation.

Believers in progressive taxation are usually also believers in abundant expenditure on 'public goods'. This is a logical inconsistency. It has been clearly shown[8] that, the taxation system being given, any additional expenditure on public goods is regressive, conferring more relative benefit on people with higher incomes.

Incidence of indirect taxation

Many of the most important theoretical problems in public finance regrettably remain unsolved. Probably the most important of them is the incidence of indirect taxation. We have the classical theory that when tax is imposed on a commodity whose producers have a high elasticity of supply (e.g. beer), or an imported commodity with still higher elasticity of supply (e.g. tobacco), the incidence will be almost entirely on the consumer. What is the incidence, however, when indirect taxation is imposed on a far wider range of commodities? It is by no means clear. But when the tax incidence is clearly on him, does the wage-earner pass it on by securing higher money wages? If a puritanical Chancellor suddenly imposed enormously increased taxation on beer, would money wages rise? I think not.

Although Professor A. C. Harberger's brilliant work[9] has done much to elucidate it, the incidence of company tax is still obscure, and may vary very widely with changing circumstances. It does seem clear, however, that the high rates of company tax (which now prevail in nearly all countries) have had a considerable effect in diverting investible funds away from corporate business, where they might have been more productively used, into the available alternative channels: private houses, agriculture, and small business.

Systems of company tax which discourage dividends and encourage undistributed profits do substantial economic harm. After some pioneer work by I. M. D. Little in this country,[10] a very large-scale inquiry in the USA by Professor W. J. Baumol and others[11] showed that returns attributable to re-invested profits were much lower than

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[8] Shlomo Maital, 'Notes & Comments: Public Goods and Income Distribution: Some further results,' *Econometrica,* May 1973.

[9] 'The Incidence of the Corporation Income Tax', *Journal of Political Economy,* June 1962.

[10] I. M. D. Little and A. C. Rayner, *Higgledy Piggledy Growth Again,* Basil Blackwell, Oxford, 1966.

[11] 'Earning Retention, New Capital and Growth of the Firm', *Review of Economics and Statistics,* November 1970.

those on debenture capital, which in turn were lower than those on the equity. In other words, company directors re-investing their own funds do not make nearly such good decisions as they would if they had to raise money by new capital issues on a sceptical stock exchange, or from a hard-faced investment banker.

The unresolved question of payroll taxes

There remains the question of the incidence of payroll taxes, to which our Chancellors are turning to an increasing degree, and which are on an extremely large scale in some European countries. Are they passed on by raising prices, or passed back to keep labour's wages lower than they would otherwise be? I once had the opportunity of raising this question in a room where Lord Balogh and Professor R. M. Solow were both present, and promptly received conflicting answers. Orthodox analysis would suggest that the critical factor is the supply elasticity of labour. This appears to be high, in the short run. There is plenty of evidence to show that, at times when employment is high, considerable additional numbers are attracted into the labour force, particularly women and older men; and that these leave the labour force when employment is low. In this situation we would expect payroll taxes to be mainly passed forward in higher prices.

But the long-run situation may be different from the short-run. It is true that in recent decades there has been a large increase in the employment of women, due to changing social customs, smaller families, and also increased urbanisation. But if we abstract from these elements, and consider only the wage effect, there has been a good deal of evidence to suggest that the elasticity of labour supply, when we consider women, men, juveniles, etc. separately, may be not only low, but negative: rising real wages, all other things equal, *reduce* labour supply. If this finding is substantiated it means that the long-run effect of payroll taxes is to reduce the remuneration received by labour.

COMMENTS

Taxation or Government Expenditure?

NIGEL LAWSON, MP

In the short time allotted me, it is quite impossible to do justice to the many points raised in Colin Clark's characteristically stimulating paper, so let me touch on two.

The first is his assertion that the present UK tax system is regressive at low incomes, with the result that to speak of the severity of the tax system for those on middle incomes is mere vote-catching politicians' cant. I do not see how it can seriously be maintained that the tax system falls more heavily on the poor than on those on middle incomes. It is manifestly not so insofar as average (or 'effective') rates of income tax are concerned; nor, as Mr Denis Healey recently pointed out, is it true of a VAT which exempts food. I assume it is an allusion to the very high marginal rates that have come to be known as the 'poverty trap' or even 'poverty surtax'. But these high marginal rates are created basically by the loss of means-tested benefits. And it is surely rather rum to maintain that means-tested benefits are a burden on the poor—with the corollary, presumably, that to remove them would help the poor.

The poverty trap

Indeed, I have always felt that far too much fuss is made of the poverty trap. I do not myself see how in practice you can adequately relieve poverty without a poverty trap—although it would obviously be better if the present hotch-potch of benefits could be absorbed in a coherent tax credit or negative income tax system.

Moreover, it is commonly overlooked that the disincentive effect of a high marginal rate of tax depends not only on the rate itself but on its persistence. The reason an 83 per cent marginal rate is such a burden is not just the rate itself, but that, once a taxpayer reaches it, there is no escape from it. By contrast, a marginal rate of even 100 per cent at some point at the low end of the income scale is very much less of a disincentive if you know that, by doing enough overtime, you can bring it down to 35 per cent. What is really pernicious about the present mix of taxation and benefits is that the disincentive is not confined to a poverty trap, from which in practice there exists an avenue of escape, at the lower end of the scale, but that it persists right up the income scale. What is really pernicious, in other words, is that, today, a family man on average earnings is only £5 a week better off working than not working. Indeed, come November 1977, on present tax rates and incomes policies, he will find himself working a full week for a net financial gain of little over £2.

So perhaps people on middle incomes do have something to grouse about after all, and perhaps politicians who allude to their complaint may not necessarily be guilty of cant.

Tax mix more important than tax total

The second point is Dr Clark's celebrated thesis (first enunciated, as he reminds us, over 30 years ago, and subsequently restated in his 1964 Hobart Paper, *Taxmanship,* before reappearing in today's paper) that, as soon as total taxation exceeds 25 per cent of net national income, inflationary pressures—by which I take him to mean pressures to increase the money supply more than is prudent—are generated.

The passage of time, it must be said, has somewhat weakened the form of the proposition we are asked to consider. In sharp contrast to the *Taxmanship* thesis, he now contends that it would be 'a mistake to assume a direct linear relationship between the tax proportion and the rate of inflation'. He adds 'Much will depend—though this question has been little analysed—on the *forms* in which the total tax burden is imposed'.

But if this is so, it finally disposes of the significance of the 25 per cent figure. For even if there were in some sense a specific tax bench-mark or danger point, it would clearly be one figure for one tax mix and a different one for another. Leaving inflation aside, the form of taxation clearly is most important. For my part, while I cannot share Dr Clark's firm preference for direct over indirect tax, I entirely agree with his judgement that the top marginal rate of tax should be reduced to 50 per cent or thereabouts—perhaps 60 per cent. But though he freely criticises the Conservatives for lacking courage, I do not think he fully realises the howls of rage and the storm of abuse that will assail the next Conservative Government when it enacts this reform.

Moreover, the rage and abuse will come not only from the left wing of the Labour Party, but from the social justice-mongers of all parties and none, whom Colin Clark seeks to defend against Professor

Hayek's iconoclasm. I must say I am with Hayek on this proposition. If you work harder than I do at the same job, and are commensurately better rewarded, then that is 'justice'. If your extra reward is then taken from you in taxation, then that is 'social justice'. Concepts which are intended to sound much the same are more like polar opposites: to use language thus is to pervert it.

High rate of government spending the crucial factor

To return to inflation, I have never believed that Dr Clark's thesis is really about taxation at all. As he himself says in his Seminar paper, '. . . a country, with a given rate of government spending, which decides to meet a substantial part of it not by taxation but by borrowing will be in a much worse inflationary plight'. In other words, the crucial proposition is that a high rate of government spending, rather than of taxation as such, tends to lead to inflationary pressures. Spelled out thus, it is scarcely a particularly novel thesis—unless, which I doubt, the special significance of the 25 per cent figure, or its equivalent, could be established in this context instead.

But I do believe that in practice—and I emphasise 'in practice'—the general proposition is true; particularly if the proportion of government spending is not merely high but rising, as it has been in Britain, sharply, ever since 1973. Let me also add that the real evil of excessive government spending, and the excessive taxation that must necessarily accompany it, lies not in the probability of inflationary pressure but in the certainty of misallocation of resources, economic and social debilitation, excessive state power, and—very far from least—the erosion of personal freedom.

'Exorbitant taxes' lead to 'prejudice'

Finally, since this is a seminar on taxation, let me end with a specifically tax point. I was reminded by Dr Clark's paper that David Hume, in his essay 'Of Taxes', more than 200 years ago, accepted up to a point the thesis that, just as adversity and necessity beget enterprise and invention, so too can the imposition of taxation act as a stimulus. But he went on to warn—and I quote:

> 'This doctrine, therefore, with regard to taxes, may be admitted in some degree: But beware the abuse. Exorbitant taxes, like extreme necessity, destroy industry, by producing despair; and even before they reach this pitch, they raise the wages of the labourer and

manufacturer, and heighten the price of all commodities. An attentive disinterested legislature, will observe the point when the emolument ceases, and the prejudice begins . . .'[1]

As an attentive and disinterested legislator myself, I would dearly love to know the precise point at which emolument ceases and prejudice begins. I remain unconvinced that Colin Clark has discovered it, although I have no doubt whatever that we have long since passed it.

Hostility to Higher Marginal Rates

T. W. HUTCHISON
University of Birmingham

If Dr Clark's famous estimate of 25 per cent of net national income as the danger level for taxation is anywhere near the mark, there is certainly a tremendous task of rolling back to be attempted. I would like to ask when, historically, in Britain, the 25 per cent figure was reached? If I have interpreted the figures correctly, we were round about, or even past, that ratio before World War II.

Targets for taxation

If any political party is going to attempt seriously the undoubtedly tremendous roll-back required—whether or not we accept Dr Clark's 25 per cent ratio—I would suggest that it must set itself, and give high priority to, quite precisely defined targets for maximum rates and totals of taxation. In the British political process, rates and totals of taxation seem to be treated mainly as residuals. The tendency seems to be for spending to be decided first, and indeed to be given over-riding priority. Then the authorities cast around for methods of raising the money by taxation, borrowing, or the printing press. One has heard recently, for example, of the Cabinet wrangling

[1] 'Of Taxes', quoted in Eugene Rotwein (ed.), *David Hume: Writings on Economics*, Nelson, London, 1955, p. 85; based on the edition (1777) of Hume's economic essays edited by T. H. Green and T. H. Grose: *The Philosophical Works of David Hume*, Vol. 3, 1875.

for weeks over cuts in expenditure. But increases in taxation, it might seem, usually go through 'on the nod', or indeed hardly come before the Cabinet at all.

Dr Clark proposes what is an obvious starting-point for setting one kind of limit to taxation, that is, that the maximum marginal rate should be fixed at 50 per cent. Both the Tory Reform Group and the Shadow Chancellor seem recently to have committed themselves to similar, if slightly higher, targets, that is between 50 and 60 per cent, or to 60 and 75 per cent for 'earned' and 'unearned' income respectively.

The politics of relative tax burdens

A fundamental question relates to the politics of the relative tax-burdens and tax-rates on people at different income levels. According to Dr Clark:

> 'Once again, a majority—this time the middle-income voters—is using its political power to behave unjustly towards the rich at one end of the scale, and the poor at the other'. (p. 26)

Assuming that the political majority is now bunched around the middle of the income scale, political analysis would suggest that the outcome would be as Dr Clark says it is. It might, therefore, seem optimistic to hope that political forces would allow any considerable alleviation of the punitive treatment of higher incomes.

But I would put forward as an uninformed impression that the recent explosion of inflation may have moved a significant stratum of the middle-income majority onto higher tax-rates. In this event it may be possible to persuade a sizeable section of voters to turn towards a generally much more hostile attitude to high marginal rates.

One could not usually persuade people to vote on issues of taxation against their clear interests. But in the real world—unlike the world of many economic models—people's interests are not clearly or unalterably defined. Their very *short-term* views of their interests may lead them to support very high rates of taxation on those a few steps higher up the income scale which they do not anticipate reaching themselves. But in our present situation many of the middle-income majority may find themselves moving into, or towards, highly punitive marginal rates. So they may come to perceive more clearly that their (and everybody's) *long-term* interests, in the general real growth of production and incomes in a free society, are opposed to very high marginal rates on people a few steps higher up which may dry up the springs of enterprise and growth.

It is in playing upon people's uncertainties and ignorance about where their true interests lie, in particular as between their narrow short-term and broader long-term interests, that the power of ideas —perhaps rather exaggerated in Keynes's famous peroration—has scope.

3. A Public Sector Without Bounds

WALTER ELKAN
University of Durham

THE AUTHOR

WALTER ELKAN was born in 1923 and educated at Frensham Heights and the London School of Economics. He has been Professor of Economics since 1966 and was appointed Chairman of the Department of Economics, University of Durham, in 1968. He has taught at the East African Institute of Social Research, 1954-58; North Western University, 1958; Makerere University College, 1958-60; University of Durham, 1960-66. A former adviser to the Governments of Basutoland, Kenya, Mauritius, Solomon Isles. Professor Elkan is the author of *An African Labour Force* (1956); *Migrants and Proletarians* (1960); *Economic Development of Uganda* (1961); *Introduction to Development Economics* (1972).

COMMENTATORS

ALAN T. PEACOCK: born 1922, educated Dundee High School and University of St. Andrews. Professor of Economics and Head of the Department of Economics at the University of York since 1962. Chief Economic Adviser to the Department of Trade & Industry, 1973-76. Member of IEA Advisory Council. Publications: (ed.) *Economics of National Insurance* (1952); *Income Redistribution and Social Policy* (1954); (with H. C. Edey) *National Income and Social Accounting* (1954); (with R. A. Musgrave) *Classics in the Theory of Public Finance* (1958); (with J. Wiseman) *The Growth of Public Expenditure in the UK 1890-1955* (1961); (with G. K. Shaw) *Economic Theory of Fiscal Policy* (1971, 2nd edition 1976); (with G. K. Shaw) *Fiscal Policy and the Employment Problem* (1971); (with Ron Weir) *The Composer in the Market Place* (1975); (with C. K. Rowley) *Welfare Economics: A Liberal Restatement* (1975). For the IEA: (with Jack Wiseman) *Education for Democrats* (Hobart Paper 25, 1964); (with A. J. Culyer) *Economic Aspects of Student Unrest* (Occasional Paper 26, 1969); and *The Credibility of Liberal Economics* (seventh Wincott Memorial Lecture, Occasional Paper 50, 1977).

MICHAEL MOOHR: born 1942, educated University of Illinois (BS) and University of Cambridge (PhD). Lecturer in Economics, University College, Buckingham, and Assistant Professor of Economics, Bucknell University, Lewisburg, Pennsylvania, both since 1976; formerly Assistant Professor of Economics, University of Virginia, 1970-75.

In the last 15 years the public sector has expanded rapidly because electorates have wanted the state to cater ever more comprehensively for every conceivable social and economic need. At the same time the link between expenditure and taxation has become progressively more tenuous, not because of the role of government implicit in Keynesian economic theory, as often suggested, but rather because we have lost sight of an earlier idea of taxation as a method of paying for state-provided services.

One result is something that very few would vote for in a referendum: a level of public expenditure which, despite heavy borrowing, withdraws some 40 per cent of personal factor income as taxes, rates and National Insurance contributions.[1] Secondly, it will be argued that this has a bearing on why an important part of our political system is changing. That system has two components: personal liberty which, happily, we still have in full; and choice exercised through the institutions of representative government. This second component, choice, is being increasingly impaired, not only by the electorate's increasing impotence in the face of the sheer inertia of a large public sector in making any dents in decisions about aggregate public expenditure, but also because the power to decide has shifted substantially from governments with elected majorities in the House of Commons to governments which can command the support of groups of organised workers, or at any rate some of their leaders.

Traditional public finance: taxes to pay for state services

It used to be said that the object of taxation was to raise revenue to pay for services that Parliament had decided should be provided by the state. Expenditure of a kind which will yield benefits for years to come, like the provision of a new water reservoir, and which adds to, or replaces, the country's capital stock was not to be financed out of taxation but by borrowing, on the grounds that, since future generations will benefit as well as the present, there is no reason why the present generation should bear the whole cost. Representative government under universal franchise gives electorates the choice of what services they wish the state to provide. New capital formation

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[1] *National Income and Expenditure 1965-1975*, pp. 26, 33, 36, 54.

will be undertaken by the state if it can borrow at rates of interest that the electorate are willing to have added to their tax bill, or, to put it another way, if, at the margin, electors prefer more water to more furniture. That 'model' can be embellished by conceding that no one will voluntarily pay taxes to have a police force, but that, equally, few in their right mind would deny government the taxes required to pay for it, especially if they did not also then have to pay a private agency like Securicor to supplement the inadequate service provided by the state. We accept here a restriction on our freedom of choice by recognising that government may be necessary if there is to be any freedom of choice and that the provision of government is not costless. Finally, any maldistribution of income could be corrected by making taxes progressive even though their prime purpose was to pay for services.

Forty years ago this was the essence of a widely held view of public finance under a system of representative government. It was not a theory, in the sense of a proposition to be tested by whether it could or could not be falsified. Rather, it was a normative statement of what *ought to be*, not a hypothesis about what *is*. For even 40 years ago it was a highly idealised version of what was, if only because in a two- or three-party political system voters do not in practice have an infinite choice of levels of expenditure or taxation.

It would be extremely difficult to analyse the current discussions of public finance in anything approximating these terms. The Public Sector Borrowing Requirement, for instance, bears no resemblance at all to 'borrowing' in the earlier sense. Yet as a normative statement it has never been replaced except in one respect, namely that the state may temporarily spend *more* than it receives in revenue in order to maintain full employment, or *less* in order to avert inflation. This modification resulted from the work of Keynes, on whom it is now fashionable to lay the blame for all our ills.

Professor Milton Friedman is almost unique among economists in a reluctance to let the institutions of representative democracy determine the size of the public sector and the allocation of resources to public goods.

It is of course no easy matter to think of ways in which one might place constitutional limits on the size of the public sector without causing other harm in the process, but it would be quite idle to pretend that there is not some great weakness at present in the constitutional arrangements which determine the level of expenditure, taxation and borrowing. If people were today asked in a referendum whether the present allocation between the private and public sectors was that which they would choose if they could start from a clean slate, with all that it implies in taxation and borrowing, only a minority would say 'yes'. Some, on the far Left, would say 'more': the majority 'less'.[2] Yet the 'democratic process' seems incapable of putting the growing volume of state employment and expenditure into reverse. Mr Healey has now proposed substantial cuts in the proposed *rate of growth* of public spending. The *reduction* in expenditure will be much more modest, if it comes to pass at all.

Growth in state sector and intervention not the source of economic weakness

I do not subscribe to the view that all that is wrong with the British economy can be traced back to the growth of the public sector and to increasing state intervention generally. Nor would drastic and indiscriminate cuts in public expenditure at this point lead at once to the increased employment in private manufacturing industry of those who would thus lose their jobs. But, given the composition of public sector activities and the system and scale of transfer payments to which we have become committed, public expenditure has manifestly got out of hand, in the sense that very few would now choose the present level of state expenditure and the implications for taxation and borrowing, if they were given that choice. There is apparently a built-in tendency in British-style representative democracy to go for ever-more public sector activity, in large part because so many of the *individual* measures proposed have seemed eminently laudable and have received widespread support. Yet collectively they have now posed a threat to representative democracy as that term is ordinarily understood. How did it happen?

To attribute the great rise in public expenditure to counter-cyclical measures is to reduce the past to stylised history. It is not really true, as Bacon and Eltis seem to suggest, in an otherwise admirable study, that the large increase in public sector employment in the 1960s and 1970s has been the result of a failure to shed labour which, in years

[2] [Some evidence for Professor Elkan's proposition is provided by the three sample 'referenda' reported in Harris & Seldon, *Choice in Welfare 1970*, IEA, 1971. These public choice referenda were based on priced alternatives, in contrast to the unpriced options in the political process.—ED.]

of recession, was given counter-cyclical public sector employment.[3] Rather the increase in virtually every case can be attributed, as they themselves show, to measures passed by Parliament and intended to produce a more efficient economy and, above all, a more compassionate society. The ever-more complex provisions of welfare benefits, the reorganisation of social services, and the provision of all kinds of new educational institutions, all of which have contributed markedly to the increase in the size of the public sector, have not been undertaken to counteract unemployment but in response to what are referred to as 'public demands'. Indeed counter-cyclical measures, except for the employment of direct labour for local authority house building, have generated very little employment in the public sector. They have taken the form more of tax and monetary inducements to stimulate private sector activity, like the house-improvement grants and the subsidies for hotel renovation, enacted in the late 1960s and implemented in the early 1970s, which were in any event not intended as counter-cyclical measures though their implementation came at a time when Lord Barber hoped it would also reduce unemployment.

The extension of the public sector is perfectly compatible with the widely held ideas about public finance under representative government outlined earlier. The increases in public expenditure, taxation and borrowing have been the outcome of decisions taken by democratically elected Parliaments under what we still think of as a system of representative government.

Public choice virtually defunct: expenditure divorced from taxation

Those ideas assume that there is a choice about the level of expenditure, taxation, and borrowing exercised through elected representatives. What has now become manifest is that this choice has become virtually defunct because government lacks the power to reduce public expenditure to any significant extent without repealing legislation. But the repeal of that legislation which is most costly to administer may easily fail to obtain an electoral mandate, and does not look like being seriously proposed.

The explanations are not difficult to find. Ever since 1945 taxation has been used for redistributing income and wealth and for demand

[3] Robert Bacon and Walter Eltis, *Britain's Economic Problem: Too Few Producers*, Macmillan, London, 1976, pp. 15-16; and *Sunday Times*, 2 November, 1975.

management. Except in relation to National Insurance contributions or rates, it would be hard to find a reference in any post-war budget speech to the need to raise taxes to finance a new or modified service, whether defence or education. For most of the 1960s and early 1970s decisions on expenditure were taken quite independently of decisions on taxation and in a totally different context, except that there was sometimes a rendezvous to consider the implications for the management of demand.[4] Even decisions about capital formation were taken not in relation to the prospective demand and supply of the goods or services to be provided but rather according to the prospective level of employment and its implications for the balance of payments. If people wanted more telephones and were prepared to pay for them at a time when the economy was expected to be operating at full capacity, they nevertheless had to wait until the next turn-down, before the additional lines and exchanges could be installed.

As far as expenditure is concerned, the 1960s and early 1970s were dominated by a zest for social reform and by an almost unquestioned belief in the efficacy of planning, not unlike the belief in the magic of 'rationalisation' in the inter-war years.

Having demonstrated in the 1950s that unemployment, the scourge of the inter-war years, could be eliminated beyond even the wildest hopes of Keynes and of the 1944 White Paper (which regarded $2\frac{1}{2}$ to 3 per cent unemployment as 'full employment'—not 1 to $1\frac{1}{2}$ per cent), government in the ensuring 10 to 15 years made a major attempt to put other wrongs to right. From the Beveridge system of social security, characterised by being both simple and comprehensive, there was evolved a highly sophisticated network of help for people deemed in need, designed increasingly to cater for every conceivable contingency, both in and out of work, and administered partly by local authorities and partly by the local offices of central government departments.

Social reform and 'fairness'

What the Department of Health and Social Security (DHSS) administers is so complicated that it has to send out some 100 leaflets

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[4] cf. Sir Alec Cairncross, *First Report of the Expenditure Committee,* HMSO, December 1975, pp. 20-22; Lord Diamond, *Public Expenditure in Practice,* Allen & Unwin, London, 1975, p. 66. I am grateful for these references to Arthur Seldon.

and circulars a year to inform its local offices of changes or to clarify how the regulations are to be interpreted. The education system has undergone continuous reform at every stage and provision has been considerably augmented, especially at the very bottom and the top. Towns were re-built and new ones created. Derelict regions were rejuvenated and roads were made fit for fast cars to ride on. People were seen to need protection and were given it: tenants from landlords, those accused of deviance from an out-dated legal system, the 'disadvantaged' from an inadequate system of social work provision, pedestrians from cars, drivers from drink, and so forth. The currency and system of measurement were decimalised, and steps were taken to ensure that buyers of packaged food would know exactly what was inside, and had access to a machinery for redress if they suspected they were given short measure or charged too much. An increasingly affluent society was becoming more and more averse to risk and sought to avert it at any cost. An explosion here or a fire there drew attention to safety standards in public buildings and places of work and created a demand to have them raised. Who could resist such demands, and still hope to be re-elected? It is, in any event, a hard man who is not moved by the mishaps and hardships of others, often dramatically brought to his attention by newspapers and television.

In addition there had to be 'fairness' at every stage. The self-employed must not receive benefits unless they had paid as much for them as the employed, and, since a few fall into both categories, 'fairness' demanded special treatment; so special as to be largely unintelligible even to those asked to administer it.

Likewise taxation: as the system grew ever more complicated to deal with tax avoidance by the few, it had to be made still more complicated in order to ensure absolute equity as between innumerable persons in apparently similar circumstances. Meanwhile a blatantly stratified or 'class' society had to be made more equal, and taxes were to be used *not* to pay for services, as the traditional public finance had it, but to redistribute income and wealth in an attempt, evidently not very successful, to eliminate class distinctions.

The new, egalitarian, equitable, public finance

The story is too familiar to require elaboration. But it contains some features that deserve attention. First, the reforms that were undertaken, with the exception of making education comprehensive, had very wide public support. Specific measures may have been opposed by whatever party happened to be out of office at the time, but the vast majority of those who think of themselves as 'responsible' were not minded to put up serious resistance. That resistance was mostly a fear that 'we could not afford it', which in a growingly affluent society sounded unconvincing. The school reforms and some of the industrial legislation apart, most of the measures had very widespread approval, and most people have already forgotten whether it was a Conservative or a Labour Government which introduced this or that extension of governmental provision.

Secondly, reforms on this scale put the machinery of government under very severe strain and almost inevitably required major administrative changes. It required ever larger numbers of public servants and eventually a complete restructuring of local government. This last was not simply a matter of changing boundaries. The whole organisation of local government had to be changed. The very large increase in the provision of personal social services, for example, seemed to require separate Social Service Departments within local authorities each with its Director and Assistant Directors. Since they had to be drawn from an insufficient number of social workers, this further exacerbated the shortage of officials ministering to people in need, whilst substantially raising the cost of providing the service.

It is now fashionable to bemoan the growth of bureaucracy, and to attribute it to central and local government offices full of idle, unproductive bureaucrats. The reason why it is proving difficult to reduce their number, and public expenditure generally, is that they are *not* idle—or, at any rate, no more so than the rest of us. The famous scene of a game of cards behind the shelter of large crates in Peter Sellers' *I'm Alright Jack* depicted, after all, a privately-owned factory, not a government office.

I am not denying that there is much wasting of time and inefficiency in the public services; that is partly a function of their size rather than of their 'public' nature. Also, in the private sector, increased efficiency has been attained by labour-saving mechanisation. The same trend is discernible in the nationalised industries, though it is even more staunchly resisted by their employees. In the rest of the public sector that is more difficult to do. Some routine operations, like the income tax Notices of Coding, might be done by a computer, though the experience of vehicle and driving licences does not set a happy precedent. But, at any rate until 1984, what can be done is fairly limited, because administration in the broadest sense cannot be as easily mechanised as manufacturing.

If we now want to make significant reductions in that part of public sector employment which we think of as the bureaucracy, it will be necessary to simplify the provision of public services and the way in which they are paid for. In social insurance and assistance that would almost certainly mean abandoning the extremely complicated system of tailor-made provision and returning to something like the Beveridge principles with or without a negative (reverse) income tax. In taxation, one might go for a much cruder system of income tax and then have people assess their liability. But almost any simplification will create some injustices or inequities and will require a willingness to accept that cheap, rough justice is preferable to absolute equity which requires a very large administrative apparatus.

Reform politically unacceptable or obstructed

Will it be done? That is doubtful, and for two reasons. First, what needs to be done is likely to come in that category of measures which are now described as 'politically unacceptable', and have to be only so described to be ruled out. Secondly, though it is really part of the same syndrome, the ideas about public finance under representative government no longer have any meaning because they assume that decisions about taxation, borrowing and expenditure are taken by an elected government. We have always recognised that a government's power to take decisions is not absolute but circumscribed by groups with power outside Parliament which could not be overlooked. Before 1945 it was widely believed among Labour supporters that any Labour Government would be thwarted at every turn by big business, banks, and the wealthy, and that belief of course survives. What is new is that groups outside Parliament now can overrule its sovereignty by insisting that government enter into contracts with them which severely and openly circumscribe their ability to take decisions. The question is no longer whether some given measure can be carried in Parliament but whether or not it is consistent with the Social Contract—not, admittedly, enforceable by any court of law but broken by governments at even graver peril. It is this which is making it so difficult to reduce public expenditure and obliging the Government again and again to do so either in ways which are not circumscribed by the Social Contract—like cuts in defence spending, welcome though they may be—or by resorting to yet higher rates of taxation. The Social Contract itself is evidently sacrosanct. Whether income tax is to be lowered will be decided by a group of not very democratically selected trade union leaders, not the elected Government, even though taxation affects many others apart from members of trade unions, and it is even questionable whether these members themselves are always accurately represented by their leaders.[5]

Erosion of democracy

This raises the question of how to describe a system of government which unwittingly has come to absorb 40 per cent of personal factor income in the form of taxes, rates and National Insurance contributions, and in which the choice how to tax and spend appears to reside to an increasing extent outside Parliament. It has been a criticism of the political system that the two major parties moved so close to one another's policies that elections turned mainly on persons rather than on issues.[6] This may have changed, and if Mrs Thatcher were now to win an election not everyone would attribute it to her charismatic personality. But would her Government have the power to implement the kind of policies designed to cut public expenditure which her party is at present advocating? It seems to me of the essence of viable representative government that voters must feel assured that governments are able ultimately to prevail over interest-groups in the society. If enough people fear that a government might *not*, and therefore vote for a party of whose policies they do not approve, merely because they fear that *it* alone can master interest-groups, that seems to me a much more serious erosion of choice than the loss of control over how one's taxes are spent.

Many say that too drastic a reduction of public expenditure would threaten the foundations of democracy. On a different definition of democracy which emphasises the element of choice as well as personal liberty, the greater fear is that this system may be eroding under our very noses.

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[5] cf. Speech by John Cousins reported in *The Times*, 8 January 1977.

[6] [The convergence of party policies in a two-party system is analysed by Professor Gordon Tullock in *The Vote Motive*, Hobart Paperback 9, IEA, 1976.—ED.]

COMMENTS

Inseparable Objectives

ALAN T. PEACOCK
University of York

I have interpreted the theme of this session as connected with the competing roles for taxation as an instrument of economic policy. Broadly speaking this accords with the interpretation of Professor Elkan and I can certainly agree with him that the growth in taxation is not simply a manifestation of growing oppression by government but reflects government response to popular demands for services which *would* not otherwise be provided (or which politicians, with at least the tacit support of voters, believe *should* not be provided) by the private sector. Nevertheless, the extended and sophisticated role which taxes are expected to perform, including not only allocational but distributional and stabilisation objectives, is in stark contrast with the role they have played recently. I should like to emphasise this conflict of role rather more than Professor Elkan has done.

Taxation and demand management

Take, first of all, taxation as a weapon for controlling inflation and make the assumption that the rate of inflation partly depends on the rate of growth in aggregate demand. Raising either taxes on income or on expenditure is supposed to lower aggregate demand through shifting demand curves to the left of where they would otherwise be, according to Keynesian theory. This proposition is now in hot dispute. Consumption expenditure may or may not be cut depending on whether the tax changes are viewed as temporary or permanent. Consumption may indeed be maintained in anticipation of 'wage retaliation' against any initial rise in prices if expenditure taxes are used or against the cut in disposable income if income taxes are used. But even if the Keynesian proposition is broadly true, the use of taxes which hit mass spending may be constrained by distributional objectives to equalise incomes. We lack enough instruments to achieve both targets, and the targets will be constantly shifting in the light of politicians' desire to stay in office.

Technical and policy uncertainty about the use of taxes as stabilisers explains why politicians unwilling to reduce the relative size of the public sector have had to look more and more towards monetary policy and incomes policy, i.e. towards the proliferation of instruments.

Taxation as an instrument of income redistribution

Take, secondly, redistribution policy through taxation. It is naïve to suppose that this policy can be separated from 'taxing to spend' for allocational reasons. Voters will be interested in maximising net benefits from both expenditure and taxation and, in a one-man one-vote system and an unequal income distribution, this is bound to promote an attempt by voters in the aggregate to demand increased services financed by progressive taxation, though the process may ultimately be self-defeating.

Rather than examining technical and policy uncertainty in this context, let me point out a different phenomenon created by the demand for income redistribution through the budget. Ambitious politicians seeking to dramatise their actions in the name of the public good as a means of furthering their careers have a strong incentive to get their hands on a redistribution instrument. The Chancellor is far from being the only politician in this position, though he may influence that of others. Social security is an obvious example, but more interesting recent examples are perhaps food subsidies and price controls and the proposed use of fuel prices as redistribution devices. If both food and fuel are subsidised the Chancellor incurs the odium of raising the taxes, and the Secretaries of Prices and Energy obtain the kudos for helping the poor. If neither is subsidised, and price controls are used to keep down, say, food prices at the cost of raising other prices, and discriminatory fuel pricing is extended to help the poor, then this is a new form of taxation without representation. I need hardly add that the efficiency losses, including those incurred through the creation of further bureaucracy, may be considerable.

I share Professor Elkan's scepticism about finding easy solutions to the problem of reconciling ambitious objectives with imperfect instruments for achieving them. So much depends on lowering the level of aspiration of voters about the claimed proficiency of the public sector in achieving popular ends. Economists who have exaggerated this claim to proficiency must share at least some of the blame.

The Tax Benefit Terms of Trade

MICHAEL MOOHR
University College, Buckingham, and Bucknell University, Pennsylvania, USA

Of the many interesting points raised by Professor Elkan, I shall concentrate on what I take to be the main thrust of his paper.

He begins by sketching out what he calls 'a view of public finance that was formerly widely held', i.e. the traditional theory of public finance. Briefly, in democratic societies, public wants and desires determine the level and structure of government revenue and expenditure. Professor Elkan argues that this 'model' can and does explain the rapid growth in the size of the government sector, especially since 1945. He then goes on to argue that the public no longer wants the continued growth of government revenue and expenditure and, indeed, would like to see it halted and even reversed. But the government has been unable to respond to this change in public sentiment and this suggests to him that the old model no longer explains what is now happening. We need a new 'model' of public finance if we are to explain government economic behaviour.

The new model he suggests would make government policy a function not of the electorate as a whole, but rather of the wishes of powerful minority groups. Although he refers to groups in the plural, he specifically mentions only 'groups of organised workers or their leaders.' Other groups that have usurped the electorate's sovereignty would presumably include the CBI, IMF and EEC.

Leads and lags in government expenditure 'model'

On the contention that the old model has broken down, I think I disagree. It is not much less valid in accounting for government revenue and expenditure policies than it has been in the past. It has possible leads and lags that can be overlooked. There are very few good economic models in which the explanatory variables are not lagged. I suspect the same can be said of models of political behaviour.

The length of these leads and lags may have grown in recent years as the government has become more complex and bureaucratised, but this does not mean that the crucial variables in this model are no longer linked causally. Recent political developments in the UK suggest just the opposite. I am thinking particularly of the resurgence of a radically reconstituted Conservative Party, committed not only to put an end to the growth of government in the economy, but also to reverse it. The Labour Party, regardless of the talk about infiltration from the radical left, is certainly making at least vague attempts to move in a similar direction. I am naïve enough to think that these radical changes in the two major political parties are occurring because of, and in response to, a prior change in the attitude and desires of the electorate.

Loss of faith in government

An interesting question, which Professor Elkan treats only peripherally, is why, after so many years of supporting and encouraging the growth of large government, the public has changed its mind. The answer is, I suggest, vitally important to the future. I am not yet convinced that it is due to a widespread intellectual or religious revolution, characterised by the mass rejection of the collectivist political orthodoxy of the immediate past in favour of an orthodoxy of a more distant classical past. To my knowledge, Friedman's *Capitalism and Freedom* has not yet found a place on the best-seller lists. All of this may come to pass, but we will have to wait and see.

The point is that the public may in fact not oppose the idea of a large pervasive government sector *per se;* what they may be protesting against is something much more obvious. For years the public demanded and received a growing volume and variety of goods and services from government, including policies designed to achieve full employment and rapid economic growth. In return, the public was obliged to turn over an increasingly large portion of its personal income to the government. And this they willingly did.

What happened to alter this apparently amicable exchange relationship? The answer may be quite simple. The government is, to put it bluntly, *no longer delivering the goods*, whether rapid economic growth and full employment *or* first-rate health and education services. In short, the terms of trade seem to have turned dramatically and increasingly against the public.

Thus, it is not necessarily a question of taxes being too high, but of the return for them being so little. How would the electorate respond, I wonder, if the government were suddenly able to deliver the goods again, as it did (or seemed to) in the 1950s and 1960s?

PART II

Administration, Politics and Equity

Address by

LORD HOUGHTON

THE AUTHOR

LORD HOUGHTON of SOWERBY was born in 1898. From 1949 to 1974 he was the Labour Member of Parliament for Sowerby, West Yorkshire. He was created a Life Peer in 1974; Privy Counsellor, 1964 and Companion of Honour, 1967. During 25 years as an MP he was Chairman, Public Accounts Committee, 1963-64; Chancellor of the Duchy of Lancaster, 1964-66; Minister Without Portfolio, 1966-67 (when he was the Minister responsible for co-ordinating the social services); Chairman of the Parliamentary Labour Party, 1967-74. Member, Commission on the Constitution, 1963-73; Royal Commission on Standards of Conduct in Public Life, 1974-76; Committee on Aid to Political Parties, 1975-76. His non-parliamentary activities have included Secretary, Inland Revenue Staff Federation, 1922-60; Broadcaster, 1941-64; Alderman, LCC, 1947-49; Member, General Council, TUC, 1952-60; Chairman, Staff Side, Civil Service National Whitley Council, 1956-58.

He is the author of *Paying for the Social Services* (Occasional Paper 16, 1967; 2nd edition 1968) for the IEA.

From what we have heard already, the state of taxation appears to be pretty bad, though we are only halfway through the day. It will be much worse by the time we are through the afternoon!

Taxation has always been in a mess, especially since we had no taxation without representation. Taxation under despots is always simpler than under democracies.

How can taxation escape being in a mess when it is tinkered about, or even mauled about, by Chancellors at least once a year and frequently twice? When Chancellors try to meet the pressures of the TUC, the IMF, the EEC, the CBI and the Child Poverty Action Group, what can taxation be but a hotch-potch? Budgets, second budgets, autumn budgets and now mini-budgets, blown up by the Press—all come down like a damp squib . . . yet we still hope for common sense in our taxation system to be accomplished.

I remember, in an essay by Ivor Brown, he said: 'When the man next to you in the train says: "I see we have increased our income tax by sixpence in the £", then we shall have a true democracy'. Alas, I see no sign of it. *They* get taxes into a mess because *they* impose them upon us. They always did.

There are, of course, bound to be technical errors and fundamental mistakes in the course of floor-bashing the Finance Bills through the Commons. (I emphasise 'the Commons', for we have already single-chamber government on all matters of taxation and finance. Since the Parliament Act 1911, the House of Lords cannot amend, reject or even delay the Finance Bill or similar Bills classified by the Speaker as Finance Bills. The Commons can introduce a confiscatory wealth tax by a majority of one and not even the Monarch can say it nay. So watch it!)

The contributory factors to much that appears to be wrong, unfair or makeshift are:

first, administration;
second, party political policies (the manifestoes, the ideological aims, etc.);
third, fairness (that is, social justice, equity: holding the balance).

Administration triumphs over (almost) all

I will give an example of the triumph of administration over almost every other consideration of principle or equity in our tax law.

(Professor Prest refers to it, though he appears not to be aware of why we got into such a muddle over the taxation of National Insurance short-term benefits and tax relief on contributions.)

Sickness benefit under the 1948 scheme became taxable: pensions under the scheme had always been taxable and relief from tax was given for the contributions relating to taxable benefits. Unfortunately, sickness benefit, not being paid by the employer, could not be brought within the PAYE system. Separate end-of-year adjustments or additional assessments had to be made for sickness benefits received. When I remind you that there are about 9 million sickness claims paid every year, you can see what an enormous and tiresome job it would have been to fiddle about with end-of-year adjustments for that number of claims. And since the Revenue would not hear of most of them until the amounts were entered on the tax returns for the *following year*, it dawned on them that they had been set an impossible task. So short-term benefits were made tax-exempt—and the tax relief for contributions was correspondingly reduced.

Renewed talk of taxing short-term sickness and unemployment benefit must not overlook the experience of 1948-9. These benefits can be brought into tax as they are paid only if the paying authority can be given the code number for tax deductions immediately. And that is going to be a severe test of administration. Who is to do it? The employer? The Tax Office? And failing a code number, would deductions be made at the full 35 per cent rate without personal reliefs? Imagine the cry of the sick if they were taxed to the full amount in Week 1.

What about the pension element in the National Insurance contributions? Why did that get lost? Right from the beginning of the 1948 scheme, pensions contributions were tax-deductible. It was not difficult while contributions remained on the flat-rate; when they became earnings-related, problems arose on a larger scale. In order to make earnings-related pensions contributions tax-admissible, it would be necessary to guess at the amount of contribution at the time of coding at the outset. In almost all cases it would be wrong by the end of the year, and adjustments again would have to be made at the end of the year for excess or deficient allowances for tax purposes for earnings-related insurance contributions: millions of them. I know that it is done for occupational pensions, but the remuneration of the workers—salaried staffs, mostly—in occupational pensions schemes is much more stable and predictable, and in many cases the pensions contributions are related not to total earnings including overtime but to standard salaries. But in the National Insurance earnings-related contribution it was going to be on total earnings, which provided the maximum variability and unpredictability of earnings for the purpose.

So the tax relief on National Insurance pensions contributions was withdrawn and the *personal* reliefs were increased for everybody to compensate. It was rough, ready and illusory. It dodged the logic of the matter, which was that if the revenue could not give tax relief on contributions it should not tax the *benefits*. But, if that had been done, the injustice of taxing occupational pensions but exempting the state pensions would have cried out to Heaven for remedy. And anyway the logic of the matter was too expensive. Money matters more than morals in taxation.

In both examples government policies are victims of the problems of administration. And there are many occasions when administration affects policies or influences government decisions on taxation. A Chancellor once said to me 'If the Board of the Inland Revenue tell me that something cannot be done, I cannot impose it upon them'. For quite a time, the Inland Revenue resisted the claw-back scheme of related child reliefs for tax and family allowances on the ground of administrative complexity. Eventually it was undertaken, but the Inland Revenue took a very poor view about the mixture of fiscal policies and social security benefits. And I remember in my own personal experience the Chairman of the Board of Inland Revenue reaching for his Letters Patent to stick under the nose of the Chancellor of the Exchequer and saying: 'But Chancellor, our Letters Patent give us the care and management of the Income Tax Act and not of the National Insurance scheme. And we must ask you to observe the strict terms of our care and management of the Income Tax Act.' And he read it out in full, and it read like a sort of apostate Chancellor's death warrant. The Inland Revenue, having Letters Patent granted by the Crown and not by Parliament, feel very keenly about their lines of demarcation.

If I had time, I would recount the story of the discovery and introduction of the cumulative tax under PAYE. Professor Prest also refers to this innovation. Sir Paul Chambers and I are probably the only two people who actively saw it happen and survive. I do not believe that our PAYE system could have survived all this time without serious industrial and trade union reaction had we not had the cumulative system. The paperwork is enormous, and there are far too many people in PAYE for small amounts of tax. I think the Chancellor realises that now. We will have to raise the threshold and remove a lot of people from marginal payments on PAYE. We had tried other schemes in World War I as well as II, and found them almost impossible. I know about other countries, but I claim that a system of taxation of wages and salaries which collects so much revenue with little or no trade union resistance or worker reaction could not be discarded for any alternative I know of.

Income tax is an *annual* tax and not a weekly or monthly tax. That is why it is more complicated than would be a wages tax in which every pay period was taxed by itself. It would be difficult to tax total *earnings* from employment on any different basis from (say) the profit of the shopkeeper, or a solicitor. Income tax is a tax on income and differential treatment of various sources of *income* has to be justified and made equitable.

Party politics and British taxes

I turn to the effect of party political policies on the state of taxation. Here we have:

(i) Economic management.
(ii) Redistribution of wealth and resources.
(iii) Ideological objectives.

Dr Colin Clark refers to the abolition of the tax on notional income from owner-occupied dwellings—known as Schedule A. This was an obvious sop by a Conservative Chancellor to middle-class interests, including the white-collar workers and the new technicians. Owner-occupation, with the aid of the building society mortgage, was not exactly a working-class condition.

Income Tax Schedule A had been a tax since the beginning. The equity of taxing rents receivable from houses let to tenants and the notional rental value of a house occupied by its owner had been accepted for a hundred years. Even the Irish saw the sense of it, for they had a Committee whose Report defended this principle at the time when Gerald Nabarro and his friends were busy convincing Selwyn Lloyd that it was a fiscal heresy.

When Schedule A was abolished there is no doubt at all that owner-occupation was put in a very preferential position. The full glamour of owner-occupation has become evident. Building society interest rates receive headlines whenever anyone breathes a word about them because of their tremendous impact upon this enormous vested interest of owner-occupation. The owner-occupier buys an asset at current prices out of money bearing current value, an appreciating asset which he pays for on a long-term mortgage—25 years possibly—and he repays the money in a gradually depreciating currency for an appreciating asset. And he gets tax relief on the mortgage payments. And even when he is not paying any tax at all he has the Option Mortgage scheme to give him a benefit in his building society interest payments as if he were a tax-payer. The moment Selwyn Lloyd gave way—when he awarded a foul to Schedule A—the owner-occupiers scored all the goals.

Mr Lawson warned you this morning that any attempt to reduce the higher levels of the marginal rates of taxation would provoke a political outcry. It certainly will! I remember when Selwyn Lloyd lifted the £2,000 surtax threshold to £5,000 a year—which was justified on almost every count at the time—the whole of the Opposition yelled their heads off by saying: 'This Government is giving tax concessions to the better-off and is ignoring the poor.' It is highly political when you come to relieve the better-off people of taxation.

The political seesaw

Political pressures are bad enough, but there is also the political seesaw. Before 1970, it had been decided to put all PAYE on computers. Experiments were made and a big scheme in Scotland had proved successful. Sites for eight computer centres to cover the whole country were obtained, and buildings planned. They had almost begun to be built when a new Chancellor—Anthony Barber—came on the scene, and he stopped it all while consideration was given to the tax credit scheme which would have needed different techniques altogether. All was put aside so that the tax credit scheme could move forward. A select committee of the House of Commons spent many months on it and produced a workable scheme; there were Green Papers and White Papers. Legislation was forecast for early 1974. Instead, there was a General Election, and another new Chancellor—Denis Healey—came on the scene and scrapped the lot. So now we have neither computerisation nor a tax credit scheme. Apart from Scotland, the millions and millions of coding notices under PAYE and the millions of end-of-year computations of net liability are prepared by hand. There is no mechanical means of producing tax-coding notices anywhere outside the computer centre in East Kilbride. It is absolutely unbelievable. PAYE is a labour-intensive industry. Two-thirds of the staff of 70,000 employed by the Revenue are doing the pen-pushing of PAYE. You all know the P.45: 10 million of them are issued by employers every year, and they are all absorbed into the tax machine by hand. And with this antediluvian organisation we have in the Inland Revenue today it is a wonder it works! In my belief our system of direct taxation is becoming almost unworkable, because we no longer have the machinery for handling the enormous amount of paper, the transfer work, and the detail that is required.

I will leave political pressures now by recalling recent events relating to the wealth tax, pressed upon the Government against its better judgement by the TUC. We may see whether the Government achieves the impossible when the trade unions make it part of the social contract.

Equity requires complexity

Now I come to fairness, equity, the holding of the balance. All simple taxes are 'unfair'. Refinements and complexities in the law are mainly to make it fair. Child allowances for tax purposes were once simple because they were the same for all but, when it was conceded that older children cost more to keep than younger children, the amount was graded according to age. There are dozens more examples, particularly in personal taxation, where allowances and reliefs are surrounded by ifs and buts to make them fair to the most fastidious taste.

There is one surprising omission in the Seminar papers—the taxation of married women. We have prohibitions against sex discrimination, we have equal pay by law, and we have passed a new divorced women's property Act. Yet a man is still required to declare his wife's income on his tax return, and is held responsible whether it is accurate or not. And if the wife is entitled to a tax refund on income other than her earnings, the receivable order will be sent by the Inland Revenue to the husband. One of the most desirable reforms of income tax law is to abolish the aggregation of incomes of husband and wife. I know it is said that this would lead to tax avoidance by husbands transferring some of their assets to their wives in order to reduce their joint tax burden. My reply is that, on the whole, the husbands of Britain are far too mean to do it.

And, even if they were not, it should be welcomed as a desirable step towards the economic independence of the married woman.

And what about the bearing on our tax laws of membership of the EEC and of our subservience to the IMF? Although harmonisation of direct taxation is not insisted upon in the Community, it is obviously one of the aims of membership to attain the maximum degree of harmonisation of economic, fiscal and industrial conditions in order to promote fair competition between industry and enterprise in member states.

Taxation and industrial investment

I want to say a word about company taxation. If we are to change the structure of company management and control, and promote the maximum investment in industrial enterprise, is it sensible to continue to impose a levy of over 50 per cent on their profits? I know that nearly all Western countries do it, but we probably suffer the greatest disadvantage. It is strange how much nonsense industry has tolerated for so long. To tax stock appreciation as if the goods had been sold, the profits had been made, and the cash was in the till makes nonsense to me. The Chancellor had to do something when he learned that about one-third of all our companies have been paying dividends (if they have been paying dividends) not out of trading profits but out of the illusory surplus believed to be created by stock appreciation. I have read recently that if the Sandilands proposals and the Morpeth guidelines are introduced, on current cost accounting (CCA), something like 45 per cent of companies now making profits according to our tax laws will move into losses.

Tax law enforcement

The new powers given to the Inland Revenue in the Finance Act 1976—the right of forceable entry—engaged a good deal of House of Commons time and engaged my attention in letters to *The Times*[1] and elsewhere. I think it is a dangerous thing to give the bureaucrat additional rights of forceable entry into the homes and offices of the British people for the sake of rooting out isolated cases of alleged corruption or of tax evasion. That must be one of the things we must guard against all the time.

[1] Reproduced as an Addendum, pp. 61-3.

And my next reference is to my public quarrel with Lord Salmon and the recommendation of his minority[2] that the Inland Revenue should be under an obligation to report to the police or to the Director of Public Prosecutions any transactions which they believed produced reasonable evidence of corrupt practices—as if the Inland Revenue should now become a branch of the CID or of the Director of Public Prosecutions. This is something else we must watch very carefully. Happily, the majority of the Royal Commission were against Lord Salmon in the minority recommendation. I think we have to adopt as a very firm principle, to be departed from only in quite extreme cases, that when information is required from the citizen, under force of law, with penalties for refusal or neglect, it should be used for the purposes for which it is required *and for no other*, unless that is given specific sanction by Act of Parliament, and only then under circumstances of quite important imperative. Otherwise circumstances of the individual disclosed to one Department will be used by another. At the present time, if the Department of Health and Social Security discover a bigamous relationship, unless it has some bearing on state social security benefit, they do not disclose it to the police. And I think that is right. Similarly, if the Inland Revenue come across what are perhaps suspected to be corrupt practices on matters unrelated to tax liability, it is not the business of the Inland Revenue to make a report to anybody else.

Tax avoidance and evasion

Now, finally, on the question of tax avoidance and tax evasion. I was fascinated by Mr Bracewell-Milnes's paper on 'The Fisc and the Fugitive'. I think he has done us a service, because he has neatly extracted tax avoidance from the great moral crusade of the Archbishop of Canterbury. I regard that as a signal achievement, and I fully support it. I think also that we must dismiss from our minds the idea that there are any ethics in taxation. There are *no* ethics in taxation. There is no moral law in taxation. And tax avoidance, in my view, is not a moral issue. Tax evasion is a different case—but only when it involves a breach of a normal code of human behaviour, when it is breaching the moral laws and not the tax laws.

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[2] *Royal Commission on Standards of Conduct in Public Life, 1974-1976: Report*, Cmnd. 6524, HMSO, 1976: 'Note of dissent', pp. 111-16.

And if we come to resistance to bad laws we now have perhaps the most important precedent in our history, because when the Industrial Relations Act of 1971 was passed the trade union movement said: 'Bad laws should be resisted'—and they set about resisting it. So we must keep that in mind too.

Finally, I think that those who would resist laws should be brought into making them. My prescription for the future of the House of Lords is that we should pass our laws by the Lords Spiritual, Temporal and *Industrial*. We should stick the General Council of the TUC and the CBI Council on the bishops' benches in the House of Lords, and keep them there for the duration of their tenure of office. Of such might be the Kingdom of Heaven!

ADDENDUM

The Times, 21 May 1976. Letters to the Editor.

'Open in the name of the taxman'

From Lord Houghton of Sowerby

Sir, When tax gatherers fall in behind Ministers to demand sterner measures of enforcement they run two risks. One is that their deservedly high reputation for impartiality and fair mindedness towards the public will be harmed by the slings and arrows which will inevitably follow. The second is that they will get let down when Ministers give ground, as they usually do, under political pressure.

That is precisely what has happened over the proposals to give tax inspectors stronger powers of enforcement in the Finance Bill.

Another point of substance relates to VAT, to which you refer (leading article, May 19). There is no comparison between the assessment of income tax and the collection of VAT. The 1972 Act, so much referred to, relates to the discovery and recovery of unpaid VAT, which is quite a different matter. In the case of VAT the exciseman is searching for defaulting *tax-collectors*, which unpalatable and unpaid role the trader, shopkeeper and the supplier of goods and services has had imposed upon him. Since no one knows how much VAT a trader may have collected and not paid over, the 1972 Act empowers the exciseman to go in, and if necessary to break in, to find out.

This is in no way comparable with the proposal (as originally made) to let a tax inspector force his way into the home or office of a citizen whose tax liability, however suspect, has not even been finally determined; and to do so armed only with a warrant from any magistrate the inspector could find to accept his oath and sign it.

No, the only connexion between

the two is the well-known danger of the thin end of the wedge.

I am, etc.,
DOUGLAS HOUGHTON,
House of Lords

The Times, 16 August 1976

Should tax inspectors have break-in powers?

From Lord Houghton of Sowerby

Sir, Whatever new powers tax inspectors are given in their battle against evasion, the least valid argument is that other public officials already have them. There is no justification for the prevailing philosophy among income tax men that they are entitled to parity of powers of forcible entry with the excise men. These two breeds of tax-gatherer are quite separate and distinct; they never mix; they are administering two entirely separate taxes which are assessed and collected on entirely different principles.

VAT, for example, is collected by traders and others on behalf of the Customs and Excise and Parliament has granted powers of forcible entry to recover the money. That has little in common with tax inspectors raiding homes and offices on suspicion that the taxpayer is cooking the books, so let us leave VAT out of it and deal with the provisions of Schedule 6 of the Finance Act, 1976.

My own starting point is that of civil rights. No citizen should suffer his home to be forcibly broken into by a civil servant in the name of the law except when less drastic steps have failed and/or no other course is left open. Forcible entry is a last resort which should not be made lawful without proven need: certainly not to meet administrative convenience or even the circumstances of the rare and extreme case.

Civil liberties are most frequently eroded with the excuse that the new powers will be used in 'only a few cases' and that 'those who have nothing to hide have nothing to fear'.

What is the proven need? Why, one might ask in passing, does this arise now, in 1976, after having managed without this break-in power for so long? If evasion is increasing, as it probably is, may the cause be that the level of direct taxation in conditions of inflation and falling real standards have something to do with it?

Are we nearing the point when acceptance is crumbling because the tax threshold is so low and the starting and marginal rates of tax so high? Are not the fiddles, the lump, the fringe benefits, moonlighting, the articles and subterfuges of avoidance and evasion signs of the breakdown of the integrity of otherwise honest taxpayers caused by the weight of direct taxation upon extra effort and successful enterprise?

If so, the new power given to the tax gatherer to demand documents and the right to break-in to get them is not part of the battle against evasion so much as part of the counter-attack upon the resentful mood of the people. And I mean the people.

A fully policed tax system would become unworkable. We all realize that. Already, some evasions and avoidances have been legalized, and the blind-eye turned to others, because they became too common to be stopped. The attack on benefits in kind has always left the masses unscathed. The trade unions have seen to that.

The taxmen do of course have a professional interest in the tools they are given to do their job, but they are not noted for their interest in any civil liberties except their own. That is why they are not always the best judges of the politics of taxation.

Powers do exist, some of them of long standing and others more recently in the Taxes Management Act, 1970, to force the dilatory, unco-operative, evasive or potentially fraudulent taxpayer into the open.

Under the recent Finance Act, the power to demand the production of original books of account and records, previously reserved to the Board of Inland Revenue, is now placed in the hands of inspectors. That is reasonable.

There is simply no evidence, however, of the need to give any taxgatherer the right, even with the sanction of a Circuit Judge, to break into any premises and forcibly to search for and remove any books and papers believed to be relevant to a case of suspected fraud.

If that step is to be taken at all it is the job of the police, whose powers and disciplines are well-defined and against whom, if need be, complaints may be made and be properly investigated. This is not an appropriate function for tax inspectors who have neither the experience nor, I hope, the stomach, for this unpleasant task.

Moreover, the more powers of coercion put in the hands of the taxgatherer the more likelihood of alienation from the public. Power begets resistance, not co-operation, and it is co-operation which makes our tax system as efficient as it is.

A close look should be kept over the use of the provisions of Schedule 6 of the Finance Act, 1976. I would expect myself little or even none at all. There is more than a suggestion of political window-dressing in all this strong-arm stuff.

I am, Sir,
Yours, etc,
HOUGHTON,
110, Marsham Court,
London SW1P 4LA.
August 11.

PART III

4. Taxing in an International Labour Market

CHARLES K. ROWLEY
University of Newcastle-upon-Tyne

THE AUTHOR

CHARLES K. ROWLEY was born in 1939 and educated at King Edward VI School, Southampton, and University of Nottingham (1st Class Honours 1960; PhD 1964). Since 1972 he has been the David Dale Professor of Economics, and since 1974 Director of the Centre for Research in Public and Industrial Economics at the University of Newcastle upon Tyne. Formerly taught at the Universities of Nottingham (1962-65), Kent (1965-70), and York (1970-72).

He is the author of *The British Monopolies Commission* (1966); *Steel & Public Policy* (1971); *Antitrust and Economic Efficiency* (1972); (with A. T. Peacock) *Welfare Economics: A Liberal Restatement* (1975); and many articles. For the IEA he contributed an essay, 'Public Preference for Market Processes', in *Catch '76. . . ?* (Occasional Paper 'Special', No. 47, 1976).

COMMENTATORS

MALCOLM R. FISHER: born 1923, educated Auckland Grammar School, Victoria University of Wellington, New Zealand, and Cambridge University. Since 1956 University Lecturer in Economics and Fellow and Director of Studies in Economics, Downing College, Cambridge. Lecturer, Universities of Auckland (1947-53), Oxford Institute of Statistics (1954-57), Chicago (1968), UCLA (1971). Publications: *Wage Determination in an Integrating Europe* (1966); *The Economic Analysis of Labour* (1971); *Measurement of Labour Disputes and their Economic Effects* (1973). For IEA: *Macro-Economic Models: Nature, Purpose and Limitations* (Eaton Paper 2, 1964); and an essay, 'Foster Economic Growth', in *Catch '76 . . .?*.

DR GEORGE PSACHAROPOULOS: born 1937, educated Athens (BA) and University of Chicago (PhD). Since 1971 Lecturer in Economics, London School of Economics; formerly Assistant Professor of Economics, University of Hawaii, 1968-69; Senior Research Officer, Higher Education Research Unit, LSE, 1969-71. Publications: *Returns to Education; an international comparison* (1973); *Earnings and education in OECD countries* (1975); and articles in *Journal of Human Resources, Journal of Political Economy, Journal of Development Economics, Comparative Education Review, Minerva, Review of Economics and Statistics.*

In this paper, I shall apply the theory of public choice and the economics of clubs to an analysis of the current British fiscal crisis and its implications for the international migration of human capital. The theory of public choice analyses the behaviour of government, political parties and bureaucrats on the principal assumption that they are motivated by self-interest and not by altruism. The economics of clubs analyses the manner in which individuals co-operate within limited groups to provide for their exclusive use facilities which cannot otherwise easily be marketed, e.g. swimming pools, country clubs, etc.

1. The public choice framework

The British electoral system—the so-called single member plurality system—has produced governments with an absolute majority of seats in the House of Commons (except briefly in February 1974) throughout the post-war period, although in no case were they elected by a majority of the popular vote. Such a system offers the party of government considerable incentives, from a vote-securing viewpoint, for discriminating in its fiscal policies in favour of an apparently decisive though minority group of voters. The Labour Government, since February 1974, has responded to this incentive with a highly discriminatory programme of fiscal legislation in return for a social contract with unionised labour which secures a minimum level of strike and disruption damage to the British economy and an abatement in the process of free collective bargaining.

The public choice framework relevant to the British situation, therefore, is one essentially of three-party politics in which all individuals, whether politicians or voting citizens, are motivated primarily by self-interest. The demand by voters for policies requiring public expenditure is a function of tax-prices, their money income and the cost of political participation. Since voters cannot, for the most part, adjust the rate of consumption of public policies to their *individual* preferences at existing tax-prices and incomes, owing to the joint benefits ('public good' characteristics) of such policies, the difference between the desired rate of consumption and that provided collectively by the state may be designated as the degree of citizen coercion. Clearly, such coercion will vary from citizen to citizen as a consequence of variations in preferences for public policies and differences in the tax-prices that are imposed. Moreover, a vote-conscious government will attempt to minimise the degree of coercion imposed on its favoured voter-grouping, even at some considerable cost to the remainder of the electorate, which, in the British example, may indeed constitute a majority. Voters who are coerced are able to improve their lot only by influencing the politicians through political participation, which may take several forms (reviewed later).

From the viewpoint of public policy supply, each politician is assumed to maximise a 'utility function'[1] comprising his objectives: re-election, pecuniary gain, personal power, idealism and ideology. Coalitions arise between elected politicians *via* an exchange mechanism (known as 'log-rolling')[2] in which policies are traded so as to reflect or create a party platform. The Government coalition is assumed to maximise the resulting collective utility function subject to the constraint of political survival which involves it in minimising the degree of coercion on its supporters in the decisive voting group. In a political market[3] characterised by uncertainty that political parties will redeem their promises, and by high costs of search for the optimum policy,[4] there is scope for influencing both the demand for and the supply of public policies *via* the process of political participation.

2. The six instruments of political participation

The Labour Government has successfully adopted, since February 1974, a fiscal policy designed explicitly to reduce differentials between citizens in wealth and in income, whether earned or not. It has done

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[1] A utility function is a set of objectives which motivate the behaviour of individuals or of groups. People in politics may be motivated to varying degrees by different objectives, e.g. one politician may be very keen on power, another on personal income. Hence, horse-trading is necessary to create a party platform. Obviously, parties will pursue such policies only to the point where their electoral position is not put to excessive risk.

[2] [Analysed by Professor Gordon Tullock in *The Vote Motive*, Hobart Paperback 9, IEA, 1976.—ED.]

[3] In a political market competing parties offer policies designed to attract sufficient votes to give them victory in the next election.

[4] In conditions of uncertainty, it may be very costly for parties to determine exactly what policies are preferred by a voting majority.

so by increasing sharply the value of the 'social wage' *via* the expansion of the public sector, and by using inflation and changes in taxes to penalise the wealthy and the average- and higher-income groups. There is growing evidence that a majority of voting citizens in the United Kingdom feel coerced by such interventions. What instruments of political participation might they be expected to adopt and with what predictable success?

The self-seeking citizen will engage in political participation only if the expected benefits exceed anticipated costs. Both expected benefits and costs will depend on the view taken of the behaviour of other citizens and of the governing party's response to it. Among available instruments, the more important are six: (i) voting, (ii) pressure-group formation, (iii) social movements, (iv) individual economic adjustment, (v) revolution, and (vi) migration.

(i) *Voting*

Coerced citizens may be expected, in normal circumstances, to vote, if they vote at all, against the government which has subjected them to coercion. Whether, in a multi-party system, they will vote for the party which promises the smallest degree of coercion or to keep the party they most dislike from being elected must depend on their view of the voting intentions of their fellow-citizens. Elections occur only at discrete intervals and the extent to which coercion early in a government's life is reflected in subsequent voting will depend on the memories of the electorate and the extent to which they are stimulated by opposition programmes. The paradox of voting, of course, is why citizens bother to vote at all, since there is only a fractional probability that any individual vote will influence the outcome of an election. Perhaps the vote process offers consumption benefits to those who place their vote, such as the visit to the election booth.

In contemporary Britain, however, coerced citizens may well fail to vote against a government which is so closely associated with unionised labour for fear of the third-party damage which can be imposed by a well-organised power bloc from a position of monopoly based on statute law. Certainly, senior citizens, with a high discount rate on future benefits, may easily be coerced by, for example, the threat of union-induced energy crises into supporting party platforms which they inwardly abhor. The October 1974 election, indeed, was notable for the rivalry of union leaders seeking the mantle of

'Godfather' in Britain's latest protection racket.

Finally, with the present system of voting, and with the invasion of the Celtic fringe by nationalist parties sympathetic to Labour, it is far from certain that even a median preference vote against the Government would bring about its fall from office. The vote solution, whilst feasible, is thus attenuated by political market imperfections in contemporary Britain.

(If we plot votes for a policy along a spectrum, say from Left to Right, the median preference vote evenly divides the votes. It is often a position at which votes cluster. Political market imperfections arise either where voter preferences are not clearly interpreted by politicians, as a consequence of information distortions, or are not clearly registered, for fear of adverse consequences.)

(ii) *Pressure-group formations*

Coerced citizens may attempt to organise themselves into pressure groups as a means of wielding political influence, either by persuading other voters of the reasons for reform, or politicians of the votes they risk losing, or by coercing the electorate (and thus the government) by threatening action that itself imposes third party damage on the public. The manner in which the junior doctors succeeded in breaching the pay policy of the Labour Government is an example of successful pressure-group formation. Even 'Godfather' is alarmed by the threatened denial of access to hospital facilities.

For the most part, however, pressure groups within the non-unionised sector are unlikely to prove effective in a battle against unionised labour, not least because others will have a 'free ride'[5] at their expense. The 'transaction' costs of effective lobbying are high, and its returns to individual citizens are often low. Thus many citizens will fail to participate, hoping or expecting to share in the spoils won by more determined confederates. In contrast, unionised labour, supported by 'closed-shop' legislation and by a well-organised system of selective benefits (e.g. cheap insurance, etc.) designed to

[5] [A free rider is a consumer who cannot be charged for a commodity or service directly in a price (fee, fare, etc.), either technically because he cannot be excluded (e.g. from defence protection) or economically because the cost of collection of the charge would exceed the revenue. In a political market free rides can be obtained by beneficiaries who dislike the price increases that union pressures create but who individually leave the lobbying to others, sometimes with the consequence of no effective lobbying at all.—ED.]

consolidate the membership lists, are able to mount a highly effective pressure-group campaign from a privileged legal position.

(iii) *Social movements*

Social movements are transitory but recurrent manifestations of coercion imposed on some citizens which lead them to demand changes in public policies. For social movements to arise, a large number of citizens must feel coerced because of well-defined structural or environmental changes. The most common cause is a change in expected income flows which shifts the existing saving/consumption relationships, and so engenders a desire to redress the situation. This unexploited demand for social and political change offers opportunities of profit to *ad hoc* political and social 'entrepreneurs'. If the politicians do not respond sufficiently quickly to the demands of the entrepreneurs, the ensuing social movement may lead to the appearance of new political parties, or alternatively to civil disobedience and unrest in an attempt to remove the cause of the coercion. As yet, in Britain, such social movements have not arisen on behalf of the dispossessed middle and professional groups. If coercion is not eased within the next year or so, social movements seem likely to congeal within these sectors of society.

(iv) *Individual economic adjustment*

Through adjustment in individual activities, citizens attempt to escape from coercion by changing their private behaviour rather than by attempting to influence politicians. Such adjustment itself may have an indirect political impact. Suppose, for example, that coerced citizens respond to penal taxation either by increasing their consumption of leisure or by increasing their tax evasion, thereby reducing the tax base available to government. If the tax revenues are to be maintained, government must then levy yet higher tax rates and thus impose additional coercion on many other citizens, thereby generating further political participation in opposition to its policies.

In Britain the combination of a large social wage and inflation-proof security benefits, on the one hand, and savage tax rates which impinge even on below-average earnings, on the other, guarantees that many citizens will escape into leisure. Britain is a paradise for the potential malingerer and a hell for people who wish to work, with evident implications for shifts in human capital. There is also a significant diversion of effort by higher-income citizens away from productive activity in favour of tax avoidance, as Britain's booming accountancy profession clearly testifies. Tax avoidance, no doubt, is the tip of the tax adjustment iceberg. Finally, many citizens have abandoned Adam Smith's dictum on the division of labour and have engaged in domestic 'do-it-yourself' production, especially of highly-taxed alcoholic beverages.

(v) *Revolution*

The threat of revolution or of *coup d'état* on behalf of coerced citizens no doubt provides an outer-bound constraint on the degree of coercion imposed by government. Both revolution and *coup d'état* involve a violent change in government, if successful. They are distinguished only by reference to the scale of operation—revolutions are *coups d'état* writ large. On the assumption that both occur not in pursuit of some ethical ideal but as a consequence of self-seeking by those who consider themselves coerced, it can be demonstrated that revolution is unlikely save in extreme cases of coercion, because of the 'public good' characteristics of revolutionary behaviour, which induce individuals to wait for others to run the risks. Those who free-ride on revolution avoid the substantial costs of participation whilst benefiting from the redistributive consequences in the event of a successful outcome. More feasible, therefore, is the *coup d'état*, usually confined to a small self-seeking group within the government/military/police establishment, and which therefore avoids the 'public good' problem by garnering the benefits for itself.

Neither revolution nor *coup d'état* seems imminent in Britain. But, in the event of a Conservative victory at a forthcoming election, followed by violent union confrontations, a plausible scenario presents itself in which the instruments of government might be seized by a disenchanted military/police group in a traditional Cromwellian *coup d'état*.

(vi) *Migration*

For coerced citizens who desire to improve their lot and who fail to do so *via* the instruments of participation listed above, migration, if available, is the ultimate escape. 'Voting with one's feet' is an apt description of political mobility of this kind, in which citizens quit one political jurisdiction for another which offers a less coercive fiscal system. As such, the international migration of human capital is appropriately analysed within the economic theory of clubs.

3. Migration and the economic theory of clubs

The theory of clubs is a theory of co-operative membership which seeks to determine the optimal size of membership under varying economic conditions. (It was first applied to the process of fiscally-induced migration by Charles Tiebout in 1956,[6] albeit in a somewhat idealised form.) If we view nations as clubs, fiscally-induced migration will take place when a number of clubs offer differing packages of tax-prices and public policies to domestic and potential citizens with widely varying tastes and incomes.

Each individual will seek membership with the club best-suited to his preferences, and the fiscal-package will represent only one element in his choice. Indeed, the existence of cultural, language, and other ties suggests that fiscal coercion must exceed some critical threshold and must be expected to continue over a significant time-horizon before citizens seek migration on a significant scale. Moreover, significant migration usually imposes external effects[7] both on clubs of exit and on clubs of entry, whether negative or positive depending on the precise circumstances of the shift, with the inference that the migration market usually is controlled to a lesser or higher degree by the clubs concerned. Whether or not such migration is to be viewed as beneficial or detrimental from the viewpoint of the world economy or of the nation-state is a much rehearsed and highly treacherous field of analysis. Rather than stray into it here, I shall set out a number of refutable propositions based on the British experience.

The present British fiscal crisis consists of an excessively high 'social wage'. It may be viewed as a return to inactivity, financed in part by the most progressive effective system of taxation in the world, in part by high interest rates which penalise entrepreneurial endeavour and in part by inflation which destroys and redistributes wealth. It is exacerbated by a highly redistributive incomes policy. As such the British club offers apparent advantages to the unambitious poor, the would-be malingerer, those who yearn for a return to the simple peasant-culture, and those whose human capital is so low as to jeopardise their chances of finding employment at any

[6] C. Tiebout, 'A Pure Theory of Local Expenditures', *Journal of Political Economy*, October 1956.

[7] External effects are the costs or benefits to others which do not confront the individual who contemplates migration, for example, in congestion or decongestion.

wage-rate higher than subsistence. In the absence of quite stringent membership restrictions one would predict a steady flow of new entrants from clubs less well-disposed towards such citizens.

In contrast, the British club offers evident disadvantages to the most productive and hard-working of its citizens, who are usually but not invariably well-educated. Within this group one would predict a strong and growing demand for outward migration as the fiscal crisis is intensified, despite exchange control restrictions designed to penalise the wealthy emigrant. Moreover, since such citizens may be viewed favourably by clubs organised to achieve high economic performance, one can predict that entry restrictions will be adjusted or evaded in order to secure their membership into non-British clubs of this kind. Most dominant among the emigrants will be the ambitious, the young, the well-educated and self-sufficient citizen whom most clubs seek out for membership and who has the most to offer to the long-run performance of any economy.

COMMENTS

The General Theory of Coalitions

MALCOLM R. FISHER
Downing College, Cambridge

Professor Rowley's paper suggests to me that the analyses of migration, customs unions, trade union behaviour, and also of labour-managed firms, to mention but four subjects, have much in common. They are all part of a more general theory of coalitions which have become known as the theory of clubs. The first two evidently are where people are distinguished by membership of fiscal/monetary systems, the third rests on classification by work role, and the fourth upon classification by type of entrepreneurial activity. To an extent they inevitably overlap.

Professor Rowley has shown the distinguishing features within various clubs, the degree to which members of one club become more alike, and yet more different from members of other clubs. In an analysis of variance this means there will be more homogeneity within than between clubs. This may be true but it is complicated insofar as there are, within a nation-state, a variety of clubs, and this leads to interacting effects. Members of common types of clubs in different nation-states may be more alike than members of different clubs within a nation-state.

Migration a marginal decision

It is on migration that we wish to concentrate. For the individual contemplating migration the decision is one at the margin. Yet in terms of physical re-location the average effects of the decision for him are as relevant as so-called marginal effects, such as the consequence of his working a little harder, or a little less hard when he gets to his new country. In assessing his net income after migration he must be mindful of the average rates of tax on incomes before and after migration for the entire intended period of migration, as well as the marginal rates of tax plus social benefits assessed in like manner. For tax purposes housing costs are treated differently in different countries. Indirect taxes also matter. Prospective tax-benefit changes are as important as current effects in the assessment.

The benefits accruing to existing members of a club do not in 'net' terms automatically accrue to new members, whether of a nation, a union, or a worker partnership. Existing members can pretty effectively exercise control over entry—indeed most nation-states exercise considerable controls of this type.[1] Hence the benefits from migration are usually much smaller than initial impressions suggest. Were it not so, on competitive theory grounds, the gap would have been closed. There are not vast areas of intra-marginal profit lying around to be picked up just for the asking. New opportunities of this type arise through disequilibrium conditions. After all, the Hecksher-Ohlin theory of international trade is pretty forthright on all this, as recent propounders of sophisticated theories of discrimination have discovered to their cost.[2]

Three (economic) kinds of migrant

In the international labour market we may distinguish the person who moves about for short periods to improve his expertise, who

[1] M. R. Fisher, *The Economic Analysis of Labour,* London, 1971, Chapter 5; *Wage Determination in an Integrating Europe,* Leiden, 1966, Chapter 4.

[2] J. Stiglitz, 'Approaches to the Economics of Discrimination', *American Economic Review,* May 1973.

moves for the long-haul but preserves a degree of international mobility with options open, and who moves with total commitment to a new location.

Clearly we must begin with a set of equilibria with respect to tax-benefit policies and the general environment in which they are set, and assess the impact of fiscal-money-exchange rate changes. Any change in the pattern of taxes and benefits will have distributed repercussions across persons, space and time. Some of them will work through the international product market and hence into factor rewards indirectly, in addition to any direct effects.[3] A rise in income taxes that serves to finance additional social benefits for the poor is disadvantageous for the potentially more affluent, save in specific poor-goods industries. If this group includes the innovator and risk-taker, a rise will be prejudicial, and a fall beneficial, provided the changes introduced are expected to be, and become, permanent. A reduction will enhance the position of the domestically located risk-taker and innovator, and, leisure-seeking apart, will induce him to expand activities and to think less of migration. It may encourage an immigrant with inferior facilities in this domain. Since a tax change is, in this sense, non-discriminatory it will give higher rewards to those not so imbued also, some of which might entail a move towards leisure and less risk-taking.

But one has then to balance the benefits from inducement to the really creative against the fillip to the less creative. In making such an assessment one has to reckon in the external benefits, pecuniary and non-pecuniary, that flow from such inducements to risk-taking and innovation. One other way that they may be secured is by subsidising to a degree, or preventing fresh tax imposts upon, short-term re-location for acquisition of training and experience abroad. If taxation is increased in such a way as to limit such benefits, the economy may be the poorer through both direct and spillover effects. If sufficiently intense and persistent, such an impost may indirectly cause the replacement of temporary absences abroad by permanent absence through migration. The Finance Act of 1974 has doubtless by now thrown up evidence of this permanent migration.

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[3] R. Mundell, 'International Trade and Factor Mobility', *American Economic Review,* June 1957.

Lifetime or Immediate Earnings?

GEORGE PSACHAROPOULOS
London School of Economics

While I fully agree with the spirit of Professor Rowley's paper, I cannot see what is gained by using the theory of clubs instead of the more straightforward theory of migration in response to economic rewards. But, whatever the theory, the prediction is the same: 'A strong and growing demand for emigration under conditions of heavy taxation.' Putting aside what 'strong' means in this context, my question is: 'Given the present state of British taxation, why is emigration not even "higher?".'

The restraints on emigration

I think there are two main reasons:

(i) the cultural, language, family and other ties that create frictions in the international labour market, mentioned by Professor Rowley;

but also

(ii) in a lifetime perspection, the expectation that the managing director of the British Club may change and that the new director will lower taxes.

The consideration of *lifetime income* after tax in the decision to emigrate is very important. People cannot simply shuttle between London and the Great Lakes. They will make a near-permanent decision to move if the present value of their lifetime income after allowing for taxes and prices is higher on the other side of the Atlantic.

Because of these two factors, I expect 'voting with one's feet' to be a minor instrument among those listed by Professor Rowley as a defence against heavy taxation. What I consider to be the most important instrument for those who adhere to the British Club is less work and living in luxury. Furthermore, I do not predict that human capital accumulation will be severely affected in the UK. Investment in human capital depends upon salary differentials by educational level *within* the UK rather than between the UK and other countries. If, in spite of the heavy taxation, the private rate of return to higher education in the UK exceeds the yield on alternative investments, human capital will continue to be accumulated in the UK.

Differential salaries most important factor

By the same reasoning, labour movements between countries depend not only on differential tax rates but also on *differential salaries*. I consider the latter factor as much the more important in the decision to emigrate.

Finally, my feeling is that the whole discussion has been very impressionistic. What I would like to see is the different hypotheses suggested, both by Professor Rowley and by me tested with UK data.

5. The Fisc and the Fugitive: Exploiting the Quarry

BARRY BRACEWELL-MILNES
Erasmus University, Rotterdam

THE AUTHOR

DR BARRY BRACEWELL-MILNES was born in 1931 and educated at Uppingham School, New College, Oxford and King's College, Cambridge. He is currently Economic Consultant, Fiscal-Economic Institute, Erasmus University, Rotterdam. In 1964 he joined the Economic Directorate of the Federation of British Industries. When the CBI was established in 1965 he was appointed Assistant Economic Director, and in 1968 Economic Director.

He is the author of *The Measurement of Fiscal Policy* (1971); *Saving and Switching* (1971); *Pay and Price Control Guide* (1973); *Is Capital Taxation Fair?* (1974); *The Camel's Back* (1976). For the IEA he contributed an essay, 'The Economics of Tax Reduction', to *Taxation: A Radical Approach* (IEA Readings No. 4, 1970).

COMMENTATOR

DENNIS LEES: born 1924, educated Derby Technical College and Nottingham University. Since 1968 Professor of Industrial Economics, University of Nottingham. Appointed Chairman, National Insurance Advisory Committee, and Industrial Injuries Advisory Council, since 1972. Member of the IEA Advisory Council. Publications: *Economics of Advertising* (1967); *Financial Facilities for Small Firms* (1971); *Impairment, Disability and Handicap* (1974); *Economics of Personal Injury* (1976); *Solicitors' Remuneration in Ireland* (1977). For the IEA: *Health through Choice* (Hobart Paper 14, 1961); *Economic Consequences of the Professions* (Research Monograph 2, 1966).

Introduction

Tax avoiders are bad citizens, their critics allege. They are dodging the column, taking a free ride, pushing the burden onto their fellows. They get up to all manner of tricks, and the tax authorities need a hundred eyes to defend the public purse from their depredations. Indeed, the avoiders are generally one jump ahead of the game, so that the authorities need extensive or even unlimited powers in order to check abuse.

The present paper considers these criticisms critically. Is it all really so simple, a matter of black and white? The tax system is a complex structure, and the concept of avoidance is subtle and ambiguous. The citizen's fiscal duty is not intuitively obvious, and the anti-avoiders have not succeeded in explaining it in English prose. Nor is it self-evident that the avoider (or even the evader) must be harming his fellows simply because he is helping himself: in *The Wealth of Nations* Adam Smith explains how the pursuit of self-interest confers unintended benefits on others, and it is worth considering whether this principle can extend to avoidance (or even evasion).[1]

The subject of tax avoidance and evasion has its own logical structure which is superimposed on the related logical structure of the tax system itself. Avoidance and evasion cannot be understood if this logical framework is ignored. Moral indignation is a poor counsellor and no substitute for understanding what the subject is about.

Private and public

Here we consider the motives of the two adversaries, the taxpayer and the fisc; in the next section we consider the consequences of their actions. 'Good' motives do not always lead to 'good' consequences, nor 'bad' motives to 'bad' consequences.

The fisc is often assumed to be a selfless entity whose sole guiding principle is the public good. This fairy tale can be accepted only by those ignorant of recent work on the theory of bureaucracy.[2] The

[1] The present paper tries to present the main themes of tax avoidance and evasion simply and briefly; they are dealt with more fully in a forthcoming publication.

[2] Notably William A. Niskanen, *Bureaucracy: Servant or Master?*, Hobart Paperback 5, Institute of Economic Affairs, 1973.

first essential for a scientific approach to bureaucracy is the recognition that bureaucrats, like everyone else, follow their private interests as modified by some conception of the public interest. Perhaps the most accurate generalisation about bureaucrats is that they aim to maximise the size of their bureaux.[3] But for tax-gatherers this may be a less important consideration than the pursuit of tax avoiders for the same mixture of personal and public motives as inspires a heresy hunt.

Just as the fisc is not a disembodied public servant, so also the taxpayer is not *homo economicus*, the embodiment of 'private man', for whom personal enrichment is the only motive. *Homo economicus* is a logical extreme. The taxpayer may be *malevolent* or even *benevolent* towards the fisc. In war time, for example, people pay taxes more readily if they approve of the war (and less readily if they disapprove). In peacetime they pay taxes less readily if they disapprove of the taxes. The taxpayer may be willing to avoid taxes even at considerable cost to himself. Tax avoidance may be a game or a hobby or a form of political protest. The common assumption that the taxpayer is feathering his own nest at the cost of the fisc may be the opposite of the truth.

Losses through tax avoidance accepted by the taxpayer in order to inflict parallel losses on the fisc are final as well as immediate: they are not counterbalanced or offset by the subsequent workings of the economic system. But avoidance inspired by the motive of self-enrichment may yield gains, not losses, to the fisc and to the taxpayer's fellows.

Gains and losses

The notion that the tax avoider shifts the burden onto his fellows has been widely accepted and little scrutinised. But as a generalisation, it is false. Its truth depends on two conditions which will often not be satisfied in practice.

The first condition is that the government's expenditure is determined independently of its income. But this is a logical extreme and may be far from reality. Governments may spend a large proportion of marginal income. This proportion may even exceed 100 per cent. The burden shifted onto the taxpayer's fellows may be small, zero or even negative.

[3] Niskanen, *ibid.*; also Gordon Tullock, *The Vote Motive*, Hobart Paperback 9, Institute of Economic Affairs, 1976.

The second condition is that the loss to the fisc is real as well as apparent. This again may be the opposite of the truth. The alternative to tax avoidance or evasion may be, not tax payment, but a shift of activity leading to a reduction, not an increase, in tax revenue. The suppression of evasion may cause losses to all parties, including the fisc. Indeed, with taxes as high as they are, the fisc is typically more at risk than any other party and may be more at risk than all the other parties combined.

Thus tax avoidance and evasion may serve the public weal by reducing public expenditure or increasing the yield of tax. Tax avoidance and even evasion may be a form of public service, in consequence if not in motive.

The balance of probability

The traditional and 'common-sense' belief that the fisc and other taxpayers must lose from tax avoidance or evasion is incorrect. They may gain from avoidance and evasion and lose from anti-avoidance and anti-evasion.

But can we say whether the fisc and other taxpayers are more likely to lose or gain from avoidance and evasion? If a gain is untypical and improbable, the proof that it is possible may be of little more than theoretical interest; if a gain is no less likely than a loss, however, the proof that it is possible yields a conclusion of substance.

To take an illustration from a related field, Jacob Viner has shown that customs unions can reduce economic prosperity through trade diversion instead of increasing it through trade creation,[4] a discovery for which he indeed deserves much credit, though perhaps less than he has received. I have argued that there is a general presumption that prosperity will be increased, not reduced, by customs unions: prosperity will increase unless a number of conditions are satisfied simultaneously, and the odds against this happening are high.[5] A reduction of prosperity through trade diversion is untypical.

The conclusion that the fisc and other taxpayers may gain rather than lose from tax avoidance and evasion, however, is not vulnerable to criticisms of this character. The assumption that governments

[4] *The Customs Union Issue*, Carnegie Endowment for International Peace, New York, 1950, pp. 44 *ff*.

[5] *Economic Integration in East and West*, Croom Helm, London, 1976, Chapter 5.

spend none of their marginal income is an implausible logical extreme: the assumption that they spend it all is not even a logical extreme, and it may be a fair reflection of what happens in practice. Whether the fisc loses revenue depends on the circumstances. It must lose revenue from malevolent avoidance (by which economic activity is reduced); but it may gain revenue from money-making avoidance (by which activity is increased): and it is money-making avoidance (which is perhaps commoner than malevolent avoidance) that is invariably the object of official anti-avoidance campaigns.[6] Moreover, money-making avoidance may benefit the taxpayer's fellows directly as well as by increasing the yield of tax.

It would be possible to specify the relative likelihood of gain or loss from avoidance and evasion under different conditions, as has been done for the relative likelihood under different conditions of increases or reductions in prosperity through the establishment of customs unions. One such proposition may be mentioned here: evasion and money-making (or fiscal) avoidance are more likely to cause gains to the fisc and the taxpayer's fellows when tax rates are high than when they are low. British tax rates are the highest in the developed world.[7]

Symmetry between tax-payer and tax-gatherer

The logical structure of avoidance is symmetrical: all the parties are influenced by private (personal, selfish) motives as well as public (impersonal, selfless) motives, and all the parties may gain or lose money from avoidance and evasion, as individuals or collectively. This is in all points the opposite of the conventional treatment, which

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[6] *Malevolent* avoidance reduces activity *in order to* reduce tax revenue. *Economic* avoidance, which includes malevolent avoidance, reduces activity *as a result* of taxation (for example, because taxable work is no longer competitive with tax-free leisure). *Subjective* or *money-making* or *fiscal* avoidance *maintains* economic activity by *reducing* its tax consequences; in this it resembles evasion, since both evasion and subjective avoidance *increase* economic activity by comparison with a tame surrender to the tax-gatherer. Subjective avoidance, unlike economic or even malevolent avoidance (which are the only forms of avoidance which do damage economically), is *political* avoidance in the sense that it is the only form of avoidance which is exposed to criticism politically.

[7] Barry Bracewell-Milnes, *The Camel's Back: An International Comparison of Tax Burdens,* Centre for Policy Studies, London, 1976, especially the Appendix.

has assumed, first, that the fisc is selfless and the taxpayer selfish and, second, that the taxpayer gains from avoidance and evasion whereas the fisc and the taxpayer's fellows lose.

There is the same contrast in the moral dimension. Conventionally, the fisc is treated as embodying the collective will, which it is the taxpayer's duty to obey. In the present paper, the fisc is treated as a fallible human institution, to be judged by the same standards as are applied to taxpayers. We are driven to this course by the impossibility of believing that tax legislation always or even generally represents the will of people or Parliament.

One example was when the Minister introducing a piece of anti-avoidance legislation in the House of Commons spoke to a brief prepared for a different clause without any of the Members present noticing the difference. Another example was the graduated estate duty schedule in force between 1894 and 1968. The principle of 'progressive' taxation requires the *marginal* rate of tax to *rise* as the income or estate increases; this is what happens under the present British income tax and capital transfer tax. But until 1968 estate duty was charged on the 'slab' basis (since the graduated schedule was specified in terms of *average*, not *marginal*, rates); this meant that the *marginal* rate did not rise with the size of estate but *alternately rose and fell.* This indefensible system lasted for 75 years until it was swept away in 1969 without a murmur of protest.[8]

Thus the tax system itself can be highly artificial and at variance with any intelligible principle of equity. Artificiality is no less characteristic of anti-avoidance legislation. The principle of symmetry indicates that anti-avoidance legislation should be judged by the same standards as the avoidance it seeks to suppress.

The mischief of anti-avoidance

The *mischief* of avoidance is a term of art. It is the name given by the tax-gatherers to the 'abuses' they are seeking to control. But the principle of symmetry indicates that it is not only the taxpayer who can be mischievous. We have already noted that anti-avoidance legislation, and indeed tax legislation more generally, can be highly artificial even though artificiality is one of the principal tests of avoidance itself. Some other mischiefs of anti-avoidance mirror

[8] Barry Bracewell-Milnes, *The Measurement of Fiscal Policy,* Confederation of British Industry, 1971, p. 23; *Is Capital Taxation Fair?*, Institute of Directors, 1974, p. 85.

those ascribed to avoidance: distortion of economic activity, for example, and proliferation of paper work. But other mischiefs are peculiar to anti-avoidance: the violation of privacy, the attack on professional secrecy, the abuse of administrative power, the growth of taxpayer resistance, the decline in tax morality as avoidance is replaced by evasion.

Under a liberal conception of society, tax enforcement imposes a moral cost: that is, it is inherently undesirable and is acceptable only in order to serve some other purpose. This has something in common with theories of punishment aiming merely to maintain public order and reduce the crime rate. But there is another conception of society, analogous to retributive theories of punishment, which sees tax enforcement as something desirable in itself, as an offering to some notion of distributive justice. This conception implies a view of what the tax system itself should be.

The structure of taxation

The conventional treatment of fiscal justice has been as defective as the conventional treatment of avoidance and evasion. First, the tax system has been considered tax by tax instead of as a whole. Second, there has been an obsession with boundary problems (boundaries between income and capital gains and between bequests and gifts *inter vivos*); and this has diverted attention from matters of importance (the relative treatment of economic categories differing in substance and not merely in name).[9]

The result has been internal inconsistency and policy confusion. Taxes like income tax and capital gains tax have been treated as complements to each other instead of alternatives. It has not been understood that taxes on capital and investment income that make saving dearer for rich than for poor necessarily make spending dearer for poor than for rich, since the marginal cost of spending for any taxpayer is the reciprocal of the marginal cost of saving. (Taxes on saving—investment income and its parent capital—always and necessarily represent negative sumptuary taxation.) Graduated tax schedules have proliferated, although, in a consistent system, graduation can be taken only once.[10]

[9] *Is Capital Taxation Fair?*, Chapter IV, especially pp. 94, 121.

[10] *Is Capital Taxation Fair?*, Chapter IV, especially p. 110; also my *Redistribution in Reverse: More Equal Shares of Wealth Mean Less Equal Shares of Spending*, Aims of Industry, 1974.

I have explained elsewhere the conceptual machinery that resolves these problems by providing a common *wertfrei* (or neutral) framework for the accommodation of all internally consistent opinions about fiscal justice. This framework distinguishes differences of value-judgement from logical confusions and enables the relevant fiscal policies to be complemented by the anti-avoidance measures they require. Since anti-avoidance measures are logically subsequent to the fiscal policies they serve, it is unrealistic to expect anti-avoidance measures to be 'fair' or logical as long as the underlying fiscal policies subsist in the confusion of the conventional treatment.[11]

Exploiting the quarry

The fisc has traditionally treated the taxpayer as an industrialist might treat a quarry under his control: as a fixed store of wealth or taxable capacity that can be exploited more or less efficiently. But the fisc has mistaken its victim. The quarry is not a sitting target but an eager fugitive from exploitation. The game is easily lost by the fiscal huntsman.

Böhm-Bawerk rules:[12] economic law sets limits to political power, and these limits shrink with the passage of time. All taxes except a poll tax are ultimately avoidable in part, and all taxes except a moderate general consumption tax are avoidable in large measure or even entirely. This holds good whether the motive for avoidance is the taxpayer's self-interest or malevolence towards the fisc.

This is avoidability in the substantial sense denoting a distortion in the pattern or reduction in the level of economic activity: for example, the reduction of work or the replacement of saving by spending. It is this *economic* avoidance that causes significant reductions in the level of prosperity; but this is not the quarry of the fisc. The fisc is after avoidance in the different sense of arrangements that reduce the tax burden *without* altering the pattern of activity; yet it is this *fiscal* avoidance (economically equivalent to evasion) which may yield gains to the taxpayer's fellows and to the fisc itself. If evasion or fiscal avoidance of this potentially beneficial character is suppressed by the fisc, it is no less likely to be replaced by avoidance in

[11] *Is Capital Taxation Fair?*, Chapter II; Chapter IV, especially pp. 119-121.

[12] *Control or Economic Law?*, English version in *Shorter Classics of Eugen von Böhm-Bawerk*, Libertarian Press, South Holland, Illinois, 1962. 'Power' is a closer translation of the original German 'Macht'.

the economic or destructive sense than by a tame surrender to the tax-gatherers.

Ultimately, the only way to reduce fiscal avoidance without increasing economic avoidance or evasion or both is to lower the highest rates of tax, especially on saving (investment income and capital transfers). Since British taxes on saving rise to the highest rates in the developed world,[13] there is plenty of scope for reduction. These reductions are the more likely to be acceptable politically if it becomes more widely understood that taxes on saving reduce the real cost of the taxpayer's spending and that reductions in taxes on saving thus increase the real cost of expenditure by the rich.

COMMENT

The Inland Revenue Bureaucracy

DENNIS LEES
University of Nottingham

Producer-groups have taken over the British economy and run it in their own, often conflicting, interests. Far from being sovereign, the consumer is occasionally relevant. Examples abound but the most recent and blatant occurred just before Christmas (1976). Lord Denning, no doubt with reluctance, declared Sunday market trading to be illegal under the 1950 Shops Act—itself a piece of producer-interest legislation. That decision was welcomed by a Mr Jack Hunter, secretary of the Institute of Shops Administrators:

> 'There is no reason for shops to be open on Sundays. The unions don't want it and the traders don't want it. It is only [*sic*] the consumer groups who want it'.[1]

The mercantilism against which Adam Smith inveighed has returned. Nowadays, production is about producers.

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[13] *The Camel's Back, op. cit.*

[1] *Sunday Times,* 12 December 1976.

'The most pernicious producer-group of all'

The modern governmental bureaucracy is the most pernicious producer-group of all and, as Dr Bracewell-Milnes cogently shows in his paper, the Inland Revenue is probably the worst of its constituents. Years ago, when delicately dipping fingers into the pockets of their betters, they turned the blind eye, kept mum and settled for a CB. Now, administering a mass income tax, they practise computerised malevolence, utter imprecations, and pocket a CB with an indexed, tax-privileged pension to match. The arbitrary, ruthless tax-gatherers in Adam Smith's time would be no match for them.

The Inland Revenue Staff Federation write the legislation that they will administer. Again, examples are numerous but the 1976 Finance Bill is salutary. You will remember the heroic clause that would tax the fringe benefit of company cars for directors, though not analogous benefits of concessionary coal for miners, free travel for rail men and airline employees or cheap mortgages for local government workers, not to mention of course free postage for MPs and peers. All would have been well for the malevolents except that, horror of horrors, it turned out that the losers would not be company directors but fellow workers or even 'brothers' producing the cars to be taxed. With that immense and sophisticated rationality so well known in political circles, the proposal was watered down to nothing at all. Perhaps Dr Bracewell-Milnes' perceptive contribution does not emphasise enough the incipient conflict between civil groups. A re-reading of Henry C. Simons' seminal article, 'Some Reflections on Syndicalism',[2] would administer a stiff and overdue shock.

Effect of taxes on allocation of resources

Tax avoidance that leaves the pattern of economic activity unaltered ('the quarry of the fisc') is not only difficult to envisage but, even if it existed, would be rather uninteresting. A major task of public finance is to identify and measure the marginal shifts in the allocation of resources that occur as a result of increasing and changing taxes. A minor example, until Cayman Island excesses mucked things up, was the wont of UK university teachers to go to Berkeley in the summer and remit their modest loot *via* the Channel Islands. Much more significant for the country at large is the unceasing

[2] *Journal of Political Economy*, March 1944, reprinted in Simons, *Economic Policy for a Free Society*, University of Chicago Press, Chicago, 1948.

calculation that goes on over dominoes and cribbage in every British pub on every day of the year. Minimising tax payments and maximising social benefits is a mass activity. We are in the phase where the fisc is venting its spite on a 'rich' minority. If ever it gets round to taking on the 'poor' majority, Henry Simons will chuckle in his tax-free heaven.

6. Taxing the Dole

IVOR F. PEARCE

University of Southampton

THE AUTHOR

IVOR F. PEARCE was born in 1916 and educated at Queen Elizabeth's Hospital, Bristol, and the University of Bristol. Qualified as an accountant and worked in industry, 1932-40. After graduating in 1949 he was appointed Lecturer in Economics, University of Nottingham, 1949-56; Reader and Professor of Economics, Institute of Advanced Studies, Australian National University, Canberra, 1956-61; Visiting Fellow of Nuffield College, Oxford, 1961. In 1973 he was appointed Director of Research, Econometric Model Building Unit, University of Southampton, after being the University's Professor of Economics and Head of Department for the previous 10 years.

His publications include: *A Contribution to Demand Analysis* (1964); *International Trade* (1970); *A Model of Output, Employment, Wages and Prices in the UK* (1975). For the IEA he contributed an essay, 'Stimulants to Exertion . . . A Deficiency of Excitements', in *Catch '76 . . .?* (Occasional Paper 'Special', No. 47, 1976).

COMMENTATORS

JOHN STANTON FLEMMING: born 1941, educated Rugby School and Trinity College, Oxford. Managing Editor of the *Economic Journal* since 1976; Assistant General Editor, *Oxford Economic Papers*, 1970-73; Official Fellow in Economics and Joint Investment Bursar, Nuffield College, Oxford. Publications: *Inflation* (1976); articles in *Bulletin of the Oxford Institute of Economics and Statistics*, *Oxford Economic Papers,* and *Review of Economic Studies;* for the IEA an essay, 'Adjust the Real Elements in a Changing Economy', in *Catch '76 . . . ?* (1976).

DOUGLAS EDEN: born 1939, educated Columbia University, New York (BA) and LSE (MSc(Econ.)). Senior Lecturer in History and Politics, Middlesex Polytechnic, since 1970; Member of the Greater London Council (Labour) for Hounslow, Feltham and Heston, since 1973 (Vice-Chairman, General Purposes Committee, 1973-74; Vice-Chairman, Housing Development Committee, 1974-75); Chairman, Heathrow Airport—London—Consultative Committee (statutory) since 1973.

Paradise, paradise lost and perdition

It is instructive to identify three stages in what might be called 'the descent of man'. The first was Paradise, the second the wilderness into which Adam was banished, and the third a régime of over-government and over-taxation.

In Paradise the means of subsistence were free. Work was unknown and the distribution of benefits followed the rule

'to each according to his need and from each nothing at all.'

On dismissal from Paradise Adam was introduced to the laws of physics and biology. Henceforth, if he did not work he would not eat. More particularly, the less he worked the less he would eat.

Even so, Adam was fortunate. His punishment was tempered by mercies unhappily denied to all but a few of his 20th-century descendants. He could decide for himself when he should work and for how long, balancing the disutility of effort against the utility of his earnings. He was free to starve, but he was equally free to become as rich as the laws of nature might allow. Above all he was not required to quarrel endlessly with his neighbours over his 'share' of the national product or to go on strike for fringe benefits. It was not open to him to make 'demands', so he was spared the tedious necessity of expressing 'bitterness', 'frustration' and 'anger' until they were met. The new rule

'to each according to his work effort and from each whatever he chooses',

could not have seemed to Adam unjust or even a matter for discussion. It would be understood simply as a fact of life.

Paying the social cost of consumption

The second fall of man came about not because of the obligation imposed upon each individual to labour for his subsistence but, perversely, because of the number and variety of attractive ways of escaping from it. Enjoyments are evidently more easily secured by stealing than by work. Furthermore, some satisfactions, called in the jargon 'public goods', are of a kind where it is not easy to identify either the consumer or the amount consumed. A notice giving warning of danger cannot be displayed without expense, but, once in being, it is freely available to all, its 'quantity' remaining undiminished however many passers-by heed it. Even though all who benefit might be willing to pay rather than go without, not everyone can be relied upon to pay since the 'good' can be so easily used without payment ('stolen'). 'Public bads' conversely impose arbitrary costs, without compensation, upon individuals who do not benefit from the product. Industrial pollution is a form of robbery.

Evidently there must be coercion to ensure that whoever consumes 'goods' created by productive effort, or imposes a 'bad' on others, is *ipso facto* obliged to *pay the cost* (that is, contribute effort of equal value). Enforcement of this rule is the first and perhaps the only duty of government. Taxation and government are necessary simply to ensure that Adam's curse falls equally upon everyone.

It is easier of course to state the first rule than to apply it in practice. Indeed, it is precisely where the consumer is especially hard to identify that the government is required to do just that. It might, for example, be known that most people would wish to buy the assurance that anyone left without means to pay the cost of his subsistence, not through his own fault, would be maintained by the community at a minimum standard. But the higher the minimum standard the more difficult to be sure that those without means are so not 'through their own fault'. It might therefore be necessary to treat the assurance as a public good; but this in no way absolves the government from its duty to compel beneficiaries to pay for anything more. An improvident person claiming benefit is stealing, and should be charged the cost. The very same 'moral hazard' which makes the risk non-insurable in the market must be dealt with by government when the assurance goes public. It is only for this reason that abnormal powers are granted to the state. And herein lies the dilemma. Abnormal powers corrupt, sometimes absolutely.

From necessary government to over-government

All government leads inexorably to over-government. Taxes, regulations, prohibitions, administrators and lawyers multiply for reasons as logical and predictable as those accounting for government in the first place.

The paradox is that, to have a ruling authority at all, it is necessary to allow it to disregard the very principle it was established to enforce. Administrators cannot be required to pay the social cost of the goods and services they 'consume'; instead they are given the right to take whatever they want from the community at large. To prevent robbery it is necessary to legalise robbery, with consequences not hard to imagine.

The ordinary person, constrained by Adam's curse, can consume no more than he produces. Successful thieves and government committees are free to spend up to 100 per cent of everybody else's production at no cost to themselves. Professional committeemen derive satisfaction from extravagance, not from parsimony. Careers depend on what is done, not on what is not done. And the demand for satisfactions which cost nothing is, of course, unlimited. Committees maintain continuous pressure for more and more money and power. There is no natural check upon their demands. They extend their interests far beyond their original purpose. They encourage elaborate theories of government claiming everything from 'the divine right of kings' to a 'social contract' which, even if it exists, no-one outside the committee has ever seen, much less agreed upon.

No dramatic expulsion from Paradise marks the passage from stage two to stage three of the fall of man. The community simply wakes up one day to find an indefinable something has gone from the world. Every endeavour likely to capture enthusiasm or excite the imagination seems to be banned by regulation, usually in a manner neither intended nor foreseen by legislators. Every effort to improve the well-being of self or family incurs a penalty. Most tragic of all is the discovery that, for those inclined to take it, there remains a way to influence the decisions of the all-important committees. It pays to engage in quarrelling, demonstrating, blackmail, threatening behaviour, bizarre publicity-seeking and political activity. Private charity remains the noblest of all virtues. Vice on the other hand feeds upon government patronage.

Britain in 1977

Our sins have brought us to a second fall. More than 70 per cent of the value of the work effort of the community, including the effort of providing capital, is taken away from those who earn it by bureaucrats, to be spent according to the whims of a committee. We have come to a new condition of life which might be expressed

> '*to each about one-quarter of the value of his product plus whatever extras political activity might squeeze out of the committees distributing the balance, and from each as much as the individual can bring himself to contribute knowing that the more he tries the more penalties he attracts*'.

How 70 per cent?

70 per cent does not overstate the extent of committee spending. Indeed, it may well understate it. If this figure seems hard to believe, then the degree of disbelief is a measure of the insidious nature of the growth infecting us. It may also be a measure of the success of countervailing propaganda.

The common practice of bureaucrats embarrassed by a statistic is to create confusion by quoting another which has nothing to do with the case but which looks as if it does. Thus 25 per cent inflation is excused by remarking it is only one-fifth of the inflation rate in Chile! Complaints that 60 per cent for the government share of gross national product might be too high were met, first, by the claim that welfare payments in Britain are lower than in some other countries, and, second, by the suggestion that the 60 per cent quoted could be reduced to 50 per cent by eliminating certain items paid to and received from nationalised industries,[1] and by reforming the basis on which debt interest is included in public sector accounts.[2]

The public must not be misled by this sophistry. As long as the question is what proportion of gross national product is spent or redistributed by committees the answer remains '*more than 70 per cent*'.

Capital invested in the public sector, like every other resource at the disposal of government, must have been subscribed, directly or indirectly, by the people and hence belongs to the people. If, therefore, the Department of Trade and Industry receives the profits from that capital instead of the community at large, the amount is a tax taken from the people as surely as if it were an income tax. Furthermore, it is quite improper to argue, as the Treasury does,[3] that the profits of one nationalised industry should be deemed to have been used to subsidise another, any more than they might have been deemed to have been spent on unemployment benefits. Even if it were, it is just as surely spent by a committee as it would have been

[1] Mainly self-financed capital and interest payments.

[2] Proposed by the Treasury in evidence by Mr Leo Pliatzky, second permanent secretary, to the Expenditure Committee (General Sub-committee) on 27 October, 1976 (HC718, p. 24): 'Mr Pliatzky's accounting', *Economist*, 30 October 1976, p. 93.

[3] The Treasury argues this implicitly by the very choice of the new accounting procedure.

if used for any other purpose. Indeed, precisely the same considerations apply to profits retained by private corporations where the management committee did not itself pay the social cost of providing the capital under its control. However much we may be aware of the importance of securing funds for investment, it is impossible to escape the consequences of choosing to raise the money by expropriation rather than by voluntary saving. And these consequences may be far-reaching.

Just how far-reaching they could be is well illustrated by a thought experiment recently proposed by the Economics Editor of *The Times*, who argued[4] that the public sector could be made as large as we like *without damage* by imposing a sales tax, scattering the revenue collected at random over the countryside from a helicopter. It is difficult to imagine a policy which would do more damage. No other policy could so swiftly reduce production towards zero or so efficiently heighten the violent scramble for the largest share of gross national product. It would clearly be more profitable to organise gangs of thugs to fight for the notes that fall from the helicopter than it would be to manufacture commodities to buy with them. Far from demonstrating the irrelevance of transfer payments to the public expenditure total, this example proves the exact contrary.

One might even see parallels between the present situation in Britain and that imagined in the thought experiment. The breathtaking proportion of GNP now forcibly requisitioned by government and quasi-government agencies may not be distributed randomly from a helicopter, but there is evidence to suggest that the creation of power-groups intent upon maximising their share might be our fastest growing industry. Nor do the published figures tell the whole story. It is now common practice for governments to require the private sector to collect taxes on its behalf. The private cost of tax-collection does not enter into the government accounts but enters into the price of the product and so becomes a tax in its own right, the revenue being notionally returned to producers to pay for the tax-collecting service. In the same way the fees paid to accountants and lawyers constitute part of the cost of tax-collection and hence should be thought of as a tax that government conveniently ignores. No-one would choose to pay a tax accountant but for the tax.

[4] Peter Jay, De-cooking the books, *The Times*, 28 October, 1976.

The problem in the past

We do not have to endure our state after the second fall. We can escape it, and there have been brief periods of history during which we did escape it. The shadow of big brother waxes and wanes. During the 16th and 17th centuries it lengthened until extinguished by its own internal contradictions. Human nature in the 20th century has summoned it back. For at least four hundred years, a war has been waged against state intervention, sometimes successfully and sometimes in vain. The lines of battle do not change. Over and over again the fundamental truths have been restated by economists and philosophers only to be ignored by statesmen and bureaucrats whose hopes and ambitions those truths frustrate. We do not have to break new ground. A body of knowledge exists which has long withstood the test of time.

200 years ago Adam Smith set out the necessary duties of the state. Not surprisingly every item in his catalogue can be interpreted as an injunction to make the consumer pay the price.

100 years later John Stuart Mill, familiar with all of the literature, could find little to add to Smith's list, and nothing at all to object to. Yet the unanimity of view owes nothing to common experience. Smith came of age in a world scarcely yet emerged from a period when, at the peak of interventionist lunacy, it had been possible to buy from the state permission to be allowed to disregard its regulations. Mill, on the other hand, lived secure in the belief that the bad old days were forever gone. Writing of qualified *laissez-faire*, he predicted that

> 'the degree in which the maxim . . . has . . . been infringed by governments, future ages will probably have difficulty in crediting.'[5]

As an illustration of past excesses too ridiculous ever to be practised again he quoted a passage from Dunoyer describing conditions in France under the Old Régime.

> 'The state imposed on manufacturers an unlimited and arbitrary control . . . it decided who should work, what should be done, what materials should be used, what procedures should be followed and what shape should be given to the product. Producers

[5] John Stuart Mill, *Principles of Political Economy with Some of Their Applications to Social Philosophy*, 9th edition, ed. by W. J. Ashley, Longmans, Green, London, 1909, p. 950.

> were not required to do a good job or to seek to do better, it was necessary only to stick to the rules.'[6]

Clearly Mill failed as a prophet. In 1977 we have little difficulty in believing in the régime depicted and none at all in imagining what it was like. The bad old days are with us now.

Onus of argument—the second principle of state expenditure

Not surprisingly, in view of the propensity of bureaucracies to grow, lists of minimal duties have always been presented not as an encouragement to do more but as an exhortation not to meddle beyond the minimum necessary.

For the same reason there has been wide unanimity over the years on a second principle of state expenditure: that the burden of making out a strong case should rest not on those who resist proposals for intervention but on those who make them. Parliament was originally set up to restrain extravagant expenditure by the sovereign, not to encourage it. The function of the Treasury used to be to question departmental spending. The duties of local councillors used to be to protect ratepayers against the excesses of those who enjoy, or seek, aggrandisement by wasting other people's money. Only in 1977 do we seem to be without a public expenditure watchdog of any kind. The second principle seems all but forgotten.

Intervention grounded on error

Mill went further than the second principle. He sought to define those things which governments should not do in any circumstances. His list has extraordinary contemporary significance. Chapter X, Book V of the *Principles* is headed 'Of Interferences of Government Grounded on Erroneous Theories'. We read:

> 'There are some things with which governments ought not to meddle, and other things with which they ought; but whether right or wrong in itself, the interference must work for ill, if government, not understanding the subject which it meddles with, meddles to bring about a result which would be mischievous.'[7]

[6] *Ibid.*, 5th edition, p. 557. Mill quotes Dunoyer (*De la Liberté du Travail*, Vol. I, pp. 353-4) in the original French. The above is the present author's translation.

[7] *Op. cit.*, 9th edition, p. 916.

The public expenditure policies of many governments throughout the world have, since 1940, been deeply influenced by erroneous theories which seemed to suggest:

(i) that there is no need to save in order to secure investment, and that on the contrary it is better to spend;

(ii) that it is therefore not necessary for the state to collect in tax revenue as much as it plans to spend; on the contrary, that whenever there is the smallest degree of unemployment it is beneficial to run into debt or to print money;

and

(iii) that we know enough about the working of the economic system to be able to use taxation as a planning device.

The consequences have been:

(i) an attack *via* taxation upon personal saving which is fast depleting the capital stock and so the productivity of the nation;

(ii) an immense outpouring of printed money leading to inflation and hence to the imposition of unjust and arbitrary taxes and subsidies of unknown incidence on a scale not seen in Britain since the excesses of Henry VIII;

(iii) a growing pressure to apply physical controls and other regulations following the evident failure of fiscal policy to achieve Utopia;

and

(iv) a persistent balance-of-payments deficit due to spending in excess of the value of production.

Taxation and the welfare state

The British government has frequently meddled, and is currently meddling, 'not understanding the subject it meddles with'. But it is worse than that. Mill ought to have added that governments should not meddle in an attempt to achieve ends which are mutually contradictory, or only half understood, or which reflect some ill-thought-out piece of conventional wisdom.

There is much talk these days about the new 'caring society' as if in times past society took no care of people in need. There has never been a time nor place where society ignored or rejected the old and the sick. Indeed many sociologists would argue that, in proportion to the available means, there has never been a time when society took so *little* care of the old and sick as it does today.

The 'welfare state' is not about *whether* or not the helpless should be cared for. It is about *how*: in state-organised compounds run by committees of social workers, or by the family or extended family on whom natural justice clearly lays the duty, supported by insurance funds protected from the sticky fingers of government committees. The welfare state is not about whether we should have a 'health service' but about whether medical care should be purchased in the quantity and quality desired, or should be rationed in quantity and quality determined by bureaucrats relatively ignorant of the hopes and circumstances of the recipient.

The caring state does not 'provide' anything. On the contrary, it restricts our right to provide things for ourselves. The health services, like state pensions and unemployment insurance, began quite properly as mutual insurance schemes. The individual was free to choose to contribute or keep his money, to choose how much to contribute for what benefits. Step by step, contributions were made compulsory and benefits rationed: the relation between the two became so confounded that it became possible to speak as if welfare services were provided free. The whole has developed into a gigantic confidence trick. The right to choose is taken away in exchange for a ration of goods. With characteristic double-think the authorities then present the resulting loss as a gain in freedom on the ground that, by furnishing a 'social wage' free of charge, part of Adam's curse is being lifted.

It is no defence to argue that national insurance provides free services to people who could otherwise not pay for them; even if this were true, which it is not, it would hardly be possible to devise a sillier way of helping the poor. Here again there is much to learn from the great thinkers of the past.

Mill on poverty

Poverty is essentially relative, and for that reason can never be finally removed. Almost by definition it exists whenever there is inequality. On the other hand, without 'differentials' there is unlikely to be effort. The inherent contradiction is, as usual, well presented by Mill:

> 'It will be admitted to be right that human beings should help one another; and the more so, in proportion to the urgency of the need . . . and there is *prima facie* the amplest reason for

making the relief . . . as certain to those who require it as by any arrangements of society it can be made.

On the other hand, in all cases of helping, there are two sets of consequences to be considered; the consequences of the assistance itself, and the consequences of relying on the assistance. The former are generally beneficial, but the latter, for the most part, injurious.'[8]

Mill goes on to propose a principle 'insofar as the subject admits of any general doctrine or maxim'. Assistance is injurious if

(i) it is systematic and certain and capable of being previously calculated on,

and

(ii) the condition of the person helped is as desirable as that of the person who succeeds without help.

Where aid is given injuriously, he says,

'the system strikes at the root of all individual industry and self government; and, if fully acted up to, would require as its supplement an organised system of compulsion for governing and setting to work like cattle those who had been removed from the influence of the motives which act on human beings'.[9]

All of this is far away from current conventional wisdom, and hence much political thinking. It seems to be accepted that every individual has a natural right to be housed and fed by the state irrespective of his own efforts or those of his family. More recently we have had the suggestion that each person has a natural right to have his home properly heated. Can a natural right to air conditioning in the summer be far behind?

Taxes are blind

We do not even believe the conventional wisdom we preach. All that is necessary is to scratch the surface of the words used to discover that we do not mean what we say. A 'just' distribution of the national income does not mean a 'just' distribution among everyone but among the élite who qualify. Few would argue a five-year-old child at school should receive the same pay as an adult worker. Why not? Because the child does not produce wealth? But even the

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[8] *Ibid.*, p. 967.

[9] *Ibid.*, p. 968.

élite produce vastly differing amounts. If it is proper that a child should receive *no* income 'as of right' because he is supposed to create *no* social value (although he does) then rewards should be determined solely by the value of the product. But those who claim they should receive a higher wage because their work is arduous or dangerous at once contradict this principle.

There are no agreed 'normative', ethical principles to determine what *ought to be.* There are only 'positive', behaviourist principles which determine what *is.* Our situation, without redistributive taxation, would be no different from that of the first Adam. Each individual sells his time and his talents in exchange for commodities at the going market price. There is no more reason to suppose that the state could influence that price by decree than there is to suppose that Adam could command a change in the laws of physics in the Garden of Eden. With vague redistributive intent, we have built up in Britain a monstrous clutter of taxes and subsidies stupifying to contemplate, tottering insecurely upon undefined notions of social justice when no one —not even the bureaucrat—has the slightest idea what and where the real effect ('incidence') of those taxes might be. Any competent economist could, at a moment's notice, construct an example where a tax *raises* the real income of the person taxed. There is ample evidence that governments pay as little attention to principles in the collection of taxes as they do in spending the revenue.

Taxing the tax-avoider

In contemplating the state of taxation in Britain, it is difficult to know where to begin, except perhaps to suggest beginning again. What we have is a Heath-Robinson structure of such exquisite perfection that the temptation is to adorn it rather than command its destruction. What opportunities the Commissioners of the Inland Revenue are missing! Anyone misguided enough to buy a Rolls-Royce to avoid the inflation tax is well and truly dealt with. He pays purchase tax when he acquires it, he pays rates to leave it in his garage, road tax and petrol tax if he takes it on the road, and capital gains tax when he sells it. But what of the unpatriotic scoundrel who evades his responsibility as a taxpayer by *not* buying a Rolls-Royce? Should we not introduce a tax on not-buying things? Relief, of course, would be allowed against not-buying tax assessed on items not yet invented and upon not-buying tax exceeding

99·9 per cent of declared income after allowance for rates assessed on dwellings of rateable value in excess of that of a council house. Imagine the correspondence from the tax inspector. 'We have reason to believe that in your return for the year 19— you might not have declared all that you did not purchase. Please state whether you did not buy a white elephant from the King of Siam.'

Taxing the dole

There is, however, a serious side to the matter. It is one thing to enjoy fantasy but quite another to forget the real cost of follies so absurd that it has become sensible to contemplate an act as ridiculous as taxing the dole.

The four canons of taxation

For two hundred years legislators have had for their guidance the four canons of taxation set out by Adam Smith, repeated word for word by John Stuart Mill, and approved by almost every serious writer on the subject since, without amendment or a word of dissent. Yet the present British tax structure violates these canons on every point and to a degree beyond all reason or restraint. The 20th century has seen fit to forget entirely principles which have stood the test of time and common sense. Almost in Smith's words they are:

(1) taxation on the subjects of every state should be levied in proportion to abilities, that is in proportion to the income they respectively enjoy under the protection of the sovereign;
(2) the time, manner, and quantity of payment must be clear and plain to the contributor and to every other person;
(3) in levying taxes the convenience of the contributor should be paramount;
(4) every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible above what it brings into the public treasury.

Those responsible for the current tax Saturnalia in Britain should be required to explain and justify at least the following deviations from the four canons.

Canon (1) Proportionate taxation on all sources of income in accordance with the first canon minimises the disturbance of prices and hence maximises the probability that lump-sum money subsidies to people in need would have the intended effect. Violation of Canon (1) means that no-one knows how to calculate the real effect of any change. Why have complicated rates with unpredictable effects when simple rates can meet all cases?

Canon (2) (a) The growth of an army of tax accountants and lawyers flatly contradicts the idea that the amount of tax to be paid is 'clear' and 'plain'.

(b) the tax laws change so rapidly under the influence of unpredictable political forces that it is impossible to plan or even to guess at net real income for more than a few months ahead.

(c) Uncertainty, according to Smith, 'puts every person into the power of the tax gatherer'. It 'encourages insolence and favours corruption'. Few taxpayers do not quail before the unassailability of the bureaucracy.

(d) Inland revenue rules prevent tax officers from giving advice to taxpayers and are totally inconsistent with canon (2).

Canon (3) has been exactly reversed. Today taxes are collected first and argued about later. In some countries the tax-gatherers have power to sequestrate bank balances without the knowledge of taxpayers.

Canon (4) (a) has been doubly turned on its head. Smith argues that taxes should be designed so as to minimise the disturbance to productive activity. They should not 'obstruct the industry of the people'. British taxes are specifically intended to influence both the amount of employment and the structure of industry and trade. The consequence has been added uncertainty and an intensified incentive to political activity as opposed to economic effort. Successive governments, obsessed with naïve notions of social justice, have taxed to the point where the relation between effort and income has all but disappeared; where the industry of the people is obstructed in the maximum degree.

(b) The complexity of the tax structure unnecessarily adds to the cost of tax collection.

(c) A high proportion of the cost of collection has been shifted onto the public and hidden.

(d) Smith reminds us that injudicious taxes create criminals. He suggests that in natural justice penalties should be fixed in inverse proportion to temptation. We have precisely the opposite.

(e) Higher taxes do not always bring more revenue since they encourage both avoidance and evasion. In some taxes we operate well outside of this threshold. The striking growth of do-it-yourself activity in recent years is neither an accident nor a change in basic preferences. Tax is avoided on work done for self. Work for an employer is heavily taxed. The cheapest way to get something done is to do it yourself, contrary to the principle of the division of labour on which our high present standards of living depend. The whole structure of industry is deeply affected.

The first step towards reform might be to seek some measure of agreement at least upon the following questions:

(1) Do we really believe that governments know better than individuals what is good for them or is the present tax structure simply the consequence of a confusion between measures designed to redistribute income and to provide public goods?

(2) Should there not be a sharp distinction between taxes designed to raise revenue to provide public goods and measures to equate social and private cost (for example, a tax on alcohol to pay the cost of enforcement of drink/driving laws)?

(3) The real cost of training for a trade or profession is a 'social' cost which should be borne by the consumer of the product. The first duty of government is to ensure that it is so borne, so that all are free to choose their desired profession. To what extent does this obligation to equate private and social cost imply equality of opportunity? If the answer is 100 per cent, is there still a case for income *redistribution?* Does equality of opportunity imply equality of incomes, or even more equal incomes than at present?

(4) If equality of opportunity can never be 100 per cent, to what extent is it necessary to 'provide a net below which no man can fall'? Should there be a ceiling above which no man can rise? To satisfy Mill's condition for assistance which is not injurious, should the net be uncertain or should it be minimal?

(5) What is the case for having more than one simple proportional tax on either expenditure or income, given that its purpose is solely to provide public goods? Two taxes are half as certain as one, and use up one hundred times as much effort in avoidance. Two taxes will not be proportional in their real burden, they will cost twice as much to collect and be one half as convenient. Non-proportional taxes have a high disincentive effect.

(6) Should any change be sudden or gradual, bearing in mind that all change is costly and that the highest cost is uncertainty? There is

no way to be certain who will pay the cost of change, and no way to return along the same route by which we came. History has shown again and again that market economies do not collapse under sudden shocks. They sometimes stifle slowly under a blanket of regulation and control, but not for long. It is not possible to contain for ever the boundless energy of human beings motivated by a desire to improve their lot.

COMMENTS

The Tax Trade-offs

J. S. FLEMMING
Nuffield College, Oxford

Mrs Whitehouse would presumably not be surprised to hear that the professors of our universities deny the existence of moral principles—recognising only mechanical ones (p. 101)—but I am. I too admire a number of 18th-century philosophers; what David Hume said was that one could not deduce what ought to be from what is, not that there were no moral principles, nor that there was necessarily so much disagreement about them that legislation in a democracy might not be based on such principles.

I am also surprised that Professor Pearce should exhibit so little of what he surely knows both about a trade-off between equity and efficiency and about the economic theory of the second best.

It was thus with relief that I found that the last pages of the paper pose six questions to which, being a challenge to much conventional wisdom, an observer more in sympathy (and possibly more familiar) with current teaching in public finance might properly respond.

I leave question 1 (on the Welfare State) to the last as it raises wider issues and really requires a three-hour session to itself.

Measuring tax incidence

I would not minimise the difficulties of measuring tax incidence, but it would seem that Professor Pearce's criteria admit unambiguously progressive redistributive taxation, namely by proportional taxation and universal poll subsidy. This is Lady Rhys-Williams's social dividend scheme or the linear income tax (optimal rates of which have been calculated for various special cases by several followers of my colleague Professor J. A. Mirrlees).

In this recent work there are two models: one in which income tax discourages labour supply measured in terms of effort (or time), the other in terms of the acquisition of skill. Taxes do not infringe one's freedom to choose a profession but they may reduce the reward of professional training. This is simply a distortion of factor prices from social marginal costs; such deviations are inevitable with *any* non-lump-sum taxation. They have to be traded-off against the benefits of taxation, whether the police or the redistribution of income.

Safety net without redistribution?

To provide a net below which no man can fall while otherwise refraining from redistribution involves two problems:

(i) It implies a massive distortion of opportunities for those subject to the 100 per cent marginal tax rate involved.

(ii) Its rationalisation invokes a peculiar discontinuity in the social assessment of various income levels. Marshall's motto was 'Natura non fecit saltum'[1] and I know of no justification for sudden jumps in marginal tax rates.

Professor Pearce raises two other questions here: (a) should there be a ceiling? and (b) should there be certainty in assistance?

On (a) there is now a well-established argument that sets out the conditions, probably acceptable to all liberals, under which the marginal rate of tax should go to zero, not 100 per cent, at the top. Under slightly less plausible conditions the same applies at the bottom.

There is something slightly odd about Pearce's, and Mill's, suggestion that taxes should be certain when positive yet uncertain when negative. However, Mill was right that the disincentive effect of taxation for both payers and recipients can be reduced by introducing a random element, as has been argued by Professor J. E. Stiglitz. If random taxation is repugnant as horizontally inequitable, one has to optimise the tax structure subject to the constraint that it be non-random.

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[1] 'Nature never made a leap.'

There are arguments against hypothecation of revenue but to distinguish 'corrective' and 'revenue' duties would be useful. Similarly, nationalised industries' products should not as such be exempt from indirect taxation. We should be able to distinguish between their price and the tax on them.

There is much to be said for a single simple tax, and it could even be proportional if there were also a social dividend. But the case is not conclusive. One counter-argument, which has been made by Lord Kaldor, is that a single tax will be at a high rate, a high tax on any base will involve evasion opportunities at the periphery of the definition of the base. Therefore have many taxes at low rates on overlapping bases.

The ideal tax

My ideal tax might be a linear tax on people's endowments of capital and talent—but these endowments are not observable. Both an income tax, and an expenditure tax, which is a superior method of taxing endowments, distort labour supply. There is therefore a case for taxing leisure indirectly—specifically the do-it-yourself equipment referred to by Professor Pearce should carry at least a 50 per cent sales tax.

The problems of optional tax reform are fascinating. Many tax changes have, as a result of their introduction, a much bigger 'windfall' redistributive effect than their effect on the long-run equilibrium distribution. Consider the corporation tax. Its effect on equilibrium distribution may well be zero or go either way but its introduction is equivalent to a capital levy on equity holders. Whether these considerations point to the need for less change, more gradual change, or merely more open discussion of proposed change is, however, moot. For example, if the corporation tax was known to come on and off every few years the redistributive effects of the capital levy/distribution would be substantially reduced.

The Welfare State—NHS or health insurance?

Professor Pearce seems to believe that he has disposed of the case for both redistribution and expenditure on non-public goods such as the National Health Service. Certainly there is scope for increasing the actuarial element in, for instance, employers' contributions for unemployment insurance. But in health insurance Pearce's argument is open to attack even if one accepts, as I do, that the present welfare system does involve substantial reduction in individual liberty. Professor Pearce refers to mutual health insurance. Unfortunately all insurance, whether public or private, involves moral hazards of various sorts and none more so than health insurance. The absence of the information necessary for condition-specific insurance (£1,000 for a 1mm. tear in one heart valve) means that benefits are related to costs. These in turn mean that at the point of decision the individual (and his professional advisers) is faced with distorted prices. A man offered the option of intensive care may hold an insurance policy that will pay 90 per cent of the extra cost.

American experience suggests that under these circumstances a vast over-expansion of medical services takes place. Even if the insurance equilibrium is not inferior to the no-insurance situation, it is quite possible that an administered scheme—despite its restriction on liberty—is preferable to both. One might argue that there could be a market in liberty-restricting packages, such as the American pre-paid insurance schemes. In practice, the cover they offer is even less comprehensive than that of the cost-plus policies which understandably impose maxima.

Nec natura vectigalia fecit[1]

A Comment on John Flemming's Comment

IVOR F. PEARCE

In case it should seem strange that one economist is clearly willing to suggest more or less exact answers to questions which another economist can do no more than formulate with hesitation, it must be explained that there is really no mystery, nor even any disagreement on matters of logic.

In recent years there has grown up a body of technical literature on what is called 'optimal tax structure'. First, points are awarded, plus for 'good things' and minus for 'bad things'. This is called 'choosing a welfare function'. Then, with the help of mathematics

[1] 'Nature never made taxes, either.'

and a model (necessarily much simplified), it is possible to identify the policy (also much simplified) which will maximise the number of points earned.

Some economists have come to believe that such optimisation exercises can help in making the difficult value-judgements in the choice of the 'best' tax structure. I have some sympathy with this view but I am not yet able to persuade myself that 'natura non fecit saltum'[2] is an especially powerful argument for smooth marginal tax rates any more than the easily invented Latin tag in the title of this postscript is an argument for the complete abolition of all taxation. Nor can I approve of expressions which abound in the literature like 'optimal tax rates have been calculated' or 'there is now a well-established argument that sets out the conditions, probably acceptable to all liberals', implying that optimisation procedures somehow impart a degree of objectivity to subjective welfare choices.

Sadly, a value-judgement is a value-judgement, and no amount of calculation or disputation can make it otherwise. Indeed optimisation procedures can, if desired, be carried out in reverse. It is easy to find, with judicious use of a standard mathematical device, the points system which will make any tax structure optimal whatever it is. Suppose, for example, that points were awarded only for the proportion of persons of the noblest virtue in the community—the greatest source of happiness of the greatest number. Suppose further that we were to accept Thomas Malthus's judgement (quite possibly accurate) that persons of the noblest virtue come into being only in consequence of suffering and of difficulties overcome. On these premises the optimal tax structure would appear vastly different from anything even momentarily contemplated by present-day teachers of the theory of public finance.

Answers to the questions posed in my paper cannot be found by any objective procedure. Indeed, where value-judgements are involved, it would appear that the answers canvassed, as history unfolds, change much more rapidly and randomly than the questions put.

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[2] 'Nature never made a leap.'

Emancipation Means Independence

DOUGLAS EDEN
Middlesex Polytechnic

Of the 17 people who have spoken to papers here today I am the only non-economist. My field is history and politics and I am also a politician. I will address myself to Professor Pearce's paper, but I will extend the argument to the historical and political dimension which has been touched on only occasionally during the course of the day.

Professor Pearce mentions Adam Smith quite prominently in his paper, and, in connection with Smith, that miraculous year 1776. 1776 is, of course, also the central date of the American Revolution which produced the first modern democracy and was a blow against restrictionism; a capitalist revolution, bought by landed aristocrats and by small entrepreneurs, farmers and artisans. At the time, it was the large businessmen, so often not the best friends of liberty nor the best patriots, who were the most divided in their loyalties. In the end, it was a very popular revolution.

No taxation . . .

One of the reasons was that it was fought on the slogan, 'No Taxation Without Representation', which was widely interpreted by most people, as far as we can discern, to mean no taxation at all. This slogan implicitly amounted to an early political promise, probably the first political promise in a modern democracy not to be kept by the politicians. People eventually realised that they were not going to be acquitted of all taxation, and that realisation produced two rebellions against the government of the newly independent country. Shay's Rebellion of 1786-87 and the Whisky Rebellion of 1794 were both, it is interesting to recall, put down by volunteer militia made up of ordinary farmers and local people. The revolts were, however, followed by government concessions recognising the grievances of the people who had come to believe they were going to have no taxation after independence.

The moral, which is hardly surprising, is that no-one likes taxation at all. Much of American history since that time has been characterised by popular resistance to taxation, although the resistance has been somewhat undermined in this century by the demoralisation of the 1930s, when America had the worst depression of any Western country, including Germany, and the demands of two world wars; but that basic resistance is still there.

Why is it somewhat undermined there but so overwhelmingly undermined in Britain? The British people seem quite resigned to handing over their money, usually through PAYE. I am talking about ordinary people here. I would suggest that resistance to taxation declines in some inverse proportion to the numbers who derive income from it. I do not know precisely what that proportion is, but I think it fairly realistic to say that no-one can like taxation unless he is living off it. He may not like it even then, but he is less likely to resist it.

70 per cent probably about right

Professor Pearce referred to the percentage of the Gross National Product spent by the state. I for one am not at all shocked by his claim of 70 per cent. For what my own non-economist views are worth, and from what calculations I have been able to do, I reckon it something about two-thirds; and that is not so far off Professor Pearce's figure. But, more significant, in my view, than the percentage of GNP controlled by the state is the percentage of the population of the country employed by, or otherwise dependent on, the state and its agents.

Some of you may be aware that 27 per cent of the working population, that is more than one in four of every person employed in this country, is employed by the state sector.[1] Even more useful, I think, for the purposes of our discussion here, is another category: people in direct receipt of income in 1975, that is the employed plus the retired on state pensions, the unemployed receiving national insurance benefits and students in receipt of local education authority grants and excluding dependent children and spouses. I reckon that between 45 per cent and 50 per cent of those in direct receipt of income in 1975 received that income from the state or a state corporation.

Dependent on the state: towards an East German system

This percentage does not include people employed by private

[1] Fourteen of today's 18 platform speakers hold posts funded by the state.

firms which derive most of their income from government grants or government contracts. Nor does it include those other than pensioners who depend for most of their income on government benefits, nor those in private employment who rely for part of their income on government subsidies such as family income supplement or housing subsidies. If we add in dependents, probably more than half the entire population is dependent on state expenditure for the larger part of its income. That to me is a crucial point.

The majority of our people are thus supported by the government either through their family breadwinner or through direct payment. For most, of course, the trade unions are the main agents of procurement. The public sector unions are the fastest growing. NALGO and NUPE, for example, are growing at such a rate that each added 100,000 members to its lists in the last year to 18 months. And they are also the most militant (even more than the mineworkers). There is also the modern phenomenon of the National Claimants Union. No doubt, if we continue progressing like this, and we are very far along the road, we will end up with an East German system in which, of course, no one pays any tax. Everyone gets his stipend after the state planning apparatus has put its hand in the coffers.

There is obviously therefore a dilemma here (and here I speak as a member of the Labour Party) for social democrats who want to retain a mixed economy, because the mixed economy is clearly no longer stable. It is so over-balanced towards the state sector that it is perhaps a moot point to say the question is one of retaining the mixed economy. It is perhaps more appropriate to ask whether we wish to *re-instal* the mixed economy.

Emancipation is independence

The Labour Party constitution sets the aim of emancipating the workers 'by hand and by brain'. Surely emancipation should be defined as independence, as the workers who supported the American Revolution believed. But what independence is there for people locked into a system which forces them to rely exclusively on the patronage of state and trade union politicians and bureaucrats? Perhaps I can recall here Professor Herbert Frankel's contribution this morning, when he talked about people not much caring who at the top spends and invests money. I think that is true; the question is: how far is an increasingly indigent population (because that is what it amounts to) prepared to accept what bureaucracy dictates? And when, and if, they rebel, do we get more freedom or a police state?

I believe we are at a watershed in this country. The situation is infinitely more grave than much of the discussion I have heard here today seems to indicate. And perhaps far more grave than many here realise. You see, social democrats who have always said they believe in the mixed economy and a healthy private sector have stood by quietly for years watching this happen and, as the assault becomes ever more vicious, they still say nothing, or they go away to Brussels, or they resign from public life.

No liberation by collectivism

Social democrats must admit that the workers by hand and by brain have not been liberated by collectivism and corporatism, and if they want a mixed economy they must find the political courage to redress the present imbalance. They must be willing to support a rolling back (and it is going to be a very difficult one) of the state sector and a concomitant reduction in taxation. They must be ready to face the confrontation and protest and difficulty that is bound to result.

Now one can well ask why in the world we should expect this of social democrats when we cannot even expect it of the Conservative Party on recent form. First of all, social democrats traditionally view liberty as more a question of human and civil rights than merely the protection of property rights. Second, it is the social democrats who have always been the barrier to Marxism-Leninism. They have always been in the front line, and it is to a large extent because they have let that front line down to the ground and have allowed Marxism to march across that they bear such a heavy responsibility. The people to the right of the social democrats thus find themselves in a position which they have not been prepared for, facing forces they do not understand and often fail to recognise. Therefore, unless social democrats finally face up to the intellectual consequences of their timidity and reassert what they have always claimed to believe, they might as well join the Tribune Group and write articles for the *Morning Star*.

Professor Pearce has dealt with morality and I think he is absolutely correct to bring that into the discussion. At the end of the day; we are talking about a moral question and therefore a question of leadership for all democrats, whether academics or industrial and trade union leaders or politicians. Unless we restore the moral will to be independent, we will continue to sink into slavery; and discussions about details of tax reform will remain purely academic.

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Lord Houghton

'. . . tax avoidance . . . is not a moral issue. Tax evasion is different . . . but only when it is breaching the moral laws and not the tax laws.'

* * *

Dr Bracewell-Milnes

'. . . tax avoidance and evasion may serve the public weal by reducing public expenditure or increasing the yield of tax. Tax avoidance and even evasion may be a form of public service, in consequence if not in motive.'

Dr Clark

'. . . a government which has departed from justice is nothing but large-scale gangsterism. Social justice means respecting the rights of groups. It certainly does not mean an attempt to create equality, or the transfer of income from one section to another by arbitrary decision, or legislation conferring special favours on any section.'

Professor Elkan

'If people were today asked in a referendum whether the present allocation between the private and public sectors was that which they would choose if they could start from a clean slate, with all that it implies in taxation and borrowing, only a minority would say "yes".'

Professor Pearce

'Complaints that 60 per cent for the government share of GNP might be too high were met . . . by the suggestion that [it] could be reduced to 50 per cent by eliminating items paid to and received from nationalised industries, and by reforming the basis on which debt interest is included in public sector accounts. The public must not be misled by this sophistry. As long as the question is what proportion of GNP is spent or redistributed by committees the answer remains *"more than 70 per cent".*'

Professor Prest

' . . . there can be no question about the UK's enormous distinction in [the] international comparison . . . of personal income tax . . . it is [this] system which has done much to foster the feelings about penal servitude.'

Professor Rowley

'The self-seeking citizen will engage in political participation [to resist coercion by taxation] only if the expected benefits exceed anticipated costs . . . the more important instruments are six: (i) voting, (ii) pressure-group formation, (iii) social movements, (iv) individual economic adjustment, (v) revolution, and (vi) migration.'

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IEA THE INSTITUTE OF ECONOMIC AFFAIRS

2 Lord North Street, Westminster, London SW1P 3LB