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PLANNING AND THE PRICE MECHANISM

by the same author

AN INTRODUCTION TO ECONOMIC
ANALYSIS AND POLICY
THE ECONOMIC BASIS OF
A DURABLE PEACE

PLANNING AND
THE PRICE MECHANISM
THE LIBERAL-SOCIALIST
SOLUTION

BY

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PREFACE

Many economists have recently published their views on the great economic issue which now confronts us : to plan or not to plan. Professor Hayek's *Road to Serfdom*, Professor Robbins' *The Economic Problem in Peace and War*, Professor Jewkes' *Ordeal by Planning*, Mr. Harrod's *Are these Hardships Necessary?*, Sir Hubert Henderson's Rede Lecture on *The Uses and Abuses of Economic Planning* and Professor D. H. Robertson's lecture to the British Association on *The Economic Outlook* are all notable contributions to this great debate. I too have not been able to resist the temptation. The following chapters began as a review of Sir Oliver Franks' *Central Planning and Control in War and Peace*, but grew inevitably into the present book.

Am I a planner ? If a planner necessarily believes in a quantitative programme of output, employment and sales for particular industries, occupations and markets and the exercise of such direct controls by the State as are necessary to carry this out, I am certainly no planner. If an anti-planner necessarily denies that the State should so influence the working of the price mechanism that certain major objectives of full employment, stability, equity, freedom and the like are achieved, then I am a planner. The thesis of this book is that a large measure of state foresight and intervention is required to guide the economy from war to peace, to prevent inflationary and deflationary pressures, to ensure a tolerably equitable distribution of income and property, and to prevent or to control the anti-social rigging of the market by private interests, but that these objectives can be achieved in an efficient and a free society only if an extensive use is made of the mechan-

isms of competition, free enterprise and the free market determination of prices and output.

The more permanent principles upon which such a Liberal-Socialist society might be constructed is the subject matter of this book ; and it would be unprofitable to attempt to summarize the argument in this preface. But it may be useful to discuss here the more topical question : What immediate action would a Liberal-Socialist advocate to meet the present economic crisis ? My programme would consist of four main planks.

First, effective but equitable measures must be taken to reduce the present inflationary pressure of excessive monetary demand. So long as there is an excessive pull of demand on the domestic market, the efforts of producers and manufacturers to expand foreign sales will be half-hearted. So long as it is relatively easy to earn money but difficult to find the goods to purchase with that money, the basic incentives to earn more money by working hard and long and by moving to the most repaying occupations will be lacking. So long as there is an excess demand for all goods and for all uses of labour, however inessential, the control of inflationary rises of prices and wage rates will be insecure, and it will also be necessary to allocate supplies and to control markets by the clumsy and wasteful method of a swollen bureaucratic machine.

But how to get rid of the inflationary pressure ? Merely to limit rises in wage rates, prices and profit margins is to play with the symptoms in a way which adds yet one more rigidity to the market mechanism. We must reduce monetary demand at the source without laying the burden unfairly on those least able to face a reduction in their purchasing power. The Budget of April, 1948, is a real landmark. It firmly establishes the peacetime Budget as a main instrument of control over inflation and deflation. But does it complete the present necessary "dis-

inflationary" treatment, particularly in so far as the demand for capital goods is concerned? The following are the remaining proposals which I would tentatively put forward in this field : a substantial cut in the food subsidies combined with an appreciable increase in family allowances and old-age pensions ; as soon as practicable, a straight-forward capital levy on a considerable scale ; an examination of public expenditure to eliminate all unnecessary outlays ; some scheme for the temporary taxation of the domestic purchase of capital goods such as plant, machinery, buildings, etc. ; a contractionist banking policy leading to some reduction in supplies of money and liquid assets and some rise in interest rates.

Such measures must be considered as a whole. Economies in public expenditure (including reductions in food subsidies), increases in taxation, reductions in the supply of money and higher rates of interest would all help to restrain the money demand for goods and services for personal consumption and for capital development. The increases in family allowances and old age pensions would help to relieve the incidence of reduced subsidies upon those least able to bear the burden. The capital levy would ensure that the property owner made his fair contribution ; and expenditure out of capital sums would be greatly discouraged by the reduction in the supply of liquid assets and by the rise in interest rates which would cause a depreciation in the inflated capital value of fixed income assets. The capital levy would reduce the budgetary burden of the National Debt, so that higher interest rates could be used to curb money demand without thereby greatly intensifying the budgetary problem.

Secondly, the working of the price mechanism should be restored piecemeal in particular markets. The price mechanism should be used again in particular markets to determine how much of each commodity or service should be produced and should be used

for each particular purpose. The immediate advantages of this would be the unthrottling of the incentives of private initiative and the demobilization of the apparatus of bureaucratic control.

It is impossible to lay down with certainty which should be the first steps in this process ; but a few potential examples may be instructive. Might not the limited imports of petrol be sold on a free domestic market to the highest bidder ? Any margin between the domestic price and the cost of the supplies in foreign markets would accrue to the State as an increased revenue, and would thus help to deflate the total volume of monetary purchasing power ; the whole apparatus of petrol rationing could be abolished ; concerns, such as bus companies or doctors, whose costs would be appreciably increased could put up their charges to cover the increased cost. Might not a similar principle be applied to steel and timber ? High present prices of such scarce commodities would provide a powerful inducement to postpone capital developments in the expectation that the cost of these essential materials would be lower in the future. Could not arrangements be made to sell electric current at a much higher price during the hours of the peak load than at other times, thus giving an inducement to avoid peak load consumption ? Might not experiments be made with a higher price for coal, in order to see how far this would have to go in order to remove controls over its consumption ? Any increased profit made by the nationalized coal mines would accrue as an increased revenue to the State and would further help to deflate total monetary purchasing power.

One particular price, namely, the rents charged for dwellings, is wildly out of line. Rents are practically unchanged from pre-war, although the general cost of living is up some 60 per cent. and dwelling space is particularly scarce. A rise in rents could not be expected to have any immediate effect in present conditions

upon the supply of houses ; but it might have a most beneficial effect upon the demand for dwelling space. The present position is grossly inequitable and grossly inefficient. Those lucky occupiers who are protected by rent restriction obtain accommodation exceptionally cheaply and have no incentive to economize dwelling space by living in a smaller dwelling, letting off rooms to lodgers, etc. Those unlucky persons (often ex-service men and women attempting to set up home) who are not in this charmed circle cannot find accommodation largely because the protected " sitting birds " have little or no incentive to make room for them. Any measure of rent derestriction could be accompanied by a temporary and diminishing tax on the occupation of dwellings which would ensure that the difference between the new and the old rents paid by tenants accrued to the State and not to the landlords—an arrangement which would further help to mop up excess monetary purchasing power. Any hardships which such an arrangement might involve could be met by higher family allowances and old-age pensions—changes which would help the needy without weakening the discouragement to excessive demands on dwelling space.

Thirdly, steps must be taken to control the export of capital. Our crisis is above all a balance of payments crisis. In 1947 we lost £972 millions of our gold and dollar reserves, though we imported only £675 millions more than we exported. The remainder was a loss on capital account. We undoubtedly have obligations to share our dollar reserves with some other members of the sterling area. But our ability to do so is most strictly limited. We must seek every means whereby these other countries may obtain their necessary supplies without drawing on our reserves and we must in any case most strictly limit such drawings. Unless this is done we shall squander our Marshall Aid, as we did a large part of the American loan, on capital exports ; and if our reserves run out before we have restored our exports, we shall

be forced to do without foodstuffs which are essential to maintain our physical strength or raw materials which are essential to keep our factories working.

Fourthly, we should do everything we can to restore the international working of the price mechanism. Our prosperity depends upon a more liberal international trading system, since we export less essential manufactured goods and import essential foodstuffs and raw materials. Protectionism must be reduced in all markets where import control is not absolutely essential for the balance of payments of the country in question. There must be possibilities for the depreciation of the currencies of the deficit countries, but competitive exchange depreciation by the countries which are not in deficit must be avoided. Deficit countries must eschew domestic inflations, and surplus countries domestic deflations. It would be of great help to us and the rest of the world if the "multi-lateral" principle could be applied to aid by surplus to deficit countries, so that, for example, European countries could purchase our coal instead of American coal with dollars provided by Marshall Aid. In other words, it is a vital interest to us to encourage the immediate application of the principles of the International Monetary Fund, the International Bank for Reconstruction and Development and the International Trade Organization. We must not fall into the foolish error that these principles are inapplicable in present international conditions.

The text of my book was finished in February 1948 before the publication of the Economic Survey for 1948 or the White Paper on the National Income for 1947, before the budget of April 1948, before the end of the Havana Conference, before the passing of the European Recovery Programme and before the many other important economic events which will occur between now (April 1948) and the appearance of this book. In present

conditions events move very quickly and books are, alas, inevitably published slowly. Particular illustrations which I have used may be out of date when this book appears ; but I doubt whether the basic analysis will be any the less applicable.

Chapter V of this book is based upon a lecture to be printed in *Economica* for May 1948, and Appendix II upon an article published in *Lloyds Bank Review* for January 1948. I would thank the Editors of these journals for permission to make use of this material. Professor Robbins read my MS. at an early stage. His comments led to many improvements of argument and presentation, although I have maintained some points which he would reject and have placed a different emphasis on a number of others.

April, 1948.

J. E. M.

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CHAPTER I

THE PROBLEM STATED

The basic principles of our economic policy are once more in the melting pot. Should we in peacetime continue a policy of economic planning? Or should we restore the working of the price mechanism? We have to resolve this issue both for the solution of the immediate and pressing problems of the transition from war to peace and also for the construction of a more permanent and lasting economic system. This book is one more contribution to the debate on this great issue. It is an attempt to sketch the principles of a middle way which no country has as yet fully attempted, but which, in the opinion of the author, it might be the genius of this country to develop.

Let us, then, plunge *in medias res* by posing the basic questions to be discussed. Should the State formulate a central economic plan for the use of the community's resources? If so, by what means should it be carried out? Should the means of production, distribution and exchange be nationalized, so that the State can acquire a more or less complete control over economic life? Or should the State hope to achieve its economic ends by exercising a number of direct controls—such as rationing, licensing, labour direction, production direction—over an economy which consists primarily of private enterprise? Or can the State hope to achieve its ends by working out a plan for the use of the community's resources in co-operative consultation and voluntary agreement with employers', workers' and consumers' representatives, which will then be implemented by a gigantic gentleman's agreement on a national scale? Or can the State hope to achieve its plans by so rigging the market—through price and wage controls and changes in the rate of interest, the rate of exchange, and rates of taxation and subsidies—that private business and private persons are induced to do that which the State plans that they should do? Or were Adam Smith and his followers after all right? Would

it be better for the State to withdraw from business and to let the unregulated price system determine the use of the community's resources?

(a) The Case for State Control and Planning.

We are all aware nowadays of the strong case for State planning and control. I will leave altogether on one side the argument from considerations of National Defence. During the war this consideration was, of course, paramount; and the principles and modalities of State intervention had then to be considered practically entirely from the point of view of achieving the single national objective, with which all citizens were in agreement, of bringing all economic resources to bear upon the achievement of victory. In peacetime this consideration is also of great importance, now that it is known that any future war will be a total war; to mention only two examples, the localization of industry has a strategic importance and the protection of particular industries must be considered from the point of view of the possible requirements of a future war. But I wish to leave this matter on one side and to consider the central issue of State planning and intervention solely from the point of view of the economics of welfare.

The "welfare" arguments for extensive State intervention are not, of course, a post-war phenomenon. In this country they were much developed during the inter-war period, and it is, I think, possible to trace them to three main strands of inter-war experience.

First and foremost was the inter-war experience of mass unemployment. By the end of the 1930's there was widespread, in fact practically general, agreement that the State should at least intervene to control the total demand for goods and services so that the community should not again experience periods in which in all industries and regions simultaneously there was a deficient demand for goods and services and so for labour. And some persons had drawn the further conclusion that for action to be effective on these lines the State must plan in some detail the use of all the community's resources in order to ensure for them full and productive employment.

Secondly, there was a growing realization of the shocking inequalities of income and property which *laissez-faire* had produced. There was widespread agreement that something more should be done about it; and, here again, there was developing a school of thought which held the view that an effective remedy could be found only through so extensive a system of State control of the community's resources as to make possible a centrally planned distribution of the product of industry.

Thirdly, there was a growing consciousness of those wastes of competition which result when there is, for one reason or another, a divergence between the private and the social interest in an economic act. The meanness of sprawling ribbon development and of the unplanned growth of suburbia; the wastes of much competitive advertisement whereby the consumer was bluffed and deceived rather than informed; the exploitation of consumers and workers by monopolistic concerns which were in a sufficiently powerful position to rig the market in their favour:—all these convinced many persons that it would be wise to replace the profit motive which could have such ugly results by planned production for the common good.

But in addition to these pre-war arguments there is a special post-war argument for the transitional period through which we are now passing. The whole structure of our economy has to be changed on a scale and with a speed which is quite unprecedented in normal times of peace. Huge numbers of persons have had to be transferred from the Armed Forces and from war production to production for peacetime purposes. Some of the tasks on which these persons are employed are themselves of a special and temporary nature, such as the repair of war damage and deficiencies, so that further extensive changes will be required. In 1947 we had an adverse balance of current payments of some £675 millions a year; we are to end 1948 with our balance of payments balanced. This means a vast increase in exports or decrease in imports. The whole structure of relative supplies, of relative prices and costs, must be changed extensively and rapidly.

Now it is arguable that there are many things which the uncontrolled pricing system can manage well in a position of fairly

calm equilibrium, which it cannot manage even tolerably if conditions are undergoing such cataclysmic changes. When it is a question of it becoming a little more profitable to produce this, and a little less profitable to produce that, private risk-bearers can reasonably plan their operations to meet the changed circumstances, and thus gradually move resources to where they are most required by society. Mistakes will be made; but the evil social effects of even these mistakes can often be met by the shock-absorber of stocks. If slightly too few bricks are in fact being produced for the number of houses in process of building, the building industry can live on its stock of bricks until the higher price of bricks which will result stimulates a greater output. But when the number of houses to be built may change by a huge percentage, this percentage itself depending upon supplies of imported timber, the purchase of which in turn will depend upon whether the engineering industry can treble or only double its exports, which in turn will depend upon whether the State's demands for armaments and munitions are to be halved in the course of the year, it is difficult for private risk-bearers to judge with any accuracy how many bricks to plan to produce.

In such circumstances, there is a strong argument for the State centrally to put together a picture of the way in which all the main pieces of the jig-saw puzzle will fit together into a coherent whole, say, a year or so ahead. Whether or not this picture should then be used merely to inform private risk-bearers of what they would be wise to anticipate, or should be used as a planned pattern to which the future economy of the country should be compelled or induced to adhere, is, of course, another matter which raises the central controversial issue which it is the purpose of this book to discuss.

Moreover, when changes are large and rapid and, in particular, when they may need to be reversed again quickly, there are special difficulties in relying solely on the price mechanism for the purpose of bringing them about. For example, suppose that it is necessary to increase the manpower in the textile industry by a large percentage in a short period of time. The price mechanism would operate through a rise in the wages of textile workers relatively to other workers. This rise might have to be very great

indeed in order to attract the desired number of workers into the textile industries within the desired period. Thereafter, the rate of textile wages might have to be put down again sharply in order to prevent a continuing influx into the industry. But there are obvious difficulties in raising textile wages by 100 per cent. and a year later reducing them again almost to the previous level.

In the case of many commodities this last argument does not apply. For example, if steel is very short now but will become plentiful in two years' time, to raise the price of steel by 100 per cent. now and to reduce it again to its previous level in two years' time may be most useful in that it would give exactly the right inducement to postpone all postponable demands for steel. But here another difficulty presents itself—namely, the problem of equity. If the commodity in question is produced by private enterprise, should the private producers be allowed to reap the scarcity windfall profits which would result from such a use of the price mechanism?

(b) Planning without Prices.

There are many persons who would wish to solve our basic problems through the formulation of a State plan giving quantitative targets for the output of each industry of any importance and for the use by these various industries of all the factors of production of any importance. Such a quantitative plan would in many cases also cover the main uses of the planned production of each industry—how much, for example, of the output of the engineering industry was to be exported, how much used for each main form of capital development at home, how much for the provision of certain durable consumers' goods, and so on. The whole plan would then be implemented by a series of State controls. Raw materials and capital goods would be allocated and licensed to achieve their planned use; labour, if the proponents of this system are both clear-headed and honest, would be directed to the planned employments; and the consumption of many, if not of all, products would be subject to rationing and licensing. Full employment and security would be achieved, since the plan would account for all available resources. Equity would be assured, since by rationing and licensing of consumption

each citizen would be guaranteed a fair share of the product. The social wastes of competition would be avoided since the plan would take account of social, and not private, interests. A consistent and coherent plan would be constructed for rapidly changing conditions so that at every stage each component would dovetail into an harmonious whole.

The above is, no doubt, in many respects a caricature. But it will serve to demonstrate certain dangers and disadvantages of methods of planning which rely not upon the price mechanism but upon direct control over quantities of production and consumption. For on examination such a system is found to be not very attractive.

In the first place, the method of direct controls contains a threat to personal freedom. It is not merely that it threatens our freedom of choice as consumers, important though this is. Why, for example, should I be prevented from spending foreign exchange on foreign books or foreign travel if I am willing to spend so much less than my fair share on other imported goods or on home-produced goods which could be sold abroad for foreign currency? The pricing method (e.g., by auctioning the available supplies of foreign exchange to the highest bidder) would permit this. The method of direct controls must imply an arbitrary decision by an anonymous official as to whether I can visit my foreign friends or read their publications.

But the most dangerous threat to freedom arises from the problem of allocating labour as a factor of production among its various alternative employments. The method of the pricing system would be to allow relative wage rates to rise in those occupations in which there was a relatively high demand for labour and to decline in those occupations in which there was a relatively low demand, and to see that there was the greatest possible ease of movement from the low-paid to the high-paid occupations. The alternative, the direction of labour, is the hallmark of the Servile State; and it is a sobering observation that there appears to be at present a widespread preference for this alternative.

In the second place, a system of direct quantitative controls is the breeding ground for spivery and corruption. It is the father

of black markets and carries with it an insidious threat to public morality. To make it a crime, or at least bad form, to buy in the cheapest and sell in the dearest market is to expose every citizen every day of his life to a temptation to break the law or the recognized conventions of society. To give central and local officials the daily task of handing out, on what must inevitably be to a large extent arbitrary considerations, pieces of paper called permits or licences of great value to the fortunate but limited number of recipients is to expose our fine and honourable public service to a strain which may in the end prove unbearable,

Thirdly, such a system of planning through direct controls involves the use of much manpower and other economic resources merely in working the controls. There can be no doubt that the system of free markets, though, of course, it involves some manpower, is much less expensive than a system of planned allocations. In this connection it is interesting to note that the number of central and local government officials increased by 700,000 between 1939 and 1947. This increase is not, of course, to be explained solely by the growth of direct economic planning. But, on the other hand, it does not take into account the effort expended by the private citizen and by private business itself in coping with the controls.

Fourthly, the method of control by the quantitative allocation of resources, quite apart from the real costs of manpower in running the controls, is bound to be clumsy, inefficient and wasteful as compared with a properly functioning price system. Take, for example, the apparently simple question whether one should plan to substitute steel for timber for a certain purpose in building. Is it economic to do so? What are the factors which the official concerned must take into account?

He must first consider the technical possibilities of substituting steel for timber in this particular use. How much more steel is required to replace a given amount of timber, and what will be the effect on the quality of the building? Unfortunately for him, the people who really know about this are not his fellow-officials but the technicians in the building industry who have a vested interest in the question and have, let us suppose, set their hearts

upon getting the timber rather than the steel, because, at the arbitrary money prices fixed for steel and timber, it happens to pay them most that way.

Then there is the question where the extra steel should come from if the substitution in building is made. Should less steel be allocated for the production of cars? If so, can less steel be used per car? If so, with what effect upon the quality of the car? And what additional supplies of alternative materials will then be required by the car industry? And where should they come from? Or must the output of cars be reduced owing to lack of steel? If so, by how much? And what is the importance to the domestic economy of this country not to have less cars or to the balance of payments not to face a reduction in the export of cars? Or should it not be cars that should be affected, but a particular sort of industrial plant, or railway locomotives, or one or more of the other thousand and one end products of steel? If so, which, and to what extent, and with what further repercussions?

What, on the other hand, should be done with the timber which is saved? Should it go to railway sleepers or to packing cases? Or can it release the use of some other material in some other industry? If so, what and where are the myriad alternative possibilities, and what is the importance of each from the point of view of the welfare of our consumers, of the efficiency of our industry and of our export drive?

Perhaps after all it would be better to produce more steel. If so, what should one give up producing in order to get the additional labour? Coal? Bricks? One could run through a long list. But this would only shift the problems from steel to other commodities. One would now have to consider all the direct and indirect effects of reduced supplies of coal or bricks or the other commodities selected for reduced production.

Or perhaps one could import less timber and more steel. Here one may be able to reach a fairly unequivocal answer; for one can judge whether the decreased purchase of timber will save more dollars than the increased purchase of steel will cost. The firm foundation of the price mechanism at last!

In fact it is the miracle of a properly working pricing system that it will answer all these questions simultaneously, taking into

account all the relevant considerations, without a centralized bureaucracy attempting to solve, without the necessary knowledge, the myriads of simultaneous equations involved. If the prices charged to domestic consumers of steel and timber bear the same relationship to each other as the prices at which steel and timber can be purchased in foreign markets, each user will, to maximize his own profit, substitute steel for timber or timber for steel if the saving in cost (and so in foreign exchange) is sufficient to compensate for any real loss in the quality of his product. If the prices of the various products which are made out of steel or other materials correspond to the costs of producing them, consumers will be induced to purchase few of the products which contain much steel, if steel is relatively scarce and therefore high in price. If the price of coal, bricks and steel all correspond to the value which the users of these commodities will place upon them—and the users will themselves take into account the possibilities of substitutes and of alternative uses—then automatically more steel and less bricks will be produced if steel is really more needed throughout its myriad uses than bricks and coal are needed through the myriad uses of bricks and coal. And the export trade will automatically be concentrated on those things which we can produce most efficiently and which have the smallest content of the scarcest, and therefore most expensive, materials.

There can be no doubt that money and the pricing system are among the greatest social inventions of mankind. Properly used they should be capable of giving each individual a general command over his fair share of the community's resources; of allowing each individual to decide for himself—where private choice is appropriate—in what form he will exercise this command; of allowing initiative to individual producers and merchants—where technical conditions permit—to produce what is most wanted, in the most economical manner, in the markets where supplies are most needed; in short, of combining freedom, efficiency and equity in social affairs.

(c) The Controlled Use of the Money and Price Mechanism.

We are faced then with this dilemma. State planning and intervention seem to be needed to prevent the recurrence of mass

unemployment, to ensure a tolerably equitable distribution of income and property, to avoid the anti-social wastes of much of the competitive process; and to co-ordinate the vast changes required in our economic structure in the present temporary, but perhaps somewhat prolonged, period of transition from war to peace. On the other hand, when one examines the possibilities of quantitative planning, one cannot but be appalled by the prospects of insidious threats to personal freedom and to public morality, of a swollen bureaucracy and of clumsy inefficiencies.

The only way out would appear to be to make a controlled and planned use of the money and pricing systems. Such a solution would combine as much as possible of the decentralized freedoms and peculiar efficiencies of the price mechanism with that large extension of the field for State planning and control over total money demand, over the distribution of income and property, and over private monopoly which is necessary to avoid the chief evils of the inter-war system. And a controlled use of inducements, through the mechanism of the money and price system, although, for reasons already examined, it could scarcely be relied upon alone to accomplish the rapid and large structural changes which are needed, might do much to influence the adjustments required in the present transitional period.

We have ourselves much to gain from the pursuit of this kind of policy. But in addition, this country at this particular time might perform a great international mission by the adoption of such a principle of economic policy—a mission wholly in accord with its ancient role as leader in the development of political, social and economic ideas and institutions. The present time is important, because, in a very special sense, many countries now stand at the parting of the ways—to plan or not to plan, to use the price mechanism or not to use the price mechanism. And the solutions which they now adopt will mould their policies and institutions for many years to come. But above all this country is in a key position. Standing as it does between the Communism of the Union of Soviet Socialist Republics and the Capitalism of the United States of America, enjoying as it still does great prestige and influence in other countries, and led as it is by a government whose express desire it is to find an efficient middle

way,¹ it is in a unique position by its own example to influence the course of world events if such a middle way can in fact be found and effectively applied.

This middle way, which—for reasons which will I hope become clear—I have called the Liberal-Socialist Solution, must proceed by making full use of the money and pricing systems, but so controlling those systems that three fundamental conditions are fulfilled: first, that the total monetary demand for goods and services is neither too great nor too small in relation to the total supply of goods and services that can be made available for purchase; secondly, that there is a tolerably equitable distribution of money income and property so that no individual can command more than his fair share of the community's resources; and thirdly, that no private person or body of persons should be allowed to remain uncontrolled in a sufficiently powerful position to rig the market for his own selfish ends. This book is devoted to a discussion of the principles involved in achieving these ends and of the very extensive measures of State planning, ownership, control and intervention which their achievement involves.

¹ Cf. the Prime Minister, Mr. Attlee's, broadcast speech of January 3, 1947, in which he said:—

"At the one end of the scale are the Communist countries; at the other end the United States of America stands for individual liberty in the political sphere and for the maintenance of human rights. But its economy is based on capitalism, with all the problems which it presents, and with the characteristic extreme inequality of wealth in its citizens. As a new country with immense resources it has not yet had to face the acute problems which have arisen in the other capitalist countries.

"Great Britain, like the other countries of western Europe, is placed geographically and from the point of view of economic and political theory between these two great continental States. That is not to say that our ideas are in any sense 'watered-down capitalism' or 'watered-down Communism'; nor that they constitute a temporary halting-place on a journey from one creed to the other. Ours is a philosophy in its own right. Our task is to work out a system of a new and challenging kind, which combines individual freedom with a planned economy, democracy with social justice. This task, which faces not only ourselves, but all the western democracies, requires a Government inspired by a new conception of society, with a dynamic policy in accord with the needs of a new situation. It could not be accomplished by any of the old parties, nor by a totalitarian party, whether Fascist or Communist."

CHAPTER II

THE CONTROL OF INFLATION AND DEFLATION

(a) The Evils of Inflation and Deflation.

The 1930's taught us the evil consequences of a deficiency of total monetary demand for goods and services. When, for one reason or another the total amount of monetary purchasing power falls off and money expenditure on all sorts of goods and services in consequence declines, all lines of production in all regions become more or less simultaneously unprofitable. Workers are dismissed and output is reduced. The evil spreads in a vicious circle. A decline in the demand for shirts reduces the incomes of shirtmakers who have less to spend on boots. Bootmakers are thrown out of work and have less to spend on furniture; and so on. Mass unemployment of resources results. The real income of the community is reduced and—(particularly in those areas in which unemployment is most highly concentrated)—standards of living are quite unnecessarily lowered, while productive power runs to waste in idleness. But perhaps more important than this material result is the spiritual malaise resulting from the feelings of frustration which must accompany unwanted idleness in a world of poverty. We are all agreed that measures must be taken to stimulate total monetary demand and to prevent it from falling below the level necessary to sustain a high output and high employment when the time next comes—as sooner or later it assuredly will come—when a deficient total demand threatens to engulf us in a major depression.

But the evils of an excessive monetary demand are also very great. If they are examined here at somewhat greater length than those of deflation, this is not because they are thought to be greater or more important. It is merely that they are less clearly understood. During the period of mass unemployment in the 1930's many particular evils—the failure of business men to go ahead with new equipment in this particular backward industry

or the failure of labour in that particular depressed region to move to another job elsewhere—were ascribed to every particular circumstance except to the general root cause, the all-pervasive lack of profitable markets. We have at last realized that no business man can have any motive to improve his capital equipment if he can see no market for its product nor a worker to leave a depressed area if he can see no profitable employment elsewhere. But during the present years of inflationary pressure we ascribe each particular difficulty to a particular circumstance rather than realize how much of our troubles are due to the too much money which is chasing the too few goods. We did our Deflationary homework in the 1930's, but unfortunately we have not yet learned our Inflationary lesson.

Inflation may be either "open" or "suppressed." In conditions of "open" inflation, too much money chasing too few goods drives up the prices of those goods. That drives up the money incomes of those producing the goods. That in turn increases the amount of money purchasing power and so prices rise still further. People begin to spend all the available liquid funds which they can on goods in anticipation of further price increases. There is a flight from money to goods, which drives up prices and money incomes still more. The process brings with it great inequities of distribution. Fixed incomes—including family allowances, old-age pensions and the like—lose their value, and those who are quick to speculate on commodity prices gain. Property fixed in money terms—including most small savings—becomes worth less and less, while risky equity shares rise in real value because the real value of all debts diminishes.

This process is not, of course, all loss. By reducing the real value of debts industry is relieved of a burden and the Government is relieved of part of the real burden of the National Debt; and for this reason some price increases after a period of abnormal growth of fixed money debt (such as the growth of the National Debt during the war) may be a useful, if a rough and ready, way of reducing the debt structure. But if the process of rising prices proceeds too rapidly, business efficiency and production suffer from the chaos which results from the fact that money can no longer perform its function of a stable measuring rod in which contracts of all kinds can be fixed and debts and credits

measured. People will not receive payment in money but only in goods. There is a return to barter.

Even if the evil does not go to this length, it carries with it a serious threat to future stability. Rapid price rises cannot be allowed to continue indefinitely and at some point something will be done to stop the rise in prices. But there will be much demand for goods and services during the inflationary period which is taking place merely because prices are rising, because people are buying goods to hold to sell at a large money profit later. As soon as steps are taken so to restrict total money demand as to stop the rise in prices, all the demand for goods which was taking place merely because prices were rising will, more or less suddenly, cease. This will bring with it the grave danger that total demand will then decline too much and the vicious spiral of deflation and mass unemployment will be released. A position of rapidly rising prices is in fact a very unstable one. History has shown it to be difficult to stop an inflation without causing a deflation; and to prevent an inflation of prices and incomes from developing is therefore a matter of importance from the point of view of making it easier to avoid deflation and unemployment at a later date.

This country has experienced a not inconsiderable dose of "open" price inflation in recent years.¹ But we have suffered much more from "suppressed" inflation. It has become the practice of many countries, including this country, to deal with an excess of monetary purchasing power by a system of controls over prices and over expenditure which prevent the too much money in its search for the too few goods from driving up the price of the latter. This system of "suppressed" inflation has no doubt avoided many of those particular evils of rapid price increases, which are examined above; but it has brought its own peculiar evils with it.

¹ This is illustrated by the following figures:—

			<i>Index of Money Wage-Rates.</i>		<i>Wholesale Price Index.</i>
1939 (September)	...	...	100	...	100 (a)
1944 (Average)	...	...	142	...	161
1945 "	...	...	149	...	164
1946 "	...	...	161	...	170
1947 "	...	...	168	...	186
1948 (January)	...	...	173	...	206

(a) Average for 1939.

The control of prices of finished products prevents a price inflation, but does not itself reduce the excessive demand for such goods. This excessive demand for final goods on the domestic market continues to exert its pull and sucks goods away from other uses, in particular from export markets and from stock building.

The excessive pull of demand in the home market has undoubtedly been a main factor attracting goods and services away from export markets. If the total internal monetary demand were restricted to correspond to the amount of goods and services which would be available in the home market if we had no excess of imports over exports, producers at home would not be able to find profitable markets at home for all that they produced unless they sold abroad as much as our imports. They would have the strongest motive of profit to divert supplies from the home market and to seek export markets. (See Chapter 5.)

When the suction of money demand is so great that everything is pulled into final consumption as soon as it is produced, there is a grave danger that working stocks will be unduly depleted. The fact that with unduly low stocks of coal a sharp spell of bad weather can bring the whole industrial life of the country to a standstill is only an extreme example of this point. Too low a stock of bricks will seriously reduce the output of workers in building because some workers will be idle waiting for more bricks to arrive, while others will be working slowly in the fear that their stock of bricks will run out and their job come to an end. These principles run throughout the economic system: at every stage there must be adequate stocks of raw materials, of goods in process, of components and of finished products. And stocks are one of the first elements to suffer when an attempt is made to get a quart of final consumption out of a pint pot of resources.

These particular evils—the sucking of goods away from export markets and out of stocks—could be avoided without any reduction in the total amount of monetary purchasing power available on the internal market for the purchase of goods and services, if adequate direct controls were exercised not only over the prices of finished goods, but also over the domestic purchase of goods and services. Suppose that every purchase of goods and services

for consumption or for capital construction were subject to rationing or to a licensing system. If the number of ration coupons and licences issued were strictly limited to the amount of goods and services which would be available after adequate provision had been made for exports and stocks, the evils so far examined would be avoided.

There are, however, other evils which are inherent in a condition of "suppressed" inflation. Foremost among these disadvantages is the fact that the incentive to work hard to earn a money income is much diminished. This has reached an extreme form in Germany where, quite apart from the great amounts of liquid capital available for expenditure, the worker can earn in a relatively short time all that is necessary to purchase his meagre rations and where the purchase of practically everything depends not upon earning the income to buy it but upon obtaining the necessary licence—a circumstance which may help to explain the fact that in the Anglo-United States zone of Germany industrial production at the end of 1946 was only 35 per cent., and at the beginning of 1947 only 27 per cent., of the pre-war level despite an almost complete absence of unemployment.¹ To a lesser degree we have been suffering from the same phenomenon. It has been estimated that money wage earnings rose in the case of men by 75 per cent., and in the case of women by 101 per cent., between October, 1938, and October, 1946, and that retail prices on the basis of working-class consumption of 1937/38 rose by only a little more than 60 per cent. between 1938 and mid-1947.² Money earnings have thus risen more than the cost of living which is held down by the subsidization of food prices at a cost of some £400 millions a year. There is thus a childish monetary pretence that the average wage-earner is appreciably better off than pre-war. Of course, in fact he is not. But the fact that he can obtain his money income with relative ease, while the goods and services which he would like to purchase are difficult to come by, means that incentives to work hard and long and to move to the most remunerative employments are

¹ See "Germany without Incentive." By the Hon. Maxwell Stamp. *Lloyds Bank Review*, July, 1947.

² Cf. "Retail Prices," by R. G. D. Allen, and "Earnings and Hours of Work," by A. L. Bowley. London and Cambridge Economic Service. August, 1947.

weakened and explains in large measure absenteeism, the demand for shorter working hours and other forms of behaviour whereby leisure (which is unrationed, unlicensed and untaxed) can be obtained. If we had all known that we had to work hard and long in order to obtain the money income required to bring our standards of living up to the pre-war level (a state of affairs which corresponded to reality), our production would be greatly increased. Selfish motives would support the precepts of public exhortation.

Finally, a condition of "suppressed" inflation makes it impossible to use the pricing mechanism and necessary to rely upon a system of direct controls in its place. To rely on the price mechanism would involve allowing an uncontrolled rise of prices so long as total demand was in excess of total supply. But if prices are held down, the distribution of resources becomes quite arbitrary, and there is no guarantee that inessential and frivolous uses will not be satisfied while quite essential uses go unsatisfied. A person at the back of the queue who wishes to satisfy an essential need cannot outbid a person at the front of the queue who is buying for an altogether frivolous purpose. And the same forces are at work in the labour market as well as in the market for goods. When there is an excess demand for labour in every occupation, however relatively inessential it may be, either a wage inflation must be permitted or else there is no guarantee that the essential industries can get labour in priority over the inessential industries. In consequence a bureaucratic apparatus of control grows up for rationing or otherwise allocating the supplies of all goods, services and other resources of any importance. And this brings with it all the evils of losses of personal freedom, threats to public morality, costs of a swollen bureaucracy, and clumsy inefficiencies of direct controls, which were examined in Chapter I.

(b) The Problem of Estimation.

For the above reasons, we shall make no progress until we take effective steps to keep total monetary purchasing power in line with the total available supplies of goods and services. How can this be done? The question must be tackled in two parts. First, how can one estimate the probable future excess or deficiency of monetary purchasing power? Secondly, having

made such an estimate, what measures can one adopt to suck out or to pump in more monetary purchasing power, as the case may be?

In the matter of estimation great technical advance was made during the war with the preparation and publication of estimates of the National Income and Expenditure. In all the war budgets of Sir Kingsley Wood and Sir John Anderson from April, 1941, onwards this technique was used to forecast how much monetary purchasing power should be mopped up in increased taxation in the forthcoming budgetary period. I suggest that this technique should be reintroduced. It is also useful, perhaps even more useful, in times of peace.¹

Thus it is possible to assess for some future period, say, the coming year, what the value of the national product of goods and services will be, if unemployment is avoided on the one hand, and an inflation of money prices and wage-rates on the other hand. This may perhaps be called the Target National Income. Against this there can be estimated the demands which, on the basis of current programmes and policies, are likely to be made on the national product. This may perhaps be called the Planned National Expenditure and may be estimated under the following five main heads:—

First, there is the current demand for goods and services by the public authorities for defence, education, police, etc. The problem of estimation here is more or less identical with that of the preparation of budget estimates of the expenditure that will be involved in carrying out current policies; but the estimates must, of course, cover all public authorities.

Secondly, there is public investment, i.e., the demand for goods and services for purposes of capital development by public bodies of all kinds. This involves the consideration of investment programmes of departments of the central and local governments on roads, telephones, houses, schools, etc., and of the boards operating socialized industries and covering, for example, capital development in the railways, in electrical generating plant, coal mining and so on. This estimate can also be made on the basis of existing programmes and plans.

¹ Mr. Frank Paish and I have made an attempt to use the technique for peacetime purposes. See "Aggregate Supply and Demand at the End of 1948," London and Cambridge Economic Service, February, 1948.

Thirdly, there is the demand for goods and services by persons for personal consumption. In this case, if the desire is to reduce the need for rationing and similar controls of consumption to a minimum, it will not be possible or appropriate to prepare estimates on the basis of governmental programmes or plans. An estimate must be made of the total amount which persons would wish to spend on consumption goods and services at uninflated prices given the size of the personal incomes which will be available for spending or saving if, in fact, (i) the Target National Income is achieved, and (ii) the taxation of incomes continues at the provisionally planned level. This sum is, of course, peculiarly difficult to estimate in present conditions. How much of their incomes after payment of taxes persons would wish to save and how much they would wish to spend (assuming a large range of controls over consumption to be removed) can only be judged on the basis of past experience; and past experience is difficult to assess in conditions in which (a) owing to the war there is a large backlog of demand for durable consumption goods, (b) there is a large amount of liquid capital funds (cash, deposits, small savings, etc.) accumulated during the war period of austerity and awaiting expenditure, and (c) the distribution of incomes after taxation is very much more equal than before the war. All three of these special complicating factors would, however, suggest that the propensity to spend on consumption out of a given income would now be a good deal higher than before the war.

Fourthly, there is private investment, or the amount which private industry plans to spend upon capital developments in the forms of new plant, new machinery, new factory buildings, additions to stocks, etc. If the State is continuing to control private investment by a system of direct controls (e.g., the issue of licences to build, to install plant and machinery, etc.), there will presumably be an investment programme drawn up centrally for private industry; and it is on the basis of the licences which governmental departments intend to grant in respect of work likely to be carried out in the period under review that probable private investment expenditure can be estimated. But in so far as such direct controls are not exercised an estimate must be made of the amount which private industry intends to spend in the

period under review on new buildings, plant and machinery. Here again an estimate of private intentions in present conditions would be precarious in view of the great backlog of real demands for investment purposes and the large liquid funds available to business for investment. But as times become more normal it is to be hoped that an increasing amount of information will be available by obtaining, at least from an adequate sample of businesses, information about their future investment programmes and intentions.

Fifthly, there is the balance of current international payments, i.e., the excess of the value of the goods and services which we export to foreigners over the value of the goods and services which we import from abroad to help to satisfy our domestic needs for current governmental services, public investment, personal consumption or private investment—a figure which is all too apt these days to have a negative sign! The basis on which this figure should be estimated for the purposes of these forward estimates of the national expenditure must depend upon the circumstances of the case. At the moment the Government has, and rightly has, a programme indicating the speed with which the balance of payments gap should be closed. In these circumstances the figure to be used would, of course, be the figure which would correspond to this programme, if it were successfully achieved.

In the final outcome, of course, the national expenditure composed of the sum of the above five items must (after making proper allowance for indirect taxes and subsidies) be equal to the national income. What is spent upon goods and services for these five purposes must be equal to the income which domestic producers receive for producing these goods and services. But that is not to say that the Target National Income must always be equal to the Planned National Expenditure. Far from it. If the sum of the five items of Planned National Expenditure is less than the Target National Income, it means that, unless something is done to stimulate total demand, there will be a deficient demand leading to deflation and unemployment. On the other hand, if the total Planned National Expenditure exceeds the Target National Income not all the public and private plans and intentions which lie behind the total of Planned National Ex-

penditure can be simultaneously fulfilled. Either they will be frustrated by an inflationary upward spiral of money prices and costs as the too much money chases the too few goods, or else, prices being controlled or sluggish in their upward movement, some needs—and perhaps among them some of the most essential needs (e.g., the provision of goods for exports or for building up working stocks)—will go unsatisfied simply because there are no goods left in the market to purchase.

If then Planned National Expenditure is deficient, steps should be taken to increase monetary purchasing power to avoid a depression. If it is excessive, steps should be taken to reduce monetary purchasing power to avoid the evils of inflationary pressure. The technique of estimation is the same and is continually needed as the first step towards the control of deflationary as well as of inflationary pressures.

(c) Methods of Control over Total National Expenditure.

But how, apart from a widespread use of direct licensing, rationing, etc., can total national expenditure be adequately controlled? This is, of course, an immense problem. All that I can do is briefly to indicate the outstanding possibilities under four main heads.

(i) The Timing of Public Expenditure.

First, there is the planning and timing of public expenditure. As far as governmental demands for current services are concerned there may not be much room for manœuvre in normal times, since it is not possible to chop and change quickly and frequently on such matters as the scale of a national educational or medical service. But even here the timing of the introduction of new schemes may make an important contribution to the relief of pressure on resources in times of inflationary pressure and the maintenance of demand at a later period. In present circumstances, when there are rapid changes in policy to be made, the timing of changes in current public expenditure may be a very important factor. For example, big changes are necessarily in progress in the size of the national expenditure on defence, and clearly in deciding to maintain defence expenditure at one figure rather than another due regard must be paid to the fact that in the immediate future there is a prospective strain on total resources for other purposes.

Another possibility in present conditions is the adjustment of the food subsidies. Some £400 millions a year is now spent annually on keeping down the cost of living by paying subsidies on foodstuffs. It will be argued in the next chapter that this is a wasteful way of redistributing income, that the subsidies should be radically reduced and the money so saved used in part in more effective measures for social welfare and in part to reduce inflationary pressure.

The field of public expenditure in which there is most opportunity for proper timing in the interests of maintaining a balance between total monetary demand and available supplies is, of course, public investment. Here is the archetype of the field in which forward planning of actual projects and schemes is to be desired on every ground; and there is everything to be said for the postponement of projects and slowing down of expenditure in this field in times of strain on the community's resources and for the speeding up of such expenditure when there is slack in the system. The possibilities of rapid change in the rate of expenditure on such projects should not be exaggerated. But I remain convinced that with adequate preparation of plans in advance, with a conscious development of the administrative machine so that appropriate variations in rates of expenditure can be facilitated to the maximum degree, and with a will to make the system work, much could be done in this field.

(ii) *Fiscal Policy.*

Secondly, another main method of control over the national expenditure is through changes of fiscal policy. If in times of inflationary pressure rates of direct and indirect taxation are raised persons will have less money income available for expenditure on goods and services. Monetary demand will be reduced, provided that the resulting revenue is not used by the State for additional expenditure on goods and services but is added to a budget surplus. Conversely, in times of threatened deflation demand may be stimulated by a reduction of taxation without any corresponding reduction in public expenditure on goods and services. This is certainly the most direct, effective and rapid method available for influencing expenditure on goods and services for personal consumption.

If the taxes are appropriately chosen, they may have a doubly beneficial effect. Thus, if increased purchase tax is levied on durable goods at a time of excess demand for goods and services, with the confident expectation that the tax will be lowered again in the future when the inflationary pressure has passed, not only will those who continue to purchase the commodity and thus pay the tax have less to spend on other things, but many purchasers may be induced not to spend their money at all but to put it aside for the purchase of the commodity at a future date when the tax, and thus the price of the commodity, will have been lowered again.

A somewhat similar effect in stimulating savings during an inflationary period, and expenditure during a deflationary period, might be achieved by an entirely different fiscal device. During an inflationary period rates of taxation on profits (e.g., the income tax) might be raised without raising the rate of the tax on the undistributed profits of companies; and during deflationary periods rates of taxation on profits could be lowered without lowering rates of taxation on undistributed profits. This would have a double effect. Not only would there be less profits after payment of tax in times of inflation than in times of deflation, but also there would be a tax incentive for companies not to distribute their profits during inflationary periods and not to put their profits to reserve during deflationary periods. Thus tax-free dividend incomes would be restrained or stimulated in such a way as to restrain consumers' expenditure in inflation and to stimulate it during deflation.

This would combine very happily with any arrangements which could be made to discourage expenditure on capital goods in times of inflation and to encourage the purchase of capital goods in times of deflation. Business would then have incentives in times of inflation both to build up its reserves by not distributing profits, and at the same time not to use these reserves to purchase bricks and mortar, plant and machinery. In times of deflation it would have incentives to use its reserves both for distribution to shareholders and for the purchase of new capital equipment. If, for reasons which are discussed below, it is not thought possible or desirable to rely entirely upon the rate of interest (with dear money to discourage capital construction in

times of inflation and cheap money to encourage such construction in times of deflation) a system of taxing and subsidizing capital construction might be considered. No doubt such a system would raise difficult administrative problems; but if there were now a 20 per cent. tax on all purchases of new building, plant and machinery together with the prospect of a subsidy of anything up to 20 per cent. on such purchases at some future date, the incentive to postpone all postponable capital projects now would be very great.

(iii) *The Blocking of Liquid Assets.*

Thirdly, a special remedy is often proposed for restricting expenditure in the special circumstances of the present. There is at the moment, partly as an aftermath of the war and partly as a result of the recent financial policy for low interest rates and easy money, a great excess of liquid capital funds overhanging the markets for consumption goods and for capital goods. Persons saved abnormally large sums during the war and have held them in fairly liquid form, waiting to spend some of them on the things they did without during the war. Similarly, depreciation allowances and undistributed profits which businesses put aside during the war but were unable to spend on new capital equipment; receipts of money from post-war credits; E.P.T. refunds; and payments received by businesses and individuals for war damage sustained; all these sums are now held in liquid form awaiting expenditure on goods and services. Meanwhile, in pursuance of the cheap money policy the supply of liquid funds has been greatly increased. The volume of liquid funds and of assets which can readily be cashed is now abnormally large in relation to the value of the goods and services annually available for purchase.¹

¹ See the following passage from J. E. Meade and F. W. Paish, "The Balance between Aggregate Supply and Demand." London and Cambridge Economic Service, February, 1948:—

"The magnitude of the liquid funds overhanging the markets for consumption goods and for capital goods may be illustrated by the fact that, whereas the gross national income at market prices is estimated to have risen by some 80% between 1938 and 1947, the currency circulation in the hands of the public had, in the same period, risen by no less than 200%, the deposits with the clearing banks by 150%, small savings (i.e., Savings Certificates, Savings Bank Deposits and Defence Bonds) by nearly 400%, and the rest of the internal debt in unofficial hands (which in present monetary conditions is fairly readily realizable) by 170%. The combined total of national debt, currency, deposits, excluding assets held by the banks and on foreign account, has risen by about 175%."

It is arguable that the combination of this plethora of liquid funds, together with a backlog of real needs on the part of private individuals for clothes, furniture, household equipment, motor cars, and other durable consumption goods, to say nothing of living accommodation itself, and on the part of business for the renewals and extensions of plant and equipment which could not be undertaken during the war, makes it essential to take special measures to deal with this situation before the other and more orthodox weapons for controlling monetary purchasing power can be fully effective.¹

There are many ways of dealing with situations of this kind. In countries where the main problem is an excessive note issue, a new currency may be introduced in which one new note is given in exchange only for a number of the old notes, the other notes being cancelled or paid into some form of blocked account. Thus the holders of cash are deprived of the use of a part of their liquid funds. Where deposit money is also excessive, deposits may be blocked, and perhaps in part finally cancelled, so that holders of deposits are deprived temporarily or for all time of the use of part of their deposits. Holders of other readily realizable assets, including certain small savings assets or other short-term Government securities, might also have part of their holdings blocked or be required to make forced loans of part of these funds on long-term to the Government.

Various measures of this kind have been tried, in some cases with a considerable degree of success, as a means of disinflating an inflated monetary circulation after the late war. Belgium, France, the Netherlands, Denmark, Norway and Czechoslovakia all did so in the course of 1945.² More recently, towards the end of 1947, the Union of Soviet Socialist Republics carried out an extensive operation of this kind and announced that, as a result of the consequential elimination of excess monetary purchasing power, it would be possible to abolish the rationing of consumption goods.

Such a policy is likely to be effective and may be necessary in a critical situation if no effective alternative means for con-

¹ See R. G. Hawtrey. *Economic Rebirth*, pages 46-51, and J. R. Hicks, "The Empty Economy," in *Lloyds Bank Review* for July, 1947.

² See pages 59-65 of the *Fifteenth Annual Report of the Bank for International Settlements*.

trolling an inflationary pressure can be found. But it is a very rough and ready measure and for that reason is bound to be inequitable. It would, for example, be most difficult, if not impossible, by administrative action to separate out those persons who might legitimately be left with their liquid assets from those who should be forced to wait before they can live on their capital. And yet there will be many and varied deserving cases. The young man or woman, and still more the young couple who have been putting their savings in a liquid form ready to furnish their first home, are not in the same position as the black marketeer who has been hoarding notes to purchase a new luxury car. The parents who have deposited part of their savings in the bank in order to finance over the next year or two the education of their son, and the newly superannuated professional man who is about to finance his modest retirement from the capital sum which he has received from a pension fund, present different problems from those of the libertine who is about to squander on riotous living the patrimony which he has just received. Where or how is the line to be drawn? But if no line is drawn would the resulting inequities be tolerable?

It has been suggested that a straightforward capital levy would be a more desirable method of dealing with this problem. It would certainly be much more equitable since it could cover all forms of capital with due regard to the total wealth of each owner. But unfortunately a capital levy even if it should prove practicable must in any case take a considerable time to assess and to collect; and what would be wanted for the control of inflation would be a measure which would rapidly block a large amount of liquid capital.

The conclusion is inevitable that a full-scale capital levy should be judged on its merits on grounds other than as an instrument for the prompt control of inflationary spending. (See pages 49 to 55.) The blocking of liquid assets does present an effective and probably practicable instrument of control over inflationary spending; but it is so rough and ready a measure that it could be contemplated only in extreme necessity.

(iv) *The Rate of Interest.*

Fourthly, there is the possibility of using the rate of interest as a method of control over the national expenditure.

In the first place, one should not forget the influence of cheap and dear money upon capital values and, through capital values, upon the willingness of property owners to spend money on all forms of consumption. During a period of excessive monetary demand for goods and services the capital value of Ordinary Shares and of other forms of equity property will tend to rise because profits and the expectation of future profits will improve. If, in addition, interest rates are lowered, the values of fixed interest securities, and of other forms of property yielding a fixed income, will also rise and the rise in the value of Ordinary Shares will be intensified because the higher profits will be capitalized at a lower rate of interest. In such circumstances property owners will enjoy a huge appreciation in the value of their capital, and the incentive to spend freely out of income rather than to save will be increased. If, however, interest rates had risen, the values of fixed income property would have fallen and the upward movement in the value of Ordinary Shares would have been mitigated, and the incentive to spend on the part of property owners would have been curbed. Similarly, in times of deficient monetary demand a reduction of interest rates will tend to raise, or to offset a fall, in property values and expenditure will thereby be stimulated.

But high and low rates of interest must be judged also by their effect in influencing the amount of expenditure on capital goods for investment purposes. It is not true, as is sometimes supposed, that the rate of interest at which money can be borrowed is a negligible factor in determining whether or not money will be spent on new projects for capital development. It is true that in much industrial production, where there are great risks involved, the main preoccupation of the producer contemplating the possibility of new capital development will be to decide whether there is going to be a large and profitable market for his product rather than to consider the difference made to his costs by a change in the rate of interest at which he can raise the necessary funds. But even he may not be entirely uninfluenced in the timing of his project if he knows, for example, that he could earn, say, 10 per cent. per annum on any funds available for investment by placing them for the next year or two in Government securities, whereas he is likely thereafter only to lose, say,

2½ per cent. on any money which he withdraws from such securities. But in other less risky forms of capital development—house-building, electrification of the railways, major capital reorganizations in fairly stable industries like steel—the direct comparison between the rate of profit likely to be reaped on the new development and the rate of interest at which the money can be raised is not irrelevant. It may be decisive.

But it may be argued that even though it may exercise an effective control over much investment, the rate of interest should not be used for this purpose because it takes no account of the social priorities which should be observed. But this is not necessarily so. It has already been mentioned (page 11) that an essential condition for the proper working of the money and pricing system is that there should be a tolerably fair distribution of money income and property. The next chapter is devoted to a discussion of the means whereby this can be achieved. The way to prevent the building of factories to produce luxury motor-cars for the rich instead of essential clothing for the poor, is to make the rich poorer and the poor richer—not to have a licensing system for factory building. And if, even when an acceptable distribution of income and property is achieved, it is found that, in the opinion of the individual Ministers, Members of Parliament and Officials who comprise “the Government,” too many breweries and too few schools are being built, there is an easy solution at hand—to raise the tax on beer and to spend the additional revenue on education. This argument is, of course, based upon the assumption that the price mechanism is also used in the markets for the goods which the different capital installations help to produce. But if the price of essential textiles were kept at an artificially low level by price control while the price of inessential motor-cars were allowed to go free, even with a perfect distribution of income and property it might be more profitable to undertake capital expansion in the car industry although all consumers would really prefer expansion in the textile industries. The reintroduction of the price mechanism into the market for capital goods must go hand in hand with the reintroduction of the price mechanism into the markets for finished products.

On the other hand, apart from the general objections to the

use of direct controls which have been discussed in Chapter I, there are special reasons for preferring a higher rate of interest to a system of licensing as a means of controlling expenditure upon capital development. The present is a time of great strain on our capital resources. Much capital re-equipment and renewal is necessary as a result of war damage and of the inevitable neglect of many lines of our capital installations during the war. What is wanted above all is a policy which will get peacetime production going again. We need quick returns. We should patch and Mend-and-Make-Do not only with our clothes, furniture and other personal equipment, but also with our industrial equipment, until the immediate pressure dies down. Then is the time to undertake the large, revolutionary, long-lasting reorganizations of our capital equipment. And this is exactly what people would have every incentive to do if the rate of interest were high now and were expected to be low again in the future. The large, long-lasting reorganizations which give their full yield on the capital involved only in the fairly distant future are profitable only if the rate of interest is low. At high rates of interest what remains profitable is the type of capital expenditure which is not too expensive but will make a large and quick difference to output or to costs, even though the improvement may not be very long-lasting.

At present we pretend to live in a world of 3 per cent. when in reality we have not enough capital to satisfy all the uses which would yield, say, 10 per cent. To control this solely by a direct licensing system is clumsy and inefficient. Every technician, having a proper pride in his job, will plan and put forward not schemes for Mend-and-Make-Do, but all the long-lasting attractive technical reorganizations which over the next half century will earn their 3 per cent.; and this is true of public as well as of private investment projects. The officials concerned with the licensing system must then select between these schemes, permitting some to start and stopping others. There is thus a tendency for our resources to become locked up in a limited number of fundamental capital reorganizations instead of being spread over a large number of quick-return schemes for getting immediate increases of output over a large range of our industrial and economic life. To some extent this can be corrected by

administrative rules that only the quick-return schemes will be licensed. But this is not so straightforward as saying that only those schemes which will earn 10 per cent. or more over the next year or two should be done this year and next year, with the probability that after that 5 per cent., 3 per cent. and $2\frac{1}{2}$ per cent. will become the relevant rates of interest.

In circumstances in which the yield on capital is high now but is expected to be much lower in the future, one would expect to find the short-term rate of interest (e.g., on loans for one year) very high and the long-term rate of interest (e.g., on loans which are repayable only after many years) relatively low. A concern which had money to invest and which knew that it could invest the money in short-term securities without risk of loss of capital at 10 per cent. for a year or two, would have an incentive to postpone, until the short-term rate fell again, the actual investment of the money in a long-lasting capital reconstruction which would yield, say, 5 per cent. It would spend the money now only on those projects which gave quick and high returns on the money invested.

A similar result is brought about if the long-term rate of interest is somewhat higher now than it is expected to be in the near future. Consider a perpetual bond having an annual yield of £3. At a 3 per cent. long-term rate of interest it will be worth £100, but at a 4 per cent. long-term rate of interest only £75. Suppose that the long-term rate is now 4 per cent. but is confidently expected to fall to 3 per cent. in two years' time. Then a man who invests £75 in this bond now can expect to earn £6 in interest plus £25 in capital appreciation in the course of the next two years, a yield of some 20 per cent. per annum.¹ Clearly there would be a strong incentive to postpone expenditure on projects of real capital development when such a high yield as this could be obtained over the next year or two on any capital funds invested in long-term Government securities.

What present circumstances would seem to call for is, therefore, a considerable rise in the short-term rate of interest and a moderate rise in long-term rates of interest somewhat above the probable average of future long-term rates. To have the desired

¹ Most of which, being capital appreciation, would in most cases not even be liable to income tax and sur-tax.

effect, the rise in the long-term rate must be confidently expected to be fairly temporary—an expectation which would be much encouraged by a clear explanation on the part of the monetary authorities that rates of interest would be reduced again as soon as the period of strain on capital resources had passed.

There are two further considerations which might limit the use of the rate of interest for these purposes.¹

In the first place, if a considerable variation in the rate of interest is needed to control investment, considerable fluctuations in capital values will take place. At 3 per cent. a perpetual bond yielding £3 will be worth £100; at 4 per cent. £75; at 5 per cent. £60; and at 6 per cent. only £50. Large variations in the long-term rate of interest would thus cause enormous and largely fortuitous changes in capital values involving many problems of equity. The monetary authorities might have to intervene in the capital market on a very large scale in order to raise long-term rates of interest much above, or to reduce them much below, what was expected to be the probable future level of long-term interest rates. For example, to raise the long-term rate of interest from 3 per cent. to 6 per cent. for a year or two in conditions in which it was confidently expected that the rate would then return to 3 per cent., the monetary authorities would have to sell bonds on a scale sufficient to depress their price to £50 even

¹ If for the reasons now to be examined it is not possible to rely solely upon variations in the rate of interest, it might be possible to combine a moderate use of the rate of interest with a moderate scheme for taxes and subsidies on capital development on the lines suggested above (see pages 23-4). During periods of temporary inflationary pressure (such as the present) the taxation of capital goods might provide the extra temporary restraint on capital development which was needed. During periods of temporary deflationary pressure (such as a general economic depression) the subsidization of capital goods might give the extra incentive to capital development which was required. It is, however, important not to use the taxation of capital goods instead of a sufficiently high rate of interest as the permanent and lasting measure for restraining capital development in the average year to the level required. For such taxation, unless it is confidently expected that it will be reduced in the future and replaced by a subsidy, is unlike a higher rate of interest in that it gives no incentive to concentrate on short-lived quick-return projects. On the contrary, a continuing tax on capital goods gives a positive inducement to concentrate on the long-lived projects, since the future payment of taxes on the purchase of machinery to replace the machinery now installed will be the less frequent, the longer is the life of the machinery which is now selected.

though speculators knew that the price would rise to £100 in a few years' time. Similarly, to reduce the rate of interest to $2\frac{1}{2}$ per cent. (i.e., to raise the price of bonds to £120) if the rate were expected shortly to go back to 3 per cent. (and the price of bonds to £100) would involve the purchase of securities on a very large scale by the monetary authorities for new money. It is not merely that the great fluctuations required in the volume of money might involve unorthodox monetary measures; such measures could probably, if necessary, be devised. It is rather that these great, and fairly certain, fluctuations in property values would give great opportunities for speculators to make large sums of money at the expense of the monetary authorities. This is merely a particularly striking example of the difficulty to which reference has already been made (see pages 4 and 5), of using the pricing mechanism to bring about very large and very rapid changes, particularly if these changes will probably need to be rapidly reversed.

Secondly, it is argued that dear money will seriously worsen the budgetary problem. Interest on the National Debt is a large item in the Central Government Expenditure, estimated to account for £525 millions out of a total of £3,181 millions in the financial year 1947/48. To raise the rate of interest on this debt by, say, 50 per cent. would clearly be a serious matter. It should, however, be remembered that the revenue from income tax and sur-tax would automatically increase as more income was paid out in interest on the debt, and that even the gross payment of interest would increase only as and when the existing Government Stocks reached maturity and fell due for redemption or renewal. The immediate increase in interest payments would be confined to the short-term debt; after a period it would spread to the medium-dated stocks; and so on. It might never, in fact, affect the long-dated securities, since by that time the pressure on our resources might be relieved and the time for cheap money might have returned. Moreover, the short-term debt is held at the present mainly by Government departments, by other public funds, by the banks or by foreigners as an asset in which they have invested the capital sums accumulated by them during the war. The payment of increased interest on debt held by Government departments or other public funds represents merely a

transfer from the formal budget to other public accounts. It is no real budgetary burden. Higher rates of interest might involve increased rates of interest payable by the banks to their depositors; but it should not be impossible to ensure that any net gain which remained to the banks as a result of higher interest rates in fact accrued to the State. Finally, there would seem to be no reason in equity why special arrangements should not be made for preventing any rise in short-term rates from benefiting the peculiar form of "war debts" which the foreign held sterling balances represent. In fact when the question is closely examined, it may well be found that the net budgetary burden of some rise in interest rates is not excessive.

If, however, dearer money were found to involve a substantial budgetary burden, the question would arise whether the policy of control through interest rates should for that reason be abandoned. An alternative would be to consider measures, such as a capital levy, which by reducing the National Debt itself would remove this particular argument against the use of the rate of interest. A capital levy would, of course, be a most formidable undertaking; and the case for it is examined at some length in the next Chapter (pages 49 to 55) on this and other grounds. Here it is necessary to point out that at current rates of income tax, sur-tax and death duties and at current rates of interest, there is little if any budgetary saving to be obtained from a progressive capital levy. But if the rate of interest were much higher, the net yield of the levy would be greater; and it is to argue in a vicious circle to maintain both that there must not be a levy because at existing rates of interest the net yield to the Exchequer would be small and also that the rate of interest must not be raised because, with the existing National Debt, the cost to the Exchequer would be unbearable.✓

(d) The Danger of Overdoing it.

Suppose then that through the timing of public expenditure and of public investment in particular, and through other fiscal and monetary measures, an attempt is made to control inflationary as well as deflationary pressures. Are we in danger of misjudging the situation, of cutting down the demand for goods and services excessively so that we turn the moderate evils of a perhaps tolerable degree of inflationary pressure into the catas-

trophe of a general economic depression? It is very difficult to foretell inflationary and deflationary pressures at all accurately even for short periods ahead, and inflationary pressures may give place to deflationary pressures with quite unexpected rapidity. And it is particularly difficult to estimate the future balance between total demand and total supply in present conditions for the reasons which have been mentioned above (pages 19 and 20).

It is essential, therefore, to be able to act quickly in order to turn on or to turn off monetary purchasing power rapidly even in the middle of any one "planning period." This was the outstanding feature of one particular proposal in the Coalition Government's White Paper on Employment Policy (Command 6527), namely, that the compulsory contributions to national insurance should be lowered if unemployment rose, in order to leave more purchasing power in the hands of wage-earners, and should be raised if unemployment fell to very low levels. Here is a device whereby a large amount of purchasing power spread over a large number of purchasers can be rapidly and promptly varied as conditions change. There are other devices capable of similar treatment. Purchase tax can be raised or lowered promptly at any time of the year. Income tax under more recent Pay-As-You-Earn arrangements can be varied with considerable rapidity at any time. There is everything to be said in times of inflationary pressure for an attempt to restrict purchasing power to total available supplies. And this can be done with greater confidence and assurance if there are a number of these rapid "thermostatic controls" at hand, ready to be used if it should be found that the restriction of demand has been overdone or that conditions rapidly change in such a way as unexpectedly to reduce the strain on total resources. With a sufficient armoury of these weapons we can be sure that we shall not overdo our control of inflation, and push ourselves over the brink to make a rapid and uncontrolled decline into the abyss of deflation, depression and mass unemployment.

CHAPTER III

THE DISTRIBUTION OF INCOME AND PROPERTY *fair share.*

In order that the monetary and pricing system should work with equity it is necessary to achieve a fair distribution of income and property. Great inequalities mean that the rich are given purchasing power over a large proportion of the real resources of the community, while the poor are given command over only a very meagre amount of goods and services. This is not only inequitable, although it is impossible to deny the injustices of a social system in which accidents of birth may decide whether a man or woman is to command a very large or a very small proportion of the community's resources. In a very real sense such a system is also extremely inefficient. If the rich are able to buy up milk to feed to their cats while the poor are unable to afford enough milk to feed to their babies, there is a real waste of milk, in the sense that more real human satisfaction could have been obtained if the babies had drunk more milk, even though the rich had had to contemplate the feeding of their cats on less delicious and less nourishing fare. This, in a nutshell, is the case for the rationing of milk. It illustrates the truth of the contention that if we wish to remove as much as possible of the bureaucratic direct controls, it is necessary to take radical measures to ensure a tolerably equitable distribution of income and property. Otherwise the money and pricing system is like an efficient and secure election machinery with the freedom ensured by secret ballot—but one where some people are given a thousand votes, and others only one vote, to cast.

(a) The Present Problem.

It must, however, be realized that since before the war certain radical steps in this regard have been taken. In particular, rates of taxation on income are now much more steeply progressive than before the war; the extension of old, and introduction of new, measures of social security and welfare (including children's

allowances, old-age pensions and unemployment and health benefits, a national health service and extensive educational reform) have greatly consolidated the ideas of a "national minimum" and of "equal opportunity" for all citizens; and the duties on large properties passing at death have been much raised. Those who have laboured to obtain a more equal distribution of income and property may well be proud of these achievements, which—as many members of the pre-war "upper" classes and as many workers who in pre-war days were working (or being unemployed) on intolerably low standards can testify from their own personal experiences—have brought about a quiet but complete social revolution in the last ten years.

The extent of the changes in progressive direct taxes can be seen from the following tables:—

Income	<i>Income Tax and Sur-Tax</i>		<i>Estate Duty</i>		
	Amount left after payment of tax. Married man with two children. Income wholly earned		Estate passing at death	Amount left after payment of duty	
	1937/38	1947/48		1937/38	1947/48
£	£	£	£	£	£
300	300	300	500	495	500
350	350	350	1,000	980	1,000
500	492	472	2,000	1,940	2,000
1,000	897	786	5,000	4,850	4,900
2,000	1,672	1,374	10,000	9,600	9,600
5,000	3,586	2,512	50,000	43,000	39,000
10,000	6,153	3,586	100,000	81,000	70,000
20,000	10,491	4,311	500,000	340,000	225,000
50,000	21,716	5,061	1,000,000	620,000	350,000
			2,000,000	1,100,000	600,000

The extent of some of the changes in "social security benefits" can be seen from the following table of weekly "benefits":—

	1938		1947		1947 as a percentage of 1938
	s.	d.	s.	d.	
Unemployment Benefit (single man) ..	17	0	26	0	153
Health Benefit (single man) ..	15	0	26	0	173
Old Age Pension (single man) ..	10	0	26	0	260
Children's Allowance (second and subsequent children)	Nil		5	0	—

After deduction of direct taxation the distribution of income is strikingly less unequal now than it was before the war, even though considerable inequalities still remain. There has not, however, been the same startling change in the distribution of the ownership of property. Pre-war ownership of property was exceedingly unequal. In 1936 the wealthiest 1 per cent. of all adults in England and Wales owned no less than 55 per cent. of all property in private hands, and the wealthiest 5 per cent. owned more than 75 per cent. of such property. At the other extreme the poorest 75 per cent. of the adult population owned little more than 5 per cent. of such property.¹ There has probably been some retreat from this extreme inequality since the war, partly as a result of the small properties accumulated through small savings during the war and partly as a result of the present much higher rates of death duty which have begun severely to reduce large properties. But the death duties are slow in bringing about any very extensive change; and until they are accompanied by similar levies on gifts from the living to their potential heirs, the death duties at their present extremely high rates on large properties are likely to become progressively less effective in diminishing the inequalities of the ownership of property, since more and more property will be passed from father to son before the death of the father. There can be no doubt that extreme inequality in the ownership of property still exists and is, on present arrangements, likely long to continue.

In the light of these facts, what further steps could wisely be taken to reduce inequalities in the distribution of income and property? At the outset it must be realized that this is essentially a matter for compromise. It is not even theoretically, much less practically, possible to find a solution in which there is full economic efficiency and freedom on the one hand and complete security and a perfectly just distribution of income and property on the other. There is here some essential conflict. This can be illustrated by taking an extreme example. Suppose that perfect security and justice were taken to mean the guarantee of an exactly equal income to every citizen in all circumstances. Then this would involve social arrangements which in fact announced

¹ See H. Campion, *Public and Private Property in Great Britain*.

to each income earner that every penny he earned over and above the exact average income of the community would be taken from him (e.g., in taxation) and that every penny by which his earnings fell short of the national average income would be made up to him (e.g., by some sort of "social security benefit"). There would be no selfish incentive left to work hard or to move into the occupations where one's work was most highly valued by the community. Economic efficiency would be bound to suffer; and in so far as attempts were made to replace the old incentives by State direction as to what kind of labour and how much each citizen should perform, economic freedom would be gravely threatened.

Some compromise has to be sought. It is here that different people will differ in the values which they place upon the social aims of freedom, efficiency, security and equity. Some will be much more willing than others to face a given sacrifice of individual freedom and of total national production in order to achieve a given increase in security and justice of distribution; and these persons will naturally be more apt to stress the real economic wastes of an unequal distribution of income. Conflicts of judgment about the relative wastes of wealth due, on the one hand, to inequalities of distribution and, on the other hand, to the damage done to economic incentives through measures taken to reduce inequalities can be reduced by a better scientific examination of the facts of economic life; but conflicts of opinion about the relative desirability of freedom, efficiency, security and equity are conflicts about ultimate values and, in a democratic system, a solution can be sought only through the ballot box. We vote for the type of Government which will attach more weight to those of these ultimate ends which, in our opinion, are at the moment too little stressed; and I personally would attach great weight to security and equity as well as to freedom and efficiency.

But we may all agree that all four ends are in themselves desirable and that, in so far as it is possible to promote any one of them without seriously impeding the attainment of the others, we should do so. The moral of all this for our present purpose is to find means of improving the distribution of income and

wealth which have the least possible adverse effects upon economic incentives.

(b) Incentives and the Progressive Taxation of Earnings.

In view of the present incidence of direct taxation on income, nothing more can be achieved by making the tax system more progressive at the upper end. At present the highest income earners pay in income tax and sur-tax 19s. 6d. of each additional £1 which they earn and keep only 6d. for themselves. Such high rates of taxation on additional income have at least four kinds of disincentive effect.

In the first place, a business man liable to taxation on additional profits at this sort of rate will have little or no incentive to try to increase his profit by producing more cheaply greater quantities of products which consumers value most highly. He will have every incentive to turn from this, his proper social function, to an attempt to make himself rich through capital appreciation, which is not liable to tax. He will attempt so to "speculate" that some capital asset which he purchases will some years hence have a higher value which he can then realize and spend. His attention will be diverted from his proper productive purpose.

Secondly, highly progressive rates of taxation put a great premium on leisure. After obtaining a certain income a man by giving up a certain amount of leisure and working longer and harder can earn, let us say, another £200. If he is taxed 19s. 6d. in the £ on this additional earning, he in fact obtains only £5 for this additional labour. But the leisure is untaxed and remains as enjoyable as ever. Is it worth going to the office or factory for the extra hours?

Thirdly, highly progressive rates of tax severely discourage risk-taking. A business man is considering whether or not to embark upon an expensive and risky new idea. If it comes off, it will bring great benefit to the community but little net profit to him (for he will pay most of the profits in taxation to the State); but if it fails, it will bring loss to him alone. In fact the State is saying to the risk-bearer: "Come, take the risk. It is your social function to do so. But remember: Heads I win, Tails you

lose." He may in the circumstances decide to stick to routine business and leave to the Americans the problems of industrial innovation.

Fourthly, high rates of taxation on earned income put a great obstacle in the way of a full and efficient division of labour. People have an incentive to become self-supporting because in many cases self-support is not taxed. Thus a skilled author who is taxed 19s. 6d. in the £ must earn £200 in order to have the money to pay £5 to get some housework done. He may well decide to do the housework himself instead of writing. Only if he is forty times more productive in writing than housework will it be profitable for him to extend the division of labour and to exchange his writing for housework.

These are, of course, extreme examples. But these disincentives are at work not only at the very highest ranges of sur-tax. Throughout the range of sur-tax and the income tax, where additional units of income are charged at rates of tax considerably higher than the average rate charged on the whole income, there is some discouragement to higher earnings, a discouragement which varies only in degree.¹

This suggests that further advance towards equality is not to be sought along the lines of further rises in the rates of taxation on high earnings. Indeed, if we can find alternative means which will reduce inequalities without such discouraging effects upon incentives it may well be that simultaneously with the adoption of such alternatives there should be an appreciable reduction in the progressiveness of direct taxation on earnings.

(c) The Food Subsidies and the National Minimum.

To turn now from the top to the bottom of the scale of incomes, the promotion of greater equality through the extension of social security, and the idea of a "national minimum," has

¹ The disincentive to work due to high rates of taxation on additional earnings is quite different from the disincentive to work due to the fact that, in an inflationary situation, people cannot find the goods on which to spend their incomes. In the extreme cases of this kind (such as in Germany recently) additional earnings are no use at all (see page 16); but with a tax of, say, 8s. in the £, 12s. in each £ of additional earnings remains of full utility. The inflationary type of disincentive can be removed without any changes in tax rates by controlling inflationary pressure in the ways described in Chapter II.

also already gone a long way with the extension and improvement of national insurance covering unemployment, old-age and sickness, with the adoption of children's allowances, and with the development of national medical and educational services. But within this field there is at present at least one important immediate improvement possible. Subsidies are at present being paid to keep down food prices at a cost of some £400 millions a year; and they are defended as a form of social service which keeps this essential item in the cost of living within the reach of the more slender purses. But they are a grossly wasteful form of social service. They subsidize the food consumption of the millionaire with no dependants as well as that of the poorest wage-earner with a large family to support. The money could be used with a far greater impact upon welfare if it were paid out in the form of increased children's allowances, old-age pensions, etc., or used to decrease the burden of income tax on the poorer taxpayers. It would then be concentrated, in a form which could be used freely for the purchase of all essential commodities (and not only foodstuffs), in the hands of those members of the community most in need of help.

This is the main indictment of the food subsidies, that they are a wasteful form of social service. But their reduction would have two other advantages in present conditions.

First, food is at present particularly short. To maintain the price of food in such circumstances at artificially low levels through subsidies is to encourage food waste. If the prices of foods were raised to correspond to their scarcity values, and at the same time consumers had additional incomes—in the form of children's allowances, old-age pensions, reduced income tax, etc.—to make up for the rise in the price of food, the housewife would be no worse off. But there would be a much greater incentive to cut down on the demand for foodstuffs by eliminating waste, by refraining from feeding animals on human food and the like.

Secondly, as has been argued in the last chapter (see page 22), in times of inflationary pressure with too much money chasing too few goods, it is necessary to raise the State's revenue from taxation or to reduce its expenditure. An adjust-

ment of food subsidies might take the form of eliminating, say, £300 millions of the £400 millions of such subsidies (the other £100 millions representing for the most part special agricultural and nutritional subsidies for which there is a different case), of using £150 millions of this saving to develop other social services or to reduce the taxation of income, and of using the remaining £150 millions as a contribution to the relief of inflationary pressure through a larger budget surplus.

(d) Lady Rhys Williams' Rationalization of Income Redistribution.

It is clear that there has grown up piecemeal an exceedingly complex machinery for the redistribution of incomes from the rich to the poor through the progressive taxation of incomes by income tax and sur-tax, through the payment of various social security benefits—unemployment benefits, health benefits, old-age pensions, children's allowances, etc.—and through the subsidization of food out of general taxation. Income tax is complicated by the various allowances for earned income, wife, children and dependants and with all the machinery of assessments, coding and tax tables of Pay-as-You-Earn, requiring the great administrative machine of the Inland Revenue and of businesses in collecting the revenue. Business concerns, individuals and the Ministry of National Insurance are concerned with the collection of national insurance contributions from employers, employees and others. The Ministry of Labour is concerned with the conditions on which a man qualifies for unemployment benefit, and the Ministry of Health is concerned with health benefits.

The Ministry of National Insurance also is concerned with these matters as well as with the separate problems of qualifications for, and payment of, old-age pensions and children's allowances. The Post Office must make arrangements for the payment of the sums so determined. The Ministry of Food, with the Treasury, must administer the food subsidies.

All this apparatus is really designed for the single purpose of taking money away from the rich, or relatively rich, and giving back some part of it to the poor, or relatively poor. Could

not the whole process be immensely simplified by some great act of rationalization? And in doing so might it not be possible still further to improve the distribution of income?

An exceedingly stimulating proposal for an architectonic reform in this field has been put forward in recent years.¹ It is suggested that a straightforward monetary payment or allowance or "social dividend" should be paid to every man, woman and child in the country—although the rate of payment might, of course, be lower for children than for adults. This would take the place of all social security benefits such as unemployment benefit, old-age pensions, health benefits, children's allowances. Every man, woman and child would thus have his or her basic minimum whether in sickness or in health, in work or out of work, young or old. There need be no means test and no tests whether a man was seeking work or whether a man was genuinely ill. Doctors could stop writing out health certificates and get on with their job of curing their patients. Employment Exchanges would stop fussing about unemployment insurance and get on with their job of introducing employers with vacancies to workers without jobs. The Ministry of National Insurance could be closed down.

These universal personal allowances would also take the place of the whole apparatus of allowances under the income tax. All income (other than the "personal allowances" which would be tax-free) would be taxed at a standard rate of tax. The whole apparatus of Pay-As-You-Earn would disappear; and the only task of the Inland Revenue in this field would be to ensure that all income was taxed at the standard rate of tax. All personal assessments would cease for income tax purposes, though not, of course, for sur-tax.

Such a system would have many advantages.

In the first place, it is obvious that the administrative simplification and bureaucratic economy would be very great. It would revolutionize the task of redistributing incomes.

Secondly, there would be a gain in personal freedom. No one would be liable to be harried and worried as to whether he really

¹ See Lady Rhys Williams' *Something to Look Forward To*. MacDonald & Co., E.C.4.

was unemployed, as to whether he should take this job or not, as to whether he was genuinely ill or should return to work. He would receive his basic allowance and could please himself.

Thirdly, the system could be used to lead to a great increase in the equality of distribution of incomes. The result would, of course, depend upon the size of the personal allowances paid and the level of the standard rate of tax imposed on incomes. But reasonable rates could be found (see Appendix I) which would have the effect of increasing equalities of income, particularly by a redistribution in favour of families with low incomes and many dependants.

Fourthly, the system would afford a perfect instrument for the most effective and prompt control over total national expenditure in the interests of avoiding inflation and deflation. (See page 34.) With an annual national taxable income of £8,000 millions, all of which would be subject to a standard rate of tax which could be promptly changed without administrative complication, a change of 3d. in the £ of income tax would change the amount of spendable incomes by £100 millions a year.

The scheme might, however, have seriously adverse effects upon economic incentives. It is true that there is one respect in which it might mark an improvement on pre-war arrangements. Under existing arrangements—and even more so under pre-war arrangements before the introduction of children's allowances—an unemployed man by finding work, or a sick man by recovering his health and returning to his job, might enjoy practically no increase in his income. His wage would replace his unemployment or health benefits; and as the latter included dependants' allowances while the former did not, a married man with children might even lose by returning to work. With the proposed scheme the wage-earner would keep his allowances when in work, and the whole of his wage, less the standard rate of tax on it, would in any case represent an improvement in his income. This, of course, *increases* inequalities of income as between those in work and those out of work; and by so doing, it would probably improve the incentive to find work.

But even so there might be dangers in paying the allowances to everyone without enquiring whether they were willing to work or not. Indeed, Lady Rhys Williams, the first proponent of the

scheme, never suggested that the allowances should be paid except to those who were willing to contract to undertake work if they were fit to work and work could be found for them. The danger that a large number of persons might prefer idleness on the allowances seemed too great. But this complicates the scheme by the reintroduction of health certificates and tests as to willingness to work.

But whatever might be the effect on the incentives to find a job, once in a job the earner who is at present exempt from income tax, or liable to income tax only at the reduced rates, would almost certainly have a smaller incentive to work hard and long and to move to the most repaying occupation in order to increase his earnings. For (see Appendix I) the scheme would involve a high rate of income tax (perhaps 8s. 0d. in the £ or even more) on all additional earnings even of the lowest paid worker. This, as has been seen above, would weight the scales in favour of leisure and self-support and against taking risks to increase taxable money earnings. Clearly, this is a serious danger.

It might perhaps be possible to modify the scheme so as to mitigate this danger. Unearned income might be taxed at a higher rate than earned income, thereby restoring the present relief in favour of earned incomes and reducing the disincentive effects on earnings. The principle of the new proposal might perhaps be modified by requiring that every income earner should pay in taxation the first x shillings he earned each week. A small poll-tax on earnings of this kind might not be too complicated administratively to collect. It would correspond very closely to present national insurance contributions and would mean, in effect, that while a man on obtaining work would not sacrifice any of the personal allowances of his dependants he would not keep the whole of his own personal allowance. It would enable the standard rate of tax on all earnings to be reduced and would reduce somewhat the inequalities between those in work and those out of work. Finally, a further important reduction in the standard rate of tax on earned incomes could be achieved if the starting point for sur-tax were considerably lowered.

Is some revolution on the lines of this scheme, modified or unmodified, desirable? It has the greatest attractions from the point of view of social security, equity, personal freedom,

administrative simplicity and the provision of a means of exercising a prompt and effective control over purchasing power as a measure against inflation and deflation. But it raises serious issues in the matter of economic incentives. Can we afford to face throughout the range of earnings the sort of rates of tax on additional earnings which at present only begin to rule in the middle ranges of incomes below the sur-tax level? Could the scheme with modifications be made workable? Certainly it deserves the most careful and serious examination; and some rationalization of our present largely haphazard methods of income redistribution ought surely to be possible.

(e) Equality of Opportunity.

But the main attack must now be launched in another direction. We must remove those inequalities of opportunity which themselves give rise to so large a part of present inequalities of income rather than redistribute the unequal incomes which result from these inequalities of opportunity. For the removal of inequalities of opportunity would reduce inequalities of income and property without any of the adverse incentive effects of progressive taxation on unequal incomes. Inequalities of economic opportunity are essentially due to inequalities of inherited property and to inequalities of educational opportunity. These two factors are closely related. For example, much inequality in the earnings of different persons is due to the fact that some of their parents have, and some have not, been able to afford the high costs of education and training necessary to enter well-paid occupations; and their parents' ability to do so may have depended upon the ownership of inherited property. Such inequalities of opportunity tend to perpetuate themselves not only through the inheritance of property. A man earning a high salary can afford an expensive training for his son who is enabled thereby to enter a well-paid occupation, which in turn enables him to afford an expensive training for his son; and so on.

(i) Education and the Movement to Better-paid Jobs.

An important means of attack on this problem is, of course, through the educational system. Recent educational reforms should greatly contribute to this end; and the more nearly it becomes true that education depends upon ability and not upon

wealth or birth, the greater should be the ultimate effect upon the distribution of income. The full effect will, of course, take time to work itself out, since it will operate progressively as each year a larger and larger proportion of able boys and girls are trained for the higher-paid occupations. Its effect will also depend upon ensuring that there is freedom of entry for all comers into the higher-paid occupations. The relative valuations of different works will have to be permanently readjusted. The supply of labour for unpleasant and less well-paid occupations will fall, and the supply of labour for the more attractive and better-paid occupations will rise. Coal-miners will be permanently paid more in relation to doctors, barristers and university professors than before the war. And the change in relative values must not be impeded by attempts on the part of the doctors, barristers and professors to maintain their rates of pay by maintaining an artificial scarcity of labour in their fields through unnecessary expenses or barriers to entry into their occupations. Only the basic tests for professional efficiency must be allowed to stand. The same principle must, of course, be applied to trade union practices. No restrictions on entry into a well-paid trade must be allowed to remain other than those necessary to ensure the minimum skill or training required in modern conditions of production. Otherwise restrictions are merely a means of maintaining inequalities by preventing the ill-paid from entering well-paid trades.

(ii) *Inheritance.*

The remaining great cause of inequality is inequality in inherited property. As has been shown above (page 36), rates of death duty on large estates are already very high; and it has already been remarked that such high rates are likely to become progressively ineffective unless a corresponding levy can be imposed upon gifts of property *inter vivos*. There is a possible reform of the principles of inheritance which might constitute a still more effective means than the present death duties for ensuring a more equal distribution of property with even less adverse effects upon economic incentives. The present duties levied according to the size of the estate which a property owner leaves at his death would be abolished; and in their place an upper limit would be imposed on the amount of property which

any individual would be permitted to receive in his life-time either by way of inheritance or gift. The advantages of such a system would be very great. It would put an end to the possession of great fortunes which were not due to savings resulting from a man's own activity. But on the accumulation of such fortunes the new system might have less discouraging effects than the present system, since any man, however rich, could leave or give the whole of his property to others without sacrificing any part of it to the State, provided only that he chose to distribute his fortune in sufficiently small parcels over a sufficient number of persons not already well-endowed with property.¹

There would be a number of formidable administrative problems to be overcome if a scheme of this kind were to be adopted. It would be necessary to keep a track of gifts *inter vivos* of more than a certain moderate annual sum; it would be necessary to record in a grand Domesday Book all gifts and inheritance received by each individual in order to rule each man off as soon as he had reached his limit; and it might prove necessary to revise the property laws in certain respects so that it was always clear how much of any property passing at death or otherwise was in fact passing to the beneficial ownership of each individual affected. These difficulties are, no doubt, formidable; but are they insuperable? They are the price which must be paid for a radical reform which in a generation would completely transform, and keep transformed, the whole structure of society.²

¹ A variant of this proposal would be to impose, not a fixed limit to the amount of property which any individual might so receive, but a highly progressive rate of duty on property received by way of inheritance or gift, the scale of progression to depend upon the total amount of property which the individual had already so received. If, on fiscal grounds, it was desired to continue to receive revenue from the taxation of property, the scheme would have to be operated on these lines.

² A minor reform which would avoid some of the above difficulties and yet achieve some of the ends desired would be to revise the existing death duties so that the charge was levied progressively according to the size of each individual bequest instead of in accordance with the size of each estate passing at death. This would provide an incentive for splitting up large estates; but (i) it would not avoid the possibility of leaving relatively small bequests to a relatively large number of persons who had already inherited much property; (ii) it would not avoid the need to tax gifts *inter vivos*; and (iii) it would not avoid the need for a reform of the property laws to ensure that it was known who precisely benefited to what precise extent from each bequest.

(iii) *The Capital Levy.*

But any scheme of this kind would be relatively slow in its operation. That is not to argue against it. Something of the kind would be needed to prevent the regrowth of inequalities of property, even if one started from complete equality. But some other once-for-all measure would be necessary if it were decided, despite the formidable difficulties involved, here and now to reshuffle the cards more quickly so that a start were made from a position in which the hands were rather less heavily stacked in favour of the large property owner. The only possibility would be a large-scale capital levy.

On this argument the essential case for a capital levy is that it would diminish the larger properties and thus result in a more equal distribution of property. The influence, prestige and power attaching to large properties would be reduced. There would be less possibility for persons to command an unfair share of the community's resources simply because of the size of their incomes from property. Moreover, rich people can and do live on their capital and can thus exercise command, for a time, over an unfairly large proportion of the community's current resources by using the capital of their properties for the purpose of their current consumption. Indeed, over the generations, those with the largest properties are obliged now to behave in this way; for rates of income tax and sur-tax are such as not to leave over sufficient tax-free income from large properties to be able to save up sufficient to meet the very high duties which will be payable on the estate at death. Such rich people can obtain an enjoyment from their properties only by failing to maintain the property intact as it passes from father to son.¹

In present circumstances, with the prospect of very high death duties at their death; with the knowledge that at current exceptionally low rates of interest and high rates of income tax and sur-tax they will lose only a very small future annual tax-free income as the result of the dissipation of a given amount of property; and with the great recent appreciations in the capital value of fixed interest assets which have resulted from the re-

¹ Unless, of course, as will become more and more frequent, the property is passed by gift more than five years before the death of the owner, in which case it escapes liability to death duty.

duction of interest rates to present very low levels: those with large properties have every incentive to live on their capital. This emphasizes the importance of achieving a more equal distribution of property as a means of equalizing purchasing power over the community's output of goods and services for personal consumption.¹

We have then to ask what would be the effects of a levy upon economic incentives, and what would be the administrative problems involved. Given that it would have desirable effects from the point of view of the distribution of wealth, would it worsen or improve incentives and would it be practicable?

Its effect upon incentives would depend very much upon whether it was expected to be repeated or not. If it were expected to be repeated, the incentive to increase earnings so as to be able to accumulate property and the incentive to save out of income for the same purpose would be considerably diminished. But if a large-scale progressive levy could be put forward in combination with the reform of inheritance proposed above, it might perhaps be effectively represented for what it was—a single once-for-all measure to reshuffle the ownership of property, which would be kept reshuffled not by the repetition of the levy but by the new arrangements for inheritance.

If this were so, the fact that total private property would be reduced in amount might improve the incentives to accumulate property. There is at the moment a gigantic bluff among property owners. The total value of the real property of the community (its land, minerals, buildings, factories, machinery, plant, stocks, etc.) is probably of the order of £40,000 millions. The total value

¹ The restriction of the consumption of the rich by means of a capital levy is not a very strong argument in favour of a capital levy as a means of controlling the present inflationary pressure. As has been argued (page 26), a levy is bound to take time to assess and collect, but the control of inflation requires something prompt in its effect. A levy might help if, in anticipation of payment of the levy, people refrained from expenditure in order to get together funds for the ultimate payment; and if, in spite of the very strong arguments against it, some form of forced loan or blocking of liquid funds were adopted as an anti-inflationary measure, a capital levy might follow this blocking measure and be payable out of the blocked assets. However, the case made out for a capital levy in the text does not rest on these arguments, but on the more permanent problem of equity in the distribution of wealth.

of the National Debt held by the public is of the order of £20,000 millions. Thus property owners own in total property worth some £60,000 millions, though there is in reality only £40,000 millions net of property to be held by them.¹ Each feels richer in wealth than he would if all properties were scaled down to correspond with reality. The incentive to accumulate more wealth—to earn more and to save more out of existing earnings for this purpose—would probably be greater if the National Debt had never existed and individuals realized that they were worth only £40,000 millions instead, as they now think, £60,000 millions.

A main argument which is normally put forward in support of a capital levy is that it will improve economic incentives by achieving a considerable saving on the central government's expenditure on National Debt interest. This, it is argued, will either enable rates of taxation to be reduced (thereby improving economic incentives) or else enable expenditure on social services to be increased without raising rates of taxation (thereby improving further the distribution of the national income without worsening economic incentives through higher rates of taxation).

But it should not be imagined that in present circumstances any very substantial net saving to the central government's budget would result from a capital levy. Conditions are all unfavourable to that outcome. In the first place, as has been seen, death duties are levied at a very high rate on large estates; and it follows that, especially if the capital levy itself were highly progressive and fell more heavily on large estates than on small, there would be a heavy loss of revenue from death duties as a result of the levy. Secondly, the rate of interest on the National Debt is exceptionally low; and it follows that any levy which raises a given capital sum (and thus involves a given loss of revenue from death duties) would result in a relatively small saving of interest on the debt which was thereby repaid. Thirdly, the taxation of income is at present both high and progressive,

¹ The figures should be somewhat adjusted to allow for the fact that the nationalization of the coal mines, railways, etc., has reduced still further the total amount of property available to be held by the public. But the above figures are so very rough and approximate that this point would hardly make any difference to them.

so that a large proportion of the interest charge which was so saved would merely result in a loss of revenue from income tax and sur-tax; and this again would be particularly true if the capital levy were itself very progressive so that the interest charge saved to the State was largely interest previously received by rich persons paying anything up to 19s. 6d. in the £ on that interest. Indeed, from the narrowest budgetary point of view, there would probably be a net cost to the central government's budget from a highly progressive capital levy in present conditions. For the subsequent annual loss of death duties would be greater than the net saving on interest on the redeemed debt after allowing for loss of income tax and sur-tax on that interest.¹ If there is to be any appreciable net saving to the central government's budget the levy must not be too progressive (e.g., a levy of, say, one-third of each property with only the first, say, £2,000 of each property exempt); and even then the net saving would not be so very great.

Against this, however, it is necessary to bear in mind certain reasons why the improvement in economic incentives is likely to be somewhat greater than is at first sight apparent.

First, it is necessary to remember that where, as at present, rates of taxation on income are high, small reductions in tax rates may cause large improvements in incentives. An extreme example will illustrate this point. If the rate of tax is 19s. 0d. in the £, a reduction of 1s. 0d. in the £ will raise the tax-free reward for effort from 1s. 0d. to 2s. 0d. In other words, it is equivalent to a doubling of the net rate of reward for extra effort. If the rate of tax is, however, only 2s. 0d. in the £, the same reduction of 1s. 0d. in the £ will raise the tax-free rate of reward from 18s. 0d. to 19s. 0d.; and this represents a rise of

¹ This is the reverse of the fact which was noticed above, that death duties are now so high that the richest property owners cannot maintain their capital intact, because they would have to put aside more than the whole of the interest on their property (after payment of income tax and sur-tax) in order to build up a fund to pay future death duties. But this does not mean that property is a net liability to the rich. They can live on the capital. Nor does it mean that the surrender of part of that property through a capital levy to the State would be a net liability to the State. The State could put the capital sum raised by the levy aside and use it as a sinking fund to meet the future loss of death duties. Meanwhile, it would have the advantage of the net saving of interest less income tax and sur-tax.

only $5\frac{1}{2}$ per cent. in the net rate of reward for extra effort. At present high rates of taxation great efforts are justified in achieving only moderate reductions in tax rates; and for this reason a capital levy which achieved only a small net budgetary saving might yet have a considerable effect upon incentives.

Secondly, even without any reduction in the schedules of rates of income tax and sur-tax, a capital levy would improve the marginal incentives of some of the rich. Rich people by losing a part of their property would become poorer both in income from property and in the capital value of property itself. Since they would have smaller incomes from property, they would on the existing schedule of income tax and sur-tax be liable to lower rates of tax on their last additional units of income. And since they would have smaller properties to leave at death, they would, on the existing schedule of estate duty, be liable to lower rates of death duty. They would experience a somewhat smaller tax disincentive against additional earnings simply because they were poorer.

Thirdly, when the State had used the proceeds of the levy to redeem National Debt, there would be less fixed interest property and the same amount of equity capital to be held by property owners. One would, therefore, expect the yield on fixed interest property to be permanently lower in relation to that on equity capital. The risk premium would be greater because a larger proportion of the remaining capital would be risky. This carries with it an interesting budgetary implication. The rate of interest on any remaining Government debt could be kept permanently lower (with a consequential improvement in the budgetary position) without the rate of yield on industrial assets thereby being reduced. In consequence, in any given situation a lower rate of interest on Government debt would be required to exercise any given degree of restraint over private investment for the purpose of controlling inflation and deflation.

Finally, the exceptionally small net saving to the budget which would result from a progressive levy in present circumstances is in large measure due to the exceptionally low rates of interest ruling at the moment. If rates of interest were higher, the net saving to the budget from a capital levy would be higher. Or, in

other words, the removal of a large part of the National Debt would remove one of the most serious arguments against the use of the rate of interest as one of the methods of influencing investment in order to control inflationary and deflationary pressures. A rise in interest rates could no longer seriously embarrass the budget because of the increased charge for interest on the National Debt. (See pages 32-3.)¹

It must not, of course, be imagined that a capital levy on an extensive scale would be administratively an easy or a rapid task. It would represent a major surgical operation on the economy and would present an enormous administrative problem. Business confidence might receive a considerable shock. Great difficulties of enforcement and of the valuation of assets would be encountered. Serious problems would arise as to the forms in which the levy should be payable. If only cash and Government securities were accepted by the State, there would be a vast realization of, and depreciation in the market value of, other assets which were held by persons who did not command sufficient cash or Government securities to pay their contribution. Such changes in relative values of different types of property would raise difficult issues of equity as between different property owners. Serious problems of payment would arise where assets took the form of goodwill in partnerships or other forms which were not easily realizable. These difficulties would be mitigated if the State were prepared to accept payment in a wide choice of properties and were willing itself, or through some special intermediary, to hold such properties and to realize them gradually over time as suitable occasion arose. The difficulties might similarly be reduced if special action were taken to ensure that, in suitable cases, the levy could be paid in relatively small instalments over a relatively long period of time or that money could be advanced on suitable terms for the payment of the levy on the security of chargeable assets which could not be quickly realized.

¹ Since a capital levy would remove a large part of the fixed interest property which would fluctuate most markedly in value as a result of changes in the rate of interest, there would also be less force in the argument that the rate of interest should not be used to control investment because of the difficult problems of equity which the consequential changes in property values would involve.

But the difficulties are, of course, very great. Are they worth facing? How much are we prepared to pay for immediate relief from the budgetary charge of the debt and for the early institution of a much more equal distribution of personal property? Or are we prepared, so far as the latter is concerned, to rely upon the much slower operation of a reform of the principles of inheritance?

CHAPTER IV

THE PROBLEM OF MONOPOLY

(a) *The Promotion of Competition.*

Provided that there is not too large or too small a total monetary demand in relation to the supplies of goods and services available for purchase, and provided that there is a reasonably equitable distribution of that total monetary purchasing power, there are strong market forces at work promoting the most economic use of the community's resources. Consumers bid most for those commodities which they most desire; and if the distribution of income and property is reasonably equitable, the price offered by one consumer can be taken to be of equal importance to the price offered by another. Particular goods should then go to the particular consumers who offer the highest price for them. And producers, if left free, will in their own interests produce in greater quantity those things for which consumers offer the most in relation to the cost of production, and—through technical innovations and through the use wherever possible of cheaper resources in place of more expensive ones—they will produce each commodity by the means which are technically the most efficient and which employ as much as possible of the plentiful (and therefore relatively cheap) resources and as little use of the scarce (and therefore expensive) ones. In such circumstances freedom of consumers' choice combined with the profit motive produces the maximum social advantage.

This is not, of course, the end of the story. Quite apart from an excess or a deficiency, or an inequitable distribution, of general purchasing power, there are unfortunately many reasons, which we must now examine, why in particular cases this happy coincidence of private and social advantage does not exist. There is nevertheless this underlying tendency at work; and where it can be made effective, the liberal solution of *laissez-faire*, of free

competition, is undoubtedly the one to adopt. For it combines complete personal freedom with maximum economic efficiency.

A main purpose of policy must, therefore, be to ensure that this principle does work over the widest possible range of activities. The profit motive will work to the benefit of society only if producers can exploit neither the consumer by restricting output and thereby raising the price of the products which they sell, nor labour (or other factors of production) by restricting the number of workers whom they employ and thereby depressing the wage-rate which they have to offer. For private producers will have a motive not to extend production as far as is socially desirable, if by producing less they are thereby enabled significantly to push up the price of the smaller output which they continue to sell or to depress the price of the smaller volume of labour which they continue to employ.

Where there are many competing producers each producing a small proportion of the total supply of a fairly standardized product, and each employing a small proportion of a fairly homogeneous type of labour, no single producer will have this power of exploiting the consumer or the worker. For since each producer accounts for so small a part of the total production and employment, a variation in his sales or employment alone will have an inappreciable effect upon the total market for the product or for labour; and he will not, by producing less, be able significantly to improve the terms on which he can sell his product or employ his labour.

There is, however, a natural tendency among producers to combine to the end that all should restrict output together, so that the markets for their products and for the factors which they purchase may be rigged in their favour. But the State should ensure that the institutional and legal background for production and trading should make such action as difficult as possible. In the private enterprise sectors of the economy, producers should be made to compete; for a main justification for private enterprise is that, because of competition, producers have every incentive to produce in the most economical manner the things which are most needed.

Much institutional and legal reform is needed for this purpose. Since the 1914-18 war there have been progressive institutional

and legal changes which have been more and more favourable to monopolistic and restrictive devices. There is nothing technically inevitable about such a development. We have chosen that it should be done. We would be well advised to choose that it should be quickly undone.

First of all, the State must itself give up the habit which it acquired in the inter-war years of promoting schemes for limiting the entry of new producers into an industry or the amount which existing producers may produce or bring to market, or for setting minimum prices below which producers may not market their products. Nobody, whether a statutory board of private producers, a public board or the Government itself, should lay down the following sort of rules: that only potatoes over a given size may be sold for human consumption; that those who want to grow more potatoes must pay a fine before doing so; that only those lucky people who happened to grow hops in a particular place in a particular year may continue to do so; that only those lucky people who happened to be running particular forms of road transport in a particular place at a particular date may continue to do so; that milk may not be sold for human consumption below a certain price; that new efficient methods of catching fish must not result in the sale of fish to consumers at low prices. Such rules hinder the efficient from driving out the inefficient; and they prevent that expansion of output and sale of any product which should occur so long as its cost is lower than its price. By restrictive devices, hidden under the guise of "orderly marketing" or "orderly production," they maintain the incomes of the vested interests who are already engaged in the given industries and they substitute stagnation for progressive change. There may have been some natural explanation for them in the desperate years of the 1930's when, as a reaction to the catastrophic deflationary decline in total demand, there was almost irresistible pressure to allow bodies of producers to get together to protect their particular interests against competition from newcomers. But there can be no excuse for them in conditions in which there is a sufficient demand for goods and services in general, so that if one line of production becomes relatively unprofitable there are many other lines in which resources can find profitable employment.

There are various reforms in the law which might positively promote competition and impede restrictionism and monopoly. The law regarding restraint of trade should be so revised as to disallow, or severely to discourage, contracts and other forms of agreement between private individuals or bodies which have the effect of restraining trade, such as agreements not to sell below a certain price;¹ agreements not to produce or to sell more than a certain quantity of output; agreements to share markets in predetermined amounts; or contracts which tie a purchaser not to purchase his supplies from a new outside competitor with the threat of being "boycotted" if he does so.

It is possible that changes in the patent law might considerably promote competition. For example, a provision that any producer should have the right to use any patented process provided that he paid a fair royalty for its use—the appropriate rate of royalty being open to some form of impartial arbitration—would preserve the incentive to invent and to patent inventions without allowing rigid monopolies to be built up on the basis of exclusive patent rights. Further changes in the company law might perhaps serve the same purpose. For example, the withholding of the advantages of limited liability from holding companies whose main effect was to bring the control of a large part of some production under single control might discourage this type of arrangement for the exercise of monopoly control.

There are particular difficulties in encouraging fruitful competition in the production of an unstandardized commodity in which consumers have preferences for the product of one particular producer rather than for that of another. To some extent differences in products are real differences and the consumers' preferences are, in fact, rational preferences for one quality rather than another. To that extent each producer must be looked upon as a natural monopolist, being the sole producer of his particular quality of product. The seriousness of the inevitable problem of monopoly which will then exist will depend in large

¹ Including agreements between producers and retailers that the retailer should not resell the product at less than a stated price. For why should not the efficient low-cost retailer have the opportunity of expanding his business, at the expense of the less economic outlet, by asking from consumers a smaller margin on his turnover?

measure upon how many producers there are in the particular industry and upon the extent to which the products of the producers in the industry are close substitutes for, though not identical with, each other. The State must then determine whether the position is one of sufficient gravity to take the drastic measures of price control or socialization which, it will be argued, are the appropriate weapons for the treatment of inevitable monopolies.

But to a large extent differences in quality between the products of individual producers are artificial and the consumers' preferences which are based upon them, irrational. There is, however, a great incentive for producers to promote such irrational consumers' preferences. Suppose one producer's product is, in fact, merely a simple, straightforward chemical substance of a given standard quality. If that producer can persuade the consumer that the product is, in fact, some special medicine with peculiar curative qualities, he may be able to tie consumers to him in such a way that he can maintain his price well above the cost of production without the fear that his customers will be immediately lost by the offer of the same product by someone else at a lower price. The institutional and legal background should be changed as far as possible to eliminate such irrational consumers' preferences. This task can be tackled along two main lines.

The first method is that of consumers' education. Steps may be taken to enable consumers to know exactly what are, scientifically, the qualities of the products which they are being offered. What is the chemical content and the medical value of this medicine and of that medicine; what is the cleaning quality of this vacuum cleaner and of that; what is the thermal efficiency of this means of heating and of that. Such education needs impartial and scientific comparison between A's product and B's product. A consumer's advice service for some products might conceivably be run by the State. Private bodies of one kind or another might undertake such tasks, in some cases as profit-making bodies acting on fee for their clients. But development on these lines almost certainly requires some alteration in the law of libel. It can be effective only if it is made possible, without the financial risk of an action for damages, to pass adverse but genuinely

scientific judgment on the performance of a particular producer's product, even though the judgment may seriously prejudice the commercial prospects of the producer in question.

Expenditure of effort by producers on the formation of irrational consumers' preferences may also be discouraged by discouraging excessive advertising. Advertisement by producers on a scale and of a kind designed to inform consumers what supplies are being offered to them is, of course, useful and indeed essential. But advertisement on a scale and of a kind designed to hypnotize consumers into believing that A's goods have a special quality which, in fact, they do not possess, is anti-social, however profitable it may be to A. A proposal was made at the time of the Chancellor's Budget of November, 1947, to allow only one-half of expenditure on certain advertisements as a deduction for the purpose of computing business profits for income tax and profits tax, which would have had the effect of making such expenditure on advertisements liable to such taxation. This would appear to be a neat and comprehensive way of imposing a general discouragement on excessive advertising, so as to promote competition between producers in supplying better products at lower prices rather than in bluffing consumers.

But when everything has been done to make the institutional and legal background as favourable as possible for fruitful competition, there will remain in many cases real obstacles to relying upon free competition and the price mechanism.

In the first place there are those cases in which consumption must be socially organized because no single individual, but the whole of society, benefits from the act of production and consumption. Thus, the State must organize national defence, since it is in the nature of things that there should be one army to serve the whole community. A local authority must organize the consumption of the amenities of a public park, since it is of the nature of a park that all should enjoy it communally, though it would not be quite so far-fetched in this case to rail in the park and to finance it by charging an entrance fee to those who wished to enjoy it.

Secondly, there are those acts of private production or consumption which impose substantial benefits or losses on third parties without the private producers or consumers being com-

pensated or charged for the benefits or damages which they indirectly produce for others. Here State intervention of one kind or another is necessary. A factory may pour forth smoke which does not so much add to its own cost of production as raise everyone else's costs and spoil everyone else's life in the neighbourhood. Similarly, it may pollute a river to the cost of everyone else but itself. Or the construction by one person of a dwelling-house in a countryside of extreme beauty may greatly please the occupier, but may spoil the view for everyone else. On the other hand, a producer may confer benefits on a third party for which he gets no recompense. A farmer by draining his own land may much improve the fertility of his neighbours' property as well as that of his own.

The State may attempt to tax the obnoxious, and to subsidize the beneficial, action to the extent which corresponds as nearly as possible to the value of the indirect benefit or damage conferred on others. This is in theory the freest and most effective method of dealing with the problem and should be adopted wherever practicable. But in many cases more direct methods of control must for practical reasons be used—smoke abatement through the prohibition of the use of certain fuels, rules against river pollution, the scheduling of certain areas against building, and so on.

There remains, however, the difficult problem of those cases where, for technical reasons, there is only room for one or two efficient producers to produce enough to satisfy the market. For example, for obvious technical reasons it is uneconomic in any one city to have a large number of competing gasworks each with its competing set of gas mains down each street and each with its separate plant for producing gas operated on less than the optimum technical scale. Efficiency requires that there should be a gas monopoly. Other industries of which this is clearly true are the generation and distribution of electricity, the supply of water, telephones, railway transport, and the like. In some branches of the iron and steel industry there is not room for more than one or two plants of the most economic size. In coal mining whole coalfields should often be run as single production units in order to obtain the greatest technical economies from the underground development of the coal seams as a whole.

In some cases competition might be effectively restored, not by reducing the scale of the individual production unit, but by extending the scope of the market for the industry's product. This can sometimes be done by the removal of barriers to international trade, which will make the domestic market only one small part of a large world market. Suppose that there are only one or two large-scale domestic producers of a certain product in the iron and steel industry. In spite of this, if the domestic market is part only of a much larger world market, the domestic producers may have little power of rigging the market in their favour. They will be restrained from attempting to restrict output and to maintain prices at home because their customers can turn to imported steel. If obstacles to the import of our steel into foreign markets are removed, our domestic producers need not hesitate too much to expand their own output in the fear that they will "spoil their market," because they can dispose of the additional output in the whole world market in which their supplies may not represent so very large a proportion. One of the great arguments for "free trade" is that it extends the scope for the fruitful application of liberal domestic policies.

(b) The Sphere for Socialization.

But when all is said and done there will remain many cases where the technically efficient scale of production does remain obstinately large in relation to the total market. To attempt to ensure that there are many competing railways between Oxford and London, or to apply principles of "trust busting" to the electrical generating industry, would clearly be an act of mere stupidity.¹ Monopoly in such cases is not merely inevitable; it is desirable if the maximum wealth is to be produced. But such

¹ In earlier paragraphs of this chapter action has been recommended for discouraging cartel arrangements and the building up of monopoly control through the holding company technique. But those are all cases where the monopolistic device does not lead to the unification of technical management. It cannot, therefore, reasonably be claimed that those devices lead to great economies of large-scale production. Devices which give monopoly control of markets without unification of technical management can be unequivocally condemned. They enable producers to rig the market without bringing economies of large-scale production. Complete mergers of production also enable producers to rig the market, but they may also bring economies of large-scale production. Where they do so, "trust busting" is not an appropriate remedy.

monopolies cannot be left uncontrolled; for the monopolization brings with it not only the economies of large-scale production, but also the power to rig the market in the favour of the monopolistic producers.

Such control might take the form of fixing maximum prices for the commodities sold and minimum prices for the factors of production bought, thus removing the monopoly's power of making a profit merely through restricting output and employment so as to charge a scarcity price to consumers and to drive a hard bargain with labour.

This solution may in some cases be the best available, but it is open to serious difficulties. Price control is, as the experience of war has shown, by no means a simple affair. Where the commodity is not standardized it is most difficult to define products at all precisely for the purpose of fixing a price; and it is easy for the producer to make his monopoly profit by cutting quality instead of raising price. Moreover, for price fixing to be at all accurate in getting the right relationship between costs and prices, it is necessary for the price controllers to examine the operations of the business concerned in so detailed a manner that to a considerable extent they duplicate the management of the business. In any case, if the price which the business is allowed to charge is fixed just at that level which will cover its costs with a "normal" profit on its capital, and if this price is open to revision, the motives for efficiency in the business will be much reduced. The business knows that if it manages to reduce its costs it will have to reduce its price so as to reduce its profit to the previous "normal" level. Finally, as will be argued below, there may well be cases in which monopolies of this kind ought, in fact, to make a considerable profit or a considerable loss; but for the State to fix prices for private monopolies which would have these results and to take no further action would clearly be impossible.¹

To attempt to make private enterprise work fruitfully where there is of necessity a wide divergence between the profit motive and the service of the community is to chase a will-o'-the-wisp.

¹ To fix such prices and then to remove the subsequent loss or profit by a subsidy or a tax is a theoretical possibility; but it would mean that the State was becoming so involved in the industry that it might just as well take it over completely.

Such industries should be socialized.¹ This is, of course, only the beginning, not the end, of the real difficulty. A means must be devised for ensuring that, when socialized, such industries are effectively run in the interests of the community.

The first difficulty is the technical economic one of devising the proper rules for the use of the pricing mechanism by socialized industries so as to achieve the maximum social benefit from them. The principle would appear to be straightforward, though its application is fraught with difficulty. Those in charge of a socialized industry should take on more of any factor of production in order to produce more of any given product, if the price offered for that factor of production in its existing employment is less than the price which consumers would pay for the additional product which that factor of production would produce in the socialized industry. For in a world in which other industries are fully competitive (or else are socialized and themselves run on this principle) the price offered for the factor of production in its existing employment will correspond to the value to consumers of the additional output which it produces in that employment. It can, therefore, do better for the community if it is attracted away to new employment in the socialized industry if, but only if, its price in its existing employment is below the price which consumers will offer for the additional output which it would produce in its new employment in the socialized industry.

But the application of this principle in large monopolistic concerns may result in considerable profits or losses in those concerns. For example, if a railway line is heavily congested, to charge for each unit of traffic on it a price which will cover all the additional costs due to adding that unit of traffic to the already congested line may be to charge a price considerably above the average cost of traffic on the line. In competitive industry this

¹ The above text is confined to economic arguments. There may well be overriding political or social reasons for abandoning this rule one way or the other. For example, on grounds of political freedom I would not advocate the socialization of the daily Press, even if there were economies of production in producing only one newspaper on a large scale. On the other hand, it may be desirable on social grounds to socialize a competitive industry in which there will not, in fact, be any great economies of production from socialization—for example, the production and sale of a dangerous drug.

could not continue for long, because some further small-scale plant would be installed to deal with the additional traffic at a cost not much different from the existing average cost. But on the railway this will not necessarily be economic. To expand the fixed equipment of the industry to deal with the increased traffic might mean duplicating much of the structure of railway lines, embankments, tunnels, etc.; and while there may be more traffic than can very easily be taken on the existing line, there may not be enough additional traffic to make economical the minimum expansion technically possible. It may be economically desirable, therefore, to go on indefinitely charging for traffic a price which will be sufficient to keep the demand down to what can be handled on the existing line, even though this price is well above average cost and thus involves a considerable and permanent extra profit.

Conversely, if the demand for traffic is not large enough fully to utilize the existing line, it will be economic to charge for each unit of traffic a price which merely covers the additional running expenses incurred by taking that unit of traffic on to the existing railway system, even though this price does not cover the average cost of operation. In competitive industry this also would not last for long, since little by little units of capital equipment would go out of production by not being replaced as they wore out. But in the case of the railway the choice may be between a drastic reduction of capital equipment (e.g., using a single instead of a double track) or maintaining it on its present scale; and while there may be too much essential traffic to make it economical to make the minimum contraction of equipment which is technically possible, there may not be enough traffic to enable the existing system to be operated to the full.

But there is a second main problem of socialized industry. It is necessary to ensure that, whatever output is produced and whatever price is charged for it, the socialized concern is run with the maximum technical efficiency, that it is a "go-ahead" concern, and that new methods of production are introduced whenever the same output can thereby be produced at a lower total cost. This, from the point of view of social welfare, is just as important as—perhaps more important than—finding precisely the best rule of pricing policy.

This then is the essential problem of socialization, to replace the profit motive in such a way that there is a drive for the utmost efficiency and progress in the industry and simultaneously to adopt scientific principles of pricing and costing. Since the actual profit or loss made in socialized industries will in any case depend not only upon technical efficiency but also upon the application of the pricing rules, it will not be possible to use resulting profits as a measure of efficiency of management. Is it possible to produce a breed of managers for socialized industries in whom professional pride will replace the profit motive in the search for technical progress and will enable scientific principles of pricing and costing to be applied? Is it possible to give these managers sufficient freedom and responsibility to go ahead with their job within the framework of the general principles on which they must operate without, on the one hand, conferring arbitrary powers upon them or, on the other hand, removing their zest for technical and economic improvement by the frustrating inhibitions of "red tape"? Here indeed is a conundrum for our society, and one which economists, cost accountants, administrators and psychologists would be well advised to consider carefully together.

In a liberal-socialist society there is room for much experimentation in the field of socialization. If the pricing system is used, as indicated above, both in competitive industry and in socialized industry, there is no reason why competitive and socialized sectors of the same industry should not compete with one another. For example, private enterprise might be left free to offer, on an untrammelled competitive basis, the services of road transport. The socialized transport system could simultaneously offer both rail transport and, where it so desired, road transport at prices equal to the cost to it of providing additional units of such transport. And the consumer of transport could take his choice. Or, to take another example, those sections of the iron and steel industry in which, on technical grounds, there was room for only one or two efficient plants could be socialized and run on the principles indicated above. But other sections of the industry where fairly full competition can prevail could be left to compete—provided, of course, that they were, in fact, willing to compete.

That last condition is, of course, a *sine qua non*. It is difficult, if the above argument is correct, to accept the view that the iron and steel industry or the chemical industry—to take but two examples—should long escape socialization, if they form close monopolies and maintain that their monopoly organization is necessary because it provides important technical economies of production. Private enterprise should establish its case on the grounds that it can and does enter into fruitful competition. Where it can establish that case, it is intellectually unassailable.

(c) *The Trade Unions and Wages Policy.*

There remains the problem of monopoly in the labour market. The Trade Unions are monopolistic bodies with the power and the incentive to rig the market to their own benefit not less than other monopolistic bodies. This does not, of course, imply that there is no need for any combination among workers. In most cases the number of employers is much fewer than the number of workers. Where firms employ on an average 500 workers each, there will in any district in which there are 2,500 workers be only five employers. Thus it is much easier for the employers to get together, tacitly or by express agreement, to depress wage-rates by restricting their demand for labour than it is for workers, unless they are well organized, to push wage-rates up by withholding or threatening to withhold their labour. There is an inequality of bargaining power which the formation of Trade Unions will rectify.¹ Thereafter the fixing of wage-rates through a Trade Union or similar body will present the employers with a wage-rate which they cannot depress by taking on rather less labour and the incentive for monopolistic restrictive practices by the employers will be *pro tanto* reduced.

But a Trade Union is nevertheless a monopoly which like any other monopoly will often promote its own sectional interest at the cost of the rest of the community. Restrictive practices which prevent the entry of new workers into an occupation will serve to maintain rewards in the occupation thus protected. They will thus not only perpetuate an undesirable inequality of income

¹ Theoretically, equality of bargaining power could be achieved with a minimum of monopoly by a rule which allowed combination of all workers employed by a single employer, but outlawed any further combination of such groups of workers or any combination of employers.

as compared with the poorer outside occupations, as has been argued in Chapter III; but they will also diminish the total national wealth since they will prevent the movement of labour from other occupations in which the product of labour is less valued by consumers (and the rewards offered to labour therefore lower) into the occupations in which the product of labour is more highly valued by the community. In addition to restrictions on new entry, rules which limit the amount which any individual should produce, or demarcation rules which prevent one man from turning from one job to another when this may be the most economic method of production, may protect the interests of the particular group of workers in question. By making the output of the particular workers artificially scarce such rules may maintain the price of the product and so the wage for this particular labour. But such rules are unquestionably anti-social. Like any other monopolistic device they rig the market in favour of one group at the expense of the rest of the community. They should no more be tolerated than restrictive practices adopted by the managements of business concerns.

Perhaps the most difficult monopoly problem is raised by the wage-fixing functions of the Trade Unions. It is essential that the price mechanism should work in the labour market. That is to say, the money wage-rate must rise in those occupations, those localities and those industries where the demand for labour, at the current wage, is in excess of the supply. The money wage-rate must not rise—indeed, if necessary and subject perhaps to the imposition of a minimum tolerable level below which no wage should be permitted to fall, it must be reduced—in those occupations, localities or industries where the supply of labour, at the current wage, is in excess of the demand and unemployment is beginning to grow.

This restoration of the supply-demand mechanism in the fixation of wage-rates is essential for two reasons. In the first place, if the Trade Unions make a free and full use in each industry of the bargaining power which their monopoly position confers upon them there is the gravest danger that it will be impossible to maintain full employment without an inflationary upward movement of money wages, money costs, and money

prices. At present only about $1\frac{1}{2}$ per cent. of workers are unemployed. This is an altogether abnormally low figure which is a result of the present excess inflationary pressure of demand for goods and services. The demand for anything and everything is now so great that anything and everything (whether it be essential or inessential and much wanted or little wanted) can be profitably sold. No worker need move from his existing job to another job; because, however little real use his present product may be to society, it can be sold at a profit. If the total demand for goods and services were more nicely adjusted to the total available supply of goods and services, the least useful products would be unsaleable and unemployment would undoubtedly be somewhat higher—perhaps 4 per cent. instead of $1\frac{1}{2}$ per cent.

But this must not be regarded as an intolerable evil. In any progressive society there must be movement of factors of production from existing employments to new and more productive employments, as old needs are satisfied and new needs develop, and as old techniques of production are discarded and new ones introduced. Some 4 per cent. unemployment may well be the technical minimum to allow for the necessary turnover of jobs in a dynamic society. Nor with adequate unemployment benefit and adequate measures to ensure that this unemployment takes the form of short bouts of unemployment for many persons rather than long period unemployment for a few unfortunate individuals need such a figure cause any intolerable social problem. Those who can remember the inter-war years, when the annual average of the unemployment percentage after 1920 never fell below 9.6 per cent. and in 1932 rose as high as 21.9 per cent., will realize what a moderate figure 4 per cent. is.

The real danger, however, is that the unemployment percentage will have to be much higher than the technical minimum for a progressive society of, say, 4 per cent. It is possible that at this level of unemployment the Trade Unions, in exercising to the full their monopolistic bargaining power in the labour market, would push wage-rates up at so high a rate as to cause an intolerable rate of rise in money costs and so in prices. Some annual rise in the general level of money wage-rates might be tolerable. For example, in a society in which there was an annual increase of, say, $1\frac{1}{2}$ per cent. in output per man a rise of 2 per

cent. per annum in the general level of wage-rates would cause only a $\frac{1}{2}$ per cent. per annum rise in money wage costs. Such an increase might well prove tolerable. But suppose that at 4 per cent. unemployment the bargaining power of the Trade Unions were so great that the general level of money wage-rates rose by 5 per cent. per annum, and that it required an unemployment percentage of 10 per cent. so to reduce the bargaining position of the Trade Unions that the general level of money wage-rates was not pushed up by more than the tolerable 2 per cent. per annum. Society would be faced with a most bitter dilemma:—either the Government must take action (on the lines discussed in Chapter II) to maintain the aggregate money demand for goods and services at a level which would keep unemployment down to the 4 per cent. technical minimum required in a progressive society and face a continuous inflation of money costs and money prices of $3\frac{1}{2}$ per cent. per annum;¹ or else the Government must restrict the monetary demand for goods and services to a level required to cause 10 per cent. unemployment in order to avoid a continuous inflation of money costs and prices.

If, however, the Trade Unions and other bodies concerned with wage-fixing accepted the supply-demand rule that the wage-rate (regardless of bargaining strength) should be raised only in those cases in which there was an excessive demand for labour and should be reduced in those cases in which there was an excess of the supply of labour and some growth of unemployment, this tragic dilemma between choosing unemployment or inflation would be avoided.

There is a second advantage to be obtained from the application of such a supply-demand principle in the labour market. It would cause those movements in relative wages as between overmanned and undermanned industries, occupations and localities which are required to adjust demand to supply for particular goods and services. Appropriate wage differentials will deflect the demand for labour away from the occupations and localities of great scarcity of labour to those where labour is more plentiful. The cost and so the price of the goods produced by labour which is in relatively short supply will be high in relation to that

¹ That is to say, a rise in money wage-rates of 5 per cent. per annum less the assumed increase in output per wage-earner of $1\frac{1}{2}$ per cent. per annum.

of the goods produced by labour which is plentiful. Consumers will be tempted to go for the latter rather than for the former type of goods, thus relieving the shortage of labour in the one case and increasing the demand for the labour which is in surplus supply. And where any given product can, in fact, be produced in a number of different districts, enterprise will be deterred by exceptionally high labour costs from establishing itself in those districts where labour is particularly scarce and will have a special incentive to seek out those districts where labour is particularly plentiful.

Moreover, with appropriate wage differentials, labour will be induced to move from the occupations in which there is a surplus to the occupations in which there is a scarcity of labour. Such mobility will apply particularly to youths and girls who are choosing their employment for the first time. But it can be true also of adult workers, particularly if a conscious effort is made to train workers in the first place so that they are as adaptable as possible for future changes from one job to another and if adequate facilities are provided for retaining adult workers. Wage differentials as between localities of labour scarcity and labour surplus should also help to attract workers to move from the latter to the former districts; and this again will be the more effective, if positive steps are taken to promote the geographical mobility of labour—such as the development of information services about the possibilities of obtaining accommodation and employment in different districts or State schemes for the finance of part of the cost of movement.

It is important to consider the alternatives to the use of the supply-demand mechanism in fixing wage-rates and to the use of the resulting wage differentials for achieving economically desirable shifts of labour. We have, in fact, a choice between four ways of dealing with this problem: the methods of Stagnation, Starvation, Slavery or Seduction. If labour is producing inessential electric fires instead of coal and essential clothing, we can, if we wish, throw up our hands in despair and do nothing. We can *Stagnate* by shivering without any clothes in front of a dozen electric fires which cannot be turned on for want of coal to generate the electricity. Or we can so reduce the demand for electric fires as to throw the workers there employed on to the

streets in large numbers. If we combine this policy with the abolition of unemployment benefit, we may drive the workers by the threat of *Starvation* into the mines and the textile mills. Or we can forget that Britons never, never will be *Slaves* and can direct workers willy nilly from the production of electric fires into the mines and the textile mills. But why not, after all, try the price mechanism? We might restrict the total purchasing power for goods and services to match the total supply, and might take measures to ensure a tolerably fair distribution of such purchasing power. If coal and clothing were then still particularly scarce we could let their prices rise; and if people needed electric fires less than they needed clothing and coal, their economies of expenditure would fall on electric fires and such fires would not command so good a price as previously. Wage-rates could then move upwards in coalmining and textiles relatively to light engineering. Is not this the background in which there is the best chance of *Seducing* labour to move where society most needs its effort?

The use of the price mechanism in the labour market to help to adjust the supply and the demand for labour means the abandonment or modification of certain existing ideas. In the first place, wage-rates must not be tied to the cost of living. If, by the means discussed in Chapter II, the total demand for goods and services is brought into a nice balance with total available supplies, then any surpluses of labour in some industries will be balanced by shortages of labour in others. In these circumstances, wage-rates should go up in industry A, if there is an excessive demand for, over the supply of, labour in industry A, even though the cost of living has not gone up. Wages should go down in industry B if there is a serious excess supply of, over the demand for, labour in industry B, even though the cost of living has not fallen. Nor is it desirable that the general level of wages should vary with the cost of living. If productivity is increasing, wage costs will fall even though wage-rates are constant, and the cost of home-produced finished products (and so the cost of living) might properly fall without any decline in the general level of money wage-rates. Or suppose that the price of our imported foodstuffs rises for reasons outside our own control without any corresponding rise in the price at which we can sell

our manufactured exports. The community will be worse off because we can get less food per unit of our manufactured exports. The rise in the price of imported foodstuffs will raise the cost of living. If wage-rates were to rise correspondingly, money costs of production would rise and we might lose even our existing export markets.¹ Real wage-rates must be allowed to mirror real improvements or disimprovements in our position. If domestic productivity rises or the terms of international trade improve, real wage-rates must be allowed to rise. If domestic productivity declines or the terms of international trade worsen, real wage-rates must fall. To tie the general level of money wage-rates to the cost of living prevents these necessary adjustments.

A second practice which needs modification is the maintenance of conventional relationships between different wage-rates. If there is an increased demand for agricultural workers and a reduced demand for labour to make and repair roads, the agricultural wage-rate must be allowed to go up relatively to the wages of roadmen. This will attract road workers into agriculture. If, however, roadmen's wages are raised whenever agricultural wages are raised merely in order to preserve a conventional relationship between the two, the whole point of the readjustment will be lost.

How can a supply-demand mechanism best be introduced into the wage-fixing process? Many of the measures which have been advocated for other reasons in other sections of this book will also help to ease the adoption of the needed wages policy. Thus the adoption of the measures proposed in Chapter III for the improvement of the distribution of income and property and, in this chapter, for the prevention of excess profits through restrictive practices by employers should ensure that there was an equitable division of the product of industry. It should thus remove a main obstacle to the adoption of a reasonable wages policy. One frequent objective of wages policy is to ensure that, by the maximum use of the Trade Union's bargaining power,

¹ Unless, of course, we offset the rise in our internal costs by a depreciation of the exchange rate, in which case the price of imported foodstuffs and so the cost of living would rise still further. If this in turn were followed by a rise in wage-rates, we should again either lose export markets or have to depreciate sterling still further, which would again raise the cost of living. And so on *ad infinitum*.

wages are in the interests of justice raised so as to eat into the profits of the owners of the businesses concerned. But if it were known that gross inequalities of income were being effectively dealt with by other measures such as taxation, social services and fiscal measures to ensure an equitable distribution of property, and that excess monopolistic profit margins were being prevented by effective measures for the promotion of competition among producers, by price control, by the socialization of monopolistic industries, etc., this obstacle to the application of a supply-demand mechanism to wage fixing would be largely removed.

Even more important, the adoption of the measures advocated in Chapter II for ensuring that the total money demand for goods and services was well balanced with the total available supply of goods and services would transform the wages problem. In conditions of general inflationary pressure there is an all-pervasive excess of demand for goods and services. In every occupation and district there is an excess of demand over supply of labour. There is an all-pervasive upward tendency for wage-rates; and it is determined by largely irrelevant circumstances—such as bargaining strength or the social responsibility or irresponsibility of the parties concerned or the date at which certain bargains fall to be renewed—which wages go up most and which least. There is no safeguard against a general wage inflation; and no assurance that wages will go up most where labour is most needed by the community.

But when the total demand for goods and services is brought into a nice balance with the total available supply, there is an excess of demand for goods and services and so for labour in certain occupations and regions and some tendency for supply to exceed demand in others. In the former there is an upward pressure on wage-rates: in the latter there is some tendency to unemployment and a reduction in wage-rates. The pressures are not all in the same direction; there is less danger of a general inflation of wage-rates; and there is a much greater probability that what changes in relative wage-rates do take place are in the right direction.

There is, however, no reason to expect that with powerful monopolistic bodies fixing wage-rates the desired results will

automatically be achieved even if a nice balance can be maintained between aggregate demand for goods and services and total available supplies. Indeed, it has been argued above at some length that it may well be that a quite unnecessarily high level of unemployment might have to be contemplated to prevent a general wage inflation; and even then there would be no reason to believe that the right relationship would be achieved between particular wage-rates. What further action is necessary? Theoretically there are two solutions. The first is to promote as much competition as possible in the labour market without reintroducing inequality of bargaining power. Employers would be prevented from combining to fix wage-rates and workers would be prevented from combining for the same purpose except into separate groups each of which included only workers employed by the same employer. The second is for the State to intervene in the fixing of wage-rates. It might, for example, set up impartial boards which, in consultation with the representatives of the employers' and the workers' monopoly organizations, would themselves fix wage-rates for each occupation in each region on the principle of raising the wage-rate where demand exceeded supply and lowering it where supply exceeded demand. Both these solutions present very obvious difficulties. Is there any reasonably efficient compromise?

CHAPTER V

FINANCIAL POLICY AND THE BALANCE OF PAYMENTS

If it be agreed that, as far as possible, financial inducements rather than direct controls should be used as a means of achieving our economic objectives, the question arises how far financial policy and the price mechanism can be used to deal with the most fundamental of all our present problems—namely, the restoration of equilibrium to our disordered balance of payments. The application of the price mechanism in this case presents special difficulty, since it depends not only upon our own choice between the price mechanism and direct controls, but also upon what other countries are doing. Nevertheless, my own view is that a great deal can be achieved by the proper use of the money and price mechanisms.

(a) The Control of Internal Demand.

First and foremost there is the problem of making the goods and services available for sale to the foreigner. This is above all, a question of the control of monetary purchasing power on the domestic market by the means discussed in Chapter II. A reduction of the domestic demand for goods and services for all domestic purposes (personal consumption, government consumption, and public and private capital development) directly reduces the demand for imports¹ and by reducing the demand for home-produced goods and services it will also cause more supplies to be available for export. A sufficiently stringent internal policy of "disinflation" will thus ensure that the restoration of our balance of payments is not impeded by an insufficiency of supply of goods for export.

¹Such restraint of internal demand will, of course, reduce the pressure on the existing import controls; but it may not appreciably diminish the volume of imports which is already held strictly in check by the existing import restrictions. But one must not overlook the fact that many forms of internal consumption use imported raw materials, and once raw materials are imported it is not possible to prevent all seepages into less essential domestic consumption. The elimination of such domestic demands would *pro tanto* reduce the demand for imported raw materials.

I am not now referring to measures designed to prevent monopolistic increases in wage-rates, profit margins and prices, such as those discussed in Chapter IV. It is, of course, important to ensure that the cost of the goods which we do make available for export enables them to be sold abroad in competition with foreign products; and I shall revert to this question later. But measures which reduce money prices as quickly as they reduce spendable incomes do nothing to reduce the real purchasing power of domestic consumers. Indeed, if there is a large plethora of liquid capital funds (in excess holdings of notes, deposits, small savings assets and the like) overhanging the market, reductions of money prices by increasing the real purchasing power of these capital funds may actually increase the excess of monetary purchasing power over the current cost of the available supplies of goods and services, and thus strengthen the internal demand which is pulling goods away from export markets.

In order to reduce the pull of internal demand measures of the kind discussed in Chapter II are required directly to reduce the domestic demand for goods and services or indirectly to do so by reducing spendable incomes more than money prices or by raising prices to domestic consumers without raising their spendable incomes. Such measures include economies in public expenditure on goods and services; discouragement of expenditures on capital developments of all kinds; increases in direct taxation which reduce spendable incomes; and increases in indirect taxation or reductions in subsidies which raise the price of goods and services to domestic consumers without raising their spendable incomes.

Measures of this kind by restricting the demand for goods and services would, in fact, be the most effective brake on the upward spiral of money prices and costs; and they could be used to limit internal demand to the extent necessary to prevent supplies required for export from being pulled on to the domestic market. Recently at my bank I was standing beside a man who was paying a series of cheques into his account. The clerk asked him how his business flourished and whether he had many export sales. He replied that business was fine, that he could obtain any amount of export orders, but that he was too busy to undertake that sort of thing. We must reduce the internal

pressure of demand, not, of course, to such an extent as to cause serious unemployment, but sufficiently to make it profitable for many more businesses to go all out for alternative export orders.

In this respect we have a stiff task ahead. In 1947 our adverse balance of payments on current account was £675 millions. To close this gap we must export £675 millions more of our products or import £675 millions less of the products of other countries. Supplies available on the domestic market must in either case be reduced by this amount, except in so far as we increase our total production or are able to obtain our imports more cheaply. In addition, therefore, to any "disinflationary" measures required to correct any excess inflationary pressure of monetary demand that already existed uncorrected in 1947 we have to reduce demand by a further large amount, if total demand is to be brought into balance with total available supplies.

Financial measures which, by restraining domestic demand, make available for export the goods and services required to bring the balance of payments into equilibrium would powerfully reinforce, and might well eventually replace, attempts to force exports by clumsy direct controls which require each industry to export an arbitrarily determined proportion of its output. Such controls are open to all the general objections which were discussed in Chapter I: they involve the inevitable wastes of such bureaucratic controls; they limit consumers' freedom of choice; and they lead to serious problems of enforcement and of the "spiv" producer who prefers not to "play the game." But they have their own particular brand of inefficiency in comparison with a proper use of the pricing system. When the controllers, in consultation with representatives of the industries concerned, lay down that 60 per cent. of the output of sewing machines, 65 per cent. of the output of vacuum cleaners, 70 per cent. of the output of bicycles, 75 per cent. of the output of motor-cars, 80 per cent. of the output of hand tools, 85 per cent. of the output of glassware, 90 per cent. of the output of toys, 95 per cent. of the output of leather handbags, and 100 per cent. of the output of decorated pottery should be exported—(my examples are entirely fictitious)—can they really feel assured that this constitutes the best possible composition of our exports? Would consumers at home be better off if rather more handbags

and rather less sewing machines were exported? A properly working pricing system would, of course, look after this, since consumers could use their limited purchasing power at home to take up more sewing machines and less handbags; and in doing so they would be duly discouraged from purchasing the goods which were the best earners of foreign exchange, since they would have to compete against the prices which foreign purchasers were offering for our handbags and sewing machines. Has a proper allowance been made in every case for the larger or smaller amounts of imported materials costing valuable foreign exchange which the exports directly or very indirectly contain? Here again a pricing system which resulted in imported raw materials being sold at prices sufficiently high to measure their relative scarcity would make due allowance for this factor, since the cost to domestic and to foreign purchasers of goods containing much imported raw materials would be high relatively to those which contained little such materials. Foreign, as well as domestic, demand would automatically be deflected on to those of our goods which were made chiefly from domestic resources.

(b) The Control of External Capital Movements.

For these reasons I consider that the task of making the necessary supplies available for export is essentially a task for internal financial policy. There is a second task of perhaps equal importance which seems to me to be equally clearly a matter essentially for financial policy—in this case for external financial policy. Having made certain that the goods will not be bought on the internal market, one must next ensure that they are not bought by overseas purchasers except for money which will enable us in turn to purchase the imports which we require. It is frequently argued that we require some system of direct control over our exports for the purpose of directing them to “hard” currency markets where their sale will earn us currencies with which we can purchase needed imports and away from markets where their sale will earn us only inconvertible currencies which we cannot readily use for purchasing essential supplies.

(i) Exchange Control.

But such a system of direct export controls would be superfluous if, by suitable financial arrangements, we insisted that

overseas purchasers of our goods should pay for them in gold, convertible currencies, or sterling acquired currently by them through the sale of useful goods to us. This result would be achieved if steps were taken to ensure that the large balances of liquid sterling funds accumulated by overseas countries as a result of war-time finance were blocked or were otherwise prevented, through firm agreements with their holders, from being run down, and if similarly stringent methods were adopted to ensure that there was no export of capital funds from this country to any overseas territory. In such conditions foreigners could obtain new sterling for the purchase of our goods only through the sale to us either of their goods or of other currencies which were useful to us for the purchase by us of imports from other sources. They could not finance purchases of our exports by means of money borrowed from us or obtained through the repayment of our past debts to them. Exporters would automatically find that only those overseas markets were profitable which gave us the power to import needed supplies.

I do not intend to maintain that there should be literally no movement of capital abroad. Even in our present critical position we are under some moral obligation to make a moderate payment on account of the indebtedness which we incurred during the war. Our payment arrangements with foreign countries need some margin of elasticity and flexibility; we must sometimes be prepared to run up our holdings of a foreign currency or to allow the foreign holdings of our currency to decline moderately and temporarily in a clearing or payments account. It may occasionally be economical for us on a moderate scale to allow a country to purchase our exports indirectly or directly on some form of loan from us, if thereby we obtain an export trade which is likely soon to become repaying and which we might lose permanently (for example, because of the growth of a domestic industry in the country concerned) if we did not enter it promptly. We may be wise occasionally to invest abroad on a moderate scale in economic schemes for the development of new sources of cheap supply of essential goods which we must import, provided that we can get no other country or international institution to advance the necessary funds. But on these and similar grounds we can consciously decide how much credit

should be granted, or how much debt should be repaid, to each overseas country and can make our financial arrangements accordingly. That done, there is no need for any further control to guide exports to repaying markets.

It is frequently pointed out that our exports tend at present to go to non-dollar markets and that we draw a large surplus of imports from dollar markets. Indeed, the Chancellor of the Exchequer stated in the House of Commons on December 18, 1947, that for 1948 we hoped to attain substantially an overall balance in our balance of payments with visible and invisible imports at £1,700 millions and visible and invisible exports at £1,680 millions; but he added that there would still be "within this total balance a deficit with the Western Hemisphere of nearly £300 millions sterling which, of course, cannot be set off against our surplus from the other areas. That could only be tackled by cutting off imports from or extending exports to the Western Hemisphere." In other words, the prospect was that we should export £300 millions more to non-dollar markets than our imports from those markets; for this must be so, if we have an overall balance and yet import from dollar markets £300 millions more than we export to dollar markets. How might our excess exports to the non-dollar markets be financed?

First, these excess exports might be sold in the non-dollar markets in return for gold or dollars—gold and dollars which the non-dollar countries would have to have earned by their excess exports to dollar countries or by untied loans or other untied aid from dollar countries. But in this case we would be able to set off our surplus with the non-dollar world against our deficit with the Western Hemisphere. We should have nothing to worry about: our overall balance of payments would balance and we should face no loss of gold or dollar reserves—unless, of course, we were prepared to allow other countries to obtain funds from us on capital account for conversion into gold and dollars to finance their excess imports from dollar markets.

Secondly, however, we might ourselves provide to the non-dollar countries the funds necessary to purchase our excess exports, either by letting these countries run down balances of sterling already accumulated by them in London, or by ourselves accumulating idle balances of their inconvertible currencies, or

by allowing some other form of capital export to them from this country. But it would be surprising if, in the present parlous plight of our balance of payments, we were to contemplate an export of capital (including the repayment of our debts) of no less than £300 millions in one year.

The figures for 1947 show that in that year our net loss of gold and other monetary reserves was £972 millions, while the total excess of visible and invisible imports which we could not finance by our visible and invisible exports was £675 millions. The difference of about £300 millions must have represented an export of capital, i.e., capital funds which we had directly or indirectly lent or repaid to overseas countries to enable them to purchase goods from us without immediate repayment or to enable them to obtain from us gold and dollars to finance their excess imports from other countries. About one-half of this export of capital represented a repayment of sterling balances. These are huge figures. A capital export of £300 millions in a year would have been very large in the best pre-war days of our balance of payments; it represents between one-quarter and one-third of the whole United States Loan; it is more than the total annual aid we can hope to get from the Marshall Plan; it is three-fifths of the reserves of gold and dollars which remained to us at the end of 1947; and it may be compared with the £43½ millions which in the United States Loan Agreement was laid down as the annual rate at which after 1951 we might repay the accumulated sterling balances without losing the benefit of the waiver of interest on the United States Loan.

(ii) *Domestic and Foreign Rates of Interest.*

In our present position we must undoubtedly rely for a considerable time upon measures of direct exchange control to prevent the export of capital. But even in such conditions it is desirable that the price mechanism should reinforce rather than pull against the necessary controls. This consideration strengthens the arguments which have been brought forward in Chapter II (pages 26 to 33) for some rise in domestic interest rates in present conditions. A rise in our own rates of interest would not only, as was argued in Chapter II, reduce the pressure on the direct controls which are at present employed to hold down domestic expenditure upon building, plant and

machinery and all forms of internal capital development. A rise in our rates of interest in comparison with foreign rates would also reduce the pressure on our exchange controls. It is not so much that one might hope or even desire to attract long-term, or even short-term, commercial loans from the United States or other hard currency countries by offering a somewhat higher rate of interest on such loans. But there may be a quite appreciable reduction in the desire of some British owners of capital to move their funds abroad, if thereby they lost an appreciably higher return on their capital at home. Moreover, many traders and other persons engaged in quite legitimate foreign transactions may often have to decide whether to leave certain funds for short periods in foreign currencies in foreign financial centres or in sterling in London. An appreciable improvement in the return in London on such short-term funds might appreciably affect their decision.¹

There may often be a conflict between the financial policy required to control domestic inflationary and deflationary pressures and the financial policy required to restore equilibrium to the Balance of Payments. Indeed, this country was in such a position during the 1930's. Domestically we needed all the armoury of weapons discussed in Chapter II for stimulating total internal purchasing power in order to increase the demand for home-produced goods and services and so to get rid of mass unemployment. Externally we already had a serious balance of payments deficit. This external trouble would have been intensified by the increased demand for imports which such measures for the domestic reflation of purchasing power would have caused; and we would have required still more extensive measures of exchange depreciation, import control or exchange control to rectify it. A low rate of interest would have helped to stimulate internal demand; a high rate was needed to restrict the demand for imports and to attract capital funds to this country. We are at present in no such tragic dilemma. Measures of restraint are required both to remove the domestic evils of

¹ There is, of course, no suggestion that higher rates of interest should be offered on the sterling balances accumulated by overseas countries during the war in order to slow down the rate of their withdrawal. Such balances represent a special problem of war debts, and should be the subject of special arrangements.

an inflationary pressure and to make goods and services available for export. A higher rate of interest helps in these respects and also in making this country a more attractive home for capital funds.

(c) Trade Controls versus Exchange Rate Adjustment.

We come now to the third main question concerning the use of financial policy and the price mechanism as a means of adjusting our balance of payments. Suppose that we have restricted internal monetary demand and have set close limitations on the purchase of our exports by overseas buyers out of accumulated sterling balances or other funds acquired on capital account. The goods will then be available for export and for export only to repaying markets. If there is no special difficulty in selling our goods in those markets, well and good. The job is done. Two heroic measures of financial policy, one domestic and one external, have done the trick and our balance of payments is balanced.

But suppose that we have taken these steps and that we then find that we cannot readily sell the goods in the repaying markets, even though the goods themselves are available. What then? Are there further adjustments of financial policy which are available to solve this problem? Or must we resort to trade controls?

(i) Quantitative Import Restrictions.

Let us first consider the nature of the trade controls which would be appropriate to meet this situation. We might restrict imports by quantitative import restrictions to the extent necessary to bring them into balance with the limited amount of exports which we find that we can sell in repaying overseas markets. What does this imply?

When imports are restricted quantitatively below the level which would otherwise be brought into the country, supplies are reduced below the demand ruling at the current overseas prices of the imported goods. This means that, after the imposition of the import restriction, the price which consumers would be willing to offer for the goods is in excess, and often greatly in excess, of the price which the foreign suppliers would be willing to take for the goods. Who gets the benefit of this

potentially substantial rake-off? Leaving aside for the moment the possibility of its accruing to the Government of the importing country there are three possibilities.

First, it may accrue to the final consumers of the imports. This is the more likely to be the result if there is an effective domestic price control. But price control is a difficult matter, and there are many goods where it may prove not to be practicable, particularly in regard to the resale of the commodity from one consumer to another. Where it is practicable it means either a consumers' scramble for the limited supplies with the resulting shop shortages, queues, etc., or a scheme of rationing, licensing or quantitative allocation to ensure an equitable distribution of the short supplies. This method is not compatible with the re-instatement of the pricing system domestically.

Secondly, the rake-off may accrue to those lucky middlemen to whom the controllers hand out the valuable pieces of paper called import licences which give permission to the privileged few to purchase in the cheap foreign market for resale at scarcity prices at home.

Thirdly, the price charged by the foreign suppliers may be raised to correspond with the higher price at home. This has often happened in the past and is a constant danger; and in so far as it does happen the saving in foreign exchange which is the object of the restriction of imports is frustrated by the rise in the price paid to the foreign suppliers. Indeed, if the domestic demand for the imports is sufficiently irresponsive to price changes, the reduction in supplies will so raise the price of the imported goods that the foreigner will obtain a larger sum of money for a smaller volume of goods. The import restriction in that case will not only have reduced our real standards of living by reducing the supply of imported goods; it will also have made our balance of payments worse instead of better.

The rake-off is the more likely to accrue to foreign governments, foreign producers, or foreign middlemen, the more easily the foreign suppliers can form a monopoly and, by restricting or threatening to restrict their sales, can obtain a price corresponding to the scarcity price in the country of import. Foreign suppliers may, of course, in any case attempt to indulge in such monopolistic exploitation of the importing market; it does not

require import restriction by the importing country to make successful export restriction profitable. But import restriction often makes export restriction by the foreign suppliers much easier to organize. This is particularly the case if the import restriction is administered by the allocation of a fixed quota to each supplying country. For in that case, the exporters in any one exporting country cannot be undercut by competition from another exporting country, since the latter will be restrained by its own fixed quota. All that each exporting country need do in order to exploit the scarcity in the importing country is to organize a national export monopoly. No comprehensive international restriction scheme will be necessary, as would be the case in the absence of import quotas in the importing country.

It might for these reasons be thought that the quantitative control of imports cannot be effectively and equitably run as part of a domestic system which is relying more and more upon the pricing system; that it will constantly expose us to all those threats of spivery and corruption and to those bureaucratic wastes which are inevitably associated with licensing systems; and that it runs the grave danger of being an inefficient instrument even from the point of view of our balance of payments because it may merely enable the foreign suppliers or foreign governments to obtain a larger payment for a smaller supply of goods.

But import licensing is not inevitably prone to these dangers. They would be completely removed by quite a moderate change in the method of applying import restrictions. I refer, of course, to the possibility that import licences should be auctioned or otherwise sold to the highest bidder. This would ensure that the rake-off between the scarcity selling price and the foreign purchase price of the imported supplies accrued, as it should, to the community in the form of increased public revenue, part of which could, of course, be used, if it were so desired, to supplement the incomes of the poorer consumers so as to offset the rise in the price charged for the imported goods. It would enable a system of strict quantitative control of imports to be integrated into a domestic economy which relied upon the price mechanism. It would not involve the selection of a privileged few importing middlemen, since all firms, old and new, domestic and foreign,

could take part in the auction. It would remove the temptation to spivery and corruption. The licences to import need not tie the importer to a single source of supply, and this would fully maintain the incentive and the power of the importers to keep down the price offered to the foreign suppliers.¹

Any experiments in auctioning import licences could be initiated on a limited scale. One or two commodities for which the conditions were considered most suitable could be chosen in order to see how such a system might work. But the really interesting possibilities would arise when the system became more general. This is so not merely because a large amount of imports would then be covered by all the individual schemes, but because there would be great possibilities of extending the range of goods covered by each individual scheme. One of the great difficulties involved in drawing up any quantitative import programme is to decide how much of each particular commodity should be imported. Would consumers be better off if, within the total value which was permitted to be spent on imports, £100 worth less of wheat and £100 worth more of maize were imported? There is nothing to prevent the organization of a single auction for the right to import such and such a total value of cereals. Indeed, the principle could go much further than this. Would consumers be better off if £100 worth less of petrol and £100 worth more of cereals were

¹ Incidentally, it would provide the only reliable criterion as to whether import restrictions were discriminatory or not as between two or more foreign sources of supply. If the import licences were sold to the highest bidders and represented a right to purchase from any market, there would automatically be no discrimination; commercial considerations alone would decide the source from which the goods were actually imported. If licences to import from different sources were separately auctioned, then the difference between the height of the bids for import licences for goods from, say, France, and that for the same goods from, say, the United States would provide a measure of the degree of "discrimination" involved in the proposed distribution of sources of supply. The import licence fees for imports from France and from the United States which resulted from the separate auctions of the import quotas from those two sources could be compared with each other just as separate tariffs on French goods and on American goods can be compared. If the auctions were of licences to import certain quantities of the commodity from each source, the resulting import licence fees would correspond to "specific" import duties; if the auctions were of licences to import a certain value of the commodity from each source, the import licence fees would correspond to *ad valorem* duties.

imported or £100 worth less of books and £100 worth more of timber? There is nothing to prevent the organization in the end, by the successive merging of smaller groups, of a single auction for the right to import such and such a total value of all imports. To the extent that it was desired to use the pricing system as a means of following consumers' choice in the home market, the same principle could be applied in the selection of imports even though the total value of imports were rigidly controlled.

There remains, however, a much more serious criticism of the restoration of equilibrium to the balance of payments by means of import restrictions—namely, that it does nothing to expand our exports. It means that we balance our international accounts at an uneconomically low level both of imports and of exports, although we are a country which stands to gain more than most from making the fullest use of the international division of labour. For we are a country which relies upon the import of essential foodstuffs and raw materials which we cannot produce at home and which we must purchase by the sale of less essential manufactured goods which many of our customers could make for themselves. Quantitative restriction of imports is clearly a second best arrangement for us and one which we should accept only if we cannot arrange to sell our exports in repaying markets on a scale sufficient to finance all the imports we need of the goods which can be produced relatively more cheaply abroad.

Import restrictions should not, of course, be dismissed on these grounds until they have been examined in the form which is least open to this sort of objection. In conditions in which there are a number of separate countries suffering from an adverse strain on their balances of payments, import restrictions, if they are to be used to correct the balance of payments with the least restrictive effect on world trade, should be used discriminatorily. For suppose that France and the United Kingdom are both suffering from serious balance of payments deficits, while the United States has a large balance of payments surplus. If both France and the United Kingdom restrict their imports on a non-discriminatory basis, then France must restrict her purchases of British as well as of American goods and the United Kingdom must restrict her purchases of French as well as of American goods. There will be an unnecessary and uneconomic hindrance

to the trade between France and the United Kingdom as an incident in action which is fundamentally designed to correct the lack of balance between the United States on the one hand and France and the United Kingdom on the other. If, however, France discriminates in her import restrictions in favour of the United Kingdom and the United Kingdom in favour of France, the division of labour between France and the United Kingdom can have full scope. Because we purchase more from France, France will be able to pay for more of our exports and we shall have a larger volume of remunerative export sales.

It should be observed at once that, while this mitigates the evil restrictive effect of import controls, it by no means removes it completely. Balance between Western Europe and North America would still be reached by a restriction of imports of North American goods into Western Europe rather than by an expansion of Western European exports into North America. Nor, unfortunately, is this the end of the problem. It is easy to say that a new balance should be reached by means of trade discriminations against the exports of a country with a persistent balance of payments surplus. But what form should this discrimination take? Should only those countries which are short of the "scarce currency"—let us say dollars—be permitted or required to discriminate against imports from the country with the balance of payments surplus? Or should all countries with an overall balance of payments deficit be allowed or be forced to discriminate in each other's favour even though one or more of them may have a surplus of the "scarce currency"? In other words, should each member of a group of deficit countries which are making, as it were, a common dollar pool discriminate against dollar purchases only in so far as necessary to ensure that that particular member does not take more dollars out of the pool than it puts in, or should each of the members discriminate equally against dollar purchases, regardless of its own particular contribution to the pool, so long as the pool as a whole is short of dollars? As Mr. G. D. A. McDougall has recently pointed out,¹ these are very different propositions, in which different members of the dollar pool will have very different interests.

¹ "Notes on Non-Discrimination." Bulletin of the Oxford University Institute of Statistics, November, 1947.

Discrimination against dollar purchases may be a polite periphrasis for going without the most essential imports; and the members of the dollar pool which contribute most dollars to it will want a quite different principle of discrimination from that desired by the members of the pool who contribute few dollars to it.

And the above is only one simple example of a clash of interests which might arise even if there were only three countries—one surplus and two deficit. But there are, in fact, some fifty countries, and at least a dozen countries of commercial importance, with a highly complex pattern of trading relationships between them. Suppose there are a number of deficit and a number of surplus countries. Against which surplus country shall which deficit country discriminate to what degree? Suppose that there is a rule that any deficit country can discriminate against any surplus country so long as the latter remains in surplus. Then if deficit country A discriminates against surplus country X instead of against surplus country Y this may mean that deficit country B cannot discriminate at all, because it imports only from surplus country X which, by reason of deficit country A's discrimination against it, it is no longer in surplus. Should deficit country A be obliged to discriminate instead against surplus country Y? Country A will not want to do so if it draws its most essential imports from country Y. Or if deficit countries A and B fix up a bargain to discriminate in each other's favour in order to save the currency of surplus country X may they discriminate against deficit country C or must they extend the benefits of their bargain to deficit country C even though that last country purchases nothing from them and cannot therefore discriminate in their favour?

I fear that if I carried this analysis much further it would become too complicated to be readily intelligible. Professor Ragnar Frisch has recently discussed¹ the problem and has pointed out that by the application of the mathematical method of matrices one might determine even in the most complicated trading patterns that system of discriminatory import restrictions which would restore equilibrium to every balance of pay-

¹ "On the Need for Forecasting a Multilateral Balance of Payments." *The American Economic Review*, September, 1947.

ments with the minimum reduction in the total of world trade. But even this will not, I fear, get one so very far. This might mean for country A, for example, that it must restrict imports only from country X and not at all from its other suppliers Y and Z. But if it bought all its essential foodstuffs from X and its luxuries from Y and Z, it might not console its own inhabitants to know that they were starving in order that statistically the volume of world trade might suffer a somewhat smaller diminution.

In fact, discriminatory import restrictions are likely to descend into a welter of bilateral trade bargains probably with a more or less exact balancing of trade between each pair of countries. However enlightened and able the officials of the future International Trade Organization may be, they will not be able to prevent such a system from deteriorating into a chaotic game of international barter causing real hardships to many unfortunate countries and imagined grievances to many more. We in this country, who stand so much to gain by the international division of labour and whose trade has hitherto run so much in multi-lateral channels, may indeed shrink from the prospect of a world in which many bilateral deals will be taking place which result in discrimination against our goods. Experience between the wars demonstrated that the quantitative import restrictions which other countries imposed were the worst obstacle which our exporters had to encounter and that the growth of vested interests behind their protective cover made them most difficult to remove even when the need for them on balance-of-payments grounds had completely passed.

(ii) *Adjustments of Exchange Rates.*

It is time to return to financial policy and the pricing system and to ask whether there is not a means on those lines by which the problem might be tackled. There is, of course, such a means in the adjustment of exchange rates. Let me make one thing clear at the outset. I am not advocating that here and now the pound sterling should be depreciated. Far from it. My argument up to this point has been that we should first restrain our own internal monetary demand to match the supply of goods and services which would still be available to us for domestic consumption if our exports were so increased or our imports so

decreased that our balance of payments balanced, and that we should make sure that we sold our exports only in return for gold, convertible currency, or sterling newly acquired from the sale of useful goods to us. Such action might, I have said, cure our problem. It is only if we are then unable to find sufficient remunerative overseas markets for our exports that we should have to choose between discriminatory import restrictions and exchange depreciation. And this choice may well never arise. An upward movement of money wage-rates is proceeding and may well continue in the United States. On the other hand, the effective application in this country of those measures for reducing excess demand which are discussed in Chapter II and which are in any case necessary in order to release our products for export would greatly restrain the upward tendency of our money prices and costs, particularly if they were supplemented by measures of the kind discussed in Chapter IV to restrain undesirable monopolistic upward movements in wage-rates and profit margins. If in addition we can prevent any widening of, or even start to close, the existing gap between the technical efficiency of American and British industry, we may well find that we can undercut United States products to a sufficient degree without any exchange depreciation. Loose talk about an exchange depreciation which may never prove necessary is to be deprecated in view of the foreigners' hesitation to purchase our goods or to hold our money which would result from any expectation that our goods and our money were just about to be cheapened in terms of foreign currency by a depreciation of the pound. Nevertheless it is important to consider whether, in the hypothetical case of our being unable to find sufficient remunerative markets to sell all the exports necessary to finance unrestricted imports, we should be wise to choose import restrictions or exchange depreciation.

In many respects the method of exchange depreciation corresponds to the auctioning of the right to import a given value of goods. As far as the disincentive to the purchase of imports is concerned a 10 per cent. depreciation of sterling is likely to have similar effects to a 10 per cent. *ad valorem* import licence fee; it will increase by 10 per cent. the sterling cost of obtaining a dollar's worth of imports. Like a single auction for the right

to import a given value of goods, exchange depreciation does not discriminate between different imports; it does not require a large administrative machinery for detailed import control; it does not encourage spivery and corruption in deciding who shall be the privileged importers; it does not give any special possibilities to the foreign suppliers to put the price in foreign currency of the supplies up against us; and generally it integrates the imported supplies into the domestic pricing system.

Appropriate exchange rate adjustments also give just the correct degree of discrimination against the "hard currency" overseas sources of supply. Let us revert to the example of France and the United Kingdom, both of which we assume to be countries which have brought their internal inflations under control and have stopped the export of capital but still have an adverse balance of payments; and let us consider their commercial relations with the United States, which we assume to have a surplus on its balance of payments. If the franc and the pound sterling were both depreciated by 20 per cent., this would make American goods 20 per cent. more expensive in both France and the United Kingdom without making French goods more expensive or more difficult to purchase in the United Kingdom or British goods more expensive or more difficult to purchase in France. In this way if each country with a deficit on its balance of payments were to depreciate, and each country with a surplus on its balance of payments to appreciate, to the extent necessary to achieve a balance in its own balance of payments, there would be just that degree of "discrimination" in the sources of imports which is required to correct the balance. And this would be done without any loss of multilateral trade or any of the complexities and arbitrary clashes of interest of bilateral barter arrangements.

In this respect the method of exchange rate adjustment is to be greatly preferred to that of direct trade controls. But there remain two further essential differences between import restriction and exchange depreciation which require examination.

In the first place, discriminatory import restriction provides the State with an opportunity for exercising a monopolistic bargaining power which is not the case with exchange depreciation. Exchange depreciation discourages all imports from all sources

equally. With discriminatory import restriction the State can attempt to obtain its imports cheaply and on favourable terms from abroad by playing one supplier off against another. It can refuse to take these particular goods from this particular country unless the country in question will sell very cheaply or will take our exports in return at a good price. By exercising pressure on those countries which could least readily sell their produce elsewhere or turn to the production of other commodities, we could undoubtedly obtain an advantage, provided, of course, that no one tried the same trick on us.

But there is the rub. A country like ours which imports essentials which it cannot produce for itself and exports in-essentials which others can fairly readily produce is not in the long run likely to come off well in a generalized system of monopolistic barter between sovereign States, even though it may be able in the short run to pick up one or two good bargains from countries which in the more liberal days of the past had been organized to serve this market and had not yet had time to extricate themselves from such a bad bargaining position. In the longer run if we wish to survive we must achieve a general set of rules, such as those adumbrated in the present Draft Charter for an International Trade Organization, which ensures a general all-round renunciation of discriminatory bargaining through import controls, although in the absence of such a set of rules we shall no doubt go bravely under stoutly asserting to ourselves as well as to others that our extensive market for essential raw materials and foodstuffs—though they are at present in short supply, though they are largely supplied by under-developed countries determined to switch from their production to that of industrial products, and though without them we must close down our industries and cease to eat—puts us in a peculiarly strong bargaining position.

In the second place, a depreciation of the exchange rate will make our exports cheaper in terms of foreign currency as well as making our imports more expensive in terms of sterling, whereas import restrictions will do nothing to cheapen our exports in foreign markets. Does this difference tell in favour of import restrictions or of exchange rate adjustment?

It is not possible to give an absolutely unequivocal answer to

this question. It depends upon the extent to which a cheapening of our exports would stimulate their sales in foreign markets. If the foreign demand for our exports were very irresponsive to price changes, a reduction in their price might so little stimulate the total amount which we sold that we should receive actually less foreign currency than before. Even though the elasticity of the foreign demand for our exports is likely to be sufficiently great to ensure that this does not happen, we should almost certainly still suffer some movement in the real terms of trade against us, in the sense that an exchange depreciation would most probably cause a greater reduction in the price of our exports than in the price of our imports in terms of foreign currencies so that the country could obtain less real imports per unit of the commodities which it exported.

But against this must be set the fact that there would be an increase in our total exports; and while we should gain somewhat less from our foreign trade on each unit of commodity exported we should enjoy this somewhat smaller gain on a larger volume of trade. If the increased volume of our exports were large in relation to the fall in the price which we could get for them in foreign currencies, we should stand to gain more from the increased volume of trade than we should lose from the smaller gain per unit of trade.

The question then comes down to this. Would a relatively small reduction in the price of our exports in foreign markets cause a relatively large increase in the volume of goods which we could sell? If so, the case for exchange rate adjustment is conclusive.

There can, I think, be little doubt that if we alone depreciated our currency and if the other countries whose markets we were thus enabled to invade did not for that reason erect barriers of one kind or another against our goods, a reduction in the price of our exports would normally lead to a very considerable increase in the demand for them. For we produce manufactured goods often of a luxury or semi-luxury character, that is to say, of a kind for which the total demand is likely in any case to be responsive to price changes; and we produce these goods in competition with the similar products of many of the countries to which we export and of many competing exporting countries. A

reduction in the price at which we can offer our goods can be expected, therefore—particularly after the lapse of a little time in which the necessary commercial readjustments are made—to lead to a considerable shift of demand in foreign markets in favour of our products.

If other countries depreciate their currencies when we depreciate ours so that we obtain no competitive export advantage over them, the foreign demand for our exports would, of course, be less responsive to changes in the price at which we offer our goods. We should obtain competitive advantage only over the products of those countries which do not depreciate. It is therefore of great importance to obtain the general international recognition of a rule which outlaws unnecessary exchange depreciation by countries whose balances of payments are not in deficit.

But there may, of course, well be cases in which a number of other countries are in deficit simultaneously with ourselves, so that some simultaneous depreciation of their currencies with our currency would be legitimate. Indeed, the present may be taken as representative of a condition of this kind. What the world suffers from is primarily a dollar shortage. If we and all the other non-dollar countries of the world could expand our exports to dollar markets and restrict our purchases from dollar markets so as to put the balance of payments between the dollar markets and the rest of the world as a whole into equilibrium, the remaining problems of adjustment between the members of the non-dollar area would be relatively easy to solve. What we have, therefore, to examine is the effect on the balance of payments between the non-dollar countries and the dollar countries as a whole of a simultaneous depreciation of, say, 20 per cent. of all the currencies of the non-dollar group of deficit countries. Or in other words, assuming always that the deficit countries were adopting effective internal policies for control of inflationary pressure, so that each had a supply of goods available for export adequate to close its own balance of payments deficit, would an appreciation of the dollar by, say, 20 per cent. remove the favourable balance of payments of the United States?

There is, in my opinion, no *a priori* reason for believing that the simultaneous depreciation of their currencies by a large

group of countries all of which are in deficit on their balance of payments with the rest of the world will be less effective in restoring equilibrium than the depreciation of its currency by a single small country which is alone in deficit with the rest of the world. The difference is that the simultaneous depreciation by the large group of countries is likely to operate mainly on the imports of that group, whereas the depreciation by the small single country is likely to operate mainly on that country's exports. A single country, comprising a small region of the world, is likely to import many commodities which it cannot at all readily produce for itself. Its demand for these imports is likely to be little responsive to a change in their price because it cannot readily turn to or from the production of the same goods at home as the price of its foreign supplies improves or worsens. On the other hand, save in those special circumstances in which a single country relies upon the export of a single commodity of which it has a natural monopoly of production, a small country is likely to produce goods for export which compete with the exports and the home production of many other countries. A relatively small reduction in the price at which it offers its goods for export may enable it to undercut a large volume of foreign production.

The large group of countries which simultaneously depreciate their currencies will be in the opposite position. Their exports will make up a much larger proportion of the total production of the rest of the world and there is a greater probability that in some lines they will together account for practically the whole output of certain commodities. They cannot, therefore, expect to obtain any given proportionate increase in their sales of exports without a much greater danger of spoiling the market for their goods in the rest of the world, although, if the rest of the world contains the United States, it will still contain a very substantial proportion of the world production of manufactured and of primary products against which the produce of the depreciating countries may compete. But on the other hand a large group of deficit countries is likely to include, as it does at the present, countries producing many diverse commodities including both agricultural and industrial products. For this reason the imports of the group from the rest of the world will be much more sensi-

tive to price changes than in the case of a small single country. For example, suppose that we and a large group of deficit countries, including both agricultural and manufacturing countries, depreciated simultaneously. The rise in the price of dollar foodstuffs to us would enable us, without deliberate discrimination against United States produce, to switch our imports of foodstuffs to non-dollar sources of supply. The rise in the price of dollar manufactures in other overseas markets whose currencies had depreciated with ours would enable them, without deliberate discrimination, to switch to the purchase of our manufactured goods instead of United States products.¹ The group's imports from the United States would as a whole be very responsive to price changes, though its total exports to the United States would be less responsive than would the exports of a single country to the whole of the rest of the world.

Thus there is no reason to believe that a simultaneous depreciation by a large group of countries will be any the less effective in putting the group into equilibrium than a depreciation by a single country in putting that country into equilibrium. Nor is there any reason to believe that the effect on the terms of trade of the group as a whole with the rest of the world will be any more adverse than the effect on the terms of trade of a single country with the rest of the world. The group will avoid too great an adverse change in its terms of trade because a relatively small rise in the price of its imports from the rest of the world will close the gap in its balance of payments by inducing a very considerable contraction of its imports. The single country will avoid too great an adverse change in its terms of trade because a relatively small fall in the price of its exports will close the gap by causing a large expansion of its exports.

Nevertheless the larger the group of countries, the more likely is it to be advantageous to it to use discriminatory import controls against the rest of the world rather than exchange depreciation as the method of restoring equilibrium. This will be so for two reasons. First, since its exports are less likely to be expanded

¹ It is, of course, assumed that "disinflationary" policies in this country have made available manufactured goods for export to replace American manufactures, and in the agricultural countries have made available primary products for export to us in replacement of our imports from the United States.

by an exchange depreciation it stands to gain less from that expansion of trade which exchange depreciation as opposed to import restriction will bring about. Secondly, less of its imports are likely to be irreplaceable by home production than in the case of a single importing country; and for this reason the large group will lose less real welfare through that restriction of imports which would be necessary to restore its balance of payments and to enable it to achieve a given improvement in its terms of trade with the rest of the world.

But it must never be forgotten that the very possibility that deficit countries may improve their balance of payments or terms of trade by means of import restrictions rests upon the assumption that the surplus countries will not retaliate by themselves restricting imports. If the surplus countries refuse to buy the deficit countries' goods as quickly as the deficit countries refuse to take the surplus countries' goods, the deficit countries do not, of course, succeed in improving their own position. Their export markets are spoiled by the surplus countries' restrictions just as badly as they spoil the surplus countries' export markets by their own restrictions. Such retaliation by the surplus countries is ruled out in the present Draft Charter for an International Trade Organization; and that is an important reason why it should be one of our main objectives to seek general acceptance for that Charter. But it is a hard doctrine for the surplus countries to accept. And while we can legitimately ask the surplus countries to agree that something effective must be done by both deficit and surplus countries to remove disequilibria in international balances of payments we cannot expect the surplus countries long to accept a solution which is unnecessarily destructive to world trade and particularly opposed to their own interests.

Indeed, what answer could we give to the following offer by the surplus countries if it were ever made to us? "You are imposing discriminatory import restrictions against our exports. We wish rather to get rid of the disequilibrium between us by appreciating our currency. This will enable you to continue to purchase each other's goods rather than ours because it will make our goods more expensive to you, but we shall get the benefit of the higher price charged for our goods. Moreover, the

appreciation of our currency will reduce the price of your goods to us and we shall then spend more on them. This will enable you to afford to purchase more of our exports. If you will not agree to this very reasonable solution, we shall not be able to continue our one-sided restraint from the use of import restrictions."

The challenge would be difficult to meet since, from the international point of view, there is always a net advantage in replacing import restrictions by an exchange rate adjustment; for what one country loses by any adverse movement of its terms of trade must be gained by the favourable movement in the terms of trade of other countries, whereas the increased volume of remunerative international trade brings a net advantage to every country. In any case, it would clearly be better for the deficit countries, in their narrowest interest, to accept reasonable arrangements for the restoration of balance through exchange rate adjustments rather than to risk a decline into a world in which all countries, surplus as well as deficit, were making an uncontrolled use of discriminatory import restrictions. In such a world this country above all would find it difficult to survive.

(d) Conditions necessary for the International Working of the Price Mechanism.

The preceding analysis should have made it clear that if exchange rate adjustment is to be effective in restoring equilibrium to balances of payments, certain conditions must be fulfilled.

In the first place when a country whose balance of payments is in deficit depreciates its currency, it is essential that this depreciation should not be offset by a competitive exchange depreciation by countries which are in surplus. Otherwise the exchange depreciation would not be allowed to have its effect in enabling the deficit countries to undercut the surplus countries.

Indeed, it would be desirable to go further than this and to obtain agreement that surplus countries might be required to appreciate their currencies. If there are one or two deficit countries and one or two surplus countries and a large intermediate group of balanced countries which are neither in surplus nor deficit, it is important that adjustment should be brought about by appreciation on the part of surplus countries as well as by depreciation by deficit countries. The depreciation by the

deficit countries will enable them to undercut not only the surplus countries but also the balanced countries. This will throw the balanced countries into deficit, and they in turn as well as the deficit countries may have to depreciate. These repercussions might have been avoided or at any rate greatly diminished if, in the first place, the surplus countries had appreciated simultaneously with the depreciation of the deficit countries. For the appreciation of the surplus countries would have enabled the deficit and the balanced countries to undercut the surplus countries while the depreciation of the deficit countries would have enabled the deficit countries to undercut the surplus and the balanced countries. As a net result, the balanced countries would not necessarily have been thrown out of balance one way or the other.¹

Secondly, it is essential that surplus countries and balanced countries should not impose quantitative restrictions or other barriers on imports which prevent a change in price relationships from leading to a natural change in the channels of trade. Otherwise a depreciation on the part of deficit countries will be frustrated because it will not lead to the natural expansion of the exports of the deficit countries which a cheapening of their products would otherwise bring about.

Thirdly, it is essential that the important countries of the world should adopt effective domestic measures, of the type discussed in Chapter II, for maintaining a stable level of general money demand for goods and services in balance with the total available supply of such goods and services. A large and uncontrolled depression of monetary purchasing power in, for example, the United States will greatly reduce the amount spent by the United States on imports. It will also lead to a rapid fall in the price at which American producers will offer their goods for export and will thus lead to an arbitrary undercutting of the producers of other countries. If the United States, as is at present the case, is already in a strong balance of payments position, such a movement is bound to have a catastrophic effect on the rest of

¹ It is a great advantage of the International Monetary Fund that it prevents competitive exchange depreciation by surplus countries; but it is a serious weakness of the Fund that there is no power to require surplus countries to appreciate or deficit countries to depreciate.

the world. United States' imports will slump and her exports will undercut the goods of other countries just at a time when she should be importing more and exporting less in order to avoid a dollar shortage.

Similarly, if the United Kingdom or France were to experience an uncontrolled inflationary movement at home which raised their prices and money incomes at a time when their balances of payments were in deficit, they would reduce the competitive power of their exports and would increase their domestic demand for imports just at a time when the restoration of equilibrium required an expansion of their exports and a contraction of their imports.

An adjustment of exchange rates (e.g., an appreciation of the dollar and a depreciation of the franc and the pound) might, in the absence of rigid import restrictions or high tariffs impeding imports into the United States, be expected to restore equilibrium if the United States expanded its domestic demand for goods as its exports declined and as it imported more from Europe and if the countries of Western Europe reduced their internal demand for goods as they exported more and imported less. But a deflation of domestic demand at this juncture in the United States or an inflation in the countries of Western Europe would make adjustment between them through the price mechanism quite impracticable.

Thus it is important to achieve international acceptance of the principle that all countries, surplus and deficit, will adopt effective domestic measures for keeping their internal monetary demand for goods and services in a nice balance with the total supplies available for purchase. If they fail to do so, uncontrolled domestic booms and slumps are bound to cause any international price mechanism to break down. In particular potential deficit countries must preserve the right, as they do in the present Draft Charter for an International Trade Organization, to impose discriminatory import restrictions against the goods of a country which is experiencing an uncontrolled deflation of its internal demand for goods and services, and thereby is generating an uncontrolled surplus in its balance of payment by reducing its demand for imports and undercutting the trade of others through the cheapening of its exports.

For these reasons the possibility of using the price mechanism effectively in the international world to correct disordered balances of world payments depends largely upon the general rules of the game accepted not only by us but by other countries for the conduct of international commercial and financial transactions. If we can obtain agreement to a set of rules which allows deficit countries to depreciate their exchange rates but does not allow surplus countries to do so; which ensures that surplus countries reduce their trade barriers to imports and do not raise them to keep out new imports as the deficit countries restore their position; and which binds the surplus countries to take measures to maintain a high and stable level of internal demand; then we shall have gone some way to achieve a situation in which the price mechanism, in the form of the necessary adjustments of exchange rates, can properly perform its international task. But these are precisely the conditions which the Articles of Agreement of the International Monetary Fund and the Draft Charter for an International Trade Organization are aimed at ensuring; and, for this reason if for no other, these international instruments are of vital importance to us and should command our wholehearted support.¹

¹ See Appendix II for a more detailed discussion of the relevance of these international instruments for the restoration of equilibrium to our balance of payments. There is one point which needs to be carefully watched. It is possible to interpret the present draft of the Charter for an International Trade Organization as ruling out the right to administer import licensing through the method advocated above (pages 87-9) of auctioning such licences to the highest bidder. This would be a serious blemish; but it is difficult to believe that the auctioning of licences is really out of line with the spirit of an international Trade Charter which does after all attempt to restore in some measure the international working of the price mechanism.

APPENDIX I.

The Arithmetic of the Amalgamation of National Insurance. Children's Allowances, Food Subsidies and Income Tax.

If personal allowances of 10s. a week were paid to 15 million younger persons and of 25s. a week to 35 million older persons, and if there were a saving of £300 millions on present food subsidies and of £150 millions net on social security arrangements as at present proposed (representing the excess of social security benefits over compulsory contributions to national insurance), there would be a net charge on the State of about £2,200 millions. If it were desired to raise net of this £1,200 millions in Income Tax, there would be in all £3,400 millions to raise. This would be the yield of a single standard rate of tax of 8s. 6d. in the £ on taxable incomes of £8,000 millions.¹ If 9s. 0d. in the £ were raised on £3,000 millions of unearned taxable income, a standard rate of almost 8s. 3d. in the £ would be required on earned incomes of £5,000 millions. If the personal allowances paid to 35 million adults were reduced by 2s. 6d. to 22s. 6d. and a poll tax of 5s. a week were levied on 20 million income earners, there would be a net saving of nearly £500 millions on the total of £3,400 millions to be raised by Income Tax. This would enable the standard rate of income tax on all incomes to be reduced from 8s. 6d. to 7s. 3d.; or with a rate of tax of 9s. 0d. in the £ on unearned income, the rate on earned income could be reduced to 6s. 3d.

The following table shows for various family incomes the amount of earned income remaining after: (A) payment of income tax and sur-tax at 1947/48 levels, deduction of 4s. 7d. a week for national insurance contribution and receipt of children's allowances of 5s. a week for all children after the first; (B) payment of income tax at 8s. 6d. in the £ and receipt of 25s. a week for each adult, and 10s. a week for each juvenile, member of the

¹ If it were decided on anti-inflationary grounds to eliminate, say, £200 millions of food subsidies without counting their savings against the cost of this scheme, another sixpence in the pound would be required.

family; and (C) payment of income tax at 7s. in the £, a poll-tax of 5s. a week on the earner and receipt of 22s. 6d. a week for each adult, and 10s. a week for each juvenile, member of the family.

Annual Earned Income	Single man			Married man with one child			Married man with three children		
	A	B	C	A	B	C	A	B	C
£	£	£	£	£	£	£	£	£	£
100	89	123	111	89	214	195	115	266	247
200	182	180	176	189	271	260	215	323	312
300	257	238	241	289	329	325	315	381	377
500	382	353	371	441	444	455	502	496	507
700	507	468	501	566	559	585	634	611	637
1,000	694	640	696	754	731	780	822	783	832
1,500	1,007	928	1,021	1,066	1,019	1,105	1,134	1,071	1,157
2,000	1,282	1,215	1,376	1,351	1,306	1,430	1,409	1,358	1,482

It will be observed how B and C, as compared with A, shift the balance in favour of the low incomes and the large families. C naturally does so to a smaller extent than B. Scales B and C fall heavily on the unmarried worker with a wage of £4 to £10 a week. C in particular, owing to the poll-tax of 5s. a week, falls on the lower part of this group; but as compared with B it has the great advantage of involving only a 7s. instead of an 8s. 6d. in the £ tax on marginal earnings. If it were decided in combination with C to raise rates of sur-tax and to lower the starting level of sur-tax in order to prevent C from improving the position, as compared with B, of families earning £500 or more, the standard rate of income tax on earned incomes could, of course, be much further reduced.

Scales B and C do not make any allowance for the increased burden on all families of the rise in the cost of living due to the reduction of £300 millions in the food subsidies which has been assumed in these calculations. If the £300 millions of food subsidies affected every member of a population of 50 millions equally, it would represent a burden of £6 a year per head, i.e., £6 a year for a single man, £18 a year for a married man with one child and £30 a year for a married man with three children.

In effect the consumption of subsidized food per head of the family is presumably somewhat higher in the families with large incomes and few dependants than in those with small incomes and many dependants. It can be seen that the modifications of B and C in the table necessary to take account of the assumed change in the food subsidies would alter the picture there presented in its details but not in its broad design.

APPENDIX II

The International Monetary Fund, the International Trade Organization, and the United Kingdom Balance of Payments

(i) *Introductory.*

Since the end of the war one of the main issues in international policy has been that of the basic system of international commercial and financial relationships which this country should adopt. Should we attempt to rebuild our external position on the basis of a set of internationally recognized "rules of the game" designed to reduce commercial and financial obstacles to international commerce and to promote multilateral trading to the maximum possible extent? Or should we preserve our freedom from any such set of international rules in order to build up a system of bilateral deals with other countries as a means of restoring our balance of payments by forcing others to buy from us as much as we buy from them and of insulating ourselves, to some extent at least, from the external instabilities which may arise in the future if there is another world slump spreading, for example, from a major depression in the United States?

The first alternative is associated with three great international projects—the International Monetary Fund, the International Bank for Reconstruction and Development and the International Trade Organization, of which the first two, on which Lord Keynes so unreservedly expended his energies, are already born and the last is confidently expected by all concerned shortly to be the subject of an interesting event at Havana. In spite of much controversy on the subject the Government have consistently adopted this first alternative. The two Bretton Woods financial institutions were accepted at the end of 1945 at the time of the acceptance of the Loan Agreement. At the same time Trade Proposals, drafted by the United States authorities after the closest consultation with United Kingdom officials, were published and the Government expressed their agreement with the main principles of these Proposals. At two successive sessions of the United Nations Commission which has been preparing for

the World Conference on Trade and Employment (now meeting in Havana) there has been elaborated a Draft Charter for an International Trade Organization, clearly based in large measure on these Trade Proposals.

Was the decision to support these institutions the right decision? The issue is of supreme importance to the United Kingdom. The prosperity and greatness of this country depend so essentially upon overseas supplies of essential foodstuffs and raw materials that the restoration of our balance of international payments must be our main preoccupation; and clearly these new international economic and financial instruments will profoundly affect the solution of this problem. My own personal opinion is that the acceptance of these instruments is unquestionably in the interest of our balance of payments. There are those who see in these instruments inflexible rules for the restoration of Free Trade and the Gold Standard imposed upon us by a United States which is ignorant of the economic realities of a world of disordered balances of payments and which is prepared to make unscrupulous use of its present powerful position to force its doctrinaire ideas down our and other throats. There are those who see in these instruments ideas which are desirable as a long-term Utopian goal and which may possibly prove practicable at some fairly distant (but, they hope, not utterly remote) future date. Let these people study the actual texts. They will find there practical international provisions which may be initiated here and now and which ensure international rules for economic and financial conduct expressly constructed according to the designs of the most stream-lined modern economic thought, to facilitate the restoration of equilibrium to disordered balances of international payments.

(ii) The Limitation of General Protectionism.

The Articles of Agreement of the International Monetary Fund and the Draft Trade Charter (particularly in Chapter IV) set limits to the use of protective devices, whether the character of these be monetary (such as exchange controls limiting the purchase of foreign goods and services) or commercial (such as tariffs, quantitative import restrictions, subsidization, or the undue restriction of imports by a state trading monopoly). These international instruments do not prohibit the use of any of these

devices.¹ They attempt to set limitations to their use, limitations which vary in severity and in method according to the protective device in question. In particular, there are special provisions included in the rules governing the use of these protective devices, which are specifically designed to enable countries to use exchange and trade controls for balance of payments reasons.

It would be out of place here to discuss at length whether each of the various rules for the limitation of each protective device has been wisely conceived or is technically capable of more or less precise application. But one general point does require consideration. Is an all-round limitation of protection helpful or harmful to the United Kingdom's balance of payments?

If we wish to restore our balance of payments without either closing down our industries or starving, there can, I think, be no ground for doubting the interest of this country in a general limitation on protectionism. We import essential raw materials, which we cannot to any great extent replace with home production but without which we could not maintain our industrial production and employment. We import foodstuffs, which we should find it most difficult to replace with home production, but without which we should starve. We export manufactured goods, many of which are not essential to the importing countries, being of a luxury or semi-luxury character and many of which can, without too much difficulty or economic loss, be produced in other countries. In fact, we maintain a large population at a high standard of living in this country by relying on the international division of labour. Can there be any sane inhabitant of these islands who does not at least start with a strong prejudice in favour of the one existing set of international institutions designed primarily to set reasonable limits to protectionism? Our balance of payments will, of course, be restored, as soon as we have either increased our exports or, having failed to do so, have cut down our imports because we have used up our reserves and can persuade no one else to lend or to give us any more. The only question at issue is whether the balance will be one which

¹ Nor, of course, do they prohibit State trading as opposed to private trading. The Trade Charter merely attempts to ensure that State trading shall not be used to give greater protection or more discrimination than is permitted to private trading through tariffs, import restrictions, subsidies, etc.

gives us sufficient imports of foodstuffs and raw materials to avoid malnutrition and serious industrial unemployment.

Anyone familiar with the present compelling desires of under-developed primary producing countries to industrialize and to turn to the domestic production of manufactures will realize the special dangers which now confront the balance of payments of a country in our position. I do not wish to deny the advantages which will accrue to the world as a whole from a sensible policy of industrial development of underdeveloped countries, or to argue that there is no justification for any temporary special protection for this purpose. There is, no doubt, in many countries at present a real "infant industry" argument in favour of State aid for the first stages of industrialization. Nor do I wish to assert that such industrialization is all loss to the older industrialized countries like the United Kingdom. The increased real income of those countries which, by sensible and economic industrialization schemes, have really raised their incomes (and have not, in fact, merely lowered their standards by uneconomic obstacles to the international division of labour) will, to some extent—and possibly wholly—replace their previous demand for the simpler types of manufactured imports with a new demand for higher quality manufactured imports which they could not previously afford. But in underdeveloped countries there is a fashionable enthusiasm for industrial development schemes which in some cases perhaps somewhat impedes the nicely reasoned calculations of economy; and in other cases it is doubtful whether the pressure behind the drive for industrialization is purely economic.¹

In all this there is room for a sensible bargain between the developed and under-developed countries. The developed countries can provide "know-how" and, in some cases, capital. The under-developed countries, moreover, can, for the purpose of promoting industrial development, be given limited exemptions

¹ In the case of many under-developed countries it is, in fact, an improvement in agricultural techniques and equipment which is the first essential from their own point of view, food still being their greatest need and agriculture being in a backward state capable of great technical improvement and expansion as a result of capital development. Any such agricultural development which increases supplies and reduces costs of the primary products which we import would, of course, be also to our interest.

from certain of the rules and procedures limiting protectionism. In return they can agree to co-operate with developed countries in the consideration and determination of what are really sensible and economic development projects. This is the basis of Chapter III of the Draft Trade Charter.

(iii) International Commodity Agreements.

We export manufactured goods and we import primary products consisting of essential supplies of raw materials and foodstuffs. It is as important for our balance of payments that our foreign suppliers should not put up the prices of our supplies to us unduly as it is that we should have unimpeded access to the foreign purchasers of our products. But if we were to insist upon unfettered freedom to make our own trading arrangements, our suppliers would, of course, insist on freedom to make such arrangements as they pleased. One of the most dangerous forms which such arrangements might easily take is the institution by producing countries of International Commodity Agreements which, in effect, restrict the production or the export of foodstuffs and raw materials and thereby raise their prices to the consuming countries.

Our vital interests are not hurt by the institution of "Buffer Stock" types of commodity control which stabilize prices to primary producers by holding supplies off the market and maintaining prices when prices would otherwise slump, and putting extra supplies on to the market and restraining prices at times of excess demand. Although the maintenance of world prices might come at a peculiarly inconvenient time from the narrow point of view of our balance of payments (for example, during a world slump when a reduction in our exports has imposed a strain which might be relieved by a fall in the price of our imports), the increased price which we should have to pay for our imports at one time would be offset by a lower price at other times. And we should gain indirectly by the stabilization of buying power in the primary producing countries.¹

¹ Similar considerations apply to international commodity schemes which consist of "internationalized long-term contracts," i.e., of arrangements which, without restricting the total quantities which may be supplied, guarantee to exporters a certain demand at minimum prices in times of slump and to importers a certain supply at maximum prices in times of boom. The Wheat Agreement negotiated in Washington at the beginning of 1948 is of this nature.

But it is quite another matter if commodity agreements take a form which restricts quantitatively the amounts which suppliers may produce or export or which disposes of surplus supplies by sales in certain favoured markets at a lower price than the price charged to us. Such arrangements mean that the price which we pay for our imports is higher than it would otherwise be.

It is an essential interest for our balance of payments to avoid such undesirable forms of commodity agreement. Chapter VI of the Draft Trade Charter lays down principles for the institution and operation of commodity agreements which will enable us to protect our vital and legitimate interests in this respect. Countries which are members of the Trade Organization will not be able to institute restrictive commodity agreements except through an internationally recognized procedure which gives the consumers as much influence as the producers.

(iv) The Best of Both Worlds on Import Restrictions and Exchange Controls.

Among the most important provisions from the point of view of our balance of payments are those which relate to the use of commercial restrictions on imports and financial restrictions on payments for current transactions. During the inter-war period there was no obstacle so harmful to our exports as the restrictions which other countries placed either upon the quantities of manufactured goods which could be imported into their markets or upon the value of the manufactured goods for which their importers might make payment. To get rid of these obstacles to our exports is perhaps an even more important interest in the present post-war period. We have now to undertake an aggressive export policy to obtain a vast increase in our exports which we shall only be able to obtain if we achieve a larger share in world exports of manufactures; for, however much total world trade in manufactures may rise, and however much we may benefit from reduced German and Japanese competition, we cannot hope to achieve a sufficient increase in our exports without an aggressive export policy. Quantitative restrictions on imports, particularly if they take the form of quotas of trade based upon performance in some earlier (probably pre-war) representative period, are the most rigid and inexorable barrier which our

exports could encounter. No matter how much we improve the efficiency and lower the costs of our export industries or depreciate the value of our currency there can be no increase in exports over barriers which fix predetermined volumes or values for our trade.¹

On the other hand, it is important that we should retain the right to control our imports so long as our acute balance of payments problem continues. The Draft Trade Charter and the Articles of Agreement of the International Monetary Fund are nicely calculated to give us the best of both worlds in a situation of this kind. The Draft Trade Charter lays it down that as a general rule there should be no quantitative import restrictions; but it immediately excepts the use of trade controls which are necessary to protect a country's monetary reserves. It lays down a procedure whereby the Trade Organization in consultation with the Monetary Fund can on complaint judge whether such import controls are necessary for this purpose or not; and it can impose sanctions against a country which fails to accept its judgment. Thus we preserve our right to control imports so long as our position makes this necessary; but we acquire a powerful instrument for challenging the unnecessary use of such controls against our exports.

In the Articles of Agreement of the International Monetary Fund it is laid down that for a transitional period of some years countries can use exchange controls on current payments as long as these are necessary for its balance of payments problems. The Fund can, however, put increasing pressure upon countries to make their currencies convertible for current payments as their balance of payments position makes this possible; and as soon as a country has accepted the Fund obligation of making its currency convertible for current purposes, it can reintroduce such restrictions only with the permission of the Fund. It is of the greatest importance to us that the pressure to make currencies convertible for current transactions should, in fact, be exercised on those countries which are important export markets for our

¹ This point should also be borne in mind in considering Chapter V of the Draft Trade Charter which deals with the problem of "international cartels." Many private business arrangements (e.g., the division of export markets on the basis of past performance) are peculiarly inimical to a country which has got to invade its competitors' markets.

goods, as soon as they are in any position to start paying us gold, dollars or other convertible currencies for our goods. One of our most difficult problems at present is that our exports tend naturally to go to countries whose currencies are inconvertible and our imports tend to come from "hard" currency sources.

There is much misunderstanding on this point. There is nothing in the Trade Charter or the Monetary Fund¹ at any time to force this country to make any funds convertible on capital account or to prevent the stoppage of any form of capital export. It is permissible to block all accumulated balances of sterling and to prevent all capital exports to any part of the world. The only obligation which convertibility of sterling for current payments would impose upon us is not to try to force countries to receive additional balances of inconvertible sterling in payment for their sales to us—a thing which we might in any case find it difficult to do in the present seller's market for the things we want. And the Trade Charter and the Fund² do not in present circumstances even impose this obligation on us, but merely give the Fund some power of putting pressure on us and other countries to accept this obligation as our conditions improve.

Broadly speaking then, the Trade Charter and the Articles of Agreement of the Fund permit countries in balance of payments difficulties to restrict imports by trade or financial controls while they considerably limit the freedom of action in these respects of those countries which enjoy a favourable balance of payments. We stand, therefore, to gain much from the general acceptance of these instruments, since freedom for us to restrict imports will not comfort us much, unless countries with favourable balances are prevented from imposing similar restrictions on our sales to them.

(v) The Problem of Non-Discrimination.

If trade or exchange controls are being used for the purpose of adjusting the balance of payments, circumstances may arise when their application on a non-discriminatory basis would unneces-

¹ Or, for that matter, in the United States Loan Agreement.

² But the United States Loan Agreement does, of course, do so:

sarily damage world trade and limit the international division of labour. If a group of deficit countries confronts a group of surplus countries or a single large surplus country, the imposition of import restrictions by the deficit countries on a strictly non-discriminatory basis would mean that they would have to restrict their imports from each other (which would do nothing to restore equilibrium) as well as their imports from the surplus countries (which would help to restore a balance).

Both the Fund and the Trade Charter recognize this important problem. In the well-known "Scarce Currency Clause" (Article VII of the Fund) it is laid down that if the Fund runs out of the currency of a particular country (a fate which should sooner or later overtake any country which continues to sell abroad without purchasing or lending abroad), the other countries can restrict imports from the country whose currency is scarce without restricting imports from each other. The principle is thus fully recognized; but the technical details of its application in the Fund are defective.

In the first place, a currency can only become scarce in the Fund when other countries exercise their drawing rights under the Fund and use their "quotas" to purchase the currency in question from the Fund in exchange for their own currencies. But there are strict limitations on the extent to which, and the speed with which, other countries may exercise these rights, with the result that any currency of which there is at the start a large amount in the Fund can only become technically scarce after the lapse of a period of time. This has the result that even in present conditions the United States dollar cannot become technically scarce for many months and perhaps some years. Secondly, countries using the resources of the Fund must pay increasingly high rates of interest as they use their drawing rights, so that it may become very expensive for the deficit countries to maintain the technical scarcity of a currency in the Fund, even in conditions in which it is unquestionably extremely scarce in reality. Thirdly, the technical scarcity of the currency could be removed by the Fund borrowing more of that currency; and if that were done at a time when a number of the deficit countries had exhausted their powers of drawing from the Fund, the

currency in question might continue to be in good supply in the Fund though it was still basically scarce in reality.¹

The need for discrimination in such circumstances is, however, also recognized in the latest draft of the Trade Charter, and in a way that is not open to similar technical defects. It is there laid down that import restrictions should in general be on a non-discriminatory basis. But it is recognized that when there is a basic disequilibrium in international payments deficit countries, if they discriminate in favour of each other, may be able to obtain additional imports from each other, without thereby being able to afford less imports from the surplus countries. Safeguarding principles and procedures are, however, laid down to ensure that such discriminatory trade arrangements are not used to promote the protection of highly uneconomic lines of production by barter deals at prices widely divergent from world prices or to canalize trade in such a way as substantially to divert the exports of the deficit countries away from the markets of the "hard" currency surplus countries, thereby restricting total trade with such countries.

Here again these safeguards are as important to us as the right to discriminate. We might well otherwise ourselves be the victims of unjustifiable discriminations in the purchasing policies of other countries which would harm our export trade. The system of financial and commercial relationships contemplated by the Fund and the Charter is not one of pure non-discrimination; it is one whereby international rules are enunciated for the legitimate uses of discriminatory devices,² and which presents an international forum for the continuing discussion and development of rules of international good conduct on this subject. Such a settlement is undoubtedly in the interests of the United Kingdom balance of payments.

¹All these are deficiencies which the Executive Directors of the Fund could avoid in any particular instance if they so decided. They may relax the limitations on drawings by deficit countries, may reduce interest charges, and may refuse to borrow fresh supplies of a scarce currency.

²Space prevents me from discussing the other uses which are permitted, such as discriminations in favour of each other between territories (e.g., the United Kingdom and the Colonies) having a common quota with the International Monetary Fund or temporary discriminations in favour of economies which have been shattered by the war.

(vi) *The Best of Both Worlds on Exchange Rate Adjustments.*

Perhaps the greatest unresolved issue in international economics is the extent to which reliance should be placed on trade controls or on exchange rate adjustments as a means of restoring equilibrium to balances of payments. This question is not resolved in the Articles of Agreement of the Fund and the Trade Charter. The Fund lays it down that, beyond a small movement, a country cannot adjust its exchange rate without the permission of the Fund, but that the Fund, regardless of that country's domestic policies, must give its consent if the country in question is in a "fundamental disequilibrium." The Trade Charter, as we have seen, allows a country to use trade controls for this purpose. It also provides a procedure for organized international consultation between the Trade Organization, the Fund and the countries concerned about the use of these and other alternative devices for restoring equilibrium to balances of payments.

I will not hide my own opinion that, where exchange depreciation would enable a deficit country to find markets for considerably more exports than it could otherwise discover, this method is greatly preferable to that of trade controls. For, in the first place, unlike trade controls, it does not reduce the real income of the world by obstructing international trade and the international division of labour; and, secondly (though this is not a purely economic consideration), it is less liable to lead to friction between countries and to internal administrative difficulties. Since the Monetary Fund and the Trade Organization leave this issue quite unresolved, this is not an appropriate occasion to produce arguments in support of these assertions. There are, however, two basic points which must be made in the present context.

First, the general limitations on protectionism and, in particular, the prohibition on the use by surplus countries of inflexible protective devices such as quantitative import restrictions should greatly increase the effectiveness of exchange rate adjustment as a method of restoring equilibrium. An exchange depreciation is useful in so far as the consequent change in price relationships expands the country's exports and contracts its imports; and its exports will expand much more if, in the surplus countries in

whose markets they will be cheapened, there are no rigid obstacles to prevent a competitive invasion of those markets and no possibility of raising new protective barriers to keep out the increased imports. Exchange depreciation should, therefore, be a much more effective weapon with the Trade Organization in existence than it would be without it.

But, secondly, an exchange depreciation can only begin to be effective if it is not offset by a competitive exchange depreciation by other countries; and this is exactly what the Fund achieves. Countries with very unfavourable balances of payments are permitted to depreciate, and countries with favourable balances of payments will not be permitted to offset this by an unnecessary competitive exchange depreciation. Have we forgotten so easily the history of the 1930's when our depreciation (entirely necessary for our balance of payments) was followed by as great an exchange depreciation of the United States dollar (entirely unnecessary from the point of view of their balance of payments)? What should we then have thought of an internationally agreed set of rules which would have allowed us to depreciate and to restrict imports and would have permitted them neither to depreciate, nor to restrict imports, nor substantially to raise their tariff? And all this without any loss of our rights to control the flight of capital. Should we then have considered this a loss of our financial and commercial freedom?

(vii) International Capital Movements.

It has already been observed that neither the Fund nor the Trade Charter limits our right to prevent an export of capital. On the other hand, the Fund does, of course, give us the right to draw some £80 millions a year for four years in defence of our balance of payments, and gives other countries in similar difficulties a corresponding supplement to their monetary reserves. And the Bank is an institution for the promotion of long-term lending, mainly by the United States, for the reconstruction and development of countries which are in need of capital. The Bank is clearly not in a position alone to provide finance on a scale adequate to meet the present great need for dollars. It does, however, make a definite, if limited, contribution; and it introduces for the first time into the rules of international good

behaviour a principle of considerable importance to us, namely, that of the untied loan. None of the loans which the Bank supports can be tied, in the sense that their proceeds must be spent on purchases in any particular country.

If the United States undertakes an adequate programme of lending, it is of the first importance to us that this principle should be observed. We sell capital equipment to countries at present short of dollars. If they can borrow dollars and, where we are truly competitive suppliers, can use these dollars to purchase our goods, we shall get that indirect benefit from United States lending which is our proper due in a multilateral world. It is, accordingly, wise for us to see that as much emphasis as possible is placed upon the principles upon which the Bank was instituted in any future international arrangements for capital finance.

(viii) The Maintenance of Full Employment.

There are provisions in the Draft Trade Charter to bind a country to take appropriate measures to stimulate its domestic demand for goods and services if a deficiency in its internal purchasing power is causing a deficiency in its buying from other countries and is thus imposing a strain on other countries' balances of payments. Chapter II of the Draft Trade Charter lays it down that a country "shall take action designed to achieve and maintain full and productive employment and large and steadily growing demand" domestically; that if a country is nevertheless exercising a deflationary pressure on the balance of payments of other countries it "shall make its full contribution . . . towards correcting the situation," or, in other words, shall do something (e.g., reduce tariffs or other barriers to imports, appreciate its exchange rate, lend more abroad, etc.) so as to make a greater use of its external purchasing power; that countries shall participate in arrangements for exchange of information and for consultation on policies for the maintenance of demand; and that the Trade Organization in exercising its functions under the other provisions of the Trade Charter "shall have regard . . . to the need of Members to take action . . . to safeguard their economies against deflationary pressure in the event of a serious or abrupt decline in the effective demand of other countries."

All this might in the not far distant future be very relevant to our balance of payments. A major internal depression in the United States would, as in the 1930's, reduce United States buying power in many markets and thus seriously intensify the problem of a world shortage of dollars. It would, of course, give some compensating relief to us, since the reduced demand for foodstuffs and raw materials would substantially reduce their price, while the price of our manufactured exports would probably not decline so rapidly. But if a United States depression were at all severe or prolonged it is virtually certain that any such counterbalancing advantages would fail to offset the difficulties caused by the decline in United States purchases from the rest of the world. It would in any case cause localized unemployment in our export industries; its effect on the external buying power of other countries would be very severe and would promote protectionism and import restrictions, to the further detriment of our exports; and the primary producing countries would have a strong incentive to organize restriction schemes to maintain the prices of their exports of foodstuffs and raw materials. Whatever protectionism against our exports and price maintenance of the primary products supplied to us was permitted within the framework of the Trade Charter would certainly be used, and the pressure might become so great that the defences which the Charter provides for us might themselves be destroyed.

The Draft Trade Charter, by creating an international obligation to maintain external purchasing power in such circumstances and by outlining an international organization for the promotion of action for this purpose, is a big step in advance. How helpful it might have been to the balance of payments of this and other countries in the depression of the early 1930's if the responsibility of countries which exerted a deflationary influence and a balance of payments pressure on other countries through an uncontrolled domestic depression had been clearly recognized in a freely negotiated international instrument, if a permanent international Organization had existed for the discussion of the implications of this responsibility, and if the Organization had had both the power and the obligation to release those countries which were the victims of such deflationary pressure from the obligations

which would otherwise have prevented them from taking the necessary defensive measures without permitting the countries with favourable balances of payments to retaliate.

(ix) Conclusions.

Any international agreement is bound to be a compromise. Apart from a number of technical blemishes in these international instruments which one would like to see removed, there are points of substance on which concessions have had to be made to obtain the many solid advantages enumerated above. In particular, in obtaining the tariff reductions granted by the United States and other countries in the General Agreement on Tariffs and Trade negotiated in 1947 in Geneva and closely connected with the Draft Trade Charter, we and the Dominions have had to make concessions not only on tariffs but also on Imperial Preference, that bugbear of the United States administration. We shall thereby lose some preferential protection for some of our manufactures in some Commonwealth markets, and this taken alone would, no doubt, increase our balance of payments difficulties. But preferences have been bargained against tariffs on the basis that the preference-tariff adjustment must itself constitute a mutually advantageous arrangement. Those who are aware of the staunch loyalty and hard-headed ability of our negotiators will be aware what this implies.

But it must be remembered that, into the bargain, so long as our balance of payments difficulties persist, we can replace tariffs with import restrictions (which the United States cannot do). And so long as the general world disequilibrium of payments remains, "deficit" Commonwealth countries can, regardless of concessions on tariff-preferences, arrange to discriminate in favour of each other through their import controls so far as this is necessary to enable them to obtain "additional imports" on the conditions already discussed above. What the United States have gained—and from their point of view it is, of course, an important achievement—is that particular Imperial Preferences should be effectively reduced or eliminated in so far as and as soon as discriminatory trade arrangements are no longer justifiable on balance of payments grounds.

Nor, of course, do these international instruments provide a panacea for all our ills or a magic formula for removing our

balance of payments difficulties. That Herculean task cannot in any case be achieved without many unpleasant domestic measures necessary to make available the supply of more goods for export and to reduce the consumption of imports. On the nature of some of these internal measures there is now widespread agreement. We must, in particular, by heavy taxation, by reduced public expenditure and by strict economy in projects for capital development, reduce and hold in check the ever-threatening excess of domestic purchasing power which, quite apart from any other disadvantages which it may bring, pulls goods into domestic consumption and so diminishes the supplies available for export.

There is nothing, of course, in the Trade Charter or elsewhere to prevent us from adopting the necessary internal measures. But, on the other hand, there is nothing which puts pressure on us to do so. It is arguable that this is a defect in the existing provisions of the Draft Trade Charter. During the 1930's it was to the disadvantage of the United States' own internal prosperity that it failed to take measures to increase and maintain its internal purchasing power; such a failure was a main cause of the then disequilibrium in international balances of payments; and it exerted a deflationary pressure on other countries which were already suffering from heavy unemployment as a result of a deficiency of monetary demand for the goods and services which they could produce. But the wheel has now turned full circle. Countries with unfavourable balances of payments which are not sufficiently restraining a domestic excess of monetary purchasing power are inflicting on themselves the wastes of an uncontrolled inflationary pressure; their failure to restrict excess domestic demand is a major contributory factor to present disequilibrium in balances of payments; and they are exerting an inflationary pressure on other countries which are already suffering from the evils of inflation. Chapter II of the Draft Trade Charter severely discourages the former type of criminal folly: but it does nothing about the latter.¹

In the present context, I have confined myself to adducing

¹ Criticism of the Draft Charter on similar lines was made by Mr. Gunnar Myrdal when he was Socialist Minister of Commerce in Sweden. See Supplement B to Svenska Handelsbanken's Index, December, 1946.)

evidence to support the claim that these international instruments provide a reasonable international background against which we can work out our own measures for the salvation of our own balance of payments. I have made no attempt to discuss the question whether we should have a still better chance of restoring our balance of payments in the free-for-all (and the absence of special dollar assistance) which would result from a refusal to accept any of the commitments of the Fund or the Trade Charter. It is my opinion (for reasons which have been ably stated by Mr. G. D. A. McDougall in two recent articles in the "Economic Journal") that our bargaining power in such circumstances would not suffice to enable us to restore our balance of payments at a tolerable standard of living.

Any such alternative would, of course, make economic co-operation with the United States impossible. I do not wish to discuss the political implications of this incontrovertible fact. The Fund, the Bank and the Trade Organization constitute, broadly speaking, the only set of international economic and financial principles on which there is any hope of achieving agreement between Western Europe, the British Commonwealth and the United States, a group which accounted for rather more than two-thirds of pre-war world trade. Serious economic friction between these countries would entail serious diplomatic and political friction. It might split the Commonwealth. How, for example, could Canada choose between the Mother Country and her great American neighbour? And the United Kingdom would indeed develop a split personality. For how should we choose between Europe, the Commonwealth and that other great English-speaking entity?

Finally, it must never be forgotten that international instruments, such as those which have been discussed above, can only operate if there is sufficient will on the part of a sufficient number of countries of sufficient importance to co-operate in a spirit of constructive compromise so as to make the agreed arrangements work practically in a reasonably just and efficient manner. However well the agreements may be drafted and however suitable their provisions may be for a world of countries which desire the ends which the agreements are designed to serve, they are bound to break down, to be evaded and to cause

friction and frustration if they are not operated with a will to make them succeed. The claim which is here made is that the ends which these instruments are designed to serve are so much to our interest that we should apply ourselves to see that, so far at any rate as the issue depends upon us, their provisions are observed not only in the letter but in the spirit.

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