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SCIENCE OF PUBLIC FINANCE



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SCIENCE
OF
PUBLIC FINANCE

BY

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PREFACE

THE appearance of a treatise in two volumes on the Science of Public Finance may be thought to require some explanation.

In revising my *Science of Public Finance* for a third edition I found that it would be necessary to expand many of the chapters in view of the progress made in the subject in recent years. No existing treatise in English contained the latest improvements which have taken place in the theory of Public Finance—in expenditure, in revenue, in public debt, and in financial administration. The passing of *laissez-faire* and the spread of economic nationalism throughout the world since the Great War have also brought in their train many new problems which demand careful handling. It was therefore decided to rewrite the work in an expanded form and to resurvey the whole field with special reference to the results of recent speculations and the application of the principles to actual conditions. The work is primarily for students and for officials concerned with public finance. I have, however, attempted to state the principles in such a way that they may be comprehensible to anyone who has not made a detailed study of the subject. At the same time the book does not avoid difficulties which call for sustained reasoning. I have stated with care the grounds on which my conclusions rest, and have done my best to be clear, though at the same time I have not made any pretext of simplifying things where simplification was not practicable.

It has not been possible for me to make due acknowledgment to every writer, although I have attempted to do so throughout the book. My indebtedness to some is far greater than to others, and in this connexion I venture to mention Marshall, who said of Sidgwick what I may say of him that " Though not his pupil in name, I was in substance his pupil. . . . I was fashioned by him. He was, so to speak, my spiritual father and mother. . . . The

minutes that I spent with him were not ordinary minutes ; they helped me to live . . . and perhaps of all the people who have cause to be grateful to him, none has more than I." To Edgeworth, too, I am also specially indebted. The discussions which we had from time to time in his Spartanic and almost bookless rooms at All Souls, Oxford, and in London, especially on taxation and statistics, have left a very strong and lasting impression, and indeed he has been to me in many ways a great Apollo. To other colleagues and friends, notably Seligman, Pigou, Stamp, and Bonar, and to several Continental writers—German, Italian, and French—I owe much. Many of the ideas which have been stated in this edition have been thought out ever since I was twenty-five years ago in the Finance Department of the Government of India. During the last ten years, while I held the Chair of Economics and the Principalship in a University College, I was able to approach questions dealing with taxes, budgets, loans, credits, etc., from a theoretical as well as from a practical point of view. Was it not Adam Smith who, when Commissioner of Customs in Scotland, in a letter to the Principal of Glasgow University, dated 16th November 1787, said that his time as a professor was even more pleasant than that as an administrator ? It has been to me also, to use his own words, " By far the most useful, and therefore by far the happiest and most honourable period " of my life.

G. FINDLAY SHIRRAS

BOMBAY UNIVERSITY,
May 1936.

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certain constituents of income is not always realised, with the result that the incidence of both is not completely understood. The incidence of the tax is on the point where it is levied. It is not shifted in the form of an addition to price, but is, with unimportant exceptions, on the payer of the tax or the recipient of income 383-385

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BOOK I

INTRODUCTION

THE SCOPE AND METHOD OF THE SCIENCE
THE DEVELOPMENT OF MODERN FINANCIAL THEORY

CHAPTER I

THE SCOPE AND METHOD OF THE SCIENCE

1. OF the many difficult questions confronting public authorities none is more important than that of finance, because, unlike the others, it is a continuing question. Governments, indeed, are nowadays judged in the long run by their record in the management of the country's finances, as finance is the fundamental basis of Government. The revenue of the State, it has been said, is the State. Everything depends on it. Kautilya, the earliest of Indian economists, writing more than 2000 years ago, said, "The beginning of every undertaking is finance". The Great War quickened men's thinking in many ways, especially in regard to public finance; it made us recognise matters as of real urgency which had passed for being merely speculative; it placed many standing questions of policy in a wholly new light. It has enlarged the subject matter of the science of finance and laid a greater emphasis than in pre-War days on one or two branches of the subject, notably in regard to expenditure, taxation, and debt. We shall attempt in a brief and business-like way to deal with the principles of public finance, or, as we shall call the subject matter of our study, the science of public finance, which may be said to be concerned with the manner in which public authorities obtain their income and spend it. By public authorities are meant mainly Central or Federal Governments and Provincial or State Governments. It includes also local authorities such as municipalities, district boards, and councils. In short, public finance is the study of the principles underlying the spending and raising of funds by public authorities. As a positive science it is concerned with facts as they exist; it investigates the intricate flux of these financial events and discovers their hidden uniformities by means of patient and systematic inquiry which we

call research; and the statements of uniformity are expressed as laws. The science is sometimes regarded as an art which seeks to provide safe rules for administration such as the necessity of a balanced budget which is the foundation of confidence in a country's currency, and therefore of the purchasing power of the incomes of all its classes, the requirements of a good tax, and the canons of expenditure. This aspect of the subject of our study is only incidental to the main object, the investigation of uniformities. It suggests a body of doctrine definite in scope and complete in itself, immutable from country to country and from time to time. It, therefore, overemphasises the static at the expense of the dynamic aspect and the fruit-bearing at the expense of the light-bearing results of the science. When we use the expression "art" there is also the danger that we subordinate all considerations in the problem which are not strictly financial and forget the relation of public finance to other branches of study such as law and political science. Financial mechanism is an object for scientific analysis and study. But it may be interfered with and controlled. Above the financial man is the political man who can and does define the field of the former's activity. The science of public finance is the equivalent of what Germans call "Finanzwissenschaft", the knowledge or science of finance. The French use the convenient expression "science des finances" and the Italians similarly "scienza delle finanze". The specialised use of the term in the sense of the management of public expenditure and public income first came into use in France in the sixteenth century and spread to other countries. The French have reserved the plural form, "les finances", for this application, while the singular denotes business activities in monetary affairs, *e.g.* "la haute finance". The main divisions of the study are: (1) public expenditure—public authorities must incur expenditure to carry on their business; (2) public revenue or income, because to meet this expenditure public authorities must have revenue or income; (3) public debts, because if revenue does not suffice to meet expenditure, borrowing has to be resorted to in order to make both ends meet; and (4) financial administration, which since the War has assumed a new importance. This last branch of the subject includes the details connected with (1) the framing of budgets, and (2) audit, audit being the check on the realisation of revenue against the demand, and

the check on expenditure in accordance with prescribed rules. Financial administration also includes the financial work of the legislature. The right of voting supplies and controlling expenditure—the power of the purse—is different in different administrations, but the methods followed have a large effect on the efficient or inefficient working of a country's finances. It is necessary for the legislature to keep an eye over its steward, if the executive is the steward of the general public, in order to avoid inefficiency and waste.

2. In the preceding paragraph we have referred to the effect of the War on public finance. The growing costliness of war is one of the great causes of increased taxation. We do not have more wars than in former times, but with the application of all the skill of modern industry war is now a most expensive business and it is rightly said that the preparation of war and the aftermath of war apart from war itself are mainly responsible for the world's public burdens to-day. The War, too, was in other ways a great teacher. During War time financial control was inevitably relaxed and the administration of finance departments the world over was marked by a certain lack of grip and strength, especially in regard to the control of expenditure. Things had to be done, and done quickly. Formulae and conventions had to be brushed aside and difficulties dealt with in hearty sword-and buckler style. As a result of this there have been developments and adjustments in theory and practice in public finance that have made treatises of pre-War years somewhat out of date. It was clear that the subject matter of our study was no longer confined to what Colbert (1619–1683), the French financier, called "the art of so plucking the goose as to secure the largest amount of feathers with the least amount of squealing". The saying of Cicero that "silent leges inter arma" did not quite apply to public finance, as so much was achieved in these years. Moreover, the growing field of State activity and increased consciousness of the spirit of nationality made a wider outlook inevitable. The British Parliament raised the question of retrenchment in public expenditure in 1921, and again in 1931. Similar action was taken in India in 1922 by the appointment of the Inchcape Committee after the Legislative Assembly had discussed the question and recommended the appointment of the Committee. A similar policy of drastic economy was also followed in 1931. The

necessity for providing for the repayment of debt has also increased the importance of that part of the subject known as taxable capacity. In various countries since the War the legislature has shown a desire to impress on the executive the necessity of looking on the system of taxation as a systematic whole, and of examining the distribution of taxation and the principles on which it was based. An example of this may be found in the remarks of Sir Padamji Ginwala, in the Indian Legislative Assembly on the 5th of March 1923, when he said: "What takes place in the office of the Honourable the Finance Member every year when he prepares the revenue side of the Budget I can well imagine. He sits in his chair. He has got three men generally with him. On his right is perhaps Mr. Cook, on his left is Mr. Ayyar, and in front of him Mr. Sim. Then he asks, 'How much do these people require?' They say, 'Oh, this year they want 80 crores [1] of rupees only from taxation'. 'Is that so? What did they have last year?' '64 crores.' 'Very well. Give me a copy of the Tariff Act, a copy of the Income Tax Act, and a copy of the Opium and the Salt Acts and a blue pencil.' He takes the blue pencil in his hands and says, 'Here, 11 per cent on this. No. I will put 15 per cent. That will give us 2 crores. Is that not so, Mr. Cook?' 'Yes, approximately that.' Mr. Sim then says, 'Income Tax has been rather sterile these last few years. We will try a little super tax on something,' and he adds on something to the super tax. Then he goes through the Opium and Salt Acts, and the same process goes on until he thinks he has secured the additional sixteen crores. I submit that this is not the way in which, any longer, the Indian Budget ought to be prepared. Every country in the world has, at definite periods, undertaken an examination of the taxation of the country with reference to the taxable capacity of the people. They have got figures and they study all the conditions with reference to the requirements of the country. I maintain that though the Finance Department claims to know everything, they have got no data upon which they can determine the taxation with reference to the taxable capacity of the people. There, I submit, is the orthodoxy of the Budget." [2] The fiscal

[1] 1 crore of rupees = 10 millions = £750,000.

[2] *Legislative Assembly Debates*, vol. iii. No. 49 (Government Printing, India, Calcutta), p. 2981. Compare also the Resolution in the Council of State on the 23rd July 1923 by the Honourable Sir Manakjee Dadabhoy, which

system of every country is moulded by its economic life. Given the economic conditions and the interrelation of economic interests, it is possible to say what the fiscal system is. The importance of the taxation of land in, for example, the United States in the past as a source of taxation and its gradual displacement by the taxation of income resulting from the development of industry and the growth of professions are due to changes in the economic basis of society.

3. The relation of the science of public finance (or, as some writers prefer to call it, the science of finance) to the science of economics and to statistics has been frequently discussed, especially by German writers. It cannot be too often emphasised that public finance is a part of the science of economics. It is, however, no mere appendage. Our subject presumes a knowledge of other branches of the subject of economics, especially of the theory of money and credit and also banking. Adam Smith, the father of the science of economics, says that " Political Economy proposes two distinct objects: first, to provide a plentiful revenue or subsistence for the people, or, more properly, to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or commonwealth with a revenue sufficient for the public service ", and in Book V. of *The Wealth of Nations*, he deals with (1) " the expenses of the Sovereign or Commonwealth "; (2) " the sources of the general or public revenue of the society "; and (3) " public debts ". It is generally correct to say with Bastable that " an acquaintance with economic science is, it may be said, an indispensable part of the equipment of the student of finance ",[1] and with Adams, that

reads as follows: " That an inquiry be made into the whole system of taxation in India with a view to its thorough revision on an economic, equitable, and scientific basis with special regard to the taxable capacity of the people ". A Committee was appointed in 1924 and the Report was published in 1926. The Executive Council of the Association of British Chambers of Commerce addressed the British Prime Minister urging the appointment of a Royal Commission to review the whole question of national and local taxation with special reference to the cost of collection of various forms of taxation, the line of demarcation between national and local taxation, and the relative contribution to the national income of productive industries (*The Times*, 11th July 1923). In 1924 the Colwyn Committee was appointed by the British Chancellor of the Exchequer " to consider and report on the National Debt, and on the incidence of existing taxation, with special reference to their effect on trade, industry, employment, and national credit ". The Report was published in 1927 (Cmd. 2800).

[1] *Public Finance* (London: Macmillan & Co.), 3rd edit., p. 10.

"a sound policy of public finance must rest upon a thorough knowledge of political economy".[1] Public finance, or, as we now call it, the science of public finance, has also an intimate relation with statistics. The groundwork is to a large degree based on full and accurate statistics. It was sometimes said that the English were the first to discover the secret that the War would be won, especially in regard to food control and shipping, by statistics. The same might be said in regard to finance although, perhaps, to a less degree. Many of the conclusions or principles in succeeding chapters are based on the tables published in the appendix. It is not possible to cover all the details set out in these tables and in the "Civil Estimates" and similar financial publications. To do so would involve in the text a mass of statistics that would terrify and bewilder the inquirer and distract the reader from the broad facts that have to be understood. As the first and greatest of India's Finance Ministers[2] puts it: "Finance is not mere arithmetic; finance is a great policy. Without sound finance no sound government is possible; without sound government no sound finance is possible." The science of public finance should always be a great policy. It is wider than the science of statistics (in its earlier days known as political arithmetic[3]), but it could not do without statistics, as, for example, in budgets or in estimating the distribution of taxation among the various classes in a state. Modern financial administration depends greatly on full and accurate statistics based on realistic investigation and verification.

4. The question is sometimes asked as to the method to be followed in dealing with the subject matter of our study. The answer is simple. In other branches of Economics induction and

[1] *The Science of Finance* (New York: Henry Holt & Co.), p. 5.

[2] Right Honourable James Wilson (1805–1860), father-in-law of Walter Bagehot; editor of the *Economist* (1843–1859); Financial Secretary to the Treasury in the Aberdeen Coalition Ministry until March 1856; 1859, Vice-President of the Board of Trade until appointed Finance Member of the Council of the Governor-General, India, the first to hold this appointment. His predominating power, according to Bagehot, was his business-imagination.

[3] *Vide* Sir William Petty's (1623–1687) *Discourse on Political Arithmetick* and *Essays on Political Arithmetick*; "By political arithmetick", says Davenant in classic phrase, "we mean the art of reasoning by figures upon things relating to Government. . . . The art itself is undoubtedly very ancient; but the application of it to the particular objects of trade and revenue is what Sir William Petty began. . . . He first gave it that name, and brought it into rules and methods" (Davenant, *On the Use of Political Arithmetick* (*Political and Commercial Works*), 5 vols., London, 1771, i. 128).

deduction are complementary: they go hand in hand. They are, as Gustav Schmoller would say, "both needed for scientific thought as the right and left foot are both needed for walking".[1] The inductive method is the method required for ascertaining, for example, important financial facts, and it is the method by which the premises of the deductive method are secured and the results verified. The deductive method, on the other hand, is also of utility, as, for example, in regard to the ultimate effects of public expenditure and the incidence of taxation. Premises are selected, consequences deduced, and these consequences are verified by comparison with what is observed to occur. If, then, we assume that induction and deduction between them exhaust all the methods by which financial truths are ascertained, we may say that a combination of both methods is required in the study of public finance. Look into the fifth book of *The Wealth of Nations* on "The Revenue of the Sovereign or Commonwealth" and ask yourself how much of Adam Smith's power comes from his ability to see and understand facts and to take a broad and general view, his capacity to see things in both their immediate or concrete and their general or abstract relations. Marshall well summarises the position when he says: "The function, then, of analysis and deduction in economics is not to forge a few long chains of reasoning, but to forge rightly many short chains and single connecting links. This, however, is no trivial task. If the economist reasons rapidly and with a light heart, he is apt to make bad connexions at every turn of his work. He needs to make careful use of analysis and deduction, because only by their aid can he select the right facts, group them rightly, and make them serviceable for suggestions in thought and guidance in practice; and because, as surely as every deduction must rest on the basis of inductions, so surely does every inductive process involve and include analysis and deduction. Or, to put the same thing in another way, the explanation of the past and the prediction of the future are not different operations, but the same worked in opposite directions, the one from effect to cause, the other from cause to effect. As Schmoller well says, to obtain 'a knowledge of individual causes', we need induction; the final conclusion of which is indeed nothing but the inversion of

[1] Schmoller on "Volkswirtschaft" in Conrad's *Handworterbuch der Staatswissenschaften*; cf. his *Grundriss* (vol. i., 1900, vol. ii., 1904).

the syllogism which is employed in deduction. . . . Induction and deduction rest on the same tendencies, the same beliefs, the same needs of our reason." [1] In short, we pass from a generalisation to the facts, and from the facts back to new generalisations. There is always give and take between the examination of particular facts and the search for general principles. Again in what Mill, in his essay on Coleridge, calls " the noisy conflicts of half truths, angrily denying one another ", we must always remember, for example, in discussing whether a particular tax or a system of taxation is good or bad, the wise and timely warning that " the besetting danger is not so much of embracing falsehood for truth, as of mistaking part of the truth for the whole ". We must be sedulously on our guard against errors of fact and of inference. Lastly, much financial work, as Marshall once said of economic work, " has less need of elaborate analytical methods than of a shrewd mother-wit, of a sound sense of proportion, and of a large experience of life ".[2]

5. It will be convenient to summarise the scope of the chapters that follow. After a brief account of modern financial theory (Chapter II.), the subject of public expenditure is discussed with its many problems, including the canons of financial propriety as applied to expenditure. It is unfortunate that hitherto the system of expenditure has not been analysed in such detail as it merited, since good finance consists as much in the spending as in the collecting of revenue, and the guiding principle of financial policy is to avoid extremes. The system of expenditure ought to be viewed as a whole and an adjudication made on conflicting claims. This raises the problem of wise spending and also a consideration of policy. The plea that economy depends on policy must never be allowed to degenerate into a timid decision that policy cannot be changed and consequently that economy cannot be realised (Book II.). Next in order comes the nature of public revenue with the treatment of such subjects as the characteristics of a good revenue system, the measurement of taxable capacity, the distribution of taxation, and its cost and incidence. The various taxes, central or federal, provincial or state, and those of a purely local nature, are examined from

[1] *Principles of Economics*, by Marshall (London : Macmillan & Co., 1916). Appendix C, p. 773.

[2] *Principles*, 5th edit., 1907, App. C, p. 778.

the point of view of the well-recognised principles that the burden of and the relief from taxation should be spread over the greatest possible number of people in proportion to their capacity to pay. The need in some countries, as in India, of increased revenue for nation-building activities, such as primary education, is discussed with special reference to new sources of taxation for Provincial or State Governments, and also the sharing of taxes with Central or Federal Governments. The line of demarcation between Central or Federal, Provincial or State, and local taxation is also discussed. In recent years, especially in the United States, Australia, and India, the question of the interrelation of the finances of Federal, State, and local authorities has been of special importance (Book III.). The burden of debt, the central problem of public finance for years to come, is referred to in Book IV. The service of the English public debt, for example, requires more than the total pre-War Budget, and was over one third of the expenditure in the quinquennium ended 31st March 1934. The flank of the problem can only be turned by a systematic and careful policy of tackling the tremendous problem of internal and external debt. In Great Britain this has already been begun, as it has, too, in some other soundly financed States. The conversion, for example, in 1932 of the British Five per Cent War Loan of £2087 millions to a 3½ per cent basis was the greatest conversion operation in history and marked the beginning of a long period of high British credit. At the time of the Armistice the floating debt of Great Britain was £1500 millions sterling, but by the end of March 1933 this had been reduced to £810 millions, and the country was rid of all its foreign debts except those due to America. All obligatory repayments of debt should be met out of revenue, and any surplus remaining should be divided between debt redemption and (to a less extent) remission of taxation. Governments must remember that borrowing is not a short cut to prosperity, and a policy of borrowing must be resisted, except for what can reasonably be regarded as productive expenditure. The arguments in favour of a steady reduction of debt, even at the cost of heavy sacrifice, are economically and socially unanswerable. The last book (Book V.) deals with budgets, audit, and the financial work of the legislature in countries in various stages of self-government, such as India, the self-governing Dominions, and Great Britain. Nothing makes for

greater inefficiency in any country than a Budget which refuses to balance. Public credit cannot be maintained unless the Budget is balanced and unless some provision is ordinarily made for the redemption of debt. It is vital for a Government to preserve public credit, because without this there can be no sure basis for private credit. No sacrifice is too great in order to secure budget balance and not a few Governments have fallen on this battle-ground.

Finally, there are statistical tables containing the detailed data referred to in the text.

CHAPTER II

THE DEVELOPMENT OF MODERN FINANCIAL THEORY

1. It is difficult in tracing the development of financial theory to avoid the common temptation of reading into ancient or mediaeval writers on the subject the ideas of our own times. A sound historical sense is very necessary in order to put the text of a writer into its contemporaneous setting, and to interpret its thought by the actual circumstances existing at the time when it was written. There are often apparent resemblances which on examination are generally superficial only and not real. This is the supreme difficulty in tracing the development of financial theory before the second half of the eighteenth century. Another difficulty is that there are in ancient and mediaeval writers only a small number of financial writings, and these, too, are usually fragmentary and scattered. The *Arthashastra* or the *Science of Wealth* of Kautilya [1] is one of the earliest treatises on the art of government and taxation, and is the oldest financial work in India. Its date is about 300 B.C. The State's activities were very wide, and taxes were raised from almost every possible source, or, as Kautilya says, " Just as fruits are gathered from a garden as often as they become ripe, so revenue shall be collected as often as it becomes ripe ". The Greeks and the Romans in ancient times, and the Florentines and Venetians in the middle ages, showed a remarkably practical sense of some of the principles of the science, but this was not the result of scientific work, nor, so far as can be judged, should it be regarded as really contemporary

[1] *Vide Kautilya's Arthashastra*, translated by R. Shamasastry, Bangalore (Mysore Govt. Press), 1929 (3rd edit.). The treatise is divided into 15 books and 150 chapters. See Book II. ch. vi. (The Collection of Revenue), ch. xii. (Mines and Manufactures), ch. xvi. (Imports and Exports), and Book V. ch. ii. (Replenishment of the Treasury). The *Arthashastra* was lost for centuries but discovered in 1909. Some European scholars would put the date as late as A.D. 320–480, *i.e.* the Gupta period.

with scientific writing. Athens had considerable revenues from tributes, public domains, customs and excise duties, market dues, duties on cargoes, fines and legal fees, a tax on slaves, a special graduated tax on property, and the "liturgies" (λειτουργίαι). She spent her public revenues on public buildings, the celebration of festivals, police, the army and navy, Government officials of all kinds, and on the relief of the destitute. Before the Peloponnesian war Athens had, like Germany before 1914, a treasure of coined money. In the Acropolis it amounted at its maximum to 9700 talents or £2,230,000. In the Roman Empire revenues were from public lands, monopolies, customs, the land tax, taxes on sales, inheritance, and the purchase of slaves, while expenditure was on the army and navy, the civil service, if the officials may so be called, the corn supply, religion, and public works, including roads and aqueducts. We are, however, in spite of the careful researches of distinguished scholars,[1] unable to compile budgets for any part of the long centuries of the Republic or the Empire, as has been done in the well-known Blue Book on Public Income and Expenditure in Great Britain from 1688 to 1868.[2] State housekeeping in these far-off times was an unknown matter and not handed down in writings. The Greeks looked on commerce, industry, and labour, as Indians sometimes do to-day, as below the dignity of the free and wealthier classes. Although the Romans laid more stress on taxation than did the Greeks, yet they never, like the Greeks, got the most out of their taxation system, and they never faced the question of just distribution. This was not surprising, since the wealth of Rome was dug out of the provinces by the sword rather than by the spade. Slave states, in short, like Greece and Rome, were not much interested in the financial and economic problems which confront modern states. The feudal system, which characterised mediaeval life, did not result, so far as modern research has been able to ascertain, in scientific literature on finance. Kings in Europe depended mainly on the income from their domains and certain feudal dues. Taxation was an extraordinary source to be used in times of emergency. From the Renaissance to the middle of the eighteenth century

[1] See the work of Tenney Frank, *Economic Survey of Ancient Rome*, 1933, and *Economic History of Rome to the end of the Republic*, 1920 (Baltimore, Johns Hopkins Press).

[2] Nos. 366 and 366-1. 1869.

financial literature grew in quantity as well as quality with the growth in wealth, commerce, and industry. There were writers of the stamp of Carafa [1] in the fifteenth century. Carafa dealt with public expenditure and taxation far in advance of his time. Thus he says that taxes should be so clearly formulated that people will not require to go to law to know what they have to pay. Taxes must not be oppressive, and oppressive they will be unless there is economy in expenditure. If there is economy, only the best taxes need be levied, and those unequal in their incidence and otherwise unsuitable will not be required. His book covers only eighty-eight pages, but is replete with much financial sense. Then there were the mercantilists, many of whom wrote on finance. Bodin (1530–1596) was under their influence, but not a slavish follower of their system, and in his last book (Book VI.) of the Republic (1576) [2] he examined public revenues and the question of taxation. Bodin wrote about the time of the birth of the modern state, and his views on taxation are broader in outlook than those of his predecessors. Convenience to the sovereign and equality from the viewpoint of ability to pay were the two great canons of taxation propounded by him (*vide De Republica*, Bk. VI. ch. ii). If revenue were raised chiefly from the public domain and customs at the frontier these canons would be given effect to. High import duties would bring not only revenue to the State but protection to home industries. He would prohibit the export of raw materials. If other taxes were to be levied, great care was necessary in levying them so that they might be equitable and convenient or regular. He held that in order to achieve a just administration of taxes there should be a general registration of property. This remarkable treatise is, with the possible exception of Montesquieu's, the greatest since the *Politics* of Aristotle. Thoroughgoing mercantilists like Petty wrote on taxation. Petty's treatise on taxation (*Treatise of Taxes and Contributions*, 1662) was one of the first scientific treatises in English. It discusses the principles of taxation, especially the distribution of the tax burden, and it places him in the front rank of pre-Smithian writers. Davenant (1656–1714) wrote his *Ways and Means of Supplying the War*, 1695, to finance war not by borrowing, and

[1] *Vide* Part III. (" De re familiari et vectigalibus administrandis ") of *De regis et boni Principis officio* (Naples, 1668, written between 1469 and 1482).

[2] *Les Six Livres de la république* (Paris, 1576, tr. by R. Knolles, London, 1606).

he favoured an excise as the best of taxes. He was commissioner of excise from 1683 to 1689, and from 1705 until his death he was inspector-general of exports and imports. In Sir James Steuart's words, he " was an admirable writer ".[1] Adam Smith refers to " Dr. Davenant " twice in *The Wealth of Nations*, once in regard to his praise of Gregory King's skill in political arithmetic,[2] and again on the incidence of a tax on malt liquors [3]

In France at this period writers were critical of the system of taxation, which was unsatisfactory. Class exemptions were many; there were heavy duties on articles of general consumption; taxes were gathered by the system of farming and not by departmental officials. No wonder that we get such vivid descriptions of economic misery in France. Boisguillebert or Boisguilbert (1646–1714) [4] was anxious to see a reform of the fiscal system of France under Louis XIV., and in his two best known works, *Le Détail de la France* (1695, translated into English 1697) and *Le Factum de la France* (1706), shows the abuses prevailing in taxation. He prefers direct to indirect taxation, a characteristic of the writers of this generation in France; he recommends the reform of some taxes such as the taille and the substitution of the troublesome internal customs and the aides by a hearth tax or, as he suggested in his work of 1706, by a tax of 10 per cent on all incomes. Boisguilbert was not, as he has sometimes been regarded, a free trader and liberal in fiscal matters.[5] He favoured bounties on the export of wheat, but opposed export duties on wheat in the interest of producers. He favoured, too, the prohibition of the import of wheat for the same reason. He was indeed a champion of agrarian protection. Vauban, Maréchal de France (1633–1707), published his *Projet d'une dix^me. royale* [6] anonymously in 1707. It is a treatise of

[1] Cf. his *Two Discourses on the Public Revenues and Trade of England* (2 vols., London, 1698). Cf. *The Political and Commercial Works of . . . Charles D'Avenant, LL.D., relating to the Trade and Revenue of England, the Plantation Trade, the East India Trade, and African Trade. Collected and revised by Sir Charles Whitworth, M.P.* (London, 1771, 5 vols.).

[2] *The Wealth of Nations*, Cannan i. 79. [3] Cannan ii. 375.

[4] *Vide* his works reprinted in *Économistes financiers du XVIII^e siècle*, E. Daire (2nd edit., Paris, 1851).

[5] Boisguilbert, *Ses théories et leur place dans l'histoire des doctrines économiques*, by Talbot, Paris, 1903.

[6] *Testament politique du maréchal de Vauban*, 2 vols. 2nd edit. Brussels, 1712. Cf. Gazin, *Essai de bibliographie. Oeuvres concernant Vauban. Écrits personnels du maréchal* (Paris, 1933).

special interest, as it shows much breadth of view in favour of financial reform. Every one must pay in proportion to their income and industry. Every exemption was unjust. Vauban aimed at a proportional income tax on all incomes, real and personal, in place of the numerous taxes then in vogue. He was in favour of retaining the import and export duties. The tax on landed property was to be levied on raw produce as was the case of the ecclesiastical tithe; the income from house property, on profits, salaries, and pensions, was to be assessed. Even wage-earners would pay the tax. He considered that, subject to the rates being doubled in times of great necessity, the maximum should be 10 per cent, never to be exceeded, and 6·66 per cent should be the normal rate. Owing to the frequency of bad seasons the rate on the wages should be only 3·33 per cent. Vauban, however, proposed taxes also on expenditure, viz. on luxuries such as "exaggerated magnificence in furniture, gilded carriages, large and ridiculous perruques," tobacco, drinks, coffee and tea, and on salt. His book, like those of Boisguilbert, shows in vivid colours the need for financial and economic reform in the time of Louis XIV.

The "never-to-be-forgotten Dr. Hutcheson" (1694–1746), to use Adam Smith's words of his teacher, was a mercantilist who in his *System of Moral Philosophy* also dealt with taxes and the proportionment of taxation to a country's wealth. Hutcheson's influence on Adam Smith, who was his pupil in the class of moral philosophy, Glasgow University, in 1740, is seen in many directions and not least in the maxims of taxation. "As to taxes for defraying the public expenses, these are most convenient which are laid on matters of luxury and splendour rather than the necessaries of life; on foreign products and manufactures rather than domestic; and such as can be easily raised without many expensive offices for collecting them. But, above all, a just proportion to the wealth of people should be observed in whatever is raised from them, otherways than by duties upon foreign products and manufactures, for such duties are often necessary to encourage industry at home, though there were no public expenses." [1] From him Adam Smith learned to value

[1] *A System of Moral Philosophy*, 2 vols. (London, 1755), vol. ii. pp. 340-41, written about 1737. First edition 1747. Subsequent editions 1753, 1755, and 1758. Cf. *Wealth of Nations* (Cannan), vol. i. p. xlii.

"natural liberty". Steuart (1712–1780) in England, and his contemporaries Genovesi [1] (1712–1769) in Italy and Forbonnais [2] (1722–1800) in France, who belong to the Mercantilist School, wrote on finance. The benefit theory of taxation was a distinguishing feature of many of the school. In Germany mercantilist views had a strong hold, and it produced a corpus of doctrine, known as Kameralwissenschaft, taught in German and Austrian Universities to students interested in administration and public finance. The writers on Cameralism range from the middle of the sixteenth to the end of the eighteenth century, and Seckendorff may be regarded as the Adam Smith of the School just as Justi is the John Stuart Mill. Their influence was greatest in the middle of the eighteenth century. Primarily political scientists and not political economists,[3] they preached that the welfare of the State, the aim of social theory, was their main task, and for this purpose they had to furnish the State with revenue. The form of taxation depended largely on their conception of the nature of the State. They were largely engaged in the practical point of raising revenue for the kings and princelings of Central Europe. Hence their aim was in a great degree a severely practical one—that of the camera or Treasury of the Prince in the collection of revenue. Von Justi (1717–1771), in his *Staatswirthschaft* (1755) and his *System des Finanzwesens* (1766), discussed the raising of revenue, the expenditure of the State, the organisation and administration of financial business as the subject matter of public finance, and, presenting a more comprehensive scope of taxation than any of his predecessors, he laid down maxims of taxation which form an interesting comparison with those of Adam Smith.

[1] Appointed to the first Chair of Commerce in Europe at the University of Naples, 1754. *Delle Lezioni di Commercio o sia d'Economia Civile*, Naples, 1764 (vol. i.), 1765 (vol. ii.), 2nd edit., 1768–70; also Milan edit., 1768, Naples, 1795, Turin, 1852. Reprinted in Custodi and in Ferrara. German translation, 1776, Spanish translation, 1785. His chief writings are published in *Biblioteca dell' economista*, 1st ser. vol. iii. (Turin, 1852), and additional political writings have been published for the first time in Monti's *Due grandi riformatori del settecento*; *Antonio Genovesi e G. M. Galanti* (Florence, 1926).

[2] *Considérations sur les finances de l'Espagne* (Paris, 1753; 2nd edit. with title *Réflexions sur la nécessité de comprendre l'étude du commerce et des finances dans celle de la politique*, Paris, 1755); *Recherches et considérations sur les finances de France depuis l'année 1595 jusqu' à l'année 1721*, 2 vols., Basel, 1758; 6 vols., Liège, 1757; 2nd edit., 1758.

[3] *The Cameralists: the Pioneers of German Social Policy* (Small, Chicago University Press, 1909). For an excellent bibliography, see article "Cameralism", *Encyl. of the Social Sciences*, vol. iii. (New York, 1930).

Justi's maxims of taxation cover those of Adam Smith's—taxes must be levied with relative equality (*i.e.* the benefit received and the ability to pay must be considered); they must be certain, sure, and true; they should be convenient; and should be economical in their collection. He also holds that taxes should be so levied as to be paid willingly, and they must not interfere with industry and commerce. The former can quite well be classified under the canon of convenience and the latter under the canon of equality.[1] His classification of public expenditures in his *System des Finanzwesens* is one of the first, if not the first, systematic grouping in any treatise. Von Sonnenfels (1733–1817) was the outstanding cameralist of the Austrian school, as Von Justi was of the German. In 1763 he was appointed to the newly created chair of police and cameral science in Vienna, and his *Grundsätze der Polizei, Handlung und Finanzwissenschaft*, 1765, was a standard text-book in Austrian and Hungarian universities up to the first half of the nineteenth century.[2] He is a follower of Justi, but more thorough and systematic in the exposition of principles.

2. In the widest sense of the term, however, modern financial theory may be said to have had its birth in the second half of the eighteenth century. Almost from its very beginning it was international in character, and this for three reasons. In the first place, it was the custom for men of culture to travel. Adam Smith, for example, resigned his chair of Moral Philosophy in the University of Glasgow in 1763 to become travelling tutor to the young Duke of Buccleuch,[3] and visited Paris, Toulouse, Bordeaux, Montpellier, and Geneva. Nearly a year was spent in Paris and eighteen months in Toulouse. It was at Toulouse that he began to write *The Wealth of Nations* "to pass away the time" as he had "very little to do". Hume, Adam Smith's great friend, after a twelve months' tutorship of Lord Annandale, visited in 1746, as Secretary to General St. Clair, the Courts of Vienna and Turin. In 1763 he accompanied Lord Hertford to Paris, and there met

[1] *Staatswirthschaft*, Leipzig, 1755 (2 vols.), vol. ii. 309 ff., 2nd edit., 1778.

[2] Wien, 1765, 3 vols. New edit., 1770–76; 5th (enlarged) edit., 1786–87; 7th edit., 1804; 8th edit., 1819–22. Latin trans. by Beke, Posen, 1807–8.

[3] It was Charles Townshend, the Chancellor of the Exchequer, who appointed Adam Smith as tutor to his stepson, the Duke of Buccleuch, on a salary of £300 a year, with a pension of the same amount as long as he lived. Adam Smith thus made about £8000 from his three years' tutorship.

the future kings, Louis XVI. and Louis XVIII. Sir James Steuart, on the completion of his education in Edinburgh, went abroad according to custom, and travelled for years in the Netherlands, France, Spain, and Italy. A second reason for the cosmopolitan complexion of modern financial theory is the frequency with which books were translated into foreign languages. *The Wealth of Nations*, between its date of publication in 1776 and 1802, when the well-known Garnier translation was published in Paris, was translated at least on five occasions into French. Between 1776 and 1861 there were six German translations of the same work. Thirdly, the introduction of new taxes into a country's fiscal system requires a thorough examination of the working of these taxes elsewhere, often under different conditions. Before one is able to say whether a real and personal property tax is suitable as a provincial source of revenue in India a detailed study of American and also Swiss experience would be required. The economist, in short, in the domain of public finance, has to draw his facts from a wider field than that of the country in which he lives.

3. Before the publication of *The Wealth of Nations* there were signs, as we have seen, of a coming change. In 1748 one of the ablest thinkers of the eighteenth century, Montesquieu (1689–1755), published his *Spirit of Laws*[1] (*L'Esprit des lois*), the thirteenth book of which deals with taxation. Adam Smith and his Scottish contemporaries, we know, studied Montesquieu with nothing short of veneration. He is the " Mr. Montesquieu " we meet with in *The Wealth of Nations*. He propounds the advantages of progressive taxation and the direct taxation of individuals after the satisfaction of their ordinary wants and not in proportion to their wealth. Montesquieu's methodology must have appealed to Adam Smith. In 1752 appeared two essays, one on taxes and the other on credit, in *Political Discourses*, by David Hume (1711–1776). Hume's contribution to financial theory is of interest and value because he belongs to a transition stage when economics had grown out of political philosophy but had not yet become a science. He denied the Physiocratic doctrine that all taxes ultimately fell upon the land, and believed those taxes to be best which are levied on consumption, especially those of luxuries, because they are least felt. In 1767 appeared Sir James

[1] Trans. by Thos. Nugent, Dublin, 1751 ; 5th edit., London, 1773.

Steuart's *Principles of Political Economy*,[1] in which public credit[2] and taxes[3] were separately discussed. A little unattractive in style and unsound in regard to the teaching of the moderate mercantilists, it fell, especially after the publication of *The Wealth of Nations*, almost into neglect. It is not even referred to nor quoted in *The Wealth of Nations*.[4] "I have the same opinion of Sir James Steuart's book that you have", says Adam Smith in a letter to Pulteney (1772). "Without once mentioning it, I flatter myself that any fallacious principle in it will meet with a clear and distinct confutation in mine." Many German writers have estimated the work of Steuart exceedingly highly, and we may safely hold with Roscher that he was "a great economist" who was unduly overshadowed by Adam Smith, and especially by the latter's clear exposition. Steuart had good ideas on taxes, as is shown in the concluding book of his *Principles*. His other writings, such as *The Principles of Money applied to the Present State of the Coin of Bengal* (1772), are mainly concerned with money and, therefore, outside the scope of this work.

4. The French Économistes or the Physiocrats[5] held tenets which would not be accepted by writers on the science of public finance to-day, and, in the words of Adam Smith,[6] "it would not, surely, be worth while to examine at great length the errors of a system which never has done, and probably never will do, any harm in any part of the world". The treatment by this school of the incidence of taxation and the analysis of public revenue are of importance if only from the effect which was produced on Adam Smith and his contemporaries. Agriculture alone of all industries produces, according to the Physiocrats, more than the total sums advanced—the surplus being the *produit net*, at the expense of which all other industries exist. It is this *produit*

[1] Written in 1759: London, 1767; Dublin, 1770; German trans., 1769–70; French trans., 1789; Collected Works (6 vols.), London, 1805.

[2] Book IV. Part 4.

[3] Book V. "Of Taxes and of the Proper Application of their Amount".

[4] Possibly because Steuart was a staunch Jacobite and was excepted by name from the Act of Oblivion, 1747, owing to the part he took in the rebellion of 1745.

[5] A name invented by Du Pont de Nemours for his friends and himself. In 1799 he first employed the word "physiocrate". It was taken from the title of a collection of the works of Quesnay, published by Du Pont in 1767, *Physiocratie ou constitution naturelle du gouvernement le plus avantageux au genre humain*. 2 vols., Leyden.

[6] *Wealth of Nations*, Book IV. ch. ix. p. 161.

net which supports all the weight of taxation. They believed in the superiority of the single tax on the *produit net* or net product of land—the *impôt unique*—while admitting the temporary use of other taxes. The best known are Quesnay (1694–1774), Gournay (1712–1759), the elder Mirabeau (1715–1789), Du Pont de Nemours (1739–1817), and the statesman Turgot (1727–1781). Quesnay was held in high esteem on account of his brilliant intellect and high character. It was only his death that prevented Adam Smith from dedicating to him *The Wealth of Nations*, and his fame as an economist was equal to that attained some years later by Adam Smith. His *Tableau économique* (1758) is quoted in *The Wealth of Nations* as in the view of Mirabeau one of the three great inventions that have contributed most to the stability of political societies, the other two being those of writing and money. Several of his maxims and his *Second problème économique* refer to finance. Turgot,[1] in numerous financial measures, showed great financial insight. After a ministry of twenty months he abolished twenty-three taxes onerous to commerce and industry, abolished the *corvée* on roads which cost the country four times as much as ordinary labour, and left a large surplus as compared with a deficit when he assumed office.[2] It was Turgot's friendship with Adam Smith that is noteworthy from the point of view of financial theory. It was he who obtained for Adam Smith Moreau de Beaumont's *Mémoires concernant les impositions et droits en Europe* (published in Paris in five volumes in 1768), which Adam Smith quotes in *The Wealth of Nations* at least sixteen times.[3] It was this volume which he declined to lend in November 1778 to Sir John Sinclair,

[1] Turgot, *Opuscules*, Rome, 1754; *Œuvres de M. Turgot, ministre d'État* (Paris: A. Belin, 1811), 9 vols. The best known of Turgot's works is on the formation and distribution of wealth (*Réflexions sur la formation et la distribution des richesses*), written in 1766 though published three years later.

[2] *Vide* Higgs, *The Physiocrats*, London, 1897, and Seligman, *The Shifting and Incidence of Taxation* (1899), pp. 95-112. The best early account of the Physiocrats and their system is Dupont's *De l'origine et des progrès d'une science nouvelle*, London and Paris, 1767, 84 pp. (cf. *British Academy Bibliography of Economics*, 1751–75, Higgs, Cambridge, 1935). It is an abridgment of Mercier's *L'Ordre naturel*, 1767.

[3] There were only three other copies in Great Britain, and "It was," says Adam Smith, "obtained by the particular favour of Mr. Turgot, the late Controller-General of the Finances." "If any accident should happen to my book, the loss is perfectly irreparable. When Mr. Sinclair comes to Edinburgh I shall be very happy to communicate to him not only that book but everything else I have upon the subject."

the author of the *History of the Public Revenue of the British Empire*,[1] a standard work which established Sinclair as a writer of finance. In Adam Smith's library there was a printed Budget inscribed to Adam Smith in Turgot's own handwriting.[2]

5. In the sphere of finance Adam Smith (1723–1790) co-ordinates all previous work. It is only in recent years that the enormous output of financial literature preceding the publication of *The Wealth of Nations* has been correctly appraised. The period was one of very great intellectual advance in Europe, and in no direction was this more marked than in finance. The printing presses in various countries, especially those of London, Paris, Glasgow, and Dublin, undertook the publication of books and pamphlets on public finance. Bonar's *Catalogue of Adam Smith's Library*, the catalogues of the Goldsmiths' Library and of the collection of pamphlets bequeathed by Haliday to the Irish Academy, the bibliographies by Morellet, Sinclair, and Massie, and the recent bibliography prepared for the British Academy indicate the sources which were then available.[3] In Adam Smith's library were works on National Debt such as those of Price (whom Adam Smith regarded "as a factious citizen, a most superficial philosopher and by no means an able calculator"), and works and pamphlets on taxation by such writers as Josiah Tucker, Sir Matthew Decker, Madox, Sir Jeffery Gilbert, Grenville, Timothy Cunningham, James Postlethwaite, Roussel De La Tour, Forbonnais, Mirabeau, Dutot, Duverney, Francheville, Necker, Coubron, Twining, and Uztariz.[4] In the

[1] Dublin, 1775; London, 1784; 3rd (best) edit., London, 1804.

[2] *Catalogue of Adam Smith's Library*, James Bonar, Macmillan & Co., London, 1932, p. 188.

[3] Haliday's collection of tracts and pamphlets (1578 to 1866) bequeathed to the Irish Academy; Morellet's *Catalogue d'une bibliothèque d'économie politique*, appended to his *Prospectus d'un nouveau dictionnaire de commerce*, Paris, 1769. It was Morellet who said of Adam Smith, "Il parlait fort mal notre langue". His dictionary, like his translation of *The Wealth of Nations*, never was published; the bibliography appended to Sir John Sinclair's third edition (London, 1804, 3 vols.) of his *History of the Public Revenue of the British Empire*, Dublin, 1775; Massie's *Library of Economic Literature* 1557–1763; and the *Bibliography of Economics*, 1751–1775, prepared for the British Academy by Henry Higgs, Cambridge, University Press, 1935. There are 1201 publications on Finance alone in this recently published volume which covers only a period of twenty-five years.

[4] *Observations on Reversionary Payments; . . . and on the National Debt*, London, 1st edit., 1769, 2nd edit., 1771, 2nd edit., with a supplement, 1772, 3rd edit., 1773, and 7th edit., 1812, by Richard Price; the works and pamphlets on taxes and their effects by Josiah Tucker; *Serious Considerations on*

quarter of the century preceding the publication of *The Wealth of Nations* we have also in addition to these already mentioned, Malachy Postlethwayt, D'Eon De Beaumont, Hartley, Harvey, and Fauquier.[1]

The Wealth of Nations is, perhaps, the best example in the world of the truth of Carlyle's saying that "books accomplish miracles. They persuade men." The author combined theory and practice in outlining (in Book V. of *The Wealth of Nations*)

the several High Duties which the Nation in General (as well as its Trade in particular) labours under: with a Proposal for . . . one Single Tax, 7th edit., London, 1756, and 1st edit., 1743; and *The causes of the decline of foreign trade* by Sir Matthew Decker; *The History and Antiquities of the Exchequer of England*, 2nd edit., London, 1769, and 1st edit., 1711, by Madox; *Treatise on the Court of Exchequer*, London, 1758, by a late Lord Chief Baron of that Court (Sir Jeffery Gilbert); *Considerations on the Trade and Finances of this Kingdom, and on the Measures of Administration with respect to those great National Objects since the Conclusion of the Peace*, London, 1766; *The Present State of the Nation: Particularly with Respect to Its Trade Finances, etc.*, London, 1768, 3 editions, and Dublin, 1768 (this publication being the joint work of Grenville and his private secretary Knox), and *Mémoire sur l'administration des finances de l'Angleterre depuis la paix*, 1767, Paris, 1768, Leyden, 1769, Madrid (Spanish translation), 1771, and Naples (Italian edition), 1775, 2 vols., by Grenville; *The History of our Customs, Aids, Subsidies, National Debts and Taxes*, London, 1761, 2nd edit., 1773, and 3rd edit., 1778, by Timothy Cunningham; *The History of the Public Revenue from* 1688 *to* 1753, London, 1759, by James Postlethwaite; *Richesses de l'État*, 1763, which proposed a graduated single tax, by Roussel De La Tour; *Recherches et considérations sur les finances de France depuis* 1595 *jusqu'en* 1721, Liège, 1757, 6 vols., *Principes et observations œconomiques*, Amst., 1767; *Élémens du commerce*, Paris, 1754, and subsequent editions, Paris, 1754, 1766, and 1796, and *Considérations sur les finances d'Espagne*, Paris, 1753, by Forbonnais; *La Théorie de l'impôt*, 1760, by Mirabeau; *Réflexions politiques sur les finances et le commerce*, La Haye, 1754, 2 vols. (1st edit., 1738), by Dutot; *Examen du livre intitulé "Réflexions politiques sur les finances et le commerce"*, La Haye, 1740, by Duverney; *Histoire générale et particulière des finances*, Paris, 1738, by Francheville; *De l'administration des finances de la France*, 3 vols., 1784, by Necker; *Nouvelles Vues sur l'administration des finances et sur l'allègement de l'impôt*, La Haye, 1785 by Coubron; *Observations on the Tea and Window Act and on the Tea Trade*, 2nd edit., London, 1785, by Twining; and *The Theory and Practice of Commerce and Maritime Affairs* (translated by Kippax, London, 1751), original Madrid, 1724, 2nd edit., English translation, Dublin, 1752 (which deals with the alcavala tax), and French translation in 1753, by Uztariz.

[1] *The Universal Dictionary of Trade and Commerce*, London, 1751, by Malachy Postlethwayt; *Mémoires pour servir à l'histoire générale des finances*, Londres, 1758, 2 vols., and Amst., 1760, by D'Eon De Beaumont; *The Budget Inscribed to the Man who thinks himself Minister*, London, 1764, which went through eight editions in the same year, and *The State of the Nation, with a preliminary defence of the Budget*, London, 1765, which reached five editions in a twelvemonth, by Hartley; *The Popular Budget*, London, 1772, by an experienced practitioner in political economy, S. C. Harvey; and *Essay on the Ways and Means for raising Money for the Support of the Present War without Increasing the Public Debts*, London, 1756, by Fauquier.

with characteristic breadth, sympathy, and sincerity, the standpoints from which the field of finance has to be surveyed. His *magnum opus*, the fruit of twelve years of concentrated work, shows that he excelled in the "osteology" of finance. *The Wealth of Nations* was, as has been noted, begun at Toulouse, and while in France he met Quesnay, Turgot, and other celebrities he most desired to know. To his French visit he owed much. His knowledge of French finance in Book V., where he compares the French system of taxation with the English, was without doubt due to his visit to France. His treatment of public expenditure, of public revenue, and of the principles of taxation precedes a criticism of various existing and proposed taxes, especially those in the English system. He judges these taxes by the canons which he has laid down, and illustrates his points with abundance of points from English and foreign practice. His chapter on public debts reminds one of what the wise Finance Minister of the first Napoleon, "le bon Mollien", said, "I avow to the shame of my first instructors" (*i.e.* the previous officials) "that it was the book of Adam Smith, then so little known, but which was already decried by the administrators with whom I had served, which taught me better to appreciate the multitude of points at which public finance touches every family, and which raised judges of it in every household".

Bagehot, in one of his best biographical essays, says that Adam Smith, the founder of the science of business, was one of the most unbusiness-like of men, as he was apparently choked with books and absorbed in abstractions. He quotes an occasion when Adam Smith, in place of signing his own name, imitated the signature of the person who signed before him. If this is true, it is surprising how his remarks on finance contain so much practical wisdom on every page. His colleagues, however, during the thirteen years he was in the University of Glasgow, regarded him as an able administrator and, as the Senate minutes show, one to whom they had recourse on all difficult questions including those of a financial nature. Between November 1766 and May 1767 Adam Smith was also engaged in a financial inquiry in co-operation with Charles Townshend, the Chancellor of the Exchequer, who was appointed by Pitt on 2nd August 1766. His mind was in reality a storehouse of financial common sense, and he was the best informed philosopher since Aristotle.

One would have expected a work like *The Wealth of Nations* rather from Ricardo, who made a large fortune in business. Ricardo arrives at his conclusions on the incidence of taxation by delicate reasoning, while Adam Smith arrives at his without abstraction and by homely illustration. The importance of *The Wealth of Nations*, even in Adam Smith's lifetime—and he lived for fourteen years after its publication—may be gauged by the fact that there were five English editions during the lifetime of the author, *i.e.* in 1776, 1778, 1784, 1786, and 1789.[1] Its influence on policy and legislative action may be illustrated from the fact that on thirty-seven occasions between 1783 and 1800 his authority was appealed to in Parliament,[2] and did not Pitt acknowledge that they were all scholars of Adam Smith ?[3]

6. The great effect of the teaching of Adam Smith on the science of public finance was not uniform in all countries. In the United States, for example, Alexander Hamilton (1757–1804), the great Secretary of the Treasury in Washington's cabinet from 1789 to 1795, ran counter in his masterpiece, the Report on Manufactures (1791), to Adam Smith by advocating protective duties to foster manufactures and bounties where necessary to agriculture. His two Reports on Public Credit (1790) contained much Smithian wisdom.[4] In Great Britain in the first half of the nineteenth century economics was a favourite study to an extent not quite appreciated by subsequent generations. The French Revolution and the Peace of 1815 had a considerable effect on the

[1] *An Enquiry into the Nature and Causes of the Wealth of Nations*, by Adam Smith, LL.D., F.R.S., formerly Professor of Moral Philosophy in the University of Glasgow (Strahan & Cadell, London, 1776, 2 vols.). The second edition, also in two volumes, was published in 1778. The third edition, in 1784, is in three volumes, and has considerable additions, especially in Book IV., "Drawbacks" and "Bounties", and in Book V. ch. i. art. 1, "On the Expenses of the Sovereign". The fourth edition, in three volumes, published in 1786, contains no alterations. The fifth and last in the author's lifetime, 1789, in three volumes (Strahan & Cadell), contains no alterations. Besides these there are the "pirated" Dublin editions in 1785 and 1793, in two volumes, based on the fourth and fifth editions.

[2] Buckle, *History of Civilization*, ch. iv. p. 60.

[3] Rae, *Life of Adam Smith*, p. 405.

[4] *Works*, ed. by H. C. Lodge, 12 vols., 1904. "Some Precedents followed by Alexander Hamilton", C. F. Dunbar, *Quarterly Journ. of Economics*, vol. iii., 1888–1889; "Hamilton as a Political Economist", E. C. Lunt (*Journ. Pol. Econ.* vol. iii., 1894–1895); History of the United States of America as traced in the writings of Alexander Hamilton (his son), New York, 1857–1864 (7 vols.); also his Life by Morse (Boston, 1876), Lodge (Boston, 1882), Sumner (New York, 1890), and Oliver (New York, 1921).

country. After the defeat of Napoleon trade was bad, employment scarce, and, as recently, there was a considerable interest in the science of business. In Great Britain problems of public finance did not agitate men's minds as they did on the Continent, except perhaps in regard to the question of public debts, where English writers have done considerably more work than those on the Continent. Nothing seems so much to hinder the growth of financial theory as an excellent revenue and budgetary system, combined with general prosperity. Financial or fiscal theory, in other words, flourishes on the defects of economic life. Robert Hamilton (1743–1829), in his *Enquiry concerning the Rise and Progress, the Redemption and Present State, and the Management of the National Debt of Great Britain* (1813), shows, with Aberdonian shrewdness, the fallacy underlying sinking funds. He was the first clearly to prove, although not the first to show, the fallacy of Pitt's sinking fund. It was the American statesman and financier, Albert Gallatin [1] (1761–1849) who first showed about twenty years earlier the fallacy involved in the old sinking fund idea as accepted by Pitt and Alexander Hamilton. Hamilton demonstrated that "the excess of revenue above expenditure is the only real sinking fund by which public debt can be discharged", and he illustrated how the then system was useless and harmful, necessitating as it did a high rate of interest and increased cost of management. It was through his writing and Ricardo's powerful support that the sinking fund in this form was soon abandoned. Four years later, David Ricardo (1772–1823) published his *Principles of Political Economy and Taxation* (1817). Ricardo had the best of preparations for abstract economics. He was a Jew by descent—his father was one by religion—and he spent his life in the most abstract of occupations, namely, that of a stockbroker. He retired with a large fortune from the London Stock Exchange at the early age of forty-two, and had it not been for his friend James Mill (1773–1836) (whose doctrines were as fire to fuel), he would probably have never written his treatise on *Political Economy and Taxation*, but merely left us a number of pamphlets of value. The first half of the nineteenth century, it is to be remembered, especially in Great Britain, con-

[1] *Vide The Writings of Albert Gallatin* (3 vols., 1879). Lord Grenville's Essay in 1827 followed by the recommendations of the Parliamentary Finance Committee, 1828, finally ended this delusion.

tains many pamphleteers, but few really comprehensive writers on the science of finance. Ricardo showed how the whole theory and incidence of taxation could be deduced from a few comparatively simple axioms and definitions. J. R. McCulloch (1789–1864), another friend of Ricardo, said of his work what is now universally regarded as true, that "the brevity with which Mr. Ricardo has stated some of his most important principles, their intimate dependence on each other, the fewness of his illustrations, and the mathematical cast he has given to his reasonings, render it sometimes not a little difficult for readers, unaccustomed to such investigations, readily to follow him. But those who give to his works the attention of which they are so worthy will find that he is remarkably consistent in the use of terms, and that he is as logical and conclusive as he is profound and original." A recent writer refers to his disinterested attitude in regard to his inquiries.[1] Lord Congleton, better known as Sir Henry Parnell (1776–1842), in his pamphlet *Financial Reform*, published in 1830, contends that public expenditure is overgrown, and that, especially in the non-productive services, considerable reduction could be effected. He is almost an extremist of the Victorian or Gladstonian school of finance. In 1845 appeared McCulloch's *Treatise on Taxation*.[2] The unattractiveness of McCulloch's writing, indeed his habitual deadness of style, resulted in his work having less influence than it deserved. While, however, he had not perhaps the tenacious grasp of abstract principle or the Euclidean precision of Ricardo, he brings together theory and practice in a way that is seldom realised. This is due to a combination of circumstances. He was on the staff of the *Scotsman* from 1817–1827, Professor of Political Economy in London

[1] Ricardo's *Economic Essays* (Gonner, G. Bell & Sons, London, 1923). Professor Gonner says: "The trend of economic thought and the new importance attached to economic inquiry make more valuable than ever the study of a writer whose attitude was so disinterested and who, despite his shortcomings, sought in all he wrote, on the one hand to elucidate facts by reference to principles, and on the other hand to build up out of the data at his command a system of coherent thought". Cf. Bonar, *Letters of Ricardo to Malthus* (Oxford Clarendon Press); Bonar and Hollander, *Letters of Ricardo to Trower* (Oxford Clarendon Press); Hollander, *Letters of Ricardo to McCulloch* (American Economic Association); Hollander, *David Ricardo*, Johns Hopkins Univ. Studies, xxviii. No. 4.

[2] *A Treatise on the Principles and Practical Influence of Taxation and the Funding System*, McCulloch (London, 1845: Longman, Brown, Green, & Longmans). This edition is scarce.

University, 1828–1832, and from 1838–1864 Comptroller of Her Majesty's Stationery Office in London. Seligman, in reviewing this period, remarks on the divorce between theory and practice. "The practical writers did not concern themselves with theory, and the economists were, for the most part, content to work in what might be called a fiscal vacuum. McCulloch was the one important writer to form an exception, and he was not sufficiently successful to find either admirers or successors." Three years after the publication of this book, *i.e.* early in 1848, appeared the *Principles of Political Economy*, by John Stuart Mill (1806–1873), the eldest son of James Mill. It was begun in 1845 and completed with marvellous rapidity in 1847. Mill's teaching on taxation in the fifth book is pursued with great vigour. He takes up the hardest parts of the subject and discusses them with consistent power—it might almost be said, with enjoyment. In looking back on the development of modern financial theory in Great Britain up to 1850, we are struck by the number of writers who were Scotch, notably precursors of Adam Smith like Hume and Steuart, Adam Smith himself, and successors like Hamilton, McCulloch, and the Mills, father and son. Reading their works is often like living on high ground. They brace the mind just as fine material air does the body. The cause of this is difficult to explain. Was it the training in metaphysics which the Scotch universities had carefully taught since the Reformation, or was it something more—the particularly practical aptitude of mind which that country has produced? Many of these writers had a special forte in throwing light on the most difficult portions of the subject and of basing theory on practice in everyday affairs.

During the second half of the nineteenth century much, if not most, of the best work in financial theory in English has been done by American writers. There have indeed been one or two notable exceptions. There is, on the purely historical side, Dowell's *History of Taxation and Taxes in England*, in four volumes.[1] There are similar works on local taxation in the United Kingdom. Professor Bastable's *Public Finance*[2] (1892)

[1] *A History of Taxation and Taxes in England from the Earliest Times to the Present Day*, by Stephen Dowell, Assistant Solicitor of Inland Revenue (London, 1884: Longmans, Green & Co.).

[2] *Public Finance*, by C. F. Bastable (London: Macmillan), 3rd edit., 1903, reprinted 1917.

is the first book of its kind published in England since the time of McCulloch. The subject is treated with adequate fullness and admirable impartiality, except, perhaps, in the meaning of terms, where the influence of German writers is clearly seen.[1] It forms a distinct landmark in English treatises on the science of public finance. Professor Nicholson, in the fifth book of his *Principles*, has surveyed a large part of the field, but without much originality. Edgeworth, in nine papers on the pure theory of taxation, local taxation, minimum sacrifice versus equal sacrifice, graduation in taxation, and the theory of incipient or moderate taxes, has contributed to financial theory to a degree that is not always appreciated.[2] He discusses with remarkable precision the incidence of various taxes and the criterion of optimum taxation; he defends minimum aggregate sacrifice as the criterion of good taxation; and his paper on incipient taxes illustrates the use of the mathematical method in which he was a past-master. American writers, such as Professors H. C. Adams and E. R. A. Seligman, deserve a high place in the financial literature of the period. Adams' *Public Debts* (1887) and his *Science of Finance—an Investigation of Public Expenditure and Public Revenues* (1898) are comprehensive works of great value, although the latter is unsatisfactory in the branch of financial administration. For Seligman's work (some of which belongs to the beginning of the twentieth century) there can be nothing but praise, and in years to come his work will be seen to have been of outstanding merit. His *Shifting and Incidence of Taxation*, *Progressive Taxation in Theory and Practice*, *Essays in Taxation*, *The Income Tax*, and *Studies in Public Finance*, which is a preliminary volume to his forthcoming *Principles of Fiscal Science*, are well known. No writer on taxation problems in this period has given himself to the subject more whole-heartedly or successfully, or with greater knowledge of his subject, than Seligman. Other American works worthy of honourable mention are Plehn's *Introduction to Public Finance*, Shultz on *The Taxation of Inheritance*, the chapters on taxation in Taussig's *Principles of Economics*, Lutz' *Public Finance*, the studies in public finance of the National Industrial

[1] An interesting criticism of this work will be found on p. 392 of Seligman's *Essays in Taxation* (Macmillan, 1915).

[2] Edgeworth, *Papers Relating to Political Economy*, Macmillan, London, 1925, vol. ii. pp. 63-270, 340-66, and 399.

Conference Board, New York, and the *Reports and Proceedings of the National Tax Association.* Since the Great War considerable attention has been given to taxation and taxable capacity. In Great Britain Sir Josiah Stamp's writings, such as *The Fundamental Principles of Taxation, Wealth and Taxable Capacity*, not to mention his *British Incomes and Property—the Application of Official Statistics to Economic Problems*, and Professor A. C. Pigou's stimulating *Public Finance* (1928), have given greater emphasis to portions of the subject matter which had, especially before the War, been unduly neglected. Many able Government publications have appeared since the Armistice in English, notably the Report of the Royal Commission on the English Income Tax, 1920; the Report of the Select Committee on the Increase of War Wealth, 1920; the Report on Public Finance of the International Financial Conference (Brussels), 1920; the Report of the Royal Commission in Australia, 1921 (5 vols.); the Report of the Colwyn Committee on (British) National Debt and Taxation, 1927; and the Reports on Double Taxation for the League of Nations, 1927 and 1928.[1] Much of this work is fine, massive, and comprehensive, and principles are being evolved afresh as a result of the experience of the War, which must guide the financial ship of State from the uncharted ocean of extravagance into the smoother seas of economy.

7. The volume of financial literature in German belonging to the nineteenth and twentieth century is large, probably on account of the fact that the financial system in Germany, as in France, was more complicated and less satisfactory than in Great Britain. Especially in the latter half of the nineteenth century, there are certain dominating characteristics of this literature, and these are: (1) the historical nature of the work done; (2) the advocacy of social aims in taxation; and (3) the erudite thoroughness of much of the work. The work of

[1] Seligman, in his *Essays in Taxation*, gives an exhaustive bibliography of official reports in the United States. Among the more modern of them may be mentioned the Report of the Special Taxation Commission of the City of Cleveland, 1915; the Report of the Committee of Taxation of the City of New York, 1915; the Report of Special Commission on Taxation, Boston, 1916; the Report of the Special Tax Commission, New Haven, 1917; the Report of the Joint Special Committee on Taxation, Boston, 1919; Reports of the National Industrial Conference Board (not referred to by Seligman) are of importance, *e.g.* Tax Burdens and Public Expenditures, 1925, the Cost of Government in the United States, 1926–1927.

Roscher is an example of the first, and of Wagner, Cohn, and Eheberg on Finanzwissenschaft of the second. The financial system is regarded as an agency for the better distribution of wealth. A good example of the third characteristic is the work of Rau [1] or Nebenius on public credit. Nebenius (1784–1857) belonged to the school of Adam Smith, and in 1820 (2nd edition, 1829) published *Der öffentliche Kredit*, which Roscher somewhat exaggeratingly says is "perhaps the best monograph in the whole economic literature of Germany, and certainly the most important treatise on the subject of public debts which has been written in any language". Rau (1792–1870), also a follower of Adam Smith, published a treatise on Economics (*Lehrbuch der politischen Oekonomie*, 1826–1837), the third volume of which, devoted to finance, appearing in 1832. Rau's work had much influence in Germany, where he was, it will be remembered, Professor of Political Economy in Heidelberg from 1822 for many years. Hoffmann (1765–1847), Director of the Prussian Bureau of Official Statistics from 1810 to 1844, published in 1840 his well-known *Theory on Taxation* (*Die Lehre von den Steuern*). Von Hock (1808–1869), Director of Customs in Trieste and subsequently in Vienna, published in 1863 a systematic treatise on public taxes and debts (*Die öffentlichen Abgaben und Schulden*). Wagner has described this treatise as presenting "in its pregnant conciseness an almost perfect science of finance, and being by far the best on the technique of finance".[2] Its value lies in the skilful elaboration of the theory of the incidence of taxation and the manner in which the administrative aspects of taxation are discussed by so experienced an official. Roscher also praises "its nice distinctions on the incidence and shifting of taxation".[3] Von Stein (1815–1890), Professor of Political Science at Vienna from 1855 to 1888, published in 1860 his *Lehrbuch der Finanzwissenschaft*, which deals mainly with financial organisation, and he treats of public finance as a branch of political science. His book covers a vast field—the financial systems of various countries in Europe—and it is

[1] *Grundsatze der Finanzwissenschaft*, Leipzig, 1832.

[2] *Finanzwissenschaft*, i. 52, Leipzig (in 4 vols.). Hock's two other contributions of lasting value are *Die Finanzverwaltung Frankreichs* (Stuttgart, 1857) and *Die Finanzen und Finanzgeschichte der Vereinigten Staaten von Amerika* (Stuttgart, 1867). The latter treats of the conflict between federal and State powers.

[3] *Gesch. der nat. Ok. in Deutschland*, p. 1030.

sometimes impossible to see the wood for the trees when statistical and historical detail is given in such profusion. Roscher (1817–1894), who was for forty-six years professor at Leipzig University, published in 1886 his *System der Finanzwissenschaft*, which is part of his *System of Political Economy*. Before this he had dealt with the history of economic literature, in which so much is to be found.[1] Roscher gives much detailed information in his treatise that is not to be found in Cohn's less comprehensive but more interesting work.[2] Cohn (1840–1919) is the happy mean between Roscher, who is as strong in history as he is weak in theory, and the radical Wagner (1835–1917), who puts forward sometimes startling theory illustrated by statistics. Both he and Wagner are Kathedersocialisten. Cohn is readable and at the same time scientific, as, for example, where he discusses the equity of taxation from the minimum of subsistence as well as from graduation. In Wagner's *Science of Public Finance*[3] one sees that Government is regarded as the distributor of wealth and taxation as the means to redress inequalities of wealth. The social aspects of public finance are emphasised and the engine of taxation is clearly an agency of social reform. Rau was the forerunner of Wagner's conservative socialism and Wagner owed much to him. Indeed Rau's treatise on public finance led to Wagner's great work. As Seligman well phrases it: "Much as we may dissent from the fundamental points of Wagner's general position, it must be conceded that he has developed his doctrines with consummate keenness and phenomenal learning, and that his *Science of Finance*, even though incomplete, still stands at the head of financial literature for the suggestiveness of its views and the wealth of its contents".[4] For over forty-six years, out of a total teaching career of fifty-eight, he held the chair of economics at Berlin, and his spoken word was as great an influence as the written. The cardinal doctrine with

[1] *E.g. Geschichte der englischen Volkswirthschaftslehre*, 1851–1852; *Adam Smithschen Systems in Deutschland*, 1867; *Geschichte der Nationalökonomik in Deutschland*, 1874.

[2] *System der Finanzwissenschaft*, vol. ii. of the *System der Nationalökonomie*, Gustav Cohn (Stuttgart: Ferdinand Enke), 1889; translated by Veblen, Chicago, 1895. His later contributions are summarised in *Zur Politik des deutschen Finanz-, Verkehrs-, und Verwaltungswesens*, Stuttgart, 1905.

[3] *Finanzwissenschaft*, Adolph Wagner (Leipzig: vol. i. 1871–72, vol. ii. 1878–80, vol. iii. 1886–89; in four vols., 1877–1901.

[4] Seligman, *Essays in Taxation*, p. 363 (7th edit.).

him was that ethical standards must of necessity be applied to economic phenomena and this explains why he was a State Socialist. There are many other writers of importance besides the great quartette Roscher, von Stein, Wagner, and Cohn, but it will be sufficient merely to mention Umpfenbach [1] (whose work has the conservatism of French writers), Neumann,[2] Dietzel,[3] Nasse,[4] and Vocke.[5] Another writer whose work will be discussed in connexion with the general property tax is Schanz (1853–1931),[6] whose *Taxation in Switzerland in its Development since the Beginning of the Nineteenth Century* is already well known, and is of special interest in view of the importance given to the development of taxation, especially property taxation, in the Swiss Cantons. It is, however, both as the founder in 1884 and the editor until his death in 1917 of the *Finanz-Archiv* that he is best known in public finance in regard to his work on direct taxation and the shifting of taxes. The work and treatises of Schäffle, Gerloff and Meisel, Lotz, Andreae, Tyszka, Moll, Béla Földes, and Terhalle are of notable importance.[7]

8. French financial theory from the time of Adam Smith has marked differences from German theory. It is more conservative and individualistic. Jean Baptiste Say (1767–1832), with his brother Louis (1774–1840), his son Horace, and his grandson, Léon Say (1826–1896), had considerable influence. J. B. Say is

[1] *Handbook of the Science of Finance* (Stuttgart: Ferdinand Enke), 1887.

[2] *Die Steuer und das öffentliche Interesse*, Neumann (Leipzig: Duncker und Humblot), 1887. With Wagner he stressed the social approach to public finance and made public interest its basis. He influenced German thought greatly in the transition from *in rem* taxation to personal taxation.

[3] See ch. xxxiii. on public credit. *Das system der Staatsanleiten im zusammenhang der Volkswirtschaft betrachtet* (Heidelberg, 1855).

[4] *Bemerkungen über das preussische Steuersystem* (Bonn, 1861).

[5] *Contributions, Imposts, and Taxes* (*Die Abgaben, Auflagen und die Steuer, vom Standpunkte der Geschichte und der Sittlichkeit*) (Stuttgart: Cotta), 1887; *Elements of the Science of Finance* (*Die Grundzuge der Finanzwissenschaft*) Leipzig: Hirschfeld), 1894.

[6] *Die Steuern der Schweiz in ihrer Entwicklung seit Beginn des 19ten Jahrhunderts*, Georg Schanz (5 vols., Stuttgart: Gotta Nachfolger), 1890.

[7] Schäffle, *Die Steuern*, 2 vols., Leipzig, 1895–97; Gerloff and Meisel, *Handbuch der Finanzwissenschaft*, 3 vols., Tübingen, 1925–29; Lotz, *Finanzwissenschaft*, 2nd rev. edit., Tubingen, 1931; Andreae, *Bausteine zu einer universalistischen Steuerlehre*, 1927, and *Grundlegung einer neuen Staatswirtschaftslehre*, Jena, 1930; Tyszka, *Grundzüge der Finanzwissenschaft*, Jena, 1920; Moll, *Probleme der Finanzwissenschaft*, Leipzig, 1924, and *Lehrbuch der Finanzwissenschaft*, Berlin, 1930; Béla Földes, *Finanzwissenschaft*, 2nd edit., Jena, 1927; and Terhalle, *Finanzwissenschaft, Grundrisse zum Studium der Nationalökonomie*, vol. xvi., Jena, 1930.

looked on as one of the fathers of Economics and, as von Stein rightly says, " the godfather of Adam Smith's doctrines on the Continent ". His *Traité d'économie politique*, 1803, has been translated into many languages, and his *Cours complet d'économie politique* saw the light in 1828–1829. His grandson, Léon Say, published in 1884 *Le Socialisme d'État*, the text of which is " State socialism is a German system of philosophy ; . . . legitimate in Germany, it is spurious elsewhere ". In 1886 appeared *Les Solutions démocratiques de l'impôt*. This is directed against the proposal to use taxation as a means of social equalisation. M. Léon Say also edited the *Dictionnaire des finances* (1894), as well as the *Nouveau Dictionnaire d'économie* (1892), and the work *Les Finances* appeared posthumously. It describes the mechanism of the French Ministry of Finance. Much of the inductive work of French writers on finance is of a high order. Vuitry [1] (1803–1883), Garnier [2] (1813–1881), De Parieu [3] (1815–1893), and Stourm [4] (1837–1917) are instances. Stourm is the very antithesis of Rau and Wagner. He is opposed to the use of the engine of taxation to effect social reform or the distribution of wealth ; he favours proportional taxation and opposes the principle of progression. Deductive writers, like Cournot (1801–1877), were few and far between, a matter of regret, as deduction is especially useful in, for example, the incidence of taxation. There are well-known treatises, such as those of Allix and of Colson.[5] Leroy-Beaulieu's *Traité de la science des finances*, published in 2 vols. in 1877 (8th edit., 1912), and Jèze's *Science des finances* [6] may, without doubt, be regarded as standard

[1] *Études sur le régime financier de la France avant la Révolution*, 1789 (1876–1883) ; *Le Désordre des finances et les excès de la spéculation à la fin du règne de Louis XIV, et du commencement du règne de Louis XV* (1885).

[2] *Le Traité des finances* (4th edit., 1882 ; 1st edit., 1858 ; 2nd edit., 1862) : the title of the 3rd edit. was altered from the original, *Les Éléments des finances*. Garnier must not be confused with Garnier (1754–1821) the French translator of *The Wealth of Nations*.

[3] *Histoire des impôts généraux* (1856) and *Le Traité des impôts* (1862–1864).

[4] *Le Budget*, Paris, 1913 ; (translation), New York, 1917. This is now somewhat out of date.

[5] Allix, *Traité élémentaire de science des finances et de la législation financière française*, 6th edit., Paris, 1931 ; and Colson, *Les Finances publiques et le budget de la France* (*Cours d'économie politique*, vol. v. (2nd rev. edit., Paris, 1931).

[6] *Éléments de la science des finances et de la législation financière française*, 1896 (new edit., Paris, 1931) as *Cours élémentaire de science des finances et de législation financière française* (3 vols.) ; *Cours de science des finances publiques professé à la Faculté de Droit de Paris*, 1929.

works, possessing as they do the characteristic clearness and freedom from ambiguity to which the French language particularly lends itself. Both writers have a remarkable gift for an analysis and exposition. Leroy-Beaulieu (1843–1916) is familiar to every student of Public Finance as a strong exponent of individual liberty as against State regulation and the *Traité* shows him to be a member of the traditional French school of individualism and free trade.

9. The work of Italian writers on finance at the end of the nineteenth century and the first quarter of the twentieth is of a very high order indeed. Of the general treatises the best known are perhaps Cossa's *Primi elementi di scienza delle finanze*, Ricca-Salerno's *Scienza delle finanze*, De Viti de Marco's *Il carattere teorico dell' economia finanziaria*, Mazzola's *I dati scientifici della finanza pubblica*, Nitti's *Principii di scienza delle finanze*, Einaudi's *Corso di scienza delle finanze*, Tangorra's *Trattato di scienza della finanza* and Graziani's exhaustive work, *Istituzioni di scienza delle finanze*.[1] Since the late seventies of last century Italy has not only taken a high place in the general treatise but she has also produced excellent work in specialised portions of the subject, especially in taxation. The following, for example, leap to mind. Ricca-Salerno's *Teoria generale dei prestiti pubblici* and his *Storia critica delle dottrine finanziarie in Italia*, a work of much erudition and commended by the Accademia dei Lincei; Pantaleoni's *Teoria della traslazione dei tributi*, a bachelor's essay but a capital piece of work on the incidence of taxation; Conigliani's *Teoria generale degli effetti economici delle imposte* and his *La riforma delle leggi sui tributi locali*; Rignano's *Una riforma socialista del diritto successorio*; Mazzola's *L'imposta progressiva in economia pura e sociale*, and papers that have appeared in the *Giornale degli economisti* from time to time.[2] The characteristics of these financial writings, indeed of all Italian work of the period under examination, are clarity, freshness, and eclecticism. Conigliani's *General Theory of the Effects of Taxation*

[1] The dates of publication are as follows: Cossa, Milan, 1876, 12th edit., 1923; Eng. trans., New York, 1888; Ricca-Salerno, 1888; A. De Viti de Marco, 1888; Mazzola, 1890; Nitti, 1903; Einaudi, 1911; Tangorra, 1915; Graziani, 1897, new edit., Turin, 1929.

[2] Cf. "Primi lineamenti delle dottrine finanziarie in Italia durante l'ultimo cinquantennio", by Benvenuto Griziotti, *Economia politica contemporanea* (vol. ii.), in onore del Camillo Supino, Padova, 1930; *Impuestos directos y reforma impositiva*, by the same author, Cordoba, 1927.

or Pantaleoni's *Theory of the Shifting of Taxes*, the *Burden of Taxes*, and his *Pure Economics* are but examples. The knotty points of the shifting and incidence of taxation are presented in a clear-cut, often in an extreme, form so that the reader's attention is at once fixed on the *punctum saliens* of the question. Conigliani's *La riforma delle leggi sui tributi locali* not only analyses with lucidity, grip, and constant reference to the legislation in advanced countries the problems of taxation in provinces and communes, but puts forward concrete recommendations for reform. Cossa's *Primi elementi* in the guise of a simple text-book contains many important generalisations suitable even for advanced students. Eclecticism of a very sane kind is more pronounced in Italian literature than perhaps that of any other country, as Italians have the gift, to an unusual degree, of harmonising the teaching of the classical economists with that of the German historical school and the marginal utility school of Jevons, Walras, Menger and his followers. Cossa (1831–1896) was a pupil of both Wagner and Stein, and referred to the former as his " revered master ". Ricca-Salerno (1849–1912) was also a pupil of Wagner, but came under the powerful influence of the Austrians in regard to taxation. His pupils Conigliani (1870–1901) and Graziani are under the same influence. The State, in taking revenues from the incomes of its citizens, must limit its needs so as not to lay claims for public purposes to what might be used by private individuals to greater advantage. There must be what Wieser would call " a dutiful observance of economic margins " in the social value of tax. The State must refrain from interfering with the historically transmitted inequality of the distribution of income, and in adjusting its policy to " charge what the traffic will bear " merely follows the principle that " the margin of use by the State economy may be extended by the larger contributions of those whose incomes give them a broader margin of use in their private economies ".[1] Pantaleoni (1857–1924) was an eclectic of the eclectics and himself regarded " schools " as mere " obnoxious syndicates of fools ", and if there were schools, there were but two —those who understand economics and those who do not. Pareto

[1] Cf. R. Meyer, *Principien der gerechten Besteuerung* (Berlin, 1884); Emil Sax, *Grundlegung der theoretischen Staatswirthschaft* (Vienna, 1887), and *Die Verkehrsmittel*, in *Volks- und Staatswirthschaft*, 3 vols., 1918–1922. The influence of Sax is marked, especially in Italy, on writers on taxation.

(1848–1923) is another example of the combination of pointed abstract reasoning with abundance of statistical illustration, as in the Paretian formula or curve of 1895 which Achille Loria calls " the best page of his best work ".[1]

It is difficult to explain the cause of Italy's rich harvest of financial literature. It may be in part due to the popularity of the study in the twenty-six Italian universities and to the familiarity with foreign languages which some of their teachers have shown. Pareto, for example, as author and as professor preferred French, and his mastery of it was sufficiently marked to justify posterity in calling it his mother-tongue as a reviewer in the *Giornale degli economisti* prophesied. It may also be due to the fact that Italy is a comparatively poor country, and under force of circumstance has to concentrate on the thinking out of the best methods of raising revenue for the communes and the provinces as well as for the central Government in Rome. But whatever the cause, there is no doubt as to the richness of the crop. It reminds one of the garden of the Phaeacians where pear followed on pear and fig on fig in successive stages.

10. There is another country in which much hard thinking has been done in taxation and that is Holland. Language difficulties have sometimes stood in the way of a correct appreciation of Dutch financial literature. The work, however, of Pierson (1839–1909) is available to English readers through the translation by Wotzel.[2] Pierson was in turn a Professor of Economics, President of the Netherlands Bank, Finance Minister, and Prime Minister of Holland, and combined to an unusual degree a sound knowledge of English, American, and Continental theory with practice in the most literal sense of the term. His work is full of good things, especially Part IV. of vol. ii. of his *Leerboek der staathuishoudkunde* on State revenues, and as Edgeworth said, " His solid sense and weighty learning move steadily along the main lines of economic reasoning like those vast engines which, rolling over our material high roads, render them more smooth, compact, and serviceable ". As an instance of his infinite capacity for taking pains Greven of Leyden mentions the fact that Pierson did not

[1] *Cours d'économie politique*, 2 vols. (Lausanne, 1896–97); *Manuale d'economia politica* (Milan, 1906).

[2] *Leerboek der staathuishoudkunde*, Haarlem (1884–1890); 2nd edit., 1896–1902; *Principles of Economics*, translated by A. A. Wotzel. London, Macmillan & Co., vol. i., 1902; vol. ii., 1912.

publish Part IV., referred to above, until after he had run over all the volumes of Schanz's *Finanzarchiv*, just as when writing in *de Economist* on the Italian economists of the seventeenth and eighteenth centuries he studied the whole of the fifty volumes of Custodi. He had, too, a remarkable gift of lucidity as well as of arrangement. Pierson's views on the faculty theory of taxation and on progressive taxation are perhaps his most solid contribution to the subject. In *de Gids* in 1888 he appealed for a mathematical treatment of these problems, and this resulted in Cohen Stuart's *Bijdrage tot de theorie der progressieve inkomsten belasting* (*Contribution to the Theory of the Progressive Income Tax*) in the following year.[1] Cohen Stuart (1855–1921) follows Pierson, Treub, and Cort van der Linden, who studied progressive taxation in the application of marginal utility to the doctrine of like sacrifice. His treatment is mathematical and is one of the relation between enjoyment and income. Each taxpayer should sacrifice an equal proportion of the total utility derived from material resources. Cohen Stuart distinguished between equal sacrifice and proportional sacrifice, ideas which have often been confounded in the hedonic theory of taxation. He believes just taxation means that each is taxed " in such a way that for everyone the amount of enjoyment of which he is deprived through the tax may be proportional to the total amount of enjoyment attainable through his economic condition, with the exception of the part which is required for the satisfaction of his absolutely necessary wants ".[2] It is strange but nevertheless true that much of the best work in taxation about the end of last century has been done by Dutch, Italian, and other writers, whose languages are unfortunately not very familiar to the generality of scholars. Examples of this are the writings of Andréadès (1876–1935), *e.g.* Ἱστορία τῆς Ἑλληνικῆς Δημοσίας Οἰκονομίας,[3] *The History of Greek National Loans from the Time of the Revolu-*

[1] The Hague, 1889.

[2] Cf. Edgeworth's Papers, vol. ii. *The Pure Theory of Taxation*, on this " judicious author ". For Seligman's criticisms on Cohen Stuart, see *Progressive Taxation in Theory and Practice*, where the conclusions of Cohen Stuart are said to depend " not only on the arbitrary assumption of a definite ratio of marginal utilities, but also on the equally arbitrary assumption of a definite minimum of subsistence ".

[3] In 2 vols., 1st edit., 1918, 2nd edit., vol. i. 1928, vol. ii. 1930, the translation of which is *The History of Greek Public Finance*, Harvard University Press, 1933.

tion to 1863 (1904), and in English, *The Finance of Tyrant Governments in Ancient Greece*,[1] *The Capital Levy in Ancient Athens*,[2] and his classical *History of the Bank of England from 1640* to *1907*.[3] Swedish financial writers have freuqently published their works in German or in English, those of Wicksell, Lindahl, and Jaeger being especially noteworthy.[4] Russian writers from time to time have published important works, but their language being unknown to most scholars do not receive the consideration which they sometimes merit. Public finance in Russia after 1835 was taught independently of economics as " Financial Law ", and had its prominent teachers in Moscow, St. Petersburg, Kiev, and Kharkov. Yanzhul's[5] *Essay on Indirect Taxes in England*, published in 1874 (where he showed that the fiscal system of England was an outcome of class structure and had changed when power shifted from the landed aristocracy to industrial capitalists) and also Kulisher's *Essays on the Science of Finance*, 1919–20 are works of this class.

11. The literature of finance is so vast that a discriminating judgment is most essential. Ruskin says books are divisible into two classes, the books of the hour and the books of all time. This is especially the case in modern financial literature, and in any survey, however careful, there is the ever-present danger of taking as permanently valuable what is in reality of quite ephemeral importance. We have to aim at what Adam Smith in his essay on Astronomy calls " connecting principles ", and therefore it is necessary to get at the main facts from as wide an area as possible and to reason from these observed facts, or, if the facts are inconsistent with the hypothesis, to look for a new generalisation that brings the facts into some sort of orderly relation. Historical elements are woven into the general contexture in varying degree. Thus in German financial literature we find in great abundance concrete elements, but this does not avoid statements of " connecting principles ". Take, for example, Wagner's rule of sufficiency—that public revenues must be large enough to meet

[1] *Economic Journal*, Historical Supplement, 1930.

[2] *Op cit.* 1931.

[3] In French 1904 and in English 1909.

[4] Wicksell, *Finanztheoretische Untersuchungen*, Jena, 1896; Lindahl, *Die Gerechtigkeit der Besteuerung*, Lund, 1919; Jaeger, *Finanzlaere*, 14 parts, Oslo, 1927–30.

[5] Yanzhul, *Opit izsledovaniya angliyskikh kosvennikh nalogov*, Moscow, 1874.

public requirements and no taxation system is financially sound, however perfect in other directions, unless funds are available to meet expenditure and to avoid a deficit.[1] The student of public finance cannot afford to confine his attention to the literature of his own country, since frequently the best work in a particular branch of his subject has been done by foreign scholars. The penetrating observation of Cournot on economics applies with equal force to public finance. " The science of the economists ", he said, " more than other sciences, without being, as has been wrongly said, a literature, is permeated by that flavour of the soil, marked by that stamp of time and place which distinguishes one literature from another. . . . Other sciences also have their history, their growth, which is linked to the progress of society, but not in such degree that their physiognomy reflects, like a literature, the physiognomy of society." [2]

[1] Wagner, *Finanzwissenschaft*, vol. ii. p. 307, 2nd edit.
[2] *Revue sommaire des doctrines économiques*, p. 336.

BOOK II

PUBLIC EXPENDITURE

CHAPTER III

THE THEORY OF PUBLIC EXPENDITURE

1. DURING the greater part of the nineteenth century comparatively slight attention was paid, especially by English, American, and French writers, to the theory of public expenditure. The general features of this important branch of the science of finance were not analysed and considered as their importance deserved. There was no sound classification of the expenditure of Central or Federal Governments, Provincial or State Governments, or of purely local authorities, and a classification is essential to understand the character and costs of governmental activity. No canons were laid down as to the principles on which all such expenditure should be based. In the present century the complexion of events has changed all this, and there is no part of the subject which has received so much consideration at the hands of practical financiers and writers on the subject. It is now recognised that the spending of money by public authorities is closely related to the raising of money (revenue). Both are different sides of the same shield. There is an intimate relation between the two great branches of public finance—expenditure and revenue. Although these two branches may be separated to a certain degree, yet there are general principles which govern the spending as well as the raising of tax funds and no final judgment can be passed on any large item of public expenditure, as indeed on any item of public revenue, until it is viewed in relation to the general scheme of public finance. In that scheme public expenditure is as important as revenue. The theory was long neglected, and Leroy-Beaulieu, writing as late as 1877 in his *Traité de la science des finances*, held that an inquiry into State expenditure did not belong to the Science of Public Finance, which was in his view

concerned with revenue only. There are different and competing ways of spending resources just as there are of raising them, and, too, there are different reactions by the community to the different ways and amounts of public expenditures. These reactions, therefore, must be studied. Public finance is a series of transfers of purchasing power usually between the richer and poorer classes which lead to a narrowing down of the inequality of incomes, and in the present century maximum social advantage is a principle requiring emphasis in any theory of expenditure.

The Importance of Expenditure

2. A theory of public expenditure in the nineteenth century was not very necessary, because the scope of the functions of Government was restricted. Orthodox Victorian finance is the best example of this.[1] It was not confined to England and other parts of the British Empire, such as India, whose finance ministers have frequently been recruited from the pick of English financiers. It was also a characteristic of Continental Europe. In the twentieth century the development of the functions of the State in social matters, *e.g.* in education and public health, and in commerical and industrial undertakings, such as railways, irrigation, and similar projects increased in a large degree public expenditure. The law of Increasing Public Expenditures has everywhere been evident.[2] English finance was profoundly influenced by the social reform which produced old age pensions and by unemployment insurance. In addition to the steady march of democracy, and from 1896 the upward trend of prices to 1920, there were other

[1] "I think the national expenditure ought to increase in proportion to the spread of wealth. Why don't you let the country live like a gentleman?" asked Sir William Harcourt. "Because", said Mr. Gladstone, "living like a gentleman means paying five times its value for everything you buy" (*The Life of Sir William Harcourt*, by A. G. Gardiner, vol. i. p. 388). For Gladstone's crusades against the growth of the spirit of expenditure *vide* Morley's *Life of Gladstone*, vol. i. p. 561; ii. pp. 53, 62, 138; iii. pp. 110, 221, 507, 537.

[2] Cf. Adolph Wagner, "Comprehensive comparisons between different countries and different periods show regularly among progressive nations an extension of activities of both the central and the local governments. This manifests itself extensively and intensively. The State and its subordinate political units continually undertake new functions, and they perform their duties, old and new, better and better. In this way, that is, through public agency, the economic needs of the population, to an increasing extent, and in a more satisfactory manner, are satisfied by the central and local governments" (*Grundlegung der politischen Oekonomie*, Book VI. ch. iii. (3rd edit., 1893).

causes, the chief of which was the preparation for and cost of the Great War.

3. In order to arrive at the causes underlying the increase in public expenditures, it will be convenient to examine the budgets of any country over an extended period. The following table shows the growth of British public expenditure over the last two and a half centuries.

BRITISH PUBLIC EXPENDITURE

(In millions of pounds: figures exclude receipts under each head; percentages are given in brackets. The figures of 1688 and 1933 exclude Ireland.)

	1688.	1750	1850.	1914.	1933.
Civil List	0 2 (9)	0 5 (7)	0 8 (2)	0 5	0 4
Defence	1 2 (52)	3 0 (42)	15 4 (28)	77 2 (50)	104 3 (14)
Public Debt	0 3 (15)	3 2 (44)	27 7 (51)	22 9 (15)	303 4 (41)
Other Expenditures—					
Law and Justice	..	..	2 3 (4)	3·4 (2)	13 6 (2)
Education	..	.	0 4 (1)	17 5 (11)	52 0 (7)
Unemployment, health, workmen's compensation, old age pension and poor law relief	0 5 (24)	0 5 (7)	7 7 (14)	13 8 (9)	141 3 (19)
Miscellaneous	..	..		20 4 (13)	126 6 (17)
Total Expenditure (net)	2 2 (100)	7 2 (100)	54 3 (100)	155 7 (100)	741·6 (100)

Sources: *Return of Public Income and Expenditure, Parts I and II* (House of Commons Nos. 366 and 366-1, 1869; Finance Accounts, 1913–1914 and 1931–1933).

An adjustment of minor importance has been made in the expenditure on the Civil List for the two earlier years as the cost of foreign ministers and secret services was in these years debited to the Civil List. For comparative purposes, therefore, the cost of these services has been placed under " other expenditures " in the table. The years do not all end on the same date but are sufficiently accurate for comparative purposes, and this does not materially interfere with the accuracy of the table. The year 1914 refers to the pre-War year ended 31st March 1914 and the figure for the post-War year 1933 refers to the year ended 31st March 1933. A glance at this table illustrates the direction and extent of public expenditures over long periods. The first conclusion from this table is the smallness of the Civil List in the total expenditure. The next is the growth in public defence, which was high even before the Great War. Thirdly, the expenditure

on public debt is relatively high, but not at the present time so high as the very large expenditure under " other expenditures " which is a remarkable feature of the twentieth century governmental finance. The enormous growth of costly social services such as those on education, unemployment, health insurance, housing grants, increased grants to local authorities, poor law relief, and old age pensions, and also of post-War services such as War pensions and the cost of new administrative departments in Governments since the War, are noteworthy.

The causes of public expenditure may be conveniently grouped under several heads. There is first of all increased expenditure resulting from an increase in area and in population. With the extension of area under an individual State or Government, the administrative structure alters, and the greater the area, other things being equal, the greater the expenditure. High costs may be due to a population sparsely spread over a large area. In Canada, for example, it has been said that 150 judges for 10 million Canadians are excessive and mortifying. It must, however, be remembered that in Canada the area is great, and a judge cannot preside in Quebec on one day and next day sit in Vancouver, for the simple reason that the distance is 3000 miles requiring a four days' journey to accomplish. In the provinces of India and in the states of Australia there are precisely the same reasons for increased expenditure. Owing to the fact that the population in some provinces of India is scattered in numerous small villages, the framework of government is expensive and the costs necessarily high. Schools and police stations, for example, have to be provided even in thinly populated areas. Again in industrially advanced provinces with large cities and ports the expenditure of Government is necessarily high owing to the density of population and the demands for sanitation, health, and police. In a state or province where there are a large number of cities and ports, these necessary services mean large expenditure. Many of these services are performed at approximately constant costs irrespective of the number of individuals benefited by them. Other services, however, increase in proportion to the population and are performed more cheaply on a large than on a small scale. A large city, for example, can gain far more than small cities in the purchase of standardised supplies. It is generally true that in a centre of a large population much public expenditure is

required to avoid or ameliorate the disadvantages from overcrowding and other social disadvantages arising from density of population, and, generally speaking, with an increase in size, overhead costs, and therefore public expenditures, must increase. The growth in population since the Industrial Revolution is well known. Before that date, the population of countries, and indeed of the world, was not very great. In 1688, for example, the best estimate of the world's population was only 470 millions, of which approximately 250 millions were in Asia, 100 millions in Europe, 100 millions in Africa, and only 7 millions in North America. The population of England and Wales in 1688 could not have been much greater than 6 millions, and in 1750 it was below 7 millions and probably not more than $6\frac{1}{2}$ millions. In 1850, however, the population of England and Wales was not less than 18 millions, and in the year before the War it was over 36 millions. At the census of 1931 the population was just under 40 millions. The population of the world, too, since 1750 has greatly increased. It was 660 millions in that year. In 1850 it had increased to nearly 1100 millions. In 1930 the world's population was over 1820 millions, of which 955 millions were in Asia, 478 millions in Europe, 162 millions in North America, 140 millions in Africa, 77 millions in South America, and 9 millions in Australasia. In some countries, notably in India and Japan, the increases in recent years have been noticeable. In ten years from 1921 to 1931 the population of India increased from 319 millions to 353 millions, an increase of 34 millions or 10·6 per cent. The increase in the population of countries, especially since 1850, has been a chief cause for the increase in public expenditure.

A second cause of the increase in expenditures is the increase in prices. Salaries and wages have to be raised when the price-level rises as Governments have to buy goods and services as before. The cost of public works is also increased during a period of rising prices. This rise also acts as an incentive to Governments to undertake new projects, as this is a period of general optimism and legislators then have their imagination fixed on governmental expansion in all directions. A rise in prices results not only in an increase in the cost of government, but it tends also to a redistribution, the burden falling more heavily on those who are adversely affected by the rise in prices. When prices fall, Government costs lag behind the general declining price-level. New projects

undertaken during the preceding period of rising prices and higher expenditure on salaries in the Civil Service are continued through the succeeding years of depression, as it is found to be impossible to return to the former level of expenditure. In a period, too, of falling prices, Governments are compelled by pressure of public opinion to speed up construction of works already begun or to proceed forward with new plans. This, however, will be dealt with subsequently in regard to the construction of public works during periods of depression.

A third cause of the increase of public expenditure is the result of the increase in national wealth and national income, and the higher standard of living. The standard of living of the individual advances, and with this advance there is the demand for greater public conveniences such as better roads, better schools, and better public buildings. People are no longer content with those facilities which they had years ago, and they demand social services which mean higher taxes. It has been well said that no one wants high taxes, but everybody wants the things that make taxes high. The increase in the complexity of the social structure has made it incumbent on Governments, central and local, to increase the responsibilities which this increased complexity has forced on them. Two principles regarding the extent of public expenditures in relation to national wealth and income may be stated. In the first place, the greater the wealth and income *per capita* of a community, the greater will be the scope of its public expenditure. Over and above the minimum which includes protection and administration, including in the latter debt service, is a wide field where sectional interests are apt to clash, especially on expenditures connected with the social services. It is here that governmental activity may be extended with the growth in *per capita* income to an almost illimitable extent. "In the particular circumstances of a given age or nation", writes Mill, "there is scarcely anything really important to the general interest which it may not be desirable, or even necessary, that the Government should take upon itself, not because private individuals cannot effectually perform it, but because they will not."[1] Secondly, the greater the inequality of wealth and income in a country or community, the greater

[1] *Principles*, Book V. ch. xi. § 16.

the field for governmental expenditure. It is here by the skilful use of the engine of progressive taxation that the Government can spend to the advantage of the community as a whole moneys which, if retained by the rich with themselves, may not be so well spent. Additional responsibility falls on the Government in cases where there is a large proportion of the population on low incomes to push forward social expenditure on health, education, and other services which in the long run will raise the earning power of the population as a whole. When people are too poor to undertake the construction of roads, schools, colleges, hospitals, and similar works governmental activity is necessary, just as it is where the population is too disunited to be capable of joint action or too blind to the results. Such action is always to be done in such a way as to stimulate and to nurture individual exertion. The extent of this public expenditure will vary not merely from country to country but also according to human progress and material change in the same country.

A fourth cause of the increase in expenditure is war and the prevention of war. The chief cause of the increase in public debt which required enormous interest payments annually has been war and the prevention of war. It is sometimes said that war is responsible for the beginning of all taxation. To-day it is the prevention of war and the aftermath of war as well as war itself which are largely responsible for our public burdens. Wars not only affect Federal and State Governments but also local authorities, all of whom have to meet increased obligations, sometimes for generations after the armed conflict becomes a matter of history. Adam Smith lived in the dark ages of modern times in an epoch of dynastic and aristocratic nationalism when war was a dominant force. " In modern times ", wrote the author of *The Wealth of Nations*, " many different causes contribute to render the defence of the society more expensive. The unavoidable effects of the natural progress of improvement have, in this respect, been a good deal enhanced by a great revolution in the art of war, to which a mere accident, the invention of gunpowder, seems to have given occasion. In modern war the great expense of fire-arms gives an evident advantage to the nation which can best afford that expense; and consequently, to an opulent and civilised over a poor and barbarous nation. In ancient times the opulent and civilised found it difficult to defend themselves against the poor

and barbarous nations. In modern times the poor and barbarous find it difficult to defend themselves against the opulent and civilised. The invention of fire-arms, an invention which at first sight appears to be so pernicious, is certainly favourable both to the permanency and to the extension of civilisation."[1] At the present time, for the purposes of war, modern Governments have used the brains and resources of industry and science, and the result is that materials for war are more expensive than ever before. At the present time the expenditure on armaments is not far short of £1,000,000,000 per annum. Before 1914, Great Britain, France, and the United States were spending from 34 to 38 per cent of their gross expenditure for military purposes. Italy, Japan, and Sweden were at the same time spending between 25 and 30 per cent, while the Argentine, Belgium, and Spain were spending between 15 and 20 per cent. In 1920 Japan actually spent 48 per cent. The total expenditure on defence for the five great powers at the moment amounts to £550,000,000 per annum or 18 times the sum required to build the Suez Canal. In the six financial years from 31st March 1914 to 31st March 1920, Government expenditure in the United Kingdom exceeded the total expenditure for the two and a quarter centuries preceding 1914, the year in which the outbreak of war took place. The British national expenditure averaged £1,500,000 a day in 1914–1915; £4,274,000 in 1915–1916; £6,022,000 in 1916–1917; and £7,389,000 in 1917–1918. The British Parliament sanctioned between 6th August 1914 and 25th November 1918 votes of credit to the extent of £8742 millions, and the War cost Great Britain over £10,000 millions, while, if allowance were made for the expenditure of the Dominions, the total would be well over this amount. The twentieth century has witnessed public expenditure on war and the prevention of war to a degree which even some years ago would have been regarded as symptomatic of financial madness and a certain collapse of world credit. The costs, therefore, are constantly rising with new and more elaborate equipments even in spite of a falling price-level. Not only do they constitute a social drain on the national income, but they are also an international danger since they produce a state of international distrust which facilitates the outbreak of war. The speed with

[1] Book V. ch. i. Part 1 (vol. ii. p. 202, Cannan's edit.).

which the implements of modern war become obsolete has also greatly added to the cost of maintaining armaments. In 1899, after the first dreadnought was built, all other battleships in the world became obsolete. Similarly gas masks may become useless by the discovery of a new gas with penetrating powers.

Fifthly, the increase in the currents of democratic ideals in the twentieth century, especially since the War, has resulted in the greater complexity of Government, and this is yet another factor making for increased expenditures. Public authorities are increasing their activities everywhere, performing old functions more efficiently and undertaking many new, such as housing, unemployment insurance, health insurance, old age pensions, widows' and orphans' pensions. Public expenditures have been in consequence increasing more rapidly than the national income and the power of the State to satisfy economic wants has been considered afresh. As a practical doctrine *laissez-faire*, or the policy of letting things drift, is dead. In democracies the activity of the State has increased. In the Communistic State, such as Russia, where political democracy is regarded as an unedifying mirage and private property is repudiated, and in the Fascist State where liberalism and parliamentarianism are denied and the sovereignty of the one-party state is unlimited, the same process of increased State interference is at work. Under large-scale industrialism there is an insistent demand that the State must be used for economic ends. In eighteenth-century England no man could vote for a member of Parliament unless he had some property, and no man could be elected unless he had much property. It was a case of government by the great families, and the standards of honesty of Governments in those days were much below that of our own day or even of earlier periods of English history. The State's activities were in no small degree restricted by early capitalism. In the present century things are far different. Since 1928, for example, the qualifications for the vote are the same for both men and women, viz. they must be 21 years old and have resided for three months in their borough or county. This and other measures have led to an increasing participation of all classes in public and local affairs. Government of the people, by the people, for the people is not a cheap form of government, and is more costly than absolute government. Classes and groups fight over public

expenditure, and the clamour for more expenditure results in more expenditure. The extension of the franchise and the political growth of labour in some countries have led parties in the State to vie with one another in buying political power by additional spending on the social services.

From mercantilist times to the French Revolution all the Governments of Europe undertook an extensive control of the economic life of the people. Commerce and industry were subjected to an infinite number of regulations, and the American and French Revolutions were a reaction to this mercantilist policy. These revolutions were not merely political in their cause and purpose. They were induced to a large degree by a vast amount of State interference. From the French Revolution to the Franco-Prussian War there was a reaction to mercantilist policy. It was the period of *laissez-faire*.[1] The functions of Government were confined almost entirely to the theoretical minimum which represents expenditure connected with the service of debt, the cost of defence and of administration. Adam Smith in his one comprehensive generalisation on the functions of the State restricted the activities of Government to three things: "According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings: first, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of

[1] Cf. such precursors of the Physiocrats as Argenson (1694–1757) and Gournay (1712–1759). The former's maxims "*pas trop gouverner*" (not too much government) and "*pour gouverner mieux, il faudrait gouverner moins*" (in order to govern better, we ought to govern less) are lineal ancestors of Gournay's favourite expression "*laissez faire, laissez passer*" (give free play to production and to the circulation of goods produced). Weulersse, *Le Mouvement physiocratique en France de 1756 à 1770*, 2 vols. (Paris, 1910); Alem, *Le Marquis d'Argenson et l'économie politique au début du XVIII^e siècle* (Paris, 1900); Sécrestat-Escande, *Les Idees économiques de Vincent de Gournay* (Bordeaux, 1911); Oncken, *Die Maxime laissez-faire et laissez-passer, ihr Ursprung, ihr Werden*; Berner Beiträge, *Zur Geschichte der Nationalökonomie*, No. ii. (Berne, 1886).

individuals, to erect and maintain ; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society ".[1] In spite of this dogmatic statement Adam Smith, with his great eclecticism and sound common sense, saw that Government must do many things which individuals as such could not or would not do, and even if they would, they could do only badly. *Laissez-faire* was, in other words, not always good or always bad, and in the economic order conflicts arise between private and public welfare. He admitted very large exceptions to the general policy of free trade. He was no doctrinaire advocate in *The Wealth of Nations* of *laissez-faire*, as is sometimes supposed, and he saw a wide range of activity for Government, but he devoted greater effort to showing the case for individual freedom than for increased governmental activity. If the thirty odd notable instances noted by Adam Smith and scattered over his book be examined in the light of his generalisation, it will be found that the latter conflicts sharply with the former. Indeed it is possible, had he collected all these instances together, he would have been quoted as an authority on State interference and indeed on socialism. *The Wealth of Nations* was in a sense written for the times as an attack on certain lines of governmental activity, such as duties, bounties, and prohibitions in international trade, monopolies, but at the same time many exceptions were made to the general argument of *laissez-faire*. Adam Smith did not go as far as Spencer, who, writing in the middle of the nineteenth century, viewed the rôle of the State as similar to that of a passive policeman whose duty it is to preserve law and order. He permitted, for example, State interference in imports in order to make a nation self-sufficient in such things as saltpetre, and also where there was already a tax on the home-produced article, and " in this case it seems reasonable that an equal tax should be imposed upon the like produce " imported.[2] He supports moderate import duties, in place of prohibitive duties, on all foreign manufactures, so levied that " our own workmen might still have a considerable advantage in the home market, and many articles, some of which at present afford no revenue to Government, and others a very inconsiderable one,

[1] *The Wealth of Nations*, Book IV. ch. ix. (Cannan's edit., vol. ii. pp. 184-185).
[2] *Ibid.* Book IV. ch. ii. (Cannan's edit., vol. i. p. 429).

might afford a very great one".[1] Also he was not against bounties on manufactures necessary for defence which, but for the bounties, would not be produced at home. He approved of bounties on the export of British-made sailcloth and gunpowder because these industries would be encouraged. "If any particular manufacture was necessary, indeed, for the defence of the society it might not always be prudent to depend upon our neighbours for the supply."[2] It was on the contrary better that the enemy should rely on us. If English products were taxed in foreign countries, it was then a matter for deliberation whether retaliatory duties should be enforced in order to abolish foreign taxation on English goods,[3] and restriction of shipping by the Navigation Acts he justified on grounds of self-sufficiency. "The Act of Navigation is not favourable to foreign commerce, or to the growth of that opulence which can arise from it. . . . As defence, however, is of much more importance than opulence, the Act of Navigation is, perhaps, the wisest of all the commercial regulations of England."[4] He supports a moderate tax on the export of wool[5] because it would be productive to Government and give the English manufacturer of woollen goods an advantage over his foreign competitor. He would levy higher tolls on luxury coaches than on carts and waggons so that "the indolence and vanity of the rich is made to contribute in a very easy manner to the relief of the poor".[6] A tax on ale may be adjusted so that "it may to many people appear not improper to give some discouragement to the multiplication of little alehouses".[7] A hint of taxation as an instrument of social reform is seen in the remark that "It is not very

[1] *The Wealth of Nations*, Book V. ch. ii. part ii. art. iv. (Cannan's edit.), vol. ii. p. 367). Cf. Gournay (1712–1759), who differed from the Physiocrats not only because he was solicitous for all sources of wealth and not merely agriculture, but also because, like Adam Smith, he was not an absolute free-trader. He believed in a system of enlightened protection sufficiently high to defend domestic enterprise against foreign competition and even to assist its expansion in foreign markets. He supported, too, state subsidies. Cf. Weulersse, *Le Mouvement physiocratique en France de 1756 à 1770*, 2 vols. (Paris, 1910); Sécrestat-Escande, *Les Idées économiques de Vincent de Gournay* (Bordeaux, 1911); Schelle, *Vincent de Gournay* (Paris, 1897).

[2] *Ibid.* Book IV. ch. v. (Cannan's edit., vol. ii. p. 23).

[3] *Ibid.* ch. ii. (Cannan's edit., vol. i. p. 432).

[4] *Ibid.* (Cannan's edit., vol. i. p. 429).

[5] *Ibid.* ch. viii. (Cannan's edit., vol. ii. p. 152).

[6] *Ibid.* Book V. ch. i. part iii. art. i. (Cannan's edit., vol. ii. p. 216).

[7] *Ibid.* ch. ii. part ii. art. ii. (Cannan's edit., vol. ii. p. 337).

unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion ".[1] In banking, too, " where the liberty of a few endangers the liberty of a whole society ", he would restrain it by law, and to the disappointment of Bentham he approved of the maximum rate of interest being restricted to 5 per cent.[2] John Stuart Mill was not blind as to the benefits of State expenditure in certain circumstances. Although usually cited as an extremist of the *laissez-faire* school because of his *Essay on Liberty*, he saw that Government could not in practice strictly adhere to such an ideal. In the last chapter of his *Principles* he lays down the proposition that " In the particular circumstances of a given age or nation, there is scarcely anything really important to the general interest which it may not be desirable or even necessary that the Government should take upon itself, not because private individuals cannot effectually perform it, but because they will not. . . . In many parts of the world the people can do nothing for themselves which requires large means and combined action. All such things are left undone, unless done by the State."[3] Mill never preached *laissez-faire* as an absolute dogma. No English economist of repute has ever done so. Writing fifteen years before the publication of his *Principles* to Carlyle, he wrote, " Your criticism on Miss Martineau is, I think, just; she reduces the *laissez-faire* system to absurdity as far as the principle goes, by merely carrying it out to all its consequences. In the meantime that principle, like other negative ones, has work to do yet, work, namely, of a destroying kind, and I am glad to think it has strength left to finish that, after which it must soon expire; peace be with its ashes when it does expire, for I doubt much if it will reach the resurrection."[4] Mill, following Ricardo, neglected the subject of public expenditure, and this is to be regretted as his treatment of principles in this regard would have, in view of his opinions on *laissez-faire*, been extremely interesting. As a result of the work of Jevons and the Austrian school on value the doctrine acquired a new sanction, different from the viewpoint of Smith and Ricardo.

[1] *The Wealth of Nations*, Book V. ch. ii. part ii. art. i. (Cannan's edit., vol. ii. p. 327).

[2] *Ibid.* Book II. ch. iv. (Cannan's edit., vol. i. p. 338).

[3] *Principles*, Book V. ch. xi. § 16.

[4] *Letters of John Stuart Mill*, Elliot, vol. i. p. 46 (Longmans & Co.).

Laissez-faire interfered with free consumers' demand regarded as the force controlling supply, maximum production and maximum satisfaction. State intervention in bettering the distribution of income was indeed overlooked, but among the economically weaker countries the teaching of Friedrich List, who demanded adequate "duties for industrial education", was bearing fruit. England was the strongest nation economically, and it was clear to the economists of the weaker countries that these countries must have protective tariffs if their development was not to be permanently arrested by the domination of England in commerce and industry. In the United States this attitude to *laissez-faire* was evident in 1885, when a group of economists, influenced largely by German thought, formed the American Economic Association under the leadership of Professor Richard T. Ely against the doctrine. In his *Past and Present of Political Economy*, published in the previous year, Ely had said that *laissez-faire* "never held at any time in any country, and no maxim ever made a more complete fiasco when the attempt was seriously made to apply it in the state". In the articles of the new Association we find the repudiation of the doctrine in the words, "We regard the state as an agency whose positive assistance is one of the indispensable conditions of human progress". The individual was giving way economically to large-scale business organisation, so characteristic of the present century, while at the same time democracy was growing as the result largely of compulsory primary education and adding to the political power of the individual. The demand was that political power should be used for positive economic ends, the last thing a member of the Manchester school or a Cobden wanted. Not only has modern large-scale production destroyed the basis of *laissez-faire*, but the large degree of combination among producers, in and after the War, and State regulation of industry have become close allies of the national state and further sapped any vitality in the doctrine that remained. Capitalism is no longer individualistic, and free and unregulated competition is no longer welcomed, and so the doctrine of *laissez-faire*, essentially a doctrine of individualism and free competition, has practically gone. It is difficult at first sight to believe that a doctrine which had been almost a universal belief of a previous age to-day is almost regarded as an absurdity. But new facts and new kinds of facts have shown that a doctrine of this kind which has so many exceptions and is at variance with

the larger demands of the economic life of the community is no better than what Bacon called " an idol of the market-place ". In reality the particular belief was based on a partial view of facts and has had to be displaced accordingly.

Economy and Retrenchment

4. In many countries committees were appointed after the War and in the great depression, 1929–1933, to examine the ways and means by which economy and retrenchment in public expenditure could be effected. Three of the best known reports of such committees are those of the Committees on National Expenditure in Great Britain, usually known as the Geddes Committee and the May Committee,[1] and the Indian Retrenchment Committee, presided over by Lord Inchcape.[2] The terms of reference to the two former Committees were : " To make recommendations to the Chancellor of the Exchequer for effecting forthwith all possible reductions in the National Expenditure on Supply Services, having regard especially to the present and prospective position of the Revenue. In so far as questions of policy are involved in the expenditure under discussion, these will remain for the exclusive consideration of the Cabinet ; but it will be open to the Committee to review the expenditure and to indicate the economies which might be effected if particular policies were either adopted, abandoned, or modified." The terms of reference to the Inchcape Committee were almost identical. These Committees explored with unusual care the field of public expenditure, especially in regard to economy and retrenchment. Such committees afford a great opportunity for reviewing and recasting public expenditure with a view not only to costs but also as to purpose. There are three principles in regard to these inquiries on overspending and the necessity of economy and retrenchment. In the first place, a change in the value of money provides a strong case for the revision of money obligations fixed under different conditions. Care, however, has to be taken not to single out for

[1] *First Interim Report of Committee on National Expenditure*, Cmd. 1581–1922 (London, H.M. Stationery Office). *Second Interim Report of Committee on National Expenditure*, Cmd. 1582–1922 (London, H.M. Stationery Office). *Third Report of Committee on National Expenditure*, Cmd. 1589–1922 (London, H.M. Stationery Office). *Committee on National Expenditure*, Cmd. 3920, 1931.

[2] *Report of the Indian Retrenchment Committee*, 1922–1923 (Delhi Superintendent Government Printing, India, 1923).

special sacrifice public servants from the rest of the community. Secondly, Governments, like private persons, have in time of stress to economise and retrench. They have to consider what they can and cannot afford. Much expenditure, in itself desirable, cannot be justifiable in changed circumstances. The alternative to economy and retrenchment is additional taxation. Strict regard to economy and retrenchment means less taxation, and less taxation means lighter burdens on industry and trade. A third principle on which these committees have worked is to emphasise that a root cause of overspending has been the absence of the will to control expenditures. Modern democracies are in danger of shipwreck on the hard rocks of finance unless public profusion and predatory taxation are avoided. Political parties, especially when in opposition, frame programmes with an eye to catch votes rather than to maintain the stability of a country's finances. Pledges are given to the electorate that cannot be carried out without a complete breakdown in administrative and financial machinery. However good the system of financial control is, it is bound to be nullified when members of the legislature are pledged to large and expensive schemes. In England it is the Cabinet that lays down policy, but it is Parliament that passes the laws. The departments of the State, the Civil Service, administer the law as laid down by Parliament. Economy and retrenchment, therefore, depend upon the unequivocal will of the Government and upon the reflection of that will in legislation and administration. The feature of post-War legislation in England and other countries has been the statutory commitment of the taxpayer not only to great expense in the present, but also to greater expense in the future.

It is advisable to distinguish what is meant by the terms —economy and retrenchment. Economy does not mean merely the saving of money, but rather the spending of money wisely in order that the greatest possible benefit may be derived from the spending of public funds. Economy means expenditure without waste and to the best advantage. To consider economy as merely a synonym for lessened expenditure is loose thinking, for the meaning of the word is good management, and this may well include wise spending. In other words, it is not merely saving money: it means avoiding waste, spending wisely, and getting the best value out of all resources, whether men, materials, or

public funds. Contrasted with economy is parsimony, which is used in two senses—thrift and the more usual sense, stinginess or the improper saving of expenditure. Tacitus uses it in the former sense as a great and untapped revenue—" magnum vectigal est parsimonia ". To-day parsimony is used in the latter sense and is then as much a vice as economy is a virtue. Retrenchment goes very much farther than economy and means the lopping off or removal of what is superfluous. There is often much expenditure in a State which absorbs enormous sums of money and is not above suspicion. There is, in short, a great deal of avoidable expenditure which, although not quite the same as waste, is in an overtaxed country unjustifiable. There does come a time when sooner or later the expenditure on existing objects requires scrutiny, and the expenditure on these, if already reduced to the minimum, may have to be re-considered whether it is justifiable to continue to incur expenditure on these objects. It may then be necessary to draw in one's horns and to reduce the number of objects on which expenditure is incurred. The possibilities of reductions in national expenditure are usually great. The plea that " economy depends on policy " is apt to degenerate, in spite of protestations of determination, into a timid decision that policy cannot be changed and, therefore, economy cannot be realised. It is true that a finance minister cannot by a stroke of the pen cut out a department here and a department there without careful scrutiny. Paring down has to be done with care and much hard thinking. Economy undertaken in haste is often repented of at leisure. In making changes of this kind care has to be taken to see that they can be permanently maintained and not reversed within a comparatively short time because they have not been sufficiently thought out. The practice of all parties in office, we have seen, is to mortgage possible economies to expensive commitments. The social services in England to-day are contractual obligations which cannot be repudiated. The utmost that can be done is to safeguard them against abuse, strictly to scrutinise administration, especially in regard to overstaffing, over-organisation, useless work, and excessive salaries, and resolutely to refuse to use the expansion of these services as electoral bribes. The favourite retort of all parties in office is that economy, except on a negligible scale, is too difficult. But there must be no excuse for slackness in economy and retrench-

ment, because a strenuous policy of this nature is a most potent factor in the public mind in reviving and sustaining that confidence which is supremely vital in public finance. A small dose of well-thought-out economy and retrenchment will often outweigh a large dose of profligacy.

Instances of economy in the Geddes Report may be seen in the recommendations relating to statistics and prison labour. "We have made inquiries as to the extent to which machines are used in the compilation of statistics. We understand that hitherto practically no machines have been used, but that tests are now being made, and we recommend that the use of machines in connection with the heavy statistical work in this office (*i.e.* Customs and Excise Statistical Office) should be persevered with, as when introduced elsewhere material economies have resulted."[1] "We are struck by the fact that this (prison) labour is not more remunerative. We are informed that the present lack of machinery is a great hindrance, and that, in view of the expense involved in having the work supervised by warders at their present rates of pay, the produce does little more than pay the cost of supervision. Further, it is found that in present circumstances Government departments, who are normally the largest purchasers of the products of prison labour, are now able to obtain the same articles at less cost from surplus stocks of War stores. We think that, although on that account it is more difficult at present economically to use prison labour, the use of it upon all Government requirements should be most carefully considered."[2] The Inchcape Report similarly gives striking examples where economy is possible, notably in the avoidance of unnecessary movements of troops,[3] the improvement of accounts and statistics on railways,[4] the method of granting house-rent allowances to general service telegraphists,[5] and the disadvantages of allowing one firm to obtain a monopoly in contracts for Government printing.[6] The Committee give two other

[1] *Third Report* (Cmd. 1589), p. 31. But cf. May Committee's Report (Cmd. 3920, 1931): "Reference should be made here to one particular form of staff economy, viz. the substitution of mechanical devices for routine labour. In this respect, we believe the Civil Service to compare favourably with the best organisations in British industry. During the last five years, as much as nearly £500,000 has been saved annually in some twelve of the largest Departments by the introduction of labour-saving machines."

[2] *Second Report* (Cmd. 1582), p. 81.

[3] *Report*, p. 17.

[4] *Ibid.* p. 70.

[5] *Ibid.* p. 99.

[6] *Ibid.* p. 256

examples which will result in economy, viz. the stopping of the rush of expenditure at the end of the financial year in order to avoid the lapse of unspent funds,[1] and to the lock-up of capital in stores [2] which the country cannot afford, apart from the consequent expenditure on establishments engaged on the maintenance of stores, the buildings for their accommodation, and the inevitable loss from depreciation. Economy is also seen in the prevention of useless work and in the reduction of excessive salaries. As an example of the former may be mentioned the instance of an Interdepartmental Committee on the subject of "Pay and Pensions During and After the Next War", and of the latter the system of reducing salary scales which tend in almost all cases to be over-generous at the top end of the scale. Examples of retrenchment may be illustrated from the Geddes and Inchcape Reports where the cutting down of staff is recommended. The Geddes Committee proposes to do away with staff in the Post Office by reviewing the question of fluidity of staff between various centres to cope with seasonal or special work.[3] Similarly, the Inchcape Committee recommended the retrenchment of staff on railways, as the retention of a large surplus staff inevitably lowers efficiency.[4] Cases of retrenchment are the abolition of Government departments and of staff in overstaffed departments, especially where there is redundant organisation, *i.e.* where work will pass through many hands when one or two would suffice.

5. It goes without saying that the actual normal expenditure in any year is to a great extent determined by historical conditions or by previous legislation. This is almost axiomatic and is illustrated in Table V., Appendix, where the main heads of expenditure in India are set out in the form of percentages. The proportional amount spent on the various heads varies from country to country, from province to province, and from local authority to local authority. The expenditure must always be viewed as a whole. Conflicting claims must be carefully weighed. When Gladstone said that "good finance consists more in the spending than in the collecting of revenue", he

[1] *Report*, p. 248.

[2] *Ibid.* p. 292. On 31st March 1922 the value of the stores was nearly Rs.59 crores (£39,333,333·33), of which Rs.35 crores were railway stores and Rs.21 crores army stores.

[3] *Third Report* (Cmd. 1589), p. 42.

[4] *Report*, p. 70.

emphasised the importance of this principle. At the same time, it is to be remembered that Gladstone lived in a period when expenditure on social and Government undertakings had not the importance in public expenditure which they now possess. There is always present the temptation for public authorities to ask for more money than is in reality required, or for services which may be performed more cheaply or dispensed with entirely. This does not in any sense imply dishonesty, but rather the inevitable tendency to over-expenditure on the part of public authorities or their officials. When the policy of Government (*i.e.* what Government does) and the administration (which carries out that policy) are not at fault, then Government expenditure is above criticism. Lavish expenditure is frequently the result of carelessness or weakness on the part of public officials, and it should be the aim of a well-organised financial administration to take measures to prevent the injudicious expenditure of public funds either by the punishment or the exposure of the responsible official or officials. Such expenditure is in most countries checked by a superior authority in the official hierarchy. One department or office subordinate to another department should have its proposals scrutinised by the controlling department, and even by the Finance Department or Treasury, according to the importance of the expenditure proposed. The Finance Department or the Treasury must be pre-eminent among the departments of Government. It should be under an independent minister who is not head of any other department of State. The British Treasury, for example, is under an independent minister, the Chancellor of the Exchequer, and the principal officer in the Treasury, the Permanent Secretary to the Treasury, is the principal officer or head of the Civil Service. There is rigour of financial control preventing too much or unwise spending and evasions of economy. This necessitates careful preparation of estimates and scrutiny at every turn. Caution in undertaking commitments of a continuing character is exercised but, for reasons stated above, this is not always successful, as members of Parliament and Governments are returned by the electorate pledged to expensive schemes. Before the expenditure is placed before the Legislature for sanction it is not unusual for a Committee of the House to sit as a Finance Committee to consider and advise Government on proposals for expenditure which

the Government proposes to place before the Legislature. There is also the salutary Standing Order of the House of Commons that it will not " proceed upon any motion for a grant or charge upon the public revenue unless recommended from the Crown ". In many countries, as in England, a further check is exercised by a Public Accounts Committee of the Legislature which follows up any question of audit to which attention has been drawn in order to avoid any improper expenditure of money already sanctioned. It is customary to restrict such committees from questioning matters of policy which do not arise out of the accounts. In Great Britain any expenditure, say by the War Office, would be carefully examined departmentally and by the financial authorities in the War Office. If it required, on account of its importance, the sanction of His Majesty's Treasury before being placed in the Budget this would be done, and then Parliament would be asked to sanction the estimates. The Comptroller and Auditor-General would see that the money was correctly spent in accordance with the purpose for which it was voted and that it was not exceeded. His report would then go before the Accounts Committee of Parliament, who vigilantly watch for any irregular expenditure. All expenditure is met out of the Consolidated Fund or the amount standing to the credit of Government in the Exchequer account. Taxation is imposed not to meet the wants of any special service, but on a survey of the whole financial position. The payments from the Consolidated Fund are made with Parliamentary sanction either annually or once for all. The Supply Services, *e.g.* expenditure on the Army, Air Force, Navy, Civil Services, Customs, Excise, Inland Revenue, and Post Office Services, are voted annually. The Consolidated Fund Services, mainly National Debt Services, payments to Local Taxation Accounts, Civil List, certain salaries and pensions of persons whose independence is held to be better secured by withdrawing these from the annual discussions in Parliament are voted once for all and not annually by Act of Parliament, although such payments are in theory liable to revision by Parliament when it so desires.

Saving and Spending

6. In many countries since the War the national income has become more widely distributed and the small investor is saving

more than he did formerly, but the rate of saving of the nation as a whole is less. The rich, who were in pre-War days savers *par excellence*, are now receiving less of the national income than before the War owing to high progressive taxation and the higher level of earnings of the working classes. The small investor in Great Britain, for instance, has savings banks, building societies, national savings certificates, co-operative and friendly societies, life assurance policies, and the Stock Exchange, which attract his savings. His accumulated savings are of the order of £2500 millions in Great Britain out of a total of £25,000 millions, or 10 per cent only of the accumulated wealth. Although the small investor in Great Britain represents the great majority of the population he contributes only a minor part, approximately one-fifth, of the new annual savings, which are the equivalent of about 2 per cent of the existing national wealth. If the rich be assumed to be those with incomes over £2000 a year, and if it be assumed that each in this category is the head of an average British family, they represent not more than 1 per cent of the inhabitants of Great Britain. If the income tax payers be taken, and if it be assumed that each is the breadwinner of an average British family—a generous assumption—income tax payers represent only about one-fifth of the income-receiving population, and the small investor, therefore, may be said to include at least some four-fifths of the population. The problem of saving and spending is accordingly an important problem from many points of view.

The question arises whether individuals and public authorities should restrict their expenditures within the narrowest limits, especially during times of depression, or, on the contrary, spend freely. The issue is not quite so simple as it appears. From the definition of economy that has been given it will be clear that wise spending is true economy and it implies wise saving. Economy, it must be remembered, has two opposites, parsimony and waste, and if waste is reduced, resources are set free for remunerative spending both on public and private enterprise. In war-time the individual is asked to stop spending on consumable goods and services and to hand over to the State the savings on this account in order that the things necessary for the winning of the war—man power, machine power and shipping power—may be produced. In peace-time the insatiable war machine no longer

functions, and saving may or may not promote wise spending. Saving may result in hoarding as in India, where gold and silver are normally accumulated in large quantities, or in cash or in idle balances. This is deflationary in its effects. In times of depression investment in new capital construction by public and private concerns is curtailed; the fruits of economy are in bank balances or are used for the purchase of securities, but owing to lack of confidence these do not readily find an outlet in the construction of factories and machinery. National income is cut down by the decrease in consumption, and men, machines, and other power are thrown into idleness. It is not in the public interest to cut down in times of depression one's expenditure ruthlessly, as this will affect demand. How can the trader sell his goods without buyers, and how can the manufacturer sell to the shopkeeper and give employment if the shopkeeper cannot buy from him? The spending by individuals of what they have earned either in the form of purchases of goods for consumption or of productive investment is the best method of increasing effective demand. This will be less if public extravagance leaves the individual with less resources and as a consequence less confidence. If taxation undermines confidence the individual will not spend as much as he could and should spend. Imprudent borrowing and spending by public authorities mean the overspending of the resources of those who have (*i.e.* from whom alone public authorities obtain their resources), the mortgaging of future budgets, and the raising of the rate of interest tends to raise the rate of interest at a time when the revival of the supply of capital to private industry is urgently necessary. Spending should be such as to revive investment in industries making for capital extension rather than in industries producing consumption goods. It is true that money spent on consumption goods, including luxuries, promotes progress in many ways, but it is also true that the best interests of a country will be better conserved by subordinating the desire for transient luxuries to attain those more lasting resources which will help production in the future and raise in various ways the standard of comfort. At the same time, the purchase of existing securities and deposits in building societies, etc., are in the public interest.

The individualist is apt to suggest a policy of drastic public economy with liberal private spending, while the socialist, on the

contrary, will suggest a policy of public expenditure so that large sums are taken from taxpayers for public authorities. The individualist believes that depression is mainly caused by the transfer of private funds to the public purse and thus preventing money to fructify in the hands of those who made it. The cure in his view is to leave more to be spent and saved by the individual taxpayer. It is sometimes even stated that there is no real danger of extravagance by private individuals, because, when it occurs in a degree that might endanger thrift, it will be rectified by the raising of the bank rate. But bank rate has little or no effect on the small investor, and it is not always clear that it has a determining effect on the well-to-do. The individualist loses sight, too, of the fact that his policy of drastic public economy means the severe cutting-down of the salaries and wages of public servants who thus would be singled out for differential treatment. Private extravagance is in reality a slippery foundation for public economy. It is admitted on all sides, except by doctrinaire socialists, that public economy is necessary and that Governments and local authorities in recent years overspend. Many of the troubles of the great trade depression 1929–1933 were due to imprudent borrowing and spending by public authorities. An increase in public expenditure involving increases in an already heavy burden of taxation does not increase purchasing power: it ordinarily diverts it in such a manner as to make existing purchasing power less effective in providing employment. It is an unsound doctrine that public expenditure is a desirable thing in itself and that the more there is of it the better. It is in this view always the time to borrow but never to repay. Public expenditure has to be met by rates and taxes and also loans. The more that is taken from the ratepayer and taxpayer, the less, *ceteris paribus*, has he to spend and save. One of the chief barriers to trade is taxation. Governments should practise economy in expenditure and direct their efforts in times of depression to the provision of those conditions requisite for a natural revival of commerce and industry. These efforts include the balancing of budgets, the organisation of markets by fiscal or other methods, the opening of new markets and the removal of obstacles as far as practicable to domestic and foreign commerce. Public economy will increase confidence and the will and the power of the individual to spend on consumption and capital goods.

Private saving and spending are closely related to public saving and spending. The individual and the State must budget carefully and thoughtfully; they must plan and not live for the moment, as life is more than a succession of hours, days, and weeks. Saving is essential, because if people were to spend all their income in the immediate satisfaction of their wants, there would be a shortage of capital which would affect the productiveness of industry. If, on the other hand, all were to save instead of spending, *i.e.* if everyone was to spend on capital goods, who would buy the goods that capital goods (machinery, etc.) make? Common sense teaches that it is wrong for those who do not subsist on private or public charity to abstain from spending, especially in a period of great depression, if they can afford to spend, merely on the mistaken idea that they are performing a public or meritorious service by hoarding or keeping money lying idle in the bank, so far as the bank allows it to be idle. The key to the situation is to distinguish between the various kinds of expenditure. Extravagance is never good for the individual or the public authority. Expenditure in itself is essential to trade, but it must be expenditure related to resources and not expenditure which to alleviate present conditions mortgages the future heavily. Public authorities must limit their activities to enterprise which avoids the ratepayers having less to spend. The whole object of economy in public expenditure is to increase effective demand and the spending by individuals of what they have earned either in the form of purchases or of productive investment. It has been well said that "Private extravagance, even though it affords a certain amount of employment, is always socially vicious, in the fat years no less than the lean. But wise spending is always good and should never be discouraged—provided that it is expenditure from income and not from capital [1]—least of all during a trade depression, because an increase in consumption should be the proper antidote to a fall in prices. In these distressing days the first duty of the citizen is to meet his taxes as cheerfully as he can, and if anything remains over there is no need to play the miser. It is no doubt both virtuous and wise to dispense with caviare and champagne suppers, but to dispense with the services of the under-gardener or the nurse-maid is neither patriotic nor amiable. This, then,

[1] See chapter "Expenditure on Public Works".

is the conclusion of the whole matter. Live within your income and pay your taxes; then spend what you have in a normal manner, but spend it in such a way as to afford the maximum of healthy employment."[1]

Public and Private Expenditure compared

7. It will already be evident that there are differences between public and private expenditure. It is sometimes said that private expenditure is determined by income, while public expenditure determines the amount of the income necessary to meet this expenditure. In short, that private spending is governed by income while public spending determines public income. This is in the long run true. In the case of the private individual, however, there is a minimum expenditure below which he cannot go, and increased expenditure is essential for increased production of the worker, and therefore increased income.[2] The income of public authorities is not so elastic as is sometimes supposed. In war expenditures rise so rapidly that it is impossible to increase public income in proportion. The relation of State income, for example, to gross income of the nation has to be considered in arriving at a basis of public expenditure. Sometimes a legislature may refuse to sanction public expenditure when very ample sources of taxation exist merely out of consideration for the burden already borne by the taxpayer.

Another characteristic of public expenditure is its compulsory character. A Government must incur certain expenditures such as on interest and sinking fund charges on foreign loans, and on defence. There are degrees of necessary expenditure. Foreign debt payments are bound by irrevocable contracts. No Government can let its debts, external or internal, go unpaid. It has to maintain a sound finance and strengthen the financial power for the future. It is never possible to say with Louis XV., "after me the deluge". Governments have to pay their way and to think of the future. They must incur expenditures, being compelled to do so often by a deep-rooted tradition. Even if the field of economy and retrenchment is gleaned and regleaned from

[1] *The Times*, 9th June 1932.

[2] Marshall's *Principles*, Book I. p. 137. Compare *Report on an Enquiry into Working Class Budgets*, Findlay Shirras, Bombay Government Press, p. 14.

time to time still a large block of expenditure has to be incurred. No Government can cut down by leaps and bounds expenditure even under a Finance Minister who has assumed dictatorial powers. Were the expenditure to be cut down wholesale on salaries and wages, on the constructive development of agriculture, public health and education, by discharging public servants, soldiers, teachers, and many thousands of other functionaries, it is pretty certain that there would be a convulsion in which one financial dictator would be replaced by another. Compulsion is a feature of such expenditure distinguishing it from private expenditure, where the will or caprice of the individual can often determine amounts, and the direction of their application.

8. Public expenditure also differs from private expenditure in that the former should balance income and should not necessarily seek a profit in the manner that an individual would. Since 1845 Indian Budgets with three exceptions, the three quinquennia ending 1862, 1923, and 1934, have more or less balanced in spite of famine. The total deficits, excluding these three exceptional periods, amounted to Rs.719 millions and the surpluses to Rs.1311 millions up to 1933–1934, the difference being only Rs.592 millions or about one-fourth of the total central and provincial expenditure in one year—1933–1934. More will be said as to this in the discussion of the canon of surplus in Chapter IV.

Another noticeable difference between private and public expenditure arises from the fact that special interests may be powerful enough to oppose successfully those of the State as a whole, with the result that expenditure may be increased unnecessarily. This is sometimes, but in a small degree, the case in private companies. The individual usually spends on what he considers to be for his advantage. In the case of the State this may not succeed because of the existence of sentiment or special interests. This applies with special emphasis to defence, and also to higher and university education. In proposing naval "cuts", after taking into consideration the results of the Washington Conference, the Geddes Committee said that "a civilian might indeed shrink from suggesting any reduction in naval expenditure. We are, however, definitely of the opinion, after our investigation, that this grave advice cannot be justified. In our judgment, this is a forcible illustration of the financial danger of accepting unchallenged the dicta of naval and military

experts. Their natural tendency is invariably to be satisfied with nothing short of perfection, to which must be added their inherent desire to maintain the prestige of the Service." [1] The tendency to this in young democracies or where communal feelings and sentiments are strong (as in India, owing to diversity of race, caste, and creed) is especially great.

There is a further difference between the expenditure of private individuals and that of public authorities. Ordinarily net advantage governs the expenditure of the citizen who takes up an occupation or occupations which, all things considered, appear most advantageous or remunerative. The State on the other hand is unable to take this as the basis of its expenditure. Similarly with municipalities or local boards. The State, for example, undertakes expenditure on defence, on law and order; on social objects such as education, poor relief, and public health; on undertakings of a quasi-commercial nature such as railways, roads, waterways (canals, barrages, and similar irrigation works), posts, telegraphs, and telephones; it subsidises commercial aerial communications and, among other things, assists agricultural and industrial research. This raises the important question as to the extent to which States should undertake such activities.

9. It is possible to divide the main schools of thought in regard to the scope of public expenditure into two classes. One school restricts the functions of Government mainly, if not entirely, to the primary functions of defence, law and order, public debt, and the necessities of civil administration. The other school is more generally in favour of an increase in State agency. In fact, it believes in the oft-quoted remark that "nowadays we are all socialists". Adam Smith, in *The Wealth of Nations*, tells us that "every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men. The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient: the duty of superintending the industry of private people, and of

[1] *Third Report* (Cmd. 1589), p. 166.

directing it towards the employments most suitable to the interest of the society."[1] He proceeds to limit the functions of Government to the three duties quoted on page 54, and the second of these duties, "the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it", may, if interpreted widely, give Government the task of reconstructing the economic order, since Adam Smith showed many phases of it where injustice and sometimes even oppression prevailed. Certain activities of Government which he probably overlooked owing to his absent-mindedness, such as poor relief, would no doubt have been approved by him. The propriety of Government participating in commerce and industry is discussed almost entirely from the viewpoint of Government making a profit out of it and not from the fact that it encroaches on private enterprise. He, in general, disapproves of Government undertaking business on the ground that Government is a poor trader and a poor manager. He severely criticised the East India Company for trying to combine private and public functions, viz. trading and governing, which he believed to be altogether incompatible. Writing over 150 years ago he said that "it is a very singular Government in which every member of the administration wishes to get out of the country, and consequently to have done with the Government, as soon as he can, and to whose interest, the day after he has left it and carried his whole fortune with him, it is perfectly indifferent though the whole country was swallowed up by an earthquake".[2]

10. One of the best exponents of the school is Parnell (or Congleton) who, in his pamphlet *On Financial Reform* (1830), says: "The great error which is commonly committed is taking the utility of an expenditure as a sufficient justification of it; whereas, however useful it may be, if it cannot be shown to be absolutely necessary for securing some public object that could not be had by any other means, it is superfluous and ought to be discontinued. . . . Every particle of expense that is incurred beyond what necessity

[1] *The Wealth of Nations*, Book IV. ch. ix. finis (vol. ii. p. 184, Cannan's edit.).

[2] *Ibid.* ch. vii. finis (vol. ii. p. 140, Cannan's edit.). Adam Smith had in his library William Bolts' *Considerations on India Affairs, particularly respecting the present state of Bengal and its Dependencies*, ed. 1772.

absolutely requires for the preservation of social order and for protection against foreign attack is waste, and an unjust and oppressive imposition upon the public." [1] It is wrongly implied by holders of this extreme "leave-people-alone" theory that private individuals spend money better than their Government does. This is in no way always so, although Gladstone, a champion of Victorian finance, used to speak of leaving money to fructify in the pockets of the people. Twentieth-century finance shows that the State does spend money to advantage, and private expenditure is often wasteful, especially since the War. Huxley, in his well-known *Essay on Administrative Nihilism*, attacks the position held by Parnell and Herbert Spencer. With trenchant logic he says: "If my next-door neighbour chooses to have his drains in such a state as to create a poisonous atmosphere, which I breathe at the risk of typhus and diphtheria, he restricts my just freedom to live just as much as if he went about with a pistol, threatening my life; if he is to be allowed to let his children go unvaccinated, he might as well be allowed to leave strychnine lozenges about in the way of mine; and if he brings them up untaught and untrained to earn their living, he is doing his best to restrict my freedom, by increasing the burden of taxation for the support of gaols and workhouses, which I have to pay".[2]

11. German writers go so far as to extend the scope of public expenditure to new social undertakings and to magnify the claims of the State against those of the individual. To-day the popular cry is for State intervention. Government should do everything. The general position, however, is that the State should spend money on defence, law, and order, and also on what will increase the material resources of the country as well as on social services such as education and public health. The Geddes Committee's recommendations bear out this view. "As regards Public Health Services, *e.g.* tuberculosis, maternity, and child welfare, there can be no question as to the merits of the objects to be attained. There has, however, been a very large increase in this form of public expenditure since 1918–1919, and, while we do not recommend reductions in this expenditure, we do feel that, having regard to the present financial position, the State's

[1] *On Financial Reform*, Sir Henry Parnell, Bart., M.P., 1830, p. 117.
[2] *Critiques and Addresses*, p. 10.

contribution next year, at any rate, should not be above the figure provided for the current year. We hope that, with falling prices and the greatly increased incentive to economy, the authorities responsible for this form of activity will be able still further to increase their beneficial work." [1]

12. Public expenditure should be carried up to the point where the advantage to the community of an additional dose of expenditure in any direction is counterbalanced by the disadvantage of a similar dose of taxation. This is the ideal of public expenditure, and is very important. A careful system of expenditure should always outweigh the possible check resulting from taxation required to finance it. It should be noticed that public expenditure may cause large changes in the character and volume of production. Considerable diversion of wealth may be directed into channels determined by public policy. Public expenditure, in other words, should increase production. Production may be increased by expenditure on defence, law, and order, as these make for conditions favourable to the increase of production. It may be increased by the way in which public expenditure affects the community's working power and its saving power. Wise expenditure on education and public health may in turn indirectly increase the ability and the desire to save, although it produces its beneficial effects only after the lapse of time. It promotes too, as we have seen, industrial efficiency *after an interval.* "It makes", said the Colwyn Report, "for physical and mental wellbeing, for happiness and for energy. Moreover, it supports and steadies the purchasing power over consumption goods, which is unreservedly beneficial to industry, provided there is a demand for productive goods in due proportion. On the other side must be set the hard fact that there is a limit to what the country can afford." [2] It is necessary to discount the future as little as possible in public expenditure. The community does not die like the individual, and it is therefore the duty of financiers and legislators to make generous provision for the

[1] *First Report* (Cmd. 1581), p. 136.

[2] Cf. A. Wagner, *Finanzwissenchaft*: "The permissible amount of public expenditures, both absolutely and relatively considered, will vary directly in proportion to (*a*) the direct economic value of State activities; (*b*) the extent to which it promotes the productive power of all; (*c*) the absolutely free social income; (*d*) the larger the part of the net State receipts coming from the quasi-private acquisition (railways-industries in general) of the State and not from taxes" (Bd. I. 565).

future by cautious expenditure, especially when such expenditure is to be met from capital.[1] It is a dangerous policy to ask, " What has posterity done for me that I should do so much for posterity ? " We must rather think of the famous line in Tacitus' *Agricola*, " Think of your ancestors and of your posterity ".

[1] Cf. Dalton, *Public Finance*, ch. iii. § 5 and ch. xvi. § 1.

CHAPTER IV

THE CANONS OF EXPENDITURE

THERE are four canons of financial propriety in regard to public expenditure. These are: I. The Canon of Benefit; II. The Canon of Economy; III. The Canon of Sanction; and IV. The Canon of Surplus.

I. Firstly, with regard to the Canon of Benefit. We shall again refer to the principle of benefit in dealing with the classification of public expenditure.[1] The ideal is maximum social advantage.[2] Other things being equal, public expenditure should bring with it important social advantages such as increased production, the preservation of the social whole against external attack and internal disorder, and as far as possible a reduction in the inequality of incomes. In short, public funds must be spent in those directions most conducive to the public interest, *i.e.* maximum utility is to be attained in public expenditure. This reminds one of Beccaria's expression[3] in the preface to his remarkable little pamphlet *Dei delitti e delle pene* (Crimes and Punishments) (1764)—"the greatest happiness of the greatest number" (la massima felicità divisa nel maggior numero), a phrase that has penetrated deep into the mind of every writer on the science of public finance. Maximum social advantage is the aim of the financier in public expenditure.

This canon requires further analysis. It does not mean that because primary public expenditure has to be undertaken before secondary public expenditure that expenditure on primary heads

[1] See Chapter XIII.

[2] See *Ibid.*

[3] Cf. Priestley's *Essay on Government* (1768) and Bentham's *Fragment on Government* (1776). "Priestley was the first (unless it was Beccaria) who taught my lips to pronounce this sacred truth; that the greatest happiness of the greatest number is the foundation of morals and legislation" (Bentham). Some think the expression goes back to the time of Marcus Aurelius.

must always have precedence over those which are secondary. It may be necessary to stop expenditure on defence after a limit is reached in order to devote more and more expenditure on a social service, such as education. Nor can each claim on public funds be settled regardless of other conflicting claims. Expenditure should be viewed as a whole, and adjudication made on the various competing claims for new expenditure.[1] "The ideal of public expenditure", says Nicholson with great truth, "on the utilitarian principle would be attained when the public utility of the marginal expenditure in each case is equal. The ideal is no doubt unattainable, but it is not unthinkable, and the pursuit of it may lead to important practical results. Without a beacon of this kind, expenditure may be continued in certain directions long after it is justified by changing conditions, and the most necessary reforms may be met with the *non possumus* of passive inertia." [2]

In regard to the canon of benefit it is a well-recognised rule that no public expenditure should be permitted for the benefit of a particular person or section of the community unless (*a*) the amount of expenditure involved is small; (*b*) a claim for the amount could be enforced in a court of law; and (*c*) the expenditure is in pursuance of a recognised policy or custom. This has been adopted in most countries. In India the principle arose in connexion with the polo grounds constructed at Delhi on the occasion of the King-Emperor's Durbar. No objection was raised to the initial expenditure, but the Auditor-General did object to the proposal that Government should maintain the grounds as polo grounds because these grounds would benefit only those who would play polo, and therefore the cost of upkeep should fall on them, not on Government. The third exception above is intended to cover such cases as the grants made on the successful termination of the War to Field-Marshal Haig and Admiral Beatty. It also covers expenditure on behalf of communities that have been recognised as a matter of policy, *e.g.* grants to certain schools and colleges and hospitals. But a grant for the construction of a temple or mosque in India would not be in accordance with the principle laid down as this is not a recognised policy or custom.

[1] Cf. Chapter III.

[2] Nicholson, *Principles of Political Economy*, vol. iii. p. 379.

II. The Canon of Economy. The canon of economy is a canon that is frequently abused owing to weak financial administration. The same vigilance is required in public expenditure as a person of ordinary prudence exercises over his private expenditure. The price of economy, as of liberty, is eternal vigilance, and there can be no assurance of effective action without the resolute application of the spur of sound financial control and sound public opinion.

Economy, too, means protecting the interests of the taxpayer not merely in effecting economies in expenditure, but in developing revenue. Especially in public works, disbursing and controlling officers must see that the expenditure incurred is necessary and the rates fair. A great deal of intelligence and care on the part of senior officers is required in the scrutiny of rates, especially in comparing the rates paid by other large consumers. It was found on comparing the rates for milk supplied to the Army during the War in one large centre in India that these were much higher than the rates paid by hospitals in the same place. A considerable saving was effected by this scrutiny in the prices paid by the Army Department after this was detected. Similarly, in stores and workshops, more attention has to be paid to large questions such as are involved in stores than to petty rules on pay and allowances. The British Ministry of Munitions (now defunct), the Office of Works, and the Ministry of Labour are all mentioned in the Report of the British Public Accounts Committee, published as a White Paper in August 1923 for a transaction under which a factory was taken over from the Ministry of Munitions by the Office of Works and handed over to the Labour Ministry, none of them apparently being aware until two years later that the £17,000 worth of stores in the building were not held on ledger charge by any of them. An officer on arrival in Bombay from England was ordered to Maymyo, the hill-station of Burma. Three days after his arrival in Maymyo he was reposted to Bombay. He had his wife with him all the time, and covered some thousands of miles. The 6th Jats Regiment was at Jhansi early in 1919; in September they were moved to Ferozepur, depot and all; and in January 1920 they were moved back to Jhansi, and at the end of that year to Delhi, where also their stay was short. May this not to some extent be due to moves ordered and countermanded,

unnecessary transfers especially of officers because of want of forethought? The British Public Accounts Committee, in the report above referred to, cites further similar examples of the absence of economy in public expenditure. The Office of Works is criticised for defective co-ordination between its different branches, as illustrated by the payment of rent for a building at Pontypridd for eleven years after it had been given up. The Colonial Office is criticised for not informing the Commonwealth Government that a proposed internment camp in Australia was not required, the result being an unnecessary expenditure of £132,000, the greater part of which, however, is recoverable from other Governments. A subsidy to the British Italian Corporation of £283,418 had been paid, as arranged by Government in 1916, and the Committee comment: "The witness who appeared before the Committee was unable to inform them what advantages had accrued to H.M. Government from the payment of this subsidy". The Committee give an apt illustration of the spending of public moneys not on the lines followed by a person in respect of his own money. In 1918 two typewriting machines were hired by the Air Force when there was a shortage of these machines, at a rent of £2 : 10s. a month, which the Committee was informed was not unreasonable for a period of a month or two, but could not be justified for an extended period. In December 1918 the Air Ministry, on learning that the Stationery Office was once more in a position to supply typewriters, gave general directions that all hiring should cease forthwith. The hire of these particular machines was continued in one case for one year, and in another case for two years, and in addition one of the machines was lost. In consequence an unnecessary payment of £120 was made from public funds. In all these examples of public expenditure there was need for pitiless economy. Public authorities, especially at the time of year when they are preparing their several budgets, require all the curb that conscientious heads, political and executive, or a vigilant public opinion can apply. The Treasury (or Finance Departments) must, in a special degree, prove to be an unsleeping guardian of the public purse. Too much stress cannot be laid on publicity either in legislatures or in audit, as this avoids extravagance, corruption, and misunderstanding in expenditure.

(III. The Canon of Sanction. The canon of sanction is that

no public expenditure should be incurred without proper authority. A remarkable instance of the breach of this rule is given in a public report of an Accountant-General on the accounts of a certain Provincial Government in India for 1921–1922. A Circuit House was, in the opinion of the Provincial Government, urgently required, and the work was commenced in April 1920 " without proper sanction, allotment of funds, call for tenders, or the other usual formalities required by the Public Works Department Code." In June 1920 the plans and estimates amounting to nearly Rs.1,97,000 were sent to the Central Government for approval, as the proposal exceeded the limit of Rs.30,000, up to which the Provincial Government was competent to sanction expenditure on a new Circuit House. The Government of India considered that the expenditure proposed to be incurred appeared unreasonable for the purpose, and regretted their inability to sanction the scheme. The Circuit House was renamed District Bungalow, " as it was intended for the use of various touring officers and others ", and the Local Government went on with the scheme, although the average cost of these bungalows was Rs.9,000. The Government of India refused to sanction the expenditure, but finally, " in view of the fact that the money had already been expended, have since decided not to press the matter further, and have accorded sanction, which they considered useless to withhold in the circumstances, to the action of the Local Government ". The Public Accounts Committee of the Legislative Council endorsed the Accountant-General's disapproval of the procedure followed, and " they desire to point out that either the Finance Department failed to exercise control or the Administrative Department failed to obtain the statutory approval of the Finance Department. To guard against the latter contingency the Committee consider that any officer taking action, or directing that action should be taken, before the statutory examination and approval of the whole scheme by the Finance Department, should be warned that he may be held personally liable." The net result was that the bungalow was built at a cost more than ten times that of the most expensive district bungalow previously erected in the Province, and at a cost more than twenty times of the average district bungalow. In the (British) Public Accounts Committee's Report, already referred to above, there are cases of similar waste through the

breaking of this canon. The Office of Works is criticised for the payment of over £12,000 for additional work on a tender which originally amounted to only £930, and the Air Services are found fault with at some length, in one case for a gift of £10,000 to a Dominion without Treasury authority, in a second case for cancelling an old contract and making a new one on a higher basis also without Treasury authority.

The canon of sanction also includes the following rules: (1) No expenditure should be sanctioned by an authority which at a later date is likely to involve expenditure beyond its own powers of sanction; and (2) loans should be spent only on those objects for which money may be so borrowed, arrangements being made for a sinking fund or other form of amortisation for the liquidation of the debts. It would be a breach of the former rule if a public authority made certain temporary appointments as an experimental measure when, as a result of this experiment, there would be a change in system costing more than that public authority had power to sanction. The second rule is intended to prevent money being spent on objects, the expenditure on which is intended to be met from current revenues.

IV. The Canon of Surplus. The canon of surplus is the avoidance of deficits in public expenditure. In arriving at a surplus or deficit the financier should be careful not to debit to capital what should be met from revenue and *vice versa*. Otherwise there will be no true surplus or no true deficit. The Great War has taught the vital importance of this canon and it applies equally to Central or Federal Governments, provincial or State Governments, and to purely local authorities. A moderate surplus, something of the nature of till-money in shops, does not produce extravagance, and in public finance it is safe and necessary. Some writers believe in moderate deficit financing, as it leads to economy. The main fact is, however, the importance in public expenditure of avoiding deficits. Public authorities must earn their living and pay their way like ordinary citizens. Balanced budgets must, as in private expenditure, be the order of the day. Annual expenditure must be balanced without the creation of fresh credits unrepresented by new assets. The International Financial Conference which met at Brussels in 1920 laid it down in most unequivocal terms that "the country which accepts the policy of budget deficits is treading the slippery path

which leads to general ruin ; to escape from that path no sacrifice is too great ".[1] In Gladstone's words : " It is not from mere extravagance, but it is from disregarding the balance between income and expenditure that those cases of financial confusion have arisen in different countries which have found their upshot in revolution and ruin. So long as you keep your income up to your expenditure, and the people pay their way, in a country like this, if they find the burden too heavy, they will take care that you reduce expenditure. Therefore, this is the real test and real safeguard, and the true corner-stone of all sound finance." [2] Stable finance rests not on pious hopes, but on making both ends meet.[3]

[1] Cf. Resolution II. of the Resolutions proposed by the Commission on Public Finance and adopted unanimously by the Conference.

[2] National Liberal Club, London, 2nd May 1883.

[3] See pages 59 ff. on economy and retrenchment.

CHAPTER V

THE CLASSIFICATION OF PUBLIC EXPENDITURE

1. THE classification of public expenditure presents several interesting problems. For the examination of the theory of public expenditure, a classification is of course obviously necessary. Without a proper classification of public expenditures it is not possible to understand the character and costs of government. In this and the following chapter we shall, in the first place, attempt to classify public expenditure in such a way as to avoid overlapping and obvious criticism. Secondly, the main heads of expenditure will be reviewed. The test of good public expenditure, as we have already shown, is not in the aggregate expenditure, but in the relative amounts which are assigned to the several heads from time to time. Governments have to invest large sums for the development of their resources. Otherwise delay will occur in reforms and in the attainment of a higher plane of living. An attempt will also be made to answer the question: What is the relation of Central (or Federal), Provincial (or State), and local expenditure to each other? and we shall also consider the advantages, if any, of distinguishing between productive and unproductive expenditure, normal (or ordinary), or abnormal (or extraordinary), and recurring or non-recurring expenditure. Finally, we shall inquire what expenditure should be chargeable to revenue on the one hand, and to capital on the other.

2. No classification is always satisfactory because it depends to a great extent on the object that we have in view. Thus in an inquiry into national debt and taxation such as that undertaken by the Colwyn Committee in Great Britain, the classification was: (1) Service of the External Debt; (2) interest on the Internal Debt; (3) Repayment of Internal Debt; (4) Pensions; (5) Defence; (6) Social Expenditure; and (7) Other Services.

The object in view was an examination of the National Debt and the incidence of existing taxation. For other inquiries another classification may be more useful. The basis, in short, of the classification is not at all absolute but relative to the purpose in view. After all, it is not for the actual killing of the animal that one likes the chase. It is everything that leads up to the result that is desired. So with classification. Nineteenth-century writers have usually classified public expenditure from the point of view of benefit conferred or from the revenue received in return for services rendered. Others have classified expenditure in accordance with governmental functions—protective, commercial, and developmental. German writers such as Cohn [1] and American writers such as Plehn [2] are the best examples of those who classify according to the benefit which each class of expenditure confers. Plehn's classification is briefly: (1) Expenditure which confers a common benefit on all, *e.g.* defence. This is the most important class; (2) expenditure which confers a special benefit on certain people, but which should be treated as a common benefit because of the incapacity of those classes, *e.g.* poor relief; (3) expenditure which confers a special benefit on certain persons and at the same time a common benefit on the remainder, *e.g.* the administration of justice, the maintenance and construction of roads; (4) expenditure which confers only a special benefit on individuals, *e.g.* expenditure on State industries. All expenditure may be said to be in the public interest, and the difficulty of assigning the various heads of expenditure to these four categories is obvious. This classification has never reached the stage of being put into operation. It has been suggested that the Budget, which is Greek to many, would be easy to understand and much dissatisfaction would be allayed if the system of grouping several kinds of expenditure with reference to the benefit conferred and of allocating taxes to each specified expenditure were adopted. The expenditure on education and other social services would be brought into relation with the taxation of necessaries, the maintenance of roads with motor taxation, and the service of debt (internal and external) with income-tax revenue. There would thus be a benefit and sacrifice account. Generally, how-

[1] Cohn, *Finanzwissenschaft* (vol. ii. of the system), 79-91.
[2] Plehn, *Public Finance*, Part I.

ever, sources of revenue are not earmarked to any particular items of expenditure, but the psychological effect may be good.

3. It is difficult to eliminate the element of special advantage even in the case of the first class. Some of us derive larger utility from expenditure on defence or on law and order than others. In fact it seems as if the third class embraced the other three. "As regards benefit alone", writes Nicholson,[1] "all these kinds of public expenditure must be held to confer a common benefit or to satisfy a public want as their essential justification, although they also—all of them—incidentally confer special benefits on individuals or classes or localities. Thus defence is placed in the first class because ostensibly it is for the common benefit only; but as a matter of history most wars have been undertaken in the defence of particular places or classes or even individuals. Poor relief is ostensibly for the benefit of the particular individuals concerned; but as a matter of public policy it confers common benefits in the prevention of crime and in the satisfaction of the sense of justice or of charity. Free education manifestly confers special benefits both on the particular children and their particular parents; but again, the common benefit is so great that by Professor Plehn it is placed in the first class. Finally, as regards class four, which is said to confer only a special benefit on individuals, it may be said that the final cause of all progress in public expenditure has been the abolition of this class. From being the greatest, it has become the least in importance. Public expenditure which does not confer some common benefit or answer some public purpose ought not to exist in the modern state. This was the position emphatically laid down by Adam Smith, *e.g.* 'The protection of any particular branch of trade is a part of the general protection of trade, a part, therefore, of the duty of the executive power'.[2] And it may truly be said that the greatest financial reform effected since his time has been the substitution of the principle of common benefit for the benefit of particular places or placemen or 'interests'."

4. The second classification referred to above, *i.e.* according to the amount of revenue obtained by the State in return for the services rendered, is that adopted by Nicholson. In many ways it is superior to that of Cohn or Plehn. The classification briefly

[1] *Principles of Political Economy*, Nicholson, vol. iii. p. 373 ff.
[2] *The Wealth of Nations*, Book V. ch. i. part iii.

is: (1) expenditure without direct return of revenue, *e.g.* poor relief; or in some cases even with indirect as well as direct loss, *e.g.* expenditure on war; (2) expenditure without direct return but with indirect benefit to revenue, *e.g.* education. It is usually assumed that educated people are better taxpayers or less expensive to the State than, say, criminals or paupers; (3) expenditure with partial direct return, *e.g.* education for which fees are charged, subsidised railways which pay part of their running expenses; (4) expenditure with full return or even profit, *e.g.* the post office, road funds, gas works, and generally State industries. The British returns of Public Income and Expenditure now have two main heads: (1) ordinary expenditure; and (2) self-balancing expenditure, expenditure which should equate with revenue, viz. the Post Office and the Road Fund. On the revenue side of the account are ordinary revenue and self-balancing revenue, *i.e.* the Post Office and motor vehicle duties apportioned to the Road Fund. The main criticism of this classification of expenditure is that it fails to distinguish the main differences in the various classes of public expenditure. It is also, like the former classification, not clear cut. There may be considerable doubt regarding the particular items to be placed in group (1) and in group (2). The Civil estimates, however, are divided into nine classes: (1) Central Government and Finance, *e.g.* House of Commons, House of Lords, the Treasury, Royal Commissions; (2) Foreign and Imperial, *e.g.* Diplomatic and Consular Service, Foreign Office, Colonial Office, League of Nations; (3) Home Department, Law and Justice; (4) Education, *e.g.* Board of Education, Museums, Universities and Colleges; (5) Health, Labour, and Insurance, *e.g.* Ministry of Health, Ministry of Labour, Old Age and Widows' Pensions; (6) Trade and Industry, *e.g.* Ministry of Agriculture, Board of Trade, Beet Sugar Subsidy, Road Fund, Scientific and Industrial Research; (7) Common Services; (8) Pensions; and (9) Miscellaneous.

5. Adams, in classifying public expenditure according to the functions of Government, has the following main groups and sub-groups: (1) protective functions—(*a*) military, (*b*) police and courts, (*c*) social disease (prisons, asylums, pauperism, sanitation, etc.); (2) commercial functions; and (3) developmental functions. These developmental functions include (*a*) education, (*b*) public recreation, (*c*) prosecution of private

business, (*d*) public investigation, *e.g.* the collection of social statistics, and (*e*) the development of the physical basis of the State, *e.g.* public works, docks, lighthouses, etc. Here, again, the main criticism is the difficulty of placing the several kinds of expenditure under these main heads. Should, for example, expenditure on recreation always be classed as developmental? Expenditure on the collection of statistics may be either commercial or developmental. The foreign trade returns belong to the former, and the collection of social statistics usually to the latter. In other words, commercial expenditure may sometimes be developmental when it makes for future well-being. Where, again, is the line to be drawn between protective and developmental functions? Expenditure on protection promotes progress or development. A classification more in harmony with the everyday expenditure of countries is undoubtedly essential.

6. There are, again, the classifications of Mill into necessary and optional, and of Roscher into necessary, useful, and superfluous or ornamental. By the term optional Mill means that the expediency of Government's exercising those functions does not amount to necessity, and is a subject on which diversity of opinion does or may exist. The terms necessary and optional connote a distinction which few would recognise in these days of the growing sphere of State activity, especially if expenditure on education and public health is classed as optional expenditure.

7. In the post-War period a classification of importance in State expenditure is that of transfer and non-transfer expenditure. Transfer expenditure is that which merely redistributes the resources gathered by Government in taxation, or in other words the money incomes of the community, the cost of collection being allowed for. It is purchasing power taken from the community as taxpayers, but returned to the community as bond-holders or old-age or war pensioners in the country. Such expenditure may have indirect effects on production. It does not, as is the case with non-transfer expenditure, result in a using up of the national income. Non-transfer expenditure is consumption expenditure such as that on the fighting services, tributes, payments on account of external debts, and civil administration. It is not necessarily avoidable or wasteful expenditure.

In both cases of State expenditure there is a transfer of money incomes from one set of people to another, but in substance they

are different. In transfer expenditure there is no draft on the community's resources, apart from the cost of transfer. The community's resources are untouched. In non-transfer expenditure the community as a whole is deprived, as against the Government, of command over a part of its resources, it being presumed that the services would have been rendered to the community had they not been used up by Government.

Pigou calls non-transfer expenditure real or exhaustive expenditure. It necessitates " the actual using up of a part of the community's resources so that the community has to do without these resources itself or has to work harder than it otherwise need have done in order to fill the gap that has for the time been made ".[1] The distinction is important from the viewpoint of theory, but it is doubtful whether the distinction is as clear and the effects of it so clear-cut in practice as Pigou suggests. It is desirable not to misinterpret him even if he is not always easy to follow. He rightly points out that in transfer expenditure " the essential fact is that from the point of view of the community as a whole, considered as standing over against the Government, there is (apart from the administrative costs involved) no surrender of real resources ". But is he always consistent ? He says, " Government expenditures to call out goods or services . . . involve . . . the actual using up of a part of the community's resources ", and he instances as real or exhaustive expenditure " expenditure in building a highly remunerative Government electricity plant ". Wages are here exhaustive expenditure. Pigou does not make it clear whether the whole of the expenditure on such wages is exhaustive. If the Government pays normal rates of wage there would be no transfer expenditure but only exhaustive expenditure. Should the Government be extravagant and pay exorbitantly high wages there would be transfer expenditure to the extent of the exorbitance in wages. Moreover much State expenditure is often a mixture of both transfer and exhaustive expenditure. If in the building of the " highly remunerative electricity plant " workmen are paid £5 per week when the value of the services or normal wages are £3 : 10s., then £3 : 10s. is exhaustive and £1 : 10s. transfer expenditure in Pigou's definition. Later on Pigou points out that if soldiers are paid " more than they would normally earn, a certain

[1] *A Study of Public Finance*, p. 19 (Macmillan & Co.).

transference of resources is made from the rest of the community to them ", and " to pay a man, whether he be a member of Parliament, or a contractor, or a workman, much more than his services are worth, that, undesirable though it is, does not directly involve any using up of national resources ". He believes there is a distinction between the extravagance involved in the making of useless shells or the transport of troops uselessly from Egypt to the Dardanelles and back, and the payment of salaries to Government servants quite out of proportion to their work or high prices paid to contractors. In the case of shells and transport there was a real using up of capital and labour, while in the latter there is (so far as the excess payment is concerned) only a transfer of resources from one section of the community to another section through the intermediary of the Government. From the viewpoint of the Government both of these forms of extravagance are the same, as the national resources are misspent, but from the community standpoint there is a distinction, viz. that unnecessarily high salaries paid to Civil servants would remain in the country, it being assumed that the officials are natives of the country (which is not necessarily the case as in India, the colonies, and elsewhere), that part of these high salaries and wages are not remitted abroad as, for example, in the case of Italians and Greeks in the United States who remit large sums to Europe from their earnings. Pigou is, certainly, on sure ground when he draws a distinction between transfer expenditure involved in paying nationals within the country interest on their loans, and expenditure on interest on loans held abroad, the former being transfer and the latter non-transfer or real or exhaustive expenditure in the sense defined above.

The Ideal Classification

8. The ideal classification for most purposes is a functional one, as it enables one to know and to understand what Governments are doing and how the direction of public expenditure is changing from time to time. It may be divided into two main classes—primary expenditure and secondary expenditure. Primary expenditure includes all expenditure which Governments worthy of the name of Governments are obliged above everything else to undertake, viz. defence, law and order, and the payment of

debts. Such expenditure is necessary for the preservation of the existence of a State. Secondary expenditure includes social expenditure, expenditure on public undertakings, and certain miscellaneous expenditure.

The primary expenditure of Governments embraces four well-known heads of expenditure: (1) defence—naval, military, and air; (2) law and order, which include (*a*) law and justice, such as the cost of the judiciary, of prisons and convict settlements,

CLASSIFICATION OF THE GROSS EXPENDITURE CHARGEABLE AGAINST THE REVENUE OF INDIA (CENTRAL AND PROVINCIAL)

(Detailed Tables will be found in the Appendix)

Heads of Expenditure.	1871–72.	1891–92.	1911–12.	Pre-War Year, 1913–14.	1921–22.	1933–34.
Primary.			(Percentages)			
I. Defence	33·4	26 5	26 5	25 6	32·6	22·2
II. Law and order	10 6	8 6	10·7	10·8	8 6	9·2
III. Civil administration	14 6	10 7	12·1	11 7	10 9	11·8
IV. Debt services	15 8	11 4	12 5	12 2	15 0	24·5
Total primary	74 4	57 2	61 8	60 3	67·1	67·7
Secondary.						
V. Social	2 7	4 2	5·4	6·8	6·5	8·0
VI. Developmental Government or public undertakings	12 1	31 8	24 2	25 7	20 8	16·4
VII. Miscellaneous	10·8	6 8	8 6	7 2	5·6	7·9
Total secondary	25 6	42 8	38 2	39 7	32 9	32·3
	100 0	100 0	100·0	100 0	100·0	100 0

and (*b*) police; (3) civil administration, which covers the salaries and allowances of heads of Governments or administrations, the charges of secretariats, the greater part of the Civil Services,[1] together with the expenses of the legislature and certain political charges such as the salaries and expenses of representatives abroad: it must also include the cost of collection of taxes; (4) debt services which cover expenditure, both for ordinary or unproductive debt, and also for productive debt on the prin-

[1] In India, for example, certain medical and educational officers (professors and inspectors of schools) are Government servants, but the cost is rightly debited under social services, as these officers are not engaged in civil administration.

ciple that both result in a mortgaging of the country's future revenues, and must be a first charge on expenditure.

Secondary expenditure, on the other hand, includes under social expenditure education, public health, poor relief, unemployment insurance, famine relief, and similar social services. From the distributive viewpoint the expenditure on social services is of great importance, and, as pointed out on page 51, it is advantageous from the standpoint of industrial efficiency as well as from that of social justice and general advantage. Wise expenditure by the State is often more economical than expenditure by the individual. It is true it sometimes may seem to bring production into conflict with distribution, but this is often over-emphasised. If you took taxation from the rich only for the benefit of the poor, this in the long run would affect production and through production the working classes. One has to aim at a proper balance and to take into consideration the evenness or the reverse of the distribution of the country's wealth. Social expenditure on balance benefits the poorer section of the community just as expenditure on debt is on balance in favour of the wealthier section of the community. Under development or Government or public undertakings are included concerns of a quasi-commercial or industrial nature, such as railways, irrigation, canals, barrages, roads, and other public works, posts and telegraphs, telephones, subsidies for industrial and agricultural research, geological and other surveys, and grants to develop commercial aerial communications. In short, expenditure intended to promote economic development, and this expenditure often appears in many places in a country's accounts, covering as it does a wide field. Under the miscellaneous group are included pension charges, grants and contributions, drawbacks, or refunds.

This classification gives on the whole the best results. It is in accordance with the primary and secondary functions of Government. All classifications presuppose a knowledge of the subject classified, and an appeal to history or common sense is essential in cases of doubt. The science of public finance postulates a knowledge of political science, especially of the State and its functions. It will be interesting to apply the classification outlined above to India. India has been selected because it has always been regarded as possessing on the whole an efficient

and an economical Government which has mainly confined its activities to the primary functions of Government. The expenditure includes the expenditure of Central and Provincial Governments, but excludes the expenditure of purely local bodies such as municipalities and district boards.

The salient fact which emerges from these very necessary figures is that primary expenditure is seven-tenths of the total expenditure. Of the remaining three-tenths, over 15 per cent is on Government or public undertakings, the expenditure on

GROWTH OF EXPENDITURE [1]

	1871–72.	1901–02.	Pre-War Year 1913–14.	1921–22.	1933–34.
Education	100	169	752	1421	1902
Medical and Sanitation .	100	183	401	945	1095
Police	100	182	329	578	581
Defence	100	159	196	479	306
Debt Services . . .	100	145	197	468	718
Civil Administration . .	100	156	204	366	373

education being woefully insufficient—only 5·4 per cent of the total. It is, however, satisfactory to note that the growth of expenditure over the last half century has been greatest in social expenditure under education and public health.

NET EXPENDITURE ON PRINCIPAL HEADS BY COUNTRIES

9. An attempt has been made to show the net expenditure in different countries in the pre-War and post-War years. The table will be found below. Comparisons have to be made with great care and with many qualifications. The basis is so radically different in each country that direct comparison is often of little value. Different meanings are attached in each country to the details to be included under, for example, civil administration and the cost of collecting revenue. The expenditure on education is the least comparable of all. In some countries local expenditure is not included in the central Budget. If it were it would raise the expenditure in Great Britain to 12 per cent, while in the Budget it is only 5·6 per cent of the expenditure. The cost of defence, interest on public debts, amortisation, and pensions are items

[1] For details see App. (Tables Nos. III. and VI.).

PERCENTAGE DISTRIBUTION OF NET* EXPENDITURE BY GOVERNMENTS (*i.e.* EXCLUDING LOCAL AUTHORITIES) IN DIFFERENT COUNTRIES (PRE-WAR AND POST-WAR)

Note.—In all cases the expenditure is *net*

Head of Expenditure.	India.†		United Kingdom.		South Africa.		France.		Italy.	
	1913–14	1927–28.	1913–14.	1926–27.	1913–14.	1926–27.	1913–14.	1927.	1913–14.	1926–27.
Cost of collecting revenue ‡	9·1	6·8	2·6	§	0·8	2·0	§	§	11·5	§
Defence	21·4	26·0	44·7	13·6	6·0	3·8	40·3	18·4	25·6	21·9
War and other pensions	8·1	3·1	8·0	10·8	2·2	8·7	7·6	17·1	4·6	10·0
Debt services	12·0	23·2	14·1	47·5	19·9	12·6	21·5	39·7	26·4	29·1
Education ‡	3·8	5·6	11·0	7·0	1·1	29·0 ‖	8·2	5·5	5·6 ¶	6·7
Civil administration	25·8	22·2	18·8	§	25·2	30·3	21·6	8·4	19·2	9·3
Deficit on quasi-commercial undertakings	..	..	..	1·6	14·6	3·7	..	0·4	..	6·0
Others	19·8	13·1	0·8	19·5	30·2	9·9	0·8	10·5	7·1	17·0
Total	100	100	100	100	100	100	100	100	100	100

* Net expenditure means total expenditure minus revenue from the particular item, *e.g.* gross expenditure on railways minus revenue therefrom.

† Central and provincial revenues.

‡ These items are not strictly comparable, as different meanings are attached to cost of collection of revenue and as education is provincialised in some countries

§ This is included under Civil Administration or others.

‖ Entire cost now met by Government.

¶ Not specified.

in which there is the greatest uniformity. Some countries show under Government undertakings in the Budget only the balance of expenditure, *i.e.* working expenses are excluded, while others include working expenses. Some include as expenditure for a given year actual outgoings in that year, while others, such as France, include expenditure payable in respect of that year, and accounts are accordingly not closed until long after the period to which they relate. Those countries which differentiate between ordinary and extraordinary expenditure do not follow a uniform method. Germany, for example, includes in extraordinary expenditure only outgoings for capital purposes, while others include exceptional items but not investments. Czecho-Slovakia, for example, has a special investment Budget. Other countries, again, include under extraordinary expenditure both capital expenditure and other more or less non-recurring expenditure. Others do not distinguish between ordinary and extraordinary expenditure in their Budgets. A protracted study of these Budgets shows the fundamental differences that exist. At the same time they throw light upon the situation brought about by the Great War, especially in regard to debt charges.

CHAPTER VI

EXPENDITURE ON THE PRIMARY FUNCTIONS OF GOVERNMENT

1. THE outstanding feature of modern expenditure is the high figure required for defence. Writing 150 years ago, Montesquieu said that "a new disease has spread through Europe; it has seized on our sovereigns and makes them maintain an inordinate number of troops. It is intensified, and of necessity becomes infectious, for as soon as one state increases its forces the others at once increase theirs, so that nothing is gained by it except general ruin. Each monarch keeps on foot as many armies as if his people were in danger of extermination; and this struggle of all against all is called peace!"[1] This was written nearly thirty years before the publication of *The Wealth of Nations*. Von Justi, writing nearly two decades after Montesquieu, laments the extravagance that prevails, and states that one-half of the income of European states was utilised in military expenditure, and in cases of states with threatening neighbours even two-thirds. Prussia spent three-fourths. The International Financial Conference of 1920 had the same tale to tell, viz. that rigorous, vigilant, and even meticulous economy as well as retrenchment were necessary. It showed that on an average some 20 per cent of the expenditure of nations was still devoted to the maintenance of armaments and for the preparations of war. The Conference affirmed "with the utmost emphasis that the world cannot afford this expenditure. Only by a frank policy of mutual co-operation can the nations hope to regain their old prosperity; and in order to secure that result the whole resources of each country must be devoted to strictly productive purposes." The Conference, therefore, recommended the desirability of a reduction in the

[1] *L'Esprit des lois*, Book XIII. ch. xvii.

burden of armaments which impoverished countries and imperilled their recovery from the ravages of war. In November 1921 an international conference representing Great Britain, France, America, Japan, and Italy resulted in the scrapping of ships and, in fact, a ten-years "naval holiday". The question of extension of the Washington Conference decision to other naval powers and the feasibility of reducing military and air forces were considered by the Assembly of the League of Nations in 1922. Both of these proposals have at bottom a great financial future.

2. It is of interest to examine the facts, and the following summary table brings out the essential facts. A column has been added to show the rise in wholesale prices, as part of the increased cost of defence is due to changes in the value of money.

EXPENDITURE ON DEFENCE, INCLUDING THE ARMY, THE NAVY, AND THE AIR FORCES IN VARIOUS COUNTRIES AT THE PRESENT TIME WITH PRE-WAR YEAR, TOGETHER WITH WHOLESALE INDEX NUMBERS

	1913.	1921.	1925.	1932.	Wholesale Prices Index, 1932.
India	100	224	188	158	100
United Kingdom	100	290	156	134	102
Australia	100	164	147	109	130
Canada	100	203	130	135	104
South Africa	100	111	211	174	92
Japan	100	399	369	265	122
France	100	377	192	527	427
Italy	100	343	329	481	310
Belgium	100	700	941	1355	502
Switzerland	100	136	191	206	96
U.S.A.	100	573	200	222	93

It will be seen that at the end of 1932 the cost of defence had in most countries, such as Great Britain, Canada, India, Japan, and Belgium, exceeded the increase in the rise of wholesale prices. Great and useful work has been done by retrenchment committees in many countries. The Geddes Committee on National Expenditure proposed, for example, a reduction of no less than 35,000 officers and men in the British Navy and 50,000 officers and men in the British Army, the reduction in the latter being made without reducing the officers and men employed by the War Office on foreign service.[1] The Committee mentioned,

[1] *First Report* (Cmd. 1581), p. 31.

too, the financial danger of relying exclusively on expert opinion on defence. To this a reference has already been made.[1] The Committee referred to the high salaries of the Fighting Services, and pointed out that these had a greater proportion of highly paid posts than the Civil Services. In order to stimulate ambition and to secure the necessary reward for ability and hard work, those occupying the higher posts deserve to be well remunerated, but not to an excessive degree.[2] Most people, too, will agree that Adam Smith was quite right when he said that to be a good soldier a man must devote his whole time to the business, and a country cannot depend only on militias. This means expenditure. Governments and legislatures recognise that an efficient system of defence repays itself by the security it affords for trade and prosperity. They recognise, too, that in ordinary times people become so used to what such a system brings that they never realise what it means—just as in the case of air and water—until there is an insufficiency. In India we have become so accustomed to the advantages of peace and good government that it is difficult for the ordinary man in the fields or in our streets to realise their true worth. Japan, with a population of about one-fourth that of British India, spends on her naval and military forces as much as India does. India's sea-borne trade amounted in normal times to Rs.6000 millions, and yet her annual contribution for naval defence is less than Rs.1·5 millions. Nevertheless, with a broken and exhausted Europe, retrenchment and economy are essential. The Inchcape Committee on Indian Expenditure recommended that "a close watch be kept on the details of military expenditure with the object of bringing about a progressive reduction in the future. Should a further fall in prices take place, we consider that it may be possible, after a few years, to reduce the military budget to a sum not exceeding Rs.500 millions, although the Commander-in-Chief does not subscribe to this opinion. Even this is more, in our opinion, than the taxpayer in India should be called upon to pay, and, though revenue may increase through a revival of trade, there would, we think, still be no justification for not keeping a strict eye on military expenditure with a view to its further reduction."[3] Expenditure on defence, as Adam Smith reminds us, is more important than

[1] P. 71; cf. *Third Report* (Cmd. 1589), p. 166.
[2] Cmd. 1589, p. 156. [3] *Report*, p. 58.

opulence, and in determining this amount considerations beyond a country's control have to be considered, such as geographical boundaries, national resources in men and materially racial unity or disunity and the power and attitude of neighbours. A legislature is not infrequently the last thing that can determine a nation's military expenditure. The expenditure on defence in India has been decreasing. In 1933–1934 it was 22·2 per cent as against 32·6 per cent in 1921–1922 and 25·6 per cent in the pre-War year of the total gross expenditure (central and provincial).[1] There are not a few who are reminded, in these days of high expenditures on defence in the chief countries of the world, of Hogarth's picture of the old steward in the "Rake's Progress" holding up his hands in horror and despair at the extravagance of his young master.

Law and Order

3. "Law and order" is a primary and indeed an all-important function of the State, but, for obvious reasons, it costs less than defence. The imagination of the plain man in the street is left gasping when he is told that the latest capital ship in the British Navy, completed in 1920, notwithstanding it is twice the size of the largest battleship in the Great War, is "now obsolescent". He realises how money has to be poured out on defence at times, and he sees that the preservation of law and order is comparatively cheap as compared with defence. In India in 1933–1934 it was 9·2 per cent of the total expenditure as against 22·2 per cent for defence. Adam Smith did not notice the importance of police in his discussion of law and order, or, as he calls it, "the expense of justice".[2] He reminds us that where there is little or no property there is no need of a civil magistrate. "But avarice and ambition in the rich, in the poor the hatred of labour and the love of present ease and enjoyment, are the passions which prompt to invade property, passions much more steady in their operation and much more universal in their influence. Wherever there is great property, there is great inequality. For one very rich man, there must be at least five hundred poor, and the affluence of the few supposes the indigence of the many. The affluence of the rich excites the indignation of the poor, who

[1] See detailed Table V. App. The figures on p. 94 are *net* figures.

[2] *The Wealth of Nations*, Book V. ch. i. part ii.

are often both driven by want, and prompted by envy, to invade his possessions. It is only under the shelter of the civil magistrate that the owner of that valuable property, which is acquired by the labour of many years, or perhaps of many successive generations, can sleep a single night in security." [1] We are not concerned with tracing the development of law and justice and also police. It is important, however, to note that sufficiently attractive salaries and wages and indeed fairly good housing or the equivalent of house-rent allowances have been found necessary in towns to prevent the wrong type of individual entering such a service as the police. It is advisable to investigate periodically, say once in ten years, the strength of the police force in order to enforce economy and to effect amalgamations of forces wherever economy would result. A similar investigation in regard to the cost of jails is also in some countries advisable, even at shorter intervals, since the cost of feeding prisoners is apt, unless most carefully watched, to vary from place to place with no apparent reason at all. In India, for example, there are wide differences in the cost of jails between province and province, and even between district and district.

Civil Administration

4. In recent years the cost of civil administration has increased for several reasons. In the first place, the rise in the cost of living made it imperative to adjust salaries and wages. Secondly, the increasing activity of Governments in social services and in quasi-commercial undertakings resulted in a natural increase in the cost of administration. Another reason for the increase is that changes in the form of Government have taken place. In 1905 the heads of provinces and members of the executive councils in India numbered twelve; after the Reforms of 1921 the number, including ministers, was fifty-one. The extra thirty-nine persons cost nearly Rs.24 lakhs or £180,000 a year in salaries. In addition there are the enlarged legislatures, increased secretariat staffs, and increased travelling allowances or touring charges. Finally, the increase may be due to a revision of the system of accounts. For example, part of the increase in the cost of general administration in India in 1921–1922, as compared with the last pre-reform year (1920–1921), was due to the

[1] *The Wealth of Nations*, Book V. ch. i. part ii. Ed. Cannan, vol. ii. p. 203.

fact that the cost of district magistrates, formerly debited to land revenue and justice, is now debited to general administration. In 1921–1922 the Government of Bombay made an interesting inquiry into the actual staffs engaged in every activity on which the Government spent money, and it was found that 4·8 per cent was spent on the Imperial Services, mainly European. On the predominantly Indian branches the expenditure was 5·4 per cent on the provincial services, 20·2 per cent on clerks, and 1·6 per cent on miscellaneous servants such as messengers. Out of an expenditure of Rs.15 crores, 32 per cent went in the payment of personnel. The State Civil servants in Great Britain and Northern Ireland also cost a similar percentage. Herbert Paul, in his *History of England*, well describes the position of the Civil Service. "The country", he says, "is governed in ordinary times for everyday purposes by these permanent members of the Civil Service, who work for both parties with equal loyalty, and in some cases with equal contempt." [1]

5. The cost of collecting both direct and indirect taxes is also to be included under "Civil Administration". In India in 1933–1934, 4·5 per cent, or a little below half the percentage in 1871–1872, was spent on this head.[2] The cost is fairly evenly distributed among direct and indirect taxes, being 2·6 per cent on the former and 1·9 per cent on the latter for the year ended 31st March 1934. There are, it is obvious, remarkable variations in the cost of collection. It should be laid down as a principle that any reduction in the cost of collection which impairs the efficiency of collection is unwise. A slight increase in the cost of collecting income tax may far outweigh such additional cost and produce greater efficiency in collection. The English Board of Inland Revenue has been obliged to establish a special Investigation Branch to deal with frauds. This is not only a protection to the ordinary (and honest) taxpayer, but results in a large increase annually in taxation, formerly fraudulently unpaid. The expenditure on civil administration in India in 1933–1934 was 11·8 per cent of the total expenditure, as against 11·7 per cent in the pre-War year.[2]

[1] Compare R. H. Hutton, a former editor of the *Spectator*—"Surely there is no bureaucracy in Europe so pleasant and so far from the domineering manner as the English".

[2] *Vide* Tables III. and V. App., also p. 91.

Debt Services

6. The fourth main head of primary expenditure is the service of internal and external debt which no State would ever desire to evade. In most countries the increase of expenditure on account of debt has been mainly due to the Great War, the consequent rise in the price level which compelled Governments to pay more for goods and services, and the growth in all directions of State activity. In Great Britain, for example, the National Debt on April 1, 1933, was £7860 millions, of which £6799 millions were internal debt and the remainder £1061 or one-seventh of the whole debt. The debt was about 13 times its amount on April 1, 1914, when it was £650 millions, and the expenditure on interest was 15 times greater, having increased from £19 millions to £280 millions. Owing to the conversion of 5 per cent War Loan of £2,600,000,000 in April 1932, the equivalent of one-third of the total National Debt, there is an annual saving of £30,000,000 in interest charges. This expenditure is on a debt which is almost entirely unproductive, unlike the case of India and South Africa, where more than three-fourths, and of Australia, where more than one-half is productive debt. Expenditure on productive debt, in India, for example, has been incurred for railways which yield as a rule a considerable surplus after meeting interest and sinking fund charges. Borrowing is not a short cut to prosperity, and the temptation to fall into debt is one which every soundly financed State strongly resists except where the money is required for purposes which, after careful investigation, can reasonably be expected to be adequately productive. If the strictest financial orthodoxy is followed all expenditure, normal or abnormal, should be met from current revenues except in regard to productive undertakings. To this, however, we shall return when dealing with public debts in Book IV.

The increases in the previous paragraph in expenditure on the service of debt demand further examination. In the first place it cannot be said without careful examination in each particular case whether the expenditure on debt service is heavier than formerly or heavier as compared with some other country. The nature of the debt has to be examined, *i.e.* whether it is external or internal, whether productive or unproductive. An external debt falls more heavily on a country than does an

internal debt, especially if the external debt is, like the inter-ally debts, unproductive. The annual payment takes the form of an export of goods and services which do not pay for any imports in return for goods and services lent. When the debt was contracted the creditor country transferred part of its wealth in return for a claim on the debtor country's subsequent production. It reduces the real national income of the country and no new source of purchasing power or of saving as in the case of an internal debt is created. If the external debt is a productive debt the profits of the concerns, *e.g.* State railways, set up a fund for both the payment of interest and the repayment of capital, and the effect of the expenditure on the borrowing country will not be the same as if the debt was unproductive in its origin. Countries with expanding resources such as India, South Africa, and Australia require external capital, and it is necessary to borrow in order to progress and to assist in the increase of the country's national income in the long run, the capital requirements in the country itself, as the history of Governments in the two Americas has proved, not being sufficient.

The expenditure on internal debt services adds to the purchasing power and potential saving of the fundholders what is taken from the taxpayers, the cost of collecting and distributing the taxes, including the costs thrown on the taxpayers in the way of solicitors' fees, etc., being neglected. One cannot say that internal expenditure on debt is innocuous because it is merely taken from one pocket and put into another. It may or may not involve a real burden although the transfer in ownership does not change the amount of the debt. It is necessary to examine both the manner in which the expenditure on debt services affects the distribution of wealth and saving. It is sometimes argued that the payment of interest on internal debt is a transfer at the cost of the active members of the community to the less active, and that on balance it adds to the existing inequality in the distribution of income, tending to increase the proportion of the national income which goes into the hands of non-producers. Expenditure on debt services in Great Britain, for example, is met in greater part by income tax payers, and in so far as this is the case this class gets no money return on its investment. The rich are especially hardly hit because they pay at a high rate, and their money incomes may be so affected as to

make saving impossible. Public loans may be said not to have intensified the inequality in wealth distribution in this respect. It is necessary to know in examining the burden of this expenditure who are the taxpayers and who are the interest receivers, what use the taxpayers would have made of the purchasing power taken away from them in taxation and what use the interest receivers make of the purchasing power made over to them. A large part of the National Debt of Great Britain is held by banks, joint-stock, and private companies, and in connection with the monetary standard of the country. A considerable amount is held by individuals liable to Estate Duty.[1] Industry would benefit from the payments of interest on Government loans held by the banks, joint-stock, and private companies. Those liable to estate duty are usually of the well-to-do classes who are able to save. It has been calculated that 2 per cent of the owners of capital in Great Britain possess two-thirds of the national capital. In these cases it would seem that the internal debt was for the benefit of industry and, all things considered, propitious to saving.

Other factors in addition to the nature of the debt have to be examined, whether we consider the case of the same country at different periods or of different countries at the same time. The increase of population, the increase in wealth which over long periods in western countries has increased at a very much greater pace than population, the difference in the standard of living among peoples in different countries and, as in South Africa, in the same country, the method of raising the revenue from direct and from indirect taxation, the degree to which saving is affected by the taxation of the wealthy, the extent to which the tax revenue is spent on social services are factors to be considered in addition to the presence or absence of external debt and the nature of the debt. The Colwyn Committee [2] published data submitted by Sir W. T. Layton, Editor of the *Economist*, which shows in an interesting way that the ratio of debt services to national income was much the same after the Great War as after

[1] No official statistics are available, but from data placed before the Colwyn Committee on National Debt and Taxation it would seem that about one-third is held in British Joint Stock Banks, the Bank of England, Insurance and Railway Companies, and in connexion with the monetary standard of the country; over one-third is held by private persons liable to Estate Duty; the remainder is held by foreigners, trusts, trade unions, joint stock companies, etc.

[2] Cmd. 2800, 1927, p. 235.

the Napoleonic Wars. The percentage of the services on internal debt—there was no external debt in 1818—to total expenditure and national income is of interest. Real income *per capita* in 1923 was four times greater than in 1818 and all classes shared in this increase, especially the working classes, owing to the large advance in real wages. Indirect taxation was a large part of the tax revenue—£40 millions out of £56 millions and many necessaries were taxed. The income tax was repealed after 1815, and the expenditure on social services was much less than in 1923.

	1818.	1913.	1923.
I. Ratio to total expenditure of :			
Internal debt services :			
Interest and management .	53·2	9·8	36·7
Debt repayment . . .	2·1	4·4	3·9
External debt service :			
Interest and management .	..	..	4·8
Debt repayment	..	..	1·5
II. Ratio to national income :			
Of Internal debt services . .	8·12	1·07	7·89
Of total debt services . .	8·12	1·07	9·13
III. Total expenditure . . (£ m.)	58·78	172·88	739·02
IV. Total income . . . (£ m.)	400	2300	3800

Leroy-Beaulieu, writing at the end of last century, attempted to lay down a percentage figure for the service of debt : " Lorsque dans un budget le service de la dette prélève plus de 35 p. 100, l'État est tenu à une grande prudence, quoique les créanciers puissent encore avoir confiance ; quand le service de la dette dépasse 45 p. 100, la situation commence à être inquiétante ; quand il atteint 55 ou 60 p. 100, il est presque certain que le moindre accident devra amener un concordat entre l'État débiteur et ses créanciers. Nous ne donnons, d'ailleurs, cette règle que comme approximative. Il y a une foule de considérations qui peuvent en modifier la justesse. Ainsi, le chiffre de la somme nécessaire au service de la dette pourrait atteindre sans danger à une proportion plus élevée que 35 ou 40 p. 100 dans un pays qui a un budget modeste et des impôts très modérés comme l'Angleterre, ou bien dans un pays où l' Union des États a peu d'attributions, comme l'Amérique du Nord." [1] The difficulty of fixing any percentage except within considerable limits will be evident.

[1] *Traité de la science des finances*, tome ii. p. 647.

CHAPTER VII

EXPENDITURE ON THE SECONDARY FUNCTIONS OF GOVERNMENT: I. SOCIAL SERVICES

1. In the previous chapter the primary expenditure of Governments was discussed. In this chapter we shall deal with secondary expenditure. In India secondary expenditure covers only a third, or slightly over a third, of the total expenditure from revenue. In the pre-War year it was almost 40 per cent. The importance of secondary expenditure in the twentieth century has increased, and will continue to increase, out of all proportion to that in the nineteenth century. Social services, such as education, public health, national health insurance, unemployment insurance, old age and widows' pensions, poor relief and housing have, for example, in Great Britain, profoundly altered the direction of public expenditure. There have been greatly increased expenditures on educational services, the payment of pensions, and on other ameliorative social services. A British Treasury return shows that the annual ascertained cost of social services to Government, local authorities and the beneficiaries or their employers on 31st March 1927 was £383 millions, an increase of £320 millions over the year ended 31st March 1911, or over six times as much as before the War, and of this cost Parliament provided nearly 46 per cent. A similar movement has been at work in other parts of the British Empire, and indeed all over the world in the present century. There are, as has been pointed out on page 75, limits to this expenditure depending in the main on the proportion between transfer and non-transfer expenditure of a country and its national income. Transfer expenditure is, as frequently pointed out in this book, expenditure transferred within limits from one group of citizens to another, and when this is re-

membered it cannot be argued that expenditure on social services is unfairly checked by the existence of transfer expenditure. So long as the disadvantage of raising taxes to pay for expenditure is outbalanced by the expenditure itself, the expenditure is good expenditure.

EDUCATION: ITS IMPORTANCE

2. Money spent on education—and by education is meant not merely the imparting of knowledge but the education of character, of the faculties and activities generally—tends to increase production by making the worker more intelligent and trustworthy. The labourer, as a result of education, contributes a larger share to the national income. Instead of a large population chiefly engaged in supplying itself with a bare existence, there is a population demanding, as well as receiving, more complex services. Adam Smith also showed a direct advantage to the State by the education of its citizens, because "the more they are instructed, the less liable they are to the delusions of enthusiasm and superstition which, among ignorant nations, frequently occasion the most dreadful disorders. An instructed and intelligent people, besides, are always more decent and orderly than an ignorant and stupid one." [1]

3. In England and Wales primary education is free, and attendance at school between the ages of 5 and 14 [2] years is compulsory, and by-laws may be made in any area requiring attendance up to the age of 15 years, either for children generally, or with certain exceptions. Provision must be made for advanced instruction, and also for practical instruction in cookery, laundrywork, housewifery, etc. The local education authorities also may arrange for nursery schools for children between the ages of 2 and 5. Employment of children under the age of 12 and street-trading under the age of 14 are prohibited. Similar regulations are in vogue in Scotland except that education is compulsory up to 15 years. In Scotland since the sixteenth century the parish schools have resulted in the percentage of illiterates being less than in England and Wales. Employment

[1] *The Wealth of Nations*, Book V. ch. i. part iii. Cannan ed., vol. ii. pp. 272-3. Compare *Report on an Enquiry into Working Class Budgets in Bombay*, G. Findlay Shirras, Bombay Government Central Press, 1923, p. 29 and following pages.

[2] It has been decided to raise this to 15 years (1936).

of children under 13 and street-trading under 17 are prohibited. Secondary education in Great Britain is provided so as to secure that children and young persons under 18 years of age shall not be debarred by inability to pay fees from receiving the benefits of any form of education from which they are capable of profiting. Under the Education Act, 1921, " the total sums paid to a local education authority out of moneys provided by Parliament and the local taxation account in aid of elementary education or higher education, as the case may be, shall not be less than one-half of the net expenditure of the authority recognised by the Board of Education as expenditure in aid of which Parliamentary grants should be made to the authority, and if the total sums payable out of those moneys to an authority in any year fall short of one-half of that expenditure, there shall be paid by the Board to that authority, out of moneys provided by Parliament, a deficiency grant equal to the amount of the deficiency, provided that a deficiency grant shall not be so paid as to make good to the authority any deductions made from a substantive grant ".[1] Arrangements for borrowing on the security of the fund or rate out of which the expenditure on education is payable, and for repayment, are also provided for in the Education Act, 1921. In 1931–1932, £63,000,000 was spent on elementary education in England and Wales, of which 47 per cent was from rates and 53 per cent from taxes ; £17,000,000 was spent on higher education, of which 44 per cent was from rates, 39 per cent from Parliamentary grants, and 17 per cent from other sources. Thus with a population of nearly 40,000,000 England and Wales spent on education over £87,000,000, or £2 : 3 : 6 per head.[2] The figures for the latest available year (1931–1932) for Scotland were over £12,000,000, of which 42 per cent was from rates and 58 per cent from taxes. Thus with a population of nearly 5,000,000 Scotland spent £2 : 9s. per head.

In India in recent years there has been a considerable expansion in expenditure on education, which since the introduction

[1] Section 118, *vide* p. 278 Owen's *Education Acts Manual*, 22nd edition (Chas. Knight & Co., Ltd., London), 1923.

[2] The net cost per student on education as a whole in Great Britain rose from £4·40 in 1913–1914 to £12·53 in 1929–1930. This is mainly due to the large rise in teachers' salaries and to larger costs of superannuation. The average salary of a male teacher was £139 in 1914 and £324 in 1930 and of a female teacher £82 and £217 respectively. The average of all teachers was £97 and £245. (Committee on National Expenditure, Cmd. 3920–1931, p. 48.)

of the Reforms in 1921–1922 has been a transferred provincial subject under a Minister. The Report by the Auxiliary Committee appointed by the Statutory Commission 1928 (published at the end of 1929) pointed out that " throughout the whole educational system there is waste and ineffectiveness ", especially in primary education where children lapse back into illiteracy because of the fact that only a small proportion who are at the primary stage reach Class IV. in which the attainment of literacy may be expected. The Committee, too, point out that many local authorities practically ignore the Minister. The Committee recommend that the Central Government " should serve as a centre of educational information for the whole of India and as a means of co-ordinating the educational experience of the different provinces. But we regard the duties of the central Government as going beyond that. We cannot accept the view that it should be entirely relieved of all responsibility for the attainment of universal primary education." The provinces have not the funds for this, and it is reasonably certain that a change in this respect will be effected in the new Reforms. A national minimum of educational efficiency is a State and not a local problem. Sir Amherst Selby Bigge, in speaking of the English Board of Education, said: " The function of obtaining higher efficiency by exhortation, stimulation, criticism, and propaganda must always belong to the Central Authority ". This means expenditure on administration. Legislation can do but little.

The figures in the table on next page require careful study. The relative importance of education to the total expenditure varies for many reasons. A country, for example, may have a heavy unproductive debt necessitating large annual payments by way of interest, and this would reduce the percentage expenditure on education.

In most federal Governments education is a provincial subject and is therefore financed almost entirely by provincial or State governments and local authorities. Thus in Australia, education is a State subject, is compulsory, as in Great Britain, between the age of 7 and 14 years, and is free at all State schools. The Federal Government, however, by the Science and Industry Research Act, 1926, appropriated a sum of £250,000 for the initiation and carrying out of scientific research, and by the Science and Industry Endowment Act, 1926, established a fund of £100,000 to

provide assistance to those persons and students engaged in research. Under Article 93 of the British North America Act education in Canada is also a provincial subject. General elementary and secondary education, so far as it is publicly con-

EXPENDITURE ON EDUCATION IN VARIOUS COUNTRIES (INCLUDING THAT OF LOCAL BODIES)

Country.	Year.	Public Expenditure on Education.	Total Gross Public Expenditure.
Great Britain * . .	1930–31	£98 millions	£1,176 millions
Canada	1925–26	$26 ,,	$499 ,,
Australia . . .	1931–32	£9·8 ,,	£219 ,,
The Union of South Africa	1927–28	£8·2 ,,	£32·9 ,,
British India * . .	1931–32	Rs. 212 ,,	Rs. 2,912 ,,
U.S.A.*	1925	$2,167 ,,	$11,124 ,,
Japan †	1928–29	yen 531 ,,	yen 3,183 ,,
*Great Britain:			
Central	1930–31	£55 millions	£881 millions
Local	,,	£43 ,,	£295 ,,
Total . . .	,,	£98 ,,	£1,176 ,,
India:			
Central	1931–32	Rs. 62 lakhs	Rs 14,721 lakhs
Provincial . . .	,,	Rs 1,221 ,,	Rs. 9,149 ,,
Local	,,	Rs. 840 ,,	Rs. 5,254 ,,
Total . . .	,,	Rs. 2,123 ,,	Rs. 29,124 ,,
U.S.A.:			
Federal	1925	$13 millions	$3,765 millions
States	,,	$434 ,,	$1,530 ,,
Local	,,	$1,720 ,,	$5,829 ,,
Total . . .	,,	$2,167 ,,	$11,124 ,,

† Figures of local expenditure are for 1926–1927.

trolled, is carried on except in Quebec in free schools supported by taxation. In South Africa, in accordance with Article 85 (iii.) of the South Africa Act, the provinces are entrusted with education other than higher education. By higher education is meant education after the matriculation standard. The Financial Relations Act, 1922, laid down that higher education shall include education provided by Universities and University Colleges incorporated by law, the South African Native College, and such technical institutions as the Minister may declare to be places of higher education. In 1925 the control of all industrial and vocational institutions was transferred from the provinces to the Union. In recent years

the Provincial Administrations, with the aid of the Union subsidy, bear almost the entire cost of school education other than technical in the Union, and this is a great contrast to the system in most countries where local school rates are levied to meet a substantial portion of the cost, the remainder being contributed by grants in aid. The Union Government makes grants in aid to the various Universities and Colleges which under the Higher Education Additional Provisions Act, 1917, are State-aided institutions. 56 per cent of the cost of Universities and Colleges on the average is met by grants in aid from the Union Government, 26 per cent from fees, the remainder from grants from local bodies, gifts, donations, and bequests. The position of Provincial Councils (which have no Ministers) is anomalous, and the Prime Minister, General Hertzog, during a tour in the Orange Free State in 1928, said, " When the Provincial Councils come to the Union Government with another request to tax for them, we may tell them that if we can tax we can also administer. The time is coming when the Provincial Councils will be no more." In the United States federal aid did not assume any importance in school budgets until 1917–1918. They exceed $125,000,000 annually. In 1925, 69 per cent of the expenditure on schools was from local taxes, 10 per cent from county taxes, 14 per cent from State taxes. Federal aid was less than 1 per cent, permanent funds and other current revenue amounted to over 6 per cent. All States contribute to the support of their State Universities and Colleges. Sixteen States, for example, have State property taxes which are devoted in whole or in part to higher educational institutions. In some States special mill taxes are sometimes levied for particular purposes—usually to finance building or the purchase of equipment. All of the States which do not earmark a regular mill tax for the support of State Universities make regular grants usually for a biennial period. South Carolina, for example, makes biennial grants for the University of South Carolina and annual grants for the State Medical College. Colorado supports both the State University and the State Agricultural College by regular mill taxes, but also makes annual grants to the State School of Mines. A few States assign the revenues from taxes other than their property taxes to Universities. The Alabama Polytechnic Institute draws income from a State tax on kerosene. Clemson Agricultural

College in South Carolina receives the proceeds from a fertilizer tax. Federal grants for education are conditional, the conditions being usually (1) the setting up within the State of an adequate administrative agency; (2) the matching of federal funds on the fifty-fifty system; (3) the submission of detailed plans to be approved by the federal bureau in charge. The carrying out of the work, however, is done by State officials. Dr. A. F. MacDonald, of the University of Pennsylvania, writing on "Federal Subsidies for Education", said, "Remarkable progress has been made under the various subsidy laws. The history of Federal aid is a story of transformed agriculture; of vocational schools with thousands of students in States which formerly did not have a single course in vocational training; of hopelessly disabled cripples, transformed into happy, independent wage-earners; of States which for the first time are giving their mothers an opportunity to find a solution for the problems of motherhood, and offering their babies for the first time a real chance for life. Few of the people who oppose Federal subsidies maintain that the work is being improperly done, or that it is unnecessary."

To sum up. When we look around and see the rewards of a sound education from the point of view of the State and its citizens, we see that capital invested in educational opportunities (in free schools, and even free colleges and universities) yields a princely return. There is, in the first place, the economic justification, viz. that the industrial efficiency of workers, male and female, is increased by such expenditure. A higher standard of living and a greater efficiency among the children of the poor result, and inequalities are levelled up. This expenditure is a sure means of adding to the national wealth and the national income. There is, on the other hand, the political justification for large expenditure on education. Self-government can only be successful in communities where there is a high level of literacy and, therefore, of intelligence. This high level is most easily and most cheaply attained through free public education. In the United States by far the largest item of expenditure is for public education, which outweighs in costliness even the expenditure on national defence.[1] In 1925 more than two billion dollars (£400 millions), or over 19 per cent, of total governmental

[1] *Vide* "The Cost of Government in the United States" (Nat. Industrial Conference Board, 1927).

expenditure were spent on education, and in fifteen years between 1910 and 1925 it increased 356 per cent.

Modern Governments, then, realise that there can be no raising of the standard of comfort and no enhancing of the value of labour and increased production until education is widespread and accessible; they also realise that there will be no sure foundation for the superstructure of national advancement without the achievement of these results. Even without access to the purse of Fortunatus, it is realised that sound and durable instruction must be brought to the doors of the people. In India to-day there is no more pressing claim than more and better education. The Indian Constitution to a large degree requires as its base an intelligent electorate. Responsible government is, in fact, a pyramid that can only grow with its base, and without an enormous development of national education this task is an impossibility. Out of a population of 272 millions in British India, 36 millions or 14 per cent will be enfranchised. Only 22·7 millions or 8·3 per cent, a surprisingly low figure, are literate, *i.e.* they can read and write a letter in one language. 3·1 millions or 1·1 per cent only are literate in English. Moreover, our education at the moment is very badly balanced. The still small voice of primary education is scarcely heard, while the proportion in secondary schools, when an allowance is made for the fact that females can be virtually left out of the reckoning, is far greater than the corresponding figures for England and Wales. The figures for university education are still more interesting—no less than ·036 per cent of the population as against ·15 per cent of England and Wales —especially when the Indian figure has practically to exclude, unlike the latter which includes, the female population. The problem, then, is of the most vital import, upon which India must set to work at the earliest possible moment. Our task is to introduce into the masses in our rural areas and into the proletariat of our towns a degree of education which will fit them, in ever-increasing numbers, to be the basis of our future political structure. In Plato's words, true education is that which "makes a man gladly pursue the ideal perfection of citizenship, and teaches him how rightly to rule and how to obey—this is the only education which, upon our view, deserves the name". The foundation of a democratic state is liberty,

Aristotle tells us, and he adds, " one part of liberty is to govern and be governed alternately ". Does the electorate, in Aristotle's words, " know how to command as well as to obey ? To do both these things well is the virtue of an accomplished citizen." As far back as September 1921 the Viceroy (Lord Reading), in addressing a joint-session of the Legislature, referred to this weak spot. Twelve months later he repeated his warnings. When addressing a joint-session in Simla in 1923 he said : " Last year I impressed on you that the electorate required education. I have the same advice to repeat to you now, but I repeat it with more force and insistence." It seems that nothing short of a complete overhauling of the national system of education will suffice. A system of sound primary education is required which will aim at imparting such simple knowledge as will be of permanent value to the taught in their daily work and help them to avoid the petty tyrannies of life which ignorance engenders. As the great Richelieu said in the seventeenth century : " When I regard the majority of those who profess to teach, and the multitude of children who are taught, I seem to see an infinite crowd of sick who need nothing but a draught of clear, sweet water for their healing. Yet so uncontrolled is the thirst which affects them that, accepting indifferently all cups which are presented to them, the greater number of them drink from tainted, and some even from poisoned, sources ; thus increasing their thirst and their malady, in place of assuaging both." The pure, sweet water of primary education would heal the malady. But it must not stop at primary education. Secondary schools should be the recruiting ground for those who are urgently wanted in commerce. banking, industry, and other responsible posts. If they possess a sound general education and are apprenticed to business they will have an economic value. Here there is material for increasing the wealth of the country. The universities, too, should shake off the incubus of the ill-prepared student and pursue knowledge not for the sake of the information to be acquired, but for the extension of knowledge and the attainment of exact truth. As Lord Brougham said a century ago : " A man should know something of everything and everything of something ". All this means money and new sources of taxation, and not a paltry sum of Rs.200 millions (£15 millions), which was the entire expenditure in British India in 1932–1933 on educa-

tion, or twelve annas or something more than one shilling per head of population, a miserably small and inadequate sum.

Rapid extension of expenditures on education is the tendency in all countries. Expenditure *per capita* and in relation to national income varies considerably between countries, although the variation in relation to national income in the major countries of Europe and the United States, a test of financial ability, is not so great. On a *per capita* basis expenditure in Great Britain is half that in the United States, but in relation to income is about the same. France and Italy spend considerably less *per capita* than Great Britain and Germany, but in relation to national income compare very favourably. There is need in many countries of greater planning of educational requirements in relation to the financial capacity of the population. Germany and the Soviet Union have made interesting experiments in this direction. In some countries the expenditure on education may be questioned on account of wastage. In India, where there is no system of compulsion, there is much wastage by the premature withdrawal of pupils from schools and these lapse back into illiteracy. No matter what stage is reached, as soon as children are of economic value to the household they leave school. Higher grants for higher classes may remedy this. Adequate inspection, too, also prevents the mis-spending of funds and keeps sanctioning authorities in close touch with the expenditure of these large sums. The reduction in the number of authorities by the concentration of all educational functions so far as local authorities are concerned in, for example, county authorities, in place of countless school boards, is advisable. Thus in Scotland, by the Act of 1918, 900-odd school boards and non-elected Secondary Education Committees were abolished, and in their place *ad hoc* county Education Authorities were created to deal with all the educational work of the area. By the Local Government Act of 1929 these have been replaced by County Councils. These are very important and responsible bodies and are served by able and responsible officials, such as the County Clerk, the County Treasurer, the Director of Education, the County Medical Officer, the County Architect, and Master of Works. The Scottish Education Department, which controls primary and secondary education by inspection, grants, codes, regulations, and circulars, and by conference and discussion with the local Education Authorities

and their expert Directors of Education, allow much more devolution and much more local responsibility than in the days of the old school boards. Grants to the extent of more than half the total expenditure are distributed by the Department on the basis of the number of teachers, the number of scholars, and the rateable value of each district, and not as in the old days on the attainments of particular pupils. The Department has power to reduce the grant on account of inefficiency and neglect of Regulations, and this is the real weapon of control. Much is done by conference and discussion, and as a result of an adverse report from the Department's inspectorate the Education Authorities always comply with the requests, and so it is not necessary to proceed to the next stage—the actual reduction of grant under section 5 of the Education Authorities (Scotland) Grant Regulations. The most characteristic features of the system, one of the finest in the world, are, firstly, the large responsibility entrusted to local elected bodies, and these bodies being *ad omnia*, education takes its place side by side with public health, housing, roads, police, etc. Financially this means co-ordination and a fixing of responsibility not existent before 1930. Educationally it means that the business man and the county councillor type takes more interest in the local administration of education. Secondly, the local Education Authority receives a lump sum grant, and is not restricted in the application of the money to any particular part of the work. Thirdly, increased attention is given to the physical well-being of the pupils, the hygiene of school buildings, the importance of practical work, games, domestic subjects, libraries, and vocational guidance. The average child in education is kept well in mind—his future life and work and not merely the University careers of the elect. All this means wise spending.

Other Social Services

4. Expenditure on other social services includes expenditure on religion, public health, unemployment insurance, pensions, national health insurance, poor relief, housing, lunacy, and similar services. Expenditure on the more important of these is dealt with in the following chapter. In an earlier chapter we referred to the change which took place in twentieth-century finance in Great Britain by the breaking away from the traditional

finance of Gladstone in the nineteenth century, when such Acts as the Old Age Pensions Acts, 1908 to 1924, the National Health Insurance Act, 1924, the Unemployment Insurance Acts, 1920–1925, and the Widows, Orphans, and Old Age Contributory Pensions Acts, 1925–1932, were placed on the Statute Book. Previous to that period the social services on which the State mainly devoted itself were education, poor relief, and lunacy. The expenditure on social services fifty years ago (1880) was 3 per cent of the national wages bill in the United Kingdom, in the pre-War year 10 per cent, and in 1929 15 per cent.

This is a good index of the growth in the social services, and it can be regarded as an addition to the real income of the wage-earning classes. This contribution is, moreover, in a form that is much more useful to the ordinary wage-earner than if it were devoted to an increase in his cash wages. He is provided with education for his children and the State makes it possible for him to discount largely the risks resulting from unemployment, ill-health, and old age. Expenditure on social services combined with the graduated taxation of wealth and income goes far to modify the distribution of wealth, especially in Great Britain, where such expenditure is greater than in any other country. In 1891 the expenditure was £23 millions, in the previous year £95 millions, and by 1927 it had risen to £383 millions. The average annual expenditure between 1921 and 1930 was £334 millions. At the present time one-eleventh of the national income is spent on this, with the result that although there is not much effect on the redistribution of ownership there have been great social effects from this expenditure. Social and individual inequality has been lessened without any serious consequences to the national economy.[1]

In other countries the effect of this expenditure has also been to compensate for checks in the rise of real wages. Even in Asiatic countries, notably in India and in Japan, where the problem of labour has become international as well as national mainly as a result of Part XIII. of the Treaty of Peace on the Organisation of Labour, the increase on social expenditure, especially on education, sanitation, and housing, is likely to be

[1] Cf. Committee on National Expenditure, chs. iii. (5) and vi.; Cmd. 3920—1931; Sykes, *British Public Expenditure*, 1921–1931, King & Son, 1933. chs. ii., viii., xiii., and xiv.

great. A very low standard of living is a menace in these days of closely knit economic solidarity not only within the nation itself but to many nations.

Religion

5. It is unnecessary here to enter in detail into the question of expenditure by the State in England and other countries on religion, because the amount is not large, and modern thought is in favour of the view that State revenues can on the whole be better devoted to other objects.[1] Experience in the United States and in the Dominions has all pointed in this direction, expecially in the former where there is almost no public money spent by the State for religious purposes. Except indirectly, through tax exemption, no State support is given. In Great Britain and on the Continent of Europe, as in France, this enlightened view continues to grow in spite of vested interests. In France no religion is recognised by the State. By the law promulgated on 9th December 1905, the Churches were separated from the State, and the adherents of all creeds were authorised to form associations for public worship. Ecclesiastics over forty-five years of age and of over twenty-five years of service remunerated by the State were entitled to a pension, and all other ecclesiastics were to receive grants during periods of from four to eight years. These were purely transitional measures. All buildings used for public worship and as dwellings in this respect were made over to the associations for public worship. Similarly, from 31st March 1920, the Church in Wales and Monmouthshire was disestablished under the Welsh Church Acts, 1914 and 1919, and the property and £1,000,000 provided by Parliament were assigned to the Welsh Commissioners, a temporary body, for distribution to a body called the Representative Body representing the Church, and to certain other authorities, including the University of Wales.

[1] Cf. Adam Smith's qualification to his doctrine that "The expense of the institutions for education and religious instruction is, likewise, no doubt, beneficial to the whole society, and may, therefore, without injustice, be defrayed by the general contribution of the whole society". He held that this "with equal propriety, and even with some advantage", may be met "by those who receive the immediate benefit, or by the voluntary contribution of those who think they have occasion for either the one or the other" (*The Wealth of Nations*, Book V. ch. i., Cannan edit., vol. ii. 300). He was by no means a sectarian, the public interests being best promoted by an equal and impartial toleration of all sects (cf. Cannan, vol. ii. 278). Adam Smith differed from Hume on the subject of sects.

CHAPTER VIII

EXPENDITURE ON THE SECONDARY FUNCTIONS OF GOVERNMENT: I. SOCIAL SERVICES (*continued*)

1. THE English poor law in the early part of the nineteenth century is a classic instance of indiscriminate charity and its many attendant evils. The method by which such charity was dispensed was virtually a demand for paupers. Adam Smith wisely eliminates in his treatment of expenditure all reference to poor relief as a recognised charge on public revenues.[1] It is still a doubtful question of financial policy, although it has been in existence for centuries in Great Britain. With the development of other forms of public assistance in the form of unemployment and health insurance and old age pensions it is becoming of much less importance than formerly. The history of poor relief, especially from the passing of Gilbert's Act,[2] 1782, which increased the cost of relief by nearly 30 per cent by obliging Guardians to find for all unemployed poor persons work suitable to their strength and near their homes, the Act of 1796,[3] which legalised outdoor relief to the able-bodied and gave it in aid of wages, the re-establishment last century of the old workhouse test and the changes that have taken place in the last fifty years modifying and liberalising the legislation of 1834, illustrates the baneful evils of this form of expenditure, which has, it has been said, crippled industry and affected public morality [4] by putting a premium on the increase of numbers. As a witness before the Poor Law Commission which led to the Poor Law Amendment Act of 1834 said, " Poor is the diet of the pauper, poorer is the diet of the small ratepayer, but poorest is that of the independent labourer ". This recalls Arthur Young's remarks in

[1] Possibly, in Bonar's view, because in effect there was no Scotch Poor Law.
[2] 22 Geo. III. c. 83. [3] 36 Geo. III. c. 23.
[4] Vide *Report of Poor Law Commissioners*, 1834.

the *Annals of Agriculture*, " The motives to industry and frugality are cut up by the roots, whenever a poor man knows that if he do not feed himself the parish must do it for him; and that he has not the most distant hope of ever attaining independency, let him be as industrious and frugal as he may ". Since the War the problem has once more come into prominence. The administration of this form of expenditure by Boards of Guardians in England, elected largely by prospective beneficiaries in many cases, proved a failure. The post-War unemployment has brought the question of outdoor relief of the able-bodied again into prominence, especially in connection with the scandals in several distressed areas where local administration had to be superseded by the Central Government (the Ministry of Health).[1] In Bermondsey in February 1928, for example, 17,787, one in every seven persons resident in the parish, were in receipt of relief as compared with 1849 in 1913. The cost of relief was four times what it was in 1913, notwithstanding the cost of living was only 70 per cent above the pre-War level and 51s. a week was the highest amount payable as relief, approximating to the wages of a worker in the factories of the district. There was very inadequate investigation, an absence of tests for able-bodied applicants. There was no incentive to work, idleness was encouraged, and relief even exceeded unskilled wages or even in some cases skilled wages. The system of administration involved unnecessary duplication. County Councils, for example, maintained their own large and well-equipped hospital organisation, while each of the 625 Boards of Guardians had its separate hospital for the destitute. Wastefulness is well illustrated by the County of Cornwall previous to the recent Act. The average number of paupers in this county was about 5000, of whom 3000 were concentrated in a single union and about 600 members belonged to 13 Boards of Guardians in the county. In Scotland, where the unit was the parish—not, as in England, the union—more than three-quarters of the pauperism in the whole country is concentrated in thirty-seven parishes; the remainder is scattered over the other 832 parishes. The Poor Law Acts of 1927 and 1930 consolidated several centuries of poor laws into a code. By the Local Government Act of 1929, in order to spread the

[1] Previous to 1st July 1919 (when the Ministry of Health came into being), the office was known as the Local Government Board.

burden of expenditure more evenly and to secure greater economy and efficiency of administration, the administration of poor relief is transferred in England from the Boards of Guardians and the Councils of urban and rural districts and municipal boroughs to the Councils of counties and county boroughs. The asset of local talent by Public Assistance Committees is not wasted, especially as these Committees may delegate their powers to Guardians Committees. The danger of over-centralisation is thus avoided. This transfer was recommended in 1888 and again in 1909 by the Poor Law Commission, and in 1918 by the Maclean Committee. The concentration of resources to meet the fluctuating costs of Poor Law relief will thus be possible. In 1926–1927 they varied from 2½d. in the £ to 10s. 5d. in England, and from nil to 17s. 3d. in Scotland. The Act for Scotland transfers the administration to the County Councils and Town Councils of the large burghs —namely, those with more than 20,000 inhabitants—and provides for the setting up, as in the case of England, of statutory committees and the delegation of functions to local committees. There are 869 parishes in Scotland, and the effect of the transfer has been to reduce the number of Poor Law authorities to 52. The Maclean Committee principle has thus been carried into effect, and it is a sound principle of expenditure, viz. if the fulfilment of the demand for improved social services is to be reconciled with the duty of securing both economy and efficiency in public expenditure, the reorganisation of public assistance must be carried out, based " upon the unification of services, the reduction in the number of separate authorities, and the choice of the most suitable area of administration ".[1]

The expenditure by local authorities in England and Wales since 1834 was approximately 1097 million pounds sterling. For the year ended March 1932 the total expenditure from rates, Government grants, and other sources, in England and Wales

[1] By the Unemployment Act of 1934 the centralisation of poor relief in certain circumstances has taken place. Local authorities no longer have power to give outdoor relief to persons whose needs have been met by the Unemployment Assistance Board, although the duty of giving relief in cases of urgent necessity remains upon the relieving officers. The Board reimburses Local Authorities for any relief so given. Public Assistance Authorities, however, retain their existing powers and duties in relation to assistance for the sick, aged, and infirm. They are also responsible for the medical needs and institutional or clinical treatment of persons who otherwise are under the Board.

was nearly £37 millions, and over £5 millions in Scotland. The pre-War year figures were £14·9 and £1·5 millions respectively. The causes of this large increase are unemployment, generous outdoor relief, a decided change in the attitude to relief—it is a short step from the " dole " to the acceptance of relief—and to changed public opinion in regard to the poor and their children leading to much larger spending. Generally speaking, if poor relief is necessary, it should be given indoor, and the reform of the habitual pauper should be regarded somewhat in the same way as the reform of the habitual drunkard or criminal. The procedure followed in some other countries is not without interest. In Germany the relief of the poor is regulated by the law of February 13, 1924, by which relief is granted by District Unions (Bezirksfuersorgeverbände) or Provincial and State Unions (Landesfuersorgeverbände). Relief is granted in the ordinary place of residence of the recipients, usually by the District Unions ; but where the recipient has no ordinary place of residence the provincial unions make the grant. Relief may be made dependent on labour, and requires a thorough examination of each individual. It aims at restoring his economic independence. German policy, however, is to prevent the necessity of poor relief by the adoption of widespread social insurance—old age, health, and unemployment insurance. In France poor relief is given through local *bureaux de bienfaisance*, and also through private and ecclesiastical sources. The communes and the departments look after the poor, and Government exercise general supervision. A general right to relief from the State is not recognised as in Italy except in the case of lunatics and children. The cost of relief is met by local and general taxation, from endowments, gifts, and charitable bequests. In the United States poor law administration, owing to the complete absence, until recently, of federal relief, varied in the different states. In New England, for example, the township is the unit of administration, while in the other states the county system operates. Where the county system obtains, the administration is in the hands of a board of county commissioners, or of specially elected county officers, or of the county court. In large cities relief is, as a rule, administered by salaried officers. In New York, Connecticut, and some other states there is the recognition of individual claims to relief, and in recent years some states have adopted old age and mothers'

pensions. Since 1929 there has been a movement for unemployment insurance both on a national as well as on a State basis. In June 1934 the Federal Government had on its relief rolls 3,716,755 families and 512,701 single persons. These figures excluded those who are employed under certain special administrations. This precedent of Federal Government aid in regard to social services is not likely to be forgotten, notwithstanding the exceptional circumstances which necessitated federal assistance in many directions. In Japan legislation in 1899 provided that the minimum amount of prefectural funds for "the relief of sufferers from extreme calamity" shall be half a million yen, and funds below that amount are to be made up by the Treasury. When the amount of relief exceeds 5 per cent of the funds at the beginning of the financial year, one-third of the amount granted is to be supplied from the Treasury. In New Zealand charitable relief and hospitals are subsidised by the Government in the following manner, which is of considerable interest: contributions to local authorities, according to a sliding scale based on the value of rateable property, ranging from 14s. in the pound to 26s. in the pound, and averaging throughout the Dominion 20s. in the pound. In India there is no system of poor relief. In times of famine, however, relief is necessary, and for this purpose each province has to set aside a fixed sum (which is not uniform, but varies according to the liability of each province to famine) year by year. Expenditure from this Famine Relief fund is made only on the relief of famine due to drought or such other natural calamity, and no expenditure except famine relief is met from the balances of this fund until they exceed a certain prescribed amount.

2. The second half of the nineteenth century was, as we have seen, remarkable for the teaching, especially in Germany, of the increased activities of the State. Even before the Franco-Prussian War, writers of the school of Wagner, Schmoller, and other "Kathedersocialisten" profoundly affected the public mind, and their views on State insurance were slowly but surely gaining general acceptance. In the eighties of the last century Germany introduced social insurance, which comprised compulsory insurance of workmen against sickness, insurance against accidents by employers, and the insurance of workmen against old age and infirmity. Denmark followed in 1891 with

a law on old age pensions. The question in Great Britain received from statesmen, writers, and others the attention in the last twenty years of the nineteenth century which its importance undoubtedly merited. It was considered, for example, in the Report of the Select Committee on National Provident Insurance (1887), the Report of the Royal Commission on Aged Poor (1895), the Report of Lord Rothschild's Committee (1898), the Report of the Select Committee on Aged Deserving Poor (1899), and in the Report of the Departmental Committee about the Aged Deserving Poor (1900). The proposals came within the sphere of practical politics before Mr. Asquith pledged in 1907 in his Budget Speech the Liberal Government to start a scheme of old age pensions. These pensions came into force from 1st January 1909, the Old Age Pensions Act having been passed in the previous year. Provision was also made under the National Health Insurance Acts, 1911 to 1924, the Unemployment Insurance Acts, 1920–1934, and the Widows, Orphans, and Old Age Contributory Pensions Acts, 1925–1932, for insurance against loss of health, cure of sickness, insurance against unemployment, and pensions for widows, orphans, and aged persons. Australia in 1908 and New Zealand in 1898, of the self-governing Dominions, introduced old age pensions. Australia, too, possesses a system of health insurance on a non-contributory basis in the form of invalid pensions and maternity allowances, while New Zealand and Canada, following the well-known examples of Germany and Great Britain, also possess employment offices or labour bureaux. France in 1905 and Spain in 1908 adopted old age pensions, and in 1928 France passed a law for the compulsory social insurance of wage-earners against incapacity, old age, death, and it extends to unemployment and maternity benefits. It came into force in 1930. In 1911 Switzerland adopted a scheme of insurance against illness, but not of a compulsory kind.[1] Holland in 1916 introduced a scheme of unemployment insurance. Three years later Poland began a scheme of health insurance which was obligatory for wage-earners. We have only to mention that even in Iceland (*mirabile dictu*) there is an old age pension fund in every community, contributed to by the community and the

[1] Insurance against accident, however, is compulsory for all officials, employees, and workmen of all concerns and trades which are within the Federal Liability Law.

State. We sometimes are apt to minimise the extent to which the State's activity expanded in the last three decades, especially in the decade after the War. Examples of State action and the discrediting of *laissez-faire* may be seen in the subsidy to wages in the form of old age pensions, health and unemployment insurance, education, hospitals, maternity and child welfare, lunacy and mental welfare, and housing. It is seen in the form of State regulation (*e.g.* the Trade Boards Acts) in regard to wages. We see it, too, in another form where the distribution of income has been altered by steep progressive taxation of income. In all capitalistic countries in the present century, especially since the World War, public assistance outside the poor law has been greatly increased. It is now regarded as the duty of the State to eradicate the conditions conducive to destitution, and no longer in modern social policy is such destitution the responsibility of the individual. With this development poor relief is of diminishing importance.

3. A glance at the Budgets of countries of industrial importance shows how these items of expenditure have expanded on the part of the State, local governmental authority, and contributors themselves.[1] With the enlargement of franchise, both for men and women, in recent years, and with the tendency on the part of the rival political parties to buy electoral support with the promise of increased reforms of a social nature, often regardless of cost, not to mention the rise in prices after the War, which necessitated a revision of salaries, allowances, and benefits, there has been a very decided increase in the expenditure on the social services. In Great Britain, for example, the total payments in 1933–1934 under unemployment insurance were £49,570,000, of which insurance benefit paid amounted to £40,290,000. The contributions to the unemployment fund from employers and employees were £39,670,000, and from the State, Exchequer "equal thirds", £19,800,000. In addition to the Insurance Account Expenditure £49,570,000 was the cost of transitional payments to those outside insurance benefit and of the administration of these payments amounting to £52,250,000, borne wholly by the State. The number of insured persons under the health insurance scheme in England and Wales in 1932–1933 was 18·5 million persons and the expenditure on benefits £31,750,000.

[1] See League of Nations Memorandum on Public Finance, 1926–1928, Geneva.

Non-contributory old age pensions for the year 1932–1933 amounted to £40 millions and the number of pensions paid was nearly a million and a half, excluding those under the contributory Old Age Pensions Acts, who numbered 664,000. The pensions paid under these latter Acts amounted to £18 millions. The estimated cost of social services in Great Britain in 1911 was £63 millions, and of this sum £28 millions was from the Exchequer, £31 millions from local rates, and only £4 millions from contributions, fees, and rents. In 1929 the cost had risen to £345 millions, of which £127 millions was from the Exchequer, £127 millions from contributions by the beneficiaries or their employers, fees and rents, and only £91 millions from rates. This change in distribution is important, and the larger share of the national Government in the cost is striking. It explains the increased control which Government must necessarily exercise in the spending of such large sums. Some of these items were non-existent or almost so in 1911, such as unemployment and health insurance, and so comparison with 1929 is impossible. But in the case of other items there have been enormous increases, the chief of which are housing (from £0·9 to £31·6 millions), old age pensions (from £7·4 to £58·7 millions), poor relief (from £16·1 to £43·9 millions), and education (from £33·5 to £97 millions). The expenditure on social services in other countries of chief industrial importance tells the same tale. The Royal Commission on Health Insurance in its Report, 1926, estimated, it may be noted, the relative cost of five social services (unemployment, health, workmen's compensation, old age pensions, and poor law relief) per head of population in Great Britain, Germany, France, Belgium, Italy, as follows: Great Britain, 100; Germany, 48; France, 17; Belgium, 7; and Italy, 4.

An incredible tide of expenditure on housing by governmental authority has taken place since the War. The problem is world-wide, and is the result, in no small degree, of the stoppage of building in war-time, of rent restrictions, and of a remarkable change in the attitude to working-class housing and overcrowding, notably by national Governments and electorates. In France rent restriction was undertaken at the beginning of the War; in Great Britain in 1915; in Norway, Denmark, and Hungary in 1916; and in Austria, Italy, Holland, Switzerland, Sweden, and Germany in 1917. The result was an almost complete cessation

of building. Even as late as 1925 the shortage of houses in Germany was 800,000, and in 1927 it was officially estimated in Poland that the shortage was 1,000,000 houses as compared with a total number of dwellings of 1,300,000 in the cities and 3,500,000 in the rural districts of the country. In France, especially in the War areas, in Belgium, Italy, Austria, Hungary, Czechoslovakia, and the Balkans the shortage was also acute. In the United States in 1917 housing legislation was passed for Minneapolis and Michigan, in 1919 for Iowa, and rent control for some years was enacted after the War in Washington, D.C., and New York. In several states of the Union, however, there are constitutional limitations which prevent the state undertaking housing schemes, and this explains, to some extent, the lack of a definite housing policy in that country to-day. Notwithstanding constitutional limitations against housing loans, New York State has encouraged the construction of houses by indirect methods such as by limited dividend companies. It is not, however, surprising, when post-War housing conditions in various countries are examined, that ideas of planned economy and Government intervention should have produced the demand for an entirely new policy of the production and distribution of houses.

The finance of housing has not followed a uniform policy in all countries. The main methods of providing funds have been, firstly, the raising of loans; secondly, special taxation; and thirdly, the providing of funds out of revenue in the budget. The raising of loans chiefly by local authorities has produced large sums for housing. The State itself sometimes raises loans or, as in Austria (outside of Vienna), guaranteed these. In some cases Government-owned corporations have been responsible for the capital required, as in the case of Belgium where the Government-owned corporation is known as the Societé Nationale des Habitations à Bon Marché. Building societies in Great Britain, building savings banks in Germany, credit societies in the Latin countries, and housing banks in Scandinavia, have furnished very considerable amounts of capital for housing construction. These Scandinavian banks make loans guaranteed by the State, and they received, too, financial assistance from the State when required. The raising of loans by the State makes it possible to provide private builders and private utility societies with funds at rates which compare favourably with ordinary mortgage loans. For

example, in Germany and Austria, and other countries on the Continent, public loans are floated for this purpose at 1 or 2 per cent below the prevailing rate on first-class mortgage loans. The second method is special taxation for providing funds for housing, frequently on the permitted increase in rents of old houses. The special tax on rentals in Austria and the special house rent tax—the Hauszinssteuer—in Germany are good examples of such taxes. Between 1924 and 1930 the Hauszinssteuer in Germany accounted for nearly one-half of the funds raised for housing, and the proceeds were advanced in mortgage loans to builders. The city of Vienna, which has, since the War, undertaken a very large building programme, covers part of the cost by a heavily progressive tax on the rents of the older houses. Funds are also provided for housing out of revenue, *i.e.* from the national budget as in Great Britain in the post-War years under the Housing Acts of 1919, 1923, 1924, and 1930 and subsequent years. These funds are spent in various ways. They may be spent by public bodies themselves such as municipalities or cities, or may be given in the form of subsidies. Lump-sum grants may be made to builders to cover the part of invested capital which can neither earn interest nor be amortised on the expected rental income. The subsidy varied with the cost or with the type of building. This latter method of subsidy was followed in England, Germany, and elsewhere during the first post-War years, but was abandoned generally because it was wasteful. In its place there was a guarantee to builders of annual payments for long periods in order to cover the deficiency in rental income. The principle embodied in the British Housing Act, 1924, which is certainly sound, was that the subsidies must gradually decline with the cost of housing. In some countries there is exemption from taxes in the case of low-rented houses for a limited period. This is in effect a negative subsidy. In Latin countries, for example, tax exemptions have been the most important aid given to private builders. It has also been an important factor in the solution of the housing shortage in New York City. Tax exemptions on this account in New York City have cost over the ten-year period (1921–1930) nearly $200 millions. The net increase in houses in the decade was over 600,000. In New York State, as there is a constitutional bar against State housing loans, State encouragement to construction has been given by the State Board of Housing created in 1926, which passes

the plans on to the limited dividend housing corporations. Those which are approved are exempted for a stated period from State mortgage and franchise taxes. A member of the State Board is on the Directorate of each approved country, so that inexperience is placed at a minimum.

The magnitude of the housing problem may be instanced by an examination of the expenditure in Great Britain in recent years. A large capital expenditure has been spread over long periods. Under the various post-War Housing Acts, 1919, 1923, 1924, and 1926, the liabilities incurred by the State up to 1931 for houses already built in England and Wales were £188,639,000 and the number of houses built up to that date under these Acts was 959,670. The net expenditure on houses in Great Britain—ordinary and new loan expenditure—was in the pre-War year £1·27 millions and was entirely undertaken by local authorities. In 1927–1928 this had risen to £88·2 millions, of which £11·12 millions were from the national budget, £2·92 from the local authorities, and the new loan (local) expenditure amounted to £74·2 millions. During the period 1919 to 1929 the number of houses erected was 1,600,000, of which 600,000 were undertaken by local authorities and 425,000 by private enterprise. The loans for building schemes raised by local authorities amounted to £400 millions by 31st March 1930. The acute phase of the housing shortage had passed, and the clearing of slum areas in cities and the raising of standards even in rural areas remained to be tackled. The Housing (Financial Provisions) Act of 1933 abolished existing subsidies in respect of slum clearances and assisted building housing societies to finance the building of houses for letting. The danger of housing policies at present is that States may commit themselves without proper forethought to the dangerous principle, noted by the British Committee on National Expenditure, that the wages of the worker are not normally intended to pay fully for his housing—a principle which, if accepted, would not stop at housing but extend to his other wants.

4. Public expenditure on unemployment relief has in recent years been very considerable in many industrial countries. It is now regarded as a permanent feature in the code of social legislation. In Great Britain £500 millions, apart from poor relief, were paid out between 1921 and 1929, a sum which would have revolutionised the industrial equipment of the country. It has

not been paid entirely by the State. Of £291 millions paid out between November 1920 and December 1926 employers contributed £102 millions, workers £92 millions, the State £69 millions, Government Departments as employers £4 millions, and the balance, £24 millions, was borrowed from the State. Since 1920 unemployment has been abnormally high in many countries, as the statistical tables published by the League of Nations monthly and annually only too clearly testify. In Great Britain since 1920 unemployment has been far higher than in any decade since 1860, and its far-reaching economic and social effects represented in loss of strength and morale, profits, and taxation are comparable only to the ravages of war and disease. Other countries like Russia, Germany, Norway, Sweden, Denmark, Holland show high percentages of unemployed. In the United States, where there is no universal unemployment insurance by the State, Congress passed in August 1935 the Social Security Act, which is a great advance.[1] In Great Britain the number of unemployed insured workpeople wholly unemployed was in 1933 above 2,000,000, and this figure of two millions represents roughly 16 per cent unemployed as against 9,904,000 or 8 per cent in 1929. Contributory schemes should provide that the extent of the benefit should not tempt the insured contributor to improvidence when in receipt of good wages, and it should be less than the general labourer's rate of wage in order to avoid the temptation to prefer benefit to work. It should not unduly restrict the mobility of work. The worker's contribution should be moderate and, subject to these principles, it should be as attractive as on an actuarial basis it is possible to make it. In some countries relief works have been opened as a substitute for relief without work. In Sweden, after the collapse of the post-War boom, the Government, in order to solve the unemployment problem, undertook this through an Unemployment Commission consisting of representatives of employers, workers, and State officials. This Commission gave assistance through local authorities strictly in

[1] This Act, which was signed by the President on 14th of August, does not establish a Federal system of unemployment insurance, but encourages the institution of statutory schemes of unemployment compensation in the several States of the Union, (1) by the provision of Federal grants towards the administrative cost of such schemes, and (2) by remitting up to 90 per cent of the supplementary tax on private employers for unemployment insurance in cases where the employer is paying contributions to unemployment funds established under State laws and approved by the Social Security Board.

accordance with rules, and relief was given in such a form as not to deter workmen from applying for work in the open market. Rent restrictions were abolished in order to facilitate the movement of labour. Relief without work was given only to those for whom relief works were not available. Neither was given to a worker unless he could not obtain work. The wages at relief works were higher than the payments of relief without work, and both were always lower than the ordinary wages in the locality. Efforts by employers to get the funds as subsidies for industries were always rejected, as subsidies would prevent the wage standard falling to the proper economic level, the point of equilibrium between supply and demand. The Commission assumed that the causes of unemployment in Sweden were primarily due to the immobility of labour from one place to another and from one trade to another, and to the slowness of wages to adjust themselves to changes in market conditions. All labour could be given employment at a certain level of prices and wages. In the most depressed industries in Great Britain wages in the coal, iron, and cotton industries are already, it is said, at subsistence level, and a further reduction would result in a lowering of the standard of living. This would be impossible for political reasons, as organised labour would prefer the burden of millions unemployed to any decrease in the standard of comforts.

5. There is an unusual want of uniformity in the payment of old age pensions; *e.g.* in Australia, New Zealand, and Denmark they are non-contributory, while in France and in Germany they are contributory.[1] In Great Britain they are mainly non-contributory. The case for the payment of gratuitous pensions is

[1] The Social Security Act in the United States makes provision for the assistance to aged persons under two headings by (*a*) authorising appropriations from the Federal Treasury for the provision of grants-in-aid of State plan for the assistance of aged and needy persons, and (*b*) establishing a Federal system of old-age pensions payable not earlier than 1st January 1942. To meet this employers and workers are each required to pay a progressively increasing tax in respect of wages, excepting those engaged in agriculture, private domestic service, or as an officer or member of the crew of a vessel sailing under the laws of the United States or of any foreign country. The amount of the tax is fixed equally for employers and workers as 1 per cent of the wage for employment in the calendar years 1937, 1938, and 1939, and thereby increasing progressively by one-half per cent for every three-year period up to a maximum of 3 per cent after 31st December 1948. At the end of 1935 the following nine States, apart from the district of Columbia, had unemployment insurance legislation: Alabama, California, Massachusetts, New Hampshire, New York, North Carolina, Utah, Washington, and Wisconsin.

that the class from which pauperism is drawn would not benefit unless they were non-contributory. Charles Booth, in his *Old Age Pensions* (1899), was the protagonist of this view. On the other hand, Mr. Chamberlain opposed strongly this view, and held that it should be contributory and voluntary. Speaking in May 1899, he described Booth's universal scheme as " a gigantic system of outdoor relief for everyone, good and bad, thrifty and unthrifty, the waster, drunkard, and idler, as well as the industrious ". But the payment of these pensions has added to the incomes of the poor. This has led to an enhanced degree of comfort and contentment among the pensioners, and has freed the workers from maintaining dependents. The workers have thus been able to keep up their consumption standards during their working life and therefore efficiency has been preserved. There is, too, no exact uniformity in regard to the age at which pensions should be paid. In some countries 70 years and over has been taken as the age.[1] In Great Britain the age is 70 years and over, except for blind persons, where the minimum age has been reduced to 50 years. In Australia the qualifying age is 65 years. It is a good plan to decrease the pension as the income advances. The pension in Great Britain, for example, varies from ten shillings weekly when the yearly income does not exceed £26 : 5s., to one shilling when the yearly income exceeds £47 : 5s., but not £49 : 17 : 6, no pension being payable above this sum. A deduction not exceeding £39 a year (or £78 a year for a married couple living together) is allowed from means other than earnings in order not to penalise thrift. Thus a married couple living together may draw the full pension of 10s. a week if they have total means (other than earnings) amounting to £130 : 10s. (£52 : 10s. + £78), thus, as the Committee on National Expenditure points out, giving them an annual income of £182 : 10s. There has been a large increase in the proportion of pensioners to the total population over 70, mainly attributable to the Old Age Pensions Act of 1924. Excluding " blind " pensions the percentage rose from 58 per cent in 1924 to 75 in 1931. The British national health insurance scheme includes both those who are compulsorily insured, known as employed contributors, and those who may become voluntary contributors. The benefits include free

[1] Under the Social Security Act in the United States the age fixed is 65 years (until 1st January 1940, not more than 70 years).

medical treatment, sanatorium treatment, payments during sickness (ordinary rate, 15 shillings per week for men, 12 shillings for unmarried women and widows, and 10 shillings for married women), disablement after 26 weeks sickness benefit (7 shillings and 6 pence per week for men, 6 shillings for unmarried women and widows, and 5 shillings for married women), in the case of women a payment of 40 shillings on confinement. Insured persons who are not members of an approved society are to contribute to a Post Office Fund and are known as deposit contributors. Their benefits are somewhat less than those of ordinary contributors. Under the British unemployment scheme, the scheme of transitional payments, which, like the national health insurance, is contributory on the part of the employer, employee, and the State, the ordinary benefit consists of a weekly payment of 17 shillings per week for a man together with 9 shillings for each adult dependent and 3 shillings for each young child, and 15 shillings for a woman. The rate for boys (16 to 17) is 6 shillings, for girls (16 to 17) 5 shillings; for boys (17 to 18) 9 shillings, and girls 7 shillings and 6 pence of the same age; for boys and girls (18 to 21) 14 and 12 shillings respectively, and for juveniles (14, the school-leaving age, to 16), 3 shillings a week payable to parents.[1] Thus a man with a wife and five dependent children would draw 41 shillings a week in unemployment benefit. The maximum period of benefit is, under the insurance scheme of 1934, a full 12 months as a maximum, *i.e.* 26 weeks in addition to the 26 weeks he gets as a minimum in a "benefit year".[2] Transitional payments are also given by the State, but only on proof of need when the applicant is not eligible for ordinary benefit, the appropriate benefit rate being the maximum limit. By the Unemployment Act, 1934, the State is now responsible for public assistance covering all persons between the ages of 16 and 65. The Act embraces practically all the able-bodied unemployed in the country, including non-manual workers

[1] Cf. the Merseyside poverty line standards, 1929–1934, 27s. 7d. for family of man, wife, and one infant; 37s. 7d. for two adults (husband and wife), one infant, and two school children; 46s. 2d. for two adults, two infants, and three school children. Poor relief for families of these sizes was respectively 22s., 29s., and 35s. (*Survey of Merseyside*, vol. i. p. 150 (Liverpool Univ. Press, 1934).

[2] *Vide* the Unemployment Act, 1934 (24 & 25 Geo. V. ch. 29), cf. *The Ministry of Labour Gazette*, July 1934, p. 230, and November 1935, p. 415. Part I. of the Act deals with unemployment insurance; and Part II. with unemployment assistance covering all persons between the ages of 16 and 65.

with incomes when in employment of under £250 a year. At the end of 1933, for example, only about 42 per cent of the employed were entitled to insurance benefit. An additional 45 per cent received transitional payments; and there were 13 per cent either beyond the range of insurance or for other reasons not entitled to benefit or transitional payments. In addition to insurance by the State there are, of course, friendly societies or trade unions which make grants to members. Poor Law Authorities (except in some cases, especially in Scotland) give, in addition to this, outdoor relief up to a sum which varies considerably according to localities, the family cares of the applicant, etc., and this may be combined with unemployment benefit.

6. To sum up. In this and the previous chapter the growth in expenditure on social services and the effects of that expenditure have been discussed. The increase on education, poor relief, housing, public health, lunacy and mental deficiency, national health insurance, unemployment insurance, old age pensions, and similar heads of expenditure, is most noticeable during the present century. In Great Britain, for example, in less than two decades, *i.e.* between 1911 and 1929 the cost increased five-fold, the charge on rates was trebled, and the charge on the Government increased four to five times.[1] In countries where this expenditure has been incurred the quality of the wage-earning classes, perhaps the most important factor in industrial efficiency, has improved, especially in the lowest classes of the population. Public policy, notably in regard to education and sanitation, is to a large degree, but not entirely, responsible for this. The expenditure on social services, as indicated on page 111, has been an addition to the real income of the wage-earning classes. The extension of the social services combined with steeply graded progressive taxation has resulted in an improved distribution of wealth. The standard of living of the working classes, in spite of the prolonged depression after the War, has been maintained, if not improved, by the expenditure on pensions, health and unemployment insurance, housing, education, and similar services. There has been an approximation in the standards of consumption among the various classes. In many countries there has been a very substantial increase in the demand for

[1] Report of the Committee on National Expenditure, Cmd. 3920, 1931, p. 145.

consumption goods and services. Had there been no War and had the taxation for the War and its legacy in the form of national debts been spent on social services the standard of living would have been much higher than it is. Nevertheless, the progress towards a solution of the problem of poverty, the aim of economic study, has been greater in the last twenty years than in any corresponding period of this or the last century. "In so far", say the authors of a recent report, "as the taxation which is raised to defray social expenditure is really prejudicial to industrial activity we pay a price for the improved distribution of wealth in the shape of diminished productivity and diminished aggregate wealth. Clearly a point comes at which it is not worth while to pay this price, and there is nothing to be said for a policy which would impoverish the rich without serving, on balance, to improve the condition of the poor. None the less, a more equal distribution of wealth is so important, it is indeed so imperative to move steadily and manifestly in this direction if we are to build up a truly democratic society, secure against the evil passions and subversive dangers of class-hatred, that we must be careful not to discard on inadequate or ill-considered grounds a policy which makes for a better distribution of wealth."[1] The heavy taxation of large incomes is well illustrated in the case of direct and indirect taxation in Great Britain of a married taxpayer with three children in 1925–1926 as compared with the pre-War year and twenty years ago. The taxation on incomes of £100 and £1000 is on the assumption these are earned, and those of higher amounts half earned and half investment.[2]

£	1903–1904.	1913–1914.	1925–1926.
	Per cent.	Per cent.	Per cent.
100	6	5	12
1,000	6	5	11
5,000	8	10	30
10,000	8	12	40
50,000	8	14	58

Notwithstanding the heavy progressive taxation especially in the highest strata during the post-War years, account must

[1] Report of the Liberal Industrial Enquiry, 1928, p. 431.

[2] Report of the Committee on National Debt and Taxation, Cmd. 2800, 1927.

be taken of the fact that there have been considerable payments as interest on public debts to the very classes paying this taxation. Three-fourths of the cost of the War were defrayed from loans, and it is the richer not the poorer classes who hold, as individuals, these commands over purchasing power. When the effect of the cost of the social services is examined, it will be found that the effect on the population as a whole has not been disadvantageous but rather the reverse. The distribution of the national income has improved; the demand for consumption goods and services has increased, a fact which has led to increased production for the home market; an analysis of trade returns shows substantial increases in goods, especially in food-stuffs and clothing—a fact closely connected with a high standard of living; the consumption of the richer classes has not been reduced, if at all, and certainly by much less than the standard has been increased in the case of the poorer classes. This has been, in no small degree, brought about by changed methods of taxing and spending. Expenditure on the social services may, however, have led to a possible fall in the exports in the case of Great Britain relatively to imports, and this diminishes the balance available for foreign lending. In this respect the effect of the change may be considered unfavourable. There has been, however, a considerable increase in the small savings in the country with the reduction of poverty and with the raising of the standards of the poorer classes. The small savings now amount to £2500 millions. In short, on the one hand incomes have been taxed heavily, but these have gained on the other hand from debt interest payments. The altered system of taxation and spending has added to the national dividend.

The greatest need in all countries in regard to the administration of the social services is closer connexion between the authorities responsible for the administration of these services and also greater co-ordination among the various destitution services, such as poor relief, unemployment, and old age pensions, and anti-destitution services, such as education and public health. Lack of co-ordination has resulted in wasteful expenditure, and there is need for a much greater need of uniformity in local authority practice by a greater degree of central supervision. The magnitude of the expenditure itself in recent years has compelled the State as well as local authorities to review the position.

In Great Britain, for example, between 1920 and 1933 about thirty Acts of Parliament connected with unemployment insurance relief and other social services were passed, and this legislation was of a very piecemeal character. Nevertheless, attempts at greater co-ordination were made and made successfully. After sixty years of *ad hoc* administration the Local Government Act of 1929 (which came into force on 1st April 1930) provided for unified local control of poor relief, education, and health. The unification of administration in the county council or the city or borough council, and the abolition of many smaller and independent authorities in education and poor relief, have resulted in increased efficiency in administration and the avoidance of considerable overlapping and wasteful expenditure. The central control by the Ministry of Health and the Board of Education in the case of England and Wales, has in recent years, with the improvement in the unified county authority, improved the standard of administration of these services. In 1934 the Unemployment Act was passed giving a new form to insurance against unemployment, the 1931 scheme of transitional payments, and part of the Poor Law system dating from the reign of Queen Elizabeth. This Act is not only one of the most comprehensive and constructive pieces of social legislation that have been passed by Parliament for many generations, but it is an excellent example of co-ordination and a *via media* between centralised and decentralised administration. Considerations of costs required that unemployment should be the responsibility of the central government, which was paying at the time the Act was passed in respect of unemployment assistance £51 millions as transitional benefits while over 200 local authorities were providing only £5 millions. There was complete divorce between the central authority providing the funds and the local authority with regard to its disbursement. There was, too, great disparity in treatment between one man and another although their circumstances were identical. A national authority, therefore, was necessary to take a comprehensive view of the whole problem. The scheme adopted was to keep the Minister of Labour free from the responsibilities for individual decisions in order that the whole question of discretionary payments may be kept out of politics while at the same time maintaining the right of Parliament to control general policy and the general standard of assistance to

be adopted. Local authorities which had no authority for raising the money were not to have the responsibility of spending it, especially in view of the experience with regard to some authorities in the ten years preceding the passing of the legislation. A National Assistance Board to administer assistance was appointed in accordance with regulations which required the previous approval and authority of Parliament. This Board is responsible for the relief of all the able-bodied industrial poor between 16 and 65. For 300 years the relief of destitution was the duty of local authorities, but by the Act of 1934 the State took over the relief of all destitution throughout industry. The relief scheme is parallel to the insurance scheme. The former is the duty of the National Assistance Board, whose detailed administration is not meant to be subject to Parliamentary review. The latter is administered directly on insurance principles by the Minister of Labour. By this Act there is no disparaging contrast as formerly between transitional payments and poor law relief, as there is now only one form of relief for all categories of workers—unemployment assistance. Relief is proportional to need and the test is that of the household, since it is but fair that a man should turn to his own family for assistance in need before he calls upon the taxpayer. The Board is assisted in their local administration by local tribunals to which an aggrieved applicant for relief may appeal. One represents the Board as the authority responsible for the decision; another is chosen from the panel of workers' representatives; and the third, the Chairman, is appointed by the Minister of Labour. In practice in disputed cases the responsibility for a decision rests with the Minister's representative. This legislation thus illustrates the principle of concatenation which is so desirable in all countries to avoid wasteful expenditure. More efficient administration will also avoid the tendency to wasteful expenditure which has been noticed by the payment sometimes of unnecessary high wages and salaries and also benefits. The high post-War salaries, for example, in Great Britain, of teachers under the Burnham scales and benefits which were not adjusted to the fall in prices in unemployment and health insurance, are examples of this.

CHAPTER IX

EXPENDITURE ON THE SECONDARY FUNCTIONS OF GOVERNMENT: II. DEVELOPMENT: AND III. MISCELLANEOUS SERVICES

1. THE next main group of public expenditure promotes the economic development of the country and includes Government or public undertakings, and this extends to railways; irrigation works; other public works such as roads, canals, and buildings; posts and telegraphs; mints; stationery and printing; forests; ports and pilotage; scientific departments; and miscellaneous undertakings such as patents, standards, departments of agriculture, fisheries, mines, transport and overseas trade, mercantile marine services, economic advisory councils, and colonial development. The limits of this field of expenditure vary from country to country, but, with the passing of *laissez-faire*, development expenditure has greatly increased in most countries. In Great Britain between 1924 and 1931, for example, home development expenditure increased by £46 millions on derating, roads, and agriculture, or more than twice the increase on the expenditure on the social services. In India this group of expenditure is from one-fifth to one-fourth of the gross expenditure from central and provincial revenues. In the pre-War year it was 25·7 per cent, and in the year (1933–1934) 16·4 per cent.[1] In other countries this percentage may be much less or much greater, according to local circumstances. In India, for example, railways belong to the State; so do irrigation works, both productive and unproductive.[2]

[1] *Vide* Table III. App.

[2] Productive works are those which within ten years of the completion of construction produce sufficient revenue to cover their working expenses and the interest charges of their capital cost. All other works are classified as unproductive. The classification based on the source from which funds are allotted for the construction of these works has been abandoned.

Indian railways on 31st March 1934 had a capital at charge of Rs.795 crores (£598 millions), and the return on this capital was 3·11 per cent. Irrigation in the same year yielded a return of 5·38 per cent on the capital at charge, Rs.144 crores (£108 millions). The value of the crops irrigated in 1931–1932 was Rs.86 crores, or the equivalent of more than three-fifths of the capital cost of the works.

2. Expenditure on Government or public undertakings is no longer regarded as a leading function of governmental activity, as are defence, law, and order. In the eighteenth century it was thus regarded, but Adam Smith and the Physiocrats, especially "the noble" Turgot, disbelieved this, although there were certain definite duties for the State to perform in this direction. Indeed the State, according to Adam Smith, had to undertake such public works as were too great for individuals and yet necessary to the community. There are those which facilitate the commerce of the country either as a whole or, as Adam Smith added in the 1784 edition, in particular branches. In India the State has undertaken such works only on the clearest of reasons, the most important of which is maximum advantage. Continuous interference, or, worse still, petty interference at every turn, is avoided. With the development of social consciousness the tendency for outlay on public undertakings is to increase. The development of industries, for example, means increased expenditure on industrial research, on factory inspection and the welfare of labour, on the means for settling labour disputes, and on the collection of full and accurate statistics. Were Adam Smith alive to-day he would, almost certainly, have enlarged his category of public works which the sovereign power should undertake. The principles underlying his many exceptions to *laissez-faire* are, as we have seen, capable of very wide extension in modern States.

3. In regard to the commercial undertakings the financier has to pay special care to one or two aspects of policy. In the first place, such concerns should be run on strictly commercial principles. It may be advisable to give railways, for example, a budget of their own, apart from the Central or Federal Budget, the railways paying to Government for the loan of its capital a fixed return annually. The Acworth Committee, for example, reported as follows:

We wish to disclaim any idea that the railway organisation should be independent, an *imperium in imperio*. This is quite out of the question. The Indian Government owns the railways; the Indian Government must control them. But that is no reason why the control should take the form which is found suitable in respect of other departments of the State. What we propose is in outline that the railways should have a separate budget of their own and assume the responsibilities for earning and expending their own income. The first charge on that income, after paying working expenses, is interest on the debt incurred by the State for railway purposes. The amount of this debt is known—we may call it roughly £252,000,000.[1] The annual liability of the Indian Government for the interest is £6,700,000. Whether the railways should pay precisely this amount, or a larger amount, in consideration of the fact that in early years taxation had to be imposed to meet that portion of the interest which the railway receipts did not then cover, or a smaller amount, in consideration of the expenditure which the railways have since incurred for non-railway purposes, is a matter for argument. We have no wish to express a positive opinion, though we think there is much to be said for letting bygones be bygones and fixing the payment to the Government at the same sum that the Government has itself to find at the present time for interest on the railway debt. The point is that the Railway Department, subject to the general control of Government, once it has met its liability to its creditors, should itself regulate the disposal of the balance, and should be free to devote it to new capital purposes (whether directly or as security for new debt incurred) or to reserves, or to dissipate it in the form either of reduction of rates or improvement of services.[2]

The condition of affairs prevailing in India prior to 1924 tended to an alternation between raids by the railways on the taxpayer and raids by the taxpayer on the railways. At the end of September 1925 the Indian Legislative Assembly agreed to the separation of the Railway Budget from the ordinary or general Budget of the Government of India, and a new agreement was arrived at according to which the taxpayer, instead of paying the whole of the expenses and taking the whole of the incomings of the railways, received a contribution as a first charge on net receipts on the basis of 1 per cent on the capital at charge of commercial lines (excluding capital contributed by companies and

[1] Paragraph 74 of the *Report of the Committee appointed by the Secretary of State for India to enquire into the Administration and Working of Indian Railways*, vol. i.

[2] *Ibid.*

Indian States) in the penultimate year, plus one-fifth of the surplus profits in that year, interest on capital at charge of strategic lines and loss in working being deducted. If after payment of this contribution the amount available for transfer to railway reserves exceeds Rs.3 crores (Rs.30 millions), one-third of the excess is paid to General Revenues. In return, the railways are left to carry on their business with the right to retain any surplus over and above what they pay to the Government and to apply it to railway purposes, first of all for creating reserves and then by using those reserves to improve the services they render to the public, and to reduce the price which they charge for those services. The amount payable to Government is of course an accruing charge. If not paid in one year owing to temporary causes it must be paid in a following year. Government is able to budget for a fixed sum from railways, and the railways now have a freer hand in disposing of the balance after meeting the statutory charges. In most countries at the present time it is recognised that efficiently administered railways bring with them many indirect advantages. With good railway communications, land values improve; trade, commerce, and industry are fostered; and, as a result, public revenue benefits. It is often, however, forgotten that efficient railway administration depends on a continuity of a sane and progressive policy, which in turn depends on an intelligent programme prepared well in advance and assisted by timely contracts, and free from vexatious changes resulting from the exigencies of the general finance of Government.[1] Secondly, there is the underlying principle that the relation of working expenses to revenue should be so adjusted as to provide for an adequate return on the capital invested. Thirdly, adequate financial provision should be made annually by the railways for the maintenance and renewal of the permanent way and rolling stock. The Acworth Committee on Indian Railways observed that what was unspent on maintenance and renewals during the War should have been carried to a reserve, and the accumulated funds spent when materials were again available. When funds so ear-marked are debited to working expenses they would be carried to a suspense account to be drawn on to meet

[1] Experience has shown that it is better to concentrate on the rapid completion of a small number of projects at one time rather than on the simultaneous initiation of many projects, spread over five or six years.

current requirements. Any unspent balance would be carried forward at the end of the year. Unless this is strictly enforced, it is difficult to judge whether there is an adequate return on capital outlay and an adequate check on ordinary working expenses.[1] It is also advisable to pay very special attention to the form of accounts, to the compilation of railway statistics, and above all to the co-ordination of research in transport problems. In India, where all railways are under the Railway Board, the pooling of such information as costs in various operations, the limit of profitable expenditure in various services, the incidence of sickness among workmen is easier than if each railway were independent.[2] But expenditure would be saved if research were better organised and the results on one railway, even if negative results, were freely placed at the disposal of other railways. In order that financial considerations should be given the weightiest consideration before expenditure is actually incurred, financial advisers of independent authority are of advantage. Similarly in Posts and Telegraphs and other quasi-commercial concerns, steps must always be taken to maintain (by a regular and systematic check) a strict relation between the staff employed and the amount of work done, and to improve the average output. The value of outside tenders for the construction of all large buildings, the cutting down of constructional and general stores to a minimum of so many months' supply, the charging of "economic" rents for all accommodation provided, care in the placing of contracts, and a general but severe control of existing and future expenditure, cannot be too highly assessed.

In other directions public expenditure on economic development must be carefully examined to prevent waste. Thus scientific research, which received a considerable stimulus in most countries as a result of the War, brings with it the danger of duplication of effort and the danger of spending public funds out of all proportion to the results to the country as a whole. The State has to avoid undertaking ordinary industrial research which is an essential cost of production. In Great Britain the co-ordination

[1] See Chapter XXXII.

[2] For efficient working the South African railways were in 1908 federalised. Inter-State rivalries were done away with. In Switzerland railways were nationalised in 1901. In 1920 the German State Railways were also nationalised, although later handed over to a company subject to Federal Control.

of research is obtained to a considerable extent by the Department of Scientific and Industrial Research and the Medical Research Council under the Privy Council. Similarly for research in agriculture an Advisory Council for Agricultural Research is essential. The Committee on National Expenditure laid down the following principles: (1) No proposal involving the future establishment or extension of activities involving the creation or addition of scientific research accommodation or staff or the payment to some outside agency for research activities should be submitted by any Department of State to the Treasury for approval without a report from the appropriate Advisory Council concerned with Agriculture, Medicine, or Scientific and Industrial Research, unless, in cases where national defence is concerned, the respective service is satisfied that the research is of a secret nature or the arrangement is for any other reason impracticable, and (2) financial control should be real. The Treasury representative should attend meetings of the Advisory Councils for industrial and scientific research when financial issues are involved, and no State aid should be given where there is little likelihood of general benefit from the expenditure. In regard to the Road Fund the same Committee referred to the quite inadequate financial control that was exercised over road expenditure. "It is far easier to get £1,000,000 spent on roads than £100,000 on any service requiring express Parliamentary sanction. We do not blame the Treasury for this state of affairs, though Treasury sanction is necessary for all expenditure from the Road Fund. Rather do we regard it as the natural consequence of a system that allocated a rapidly expanding revenue to a particular service irrespective of the needs of the service and with no power reserved to Parliament to check its growth. The Road Fund has come to be regarded by successive Governments as a convenient means of financing grandiose projects without the inconvenience of obtaining Parliamentary approval and providing for the cost in the annual budget." "Self-balancing expenditure" in the British Accounts, which include under this head the Post Office and the Road Fund, is clearly an inaccurate description of the expenditure in regard to the Road Fund, as the Road Fund is far more than a self-supporting service. The principles, therefore, laid down by the Committee are sound. Some of the expenditure was for economic development, but much merely for pleasure traffic, and therefore

unnecessary and wasteful. Similarly in Government Departments, such as the British Overseas Department, the Departments should be as self-supporting as possible, on the principle that if traders are unwilling to pay for the services they obtain it indicates that the Department is not of use to them and therefore the reason for its continuance does not exist. The same principle should be applied to economic development in other directions, such as the encouragement of small holdings which must bring in an adequate return on the capital lent by the State, and the holdings must be as nearly economic as possible. With the great advance of mechanisation in the great grain-producing countries of the world it is wasteful to compete with small holdings of twenty or thirty acres in Great Britain even if suitable men are obtained for these holdings and efficient co-operative marketing made possible. In all forms of economic developmental expenditure the greatest and speediest benefit to the country itself must be laid down as a first principle of development expenditure.

Another principle is that development expenditure should not be mixed up with amenity expenditure as it has not infrequently been. There are two main classes of development expenditure: (*a*) That which is more or less regarded as the normal activities of Governments such as that for the aid of home industries, State enterprises, and overseas or Empire development, and (*b*) that connected with periods of depression when Governments have to try to restore confidence and to maintain the unemployed in a state of moral and physical fitness. It is especially in regard to this latter class of expenditure that waste is apt to occur. As has been stated elsewhere [1] State expenditure from revenue or capital on public works as a cure of unemployment has not proved successful, even if the saving, by this expenditure, of the cost to the community of maintaining men in idleness be allowed for. Other examples of trade depression services are export credits, and the training and transference schemes of the British Ministry of Labour. In this connection the Committee on National Expenditure wrote what deserves to be marked, learned, and inwardly digested: "With the fundamental immediate object of improving employment in this country no one will disagree, nor will anyone dispute that one of the most important lines of advance towards this goal is the economic development of this country;

[1] Chapter XI. para. 7, p. 167.

but when we find golf courses, tennis courts, and swimming baths being subsidised as economic development, when we find roads being constructed at great cost in the remoter parts of Scotland, or to meet holiday traffic on the South Coast whereas the road needs of industry and trade lie rather in our congested urban streets; when we find grants paid to local authorities for ten years in succession for accelerating work which it was their duty to carry out if it should be done at all; when we find Government Departments giving free of cost to private traders services which more progressive traders are providing for themselves; when we find schemes of land settlement or development proceeding at a cost out of all commercial relation to any results likely to be attained; when, in short, we see these and many other activities being pressed forward to the embarrassment of the national finances with danger of increased taxation and serious repercussions on the general economic position of the country, then indeed we think it is time for a careful review of the whole policy of development."[1] In brief, there has been a confusion between economic development proper and amenity development. The promotion of economic development need not be only that which gives a return on the capital invested in the enterprise, the sense in which "productive" is generally used in treatises on Public Finance and in Financial conferences, but it may be in the sense that such expenditure results in some general economic advantage to the community, although there is no direct return on the capital invested. Development expenditure should not include merely wasteful or unproductive expenditure. Expenditure in this latter sense results in an absence of economic advantage.

III. Other Expenditure

The last group of public expenditure is an omnibus head, and will vary in different countries. It includes, in the case of India, what cannot be included under the main groups, *e.g.* allowances under treaties, refunds, drawbacks, and certain civil superannuation charges.

It includes, in the case of belligerent countries such as Great Britain, France, and Germany, War pensions which are decreasing

[1] Report of the Committee on National Expenditure, Cmd. 3920, 1931, p. 95.

with the deaths among all classes of pensioners, the remarriage of widows, the disappearance of children of dependent age—a rapidly diminishing factor which in Great Britain will disappear in 1936–1937—and the reduction of pension and medical treatment required mainly on account of the fall in the cost of living. In Great Britain miscellaneous expenditure will include the State monopoly of broadcasting which is not a direct Government undertaking. The Post Office pays annually to the British Broadcasting Corporation a percentage of the gross revenue derived from wireless receiving licences in the preceding year after deducting 10 per cent for the cost of collection and administration, but the deduction excludes an additional grant in the form of a subsidy to the Grand Opera Syndicate. The State enjoys a supplementary revenue which is not a compulsory levy as is taxation, and it can increase this when the agreement with the Corporation expires. At the end of 1933 the number of licences issued was 6,000,000, indicative of the importance which broadcasting has won in British national life. Expenditure, therefore, on this service by a public corporation (the Chairman, Vice-Chairman, and other Governors of which are appointed by H.M. Government) is of much importance. The expenditure is over £1,000,000 per annum, and this is met from the proceeds of licences, a smaller percentage of net revenue being paid on a sliding scale to the Corporation on each succeeding million after the first million licences. Subventions to local authorities on an "all-in" block grant are included under the miscellaneous head. The British Local Government Act,1929, is a case in point. This Act was intended to relieve industry and agriculture of the burden of rates, to spread the burden of local taxation more equitably over the country, and to reorganise the machinery of local government administration so as to adapt it to modern needs under a "formula" grant applicable to all services except education, police, and the main roads.[1] This block grant gives the largest grants per head of population to the necessitous areas. Differences, of course, in the form of political organisation affect considerably the distribution of expenditures between central and local governments, but this had better be dealt with in the following chapter.

[1] For details see Chapter XVI. on the Distribution of Revenues.

CHAPTER X

THE DISTRIBUTION OF CENTRAL, PROVINCIAL, AND LOCAL EXPENDITURE

1. THE distribution of public expenditure between the Central or Federal Government, Provincial or State Governments (where these exist), and local authorities is a complicated problem and is not of mere theoretical interest. It is frequently, if not always, the result of historical conditions. The question has assumed a new importance on account of the changes that have taken place in the governmental functions of different authorities resulting in the main from changes in economic conditions. The distribution of expenditure between the central, provincial, and local authorities depends on the relative distribution of the sources of revenue, and that is ultimately determined by the Central or State Governments. In the United States and Australian constitutions, for example, the powers of the Federal Government are set out, and all powers of government not taken over by the Federal Government belong to State Governments. Similarly in the Swiss Constitution the cantons exercise all residuary powers, *i.e.* those not specifically allotted to the Federal Government. The British North America Act of 1867, framed shortly after the American Civil War, enumerated the powers of Provincial Governments, and all powers not so enumerated were to be exercised by the Dominion or Central Government. It is true that the British North America Act enumerates a series of subjects pertaining to the Dominion Government. This is " for greater certainty, but not so as to restrict the generality " of the legislative power " with regard to all matters not coming within the class of subjects of this Act assigned exclusively to the legislatures of the provinces ". Similarly, in the Indian Constitution of 1919 central and provincial subjects are given, but it is expressly

provided that all matters exempted from inclusion among provincial subjects, and " all other matters not included among provincial subjects ", belong to the Central Government. In the Government of India Act 1935 the competence of the Federal and of the Provincial Legislatures is clearly defined and therefore the expenditure of the Federation and the Federal units. For historical reasons, too, the most important sources of revenue, direct taxes, belonged to the individual component States of the German Empire, while the Empire itself had to rely on indirect taxation. Germany paid the penalty for delaying to adapt, before the outbreak of war, the needs of the Imperial Budget to the changing conditions, and therefore it had to depend on enormous loans. Since the War, by the Weimar Constitution of 1919 the Reich has brought the whole financial system of the country under its control and the freedom of the States or Länder and of the Communes has disappeared. Nevertheless the States and Communes spent respectively in 1927–1928 4560 and 7057 million marks out of a total of 17,891 millions, and the transfers from the Reich to the States and Communes in that year were 3016 millions. The Reich's expenditure, excluding transfers, was 6274 millions. In Great Britain and New Zealand the division between central and local expenditure is also traceable to historical factors. The modern history of rates in the former begins with the poor-rate of 1572, 1598, and especially 1601. These rates are all levied according to the annual value of property rateable to the poor-rate, either as part of the poor-rate or on the same lines as the poor-rate. In some countries, as in India, a possible widening of provincial and local powers, and a corresponding curtailment of the Central Government's powers, *i.e.* a distribution of functions, especially in matters of a more or less local interest and importance, is at work. While the advantages of a strong Central or Federal Government are as clear as sunlight, a wise decentralisation for financial reasons alone is invariably essential. No better illustrations of this principle can be found than in The Dominion of Canada Act of 1867, the Commonwealth of Australia Constitution Act of 1900, the South Africa Act of 1909, and, to a less extent, in the Government of India Act of 1919 and the Government of India Act of 1935. In these Acts the golden workable mean appears to have been attained in view of the local conditions peculiar to each country. In some countries. however, there is

a " tightening up " on the part of the Central Government at the expense of provincial or local authorities. Thus in the Union of South Africa two-thirds of the total expenditure is central and about one-third provincial, purely local expenditure being small. The greater part of provincial expenditure is from Union subsidies. Here again this is at bottom obviously historical.[1] In India, on the other hand, the post-War reforms have been in the direction of devolution, demarcation, and the cutting of long-standing ties, the very reverse of the task which confronted the Fathers of the Union in the United States, Canada, and Australia. The powers of an Australian State, an Indian or Canadian provincial government, an American State or " Commonwealth ", or a Swiss canton are very much greater than those of the English county. The basis of the French canton, arrondissement, and department, or the Prussian district, circle, and province, is historical, and the centralised system of the former and also of Italy goes back to the eighteenth century and earlier.

2. The importance of central, provincial, and local expenditure varies, as is to be expected, in different countries. Before the War, in Great Britain central and local expenditure (excluding expenditure from loans) was 53 and 47 per cent respectively. Since then the proportion has changed, and approximately 62 per cent of public expenditure in 1929–1930 was central, and the remainder, 38 per cent, local.[2] The proportionate expenditure expressed in the form of percentages will be found on next page.

3. In the table below it will be seen that in all countries, with the exception of Australia and the United States, the Central Government is responsible for the larger part of public expenditure. In the United States in the depression of 1929–1934 the Central Government very greatly increased its expenditure. In

[1] *Vide* Selborne Memorandum, 1908. Cf. First and Second Reports of the Financial Relations Commission, 1912 (Pretoria: Government Printing and Stationery Office (U.G. 11 and 14)); Act No. 10 on Financial Relations and Union of South Africa, 1913. Report of the Provincial Finances Commission, 1923.

[2] " The fact that an overburdened Central Government hands over some of its functions to Local Government, which is often in a position to discharge them more economically and efficiently, is no reason why the taxpayer at large should be relieved at the expense of the less fortunate groups of ratepayers. Government, therefore, makes an annual contribution from the public purse towards the needs of local authorities " (Higgs, *National Finance* (Methuen & Co.), p. 88).

PROPORTIONAL EXPENDITURE—CENTRAL, PROVINCIAL, AND LOCAL*

Country.	Year to which Percentages refer.	Central.	Provincial.	Local.
Great Britain . .	1929–30	62	..	38
Canada † . . .	1926–27	68	32	..
Australia . . .	1931–32	34	52	14
New Zealand . .	1925–26	54	..	46
South Africa † . .	1931–32	66	34	..
India	1929–30	49	32	19
Germany . . .	1928–29	40	20	40
Italy	1925–26	77	4	19
U.S.A.	1929	30	15	55
Japan	1926–27	51	12	37

* In this statement care has, as far as practicable, been taken to count figures only once, *e.g.* expenditure paid out of central or provincial revenues to local authorities has been included only under local authorities. Exact uniformity in the table can scarcely be looked for.

† Central and Provincial only.

Great Britain, Germany, and Italy, 62, 40, and 77 per cent respectively was expended by the Central Government, as will be seen from the table above. The distribution of public expenditure depends on political and economic factors, such as expenditures on development and the social services. This is not unnatural, as the Central Government has to do those things, such as defence, where unity is essential or where a wide outlook must be taken. Moreover, the Central Government has a well-trained secretariat or body of officials which a local authority does not ordinarily possess. There are, however, certain heads of expenditure which are better controlled by local than central or State authorities. Minute supervision is required in expenditure on lighting, sewers, and the poor-rate, and this is often, but not invariably, done far more efficiently by local authorities where local patriotism exists. In New South Wales, for example, hospitals, benevolent institutions, public libraries, parks, and churches are under the control of municipal and shire councils. These councils are permitted to borrow up to 20 per cent of the unimproved value in municipalities, and the loans are guaranteed by the Government. Special local and loan rates are imposed on the improved or unimproved value as the council prefers. The rateable value of coal mines, for example, is fixed at 50 per cent for the same period. At the same time, central control is often beneficial. The control of poor relief in England and

the control of education by a Central Authority where concatenation is, as in England and even India, are not without very great advantages. In the self-governing Dominions it is customary for the Central Government to subsidise the provinces, as, for example, in Australia, South Africa, and Canada. In Canada each Provincial Government receives a fixed grant according to population, and an additional grant at the rate of 80 cents per head of population up to 2,500,000 and at the rate of 60 cents per head of so much of the population as exceeds that number. Some provinces receive additional grants under special acts, and special payments such as compensation for land, allowances in lieu of debt, and allowances for buildings are also made by the Dominion Government. The Commonwealth Government of Australia, in accordance with the agreement of 1927 with States, now takes over all State debts existing on June 30, 1927, and must pay £7,584,912 a year for fifty-eight years as interest charges. In the Union of South Africa subsidies for expenditure of all kinds are paid to provinces on a basis of the number of pupils. This system was introduced in 1925 in place of the £ for £ system. The index on which the subsidy is based is the number of pupils, which is regarded as the chief index of provincial needs. In other words, the provinces with the greater literacy obtain the larger subsidies. The variations between the coastal and the inland provinces are provided for by means of graduating the rates of the subsidy. The Orange Free State, for example, receives approximately 10 per cent more than the coastal provinces, and the Transvaal about 16 per cent more than the latter. In the United States federal aid is given to the States for roads, education, agriculture, health, etc., and in the years 1933 and 1934 for unemployment and recovery in various directions. Such aid did not assume any importance until 1917–1918. Federal aid in education is less than 1 per cent of the expenditure on schools as against 14 per cent from State taxes, 10 per cent from country taxes, and 69 per cent from local taxes. In Australia the history of subsidies has been a chequered one. In Canada and in the Union of South Africa the ratio of provincial revenues to central revenues is much lower than that in India. In the United States similarly the federal subsidies were before 1933 negligible in the total governmental expenditures of the various States. On the whole, it is desirable to avoid subsidies in the interests of complete equi-

librium in central and provincial finance. Conditional subsidies lead to administrative centralisation and interference; unconditional subsidies may result in extravagance, and it is not impossible that the provinces which are receiving subsidies are through federal taxation themselves bearing the burden in a disproportionate degree. It is in the long run better to keep them within narrow control. The question of subsidies on a *per capita* or any other basis is a difficult one and cannot be applied to countries in a light and airy fashion. They are bound up with the financial structure of a country and must be examined with care. A little history is sometimes a dangerous thing.

4. What then should be the broad lines of the division between Central or Federal, Provincial or State, and local expenditure? A precise line of demarcation is of course impossible. It will be advisable to examine the Budgets of various countries and to draw from this examination the principle or principles on which the division has been made in practice.

In all Federal Governments security is their primary function, and therefore expenditure on defence is retained by the supreme or Central Government. In the United States, India, and the self-governing Dominions, defence, a subject of the most vital and general interest to the country as a whole, is rightly a central subject. Expenditure connected with customs, including tariffs, shipping, ports, immigration, foreign relations, post offices, telegraphs, including wireless telegraphy, census and statistics, grants-in-aid, assignments, subsidies or subventions to units of the Federation, and the country's debt apart from the debt of State and local authorities are suitable subjects of federal or central expenditure. But as the Central Authority is responsible in the long run for the credit of the country as a whole, it cannot divest itself even of responsibility in regard to State debts. The experience of Australia is an example of this, as the Commonwealth Government arranges all Central and State borrowings through a Loan Council.[1] The Federal Government has undertaken to control the future debt operations of Australian Governments as a whole, to pay interest on State debts and to provide a common sinking fund. This harmonises with the principle which hardly admits of challenge that the Federal Government should retain ultimate control over the financial position of the States and their relations with itself.

[1] *Vide* the Australian Financial Agreement Validation Act, 1929.

Other subjects which may conveniently fall within this category are the civil and criminal law of the land, together with central police organisation. It is in the long run a gain to a federal constitution to have uniformity throughout the country in these matters. Demarcation is strongly to be recommended in expenditure and in revenue. It is a bad principle when one authority spends the revenue raised by another authority. In the Union of South Africa, for example, there is too much divorce between the responsibility of spending funds and the provision of funds.

State or provincial items include education, the conservation of health[1] and sanitation, law and justice, including prisons and police, public works such as irrigation works, roads, bridges, and provincial buildings, agriculture, industries, labour, payments for interest and sinking funds in connection with State debt, grants to local authorities, and similar payments. Anything affecting local self-government, such as the constitution of municipalities, district boards or similar local bodies, is a fit subject of State or provincial expenditure.

Local expenditure ordinarily should include expenditure on education, police, a fresh and adequate supply of water, sanitation, lighting, roads, tramways and buses, cemeteries, crematoria or burning ghats, markets, parks, and similar works and services.

Expenditures connected with the social services, such as unemployment, health insurance, and old age pensions are better undertaken by State and local authorities than by Federal authority since the former come into closer contact with the people. It is, however, sometimes argued that as these services are clearly national in character and as Federal Governments have successfully invaded the field of direct taxation, especially of personal and corporation incomes, the Federal Governments should assume the whole burden of such expenditures. An additional argument in this behalf is the necessity for uniformity throughout the federation in, for example, the payment of old age pensions, and therefore of central control. In Australia expenditure on invalid and old age pensions is federal, and in Canada and Switzerland the provinces and cantons respectively are assisted by subsidies or subventions from Federal authority.

The table on next page should be read vertically rather than

[1] Including hospitals, dispensaries, asylums, and provision for medical education.

horizontally, but when read either vertically or horizontally it must be read with care. The aim of the table is not to show relative expenditures so much as the percentage of the total which each service demands from central, provincial, and local authorities. Thus in all cases defence and the services of debt are central heads. Education and other social services are both provincial, local, and to a much less degree central.

PERCENTAGE DISTRIBUTION OF GOVERNMENTAL EXPENDITURE, 1925–26

Heads.	Great Britain.		U.S.A.			India.		
	Central.	Local *	Federal.	States.	Local.	Central.	Pro-vincial.	Local.
Defence † .	15 0	..	36 2	11·6	9·1	42·4	..	..
Law and order	1·5	6 1	10 0	5·7	6 8	1 0	20 8	..
Civil administration .	10·3	..	..	..	..	7 6	20·3	2·8
Debt services.	45·3	..	42 9	6·5	13·0	29 6	7 6	10·9
Education .	6·1	20·2	3	26 2	29·7	·2	12·2	12·3
Other social welfare .	8 3	42·4	2 2	11·3	12 9	·6	7·0	14·2
Government and public undertakings	1 1	28 8	4 5	34 7	25·9	13·7	25·7	18·5
Miscellaneous.	12 4	2 5	3 9	4 0	2 6	4 9	6 4	41 3
Total .	100	100	100	100	100	100	100	100

* England and Wales only.
† This includes expenditure on "Protection" in case of U.S.A.

From the classifications given above it will be evident that there is no absolute uniformity between country and country, owing mainly to historical causes. In some cases, as in Canada, Australia, and South Africa, the Dominion or Federal Government had a later birth than that of the provinces or States. This is not an invariable rule, as, for example, in India, where there has been for long a powerful Central Government. The long list of Governors-General from Warren Hastings shows this to have been the case, and the supreme Government, with the acquisition of new territory and general economic progress, has gradually delegated powers to local administrations, especially where a high degree of co-ordination appears to be, in changed circumstances, unnecessary. No uniform division applicable to all countries exists between central or federal, provincial or State, and local expenditure. A clear-cut division of subjects is not

always easy. Take, for example, education and police. Education is both State and local expenditure, since education is of general interest to the community (and therefore of importance to the State as a whole) and of special or local interest as in elementary education. In Prussia and other States of the Deutsches Reich, where education is compulsory for children from six to fourteen, the free elementary schools (Volksschulen) and the middle schools of the towns (Burgerschulen and Hohere Burgerschulen) are maintained by local rates with grants from the State. In addition to these the well-known gymnasien (which prepare in a nine years' course pupils for the universities) and technical and normal schools are also met from State and local resources. In the highest spheres of education it is not possible to expect local rates to bear a large proportion of their cost—at any rate in cases where such institutions are national or provincial in character, and therefore rightly a charge on national or provincial revenues. Expenditure on police is usually partly State and partly local. While the State is vitally interested in the preservation of law and order, it cannot be doubted that local authorities, if animated by a real spirit of local self-government, can supervise the control of the police, only general supervision being kept in the hands of Government. Thus in Great Britain local authorities possess a considerable control over their police, but the Home Office, Whitehall, exercises general supervision. In other cases the whole of the expenditure on police is State expenditure, on the principle laid down by John Stuart Mill in his *Representative Government* (1861) that "it would not be a matter personally indifferent to the rest of the country if any part of it became a nest of robbers or a focus of demoralisation, owing to the maladministration of the police".

5. It is not the duty of State or provincial governments to relieve local authorities of expenditure that rightly pertains to local authorities. In some countries, notably in India, municipalities have been accustomed to look to Government for grants, and to shun improving the machinery of rating and valuation. In a city like Ahmedabad, for example, with a population of 410,000 and about 80 cotton mills, it is very doubtful whether local rates should not bear the full cost of renewing, for example, machinery for pumping water, instead of seeking and obtaining *in*

forma pauperis subventions for this and for other similar purposes such as hospitals and other local institutions. Grants have been given, notwithstanding a rise in recent years of at least tenfold in land values. In short, expenditure should have been met by increased local rates on real property in order to meet what is of particular value to the community. The example of the United States in this respect is of interest. The main expenditure in individual States is undertaken by the local authorities in counties, townships, or school districts.

6. To sum up, no clear line of demarcation is possible between central, provincial, and purely local expenditure. The differences that exist are largely, very largely, the result of historical conditions. There is no country in the world where the distribution of the whole of public expenditure is worked out from first principles, although in the present century such principles are being sought as never before with a view to securing the maximum of justice. As a general rule it may be stated that where the interests of the State as a whole are concerned (*e.g.* in defence), then the expenditure is undoubtedly central and not local. Where, too, in addition to the good of the whole community, there are advantages in uniform action, then the expenditure should be met from central (or State) sources. In cases where particular interests are paramount, or detailed local supervision required, local authorities should be the spending authority.

In regard to the distribution of expenditure in federal systems some cardinal principles may be summarised. In the first place the Federal authority and the States should have as far as possible different heads of expenditure as they should have of revenue. In accepting assignments, such as those in Germany under the Financial Settlement Law (Finanzausgleichsgesetz) of 1923 and its amendments (where, in some cases, the Länder receive from 50 to 90 per cent of revenue collected by the Reich) or subsidies or subventions, such as those given by the Federal Government in the United States and the Union of South Africa, States are apt to lose their freedom at the expense of an encroaching central authority. Similarly, if the Federal Government has to depend on State contributions it will tend to become impotent and subservient to the States. Such largesses lead to ill-feeling among the units of the federation, and as the history of the Matrikularbeiträge in Germany and the contributions to the Central Govern-

ment in India from the provinces from 1921 to 1929 show, these are never paid willingly. Moreover, a State which can spend without the necessity of raising the funds which it spends is likely to follow the path of extravagance rather than of economy. But in practice, a clear line of demarcation being impossible, such expenditure, without equivalent recompense (*i.e.* subsidies, subventions or grants-in-aid) by the Federal Government, if made to the States in moderation, cannot be proved to be harmful in its effects. In addition to the principle of freedom of spending is the principle that expenditure in a federal financial system should be administratively tidy and easily workable. Again a Federal Government can discriminate quite legitimately between the various units of the federation by assisting poorer States at the expense of richer by subsidies and subventions. The cases of Tasmania, South Australia, and West Australia in the Australian Commonwealth, British Columbia and Prince Edward Island in the Dominion of Canada, and the North-West Frontier Province, Orissa, Sind, and Assam in India, are examples. Similarly situated States in a federation should be treated similarly and dissimilar States dissimilarly. Purchasing power is transferred from certain individuals to public authorities by taxation, and from these authorities to other individuals by public expenditures. Adjustments, therefore, can be made by the method of transference which reduces distributional inequality. It is essential that the federal authority should level up the standards of expenditure in the federal units since the economic and cultural backwardness of any State or Province is a weakness, if not a danger, to the Federation. This must be done at the expense of the relatively advanced states or provinces. The federal authority, however, must be satisfied before giving subventions or grants-in-aid (for housing, slum-clearing, roads, rehabilitation, education, and subsidies in emergency such as for earthquakes or for social services in specially distressed areas) that all available sources of taxation have been tapped, that there remains no residual taxable source untouched, and that the expenditure already existing in these units is in no way extravagant.

CHAPTER XI

EXPENDITURE CHARGEABLE TO CAPITAL—THE THEORY OF GOVERNMENTAL BORROWING

1. THE problem of expenditure chargeable to capital has received unusual prominence in recent years, mainly, if not quite entirely, owing to the Great War and to abnormal conditions in the post-War period. What expenditure on the part of public authorities should be incurred out of capital, and what expenditure should be incurred from revenue? What are the general principles on which capital expenditure is to be incurred? Should non-productive expenditure invariably be met out of revenue, and out of revenue only? For the present we shall attempt briefly to answer these interesting points of public expenditure.

2. There are some writers on public finance who hold that to charge to revenue what should be charged to capital is a great injustice to the taxpayer. It is, in addition, an instance of very faulty book-keeping. German writers of the middle and latter half of the nineteenth century, such as Dietzel, Umpfenbach, Stein, Wagner, Schäffle, Nasse, and Schanz, would have all extraordinary expenditure met from loans because of a capital investment. Dietzel, for example, held that pure governmental functions are as productive as industry, and the capital required may be supplied by borrowing quite as legitimately as in the field of industry. Expenditures on public works are for future as well as for present benefits. Therefore the cost should be spread over the entire period, and public debts do not impose unfair burdens upon coming generations. His book [1] had a profound effect on German writers on finance of the later nineteenth century. On

[1] *Das System der Staatsanleihen im Zusammenhang der Volkswirtschaft betrachtet* (Heidelberg, 1855).

the other hand, there are others who hold that all extraordinary expenditure, if unproductive, should be met from income, and unless it can thus be met should not be incurred. Gladstone attempted, although unsuccessfully, to finance England's war expenditure in the Crimea without loans.[1] He believed that nations should meet from year to year the expenditure which war necessitated. This " is a salutary and wholesome check, making them feel what they are about, and making them measure the cost of the benefit on which they may calculate ".[2] Typical of the orthodox English nineteenth-century point of view is that of Bastable, who in his *Public Finance*, holds that " actual purchase of productive property or creation of revenue-yielding works may fairly be defrayed by loans. . . . This concession to the policy of borrowing should not be stretched to include the cost of works or other State action that yields no revenue. Non-economic[3] expenditure is primarily to be met out of income, and unless it can be so dealt with ought not to be incurred. National culture, education, the promotion of social progress are all most desirable ; but their promotion is not so urgently required as to need the use of borrowing by the public powers. It is, indeed, true that much of State expenditure may be regarded as indirectly productive, and as likely to add to the national income in the future. A loan for the purpose of extending education, or for improving the housing of the workers, though it does not directly provide the interest needed, may yet so increase the income of the community as to make the tax receipts greater, without any increase either in rates or in rigour of collection. Regarded in the abstract, such a proceeding seems defensible ; the real objections to it arise from the difficulty of application. The results of expenditure of the kind are hard to trace or measure, and any statement respecting them must rest in a great degree on conjecture. The cost of the loan is definite and precise, and it constitutes a real burden on the resources of the society. Prudence seems accordingly to suggest that borrowing should hardly ever

[1] Cf. Morley's *Life of Gladstone*, vol. i. pp. 515, 561 ; vol. ii. p. 48.

[2] Hansard, p. 376, March 6, 1854.

[3] *I.e.* non-productive. The word " productive " applied to public expenditure means that there is a return on the capital invested. It sometimes is taken to mean " productive " of general advantage, the expenditure promoting well-being, but without pecuniary return on the capital outlay and without necessarily the creation of tangible commodities. In this latter sense it enhances the material prosperity of the people.

be adopted except for strictly economic expenditure, and then only when the extension of the State domain is clearly advisable." [1]

A view similar to this was expressed by a late Finance Minister of India, in his Budget speech, 1923. Speaking in the Indian Legislative Assembly, he said : " We have spent many crores on unproductive purposes, the expenditure on which is classed as capital expenditure. New Delhi [2] is the most obvious example. I can see no justification other than sheer necessity for not treating this expenditure as chargeable against revenue, and in any case it ought to be repaid out of revenue at an early date." [3] In regard to those States which, refusing to balance their income and expenditure, meet deficits from loans, *e.g.* by expenditure from capital in place of expenditure from revenue, he said : " The individual who lives beyond his income year by year does not escape the penalty, and the same is true of a State. The individual who makes this mistake quickly finds himself compelled to consent to a ruthless cutting down of his expenditure or is driven either to sell or to mortgage a part or the whole of his possessions ; or, in the worst event, to cheat his creditors. A State is in the same position, but the position is frequently obscured by the fact that the State's creditors are in another capacity the citizens of the State, and its taxpayers. And the State which is driven to cheat its creditors does not always realise what it is doing, although its unsound methods are adopted at the expense not only of the wealth and happiness of its own citizens, but also at considerable risk to social order within its borders." A striking example of the truth of this is Germany, which entered the War with an undeveloped system of taxation, having no large annual revenue from taxation. To meet the enormous cost of the War it relied on loans followed by more loans—a suicidal policy financially. Its persistent and heavy borrowings crippled it, and in 1918 the Revolution took place. Too large borrowings affect the ordinary revenue detrimentally, as an unusual proportion of expenditure is required for debt charges. Still further borrowings are made on disadvantageous terms, and insolvency usually follows.

[1] Bastable, *Public Finance*, Book V. ch. v. pp. 670-71.

[2] Originally estimated to cost £4,000,000. On 31st March 1934 the cost was Rs.1458 lakhs or £10,962,000.

[3] *Legislative Assembly Debates*, vol. iii. No. 48, p. 2931.

3. All things considered, it may be said that expenditure chargeable to capital is justified in four instances :

(i.) for permanent productive investments, *i.e.* for the construction of public works such as irrigation works, railways, etc., and also certain works, civil and quasi-military, which give the prospect of a return on capital over a long series of years ;

(ii.) in an extraordinary emergency like war ;

(iii.) in cases of temporary necessity—(*a*) casual deficits and (*b*) wasting assets ; and

(iv.) non-revenue producing public works and the participation of governments and local authorities in economic activities in certain circumstances.

4. Firstly with regard to (i.)—capital expenditure for productive purposes. It is unfair to ask the taxpayers of a single year to bear the entire burden of works which will be a source of profit as well as a benefit to the community over a period of years. In most cases the taxpayers would be unable to meet such a demand. The Sukkur Barrage, the largest irrigation scheme not only in India but in the world, is estimated to cost nearly Rs.20 crores (£15 millions), and on completion will increase the area under cultivation by 3,300,000 acres. The ultimate annual net revenue forecasted as obtainable from the scheme, after paying working expenses, is Rs.194 lakhs (£1,460,000) or 10 per cent on capital. The Lower Chenab Canal Scheme in the Punjab gave a return of more than 50 per cent in 1929-1930 and the Sutlej Valley Works will probably rival this. The acreage irrigated in India by Government works, 31 million acres, is much higher than in any other country of the world, and in 1930-1931 the net return on capital (Rs.136 crores (£102 millions) was 4·7 per cent. As the State develops its activities the amount of capital expenditure increases in many directions. In some countries capital expenditure by the State has increased very rapidly in the present century: in others much less rapidly. In India, for example, capital expenditure is all too small. The habit of investment is not widespread as it is in France and in England, owing to the blight of illiteracy that prevails up and down the countryside. Instead savings are put into the precious metals, and were they put to productive uses, instead of being allowed to lie inert, the main problem of Indian finance, the development of the country's latent sources of wealth, would be solved. The net imports of gold

in the ten years 1919–1920—1928–1929 were the equivalent of 22 per cent of the world's production of gold, and the average of the net imports of gold and silver were £27,500,000 per annum. Had the favourable balance of trade not been taken in bullion to this extent more funds would have been available for rupee loans in India, and it would have been unnecessary to borrow abroad for capital expenditure. At the rate of £27,500,000 per annum the country would have been able to repay the whole of its sterling obligations within twelve years by converting this into foreign currency through the ordinary operations of the exchange market. No country will grow rich by merely accumulating gold, and as conditions cannot be changed in a day and the necessary capital required for a reasonable policy of development in India cannot be raised within the country, it is essential to borrow abroad to prevent the evil that would result were the development of the country to be delayed. It is not a sign of weakness to borrow in such circumstances. It is an essential condition of any country in the early stages of its development, as the history, for example, of the United States before the War, or the history of South American railways or Japan's economic progress has only too clearly shown. If there is improvement in the power of production the standard of life of the population, rural and industrial, will rise. Care has always to be taken in the pressing forward of any wise development policy not to overstrain the credit of the borrowing country and a wise and firm control of capital expenditure is essential. Caution and enthusiasm must go together in all such enterprises. It must never be assumed that the contraction of debt means the destruction of capital. So far from being thrown away, it may increase the revenue.

Loans for capital expenditure should be fixed within such limits as will make the payment of interest and the gradual repayment of the principal over a stated period, *i.e.* by the operation of a sinking fund, a certainty.[1] In regard to local authorities, such as municipalities, it is often advisable to limit even arbitrarily the amount of the debt which these authorities may legally contract, *e.g.* a fixed percentage of the assessed valuation of its real estate. It is sound policy to make provision for the gradual repayment of the loan from an early period of its currency. The payments may be spread over even 80

[1] The charging of at least part of the interest to capital during construction and the earlier years of partial working is necessary and reasonable.

years,[1] according to the nature of the undertaking and the length of time for which its utility is to endure. If the original form of the capital is an asset which is liable to become antiquated in, say, 40 years, the sinking fund payments should be such as to extinguish the debt within that period. It is not essential that sinking fund payments should take place from the first year of the loan. Indeed it is often convenient to postpone these payments until the concern for which the capital was raised is in working order. The construction of the work should be pushed on rapidly, as small grants are to be condemned not only from the engineering but from the financial point of view. Commercial methods should be adopted from the outset.

Where a State's resources are limited and credit easily shaken by even slight over-borrowing (and many instances leap to one's memory), the sinking fund, even in productive capital expenditure, increases confidence and the marketability of the loan. Insurance companies, for example, when looking for sources of investment, always prefer loans of a reasonable terminable nature with adequate sinking funds. Many countries, therefore, apply a given sum annually from taxation or savings to the reduction of debt, and the interest on these annual sums accumulates for the same object. The Chinese Imperial Government 5 per cent Gold Loan of 1896 for £16 millions has a sinking fund which will extinguish the loan in thirty-six years. The Chinese Government 5 per cent Reorganisation Gold Loan of 1913 for £25 millions is for 47 years and is redeemable by the action of a sinking fund by 37 annual drawings commencing in 1924. Experience teaches that it is of little use to devote the surplus of good years to the reduction of debt. There is always a strong temptation to reduce taxation or to spend the surplus in directions other than in the reduction of debt. An overflowing treasury is almost certain to produce unwise legislation in this respect, especially in countries comparatively young in democracy.

5. Capital expenditure is, in the second place, permissible in the extraordinary emergencies demanding large outlays, *e.g.* wars, floods, fires, or earthquakes involving excessive destruction, such as the Japanese earthquake of 1923. The cost of these calamities

[1] The annual sinking fund for the Dominion of Canada extinguishes the gross debt of the Dominion in 75 years. For productive expenditure in India 80 years would be suitable.

is so great that it cannot be met from revenue, and a resort is had to borrowing. We have already indicated that public expenditure chargeable to capital does not mean the destruction of capital, but even profitable investment. McCulloch goes so far as to hold that the provision of funds from capital for war may bring a considerable net gain to a country. "No sacrifices", he says, "can be too great that are required to preserve national security and independence, and a loan expended on armies and fleets employed for such a purpose is quite as well and profitably employed as if it has been laid out on agriculture or in promoting manufactures or trade." Expenditure for war does not in general add to the productive capital of the country and is, therefore, unproductive. Unlike productive expenditure it does not bring into being any fund of new wealth from which the interest and repayment of capital are made. In war the fate of present and future generations is in the balance and part of the burden rightly falls on posterity. Moreover, the expenditure has to be undertaken promptly, and the money is required immediately at almost any cost.

With his usual shrewdness, the author of *The Wealth of Nations* remarks that the borrowing of capital for war expenditure has the disadvantage that it removes an adequate check on the undertaking and continuance of war. Taxation, on the other hand, raises criticisms in the legislature which affects those responsible for the policy of war. Between 4th August 1914 and 31st March 1920 the German Reich issued loans to the enormous sum of over 222,000,000,000 marks, and, as we have already seen, the War expenditure had to be met from loans contracted in an ever-rising market. In Great Britain, however, the maximum of taxation was imposed, and resort to loans was accompanied by a change in the revenue system.[1] Expenditure from capital is indispensable to sound war finance, and lightens, if intelligently and discreetly used, the burden of war.

The financing of the Great War has taught us that a war

[1] The expenditure chargeable against revenue was as follows—the revenue is given in brackets—(in millions sterling): Year ended 31st March—1914, (pre-War), £197 (£198); 1915, £1133 (£227); 1916, £1560 (£337); 1917, £2198 (£573); 1918, £2696 (£707); 1919, £2579 (£889); 1920, £1666 (£1340); 1921, £1995 (£1428); 1922, £1079 (£1125); 1923, £812 (£914); 1924, £789 (£837); 1925, £796 (£799); 1926, £816 (£812); 1927, £842 (£806); 1928, £839 (£843); 1929, £818 (£837); 1930, £829 (£815); 1931, £881 (£858); 1932, £851 (£851); 1933, £859 (£827); 1934, £778 (£809); 1935, £797 (£805).

cannot be financed either by loans or by taxes but by both. At the outbreak of war more has to be raised by loans than by taxes, but as the war proceeds the proportion of expenditure from revenue must increase. In other words, the machinery of taxation should run at a greater speed. The aim of the statesman is to increase taxation to a point that the taxable capacity of the country can bear. This should be sufficiently high to provide for all extra debt charges, and at the same time to make adequate provision for the repayment of debt within a reasonable period without prejudicing industry or curtailing war production. A nice balance between taxation and loans is essential. Taxation prevents costs from being swollen by inflation, while too heavy taxation may have a deflationary effect and detrimentally affect war industries. Above all, it checks extravagance and avoids years of post-War taxation to meet debt charges. There is no definite time within which the war debts should be repaid, because the date of the next war cannot be foreseen. The golden rule is to pay off the debt as fast as the resources of the country will allow. If a provision for a sinking fund will enable the country to float its loans at a lower rate of interest this is an undoubted advantage, but a sinking fund for dead-weight debt sometimes results in a good deal of statistical juggling, as the history of English sinking funds proves. A sinking fund, if provided, would probably be for half the period fixed for productive expenditure, say forty years. In the case of a great nation which raised its revenue from taxation to the highest possible limit to defray a large part of the extraordinary expenditure, a simple paying off and wiping out of its own debt is a sufficiently safe plan.

6. The third case where recourse to loans may be desirable is that of temporary necessity. This class must not be strained to include too much. It is indeed intended to be anything but comprehensive, and to be severely limited in its meaning. "Temporary necessity" is not a haven of rest for the financier anxious to raise loans. It embraces practically only two instances of temporary necessity. In the first place it includes the covering of a *casual* deficit of a small amount (but not a series of recurrent deficits). Careful budgeting means the equating of revenue with expenditure.[1] Sometimes it happens that revenue may not

[1] A budgeted surplus tends to encourage extravagance, while moderate deficits tend to the exercise of economy.

come up to expectation on account of some unforeseen event. As Governments do not keep a large reserve in their Finance Departments, it may be necessary to throw this deficit on to the following year. The deficit of a bad year is thus carried by the surplus of a good year, and a revision of the taxation system and retrenchment are avoided. If the revenue is apt to be upset by a failure of the monsoon, as in India, or any similar uncertainty, it is not a bad plan to have a Revenue Reserve Fund to correct such disturbance or to meet certain special items of expenditure of a non-recurring nature.[1] Public credit will not be injured, but rather the reverse, by the knowledge that Government has been alive to the situation and taken time by the forelock. Short-term loans will ordinarily suffice, because if a deficit were to occur, except in exceptional circumstances, it would be a sign that the tax system clearly requires adjustment.

7. The fourth instance in which financing out of loans is permissible is, *in certain circumstances*, the construction of non-revenue-yielding public works and the participation of national and local Governments in economic enterprise which may be of considerable social benefit to consumers. By public works is meant all construction projects undertaken by Governments including local governmental agency and financed out of public funds. It includes construction work done by autonomous bodies of a public nature such as the British Central Electricity Board and the Port of London Authority. I include also Government-owned corporations such as the United States Shipping Board and the Belgian Central Credit Bureau, the Société Nationale des Habitations à Bon Marché, set up as a result of the post-War housing shortage. In some cases the State owns the entire capital, as in Great Britain and the United States and also in Russia, where Government control is complete in the larger industrial and commercial concerns. In certain instances Government owns the whole or part of the capital and leases the concern to private persons, as in the case of certain salt mines in India. In other cases, especially common in France and Germany,

[1] The Famine Relief Fund amounted to Rs.297 lakhs (£2,200,000) on 31st March 1934. The first charge on this is famine relief, and an annual assignment is made from revenue except in Burma and Assam, where no Famine Relief Fund has been created. Until the balances exceed a certain prescribed amount they are expended only on famine relief (*vide* p. 380, Finance and Revenue Accounts, 1933–1934; New Delhi, Government of India Press, 1935).

the capital is held partially by Government and the companies are controlled by directors representative of both Government and private shareholders. This last form of mixed corporation is typified in the Suez Canal and in the Anglo-Persian Oil Company. In the latter the State now holds the greater part of the voting stock. In the post-War period such mixed companies have greatly grown in popularity. Indeed, outside Germany the mixed corporation is almost, but not quite, entirely a post-War development.

The nature and scope of public works varies between countries and has varied too in the same country at different periods. As a result of the drastic economic change that has taken place in the last half-century, Governments have acquired new and complex functions. The volume of public works has increased as compared with private concerns both absolutely and relatively. Not only do Governments own, for example, railways, irrigation works, forests, printing works—the Government Printing Office in Washington is probably the largest printing and publishing establishment in the world—but Governments own in one or two cases rubber plantations, such as those of Java; vineyards, such as the State vineyards of Prussia and Austria; and monopolies, such as the camphor monopoly of Japan. Local Governments now undertake the supply of electricity, gas, water, schools, housing, hospitals, sewers, not to mention slaughter-houses, swimming baths, crematoria, cemeteries, picture galleries, museums, canals, ferries, golf courses, gambling houses, lotteries, bakeries, tourist bureaus, the sale of art wares, bill-posting services, medical and dental clinics, banks, insurance, grain elevators, street railways, tramways, buses, hotels, and laundries. This requires capital. Until the nineteenth century Government ownership of the instruments of economic activity was little questioned. But with the temporary dominance of the policy of *laissez-faire* the belief in this in a capitalist system of society was obscured. In England, for example, municipal Government dates from 1835 and county Government from 1888. Before the former date nothing was paid by the Central Government to local bodies. Until the middle of last century, except in very large cities, local authorities in Great Britain rarely resorted to the flotation of any loan. Public sentiment, however, was gradually changing in Great Britain and the Continent. With

this change in public opinion the history of British and German legislation took a new direction after 1870. Marxian or revolutionary socialism on the Continent and Fabian or evolutionary and gradualist socialism in England (as its name derived from the tactics of Fabius Cunctator implies) had widespread influence and programmes of human betterment were undertaken by Governments. The Fabians, founded in 1883, believed in the continuity of development from capitalism to socialism and held that the social reforms of the nineteenth century in education, housing, factory, and mines acts was socialism within the framework of capitalistic society. Progressive taxation and legislation on wages, hours, and conditions of labour were making for the more equitable distribution of wealth, and the next step towards socialism was, in Fabian opinion, public ownership with the socialisation of industry as a natural consequence. Even in the United States, where ideas of individualism and *laissez-faire* have accompanied the expansion of governmental activities, there has been a clash of individualistic and socialist ideas resulting in a confused and empirical doctrine of liberalism. When the new trend in most countries set in towards the close of last century Government undertakings have thus occupied within the capitalist economy an increasingly important position in public finance. The earlier conception of Government as an instrument of protection and regulation has given way to the conception of Government as a collection of public services, a means to satisfy human wants and desires. The aim of Government is to be interpreted less in terms of police protection and the enforcement of the law and more in terms of providing public services. Public works, therefore, are undertaken in many directions and for several reasons. Private capital may not be available owing to the uncertainty of profit or to its scarcity. A project may be so vast as to be incapable of being undertaken except by governmental agency. Among other causes may be mentioned military or political reasons (such as the construction of the Panama Canal and the making of strategic railways in North-Western India), or the safeguarding of national resources (such as oil), or the desire to supplement tax revenue by entering the field of economic activity such as the monopolies of tobacco and matches. Governments sometimes find it necessary to enter the field in order to control the consumption of the article as well as to get a revenue.

Thus in Canada liquor is controlled by provinces, and in India liquor, opium, and similar drugs. In other directions governmental agency is required where profit-making motives are subsidiary to those of public advantage. Thus it is necessary to have a good water supply free from all contamination. To-day municipalities with or without the support of the National Government are extending their activities in regard to housing schemes owing to the post-War shortage of houses and the necessity of getting rid of slums. Even before the World War there were extensive building projects by municipalities in London and Manchester. To-day this question of housing has been developed not merely in Great Britain but in the Continent of Europe and in the United States. The Chief Justice of the Supreme Court of the United States (Chief Justice Taft) declared in 1923 what is generally held to be true for most countries to-day, that the State may engage in " almost any private business if the legislature thinks the State's engagement in it will help the general public and is willing to pay the cost of the plant and incur the expense of operation ". There is thus an increasing number of the special services which modern governmental agency can undertake with obvious benefit to the community. It is clear, therefore, that the problem of expenditure on public works even of a non-revenue-yielding nature and the increased participation of Governments in economic activities in the capitalist State must be re-examined with a view to laying down principles governing such expenditure.

The orthodox British or Gladstonian School of Finance maintains that all expenditure on non-revenue-producing schemes is to be met out of revenue or income, and it ought not to be incurred from capital, however strong a sinking fund may be established. Successive Chancellors of the British Exchequer have followed in the main this policy, which is held to be strictly in harmony with the best of financial traditions. Within limits it is certainly sound. It predicates firm central control over governmental capital expenditure of all kinds, which is so essential. Otherwise interest charges will mount up year by year in an alarming way and confidence in a country's financial health will disappear. A narrow adherence, however, to this principle in normal times would mean the curtailment of public works until the revenue position of the country improves. It refuses to

recognise (1) the benefit conferred on posterity by the work which will last for a period, often for a long period, of years; (2) the heavy pressure of existing taxation, especially if there is a large degree of inequality in distribution, and the consequent fear that the imposition of any additional burden may involve an unbearable strain; and (3) the fact that the growth of towns and widening scope of municipal and county functions have made it imperative for local authorities to raise loans rapidly. It is a point of Gladstonian orthodoxy that the very considerations which demand urgently individual thrift are those which call for national thrift. A period of national poverty is not an occasion, it is said, when a Government should embark on schemes which do not give a return on the capital sunk in them. Indeed, even on schemes of a revenue-producing character, there should not be large capital expenditure at such a time, because resources of the individual are required for more urgent ends. This view, however, does not give due importance to the drift towards public welfare which has been more pronounced during recent decades than during the entire preceding century.

The Gladstonian theory has its stronghold in the fact that a firm grip over capital expenditure usually is part of a policy of budget equilibrium and with this the confidence in a country's finances. At the present time local policy in Great Britain is highly centralised and controlled. Similarly in India where this Victorian tradition has long been in practice, capital expenditure has been met from revenue and from loans, but this expenditure has very largely been on self-supporting public works. At the present time 80 per cent of the Public Debt of British India consists of interest-yielding assets, and, largely by a careful policy of capital expenditure, India's financial position to-day challenges comparison with that of any country in the world. During the five years 1923 to 1928, for example, the Government of India undertook capital expenditure, mainly on railways, to the extent of Rs.186 crores or £139,505,000. About one-fifth only of this total was by way of loans, *i.e.* public debt, the remainder being financed from revenue, Post Office Cash Certificates, and Post Office Savings Bank deposits. Government, it cannot be too often emphasised, in all countries is the heart of the financial and economic system, and what it does has most far-reaching effects for good and evil. Governments have to walk with much circum-

spection in regard to capital expenditure, and must follow a policy which, while not unduly rigid, must always keep capital expenditure under control. Unless this is done difficulties will arise, as in Australia and in post-War Germany which pursued a policy of borrowing from abroad and spending the proceeds on non-revenue-producing public works. At the end of 1929 with the disastrous fall in commodity prices, especially in those commodities which formed the chief exports—Australian prosperity is in the main dependent on wool—Australian Governments found their finances completely disorganised. The meeting of interest payments abroad on capital borrowed too freely in the past was well-nigh impossible. A severe curtailment by Australia in public expenditure, a reduction in the rate of interest in internal debt and additional taxation were enforced to rectify the mistakes of the past, mistakes which debtor countries are apt to commit.

Local authorities, especially cities and counties, as we have seen, have incurred large capital expenditure not only on productive works, such as gas and electricity concerns, but on non-revenue-producing works, such as roads, bridges, drainage works, schools, and hospitals. As compared with the pre-War year, local expenditure increased in 1925–1926 in Great Britain from £201 millions to £495 millions, *i.e.* about two and a half times the pre-War figure,[1] or allowing for price changes one and a half times ; in the United States in the same period the expenditure of local authorities (*i.e.* other than Federal and State Governments) increased from $1844 millions to $5829 millions, or more than three times the pre-War figure. If the rise in prices were allowed for, the expenditure almost doubled. Local indebtedness, however, in the United States increased from $2908 millions in 1913 to $8661 millions in 1925, *i.e.* it trebled.[2] In Great Britain in the same period it increased one and a half times—from £635 millions to £1046 millions. In recent years in almost all countries there has been a large diversion of purchasing power from the individual to local authorities as well as to the State. It may be that, had this money been allowed to fructify in the pockets of taxpayers, it might have been invested in different concerns, and thus it

[1] *Statistical Abstract for the United Kingdom*, Cmd. 4233 (1933). Tables 133, 135, 137, and 138.

[2] *The Cost of Government in the United States, 1925–26* (National Industrial Conference Board, New York, 1927), pp. 9 and 57.

would have added to the supply of private capital. It may, on the other hand, have been the case that it would have been wasted. The State, however, can and does on occasions spend far more wisely than the individual. Public expenditure not only makes the social life of the community far more secure and orderly, but it improves the quality of that life in a community. Expenditure on education improves productive efficiency and may be a stimulus to production. Governments can also borrow on more favourable terms than private enterprise.

8. When, then, is it permissible for local authorities to borrow? It is often a question of expediency. Has local taxation reached such a pitch that it would be unwise to raise local taxes or rates to meet the cost of the public undertaking, let us suppose a school or a hospital? Is the cost so great that taxation alone will not suffice? While the Federal Government of the United States has hitherto met its expenditure on public works wholly out of revenue, federal loans in certain circumstances have been used when revenue could not meet the entire costs. With the advent of the Roosevelt administration the policy was changed, as an extensive public works policy by the Federal Government was undertaken from loan funds to relieve the great depression. State Governments, counties, and cities have met about three-fifths from revenue and two-fifths from loans. Practice, however, is far from uniform. Some cities follow a policy of pay-as-you-go, while others depend almost entirely on loans for capital expenditure. In Great Britain the Road Fund depends on revenue mainly from motor vehicles and is self-supporting. The Central Government contributes directly from the fund one-half to three-fourths of the capital costs of Class I. and Class II. roads. The remainder is financed largely from loans with or without grants from the Central Government. In some cases tolls are levied as a method of financing. In the United States special assessments are in addition made to pay for local improvements. Practice varies greatly. It is, however, possible to lay down the following general principles.

In the first place, where the cost of non-revenue-producing public works is heavy in comparison with the available resources of the taxpayers and where these works are necessary, beneficial, and lasting, the cost may be financed by borrowing, provided the work is one the utility of which will continue within the life-

time of the loan and provided the loan is raised on reasonable terms, it being assumed that the credit of the borrower is sufficiently good. The existing loan must be paid off within the currency of the debt, and interest and similar charges must be provided for in regard to this occasional work. If, for example, a school or a hospital in a locality could not be erected without increasing local taxation to an extent which would be unpopular and even unfair, and if the cost is spread over, say, fifteen years, the additional burden on the taxpayers annually will scarcely be felt. Fifteen years hence the taxpayers will be benefiting from the construction of the work. The increased rate or tax must include annual provision for one-fifteenth of the principal in the case mentioned above plus the interest on the capital outstanding. If Government decides that it must construct houses for its police in an area where housing accommodation is difficult to obtain, it may be compelled to undertake out of sheer necessity the construction of tenements from capital in the same way that a manufacturer may do so for his mill hands. The millowner would ordinarily build the houses or tenements from capital and set aside a suitable sum annually as depreciation over, say, forty years or less. If he had a good year or series of years larger amounts might be set aside and the buildings written down considerably. Similarly Government would set aside a certain amount annually to a sinking fund—the longer the period of the currency or running off of the loan, the less the annual payments to the sinking fund. It might be possible to pay part of the expenses for construction from revenue and part from capital. The amount absolutely necessary for Government to grant as house allowance to enable these officers to live in the area in which they have to live might be capitalised, say over forty years, the life of the buildings, and this amount met from revenue. At all events, in the case of wasting or melting assets the debt charge should be sufficient to pay interest and to wipe out the principal in a stated number of years.

Secondly, where the cost of public works is recurring from year to year as in the case of large cities practice varies greatly from the case of those local authorities which finance capital expenditure entirely from loans to that of others which favour a pay-as-you-go policy. In normal circumstances it is wise to pay for roads, schools, and other non-revenue-producing schemes

which may be regarded as ordinary and not extraordinary from revenue and to follow the pay-as-you-go policy, thus relegating loans to their true place as only supplementary to revenue or taxation. The advantage of public borrowing depends on the purpose in view, and here it is essential to lay down as a principle that credit is only the handmaid of taxation and never its equal. It is a means of meeting burdens too heavy for the taxation system at any moment of time and burdens which from their nature can be lightened by being spread over a period of years. It may be admitted that although loans of this character do not give a return on the capital outlay, still they add to social wealth and welfare and may on this account be said to be indirectly productive. But borrowing must be limited to that which cannot be met from current revenue. It must be limited, since public credit is limited. Public credit, like private credit, is limited by the income from which interest and principal have to be met. Governments and local authorities have to submit in their borrowings to the same rules as private individuals. Once a community defrays costs by means of loans which should really be met from revenue its credit will be strained, and there will be no reserve of credit for real emergency or extraordinary expenditure. " A good name is ", as the Book of Proverbs reminds us, " rather to be chosen than great riches ", and no Government and no local authority worth the name must live beyond its means. It is sheer folly to meet, except in rare emergencies, current expenditure by long-term borrowings. A pay-as-you-go policy avoids the inflation of credit and of prices which loans invariably produce when resort is had to large borrowings. Taxation often checks waste. Taxpayers, moreover, view as a rule with far less concern wasteful expenditure from loans than from tax revenue. It is assumed that taxation, if levied, would cripple or retard commerce and industry. Financing by loan may in the long run be heavier than the taxation method because the gain of compounding heavier taxation by loans may not accrue to any except those who would have had, on account of their large incomes, to pay heavy taxes and who are alert enough to take advantages of saving and investing at all times. If capital expenditure is properly planned over a series of years, kept within strict control, and governed by strictly budgetary principles and sound public opinion, it is possible to meet continuing capital expenditure without irritation

to the taxpayers from revenue and loans. Planning is essential, and the cost of interest and sinking fund charges may be met by a special levy without difficulty.

Thirdly, in the case of public utilities, such as those relating to electricity, gas, telephones, and transit, which, although revenue-producing, are greedy of large and permanent amounts of capital usually in a specialised form, it is well to separate these undertakings from the local governmental budget. Public utilities should be financially self-supporting, provision being made to pay from income all current costs, depreciation, and capital charges. The Hydro-Electric Commission of Ontario, for example, with a plant investment in 1930 of nearly $260 millions, supplies municipalities and specially organised districts all over Ontario with power at a price which includes interest on capital, the amortisation of the capital on a forty-year basis, depreciation, maintenance, and other charges. Although its most striking characteristic is the low rates charged and the high consumption for domestic purposes, its financial self-sufficiency is all-important. The Port of London Authority, the Port of New York Authority, the American Telephone and Telegraph Company, and the British Central Electricity Board are similar examples. The principle of financial self-sufficiency has assumed new importance in modern public works expenditure. There should be almost complete divorce in Government-owned economic services from the ordinary administrative organisation of the Government, and virtual autonomy should be delegated as far as practicable to the directors of the Corporation. This has been achieved to a great degree in the case of the British Central Electricity Board and the British Broadcasting Corporation. Where it is necessary for public utilities to be referred to in the main budget of the local authority, it is well to take over only the surplus or deficit on the year's working to the main budget. The details of the public utility budgets may be appended and separately shown. Sometimes a distinction is made between undertakings such as hospitals, baths, and housing, which are of such general social utility that they must be provided at low cost even if a budgetary deficit results, and public utilities, which should be run at a profit to pay for the deficits on other types of enterprise. But this does not run counter to the principle of financial self-sufficiency in regard to public utilities. Lastly, there must be control over the amount of indebtedness to be

incurred on account of non-revenue-producing public works by the Treasury or Finance Department of the Central Government where State Governments undertake such works, and by the National Government in non-federal countries in the case of local indebtedness. An effective system of control is essential. It varies from country to country. In Europe, for example, measures of control are effective. In England local loan policy is rigidly supervised by the Central Authority in Whitehall—the Government Department concerned such as the Ministry of Health and the Board of Education and, above all, by the watch-dog of financial rectitude —the Treasury. In France the floating of local loans requires the sanction of higher authority, in some cases the concurrence of the President of the Republic. In India, and indeed in most countries, there are restrictions of a similar kind. In addition to supervision of local indebtedness there is the centralisation of local borrowing. There is, for example, the Public Works Loan Board which advances money to municipal authorities for public works, chiefly for sewers, water, and housing. In France the law of 1931 centralised local credit in the Caisse de Crédit aux Départements et aux Communes. The Crédit Foncier lends to local authorities funds obtained by public subscription. Similarly in Belgium there is the Credit Communal; in Germany the Deutscher Zentralgiround Sparkassenverband; and in Italy the Cassa dei Depositi e Prestiti. In the United States in the majority of State constitutions there are restrictions in regard to the total local indebtedness that may be incurred, fixed as a rule in relation to the value of property. In some States the purpose of such loans is laid down, in others the limit of maturity, and in others a popular referendum is prescribed before the loan is floated. These American constitutional restrictions are found to be on the whole too restrictive, although it is obviously right that a limit to indebtedness should be set. It is imperative that there should be centralisation and effective supervision. Local debts should be for a currency of years and never perpetual. Perpetual loans are reserved for the Central Government itself. The period of amortisation should be usually short.

Another object of capital expenditure on public works, even on works yielding no return on the capital spent on them, is for the purpose of creating employment. The stimulation of enterprise in this way is very old. It is said that the beautification of

the Acropolis at Athens by Pericles was undertaken to provide employment. In our own time large sums have been spent upon useful schemes of capital development with a view to assisting the solution of the unemployment problem. In Great Britain, the policy of stimulating enterprise by appropriate schemes of capital expenditure was attempted in 1905 [1] under the Unemployed Workmen's Act. After the Great War, when useful schemes of capital development were undertaken to combat unemployment, capital commitments under the Unemployment Grants Committee and the Development (Public Utility) Advisory Committee set up under the Development (Loan Guarantees and Grants) Act of 1929 amounted between 1920 and 1931 to no less than £222 millions and were spent on public works usually undertaken by local authorities. These varied in their utility from public utilities, such as those connected with water, electricity, sewerage, and other health services, to gardens, tennis courts, and bowling greens. The May Committee on National Expenditure calculated that it cost on an average to maintain one man in work for a year £250,[2] and the saving on the cost of maintaining a man in idleness in the same period was usually estimated at £60 a year. "Thus proceeding on this basis, unless the man's work is worth at least £190 to the nation when it is done, the nation loses economically by carrying it out." "We cannot endorse a policy of great expenditure on capital works, irrespective of their economic value, as a means of providing work. It is too expensive." [3] In the House of Commons in November 1932 the Minister of Labour announced that efforts to stem abnormal unemployment by inventing and expediting public works for the unemployed had definitely failed, and nothing less than the stimulation of ordinary business could be of any use. In short, the amount of employment provided by the vast expenditure on these schemes was very small in comparison with the total volume of unemployment, and

[1] The reservation of important public works for times of high unemployment was endorsed by France as a policy in 1902. Great Britain, Norway, Sweden, and other European countries followed France to a more or less degree in regard to controlled public works.

[2] This includes the primary employment given directly and indirectly, but it does not include the secondary employment in the demand for consumers' goods. It has been calculated in times of depression that secondary employment is approximately equal to the total primary employment.

[3] Cmd. 3920—1931, p. 139. Cf. British House of Commons White Paper—*Memoranda on Certain Proposals relating to Unemployment*, especially the Treasury Memorandum on the finance of development loans (p. 43), Cmd. 3331—1929.

the policy was completely unequal to the task of dealing with unemployment on a large scale. The costly and disappointing experiment conducted by the Government between June 1929 and August 1931 when the policy was most vigorously pressed forward, showed that the number of persons registered as unemployed in Great Britain increased from 1,100,000 to over 2,700,000, despite the putting in hand of relief works to the extent of £192 millions. The number of men employed thereby never exceeded 114,000 out of a total of unemployed at that date (June 1931) of over 2,600,000. It was, therefore, decided in 1932 to discontinue the policy by reason of the burdens it imposed on the finances of State and local authorities, and so ultimately, as a Government Memorandum pointed out, on industrial enterprise and efficiency and on the competitive power of British industry.[1] Instead, the Government aimed at creating the conditions under which industry can thrive, such as a policy of cheap money, economy in national and local expenditure (which would reduce immediately or in the future the burdens of national and local taxation), and a comprehensive and adjustable system of tariffs. At the same time the Government did not, it was said, switch on to the other extreme of unimaginative parsimony. No embargo was placed on public works, as such, undertaken by local authorities. The Central Government continued to sanction loans. for example, on new schools, on roads, on housing and slum clearance, and on capital account in connection with the Post Office. At the World Economic Conference in 1933 a discussion on the French proposal on public works revealed two broad conclusions, the vast total of the unemployed throughout the world, running to more than 30,000,000, and the existence of enormous sums of idle capital hoarded either by private individuals or in banks. The Chairman of the International Labour Office Governing Body stressed the fact that the social and economic value of public works was much greater in times of depression than in times of prosperity. Money could be borrowed more cheaply than in good times, and the expenditure of this money constituted an important item in the maintenance of the purchasing power of the community and thus was a contribution to reviving industrial activity. Capital should be circulated between creditor countries and countries lacking capital in order that the latter may under-

[1] Cf. *op. cit.* (Cmd. 3331—1929), p. 54.

take works likely to augment the national income and thereby to increase their capacity to pay debts. It was also suggested that international co-ordination was advisable to avoid the possibility, which might arise, if individual action were taken, of a disequilibrium in the balance of payments of the various countries, detrimental to international monetary stability. The leader of the Italian delegation was of opinion that each country should carry out a national programme of public works, adapted to its internal requirements and within the bounds of its financial possibilities. In regard to an international programme, however, he was far more reserved, and wondered whether any delegation would dare to add fresh debts to the great volume of existing international debt. The President of the Board of Trade bluntly declared that the British Government would neither itself embark upon a great programme of public works nor encourage others to do so by taking part in the grant of loans to so called " under-developed " countries. " We speak ", he said, " not as those who have great plans for the future, but as a country which has some recent experience of dealing with the unemployment problem by way of capital spending.... In our view it is unduly expensive, and it is an experiment which we are not going to repeat. We have terminated our scheme for dealing with the unemployed by way of capital expenditure works, and we shall not reopen these schemes, no matter what may be done elsewhere. Having said that with regard to our home position I do not wish to intervene in the policy of any other country. I can say emphatically that for our purposes we are abandoning this policy once and for all, and we do not think we can usefully participate in any international scheme of this nature." The British principle thus is that expenditure of public money upon works which give no commensurate return in cash or in providing employment or in the stimulation and facilitation of normal trade must be discontinued, and that no scheme of international public works must be considered. It is a matter for other countries to follow or discard British experience. It may be argued that conditions in other countries are different from those of Great Britain, which has, it is remarked, tried the palliative to a greater degree than most. The Federal Government of the United States decided on an extensive programme of capital expenditure to relieve unemployment in 1931 when the Wagner Bill setting up a permanent

Federal Employment Stabilisation Board became law. Not only was the advanced planning of federal construction programmes provided for, but it was also provided that schemes should be accelerated in times of depression, perhaps the first instance of real importance where theory has been put into practice over so wide an area. In July 1932 $300 millions were set aside for federal works by Congress and loans from the Reconstruction Finance Corporation up to $1500 millions were authorised to States, counties, cities, and in some cases private corporations for " self-liquidating " public works, the first important example of federal assistance to local borrowing for public works. In June 1933 under the National Industrial Recovery Act, the President was empowered to spend on public works as an urgent measure $3,300,000,000. In August 1934 it was officially stated that $3,665,000,000 out of $3,700,000,000 voted by Congress had been allotted, but 30 per cent of this only had been sent. The Public Works Administrator recommended to the President that " the Public Works administration and its power to make loans should be continued for a period of at least two years longer after June 1935 ", when its existing powers expire, illustrative of the well-known fact that such large sums cannot be spent without considerable planning in advance, and also of how this expenditure may upset hopes of balanced budgets, as such action destroys all hope of a balanced budget in 1935. Unless planning is made well in advance various financial and administrative difficulties will arise, and the advancing or postponing of these, so vital in any policy of controlled public works, will not be possible. It may be concluded that a vast expenditure upon public works as a cure for unemployment of a more or less permanent character resulting from deep-seated forces cannot have any permanent effect or on balance any favourable effect upon unemployment. In Great Britain it did not help the export industries to any extent, and it was there that the bulk of unemployment was concentrated. It may be a means where unemployment is local rather than national of mitigating the transfer of workers in these localities to other occupations. Owing, however, to the need of absorbing men of varied types and capacity, the efficiency of the labour is not always high and is therefore expensive.

In recent years a distinction has been made between unemploy-

ment of a quasi-permanent character and unemployment resulting from cyclical business fluctuations. It has been suggested that public works expenditure may be used as an agency of economic stabilisation. Hitherto in times of good trade it has been customary to push on the construction of public works and thus to increase the demand for both capital and labour. Thus inflationary tendencies were encouraged. In times of depression, on the other hand, public works were restricted because local governmental authorities had not the necessary funds, were faced with a load of debt, and their borrowing powers were restricted. This causes further depression just when private spending on account of the depression is much reduced. In good times when industry and trade are expanding, public works which are not urgent should be held back, and national, State, and local Governments should prepare for the rainy day by strengthening their sinking funds and reserves. As a general rule, however, this sound policy is not followed ; more is spent ; rates and taxes are reduced ; and the strengthening of the finances to meet the period of depression in the business cycle that is to come is generally overlooked. This policy of undertaking public works in good times when public opinion demands these and public authorities find the necessary funds without much difficulty has inflationary results owing to pressure on the capital and labour markets. More spending in times of prosperity is not advisable. It is not realised how useful a policy of retardation in reality is on the upward swing of the cycle. Its extent should depend, of course, in no small degree on the behaviour of private industry itself. In times of depression, on the other hand, and especially towards the later stages of the downward movement of the trade cycle when the necessary amount of liquidation has been effected and sometimes before this point is reached in order to prevent further contraction of business, expenditure on public works should be expanded. This stimulus to demand, directly and indirectly, is likely to have a cumulative effect, and to give an additional push to the wheel which must be made to turn. Unfortunately in bad times the natural instinct for public authorities, as for private individuals, is to economise and to forget that this is the time when wise spending is essential. Public authorities should then energise expenditure on public works and put a curb on deflation. But here again instinct makes these authorities

deviate from sound policy. Public works are not accelerated and arrears brought up to date. The spending of large sums involves the preparation of detailed plans and estimates, arrangements for the acquisition of property and many other preliminaries if the money is to be wisely spent. This is the period of the business cycle when money is cheap. It is the time for cautious expansion. Money can be borrowed from banks without the rate of interest being appreciably affected and without draining the reservoir of the finance required by industry. In times of depression there is usually a surplus of idle funds which private industry cannot use. Again it must be remembered that it is a fallacy to imagine that there is a rigid and inflexible volume of credit. In the downward swing of the cycle there is plenty of room, as the experience of 1933 showed, for a greater turnover of money without any danger of money wages being violently forced up. Private enterprise is insufficient to provide all the useful work that might be undertaken. In a period of unemployment public works will not divert employment to any degree by raising, for example, the cost of borrowing. There may be some diversion, but it would not be considerable. It would also have a stimulus on the general price level, a very desirable thing in periods of depression. Of the dynamic quality of strong action along these lines there can be no doubt. It is the way to expansion and to prosperity.

A policy of controlled public works steers a middle course in national policy between stagnation and hysteria. It does not mean a policy of spectacular State-promoted projects or the deliberate unbalancing of budgets which might upset the psychology of the country's solvency and indeed the whole basis of national credit. It is a means of mitigating, not of eliminating, cyclical variations. Its importance in a period of return to normality is often exaggerated. It means the removal of inhibitions on and the stimulation of public enterprise in times of bad trade when costs and private enterprise are at a minimum, just as in periods of good trade it means the checking of schemes which tend to press on the capital and labour markets and thus to encourage inflation. Large public works programmes stimulate or retard—it depends, of course, on when they are undertaken —expenditures and purchasing power directly and the demand for capital and consumers' goods. In 1933, for example, the British Minister of Health invited local authorities to submit

five-year programmes in regard to slum clearance. He announced in October of that year that the returns then received covered three-fifths of the total population of the country. The programme will provide for the clearance of about 210,000 houses and the rehousing of about 1,050,000 people in five years as compared with only 20,000 slum houses cleared in the last ten years. When this is done the back of the slum dragon will have been broken. The cost of this notable achievement involving a capital outlay of £95 millions in five years both to the taxpayer and the ratepayer will be just over £3 millions a year for forty years. This does not take into account the saving in unemployment benefit, estimated at £4 millions spread over five years. The main obstacle to programmes of public works is the likelihood of contracting a future burden in interest charges so heavy as to endanger the budget. On the other hand, with the return to normal business conditions there are increased receipts in the form of taxes and rates without higher taxation and rating. At the same time the burden of indebtedness is reduced by the amortisation of existing debt and, in periods of cheap money, by conversion which reduces the annual charges on debt.

It is difficult to summarise the pros and cons of a policy of controlled works, as each reason for and against is subject to many limiting facts. The case for a policy of expansionism rests mainly on the alleged stimulus to industrial recovery. This leads to higher national income, higher revenue to Governments and local authorities, and higher prices. Public expenditure, for example, on housing and slum clearance gives rise in many ways, directly and indirectly, to demands for goods, both capital and consumers' goods. It is important to encourage the consumption of working classes on goods other than food. Additions by the policy of spending on public works are made to capital assets or wealth from which considerable utility has been derived. It is also urged that the policy leads to a relief of the tension between debtor and creditor countries. The case against the doctrine which must always be put in its proper prospective is that it is expensive and adds to the burden of taxation and rates. If it leads to unbalanced budgets it may lead to a lack of confidence, and all the evils of 1930–1931 will be on us again. It perpetuates high wages, is no cure for unemployment, leads to clumsy inflation, depletes the sources available for business, and gives little

hope of quick results. The policy of controlled public works has much in its favour. It assumes that (1) plans and estimates are carefully planned in advance; and (2) the timing of the increase or decrease is accurately carried out. If the policy is well timed it may have a great effect on business, quite disproportionate to the magnitude of the works undertaken. It is sometimes urged in addition, as at the World Economic Conference, 1933, that it must be adopted internationally, since the country which undertakes a policy of inflation or deflation under an international monetary system, such as the gold standard, may find its position threatened by external drains resulting from an adverse balance of payments, a flight of capital, or, perhaps the greatest of all, the danger threatening the country's budget.

Conclusions

9. The principles governing public expenditure chargeable to capital may be summarised thus:

(1) Except in four cases where recourse to loans is necessary or desirable, public expenditure should be met from income, if necessary by increased taxation.

(2) Even if the expenditure is abnormal and extends for more than a twelvemonth, taxation should be increased to meet this charge as far as practicable.

(3) The four instances where loans are necessary or desirable are (*a*) permanently productive investments; (*b*) an extraordinary emergency, such as war; (*c*) certain cases of temporary necessity, *e.g.* a *casual* deficit; (*d*) in certain circumstances non-revenue-producing public works and the participation of Governments in the field of economic activity. This includes the construction of public works as a policy of economic stabilization in connexion with business cycles.

(4) In permanently productive investments the repayment of the capital spread over several years is better than sudden heavy taxation, and commercial methods should be adopted from the beginning of the undertaking.

(5) Requirements for new capital should be supplied as far as possible from internal sources so far as internal capital is not forthcoming. The inflow of external capital is not only unobjectionable in itself, but is a valuable factor in assisting the

economic development of a country and in increasing its wealth and employment.

(6) In an extraordinary emergency, such as war, enhanced taxation would neither be sufficiently productive nor immediate. The dangers of the system arise from the apparent lightness of the burden of loans as compared with that of taxation. The ideal is to impose the maximum of taxation from the outset, *i.e.* to get the maximum in the form of taxes from the unwilling as well as loans from the willing. (See (2) above.)

(7) In cases of temporary necessity public credit will not be affected by, for example, provision against a casual deficit of a bad year being carried on to the following year. Constant changes in the taxation system are avoided. On the rarest of occasions political reasons may be so important that it may be considered politic to avoid fresh taxation and to incur the expenditure from capital.

(8) Sinking funds for productive and unproductive capital expenditure increase confidence, especially where resources are limited and credit easily shaken by over-borrowing. It is therefore necessary to make gradual provision for the repayment of a loan from an early period of its currency. This is preferable, as experience shows, to devoting the surpluses of good years to debt reduction.

(9) The successful operation of a sinking fund depends on (*a*) the regular investment of a sum obtained from taxation or from savings, and (*b*) the accumulation of all the interest upon such sums. Both the original grant of a sinking fund and the interest on the securities purchased by the fund are met from taxation. Amortization depends, as we shall see, on the will of the taxpayers to pay taxes for this purpose. As a general rule the period for productive loans may be fixed at as much as eighty years and for unproductive loans at forty years or less according to the life of the wasting asset.

CHAPTER XII

SOME GENERAL PROBLEMS OF EXPENDITURE

Ordinary and Extraordinary Expenditure

1. We have already referred to the difficulty of distinguishing between ordinary and extraordinary expenditure.[1] "Every Government should," according to the Brussels Financial Conference, 1920, "as the first social and financial reform on which all others depend, restrict its ordinary recurrent expenditure, including the service of the debt, to such an amount as can be covered by its ordinary revenue; . . . abandon all unproductive extraordinary expenditure; restrict even productive extraordinary expenditure to the lowest possible amount. If the above principles are accepted and applied, loans will not be required for recurrent ordinary expenditure; borrowing for that purpose must cease. In a number of countries, however, although the ordinary charges can be met from revenue, heavy extraordinary expenditure must at the present time be undertaken on capital account. This applies more especially in the case of those countries devastated during the War, whose reconstruction charges cannot possibly be met from ordinary receipts. The restoration of the devastated areas is of capital importance for the re-establishment of normal economic conditions, and loans for this purpose are not only unavoidable but justifiable.[2] But in view of the shortage of capital it will be difficult to secure the sums required even for this purpose, and only the most urgent schemes should be pressed forward immediately."

[1] P. 53.

[2] French savings have provided most of the capital required for the restoration of the French devastated areas. (One of the problems of Reparations is to shift this capital liability of the French Government to the shoulders of the German Government with the least disturbance.)

The expressions "ordinary" or "normal" and "extraordinary" or "abnormal" are for all practical purposes sufficiently well understood in the science of finance, and it was in view of this that the Brussels International Conference (which comprised leading financial experts of the thirty-nine countries represented) passed the resolution already quoted. The terms ordinary and extraordinary are self-explanatory. Extraordinary expenditure includes exceptional expenditure of a more or less non-recurring nature. It may be unforeseen but not necessarily so. Ordinary expenditure meets the continuous requirements of the State. The distinction between ordinary and extraordinary expenditure will vary in their application according to local circumstances. This does not mean, however, that all extraordinary expenditure should be met from loans. Governments should make provision for extraordinary expenditure from revenue if it tends to be periodic in its incidence, such as the recurrence of famine in India. Famine insurance is annually provided for from revenue. Some countries, such as Canada and Germany, under extraordinary expenditure include all capital expenditure. The "Dominion" expenditures of Canada, for example, under "ordinary"—debt charges, subsidies to provinces, cost of collecting revenue, defence, pensions, civil government, public works and some miscellaneous items; while under "extraordinary"—capital expenditures, railway subsidies, War loans—expenses and discounts, and War charges. Thus extraordinary expenditure in Canada includes recurring expenditure in that it includes year after year a provision for capital expenditures, and from 1915 War expenditure over and above the provision under "ordinary expenditure —militia and defence". In Indian public expenditure Famine Insurance is an ordinary item year after year. In a time of very exceptional famine (*quod avertat Deus*) it may be necessary to budget for a sum over and above the amounts assigned for famine insurance. This would then be extraordinary expenditure. At the outbreak of the Great War, War expenditure in English finance was extraordinary, but when Mr. McKenna was Chancellor of the Exchequer in 1916 he insisted that the Budget should include all normal expenditure and the War debt charge: a high standard of finance. In the English Budget itself there is, of course, no distinction between ordinary and extraordinary.

In the sanctioning of estimates legislatures rightly insist on proposals laid before them for sanction being grouped into two classes—recurring or recurrent and non-recurring or non-recurrent. The former have to be carefully watched since these have a permanent effect on the State's expenditure. There are also supplementary estimates which come up for sanction between the presentation of one Budget and that of its successor. Supplementary estimates may be either items which were not ready at the preparation of the Budget or items which were of a completely unforeseen nature. Orthodox finance of the last century disliked such estimates as being of the nature of " sloppy finance ". " I look " (said Gladstone, when Chancellor of the Exchequer in 1862, to the Public Accounts Committee) " with great jealousy upon Supplementary Estimates. I think that Supplementary Estimates are very plausible in principle, but that in practice nothing would so much tend to defeat the efficacy of Parliamentary control as the easy resort to Supplementary Estimates. It is absolutely necessary, in my opinion, to the efficacy of Parliamentary control that the House of Commons should have the money transactions of the year presented to it in one mass and in one account." [1]

2. In the Brussels International Conference Resolution productive and unproductive expenditures are contrasted. The same distinction is often seen in the distinction between productive debt and ordinary or dead-weight debt. Expenditure which brings in a fair return on the capital invested is said to be productive. Thus irrigation works which pay the current or normal rate of interest are productive. Expenditure on a town hall or park would ordinarily be unproductive, while expenditure on waterworks productive. As in the case of the individual, expenditure, in essence unproductive, may be indirectly productive and the whole community may increase its production or wealth in the long run by such expenditure. In reality all public expenditure should be of this nature, but this should not blind one to the distinction already made. In regard to productive expenditure Government naturally regards it, to some degree at least, as a question of investment. Take, for example, the Sukkur barrage in Sind, the largest irrigation project in the world. In unproductive expenditure such as protective irrigation works and the construction of New Delhi other issues are

[1] Cf. *National Economy*, Higgs (Macmillan, 1917), p. 23.

introduced. General financial considerations must obviously govern the limit of expenditure of this class, except perhaps where a nation's honour and security are threatened.

Public Expenditure and National Income

3. Elsewhere the expenditure by the Government has been shown to have had an effect on distribution as well as on production. The State spends a part of the national income in a manner quite different from the way the taxpayers would have done had the money been left in their pockets. State expenditure should stimulate production just as taxation checks it. The stimulus to production may be achieved by increasing the productive capacity of the population by, for example, education and sanitation, and by the development of the saving habit. The expenditure by the State on the social services may increase, as we have seen, both the efficiency of the recipients and of the future generation. A part of transfer expenditure as, for example, the interest on internal loans, may increase the saving power of members of the community. The State also transfers through high progressive taxation a part of its revenue to the poorer citizens, and this in a certain degree affects the distribution of the national income.

4. The question is sometimes asked whether there is any relation between public expenditure and national income. Is there a percentage relationship of public expenditure to the gross annual income of society which will provide a basis for judging the expenditure of a Government? Is there a percentage beyond which a Government should not go, unless it wishes to dislocate industry and indeed the economic organisation of society and to compel its citizens to live a worried and down-trodden existence? In the second half of the eighteenth century Justi, who published in 1766 his *System des Finanzwesens* (one of the first systematic works on Finance), answered the question in the affirmative; 16 per cent was an average and 25 per cent excessive. No writer to-day, after the experience of the Great War and its financing, would regard these figures as applicable to present conditions, and a much larger percentage would be taken as moderate.

The following table shows the percentage of public expenditure

to national income. The details will be found in Table VIII. of the Appendix.

ORDINARY EXPENDITURE OF CENTRAL AND PROVINCIAL GOVERNMENTS STATED AS A PERCENTAGE OF NATIONAL INCOME

Note.—Purely Local Government expenditure is excluded, as accurate data are not available in all cases.

Country.	Pre-War Year. (1913–14)	Post-War Years.
United Kingdom	8·8	24·3 (1931-32)
India	6·4	14·3 (1932-33)
Canada	11·6	8·5 (1928)
Australia	26·0	27·3 (1927-28)
United States of America	3·1	15·1 (1932)
France	12·6	20·2 (1928)
Japan	13·1	11·4 (1925)
Italy	10·5	22·2 (1928)

The very simplicity of the above table hides the fundamental difficulties of the problem. Even in the same country comparisons are, at different periods, difficult on account of the fall in the purchasing power of money. This may be corrected by dividing the expenditure and national income by the index number of wholesale prices, as is done in Table VII. Appendix. Other reasons are the development of State activities or the acquisition of new territories. Social legislation (*e.g.* State management of certain undertakings, State aid to schools and hospitals, and old age pensions) makes it difficult to compare present-day expenditure as a percentage of national income with that of earlier times. The acquisition of new territory or the cession of it renders comparisons also difficult. Again there is always the danger of expenditure being counted twice, as, for example, when the State gives grants-in-aid to local authorities. The preparation, therefore, of detailed table No. VIII. Appendix was unusually difficult.

Then again in making comparisons between different countries it is necessary to see that the figures which are compared are really comparable; central and provincial expenditure should be included in all cases, and, if possible, also local expenditure. Official statistics of actual local expenditure country by country are very difficult to obtain. In 1925–1926 34 per cent of the total public expenditure in the United States was incurred by the Federal Government, 13 per cent by the States, and 53 per cent

by the Local authorities. In comparing this percentage with that of, say, Canada or Australia, the scope of the statistics should be the same. There are other factors, such as differences in the size of income, accumulated wealth, the distribution of wealth, and economic progress, that do not always strike one as one's eye runs down the percentage figures in the table. Differences in the amount of income have to be remembered, since 10 per cent in India would not be the same as 10 per cent in the United States, any more than 10 per cent means the same to a man earning Rs.100 a month and another earning Rs.10,000 a month. Another factor is the accumulated wealth of a country which is somewhat used to no purpose or for a wrong purpose. In one of the largest native States in India there is considerable wealth, the accumulation of centuries. The ruler's *private* wealth (*i.e.* apart from the State treasure) in coin and bullion is over Rs.10 crores, or about £7 millions. The jewels, valued on the accession of the ruler, were worth over Rs.200 crores, or about £133 millions. These could be drawn on in cases of emergency. The distribution of wealth is also of some importance. Countries are so diverse in their economic conditions and their tax systems so different that the tax *per capita* and *per "contribuable"*, as the French would say, vary considerably. Economic progress in one country may be slower than in another. Vauban, writing in 1717 to Quesnay the Physiocrat, rightly held that poor peasants make a poor kingdom, and a poor kingdom a poor king. The object of the outlay has to be considered. Expensive programmes of education, public health, irrigation, and street construction may, for example, be incurred in one country while another country may be spending on what is not enriching citizens to anything like the same degree. The extension, then, of administrative action is important, as in India, where the Bombay Government has extended administrative action further than other provinces in India. In times of grave national danger, as in the late War, high expenditures in proportion to national income would be justifiable.

The general conclusion is that something in the neighbourhood of 20 per cent of the national income, other things being equal, is spent by public authorities in normal times. In grave emergencies, as in the War, this is even doubled for a time. Increasing expenditure presupposes elasticity of revenue, and this is

always possible so long as national income increases faster than national expenditure. To this we shall return in discussing taxable capacity,[1] and in estimating the real burden of taxation and national income. Care has to be taken to see that enough is left for national consumption, and that industry is not crippled for want of funds, otherwise thrift will be penalised and industry so affected that the source of taxation will dry up. The limits of taxable capacity are not fixed but flexible, depending on the direction of public expenditures, the methods of taxation, the distribution of wealth, and the psychology of the people taxed. Twenty per cent will not, from what has been said, affect rich and poor countries alike. When the limits of taxable capacity are reached, recourse in urgent cases to capital expenditure makes it possible to distribute the burden over a long period.[2]

[1] Chapter XV.
[2] See Chapter XXIX. on The Burden of Taxation

BOOK III

PUBLIC REVENUE OR INCOME

CHAPTER XIII

THE CHARACTERISTICS AND CLASSIFICATION OF PUBLIC REVENUE OR INCOME

THE CHARACTERISTICS OF A GOOD REVENUE SYSTEM

1. WHAT are the characteristics of a good revenue system when viewed as a whole? It should in the first place possess the characteristics of good taxes which make up the system—the characteristics of equality, certainty, convenience of payment, and economy in collection.[1] If a revenue system requires a large number of officials for the collection of taxes,[2] if evasion and vexation are common, if it favours special classes and is therefore lacking in equity and if trade is hampered, then the system cannot be said to be satisfactory.

A good revenue system should be truly a system and not a collection of isolated acts, based on haphazard methods. It should rest securely on a basis of comprehensive statistics. It should be possible to budget with fair accuracy for a steady calculable return, and when new changes are made, greatly increased expenditure on collection and new machinery should not be necessary. It should have the merit of simplicity; it should not be more complicated than is necessary. Simplicity in the tax itself as, for example, in the various kinds of sales taxes, is required, but simplicity means, too, simplicity in the administration of the tax system. But simplicity is only one of several other features, and complexity as in income tax legislation where the concept of income is itself complicated is unavoidable. Simplicity must be a test but consistent with the efficient working

[1] For the canons of taxation see Chapter XIV. p. 213.

[2] "Every tax ought so to be contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State" (*The Wealth of Nations*, Bk. V. ii.).

of the system. Each new fiscal act should be capable of being interpreted as part of a connected scheme possessing a definite place in the financial structure. Every sound tax system has a number of taxes which must fit into the system as a whole. All classes must share in the duties of citizenship. Diversity, thus, is also a test as is flexibility. There should be, moreover, as far as possible no conflict of tax jurisdiction among administrations.

A good revenue system should also possess the mark of elasticity, the capacity to respond quickly to changes in revenue demand. The British Income Tax and the Indian Salt Duty are good examples. This is of special importance in times of emergency and elasticity, therefore should always be an important characteristic of a Central or Federal Government which is responsible for defence. Gladstone in his first Budget speech [1] spoke of the income tax as "an engine of gigantic power for national purposes", an elastic tax which in a time of vital struggle makes it possible to raise additional revenue to meet war expenditures. A revenue system ought to be capable of increasing automatically with the wealth of its citizens and with the consequent demands for greater expenditure on the part of Government. Under the Indian Constitution of 1919 a provincial Government, like that of Bombay, has land revenue and excise as its two main heads, but these are not adequately expansible. They depend on uncertain factors, *e.g.* land revenue depends on the monsoon, and excise on the prosperity of the working classes. It is therefore not possible for the provincial Government to finance comprehensive schemes of universal primary education and of public health. The Finance Member said in the Bombay Legislative Council, while introducing the Budget, that "the House will no doubt remember the fluctuating character of our revenue. Our Land Revenue only two years ago, owing to an adverse season, fell to 431 lakhs, while this year we are collecting 582; our Excise has varied 50 lakhs in a year; our Stamps have fallen off 40 lakhs from the estimates." [2] "We cannot rest content until our revenue is more broadly based; until we have secured resources which are not all liable to diminution simultaneously, and, so far as possible, solid resources which will not be subject to fluctuation at the very time when the strain on the public exchequer

[1] 8th April 1853.

[2] *Bombay Legislative Council Debates*, vol. viii. Part I. p. 41 (Government Central Press, Bombay).

increases most severely." [1] An amount of land revenue per acre, fixed for thirty years, is far less advantageous than a proportionate amount of the annual rental or capital value. This defect of inelasticity has been remedied in the reforms embodied in the Act of 1935 to some extent by the sharing and distribution of revenues between the central and provincial governments.

Lastly, there are the characteristics of sufficiency and productivity. The revenue should be equal to the demands made on it. As a rule revenue is ordinarily raised from a small number of productive taxes rather than from a large number of comparatively unproductive taxes. In Great Britain, however, before the War there was a tendency to over-concentrate on a few taxes, with the result that indirect taxation might have been less felt if the taxes had been scattered over a large number of commodities. Productivity is an important quality of a good revenue system, and covers, as has often been said, a multitude of faults. Indeed, fiscal adequacy is usually regarded as the chief test of a sound tax system. In a great emergency, such as war, it is the only test, but the long-period viewpoint has to be considered, viz. that after a time the stream of income flowing into the public treasury shall not be dried up as a result of this or that tax.

In applying the test of fiscal adequacy the necessity of safeguarding the sources from which public revenue is drawn must be kept in view. The income tax, the surtax, and death duties in Great Britain are fiscally productive and give much strength to the British revenue system. The objection of most substance to these taxes is their tendency to diminish the volume of saving. The remedy is the development of the saving habit among those of smaller means, a habit that has increased by leaps and bounds in the present century, especially since the War.

The characteristics, in short, of a good revenue system are mainly productivity and elasticity. Other requisites are economy, equity and diversity, simplicity and harmony. Another characteristic, often stressed by American writers, is flexibility, as some State constitutions of the Union are too rigid in regard to taxation, especially in regard to the revision of property taxation, to meet changed circumstances. Tempora mutantur; nos et mutamur in illis. A sound budgetary system, too, is essential

[1] *Ibid.* vol. vii. Part II. p. 535 (Government Central Press, Bombay).

in order to balance revenue, and expenditure and revenue systems can be improved in many directions by such a system.

The Classification of Public Revenue or Income

2. "The revenue which must defray", writes the author of *The Wealth of Nations*, "not only the expense of defending the society and of supporting the dignity of the chief magistrate, but all the other necessary expenses of government, for which the constitution of the State has not provided any particular revenue, may be drawn either, first, from some fund which peculiarly belongs to the sovereign or commonwealth, and which is independent of the revenue of the people; or, secondly, from the revenue of the people. The funds or sources of revenue which may peculiarly belong to the sovereign or commonwealth must consist either in stock or in land. . . . Public stock and public lands, therefore, the two sources of revenue which may peculiarly belong to the sovereign or commonwealth, being both improper and insufficient funds for defraying the necessary expense of any great and civilised State, it remains that this expense must, the greater part of it, be defrayed by taxes of one kind or another; the people contributing a part of their own private revenue in order to make up a public revenue to the sovereign or commonwealth."[1] Adam Smith tells us, in short, that the sovereign in some cases had a fund or source of revenue of his own, as in Holland and Venice a bank, and in Hamburg a wine cellar and an apothecary's shop. He is of opinion that the Government of England would be well advised not to undertake banking, but the Post Office is within its powers as Government can manage it with successful financial results.[2] It does not manage the Crown lands well, and could not undertake the management of all the lands in the State. The sovereign is a poor farmer and a poor forester. The public domain except for parks should be given up.[3] Whence, then, is its revenue to come? Obviously from taxation.

The classification of public revenue or income on the lines of

[1] Book V. ch. ii. Cannan, vol. ii. p. 302 and p. 309.

[2] Book V. ch. i. part iii. Art. I. Cf. ch. ii. part i. Cannan, vol. ii. p. 303.

[3] Smith did not perhaps realise how some of the German principalities successfully managed the public domain and other phases of public administration. He did not apparently know German. This would have lessened his opposition to Government ventures in the realm of industry.

Adam Smith is hardly suitable to-day as it is too antiquated for twentieth century finance. His main divisions, two in number, (*a*) property belonging to the sovereign, and (*b*) revenue derived from the people, would hardly be sufficiently comprehensive. Since Adam Smith's time local self-government has grown apace, the activities of public authorities have increased, and social services have developed to a degree never dreamt of half a century ago. The property of the sovereign is now, in most countries, an almost insignificant source of the State's annual income. The main source is taxation. Nearly two-thirds of the ordinary revenue of India to-day are from taxation, and a shade over 30 per cent from Government undertakings, as will be seen from the following table:

PERCENTAGE OF TOTAL ANNUAL REVENUE OF INDIA (CENTRAL AND PROVINCIAL)

	1871–72	1901–2.	1911–12.	1921–22.	1933–34.
Tax revenue . . .	89·4	67·6	63·1	66·7	62·4
Non-tax revenue:					
Government or public undertakings . .	5·0	27·5	31·5	22·9	30·2
Others . . .	5·6	4·9	5·4	10·4	7·4
	100	100	100	100	100

It should be noted that loans have not been regarded as a source of revenue in the above table, as borrowing to meet current expenditure, as in the late War, simply postpones the time when the required revenue must be obtained from some other source. In addition to this postponement is the disadvantage that interest has to be paid on the loans, and thus this resort to loans is justified only in exceptional circumstances. Loans belong, therefore, to an extraordinary source of revenue, and are not always included in the revenue or income of public authorities. On the other hand, public loans may be regarded as a source of public revenue at the time of borrowing. They augment or replace the revenue from taxation, although in the long run they are merely a device (assuming the loan is repaid in something like the same unit) for distributing the burden of taxation. If, however, loans were included, the pre-War year's income and that of 1927–1928 for the Governments of Great Britain and India (central and provincial) would have been as on next page.

3. Taxes are compulsory contributions to public authorities to meet the general expenses of Government which have been incurred for the public good and without reference to special benefits. From the time we enter the world until we leave it, whether we are rich or poor, we depend at every stage on the machinery of Government especially for the protection of life and property. Taxes, therefore, are paid for the participation in such common benefits and not for any special advantages enjoyed by the taxpayer.

PERCENTAGE DISTRIBUTION OF GOVERNMENTAL EXPENDITURE, SOURCES FROM REVENUE AND LOANS

	India.		Great Britain.	
	1913–14.	1932–33.	1913–14.	1932–33.
Receipts from				
1. Tax Revenue . .	41·5	39·9	65·2	69·2
2. Non-tax revenue: .				
i. Govt. undertakings	23·5	32·5	12·4	6·9
ii. Others . . .	3·6	8·0	1·6	2·7
3. Loans to meet capital expenditure . .	31·4	19·6	20·8	21·2
Total . . .	100	100	100	100

Fees are payments primarily in the public interest for special services which people must accept whether willingly or not. Prices are like fees in that they are charges for special services, but they differ from fees in not being compulsory since the consumer or purchaser can go without the service rendered. Fees have been defined by Wagner as "charges arbitrarily fixed by a Government in amount and method of payment, which individuals or groups of individuals pay as a special compensation for some service rendered by a public body, or for some expense which the individuals have caused the State in the exercise of its functions".[1] They confer a special advantage on the fee-payers in their legal or personal capacity, although this special advantage (as in the case of registration fees, *e.g.* for documents or marriage licences) is secondary to the primary motive of regulation in the public interest. In this respect fees differ from prices. Fees are

[1] Wagner, *Finanzwissenchaft*, section 277.

for governmental services, while prices are for services of a business character. They differ also from taxes in that they are payments for special benefits enjoyed by the payer, while taxes are for general benefits, expenses which are laid out, as Adam Smith says, "for the benefit of the whole society". The essence of a tax is the absence of a *quid pro quo* between the taxpayer and the public authority. Fees, in Adam Smith's words, are "particular contributions" (as opposed to general contributions) by "persons who give occasion to this expense" and "are most immediately benefited by this expense". They are what Rau terms "Gebühren". Fees are undoubtedly coordinate with taxes, and are sometimes grouped under the main head tax revenue just as prices are grouped under non-tax revenue. It is, indeed, sometimes difficult to draw a clear line of distinction between taxes and fees. When, for example, is a licence a fee and not a tax? Where the licensee gets a special benefit for the privilege it is a fee, but where the licence charge is so high as to bring in a *net* revenue to the public authority it is a concealed tax.[1] Licence fees concealed are ordinarily far more than the mere cost of service, and the positive service rendered is very often absent. Take motor licences, for example. At first motor car licences were necessary as a measure of safety. To-day the licence has become a productive tax, paid by a group of people specially benefited by the governmental activity—the upkeep of roads—a predominantly public one. When fees shade in this manner into taxation it is difficult to distinguish fees from taxation. Special assessments for benefits conferred by governmental expenditure are best known in the United States, and may with great advantage be generally introduced in India and other countries. These are sometimes classified with fees. Special assessments, unlike fees, are levied, especially by municipalities, once for all to meet some extraordinary expenditure, such as a special improvement to property undertaken in the public interest, and are unlike fees in this respect which are charged for services that are constantly recurring in the course of relations between a Government and its subjects. These are levied on property in proportion to the benefit that results. Seligman in his able treatment of this subject points out the following characteristics of special assessments: "(1) there is the

[1] Cf. Seligman, *Essays on Taxation*, p. 275.

element of special purpose; (2) the special benefit is measurable; (3) these assessments are not progressive but proportional to the benefit received; (4) they are for specific local improvements; and (5) they provide for the capital account to increase, as it were, the permanent plant of the community". There is an element of coercion in special assessments which is not present in the fee. These are levied as taxes are.

The revenue from public undertakings is sometimes spoken of as a price. Prices are in this sense charges paid by the consumers of the commodities sold by the public authority, and these special commodities or services people are not compelled to accept unless they choose.

In regard to loans it is advantageous to restrict the borrowing powers of public authorities, such as provincial or State Governments and local authorities. This may be done, for example, by limiting the amount to be borrowed to a percentage of the value of taxable or rateable property, or by prescribing the rules for sinking funds and for objects for which loans may be incurred. In 1894, in the Constitution of the New York State, the indebtedness of any city within the State was limited to 10 per cent of the assessed valuation of its real property. This has been criticised on the ground that no distinction was made between productive and non-productive debt, and therefore productive municipal improvements were unnecessarily postponed. Exception, however, was made of revenue bonds issued in anticipation of receipts from taxes and of water bonds. These water bonds were to be included in the municipality's debt when the issue of bonds for any other purpose was proposed.

Under "miscellaneous", fines and gifts are the best examples. Fines are imposed, not for revenue, but mainly to deter from certain acts, and in this respect are different from taxes. Taussig, then, is not quite correct when he says that the characteristic of a tax is "the absence of a direct *quid pro quo* between the taxpayer and the public authority". This would equally apply to fines which are not taxes. Gifts to Government are not, unfortunately, very large or frequent. Examples are "conscience money" in the British fiscal system, donations to the "conscience fund" in the United States (which are in both cases usually moneys which should have been paid in income tax), and gifts in the form of gilt-edged securities, as when certain citizens

handed over War loan for cancellation on patriotic grounds during the War. It is a matter for comment that few realise in giving gifts to Government[1] that they are contributing to the agency whose first aim is the advance of the general welfare.

There has been a tendency in modern financial literature to lay unnecessarily great stress on the classification of revenue. The chief value of classification is the light which such classification throws on the nature of public income. The object in view is a practical one. It prevents loose thinking and much confusion of thought, and at the same time is of assistance in dealing with matters of fact. It must be logical and adequately realistic.

4. German writers of the nineteenth century from Rau onwards devoted considerable space to this aspect of public revenue. In the present century, American writers, pre-eminently Seligman,[2] and Italians, like Einaudi, have done good work in this direction. One writer, following in the main Adam Smith, divides public revenue into two classes: (1) " that obtained by the State in its various functions as a great corporation or ' juristic person ', operating under the ordinary conditions that govern individuals or private companies ", and (2) " that taken from the revenues of the society by the power of the sovereign ".[3] This classification does not appear to be comprehensive, and fees, gifts, fines, special assessments, monopolies, etc., are difficult to classify under this classification. Is not much of economic revenue (group 1) collected " by the power of the sovereign " ? It has, however, advantages, as it is a practical division of the two well-known classes of income. In Bastable's own words, " These are broadly contrasted and must form the basis of any division: it is to their discussion that by much the largest part of any work on the subject must be devoted, and it is by the way in which he handles them that a writer will be judged ".[4]

5. Adams has three main groups with sub-groups:[5]—I. Direct revenue: (*a*) public domains; (*b*) public industries; (*c*) gratuities,

[1] This is in contrast to gifts for schools, hospitals, etc. Even here in some countries, as in India, public effort in this direction with rare exceptions is conspicuously absent.

[2] " The Classification of Public Revenues," ch. xiv. of *Essays in Taxation*, 9th edition (Macmillan & Co.).

[3] Bastable, *Public Finance*, Book II. ch. i. p. 158.

[4] *Public Finance*, Book II. ch. i. p. 164.

[5] *The Science of Finance*, p. 219 ff.

gifts, or treasure trove; (*d*) confiscations and indemnities. II. Derivative revenue: (*a*) taxes; (*b*) fees, assessments, fines, and penalties; and III. Anticipatory revenue: (*a*) the sale of bonds or other forms of commercial credit, and (*b*) Treasury notes. Thus one group deals with revenue from mainly public lands and public industries. It is too wide and combines administrative with developmental revenues. The second group has for its scope taxation, and the third public credit. It is doubtful whether direct and derivative revenues do not overlap. It is questionable, too, whether in public accounts income from loans should be regarded as (ordinary) income or revenue. Loans are more in the nature of "receipts" [1] than revenue, and are in reality a charge on revenue. They are often regarded, as already noted, as constituting an extraordinary rather than an ordinary source of revenue.

6. A third classification which has received considerable attention in recent years is that of Seligman, which is based on the relative importance of the public and private purposes in the service rendered by the public authority. He classifies all public revenues into three classes: I. Gratuitous, such as gifts; II. Contractual, such as prices. This includes revenues from public property and industry; III. Compulsory, (*a*) eminent domain—expropriation; (*b*) penal power—fines and penalties; (*c*) taxing power, (1) fees, (2) special assessments, and (3) taxes. Here Class I. is put on a level with Class II. and with Class III., which is logical enough but unreal. Class III. (*a*) is not an important source of public revenues. The State usually pays a fair, if not the market price when exercising this power. Seligman's classification depends upon the relative importance of special to common interest. "In the one case the individual is the chief or only factor; in the other case the individual sinks his own importance in the common welfare of the community, and whatever benefits he derives come to him only incidentally as a result of his membership in the community. At one extreme lie prices, which depend upon the relation of the Government to some particular industry or individual; at the other extreme lie taxes, which depend upon the relation of the Government to all industries or individuals; midway between these extremes lie fees." [2]

[1] Whatever is received into the Treasury may be termed receipts, but revenue is receipts which need not be repaid in the same form.

[2] *Essays in Taxation* (9th edition), p. 431.

Continental writers distinguish two main classes of revenue —ordinary and extraordinary. In the former are placed taxes, fees, income from Government property, and in the latter revenue from public loans, the sale of State property, coinage, etc. The distinction between what is ordinary and what is extraordinary revenue is sometimes difficult to maintain.

The League of Nations [1] classifies revenues thus: (1) Taxes on income and property, *e.g.* taxes on income and land taxes; (2) taxes on production, use and transactions, *e.g.* customs, excise and stamp duties, registration and turnover taxes; (3) net receipts from State fiscal monopolies, *e.g.* salt, tobacco, and match monopolies. These three heads are clearly taxation. There are (4) fees, contributions and other administrative receipts, *e.g.* tributes, contributions, receipts from departments and miscellaneous receipts; (5) net receipts from public domain and public undertakings, *e.g.* railways, irrigation, post and telegraph services, and coinage; (6) dividends on Government shares in private corporations or companies, *e.g.* Suez Canal and the Persian Oil Company in the case of Great Britain; (7) interest on advances granted by the State; (8) receipts from Banks of Issue; (9) receipts from the realisation of State assets; and (10) loans —receipts from loan operations. In some cases coinage receipts are shown as a separate head, and in the case of some countries receipts from payments under international treaties are also shown separately. The above classification has the merit of being practical and useful. It is a functional classification of public revenues derived from the accounts which Governments publish.

The Ideal Classification

7. From what has been said, it will be seen that there is one main division, in fact the main division, of public revenue or income common to the majority of classifications. It may sometimes be the case that this division is not called by the same term, and in one or two unimportant sub-heads these may not be identical. Adam Smith speaks of the source "from the revenue of the people". Contemporary writers speak of it as "that taken from the revenues of the society by the power of the

[1] Vide *Memorandum on Finance*, published by the Economic and Financial Section of the League Secretariat.

sovereign", or "derivative revenue". Others speak of compulsory revenues with the sub-group taxing-power, viz. taxes, special assessments, and fees.

Taxes are often grouped into two main classes—direct taxes and indirect taxes. Direct taxes are sometimes defined as those paid once for all by the person from whom they are collected and not passed on to others, while indirect taxes are paid by the producer or importer and passed on to the consumer. John Stuart Mill defined a direct tax as "demanded from the very persons who, it is intended or desired, should pay it", and an indirect tax as one "demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another".[1] The intention referred to is doubtless that of the legislator, but the intention of the legislator does not always square with actual fact. Thus in the British income tax under Schedule A the tax on the landlord's income from the ownership of land and buildings is collected under statute from the occupier of the land or buildings, although it is legally imposed on the landlord. The occupier deducts the tax from the rental due to the landlord, any contract not to deduct it being legally void. According to Mill's definition this tax would be indirect, but it is really direct. The fact that the distinction between direct and indirect taxes is so closely related to the difficult question of incidence has led some writers to overlook the difficulty of defining precisely direct and indirect taxation. Sidgwick, indeed, realised this when he wrote "we can only partially succeed in making the burden either of 'direct' or 'indirect' taxes fall where we desire: the burden is liable to be transferred to other persons when it is intended to remain where it is first imposed; and, on the other hand, when it is intended to be transferred, the process of transference is liable to be tardy and incomplete".[2]

The intention of the legislator is hardly a sufficient reason for the distinction between direct and indirect taxes. Moreover, the example quoted above from the British income tax shows that what might at first blush be taken as an indirect tax is in reality a direct tax. It is necessary, therefore, to explore the subject a little further. Hadley[3] believes that the distinction between

[1] *Principles*, Book V. ch. iii. para 1.
[2] *Principles of Political Economy*, Bk. III. ch. viii. § 8.
[3] *Economics*, pp. 459-461 (Putnam's, London).

direct and indirect taxation should be based on the immediate and not on the ultimate incidence. According to him, taxes which are not shifted at all and those which are shifted legally (for example by the occupier to the landlord) are direct, while those which are shifted quickly through commercial competition among consumers are indirect.[1] This distinction is of interest, but it hardly conforms to the meaning in financial practice. Bastable, too, is hardly correct when he writes that "practical financiers . . . regard those taxes as direct which are levied on permanent and recurring occasions; while charges on occasional and particular events are placed under the category of indirect taxation".[2] Practical financiers the world over regard death duties as direct taxation, but if this latter definition were accepted these inheritance taxes would be indirect. Other writers have attempted without success to define direct taxes as taxes on persons and indirect taxes as taxes on things, but such a definition is no more useful than a distinction between personal and specific taxes or between subjective and objective taxes. Paul Leroy-Beaulieu, like Mill, looks at the intention of the legislator, and groups all taxes as direct when they are intended to be a charge on the taxpayer immediately, but he adds proportionately to the fortune or revenue of the taxpayer. This distinction would place a poll tax which was not graduated and such consumption taxes as are imposed immediately on the consumer, *e.g.* the former British inhabited house duty and taxes on male servants, under indirect taxation.[3]

All things considered, it is preferable to define direct taxes as those levied immediately on the property and income of persons and those which are paid by the consumers to the State direct. Thus income and property taxes, death duties, poll taxes, and

[1] Hadley refers to shifting *slowly* through industrial competition by the withdrawal of capital as ultimate incidence, and therefore not entering into the distinction between direct and indirect taxation.

[2] *Public Finance*, p. 271.

[3] By "direct" taxes on the Continent is meant in practice those for which the taxpayers' names are entered on a register, maintained by central and local authorities. This register gives the basis of assessment and the amount due. Thus the division between direct and indirect rests on the mode of collection, and not with the incidence of the tax. The League of Nations has abandoned the classical nomenclature of direct and indirect taxation. "It was thought preferable to avoid a terminology which might induce the reader to believe that it was employed in the particular manner customary in his own country when such, in fact, may not be the case."

consumption taxes paid to the State direct, would form the group of direct taxes, while all other taxes would be grouped as indirect, *i.e.* those which reach the income and property of persons through their acts and enjoyments and also through their consumption of

PERCENTAGE DISTRIBUTION OF THE GROSS REVENUE OF THE GOVERNMENT OF INDIA (CENTRAL AND PROVINCIAL)

Heads of Revenue.	1871–72.	1891–92.	1911–12.	1913–14. Pre-War.	1921–22.	1933–34
A. Tax Revenue						
Land revenue . .	41·0	26·9	25·1	25·1	17·2	13·6
Other direct taxes .	3·1	6·6	3·4	3·2	12·8	9·1
Total direct taxes .	44·1	33·5	28·5	28·3	30·0	22·7
Indirect taxes . .	45·3	31·6	34·6	32·1	36·7	39·7
Total tax revenue .	89·4	65·1	63·1	60·4	66·7	62·4
B. Non-tax revenue:						
Government or public undertakings . .	5·0	30·3	31·5	34·3	22·9	30·2
Social services . .	..	0·3	0·3	0·4	0·4	0·9
Other sources . .	5·6	4·3	5·1	4·9	10·0	6·5
Total non-tax revenue	10·6	34·9	36·9	39·6	33·3	37·6
Grand Total . .	100·0	100·0	100·0	100·0	100·0	100·0

PERCENTAGE DISTRIBUTION OF REVENUE IN GREAT BRITAIN

Heads of Revenue.	1901–2.	1911–12.	1913–14.	1921–22.	1933–34.
Income tax	24·3	24·2	23·8	35·5	34·8
Other direct taxes . .	11·7	15·6	15·5	10·1	14·6
Total direct taxes . .	36·0	39·8	39·3	45·6	49·4
Total indirect taxes . .	49·2	44·0	42·9	30·6	38·2
Total tax revenue . .	85·2	83·8	82·2	76·2	87·6
Posts and telegraphs and telephones . . .	12·5	13·9	15·5	5·0	8·9
Miscellaneous . .	2·3	2·3	2·3	18·8	3·5
Total non-tax revenue .	14·8	16·2	17·8	23·8	12·4
Total revenue . . .	100·0	100·0	100·0	100·0	100·0

commodities under customs and excise. In addition to customs and excise duties, taxes on business turnover, amusements, and betting would be grouped as indirect taxes. This distinction does not look to the intention of the legislator as to who bears the tax, but it rests on whether the tax is immediately paid from income or property and by the consumer direct. If so, it is a direct tax. All other taxes are indirect.

In addition to direct and indirect taxes, special assessments and fees, should be included tributes, capital levies, and indemnities. Although it is desirable to keep "revenue" and "capital" accounts separate, it is not out of place to regard a capital levy or an indemnity as a tax. Fines and penalties are sometimes included under tax revenue, but they are more correctly classified under non-tax revenue. These are, however, of little importance as a source of revenue when compared with taxes, fees, and prices.

The tables opposite show for India and Great Britain tax and non-tax revenue in detail.

What then is the ideal classification? One does not, it is true, foxhunt in order to kill the fox but rather for the pleasures of the chase. We have seen the various difficulties in the search for a scientific classification. Apart from differences of national structure there is the complicated and peculiar nature of the public accounts in every country. No simple classification is possible without the danger of serious omissions and inaccurate inferences. Careful definition and interpretation are required in each particular case, and when comparisons are made between countries dangers owing to complexity of public revenues are still more likely. It is, however, possible to classify heads of revenue under major heads provided the *caveat* just stated is remembered. It is best to divide modern revenues into two main classes—tax revenue and non-tax revenue. Tax revenue may be divided into direct and indirect taxation. In view of the different meanings of direct and indirect taxation and the danger of comparing like with unlike in comparisons between countries, it is preferable to divide tax revenue into (1) taxes on income and property; (2) taxes on production, consumption, and turnover duties imposed on a variety of transactions; and (3) the net surplus from State fiscal monopolies. This gives the receipts from taxation, although, as already explained, licence fees are concealed taxation. But a clear-cut classification in any realistic study of the subject is almost impossible. Non-tax revenue may be subdivided into three main classes—(1) developmental revenues from the public domain and from public undertakings of various kinds. This includes not only revenue from the State domain but also the municipal domain. It includes railways, canals, the post office, telegraphs, water, electric light, gas, rents, etc.; (2) administrative and miscellaneous revenues other than

loan revenues. This includes fees, contributions, special assessments, tributes, whether in acknowledgment of suzerainty or in commutation of obligations, dividends on Government shares in private corporations, interest on advances, lotteries, receipts from the realisation of State assets, and also receipts from the compulsory acquisition of property by right of eminent domain, *i.e.* receipts from the sale or lease of more property than is required for public improvement;[1] (3) Loan revenues, public loans increase the Government's spending power at the time of the issue of the loan and may, therefore, be viewed as a source of public revenue. For ways and means purposes loan revenues have to be considered as placing a Government or local authority in funds. They augment the revenue from other sources, mainly taxation, or take the place of such revenue.

[1] Known in the United States as " Excess Condemnation ", cf. Cushman, *Excess Condemnation* (New York, Appleton, 1917). This differs from a special assessment in that in the case of the latter the local governmental authority is recouped only to the cost of the improvement, while in the former it obtains the whole value of the improvement to the surrounding property which may be more than the total cost. " Excess Condemnation " may be of advantage to the improvement, or it may be simply a means of making money or of financing local improvements. The increased value of property resulting from the improvement may be regarded as belonging to the community and not to individual owners of property.

CHAPTER XIV

THE CANONS OF TAXATION

1. In a previous chapter where the characteristics of a good revenue system were dealt with,[1] a reference was made to the canons, or to use Adam Smith's expression, the maxims of taxation, which are an indispensable part of any exposition on public finance. We shall now refer to these in greater detail. In spite of the unfair and destructive criticisms of Cohn and Walker,[2] these Smithian canons have rightly been regarded as classic. Modern writers, notably Garnier, Roscher, and Ricca-Salerno, not to mention Wagner, have attempted to lay down precepts or rules regarding the characteristics of a good tax system. No genius, however, has succeeded in condensing the principles into such clear and simple canons as has Adam Smith. His acute and capacious mind gave an entirely new turn to former inquiries, and his successors have not, to any material degree, improved on these principles or succeeded in displacing them from the position which they hold in the science of finance. It is true some have altered the relative importance of these canons, and others have attempted (not always successfully) to introduce new fundamental principles. One writer,[3] for example, analyses taxes from three points of view: (1) that of the taxpayer; (2) that of the State; and (3) that of society as an economic or producing unit. Prof. Cannan, however, with reason shows that

[1] Chapter XIII. p. 197.

[2] Cf. F. A. Walker's remarks in his *Political Economy* (Macmillan), §§ 587-589: "A vast deal of importance has been assigned by English economists to these maxims. They have been quoted over and over again, as if they contained truths of great moment; yet if one examines them he finds them, at the best, trivial; while the first and most famous of these cannot be subjected to the slightest test without going all to pieces" (§ 587).

[3] Sir Josiah Stamp, *The Fundamental Principles of Taxation in the Light of Modern Developments* (The Newmarch Lectures for 1919), Macmillan, 1921.

these are not fundamental principles but merely another way of saying that equity, productiveness, and economy (economy being used in its wider sense of general social advantage) are the basic principles of taxation.[1]

Some have sought to trace the maxims to the two Physiocrats —Moreau de Beaumont and Turgot. There was, it is true, in Adam Smith's library the *Mémoires* by Moreau de Beaumont.[2] In a letter to Sir John Sinclair, Adam Smith confessed that "he (Smith) had frequent occasion to consult the book himself, both in the course of his private studies and in the business of his present employment (as Commissioner of Customs), and is therefore not very willing to let it go out of Edinburgh. The book was never properly published; but there were a few more copies printed than were necessary for the Commission for whose use it was compiled. One of these I obtained by the particular favour of Mr. Turgot, the late Controller-General of the Finances. I have heard but of three other copies in Great Britain. . . . If any accident should happen to my book, the loss is perfectly irreparable." Cunningham, in his *Growth of English Industry and Commerce*, holds that "Adam Smith's celebrated maxims about taxation are improved in form, but in substance they are found in the Avertissement to the splendid *Mémoires* which were compiled and printed for the French Government in 1768".[3] Similarly Léon Say and Thorold Rogers[4] believed Turgot's *Formation and Distribution of Wealth* had a considerable effect on the author of *The Wealth of Nations*. The maxims of the Physiocrats[5] were

[1] *Economic Journal*, vol. xxxi., 1921, p. 350.

[2] Cf. Bonar's *Catalogue of the Library of Adam Smith* (Macmillan, Second Edition, 1932), p. 18. *Mémoires concernant les impositions et droits en Europe* (par Moreau de Beaumont), Paris (vols. i.-iv. 1768–69; vol. v. 1789). In Bk. V. ch. ii. pt. i. of *The Wealth of Nations*, Adam Smith thus describes the book: "This work was compiled by the order of the court for the use of a Commission employed for some years past in considering the proper means for reforming the finances of France. The account of the French taxes, which takes up three volumes in quarto, may be regarded as perfectly authentic. That of those of other European nations was compiled from such informations as the French Ministers at the different courts could procure. It is much shorter, and probably not quite so exact as that of the French taxes."

[3] Vol. ii. p. 436.

[4] Cf. Rae, *Life of Adam Smith* (Macmillan), p. 203. "Questions of literary obligation are often difficult to settle. Two contemporary thinkers, dealing with the same subject under the same general influences and tendencies of the time, may think nearly alike even without any manner of personal intercommunication."

[5] *Œuvres de M. Turgot, Ministre d'État* (Paris, A. Belin, 1811 (9 vols.)).

far from perfect from the undue importance given in their system to the rent of land as the only " net product " and, therefore, the only source of taxation. To-day Adam Smith's canons continue to be regarded as almost an essential part of the study of finance, and they have had a considerable effect on practical financiers, as, for example, on Gladstone in England,[1] and on James Wilson, the first Finance Minister of India.[2] They are extremely simple maxims, and in this lay their author's stroke of genius. In short, they were, in the phraseology of *The Wealth of Nations,* " intelligible to common understandings ".

These celebrated canons are quoted because they are the foundation of the principles governing the imposition of taxes, and are quoted *in extenso* because when quoted partially they omit much that Adam Smith considered to be of real importance. If a tax combines all these things it is plainly a good tax.

I. The Canon of Equality or Equity

2. " The subjects ", says Adam Smith, " of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation. Every tax, it must be observed once for all, which falls finally upon one only of the three sorts of revenue above mentioned, is necessarily unequal, in so far as it does not affect the other two. In the following examination of different taxes I shall seldom take much further notice of this sort of inequality, but shall, in most cases, confine my observations to that inequality which is occasioned by a particular tax falling unequally even upon that particular sort of private revenue which is affected by it." [3]

[1] *Vide* Gladstone's budgets, especially that of 1853 (*Gladstone's Speeches,* Methuen & Co.).

[2] Finance Minister 1859–1860. *Vide* Bagehot (his son-in-law), in *Life of Walter Bagehot,* vol. x. p. 347 (Longmans, Green & Co., 1918).

[3] *The Wealth of Nations,* Book V. ch. ii. part ii; Cannan, vol. ii. p. 310.

The first canon contains an important rule of taxation and deals with the elements of several distinct theories on equitable taxation. The sovereign power has the right to impose taxation, and it is the duty of the subjects to contribute. We have already referred to this compulsory character of the contribution, and it was the determination to insist on this right which led the British Government to insist on the threepence per pound duty on tea, and also the retention of the stamp duties, both of which lost the American colonies. The expression "under the protection of the State" was regarded by Walker[1] as unnecessary and inconsistent, but to those who know *The Wealth of Nations* well it is probable that Smith was thinking of greater issues, *e.g.* the taxation of property held in different countries. At the end of *The Wealth of Nations* Smith deals with a project of Empire representation and taxation,[2] and elsewhere he refers to the movement of capital from one country to another in order to escape taxation. His outlook was imperial and international as well as national.

The content of the first canon is both financial and ethical. The meaning of equality has been different at different times in the history of financial doctrine. Adam Smith speaks of the taxpayers contributing "as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State". In a later portion of the same book (Book V.) of *The Wealth of Nations* in dealing with taxes on the rent of houses he gives countenance to progressive taxation, *i.e.* taxation increasing in rate with the increase in income. "It is not very unreasonable that the rich should contribute to the public expense, not only in

[1] *Political Economy*, § 588: "What mean those last words, 'under the protection of the State'? They are either irrelevant, or else they mean that the protection enjoyed affords the measure of the duty to contribute. But the doctrine that the members of the community ought to contribute in proportion to the benefits they derive from the protection of the State, or according as the services performed in their behalf cost less or cost more to the State, involves the grossest practical absurdities. Those who derive the greatest benefit from the protection of the State are the poor and the weak—women and children and the aged; the infirm, the ignorant, the indigent."

[2] "If the project cannot be completed, it ought to be given up. If any of the Provinces of the British Empire cannot be made to contribute towards the support of the whole Empire, it is surely time that Great Britain should free herself from the expense of defending those provinces in time of war, and of supporting any part of their civil or military establishments in time of peace, and endeavour to accommodate her future views and designs to the real mediocrity of her circumstances" (Book V. ch. iii. finis, Cannan, vol. ii. p. 433).

proportion to their revenue, but something more than in that proportion."[1] Over a quarter of a century before the publication of *The Wealth of Nations* Montesquieu wrote regarding a progressive tax of ancient Athens thus: "La taxe était juste, quoiqu'elle ne fût pas proportionnelle. Si elle ne suivait pas la proportion des biens, elle suivait la proportion des besoins. On jugea que chacun avait son nécessaire physique égal, que ce nécessaire physique ne devait pas être taxé: que l'utile venait ensuite et qu'il devait être taxé, mais moins que le superflu; que la gradation de la taxe sur le superflu empêchait le superflu." The attitude of the nineteenth century is summarised in McCulloch's well-known remark, "When you abandon the plain principle (of proportion) you are at sea without rudder and compass, and there is no amount of injustice you may not commit". The ideal was to leave the taxpayer after paying his tax in the same proportion as he was before, an argument which no opponent of direct taxation, however strong, would put forward in the twentieth century. In his *Principles*, and more forcibly later, John Stuart Mill argued that any other method of taxation than proportional taxation was unfair and a step towards confiscation. "The rule of equality and of fair proportion seems to me to be that people should be taxed in an equal ratio on their superfluities, necessaries being untaxed, and surplus paying in all cases an equal percentage. This satisfies entirely the small amount of justice that there is in the theory of a graduated income tax, which appears to me to be otherwise an entirely unjust mode of taxation, and, in fact, a graduated robbery."[2] From the last decade of the nineteenth century to the present time, especially in Germany and Great Britain, proportional taxation in theory and in practice has been proved to have a considerable element of arbitrariness which was not to be found to the same extent in progressive taxation. Mill's idea of confiscation in progressive taxation is no longer tenable. The development of the marginal theory of value affected taxation, and it was clear that the hurt or sacrifice involved in taking a unit from a large income was not so great as taking the same unit from a small income. Progression rests on the decreasing utility of wealth to its owner and also in the way in which such taxation

[1] *The Wealth of Nations*, V. ii. Art. I., Cannan, vol. ii. p. 327.

[2] 1861 Comm. Q 3540, quoted by Stamp, *Newmarch Lectures*, 1919, on Taxation, p. 38.

prompts economic and general wellbeing so long as there is no danger to capital accretion with its resulting effects on industry and employment. In Marshall's words, " While special provision is made for those whose incomes fall short of the necessaries of life and vigour, every one else must bear a considerable share of the national burdens, but the shares must be graduated very steeply ". The one ultimate principle of taxation in the twentieth century, as we shall see, is the principle of least aggregate sacrifice. A recent writer has suggested that the equal sacrifice principle, if properly analysed, indicates progressive taxation. Equality of sacrifice can be effected only among similar and similarly situated persons and not among all members of the community. There are persons with equal incomes in equal economic conditions, with equal incomes in different economic conditions, with different incomes in different economic conditions, and with different incomes in the same or similar economic conditions. Is not sacrifice measurably reduced when others in the same income class are similarly treated ? He considers taxation in its announcement aspects and its distributional effects. " The best scheme from an announcement point of view is one under which the levy on each taxpayer is made in such wise that he cannot alter the amount he has to pay in taxation by altering his way of life ". A poll tax is an example, but in practice a search must be made for " the formula which, when viewed in connexion with the whole tax system, is best from a distributional point of view ".[1] Progressive taxation really has its securest foundations not in the fact that the small taxpayer values more his marginal tenth of income than the large taxpayer does his marginal tenth, but that the Government or community regards the uses of the small man's marginal tenth as more important than the uses of the large man's marginal tenth. The last three or four decades in taxation have been noteworthy by the movement away from proportional taxation and the development of sensitive subject taxation in its stead.

II. The Canon of Certainty

3. " The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner

[1] *A Study in Public Finance*, A. G. Pigou (Macmillan, 1928).

of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put, more or less, in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty."

The second canon, the canon of certainty, has received great prominence by some American writers. So much so that certainty is regarded as the most important of the canons. Thus Hadley, somewhat dogmatically, holds that "in the light of experience in modern industrial communities there can scarcely be any doubt as to the proper choice. *Certainty* is the fundamentally important object, without which all attempts at equality prove illusory. With an uncertain tax no systematic improvement can be hoped for. With a certain tax many evils which exist at the outset tend to diminish as time goes on. Uncertainty may result either from failure to discover the objects which should be taxed; or from doubt as to their value; or from the possibility of collusion between the assessor and the person who should pay the tax by which consent is given to an unduly low valuation."[1] The infringement of the canon of certainty is well illustrated by Tenney Frank in his *Economic Survey of Rome*.[2] Provincial governors frequently raised revenue by *vectigalia*, which were raised very arbitrarily and without certainty. In Palestine in the days of Christ taxation was very burdensome and lacking in certainty. Hence the tax-gatherers (*publicani*) were bracketed with sinners in the New Testament and detested by the wretched provincials. Seligman in discussing the importance of precision in assessments is also of opinion that "ever since the days of Adam

[1] *Economics*, Hadley (Putnam), p. 451.

[2] *An Economic Survey of Ancient Rome* (4 vols. Edit. Tenney Frank). Vol. i. *Rome and Italy of the Republic* (by Tenney Frank), Baltimore, Johns Hopkins Press, 1933.

Smith, the demand for certainty has been one of the cardinal rules in taxation. Adam Smith borrowed his rule from one of the French writers. The arbitrariness of the French system of taxation in the eighteenth century had assumed such proportions as already to pass beyond belief, and it is no wonder that the would-be fiscal reformers raised a loud note of protest against the utter lack of certainty and precision in the French system." [1] An old tax is sometimes said to be no tax because it makes no disturbance of the *status quo*. There is, indeed, a good deal of truth underlying this. The canon of certainty, like the canon of convenience and the canon of economy, is a rule applicable in the long run to taxes as a whole.

III. Convenience of Payment

4. "Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. A tax upon the rent of land or of houses, payable at the same term at which such rents are usually paid, is levied at the time when it is most likely to be convenient for the contributor to pay; or, when he is most likely to have wherewithal to pay. Taxes upon such consumable goods as are articles of luxury, are all finally paid by the consumer, and generally in a manner that is very convenient for him. He pays them by little and little, as he has occasion to buy the goods. As he is at liberty, too, either to buy or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconveniency from such taxes."

Not only should the time of payment, the manner of payment, the amount to be paid be clear to the contributor and to every other person—the canon of certainty—but the tax should be levied at the most convenient time and also in the most convenient way—the canon of convenience. In Britain under the Romans many of the taxes were in kind, usually a tenth of the produce; the cartage was often more burdensome than the tax itself, and owing to the difficulty of transport complaints were made against the inconvenience of the taxes. If a farmer has to travel many miles to pay his tax the burden of the tax is added to considerably. The canon of convenience is justified on the

[1] *Essays in Taxation*, Seligman (Macmillan & Co., 9th edition), p. 390.

ground of good administration and productivity. Indirect taxes satisfy this canon because they are usually paid in small amounts by the consumers in the price paid and are scarcely noticed at the time of payment. Taxes on luxuries are specially convenient: the consumer pays the tax when he decides when and how much he is to spend. In the case of direct taxes the principle is no less important. The British income tax on wage-earners can be collected by the purchase of stamps at the convenience of these taxpayers. In India the land revenue or tax is collected in instalments at times when it is convenient for the cultivators to pay it, for example after the crops have been reaped. Instances may be multiplied.

IV. Economy in Collection

6. "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals. An injudicious tax offers a great temptation to smuggling. But the penalties of smuggling must rise in proportion to the temptation. The law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it; and it commonly enhances the punishment too in proportion to the very circumstance which ought certainly to alleviate it, the temptation to

commit the crime. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it. It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign. The evident justice and utility of the foregoing maxims have recommended them more or less to the attention of all nations. All nations have endeavoured, to the best of their judgment, to render their taxes as equal as they could contrive; as certain, as convenient to the contributor, both in the time and in the mode of payment, and in proportion to the revenue which they brought to the prince, as little burdensome to the people." [1]

The canon of economy has been regarded as the most important of all canons on taxation, and the term "economy" has sometimes been extended to embrace all that is of importance in the other maxims. By economy is usually meant not merely cheapness in collection of the tax, but also that the tax should not interfere with the productiveness of industry, with industry and the accumulation of wealth. In China to-day many taxes are unproductive and wasteful. After the Napoleonic Wars there were 1150 dutiable articles the taxes on which were uneconomical. Indirect taxation is now attacking the non-functional element in spending, *i.e.* on commodities not absolutely necessary for an individual in the discharge of his duty, and such taxes are, as a rule, economical. It would be impossible to replace indirect taxation by direct taxes on wages, as this would require a highly expensive system of income tax and the collection of such taxes would defeat the principle of economy. "A sound tax policy", a Secretary of the United States Treasury has said, "must take into consideration three factors. It must produce sufficient revenue for the Government; it must lessen, so far as possible, the burden of taxation on those least able to bear it; and it must also remove those influences which might retard the continued steady development of business and industry on which, in the last analysis, so much of our prosperity depends. Further-

[1] *The Wealth of Nations*, Book V. ch. ii. part ii., Cannan edit. vol. ii. p. 311.

more, a permanent tax system should be designed not merely for one or two years, nor for the effect it may have on any given class of taxpayers, but should be worked out with regard to conditions over a long period and with a view to its ultimate effect on the prosperity of the country as a whole." [1]

Other Canons

6. The Smithian maxims are at the basis of all sound taxation proposals. A change of emphasis takes place from time to time and new principles are evolved. Productiveness in taxation is, all things considered, the main characteristic of a good tax. This quality of fiscal adequacy means more than sufficiency of revenue to meet the needs of the State. The State is or ought to be like a good cultivator, whose aim is to get as much from the soil as possible without robbing it of its future productiveness. A considerable amount of the reputation which Gladstone won as a Finance Minister was due to his realisation of this point. "The very object for which the revenue system exists is to provide for the maintenance of the State, and therefore the Minister in charge of the finances naturally estimates the merits of a tax by the amount of its yield." Not only must the tax produce sufficient revenue for the Government, but it should not cripple those least able to bear the burden. Among other characteristics, as we have seen, are elasticity, flexibility, simplicity, and diversity. Elasticity is a corollary of fiscal adequacy. A State may require revenue in one year to make up a deficit of the previous year or to meet an emergency. Means should be forthcoming to draw from people's pockets in the form of taxes sufficient to meet such needs. Flexibility simply defined is that the tax system should not be so rigid that a change in the system cannot be made without an earthquake or Herculean effort. The English system, for example, is a good example of elasticity. The needs of modern States are so great that no single tax such as that suggested by the Physiocrats or Henry George would be sufficient. Diversity is required. Both direct and indirect taxation are necessary: indirect taxation is the most suitable method for raising revenue from wage-earners on whom direct taxation would be administratively impossible and vexatious. Direct taxation is from a small

[1] *Mellon; Taxation; The People's Business* (Macmillan, 1924).

proportion of the population only and cannot be carried beyond a certain limit. This does not mean that there must be any fixed balance between the two such as a 50-50 relation, which is sometimes suggested as if it were sound in itself. A diversified system, in short, tends to hit all taxpayers and to frustrate the efforts of those seeking to evade taxation.

Some writers have attempted to enlarge on the canons by emphasising that a tax should fall on revenue and not on capital as in the case of death duties and a capital levy, and that it should not interfere with the minimum of subsistence nor result in the transfer of capital on account of the taxation imposed. These points will be discussed in their proper place. In spite of all the progress that has been made in recent years there is no country whose tax system is completely in harmony with fundamental principles.

A Conflict of Principles

67. When there is a conflict between these principles it is usual to adopt the most important canon in preference to the less important. Productiveness is, as we have seen, more important than equality and convenience. Similarly a large amount of economy should outweigh a small amount of inequality and *vice versa*. After all, since successful administration of the State is the primary object, it is not unreasonable that equity and convenience should yield to productiveness. In short, in cases where conflict arises, choose the more important. "After all the proper subjects of taxation", says Adam Smith, "have been exhausted, if the exigencies of the State still continue to require new taxes, they must be imposed upon improper ones. The taxes upon the necessaries of life, therefore, may be no impeachment of the wisdom of that republic, which, in order to acquire and to maintain its independency, has, in spite of its great frugality, been involved in such expensive wars as have obliged it to contract great debts. The singular countries of Holland, and Zealand, besides, require a considerable expense even to preserve their existence, or to prevent their being swallowed up by the sea, which must have contributed to increase considerably the load of taxes in those two provinces";[1]

[1] *The Wealth of Nations*, Bk. V. ch. ii. pt. ii. art. iv. (Cannan edit. vol. ii. p. 390).

and again, "It ought to be remembered, that when the wisest Government has exhausted all the proper subjects of taxation, it must, in cases of urgent necessity, have recourse to improper ones. The wise republic of Holland has upon some occasions been obliged to have recourse to taxes as inconvenient as the greater part of those of Spain." [1] A finance minister finds himself confronted with demands for revenue on the part of spending departments and on the other with opposition from those whom he wishes to tax. A tax which brings in a large net revenue without protest from taxpayers with political influence he regards as a good tax. Much indirect taxation rests on this, and it is a tempting one to follow since it is often the path of least resistance. He plucks, in short, the feathers of the goose with as little squealing as possible. In the *Laws of Manu* the king is counselled to tax little by little "as the leech, the calf, and the bee take their food". In critical times he may take as high a proportion as one-fourth, "if he protects his subjects to the best of his ability", but he should not "cut his own root, nor the root of others, by excessive greed".

[1] Book V. ch. iii., Cannan edit. vol. ii. p. 414.

CHAPTER XV

THE MEASUREMENT OF TAXABLE CAPACITY WITH SPECIAL REFERENCE TO GREAT BRITAIN AND INDIA

1. In a previous chapter [1] the percentage of gross national income spent by public authorities was discussed. Gross income was taken since it was, on the whole, the fairest and best possible test of what is after all an approximation. In normal times it was shown that 20 per cent is spent from all sources by public authorities, and in abnormal times (as in the War and post-Armistice period) the figure is as high as 40 per cent. The State can take large appropriations for a short period from its subjects for temporary objects without *permanent* injury. On the other hand, a State which appropriates only a small proportion of the gross income has much larger resources in times of necessity. When taxes are very moderate the revenue appropriated by the State is small, and individuals, especially in a rich country, may spend far less wisely than if the State imposed taxation for social services such as education. It is sometimes an unwise policy to allow money to fructify in the pockets of the people, but the reactions on production have to be considered by the State in extending taxation beyond a certain limit. Education and compulsion in taxation can do much.

The Concept of Taxable Capacity

2. In the present chapter we propose to examine the conception of taxable capacity as applied to a country. In post-War finance this has become a matter of unusual interest. The necessity to have larger revenues to balance budgets, to repay War debts,

[1] *Vide* p. 190.

not to speak of reparations, has made this one of great practical importance. It is a question that has taxed the brains of the most expert financiers. The value of accurate definition, of full and accurate statistics of a country's production and its consumption, as shown in a census of production and in carefully collected family budgets, and of statistics of income tax can scarcely be exaggerated. It is always wise and useful for a Government to know even roughly the limit that the country can contribute by way of taxation both in ordinary and in extraordinary circumstances. The lack of information on taxable capacity has reminded not a few Governments of the parable of the foolish virgins who went forth to meet the bridegroom without oil in their lamps.

3. The term taxable capacity is regarded by some as an unattractive cryptogram. This is unfortunate because the conception is obviously one of financial importance and it has rightly won a place in the science of public finance. When it is desired to inquire into the capabilities of the fiscal machine of any country in order to ascertain how much a country can bear in the way of tax burdens an attempt is made to measure absolute taxable capacity. The necessity in post-War finance especially of balancing budgets heavily laden with public debt often of short maturity has made the question of absolute taxable capacity a real and an abiding problem of taxation. The advance of statistical methods is unfolding hidden secrets and, as in other branches of the science, realistic statistical investigation and careful verification are doing much in the advancement of knowledge in this direction. A good example of absolute taxable capacity is the work of the Dawes Committee of 1924, which was essentially temporary in character because it left untouched the question of Germany's final liability. Until the Young plan was accepted Germany's liability stood at the preposterous figure of 132 milliards of gold marks (£6,600,000,000), but the Committee provided the Allies with payments rising year by year to £125 millions, and it furnished valuable data for estimating Germany's capacity to pay in the future.[1] Another and more common aspect of the problem is relative taxable capacity, which deals with the amount which a state should pay in comparison with others towards a common contribution or how a given burden to

[1] Cmd. 2105, 1924.

be raised should be distributed among the states or provinces of a Federation. In recent financial history there are numerous examples of relative taxable capacity. There are, for example, the Report and Evidence on Financial Relations between Great Britain and Ireland, 1894–1896, the Reports of the Financial Relations Commission of the Union of South Africa, 1912; the Report of the Indian Financial Relations Committee, 1920; the Reports of the Northern Ireland Special Arbitration Committee, 1924–1925; the Report on The Taxable Capacity of Australian States (Hobart), 1924; the Report of the Royal Commission on the Finances of Western Australia, 1925; the Report of the Canadian Royal Commission on Maritime Claims, 1926; the Report on the Financial Position of Tasmania, 1926; the Report on the Financial Effect of Federation on South Australia, 1927; the Memorandum of the Financial Assessor to the Simon Commission; and the Report of the Commission on Indian Reforms, 1930. Both absolute taxable capacity and relative taxable capacity are of importance. If it is desirable to ascertain how much a country can carry as war debt, that belongs to the former, but it should not be mixed up with irrelevant issues such as that the debtor, say Germany, should be taxed as heavily as the creditor, say the United States, France, or Great Britain. In this way absolute taxable capacity is sometimes confused with relative taxable capacity. In the case of Germany the problem of absolute taxable capacity has been complicated by another and distinct problem, the problem of external transfer or of making the external payments due on reparations account to the Allies.[1] If the transfer is too great it will affect as a result of budget and currency instability the capacity of the debtor, and this will be seen in the yield of taxation. In absolute capacity we examine the amount of taxation that may be, all things considered, raised. In relative taxable capacity we examine the relative amounts which communities should pay to a common expenditure, and in making such contributions the limit of taxation by the contributing states may never be reached.

The definition of taxable capacity gives rise to several matters of a theoretical as well as of a practical interest and importance. Absolute taxable capacity may be defined as the maximum amount which the citizens of a country can contribute towards

[1] Dawes Report (Cmd. 2105, 1924, p. 22).

the expenses of public authorities without having to undergo an unbearable strain, or, as Sir Josiah Stamp in a singularly attractive way describes it, " without having a really unhappy and downtrodden existence and without dislocating the economic organisation too much ".[1] Public authorities are like the mother in the sanskrit verse—" The girl covets beauty, the mother riches, the father knowledge, the relatives good family, other people sumptuous marriage feasts ". These authorities have to earn their living, and it is desirable to ascertain what this maximum limit at any time approximately is. Briefly absolute taxable capacity is the limit of squeezability. This definition may sometimes conjure up the thought of the rack and other unpleasant ideas depending on the psychology of the taxpayers in the country concerned. It is the optimum taxability of a nation, the maximum amount of taxation that can be raised and spent to produce the maximum of economic welfare in that community. The facts that determine this optimum are both economic and non-economic in character. The ultimate test is the residual national income when national income is taken to mean the income arising within the country together with what the inhabitants derive from abroad. It is the surplus of production over the minimum of consumption required to maintain that volume of production per head of the population, the essential standard of living remaining unchanged over a number of years. The savings of the population must be considered as capital cannot be allowed to waste and not be replaced. Assets must be rendered secure against depreciation, and accretions to capital must take place side by side with increases in the labour force. The standard of living of an increased population must be regarded from the viewpoint of capital, for if the surplus were taken away regardless of this and devoted to unproductive expenditure the production per head of population would certainly fall. A tax, moreover, may form part of the total taxable capacity and at the same time add to general economic welfare in the long run. By minimum of consumption we mean necessaries for efficiency.[2] This minimum will, of course, differ, and differ widely, in different countries. The standard in the United States would be very much greater than that, for example, in Italy, and Italy's

[1] *Wealth and Taxable Capacity*, p. 134.
[2] Cf. J. A. Hobson, *Taxation in the New State*, p. 41.

standard would be similarly greater than that in India. On the Dawes Committee Sir Josiah Stamp said, "Some set out gaily with the notion that all that was necessary was to arrive at the total national income per head and find out what taxation was being borne, and then to bring the laggards up to the level of those who were doing best. The question was what should be adopted as the minimum of subsistence figure for maintaining the population. A figure that appeared to an American to be an impossible thing on which to sustain life was sufficient to wipe out the whole national income of Italy. The actual solution suggested was that the minimum must vary proportionately to the national income per head; nothing else was possible." [1] If a *per capita* expenditure is taken for any country it may be too large for some of the population and too small for others, but like army clothing it does for everybody although it fits no one in particular. The fact that part of an income, which is seemingly at a minimum, is used to purchase other things than necessaries is conclusive evidence of there being more to be taken account of than mere necessaries of existence. As Maggie Mucklebackit replied to the Antiquary of Sir Walter Scott when the Antiquary expressed the hope that the distilleries would not work again: "Ay, ay, it's easy for your honour and the likes of you gentlefolks, to say sae, that hae stouth and routh and fire and fending and meat and claith and sit dry and canny by the fireside—but an ye wanted fire and meat and dry claise and were deeing o' cauld, and had a sair heart, whilk is warst ava', wi' just tippence in your pouch, wadna ye be glad to buy a dram wi't to be eilding and claise and a supper and heart's ease into the bargain till the morn's morning". The Dawes Committee constructed an index [2] to enable the Allies to share in the increased prosperity of Germany which included the following items: (1) the total of German exports and imports taken together; (2) the total of budget receipts and expenditure taken together; (3) railroad traffic as measured by statistics of the weight carried; (4) the total money value of the consumption of sugar, tobacco, beer, and alcohol within Germany (measured by the prices actually paid by the consumer); (5) total population of Germany; and (6)

[1] *Vide* my "Taxable Capacity and the Burden of Taxation and Public Debt", *Royal Statistical Society's Journal*, vol. lxxxviii. Part IV. p. 547.

[2] Annex 2, Dawes Report, Cmd. 2105, 1924, p. 78; cf. para. viii. (c), p. 20.

the consumption of coal *per capita*. The base of the index was an average for three years in the case of (2), (5), and (6), and for six years for the other categories. The percentage increase or decrease is compared in each of these six groups with the base, and an arithmetical average of the six percentages is taken as the index.

4. Relative taxable capacity does not, of course, mean the maximum or absolute capacity to bear tax burdens. It indicates rather ability to pay. Indeed if one country is contributing more than its due proportion the taxable capacity of that country to the common expenditure may be exceeded. If the countries have very nearly the same system of taxation the solution of the problem is not very difficult. The British Treasury in a memorandum prepared for the Committee on the question of contributions from the islands of Jersey, Guernsey, and Man was on the whole correct when it propounded the thesis that "Relative taxable capacity is not susceptible of any precise measurement or even of any precise definition. If two different countries have to contribute to a common object, and if they are closely similar in their standard of wealth and in economic conditions, apportionment in the ratio of population is good enough. Where there are serious differences in relative wealth the most equitable method of apportionment would seem to be to estimate the yield of a justly graduated system of taxation applied on identical terms to both countries, to deduct therefrom the cost of internal government, assumed to be conducted on similar principles in both, and to treat the surplus as the proper contribution of each to the common purpose." [1] This method in the case of the Channel Islands left out of account income tax deducted at source from taxpayers resident in the Islands where no income tax system similar to that in Great Britain prevails, and in a small community, especially if that community be scattered, the cost per head of administration is likely to be higher than in a larger one. Moreover, a larger community possesses greater economic resiliency, engaged as it is on many forms of production, and its *per capita* yield of taxation is greater. A greater margin has, on the Treasury formula, to be allowed for when the circumstances of the communities compared differ widely in relative wealth. The Channel Islands argued that the contribution to be paid to

[1] Cmd. 2586, 1926, p. 37; cf. p. 34, para. 65.

the British Exchequer would be similar to the payment of an external debt. "It would be perfectly fair if the common object was outside both the countries concerned, but in this case any such contribution made by Jersey would be taken out of Jersey and would pass into circulation in Great Britain; whereas the contribution of Great Britain would, to a very large extent, still circulate in Great Britain and would not irretrievably be lost to that country. It cannot be denied that it would be economically impossible for Great Britain to spend, say in Canada, upwards of £500,000,000 a year, and yet this is the equivalent of what it is suggested in the Memorandum Jersey should spend annually in Great Britain", and "although individuals might be poorer, collectively Great Britain would not be impoverished to the same extent as Jersey."[1] The Channel Islands were of opinion that the most important factor in considering relative taxable capacity was the economic position of the contributors,[2] and the industry and efficiency of the population.[3] The Channel Islands as well as the Isle of Man agreed to give a fixed contribution on account of the War to the Exchequer, and in addition to prevent the formulation of companies in the islands seeking domicile to escape English income tax, they also decided to assist the British Exchequer in regard to incomes of rich persons, indeed of all over £2000 (or $10,000) per annum, as domicile to those evading income tax would not be given in such circumstances. Other tests of relative taxable capacity, it may be noted, are referred to in the Final Report on Financial Relations between Great Britain and Ireland and include the relative assessment to death duties and income tax equally levied in both. Lord Castlereagh's dictum, now somewhat out of date, is well known, viz. "the best possible criterion of the relative means and ability of two countries to bear taxation would be the produce of an income tax levied on the same description of incomes in both, and equally well levied in both". In a subsequent paragraph will be found the method adopted in a Memorandum prepared for the Simon Commission on Indian Reforms where an index of each province in India was constructed showing the comparative

[1] Cmd. 2586, 1926, pp. 45 and 51.

[2] *Op. cit.* p. 44; cf. p. 50, para. 2; cf. Final Report of the Northern Ireland Special Arbitration Committee, Cmd. 2389, 1925, p. 4, para. 5.

[3] Cmd. 2586, 1926, p. 65.

taxable capacity of the provinces. The items included population, production (agricultural, mineral, and industrial); the consumption of necessaries, *e.g.* salt; the number of letters and postcards delivered, revenues and expenditures; tax collections; agricultural and non-agricultural income; economic strength (aggregate income multiplied by average income per head); personal incomes assessed to income tax and super tax, province by province.

5. The concept then of taxable capacity whether viewed absolutely or relatively is of real importance in the science of finance. One must not be led away by the intricacies of the problem, especially in regard to absolute taxable capacity, to declare inconsistently that relative taxable capacity is a reality while absolute capacity is not, and to say that "In the interests of clear thinking it would be well that the phrase 'taxable capacity' should be banished from all serious discussions of public finance".[1] Experience has shown that in the last decade the handling of statistics by trained minds in this respect has been of value. The Dawes plan transferred, it has been said, the question of Reparations from the point of the sword to the point of the pen, suited the complex of political and economic forces, and it estimated Germany's absolute capacity over a period of years. It was left to the Young plan to complete the Dawes scheme by examining and limiting Germany's total liability to pay. It dealt, too, with inter-allied debts as an integral part of Reparations. The budgetary or treasury position of the various countries, the credit position of Germany as well as the industrial aspects of her taxable capacity were examined by experts who considered the ultimate realities of the problem. Similarly in other parts of the world taxable capacity, both absolute and relative, has been considered and clear thinking has removed difficulties. We must beware of financial Hotspurs who jump at hasty conclusions regarding the value of the concept. If the term be clearly understood, if the essential facts are remembered, such as the way in which the taxation is raised, the use to which it is put, especially to reduce external debt, the importance of the time element and the psychology of the taxpayer, it has, in both senses of the term, a very real value. The concept is also of importance since it emphasises that public expenditure and

[1] Dalton, *Public Finance*, 6th edit., p. 169.

taxation are complementary and closely related to each other. Public expenditure from the viewpoint of economic welfare is in many ways as important as taxation.

6. It is necessary to deal with these essential factors in greater detail. Taxable capacity depends on (1) the number of inhabitants in the State; (2) the distribution of wealth in the State; (3) the method by which taxes are raised; (4) the purpose of taxation or the way in which the tax money is spent; (5) the psychology of the taxpayers; (6) stability of income; and (7) inflation. In regard to (1)—the number of citizens—it is obvious that a population of 20 millions with an aggregate production of £200,000,000 has a different taxable capacity than if the population were 100 millions. In the former case there would be more than in the latter to spare to the State for public purposes. In regard to (2)—the distribution of the surplus—the taxable capacity will not be the same if incomes are more or less equal, while in others they are graduated. If there are 10,000 persons at a level of £100,000 and 1 person with £1,000,000 there would obviously be a larger taxable capacity than if the same aggregate income were equally divided among all persons. Thirdly, capacity also depends on the way in which the taxes are raised. A well-thought-out mixture of taxation produces a larger sum than if any one line of taxation were followed. It is, for example, necessary to stop increasing taxation in one direction when it is felt to be exceedingly onerous, and to launch out in another direction, such as by heavier death duties. A tax on the necessaries of life or a tax on savings is not the same as a tax on drink. Fourthly, the surplus depends on the object or objects in view. To what purpose is taxation to be applied? Taxation devoted to the repayment of internal debt is very different from taxation devoted to the payment of external debt or for such unproductive purposes as armaments. Interest on internal debt is spent within the country. The payment of interest on external debt reduces the net income of the debtor or paying country by the transfer of part of its income abroad, to pay the interest, *i.e.* a certain amount of the country's produce is exported without any return and not, as in the case of payment of interest on internal debt, transferred to others who consume it in the country. The former is the case with war debts, such as the debt payments to America and reparation payments by

Germany. Similarly with productive loans advanced to countries for their industrial development, as India, Australia, Canada, and the Argentine, the debt may increase the national income of the country by a sum much larger than the debt payments abroad, and payments for public servants and others temporarily resident in the country may also increase the national income to a far greater extent than what they send as remittances to pay for the education of children, etc., in, say, England. To make this payment for interest charges and to provide for the gradual repayment of the capital, the country which has to pay the debt raises revenue by taxation, borrowing, or inflation. Whichever method is adopted the real incomes of her citizens *qua* citizens are reduced, *ceteris paribus*, and where, as a result of this, production is decreased, it means further impoverishment. There is no direct compensation for the taxation. If the money is applied in paying interest on internal debt or in repaying internal debt, there will, in either case, especially in the latter, be a greater taxable capacity, because the taxes are returned to the citizens, *i.e.* money is raised within the country and paid out to holders of Government stock who are also within the country. For example, the present public debt of England, excluding debt to America, is held to the extent of nearly seven-eighths by " nationals ". Taxation, moreover, may be applied to the construction of irrigation works, railways, and similar undertakings, which increase the productive powers of the country. The psychology of the people taxed has much to do with the extent of taxable capacity. All communities are not equally developed in civic sense, and in the same community it is a variable factor as, for example, in time of war as compared with peace time. Rarely is the civic sense of a community so highly developed that an addition to the welfare of any part of it is looked on as an addition to the welfare of the whole. Where the civic sense is developed, high taxation is borne almost without complaint. People are often willing to bear heavier taxation on customary patriotic or sentimental grounds, or, as stated above, to pay more in indirect taxation distributed over every day of a year than a direct tax levied in lump once a year. In India a town will thrive with octroi taking much more than a house tax which will drive population away. Great Britain, at the beginning of the nineteenth century when fighting Napoleon, was spending one-third

of the aggregate of individual incomes, that is, as £90,000,000 to £270,000,000. France after the Franco-German war and recently has been bearing for patriotic reasons a heavy amount of taxation. Sentiment plays a considerable part in taxation as in politics. Oppression may raise men into heroes or sink them into slaves. Heavy taxation may make some men industrious, enterprising, and wealthy, while others become indolent, dispirited, and impoverished. Excessive taxation usually appears first in diminished saving and then in a diminished standard of living. If excessive taxation had been imposed in Germany for reparations it would have seriously affected savings and production. The future taxable capacity of the country would have been for a long period curtailed. Stability of income must also be considered. A country like India subjected to the vagaries of the monsoon, the jugular vein of India's prosperity, has a much less stable income than Japan or European countries, and it cannot be taxed to the same extent as a country free from all such vicissitudes. The flow of production and, therefore, of income is not so regular in an agricultural country as in a country with agriculture and well-organised industries. If wages keep pace with prices the increases brought about by inflation cancel one another. If not, this would have to be allowed for. Inflation may have the effect of a burden similar to taxation. The purchasing power of a currency falls when paper money is issued for the purpose of replacing money that should have been gathered by taxation and paid into the Treasury. A road leading to an important centre has often many crossings, signposts, and danger signals, but this does not lessen its value as a road to the cautious sojourner. Rather the opposite. The various considerations referred to above do not, in short, impair the value of the concept.

7. The statistical determination of the absolute capacity of a country is not an easy matter. The statistics are complex, and the problem has to be approached from more than one standpoint and from independent groups of data. The results at various stages have to be checked and controlled, and the calculations are often such as to bewilder the ordinary student of public finance. The national income, consumption, and saving, and the nature of taxation have to be examined. The most difficult part of the inquiry is to arrive at the national income, and the difficulty

is enhanced by the exact meaning to be given to national income. Broadly speaking, the national income of a country is the total of the incomes of the people without duplication, wages, salaries, rents, profits and interest in a twelvemonth. It is thus the aggregate net income or heap of goods produced and services rendered in a year within a country and measurable in money. We take all commodities produced and all services rendered at their market value during the year, and from this total subtract the value of that part of the country's goods expended (both raw materials and capital goods) in the production of this total, and the remainder is the net national income of the year. The convention that goods and services that are exchanged should be included must be interpreted widely in cases where, as in India, small scale agriculture is carried on, and much of what is grown is not marketed but consumed by producers. Commodities and services, although not exchanged, must in such a case be included. In short, national income should not be restricted to market phenomena alone. This point further illustrates the necessity of clearly defining in the case of each country what is and what is not included. In recent years the methodology has greatly improved, and comparisons between one country and another can only be made with advantage if the items in each are comparable. Hence it is necessary to itemise rather than to deal in aggregates of national income. It must be remembered that the national income figure is never a precise measurement but rather an amalgam of accurate and approximate estimates. It is for this reason that the parts should be shown separately, and this will be specially useful in making international comparisons, or in comparisons for the same country for different years. The aggregate ignores a large item, viz., the value of domestic services done by women in their own houses and of similar unpaid services, as well as the annual value of assets such as pictures, motor cars, furniture, hobby products, which yield, as Bowley and Stamp term it, " a fund of annual satisfaction which might be, but is not in fact, regularly measurable in money ". The term has other shades of meaning. Thus it may or may not include the income that accrues from abroad. It is sometimes taken to mean the total income arising within the country and from abroad—the taxable income. Often, if not usually, it is the social income, the consumption and saving in a year, or the aggregate of incomes, individual and collective, in

a country, less incomes received by individuals without actual services rendered by them in that year, as, for example, recipients of war and old age pensions. If these deductions are not made, the greater the amount of such transfers, *e.g.* pensions, the richer the country will appear to be, and the aggregate result will be unduly and fictitiously high. In other words, it is the value of goods and services within a country, together with the value of payments due from abroad less those due by the country to outside in a year. A census of production usually regards national income in this last sense. These nice distinctions do not vitally affect the importance of the concept in its relation to absolute taxable capacity, provided care is taken to define the term at the outset of the inquiry. If aggregate national income, for example, is taken, certain deductions from taxation will be necessary in arriving at absolute taxable capacity. If social income is taken, no such deductions have to be made. This will be clear from the table on p. 239, where certain items are deducted from the aggregate income item.

8. Considerable advance in methodology has been made in recent years, and to-day the earliest efforts, those of Petty and King, seem crude in the extreme. Two methods of arriving at the national income are followed—the aggregating of income method and the census of production method. In some countries it has been possible to follow both methods, as in the United Kingdom, and the surprising thing is the remarkable agreement between the results of each for the year 1924. Thus Bowley and Stamp, working on the former method, estimated the national social income to be between £3700 millions and £3900 millions and the taxable income at £4230 millions. Flux, working on the latter method for the same year, arrived at a figure between £3750 millions and £4200 millions.[1] Layton and myself, working independently, arrived at a figure of £3800 millions and £3850 millions respectively. The estimate of £3850 millions included income tax payers, excluding wage-earners, £1900 millions (49 per cent of the total), wage-earners £1500 millions (39 per cent), and

[1] Vide *The National Income 1924* (Bowley and Stamp), Oxford (Clarendon Press), 1927; "The National Income (1924)", *Journal of the Royal Statistical Society*, vol. xcii., 1929. The discussion is of special interest. "Taxable Capacity and the Burden of Taxation and Public Debt", Findlay Shirras, *Journal of the Royal Statistical Society*, vol. lxxxviii., 1925. Cf. *Economic Journal*, "The Definition of National Income" (Bowley), vol. xxxii., 1922.

others £450 millions (12 per cent). The aggregating of incomes method is based, as in the United Kingdom, partially on an analysis of the income tax returns published year by year by the Commissioners of Inland Revenue. It is supplemented by the statistics of wages published by the Ministry of Labour, by salaries and wages collected from the principal local authorities employing clerks, and a number of private firms, and from the occupational tables of the population census. The estimates of Stamp and Bowley for 1924 are as follows:

INCOME OF THE UNITED KINGDOM, 1924

	£ millions.
1. Income, other than wages, above the exemption limit— Lands and buildings, 222; occupation of land, 30; Government securities, 145, Government securities not subject to tax, 25; trades and professions, 1130; salaries, 641; net difference between assessed and full income, 25	2218
2. Intermediate Income— Salaries, 101; other earned income, 89; dividends, etc., 77	267
3. Wages	1600
4. Other Income— War pensions, 69; old age pensions, 24; employers' contributions to insurance funds, 35	128
Aggregate income	4213
5. Subtract income going to foreigners	25
6. Subtract payments to U.S.A. (31, less receipts from Reparations, 7)	24
Income belonging to residents or corporations in the United Kingdom (disposable income)	4164
7. Subtract transfers without actual service during the year (pensions, 93; national debt interest, 268)	361
Social income	3803

The national income in 1924 was made up of income arising within the United Kingdom, £4008 millions; income belonging to non-residents, £56 millions; income from abroad, £212 millions; corporate and undivided income, £205 millions; transfers without actual service in the year, £361 millions.

9. The second method of measuring national income is by a census of production such as that undertaken in the United Kingdom in 1907, 1912, and 1924. The information that has been collected will be seen from the data of the 1924 census of production.

NATIONAL INCOME OF THE UNITED KINGDOM, 1924. GOODS AND SERVICES

	£ millions.		£ millions.
Materials available	848	(Rearranged)[1]	
Net output of industry	1630	Net output—	
Goods ready for use— agricultural	177	Industry	1630
		Agriculture	241
Total production	2655	Waste products	16
Exports (at place of production)	710	Distribution and dealing:	
		Imports into factories	94
Balance of home-production	1945	Exports to ports	89
Goods ready for use— imported	463	Foods to customers	945
Import and export duties	227	Customs and excise	227
		Houses and services	650
Total for distribution	2635	Excess of imports	338
Charges of distribution	945	Increase of capital abroad	45
	3580		4275
Allowed for depreciation	305	Less depreciation	300
New goods in consumers' hand	3275		
Services	650		
Income arising abroad and invested abroad	50		
	3975		3975

The census of production method differs from the aggregation of income or accountancy method in structure and in regarding income from a slightly different point. It looks at the goods at the point of their final disposition, *i.e.* as if they were in the hands of the consumer. The accountancy method, on the other hand, is based on returns of income, and therefore on an aggregation of trading and profit and loss accounts after these have been scrutinised by chartered accountants and by technical experts of the Inland Revenue, *i.e.* the goods are regarded as in the hands of the final trader—production plus stock less final stock—and not as if they were equivalent to the amount consumed. At the same time it should be remembered, as pointed out in the discussion at the Royal Statistical Society, where goods were not sold the census of production form prescribed that these were to be valued on the basis of cost. Where quantity or price moves rapidly the difference between the two methods may be of considerable importance and in favour of the accountancy method. The census of production method is in one respect less satisfactory than the accountancy method in the United Kingdom, in that there is no permanent machinery throughout the whole country

[1] *Journal of the Royal Statistical Society*, vol. xcii. p. 164.

for reconciling and checking returns submitted by the manufacturer in regard to the census, as there is in the case of income tax. It might be argued with less truth that apart from the data of industrial and agricultural output, imports and exports, there are in the census of production estimates and not figures that are known, *e.g.* in the sum allowed for distribution, for services, and for depreciation (apart from the maintenance of plant, which latter is included in the estimates of goods and services). The census of production method should aim at including the net value of goods produced and services rendered in a year within a country, together with the value of receipts due from abroad, less the payments from the country to abroad during the same year. Both methods are complementary in the same way as the two blades of a pair of scissors are. The problem, in short, must be approached from both sides, viz. from that of production and from that of incomes of individuals. The expression of the national income in money tends to obscure the fact that a rise or fall in prices may show an increase or decrease in values without an increase in the quantity of goods and services, which is the real index of prosperity of productivity or welfare in a country. In times of rapidly changing prices it is the real income that must be considered. Many of the goods and services produced do not reach the market, and the valuation of these and also marketable goods and services has to be considered from the viewpoint of real income. It will be found, for example, that the fluctuations in the real income of a country in times of trade depression are relatively small.

10. In some countries, notably in the United States [1] and the United Kingdom, the census of production method has been used with skill and good results. In India the problem is far more difficult because of the fact that, although there are estimates of agricultural production based on accurate statistics of area, fairly accurate normal out-turns, and statistics of crop condition, which are as a rule under-estimates,[2] we have not yet had

[1] Cf. *The Wealth and Income of the People of the United States*, by W. I. King (New York, Macmillan), and similar inquiries by American statisticians such as Prof. Wesley Mitchell. The Australian inquiry was a direct inquiry made by the Commonwealth Government.

[2] If the area be 60,000 acres, the standard normal out-turn 500 lb. per acre, and the percentage estimate 80, the required quantitative estimate is $60{,}000 \times 500 \times \frac{80}{100}$ 24,000,000 lb.

a census into the various elements of our national resources including industry and trade. The returns of income for income tax purposes exclude income from agriculture, in which over seven-tenths of the population are engaged, and the method based on income tax statistics, such as that used by Stamp and Bowley in the United Kingdom, could not be used to the same extent in India. The output of agriculture was valued at harvest prices, *i.e.* the prices actually received by farmers for their produce. Market prices at the ports of Bombay and Calcutta for the main staples were not used, but the harvest prices of the various commodities district by district, and the large totals were built up from small units. The value of jute in 1926-27 to the cultivator was Rs.61 crores; if valued at Calcutta prices it would have been Rs.90 crores, or 50 per cent higher. Similarly with cotton, the value to cultivators in the same year was Rs.35 crores. At Bombay prices this would have been approximately Rs.54 crores, or 28 per cent higher. In cases where actual outturns were not available, agricultural departments were consulted as in the case of milk production. In the case of opium, a Government monopoly, the price taken was that paid to the cultivator in British India (Rs.64 lakhs), not the total revenue obtained by Government from the sale of its monopoly in and outside India (Rs.433 lakhs).[1] Special care had to be taken in calculating agricultural production to avoid duplication, and to get for each unit area not only an accurate out-turn but the price paid to the cultivator for his crop. The results of the census made for two years, 1921–22 and 1926–27, are given in the tables on pages 235 and 236.

11. The method of calculating non-agricultural income required considerable care, and the results had to be arrived at from different directions. Marked consilience was able to give confidence, especially when the same statistical results were obtained from different groups of data. Sampling, long suspected because it was thought by some to be a mere generalisation from the particular, with its well-known tests for a limit of error, can be applied to a wide variety of data which land us within speaking distance of the truth, although only a few will go to the bottom of the well to look for truth. Statistical results, unlike account-

[1] Finance and Revenue Accounts, Government of India, 1926–27. Tables 17 and 17 B, p. 94.

ancy results, are generally estimates rather than exact statements, but they are scientific and the degree of their accuracy

(A) AGRICULTURAL INCOME OF BRITISH INDIA, 1921–22

Crop.	Area.	Out-turn.	Value.	Percentage to Total.
	Acres.	Tons (000).	Lakhs of Rs.	
Rice	79,699,870	32,764	576,86	29 1
Wheat	22,403,559	8,289	157,93	8·0
Barley	7,356,429	3,155	36,60	1·8
Jowar	24,214,263	5,156	80,50	4·1
Bajri	15,900,829	2,273	39,45	2 0
Ragi	4,211,067	1,594	18,97	1 0
Maize	6,334,705	2,456	31,63	1·6
Gram	15,054,855	4,458	70,66	3 6
Other food-grains	29,615,231	5,406	90,23	4·5
Total food-grains	204,790,808	65,551	1102,83	55 7
Sugar-cane	2,363,436	2,296	64,59	3 3
Other sugar	158,740	241	12,82	0 6
Total sugar	2,522,176	2,537	77,41	3 9
Condiments and spices	1,412,359	706	23,45	1·2
Fruits and vegetables	5,537,462	..	96,87	4 9
Miscellaneous food crops	1,244,970	..	24,15	1·2
	8,194,791	..	144,47	7 3
Tea	713,379	117	15,15	0 8
Coffee	96,611	8	90	..
Tobacco	1,050,685	502	23,91	1·2
Opium	122,888	1	1,11	..
Cinchona	6,538	1	7	..
Other drugs	256,818	..	2,47	0·1
Total drugs and narcotics	2,246,919	..	43,61	2·1
Total food-crops	217,754,694	..	1368,32	69 0
Cotton	11,665,395	502	35,60	1 8
Jute	1,505,527	710	11,31	0 6
Other fibres	683,521	229	7,04	0 3
Total fibres	13,854,443	1,441	53,95	2 7
Linseed	2,053,858	312	5,48	0 3
Sesamum	3,707,066	363	8,46	0 4
Rape and mustard	4,232,822	661	13,04	0 7
Cotton seed	11,665,395*	1,171	12,49	0 6
Ground-nut	2,061,199	1,006	26,76	1 3
Other oil seeds	2,141,625	546	11,19	0 6
Total oil seeds	25,861,965	4,058	77,42	3 9
Indigo	328,829	3	3,94	0 2
Other dyes	525,248	..	5,52	0·3
Total dyes	854,077	..	9,46	0 5
Rubber	75,500	2	29	..
Miscellaneous non-food	971,244	..	4,71	0 2
Straw	142,268,521	74,428	101,30	5 1
Fodder	8,608,219	..	42,97	2 2
Milk	..	(Mds.) 290,665	310,36	15 6
Wool	..	552	1,23	0 1
Hides	..	59	7,46	0 4
Forest produce	..	..	6,40	0·3
Grand total	256,582,463	..	1983,87	100 0

* The area for cotton seeds is the same as for cotton, and hence this is not included in the grand total of area.

should be known. In 1871 Mr. Dadabhoy Naoroji estimated the non-agricultural income by adding together the annual value of manufacturing industries, the net opium revenue, the cost of

production of salt, the produce of coal and other mines, the profits of foreign trade, and a figure which he estimated at Rs.30

(B) AGRICULTURAL INCOME OF BRITISH INDIA, 1926–27

Crop.	Area.	Out-turn.	Value.	Percentage to Total
	Acres.	Tons (000)	Lakhs of Rs.	
Rice	78,501,389	28,926	526,11	29·7
Wheat	24,181,145	7,251	100,65	5 6
Barley	6,387,222	2,550	26,21	1 5
Jowar	21,120,754	4,317	52,78	3 0
Bajri	13,801,088	2,455	31,39	1·8
Ragi	3,854,152	1,459	18,53	1·0
Maize	5,554,841	1,919	22,51	1·3
Gram	14,664,317	3,979	45,34	2 5
Other food-grains	29,154,122	5,322	68,46	3·8
Total food-grains	197,219,030	58,178	891,98	50·2
Sugar-cane	2,881,388	3,173	69,23	4 0
Other sugar	159,281	242	11,33	0·6
Total sugar	3,040,669	3,415	80,56	4 6
Condiments and spices	1,378,768	689	36,91	2·1
Fruits and vegetables	4,931,590	..	86,29	4 8
Miscellaneous food crops	1,226,940	..	23,78	1 3
	7,537,298	..	146,98	8 2
Tea	738,159	162	29,09	1·7
Coffee	91,184	8	1,37	0·1
Tobacco	1,055,410	450	21,90	1 2
Opium	59,215	4	64	..
Cinchona	6,363	924	6	..
Other drugs	235,665	..	2,27	0 2
Total drugs and narcotics	2,185,996	..	55,33	3 1
Total food-crops	209,982,993	..	1174,85	66 2
Cotton	15,687,029	541	35,03	2 0
Jute	3,609,490	2,239	61,32	3 4
Other fibres	805,057	270	6,55	0 4
Total fibres	20,101,576	3,050	102,90	5 8
Linseed	2,325,291	384	7,15	0·4
Sesamum	3,171,632	338	9,72	0·6
Rape and mustard	3,280,073	988	21,44	1 2
Cotton seed	15,687,029	1,569	14,95	0 8
Ground-nut	3,863,486	1,901	49,50	2·8
Castor seed	575,741	57	1,15	0 1
Other oil seeds	1,782,426	365	7,48	0·4
Total oil seeds	30,685,678	5,602	111,39	6 3
Indigo	103,755	1	66	..
Other dyes	478,791	..	5,02	0 3
Total dyes	582,546	..	5,68	0·3
Rubber	85,300	6	1,38	0·1
Miscellaneous non-food	919,212	..	4,46	0·2
Straw	..	67,000	90,98	5 1
Fodder	8,939,854	..	44,63	2 5
Milk	..	(Mds.) 297,928	223,44	12·6
Wool	..	581	1,30	0·1
Hides	..	65	6,49	0 4
Forest produce	..	..	6,20	0·4
Grand total	255,953,289	..	1773,70	100 0

crores for contingencies. The total non-agricultural income arrived at was Rs.63 crores, based on data for the year 1868. The criticism of this method is that it was incomplete owing to the absence at that time of full and accurate statistics of agri-

cultural as well as non-agricultural production, including services in the country. In the inquiries which were made between 1881 and 1911 it was assumed that the gross income of the agriculturists and non-agriculturists is distributed between the two classes in proportion to their numbers. If the total agricultural produce or income in 1911 was Rs.876 crores, and if the non-agricultural population were three-eighths of the agricultural population, then the non-agricultural income was estimated to be three-eighths of Rs.876 crores, *i.e.* Rs.328 crores. When a country was industrialised to only a small degree, as was the case before the rapid changes that have been taking place since 1905, especially in the last decade, the method was perhaps approximately correct, but industrial progress in recent years has been so great that some additional allowance is necessary to arrive at non-agricultural income. Commerce and industry as well as transport have developed, and this part of our national income has increased, all things considered, at a far greater rate than agricultural income. India is now recognised as one of the eight countries of chief industrial importance under section 393 of the Treaty of Peace, and is sixth in the world's foreign trade. She has over 17,000,000 workers in industries, including cottage industries, mines, and transport, an export of manufactured goods of Rs.84 crores, an export which is in itself very considerable and would be much greater but for the home consumption of so large a country, a jute industry which is unrivalled, a cotton industry fifth in the world, iron and steel works, foundries, railway workshops, dockyards, paper mills, petroleum refineries, and rice mills, and a railway mileage in excess of every country except the United States and Russia. It was necessary, therefore, to face the heavy burden of routine labour, computers, and local inquiries to arrive at results, for as Chaucer has well said, " In everything, I wot, ther lyeth mesure ".

Non-agricultural income includes wages, salaries, profits, and interests and was arrived at as follows. Wages and the numbers employed were obtained without much difficulty for the year 1926 in regard to the textile trades. In the cotton mill industry it was possible to estimate the total annual wages bill from the average wages and bonus, less deductions due to absenteeism—Rs.12,94 lakhs. The earnings of the handloom weavers were calculated on lines similar to that followed by the Indian Indus-

trial Commission 1918, and amounted to Rs.75 crores. Similarly, for the jute mill industry the annual wages bill amounted to about Rs.14 crores. For industries other than the textile industries, cotton, jute, wool, silk, etc., it was possible by sampling to get the aggregate earnings for male and female workers, who were divided into 27 groups. In the case of trade and transport a similar method was employed, and various checks to the estimates for each group and sub-group were used with the assistance of experts concerned. The earnings of persons engaged in public administration and the public force were arrived at by a study of the Finance and Revenue Accounts of the Government of India. The estimates of earnings in the professions and liberal arts and domestic services were based on information collected from all quarters where it seemed probable that information could be obtained. Profits were gross profits, and were arrived at from an examination of 536 balance sheets of companies registered and working in India during 1926–27. The total number of such companies was 5136, and the sample thus represents 10·4 per cent of the total. The gross profits of railways and irrigation, in no way taxation, were obtained from the Finance and Revenue Accounts. Interest has been included under sub-heads included under the main head, trade. The non-agricultural earnings, excluding profits arrived at in this way, were Rs.980 crores.

	Population millions.	Total earnings crores of Rs.
Industries	11·8	387
Trade	6·0	249
Professions and liberal arts	1·4	134
Transport	1·6	67
Public administration	0·6	57
Domestic servants	1·9	39
Public force	0·6	27
Fisheries	0·6	11
Mines	0·3	9
Total	24·8	980

To this figure of earnings Rs.980 crores gross profits must be added. The gross profits of joint-stock companies, less depreciation at 5 per cent, were Rs.27·1 crores, the gross profits on irrigation, less the same depreciation, Rs.5·1 crores, and of State railways, less the actual net depreciation, Rs.37·5 crores. This makes the total non-agricultural income to be Rs.1050 crores,

which added to the agricultural income gives a total national income for the year of Rs.2824 crores.

This result was checked by the detailed calculations of the national income of 1921–22 and by taking account of the various changes from year to year in the volume of production, as shown

NATIONAL INCOME (BRITISH INDIA)

I. *Calculated on* 1926–27

	1921–22.	1926–27.	1927–28.	1928–29	1929–30.	1930–31	1931–32.	1932–33.
Index of business activity (1921–22=100) . . .	100	118	122	123	129	117	103	102
National income at 1926–27 prices (crores of Rs.)	2393	2824	2919	2943	3087	2800	2464	2441
Price index (average of Bombay and Calcutta index 1926–27=100) .	127	100	99	98	96	82	70	67
National income at each year's price.	3039	2824	2890	2884	2963	2296	1725	1636

II. *Calculated on* 1921–22

	1921–22.	1926–27	1927–28	1928–29.	1929–30	1930–31	1931–32	1932–33.
Index of business activity (1921–22=100) . . .	100	118	122	123	129	117	103	102
National income at 1921–22 prices (crores of Rs.) .	2866	3383	3497	3526	3698	3354	2952	2923
Price index (average of Bombay and Calcutta index 1921–22=100) .	100	79	78	77	76	65	55	53
National income at prices of each year	2866	2672	2728	2714	2809	2180	1624	1550

III. *Average of* 1926–27 *and* 1921–22.

	1921–22	1926–27.	1927–28.	1928–29	1929–30.	1930–31.	2932–32.	2932–33.
National income to nearest Rs.50 crores (Rs.50 crores less than 2 per cent of the total income)	2950	2750	2800	2800	2900	2250	1700	1600

by an index of business activity,[1] and also the changes in prices. The results are given in the table above. The table also shows the national income of each year up to 1932–33, as it is

[1] Geometric average of 22 articles or commodities which include the quantities of production, agricultural, mineral, manufactures, main exports and imports (quantities), tonnage of vessels entered and cleared with cargo, goods carried on railways, value of money orders paid, bank clearings, and the paid-up capital of Indian joint-stock companies.

preferable not to consider the income of any year in isolation. A moving national income, as Corrado Gini well puts it, cannot be measured with accuracy by itself for the same reason that a moving object cannot be weighed, and this applies especially to India.

The national income for 1926–27 may be rearranged as follows:

Goods and Services	Crores Rs.
Agriculture	1774
Industry	402
Mines	29
Fisheries	11
Imports	269
Exports	– 301
Import duties	40
Total for distribution	2224
Charges for distribution (retailing and transport)	445
	2669
Allowance for depreciation	198
New goods for consumption	2471
Services and houses	333
	2804

The items above that call for explanation are import duties, charges for distribution, allowance for depreciation, and services. Import duties only have been added, because under the Sea Customs Act 1871 the declared values are wholesale market prices less the import duties. In the case of exports the values are wholesale market prices without any deduction of export duties if any. The charges for distribution in the census of production in the United Kingdom 1924 varied on the average between 29 and 43 per cent. Some goods, passed direct from producers to consumers, and the values of these goods required no addition except in so far as delivery, were carried out by agencies quite apart from the firms producing the goods. Other goods, however, required wholesale dealers, transport agencies, and retailers. For this latter class, which was 69 per cent of the total available for distribution, 40 to 60 per cent was taken. There was a third class, for which the percentage of retailing and transport was 15. In India, owing to the self-sufficiency of the villages the percentage would be less, and after inquiry a percentage of 20 has been taken for retailing and transport. The allowance for de-

preciation was not the amount used during the year, but the amount believed to be chargeable for depreciation in the year. Ten per cent was taken for agricultural production and 5 per cent for industry. Some of the depreciation in mills, etc., is met from materials and wages paid to the maintenance staff which make good the depreciation. This is included under industrial production (staff and materials). It has been said that in the British Census of Production the result consisted of 57 per cent fact and 43 per cent estimate.[1] The Indian estimates do not compare unfavourably in this respect if agricultural statistics of India be regarded as fact—the percentage would be 65 and 35 respectively.

12. The *per capita* figures of income have only a limited use. They show the comparison of one year with another, the change from time to time. They do not show the distribution of income about the average, which is as important as the average itself, since the distribution of wealth is an important factor in absolute taxable capacity. Indeed, Marshall suggests " A rough opinion of the economic strength of a nation . . . may be got by the multiplying the aggregate income of the inhabitants by their average income ".[2] The *per capita* income is the average obtained by dividing the national income by the total deduced population in the intercensal period or the total population at censal periods. It is not the average obtained by dividing the income by the total number of adult wage-earners or heads of families, but by the total of men, women, and children. A *per capita* figure rarely can be used for comparing the income of one population with another. It is sheer charlatanism to compare the *per capita* figure of different countries with varying standards of living and marked differences in production, customs, and habits and also

[1] Vide *Journal of the Royal Statistical Society*, vol. xcii. (1929), p. 174.

[2] This is in accordance with the mathematical law, which states that if A varies as B when C is constant and varies as C when B is constant, then A will vary as B × C when both B and C vary. A simple illustration of this is that if two rooms have the same length that which has the greater breadth has the greater space or area, and if two rooms have the same breadth that which is the longer has the greater area. Hence in comparing the size of two rooms the quantity length × breadth is taken. Similarly, in two countries having the same average national income, that country which has the greater aggregate national income is economically the stronger. If two countries have the same aggregate income, that which has the greater average income (thereby showing a greater aggregate income for a smaller population) is economically the stronger. Hence Marshall's suggestion above.

in prices. Thus if a comparison is made with British income, the comparison should be with countries like the United States, Germany, and other advanced industrial countries. Similarly, in the case of India a comparison should be made with China, Japan, and with Greece, Bulgaria, Northern Italy, and Yugoslavia, where agricultural methods are not dissimilar. For example, in China the average per square mile is 1783 people, most of whom live on agriculture with no other subsidiary occupations. Rice is the chief crop, as in India and Japan. Many villages are self-sufficing and are almost landlocked, there being no roads and means of transport. Houses are of clay and consist of a single room with a sleeping-place heated from below. Japan, which resembles China in its agriculture, has an average number per square mile of 2350. In Japan, however, there is a much better exploitation of the soil, more modern implements, and a closer contact with the outside world owing to the rural population being able to read and write. " The peasant is a dynamic element in Japanese economics, he zealously strives to increase his income, he is exposed to all the temptations of his age." [1] India supports as a whole 177 persons per square mile, although in some agritural districts it is as high as 700, and only about 40 per cent of the total area is under cultivation and 25 per cent is classed as " culturable waste ". The standard of living is low as in Japan, although higher than in China, and village houses are of mud or thatch. In parts of Greece the wooden ploughs are the same as those in use more than 2000 years ago. Production should be studied in relation to the factors of land, labour, capital, and organisation, the factors responsible for that production. Instances could be multiplied to show that *per capita* figures in international comparisons are in most cases of little value except in comparing one year with another in the same country, and even here this has its limitations. To take statistics, as Sir Robert Giffin once said, " haphazard from statistical abstracts and dictionaries, and assume that figures called by the same name in different countries have exactly the same values, is either foolish or dishonest ".[2] With these reservations the following annual *per capita* figures of national income of British India are of

[1] *Encyclopædia of the Social Sciences* (The Macmillan Company), 1930, vol. i. pp. 589-593.

[2] *Economic Inquiries and Studies*, 1904, vol. ii. p. 60.

interest: 1921–22, Rs.119; 1922–23, Rs.120; 1923–24, Rs.117; 1924–25, Rs.126; 1925–26, Rs.114; 1926–27, Rs.108; 1927–28, Rs.108; 1928–29, Rs.106; 1929–30, Rs.109; 1930–31, Rs.84; 1931–32, Rs.63; 1932–33, Rs.58. If the family is taken to consist of four members the figures would be four times the *per capita* figures, or for 1926–27 36 *per mensem*. The average size of an Ahmedabad working-class family in 1926 was 4, and the average income Rs.44·5 *per mensem*. If the family were taken to be the equivalent of one household, the size in the 1931 census was 5 persons. The income per family would be for 1926–27 Rs.45·0 *per mensem*, as against a *per capita* figure (man, woman, and child) of Rs.9·0 *per mensem* for that year. The national income figure, it is to be remembered, includes all the incomes in British India, large and small, and not as in the budget inquiries of the Bombay Labour Office only working-class budgets in large cities. It is interesting to note that the *per capita* estimates of 1871 were Rs.20 per annum, 1881, Rs.27; 1901, Rs.30; 1911, Rs.80; and 1920–21, Rs.107. The earlier figures of *per capita* income can be compared in a general way with the more elaborate figures of recent years.

Absolute Taxable Capacity

13. It is not sufficient to point out that the percentage of taxation to national income was in 1932 20·9 in the case of the United Kingdom and 8·3 in India. These percentages tell us nothing regarding absolute capacity. Nor can we say as did a distinguished English banker, Mr. McKenna, in 1920, that a budget of £1000 millions was as much as the country could afford; there was grave over-taxation, and that £1000 millions left an insufficient margin for the increase of capital required for the recuperation and development of industry. Interest and repayment of debt cannot be treated in the same way as expenditure on, for example, armaments, and, it is necessary to remember some of the precautions if such calculations have "any approach to correctness of degree and if the results are to be inaccurate only to the extent of errors in the statistical assumptions". The heaviness of taxation must be considered with due regard to prices, as the burden of taxes is heavier when prices are falling than when they are speedy or rising. Moreover, interest on debt and repayment of internal debt are deducted from taxation, as

these sums are returned to the taxpayers by the Government and do not diminish the surplus. The table on p. 253 will indicate the principles that have to be considered.

14. In some ways in an agricultural country like India a

TAXABLE CAPACITY OF THE UNITED KINGDOM (In £ millions)

	Pre-War Year 1913–14 Stamp.*	1921–22 Stamp.	1922–23. G.F.S.
1. Difference between production and minimum consumption	750	960	810
2. Savings for ordinary replacement of and addition to capital	500	150 †	140 †
Taxable capacity (1-2) . .	250	810	670
3. Actual budget (excluding non-tax revenue)	163	964	729
4. Interest paid on Government loans	15	200	200
5. Redemption of internal debt by Government . . .	10	100	100
Effective taxation (3, minus the sum of 4 and 5) . .	138	664	429
Balance	112	146	241
6. Taxable capacity expressed as a percentage of the difference between production and minimum consumption . .	33	84 ‡	83 ‡
7. Effective budget (tax revenue only) expressed as a percentage of the difference between production and minimum consumption . .	18	69	53
8. Balance expressed as a percentage of taxable capacity	45	18	36

* With certain small additions as No. 5.

† In these abnormal years savings should be considerably less than in normal times.

‡ These figures are high as compared with the pre-War year, mainly owing to a considerable reduction in savings in recent years.

three- or five-yearly average might have been preferable. India depends at the present time on the vagaries of the monsoon, which may be said to be the jugular vein of Indian prosperity. As years go on, more and more irrigation projects are launched to prevent as far as practicable the risks entailed in this respect. The area under irrigation is 20 per cent of the cropped area.

The years 1910–11 and 1921–22, together with the year 1926–27, have been taken for the purpose of absolute taxable capacity. The variations in the table below between 1921–22 and 1926–27 in the case of India should be compared with the variations in the table on p. 252 relating to the taxable capacity of the United Kingdom, where the industrial depression of 1921 was the worst probably since the time of the Napoleonic wars. A year of scarcity or famine in India is a year of agricultural unemployment, and may be compared with industrial unem-

THE TAXABLE CAPACITY OF BRITISH INDIA

Details.	1910–11.	1921–22.	1926–27.
1. Income :	Lakhs of Rs.	Lakhs of Rs.	Lakhs of Rs.
Agricultural	1412,00	1984,00	1774,00
Non-agricultural. . . .	530,00	882,00	1050,00
Total income	1942,00	2866,00	2824,00
2. Allow for minimum consumption	1214,00	2220,00	2313,00
3. Allow for seed and manure . .	141,00	198,00	177,00
4. Allow for replacement of and ordinary additions to capital . .	15,00	25,00	30,00
5. Taxable capacity [1 – (2 + 3 + 4)]	572,00	423,00	304,00
6. Tax revenue :			
Central and Provincial Governments	79,83	135,30	139,00
Local bodies	7,17	12,63	16,00
Total	87,00	147,93	155,00
7. Expenditure on internal debt :			
Central and Provincial Governments	5,61	24,27	36,00
Local bodies	1,70	2,34	5,00
Total	7,31	26,61	41,00
8. Effective taxation (6-7). . .	79,69	121,32	114,00
9. Balance (5-8)	492,31	301,68	190,00

ployment in an advanced industrial country. The effect is in the first place a shrinkage in aggregate income and, therefore, of taxable capacity. Most of the figures in the tables on pp. 252 and 253 are self-explanatory.

The allowance for minimum consumption has been arrived at after a study of family budgets, as this is statistically more satisfactory, affording as it does a clearer view than aggregated statistics. The standard of comfort is an elastic term, and taxable capacity will vary with different standards of comfort. In India the standard is low, and one looks hopefully to education and greater productivity as a means to the raising of this standard of living. We take, then, the standard of living as it is, not what

it ought to be, and without suggesting comparisons with the standard obtaining in Western countries. In 1910, for example, Jack in his *Economic Life of a Bengal District*,[1] calculated that an average family of five persons required Rs.240 a year for subsistence. This gives a consumption allowance of about Rs.48 per head for the year 1910. But since that date, *i.e.* nearly five years before the War, prices of food-stuffs and raw materials increased by 88 per cent in 1921–22. In other words, Rs.48 in 1910 would be Rs.90 in 1921–22, and Rs.85 in 1926–27. Family budget inquiries show that an improvement in the standard of living has been at work in several directions, and it would not be wrong, allowing for this, to retain a figure in the neighbourhood of Rs.90. The allowance for seed and manure has been taken at 10 per cent, although Mr. Dadabhoy Naoroji took only 6 per cent, and agricultural experts frequently a figure below that taken in the table on p. 253. For the replacement of capital, 5 per cent of the gross profits of joint-stock companies have been taken, which is a fair amount for depreciation. This is deducted from the non-agricultural income. Twenty-five crores have been allowed for additions to capital in 1921–22 and 30 crores in 1926–1927. The figure in the table of taxation should not be confused with the figures of total Government revenue. They refer to tax revenue only. The expenditure on internal debt has to be subtracted for reasons already given, as it is in effect a transference of money from one pocket to another.

The taxable capacity is not so high as in an advanced industrial country like Great Britain. In 1926–27 the taxable capacity was in the neighbourhood of Rs.304 crores, but the effective taxation, *i.e.* taxation minus interest on internal debts and debt repaid, was Rs.114 crores, leaving a balance of something in the neighbourhood of Rs.190 crores. The effective taxation, as already defined, was in India 4 per cent of the gross income, as compared with 24 per cent in the case of Great Britain. In India 38 per cent of what might have been taken, *i.e.* total taxable capacity, was taken by public authorities in the form of taxation as against 64 per cent in the United Kingdom. These figures, however, must not be interpreted too rigorously. The reservation of the standard of living applies to all these figures. The standard of living is much higher in Great Britain, and ulti-

[1] P. 59 (Clarendon Press, 1916).

mately Great Britain can stand much higher taxation. That explains why 64 per cent taken from total taxable capacity did not lead to the same hardships as the same percentage might do in a country with a lower standard of living. Again it must be emphasised, with almost wearisome iteration, that the taxable capacity of British India is not an absolute amount for any one year. It is possible only roughly to indicate the direction in which this limit lies. A great deal depends on the purposes for which the taxation is imposed, and on the extent to which the tax proceeds are spent inside or outside the country. Again great care has to be taken in making comparisons. No test can be looked on as more than an approximation. Any person who skates over these difficulties with lightness and agility deserves to be treated like the mimic or acrobat in Plato's *Republic*. That pantomimic gentleman was congratulated on his accomplishments, crowned with garlands, and then led to the gate of the city and bade never to return.

Relative Taxable Capacity

15. The problem of relative taxable capacity is not concerned with the absolute capacity of a state as we have seen, but with the capacity to contribute to a common liability or expenditure. If the states are closely similar in economic conditions, the contributions may be according to population. Where the wealth of the states differ, as, for example, between New South Wales and Tasmania, Bombay and Assam, the yield of an income tax levied on the same descriptions of incomes and levied equally well in both may be followed. The British Treasury method of taking the yield of such taxes, deducting therefrom the cost of Government, assumed to be similar in both, and of treating the surplus as the proper contribution to the common expenditure, has already been discussed. To use the income tax method alone is not satisfactory. The income tax of Bombay and Bengal (where the headquarters of firms are) is paid on income arising in or belonging to other provinces. In a large state or province, such as Western Australia, where the area of Government is seventeen times greater than England and Wales, and Tasmania, where the area is only less than half the size of England and Wales, the cost of Government per head is higher. In West Australia

it was £19 in 1925–26, as compared with £12 in Tasmania and £17 for all states. The same applies to Burma, which having the largest area has the largest *per capita* cost of Government in India. The best method is to construct an index of relative taxable capacity by taking the following factors into consideration. The factors are indirectly weighted :—

1. Population :
   Gross : occupied (agriculture, industry, transport, trade).
2. Cultivated area :
   Total : number of acres per agricultural worker ; number of workers: the percentage of cultivated area to net area.
3. Revenue :
   Gross : net : net revenue per head : net revenue per 1000 square miles.
4. Expenditure :
   Gross : net : net expenditure per head : net expenditure per 1000 square miles.
5. Taxes collected in each province :
   (*a*) Income tax (total (persons, companies, etc.) per head, percentage of income tax to gross Provincial Revenue).
   (*b*) Land taxes.
   Total per head, percentage to gross revenue.
   (*c*) Taxes collected by or on behalf of the Central Government—Direct ; indirect (total and *per capita*).
   (*d*) Provincial taxation.
   Direct ; indirect (total and *per capita*).
   (*e*) Total taxation.
   Central and Provincial ; direct and indirect.
6. Consumption of recognised necessaries.
7. Number of industrial establishments.
8. Average number of people employed in industrial establishments.
9. Numbers of letters and postcards.
10. Value of agricultural production (total and per head).
11. Value of industrial production.
    Textiles, minerals.
12. Total income (total and *per capita*).

13. Economic strength.[1]
14. Personal incomes assessed to (*a*) income tax and (*b*) super-tax.

These factors if applied to India would give the following results :

INDEX NUMBERS OF RELATIVE TAXABLE CAPACITY

Bombay	100
Madras	73
Bengal	87
United Provinces	60
Punjab	48
Burma	54
Bihar and Orissa	43
Central Provinces	39
Assam	16

Another method of the formulation of relative taxable capacity is to take the incomes province by province or state by state. A full account of the national income of each unit is not usually available and therefore recourse is had to the uniform federal tax assessments and also, in the case of incomes below the income-tax limit, the real wage index, as these incomes may be said to be determined by the rates of wages. These two results may be combined in a weighted index, the weighting being in proportion to the amounts derived from federal taxpayers for each state and the amounts derived from those who do not pay such taxes. From this an index of relative taxable capacity is obtained. Thus the taxable capacity for 1933–34 for each of the States of the Australian Commonwealth has been estimated as follows :

TAXABLE CAPACITY *

State.	For Incomes coming under Federal Tax	For Incomes exempt from Federal Tax.	For all Incomes (Weighted average 3 (Col 2) . 1 (Col. 3)).
Victoria	115	94	110
New South Wales	108	100	106
Queensland	86	133	97
West Australia	79	94	83
South Australia	71	84	74
Tasmania	60	88	67
	100	100	100

* Cf. Commonwealth Grants Commission Report, No. 148, 1934–35, Ch. VI. and Appendix I.

[1] See footnote 2 on p. 249.

Most of the items in the index in the case of India are self-explanatory and review the general circumstances of the economic life of the contributing provinces. From this an ideal basis for an equitable distribution is possible. This distribution is considered in the light of agricultural and industrial wealth and other relevant factors of relative economic position. When relative taxable capacity has been ascertained it is easy to establish the burden or severity of taxation or the reverse. Thus the relative severity of taxation of the Australian States in 1933–34 is calculated in the following table:

SEVERITY OF TAXATION, 1933–34

	Total Taxation per Head.	Taxable Capacity.	Severity of Taxation.*
	£		
Victoria	4·91	110	82
New South Wales	5·89	106	101
Queensland	6·64	97	125
West Australia	4·19	83	92
South Australia	4·93	74	122
Tasmania	4·13	67	112
Six States	5·47	100	100

* The figures of severity of taxation are obtained in the following way If £5 47 are the average taxation per head of all States, *i e* 100, then £4 91, the taxation in Victoria, is 90 The taxable capacity, however, of Victoria is 110. If this taxable capacity (110) be regarded as the fair measure of taxation, then what should 90 be? This is 82 and 18 per cent below the average for all States.

CHAPTER XVI

THE DISTRIBUTION OF CENTRAL, PROVINCIAL, AND LOCAL REVENUES

1. THE distribution of public revenues between Central or Federal, Provincial or State Governments, and purely local authorities, is, it need hardly be said, largely determined by historical considerations. In a study of the separation of revenues country by country the importance of this becomes clear. In recent years the problem of the distribution of public revenues as between the Federal authority and its units has given tise to much discussion, notably in Australia, Canada, South Africa, India, Germany and the United States. The distribution suitable in one country may not be equally suitable in another where different conditions obtain. That indeed is a commonplace. Revenues, in short, are affected by economic, political, and social conditions. The basis of taxation varies as economic life changes. Land taxation, for example, plays a far less important rôle in industrial as compared with agricultural countries. Nevertheless it is possible to lay down a few principles based on a study of recent Budgets in the more important countries.

2. In the first place there has been a greater emphasis on the taxation of income than ever before, due to the increased fiscal burdens, the result of War and post-War costs, and of a change in men's minds towards socialism, especially State socialism, and democracy. There has been an increase in tax-mindedness in modern communities which, among other reasons, is due not only to heavier fiscal burdens, already noticed, but also to the growth of a money economy and the development of commerce and industry. New states created by the Treaty of Peace turned to income tax as a main source of revenue. The older states, on the other hand, found income tax an elastic head of revenue in

times of heavy expenditure. In the United States, as well as in Great Britain, income taxation became the main head of central revenues. In Italy it produces from 30 to 40 per cent of the total tax revenue, and in France and Germany, where sales taxes are important, income taxes are also of high importance. In France the income tax varies from 20 to 30 per cent of the total ordinary receipts, and in Germany to even 35 per cent. In the States of the American Union, where the general property tax has so long held the field, it is being used as an important supplement to State revenues, and in some, as in New York State, it replaces the general property tax as the chief source of revenue. As an engine of taxation it has made great progress since it was adopted in 1913 in the United States after the Sixteenth Amendment was passed, in France in 1917, and in Italy in 1919. The concept of income, the subjects of income taxation, the rate, amount, incidence, and effects of such taxation have received careful attention from the taxing authorities in all the more advanced countries, whether the tax is a composite income tax as in France or Italy where a series of quasi-personal taxes on particular sources of income is accompanied by a super-imposed personal tax on total income or a unitary income tax as in Great Britain, Germany, and the United States. In federal constitutions the productiveness of the tax has led to a conflict of jurisdiction between federal and provincial or state authorities. In some cases the Federal Government has entered the field later than the provincial or State authorities ; in other cases the latter are invading or trying to invade the field of the Federal Government. In recent years with the increase in communications there has been a tendency to increased centralisation, notably in Germany and the United States. State administration in turn has been replacing more and more purely local administration. In the Reich the main revenues, income and net fortune taxes, customs duties, the sales tax and death duties belong to the central government, while the states and communes have real estate taxes, certain excises, and fees. The Reich, however, shares with the states and communes its revenues. Another characteristic of recent budgets is the discovery or rediscovery of certain taxes, notably the sales tax levied upon the sales of commodities or services, the gasoline or petrol tax, and in the United States special assessments. Sales taxes, which are collected in a stream

of small payments usually at the rate of 1 or 2 per cent, have since the War proved remunerative and practicable under certain conditions. The taxes are not as a rule difficult to collect as they are paid without much conscious effort on the part of the taxpayer. To-day almost all leading countries have introduced the tax, which is often more productive than customs or excises. Germany introduced payments taxes in 1916, and France followed in the following year. By 1933 some thirty countries had sales taxes which avoid the strictures of Adam Smith on the Alcavala of Spain in regard to the high rate of tax, the large costs of collection, and the inconvenience to the taxpayer subjected " to the continual visits and examination of the tax-gatherers ".[1] The gasoline tax was first imposed in four states of the American Union in 1919 to aid in the construction and maintenance of public roads. In ten years it spread to all states of the Union and to several foreign countries. It is productive and easy of collection, the cost rarely exceeding 1 per cent of the yield. As a tax it has, therefore, high merit. Special assessments in local finance are of great value as an effective method of raising revenue from the owners of property for the cost of public improvements likely to enhance the value of the property assessed. In the United States this source of revenue is second in importance to the general property tax. The growth of cities, the construction of roads, town planning schemes, the demand for more and better drainage and public health amenities, are the causes of the growth of revenue under this head. These special assessments are not merely for non-revenue yielding local improvements but are also for nuisance abatement, such as refuse collection, and for revenue yielding utilities, such as levies for electric and gas plant, tunnels, and similar utilities. They are, unlike taxes, levied to defray the cost of improvements and do not recur regularly but are for measurable special benefits, levied only when the specific improvement takes place. They are not levied to yield general revenue and are not levied, as taxes are, without special benefit. In times of falling prices when property values fall considerably they may approximate to a tax, the special assessment exceeding the special benefit.[2]

[1] *The Wealth of Nations*, Book V. ch. ii. part ii. art. iv. Cannan's edition, vol. ii. p. 383.

[2] Rosewater, *Special Assessments: a Study in Municipal Finance* (Columbia University Studies: New York, 1893), Seligman, *Essays in Taxation* (10th

Another principle in the distribution of revenues is that in most countries local taxation is obtained from real estate. Income and corporation taxes have been found to be unsatisfactory, as the base of these taxes extends beyond local boundaries. In Germany in pre-War times local authorities were restricted in regard to the levying of income taxes. In Holland, where three-fourths of all municipal taxation came from a local income tax, the Government prohibited in 1929 this form of taxation altogether, and established a centrally administered fund which is redistributed to local bodies according to population, wealth, and average expenditure on the police, education, and public assistance. As income taxation failed, local authorities were compelled to fall back on specific taxes, chiefly on land and buildings, which are especially a good tax where the property has benefited by local expenditure. In Great Britain, the bulk of local taxation is levied on the occupier of real property. In the United States the proportion of revenue from property taxation to total local tax revenue was 92 per cent. Local bodies, especially municipalities, can by charging for public utility services exact an indirect tax. Local excise duties are defective because they are easily evaded and undermine federal or state taxation. Concurrently with the decentralisation of expenditures in modern times, local finance tends to the centralisation of revenues. Local authorities have to depend to a greater extent than ever before on central or state governments. In Germany, for example, they have been assigned a portion of central taxes. In Soviet Russia, practically the whole local revenue is supplied from national revenues. In 1925–26 the proportion of such revenue, viz. revenue from grants-in-aid, subventions, and centrally administered and locally shared taxes amounted to 25 per cent in Great Britain, 21 per cent in Belgium, 13 per cent in France, 11 per cent in Italy, and in the United States state grants were about 8 per cent of the total local revenue for all states. The financial settlements (Finanzausgleiche) in Germany, Austria, Switzerland, and other countries are interesting as showing the attempt to solve the problem of the distribution of revenue between federal, state, and local authorities. An increase in centralisation of revenues

edition, 1925); Haig, "The American System of Special Assessments and its Applicability to other Countries", *Proceedings*, Pan-American Scientific Congress, Washington, D.C., vol. xi., 1917.

is the characteristic note of local finance in European countries, and indeed elsewhere at the present time.

3. In non-federal countries, such as Great Britain, the separation between the Central Government and local authorities is not without interest. This is usually determined by the history of each particular country, and hasty generalisations have to be avoided. In Great Britain the tax system is simple, the sheet-anchor being income tax, which is aided by customs, excise, and death duties. Even local rates are largely based on annual income. Taxes on business are avoided. In France, on the other hand, the tax system is very complex, and taxes on business transactions quite important. In 1934–35 the revenue for Great Britain and Northern Ireland was £805 millions, of which nearly £684 millions or 85 per cent was tax revenue and £121 millions or 15 per cent non-tax revenue. The main heads in order of importance are as follows (the percentages of the total distribution are given in brackets): Income-tax (35 per cent), customs (23 per cent), excise (13 per cent), estate duties (10 per cent), stamps (3 per cent), motor vehicles duties (1 per cent), posts and telegraphs (9 per cent). There are other sources, mainly land tax, excess profit tax, corporation profits tax, Crown lands, interest receipts, and other miscellaneous receipts, which amount to 6 per cent.

To Local Taxation Accounts there are paid out of the Consolidated Fund sums equivalent to the proceeds, in some cases of the year 1908–9 and in other cases of the current year, from excise licence duties, part of the beer and spirit duties and part of the probate and estate duties. Certain other grants-in-aid of the cost of specified services such as education, public health, and police, and grants to compensate for the loss of rates, are also payable to local authorities. In 1930–31 the Central Government paid to local authorities in England and Wales £130 millions, These local authorities also derive revenue from rates (26·4 per cent of their total revenue in 1930–31), loans (20·7 per cent), prices or receipts from public undertakings, mainly trams, electricity, gas, and waterworks (19·8 per cent), Government grants (23 per cent), and miscellaneous, including certain fees, rents, and interest receipts (10·1 per cent).

4. The principal sources of ordinary revenue of the Dominion (or Federal) Government of Canada are customs, excise, the post office, interest on investments, and, above all, War tax revenue

(imposed during War time), which includes income tax, the sales tax, the transportation tax, taxes on banks, trust and loan companies, insurance companies, and business profits. Before the War nearly four-fifths of the federal revenue was derived from customs, excises, and immigration taxes. Indirect taxation was popular, but in the post-War period with War debts, War pensions, and higher administrative costs due to a rise in prices and an increase in population "War taxes" were levied by the Dominion Government. Provincial Governments increased their revenues by direct taxation and licences, such as those on motor vehicles, liquor, gasoline, and amusements, including racing. It was not difficult for the Dominion Government to increase its taxation, because under Section 91 of the British North America Act, 1867, the Dominion Government has the power of "raising money by any mode or system of taxation". Thus in 1915 internal taxes were raised from certain classes of companies, from banks, from cheques, from railway tickets and telegraphs. In 1916 the War profits tax was introduced. In 1917 the Federal Government entered the field of income taxation. In 1920 a sales tax was introduced, originally on sales by producers to wholesalers, by wholesalers to retailers, and by producers direct to retailers or customers, but now with certain exemptions a 6 per cent charge on the sales of goods imported and on sales by producers. The framers of the Canadian Constitution did the very reverse of that which the Fathers of the United States did and were against endowing the units with large residual powers. They preferred a very powerful federal government. War-tax revenue in 1933–34 was 52·5 per cent of the consolidated fund or ordinary revenue, while customs amounted to 20·5 per cent, excise to 11 per cent, and the post office to 9·5 per cent. Provincial revenues for nine provinces for the fiscal year 1932 were equivalent to 60 per cent of Central or Dominion revenues; of these about 10 per cent was derived from Dominion subsidies given to provinces in varying degrees, according to their needs and circumstances; *e.g.* from 30 per cent of the total provincial revenues in a maritime province like Prince Edward Island to 5 per cent in a province like Quebec. The Canadian provincial Governments in regard to taxing powers are rigidly limited, and obtain their revenue from forests, mines, game and fisheries, and various direct taxes, such as taxes on corporations, succession duties, taxes on property, taxes on incomes (Prince Edward Island, British Columbia, and Manitoba), taxes

on land transfers, the gasoline tax, the amusement tax, and licences.[1] Local authorities have, as in India, such sources as property, certain fees, and prices. The most striking characteristics of revenue distribution in Canada to-day are briefly: (1) the financial strength of the Dominion Government as compared with that of the provinces, which are responsible for nation building activities and social services undertaken at the instance of the Dominion Government: (2) the grant of subsidies by the Dominion Government to provinces. It is true that these subsidies have diminished in importance as a source of provincial revenue with the development of income and inheritance taxation by provinces, and in 1930 were only about 3·5 per cent of the total Dominion expenditure as compared with 10 per cent a quarter of a century earlier. Nevertheless, these payments have given rise to friction, and they lead provinces to think that the Dominion Government will always come to the rescue when they are in financial difficulty. They, therefore, do not make for economy and real provincial autonomy. The separation of the spending from the raising of revenue has made for recklessness on the part of the provinces which looked on the Dominion Government as a magnificent milch cow. (3) The Dominion Government by entering the field of direct taxation has given balance to its federal tax system. It corrects a hitherto unduly regressive system of central taxation. The federalising of income tax and of the taxation of companies is in these days of easy communications and industrial progress necessary, because it avoids evasion, unfair double taxation, and inefficient and expensive collection. It may be possible to share the revenue from personal incomes collected within each province, or alternatively the Dominion Government may assume the burden of old age pensions, unemployment relief, and similar social services, at present only partially met by subsidies. In the future there seems room for more and better income and corporation taxation and for greater revenue from public utilities. In regard to the former some Canadian authorities criticise the taxation sources

[1] *Vide* Section 92 (2) of the British North American Act, 1867, which reads, "Direct taxation within the Province in order to the raising of Revenue for Provincial Purposes". Cf. sections 91, 121, and 125 of the same Act.

A resolution paving the way for the amendment of the Act was passed on 15th May 1936 by the Canadian House of Commons. This will validate and widen Provincial rights over indirect taxation, including retail sales taxation; it endows the Federal Government with power to guarantee Provincial securities and to erect safeguards for the Federal Treasury for such guarantees.

of revenue of the Dominion, Provincial, and Local authorities as having too great an element of regression in it. (4) Certain provinces, such as Prince Edward Island and British Columbia, have received differential treatment from the specially favourable treatment from the Dominion Government owing to their low taxable capacity. This is a characteristic which is not unusual in the financial relations of units in a federal constitution.

5. Although the Constitution of the Commonwealth Government of Australia is on the American model, it has shown a flexibility through consultation between the Federal Government and the Units on financial relations that has been wanting in its prototype. The powers of the Federal Government are enumerated and the residual powers belong to the States. By the Braddon clause (or " blot " as it was subsequently called) of the Constitution [1] it was provided that " During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, of the net revenue of the Commonwealth from duties of customs and of excise not more than one-fourth shall be applied annually by the Commonwealth towards its expenditure ". The balance was made over to the States or applied to the payment of interest on debts taken over by the Commonwealth from the States. By the Finance Act of 1910 the Commonwealth Government kept the whole of the proceeds from customs and excise and gave for ten years and thereafter until Parliament otherwise provided, subsidies to the Units, calculated at the rate of 25s. per head of population. Special additional subsidies under section 96 of the Constitution [2] were given to Western Australia and to Tasmania for a period of ten years. Special assistance from the Commonwealth Government has been continued in the case of these two States, and since 1929–30 South Australia has received a special grant. Owing to the War the Commonwealth Government was compelled to enter the field of direct taxation. In 1914 federal succession duties were levied, and in the following year a federal income tax was introduced. The *per capita* subsidy system proved unsatisfactory. It was based on the bad principle of one authority spending the revenue raised by another. The Commonwealth Government decided to abolish it at the earliest

[1] Commonwealth of Australia Constitution Act, 1900, section 87.

[2] " Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit."

opportunity. This was effected in 1927, and in place of the payment of subsidies the Commonwealth took over the State debts in accordance with a Commonwealth Referendum, an arrangement ratified by an Act of Parliament, the Financial Agreement Validation Act, in 1929. The Commonwealth pays £7,584,912 a year for 58 years towards the interest charges, and makes substantial payments for a sinking fund which will extinguish debts in 58 years and future debts in 53 years. The States also contributed to a sinking fund, and further indemnified the Commonwealth against liability to the payment of interest in excess of the federal contribution. The States no longer borrow independently of each other and of the Commonwealth Government and there is now unified control. For the first fifteen years the States, it is estimated, will gain more than under the *per capita* grants—it is assumed that there will be a 2 per cent annual increase in population—and after this period will be paid less. From the viewpoint of State credit the new system is greatly to be preferred to its predecessors. Funds are raised only by Commonwealth securities issued by authority of the Australian Loan Council and adequate arrangements are made for sinking funds. Federal finances are in a remarkably healthy condition, a contrast to those of the States. In 1932–33, for example, the combined deficits of the States amounted to £8,609,000 as compared with a surplus of £3,546,608 in the Federal budget. The history of Australia's recovery policy in the world crisis of 1929–1933 is one of the few cheerful episodes of the depression. The two main sources of Federal revenue are customs (26 per cent, 1931–32) and excise (14 per cent). Other sources are: income tax, postal department, railways, land tax, estate duty, and entertainment taxes. State revenues for 1931–32 were £97 millions, of which £9·1 millions, or 9·4 per cent, was obtained from the Commonwealth payments to the States, 24·7 per cent from taxation, 52·5 per cent from public works (railways, posts, and telegraphs), 3·7 per cent from land, *i.e.* from the sale and rental of Crown lands, and 9·7 per cent from other sources. The main sources of State taxation are probate and succession duties; stamp duties, the land tax, income tax on the income of persons, and motor taxation. Local revenue is mainly derived from rates and Government grants.

6. The Constitution of the Union of South Africa as embodied

in the South Africa Act, 1909, gives the Union Government large financial powers while those of the provinces are small. This gives a lack of balance in the Union and Provincial budgets, the latter depending to a very large degree on subsidies from the centre. The Financial Relations Act, 1913, provided that the amount of the subsidy was to be one-half of the expenditure for any year, but if the expenditure of a province exceeded that of the previous year by more than 7½ per cent, that province was to get only one-third instead of one-half of the excess. A special subsidy of £100,000 per annum was also granted to Natal and the Orange Free State, which were in a less favourable position than other Units. The Act also extended the financial powers of Provincial Legislatures in regard to taxation. The provinces were assigned the revenue from licences on alcoholic liquor, the transfer duty on immovable property, and the native pass fees payable in proclaimed labour districts of the Transvaal. The provinces have no control over these revenues, and in point of fact, although not in theory, they are subsidies. The Finance Act, 1917, granted additional powers to the provinces to raise revenue from licences for places of amusement, and in assessing the subsidy an increase of 15 per cent per annum was allowed for the main item of expenditure, education, and 5 per cent on other matters. The Provincial Subsidies and Taxation Powers (Amendment) Act, 1925, based the subsidies mainly on the number of pupils, as education is the main index of provincial needs. The taxing powers of provinces were curtailed by the Act as the power of direct taxation was withdrawn, certain taxes such as motor-vehicle licences and dog licences, taxes on the ownership of immovable property, taxes on persons, *i.e.* poll or capitation taxes, and taxes on the income of persons and companies subject to a maximum of 20 per cent (or 30 per cent in the case of unmarried persons) of the Union income and super tax, and to a limit of 6d. in the £ of the taxable income of companies derived from income within the province were permitted. The system of the separation of financial powers cannot be said to have worked satisfactorily, as there is too much reliance on the part of the Units on the Centre and too great a divorce between the raising and spending of funds. Subsidies should serve as a balancing factor and not as a main element in provincial revenue. The Provincial Finances Commission, the Baxter Commission, rejected the idea

of dividing certain sources of Union revenue, such as income tax and customs, between the provinces on the basis of population because population was not by any means the only test of needs, and it was impossible to say what the contribution of each province to the Union was.

The main sources of Federal revenue in the Union of South Africa are customs (22 per cent, 1933–34), income tax (21 per cent), and the gold mines excess profits duty (17 per cent). The next important heads are posts, telegraphs, and telephones (11 per cent); forests, irrigation, mining lands and mineral rights, contribution from the railway surplus, excise, estate and succession duties, stamps, land tax, native taxes, fees and other miscellaneous sources. The provinces of the Union depend upon subsidies or grants amounting to more than half of the total provincial revenues. As in Canada, the provinces of the Union are authorised to levy *direct* taxes,[1] and as we have seen they derive their revenue from transfer duty, auction dues, poll and income tax, immovable property tax, enployers' tax, motor tax, entertainments taxes, and licences.

7. The East India Company, both as a trading corporation and as the successor of the Moghuls, had certain centralising characteristics. Thus the East India Company Act, 1773, provided in section 9 that every President and Council of Madras and Bombay should "constantly and diligently" transmit to the Governor-General and Council of Bengal "advice and intelligence of all transactions and matters whatsoever that shall come to their knowledge relating to the government, revenues, or interest of the said United Company". By the Charter Act of 1833 the Governor-General of Bengal became the Governor-General of India and was invested with complete control over the revenues of Bombay, Madras, and other subordinate governments. The Acts of 1853 and 1858 continued the Central Government's control over all revenues as well as expenditures. Sir Richard Strachey described how "the distribution of the public income degenerated into something like a scramble, in which the most violent had the advantage, with very little attention to reason; as local economy brought no local advantage, the stimulus to avoid waste was reduced to a minimum, and as no local growth

[1] *Vide* South Africa Act, 1909, Article 85, Section (i.): "Direct taxation within the province in order to raise a revenue for provincial purposes".

of the income led to local means of improvement, the interest in developing the public revenues was also brought down to the lowest level".[1] This overcentralisation of finance in Calcutta was regarded with aversion by the provinces and led to thoroughly inharmonious relations between the Government of India and provincial governments. In 1870 a decentralisation scheme took place and each local government was given a fixed assignment of revenue with the power to impose provincial taxation. There was no inducement to the provinces to develop their revenues because of the fixed assignment. In 1877, however, the whole or part of specified heads of revenue were given to the provinces, and for the first time we meet with divided Indian and provincial heads of revenue. The settlements regarding divided heads were revised quinquennially, and in 1904 were made quasi-permanent in order to encourage provincial economy in finance. In 1912 these settlements were made permanent. In 1921–22 a new system was introduced with the reforms.

8. The Report on Indian Constitutional Reforms, 1918, demolished the existing structure by completely separating central and provincial heads of revenue in order, if possible, to make provincial autonomy a reality. Central revenues included two main sources—customs and income tax. Other sources were taxes from salt and opium, tributes, and certain other heads, "non-tax" in character, such as railways, posts and telegraphs, coinage, military and other miscellaneous receipts. Provincial heads of revenue included mainly land revenue and excise. Other sources were stamps, registration, irrigation, and forests. Under the Government of India Act, 1919, the legislature of a province could impose any of the following taxes: (1) a tax on land put to uses other than agricultural; (2) a tax on succession or on acquisition by survivorship in a joint family; (3) a tax on any form of betting or gambling permitted by law; (4) a tax on advertisements; (5) a tax on amusements; (6) a tax on any specified luxury; (7) a registration fee; and (8) a stamp duty other than duties of which the amount is fixed by Indian legislation. The Governor-General in Council could at any time by order make any addition to the taxes enumerated above. In all other cases under the Constitution[2] the local legislature

[1] *India*, p. 113.

[2] Section 80A, 3 (*a*), of the Government of India Act, 1919.

had to have the previous sanction of the Governor-General. Thus the Central Government rightly reserved to itself what was not specifically mentioned unless it wished to delegate the power to the Provincial Government by enlarging the schedule. Local authorities were similarly empowered in certain circumstances to impose the following taxes, cesses, rates, duties, or fees: (1) a toll; (2) a tax on land or land values; (3) a tax on buildings; (4) a tax on vehicles or boats; (5) a tax on animals; (6) a tax on menials and domestic servants; (7) an octroi; (8) a terminal tax on goods imported into a local area in which an octroi was levied on or before the 6th July 1917; (9) a tax on trades, professions, and callings; (10) a tax on private markets; (11) a tax imposed in return for services rendered, such as (*a*) a water rate; (*b*) a lighting rate; (*c*) a scavenging, sanitary, or sewage rate; (*d*) a drainage tax; (*e*) fees for the use of markets or other public conveniences. Some provinces, such as Bombay and Bengal, have an entertainments tax, while others, such as Madras, for local purposes, a professions tax. Burma has a betting and luxury tax. No province, however, has in practice a system of general property taxation broadly on the lines of State and local authorities in the United States. No province has a system of provincial income taxation in addition to the central income tax as in other or federal constitutions. Nor are there death and succession duties. A reference to this in regard to the financing of social services, notably universal primary education and public health, will be made in a subsequent chapter. There are other sources of revenue which can be tapped, such as a sales tax or an excise duty on locally made cigars, cigarettes, and tobacco, an indirect excise by the system of licences, taxes on patent medicines, and an import duty on gold and silver for non-currency purposes. An increase in some directions of the tariff, accompanied by the taxation of agricultural incomes and a company super-tax, would also bring grist to the mill.

9. During the last fifteen years the financial relations between the central and provincial governments have been unsatisfactory. The heads of revenue assigned to the provinces have been, as compared with those of the Central Government, both inelastic and insecure. The functions of provincial governments include nation-building departments, such as education and public health, and require expanding heads of revenue to meet such

rapidly growing expenditure. With the provincialising of land revenue and the centralising of income tax, the counterpart of land revenue in an industrial province, the agricultural provinces were advantageously placed. The pitch of revenue and the scale of expenditure in many provinces have not come up to expectation. For these reasons the Simon Commission on Indian Reforms in its Report, 1930, discussed the feasibility of income tax becoming a shared head of revenue between the Central and Provincial Governments, and the alternative of the Central Government paying to provincial governments annual subsidies for education, etc. The revenues of the Central Government must be adequate, stable, and in times of national emergency capable of expansion. Provincial revenues, as provinces are responsible for education and social uplift, must be substantial and at the same time capable of expansion.

These criticisms have been met to a large degree in the British Government's Proposals for Indian Constitutional Reform, usually known as the White Paper,[1] published after extensive inquiries by committees, conferences, and consultations in India and in England. Revenues derived from sources in regard to which the Federal Legislature has exclusive power to make laws are allocated as federal revenues. These include customs, salt, excise duties (excluding those on alcoholic liquors, drugs or narcotics other than tobacco which are provincial sources), taxes on the income of companies, taxes on income derived from federal sources, *i.e.* on the salaries of federal officers and on income attributable to Chief Commissioner provinces and other federal areas. Death duties other than those on land, terminal taxes on railway, water, or air borne goods and passengers, taxes on railway tickets and goods freights, and stamp duties which are the subject of legislation by the Indian Legislature at the date of federation are federal for administrative purposes, provincial as to proceeds.[2] Revenue derived from sources in which Provincial Legislatures have exclusive or concurrent power to make laws are allotted as provincial revenues. These include land revenue, excise duties except tobacco, stamp duties which are not the subject of legislation by the Indian Legislature at the date of

[1] Cmd. 4268—1933.

[2] *Vide* Government of India Act, 1935. Part vii section 137, and schedule 7 of the Act (Legislative Lists of Subjects).

federation, registration fees for deeds and documents other than the compulsory registration of documents affecting immovable property, taxes on land including death or succession duties in respect of succession to land, taxes on agricultural incomes, on entertainments, capitation taxes, taxes on personal property such as houses, animals, windows, vehicles, taxes on trades, professions and callings, and the revenue from public domain (*e.g.* lands, forests, and mines), and from public enterprises (*e.g.* markets, tolls, ferries, and irrigation). The taxation of personal incomes is to be administered federally but shared between the Federal and Provincial Governments. The White Paper suggested that the proceeds should be shared on a prescribed basis, not less than 50 and not more than 75 per cent of the net revenues being given to Provincial Governments. From the sum assigned to provinces the Federal Government were to retain a fixed amount for three years, and this was to be reduced to Rs.3 crores in the next seven years. These shared net revenues were to exclude taxes on agricultural income, taxes on the income of companies, provincial surcharges imposed by the provinces, and taxes on the official emoluments of federal officers or taxes on income attributable to Chief Commissioners' provinces and other federal areas. The White Paper proposed that surcharges on personal incomes not exceeding $12\frac{1}{2}$ per cent may be leviable by Provincial Governments on such incomes in their territory. The Federal Government should also have this power, exercisable in times of serious financial strain, of levying surcharges solely for federal purposes on income, and when such surcharges are in operation the Indian or Native States will also make contributions to the federal treasury on a predetermined basis as a fair counterpart of the yield from surcharges in British India. Unspecified items of taxation go to the Units, but the Governor-General has the power, after consulting the Federal Ministry and the Provincial Ministries or their representatives, to declare any unspecified item federal. The Federal Government may assign to the Units (and not merely to the provinces) in whole or in part the net revenues from salt, federal excises, and export duties, except in regard to export duties on jute or jute products at least 50 per cent of the net revenue must go to the producing Units. Duties, as we have seen, on property passing on death (other than land), taxes on mineral rights and on personal capital (other

than land), terminal taxes, taxes on railway tickets and goods freights, and stamp duties which are the subject of legislation by the Indian Legislature at the date of federation, are federal for administrative purposes but provincial as to the proceeds, the Federal Government reserving the power of surcharge for federal purposes.

The Joint Parliamentary Committee in its Report [1] on which the Indian Constitutional Act, 1935, is based accepted these proposals, with the exception that they did not agree to a surcharge by provinces on personal incomes as this might lead to differential rates of tax on the inhabitants of different provinces. The Joint Parliamentary Committee held that 50 per cent of personal incomes to be given to provinces should be the maximum and not the minimum as recommended in the White Paper, because for many years to come the Federation and provinces will require as much as can be obtained from taxes on income, and the fixing of the rate is likely to depend more on taxable capacity than on the budgetary position at any given moment. The percentage must be fixed as late as possible by Orders in Council and not by Statute. [2] Fixed subventions from federal revenues to deficit provinces have also been necessary.

[1] H.L. 6 (1 Part 1), H.C. 5 (1 Part 1), 1934, pp. 160-172, paras. 243-273. Cf. sections 136-144 Government of India Act, 1935 (25 and 26 Geo. V.).

[2] This independent inquiry on the finance of Indian Reform was made in 1936 by Sir Otto Niemeyer of the Bank of England, formerly Controller of Finance H.M. Treasury. His terms of reference were: "To make recommendations to H.M. Government, after reviewing the present and prospective budgetary positions of the Government of India and of the Governments of the Provinces, on matters which, under section 138 (1) and (2), 140 (2), 142 of the Government of India Act, 1935, have to be prescribed or determined by His Majesty in Council (subject to the approval of both Houses of Parliament), and on any ancillary matters arising out of the financial adjustments regarding which H.M.'s Government may desire a report". The Report, published as a Parliamentary paper (Cmd. 5163) on 30th April 1936, is of interest to the student of Public Finance from six points of view. The first is the method by which assistance, required by the Units in order to give a reasonable prospect of maintaining financial equilibrium, is proposed at the inauguration of provincial autonomy. A detailed examination of each provincial budget was made, and grants were recommended for eight out of the eleven provinces. The grant takes the form partly of cancellation of debt to the Centre, partly by an increase in the allocation of the jute export duty to the jute-producing provinces from 50 to 62½ per cent, and partly by direct subventions from the Centre. The total annual cost is Rs.192 lakhs or £1,440,000. Secondly, it is proposed to transfer additional resources to all the Units out of the proceeds of income tax in addition to the grants already described. Fifty per cent of income-tax collections shall be distributed to the several provinces on a basis of fixed percentages and not on figures to be ascertained each year so

10. Before the Constitution of the German Republic in 1919 the Central Government was mainly supported by proportionate State contributions—*Matrikular-Beiträge*—just as was the Federal Government of the United States under its First Constitution. The reverse system, viz. payments from the Central or Federal Government to Provincial or State Governments, is customary to-day and is in force in the self-governing Dominions of Canada, Australia, and the Union of South Africa, and in Switzerland. Germany now belongs to this class. The Central or Federal Government of Germany entered the War with an undeveloped system of finance. From the time of the Constitution of 1871 up to the close of the War the financial relations between the Reich and the Länder (or States) were confused. It is true that the Constitution of 1871 contemplated that the Reich should have four main sources of revenue: (1) customs, (2) consumption taxes, (3) revenue from posts and telegraphs, and (4) State contributions assessed in proportion to population. In addition the Reich had the sole right to the taxation of salt, tobacco, beer, spirits, and certain sugar products, although Bavaria, Würtemberg, and Baden were to retain the power of taxing beer and native spirits within their territories. The States and local bodies were to enjoy the residual powers of taxation. In 1879, however, the Franckenstein Clause of the Tariff Law provided that the revenue from tariffs and the tobacco tax in excess of 130,000,000 marks in any

far as they may be ascertainable. The scale of distribution was fixed "partly on residence and partly on population, paying to neither factor a rigidly pedantic deference". For the first five years after the inauguration of Provincial Autonomy the Central Government should retain the full sum assigned to the provinces unless the yield obtained by it from income tax, together with any general budget receipt from the Railways, exceeds R.13 crores or about £9,750,000. In the following five years this sum will be annually decreased, so that in the relatively short space of ten years the Centre will be able to relinquish finances essential for the reforms. On the basis of the 1936–37 estimates this transfer is R.6 crores or about £4,500,000. Thirdly, the Report emphasizes the paramount importance of preserving the stability of central finances. Fourthly, there is a tendency to exaggerate the extent to which provinces are likely to be dependent on central assistance, and also the comparative rigidity of provincial revenues. Fifthly, the Report points out that in India the existing rates of income and supertax are by no means excessive, the wealthier commercial classes being relieved in the general scheme of taxation "to an extent which is unusual in taxation schemes". Lastly, the principle is clear from the Report that where the units in a federation, provinces or states, are entrusted with heavy and expanding expenditure of a nation-building character, complete separation of tax sources is impossible. This principle is instanced, especially in regard to income tax, in federal constitutions elsewhere.

year were to be assigned to the individual States in proportion to their population. In the early years of the present century the struggle between the Reich and the States continued with even greater vehemence, and the military and naval policy of the Imperial Government required much additional revenue for armaments. Thus in 1909 the contributions from States were increased, and their share also of the Reich inheritance tax was at the same time reduced. Indirect taxes were also increased and a Reich tax on the unearned increment of land was levied. During the War the Reich's financial powers increased and the freedom of the States and Communes practically disappeared. In the Constitution of 1919 and during the decade which followed the whole financial system of the country became highly centralised, the States and Communes obtaining large transfers (*Überweisungen*) from the Centre. These have been based on financial settlements between the Reich and the States and Communes (of which there were no fewer than five such settlements between the years 1924 and 1931). Originally the Länder and the Communes shared only a few taxes, but in recent years the list of taxes has been added to and the Reich has also given the States a large share of these taxes. The financial relations between the Reich and the Länder, it is interesting to note, can be altered by legislation, *i.e.* without altering the Constitution. Every federal tax excludes a state or local tax of a similar kind, and supplements to a federal tax are subject to the special permission of the Reich. The outstanding feature of this centralised system of federal finance is the concatenation of local tax offices under the State Tax Office and of the State Tax Offices with the Federal Finance Ministry.[1]

The Reich possessed in 1914 no elastic sources of revenue, although the brunt of the costs of the War fell on the Imperial Treasury. She had almost entirely to finance the War by loans, as it was not anticipated in 1914 that the War would be a long and expensive affair. When defeat occurred, the financial system was already in a state of chaos. It was essential that the Central Government, the Reich, should no longer be deprived of the chief sources of revenue. Indirect taxes up to 1920 were mainly reserved for the Federal Government, although to a less extent than in the United States. For the year 1922–23 the main sources of the Reich's

[1] Cf. Hensel, *Der Finanzausgleich im Bundesstaat*, 1922.

revenue were still the indirect taxes, viz. on coal, turnover, customs, tobacco, beer, and wines. These amounted to 50 per cent of the total estimated revenue. The income tax amounted to 22 per cent and a capital levy to 7 per cent of the total revenue of the Reich in the same year. Direct taxation, hitherto a State head of income, had to be made free for the Central Government. This was achieved by the National Taxation Law of 22nd March 1920, when the relations of the Reich, the States, and local authorities were put on a new basis. Certain sources of taxation were no longer reserved for the States. In fact the position was reversed. Heads of revenue were definitely reserved for the Central Government, and the individual States and local authorities, such as counties and municipalities, were not to collect similar taxes unless permitted expressly to impose a supplementary levy. This was a great step forward in regard to the placing of the Reich's finances on a more satisfactory basis. The central Finance Department controlled under the law of 1920 the income, inheritance, land transfer, and turnover taxes, and assigned a portion of the collection to the States. In 1936 the Reich took the entire proceeds of customs, salt, tobacco, inheritance, the general property tax on the value of real and personal property (*Vermögen*), the directors' compensation tax, the circulating capital tax and taxes on exchange, insurance, conveyance (the transportation of persons and goods), matches and lighting materials, playing cards, acetic acid, spirits, mineral oils and fats, but retained 26 per cent of the income tax, 70 per cent of the turnover tax, and only 4 per cent (sufficient to cover costs of collection) of the land transfer tax, the motor tax, the betting tax, the mineral water tax, and the slaughtering tax. Of the beer tax five-sixths were retained by the Reich and one-sixth by the States. The States distributed the proceeds of many of the taxes according to the needs of local authorities. This was determined, for example, in the case of the turnover tax on a formula based on two-thirds according to population and one-third on the amount of local payments. In the case of the motor tax 25 per cent of the amount returned was determined by population, another 25 per cent by local payments and 50 per cent on the area of the State. In most cases the distribution was based on a population basis (two-thirds) and on a percentage of the total paid by the State (one-third).

The share of local authorities in the yield of federal taxes has altered in recent years, as no final settlement of financial relations between the Reich and the Länder has yet been made. In order to have the material required for a close study of actual conditions the Länder and the municipalities have to forward to the Minister of Finance returns of actuals and estimates. A rigorous control is thus exercised by the Reich. The local authorities share, as we have seen, in the yield of some taxes, such as income tax, the corporation tax, the turnover tax, and the tax on real estate transactions. The local share in the yield of income tax and corporation taxes was in 1925 fixed at 75 per cent, and that of the turnover tax at 35 per cent. In 1926 the percentage share of the turnover tax was reduced to 30 per cent with the proviso that if the total yield of the tax was less than 1500 million marks, local authorities should release 30 per cent of 1500 million marks. A guaranteed minimum of the amount to be handed over to local bodies from the yield of income, corporation, and turnover taxes is fixed. Thus for 1927–28 a sum of 2400 million marks was guaranteed. The direct taxes levied by the Reich include the income tax, described in a later chapter, a corporation tax, a property tax, and succession duties based both on relationship and on the size of the legacy. Indirect taxes include customs, excise duties on tobacco, sugar, beer, alcohol, sparkling wines, acetic acid, matches, lighting apparatus, playing cards and sweetening substances; taxes on transport (motor vehicles, passenger and goods transport), and taxes on transactions (turnover taxes, taxes on real-estate transactions, taxes on the movement of capital (*e.g.* a company tax, a tax on securities), an insurance tax, a race-betting tax, lottery taxes, and a tax on bills of exchange). Over nine-tenths of the ordinary revenue of the Reich in 1928–29 were from taxation and the remainder from public undertakings. The Reich has wide financial powers, as it can impose any taxes and draw up regulations for the management of local finance. It controls railways, posts and telegraphs, and waterways, while the local authorities—the Länder—provide for police, education, justice, health, and social welfare. The Länder and Communes levy such taxes as taxes on income from property and taxes on industry. Thus in Bavaria, for example, the State taxes are the land tax, the house tax, the rental tax, the business tax, the stamp tax, the welfare tax and

meat taxes. Local Communes are able to raise up to 400 per cent, and the districts up to 50 per cent of the State land, house and business taxes. Similarly in Prussia there are local supplements to the land tax, and of the house tax the first 50,000,000 R.M. go to the State, and of the remainder 53 per cent to the State and 47 per cent to the Communes. The Communes are compelled to raise revenue by an amusement tax. They are permitted to exploit those fields which are not occupied by the Reich. The States and Communes require large revenues to defray the cost of education, health, poor relief, housing, police and justice. The budgets of the States and Communes deal with more than one-half of the total tax revenue of Germany and more than two-thirds the receipts from all sources. The tax collections of the Reich in 1928–29 were 8,988,000,000 marks, and those of the States, Communes, and Hanseatic cities 4,228,000,000 marks, or a total of 13,216,000,000 marks. It is interesting to note that the centralisation of finance is taking place, too, in the other important federation of Europe, viz. in Switzerland. The Federal Government in Switzerland are giving increased subventions to the Cantons. In 1915 the Swiss Federal Government imposed a direct tax on incomes and property and in 1917 obtained the sole right to levy duties on securities, insurance premiums, bills of exchange, etc., the amount of revenue meanwhile from the share of taxes having increased to the Cantons. In 1928 the Cantons persuaded the Federal Government to surrender one-fourth of the proceeds from the import duty on petrol, and this has been of great value both to the Federal as well as to the Cantonal authorities. The Cantons get 20 per cent of the Stamp duties, 33 per cent of the fines, 40 per cent of the crisis tax and 50 per cent of the tax on distilled liquors. By assignments and subventions the Federal Government of Switzerland, compelled to have recourse to direct taxation of property and incomes, has won over the Cantons to its side. In Switzerland, however, as is now the case in Germany, there is to-day no clear distribution of revenues between the Centre and the Units, and this is said to be the main problem of Swiss financial policy—the distribution and, one might add, the exploitation of existing sources rather than the discovery of new sources.

11. In the United States customs was the main source of Federal revenue before the War, followed by excise duties on

tobacco and alcoholic beverages. The 16th Amendment of the Constitution in 1913 permitted Federal authorities to "lay and collect taxes on incomes, from whatever source derived", and this became effective by the passing of the Tariff Act in October of that year. Direct taxation in the form of income tax of individuals and corporations now yields more than any other head of revenue. Indeed in 1932–33, in spite of large reductions in the scale of income taxation, the yield was 36 per cent of the total ordinary revenue. Indirect taxation is of two kinds, customs (12 per cent in 1932–33) and excise and other duties (internal revenue) which amounted to 41 per cent. Tobacco is more than half the revenue from excise and other duties. In view of prohibition the yield from distilled spirits was of comparatively little importance, but with its repeal the yield will be large. The other sources are stamps, playing cards, automobiles, firearms, jewellery, watches, clocks, etc., and admissions to theatres, cabarets, etc. Interest receipts from foreign governments form 4 per cent of the total revenue. Federal taxation in the United States is elastic and in times of emergency is capable of great expansion, as the following table clearly shows:

PERCENTAGE DISTRIBUTION OF TAX REVENUE IN THE UNITED STATES

	1913	1916	1926
Federal . . .	30	60	37
State . . .	14	8	15
Local . . .	56	32	48
	100	100	100

Federal collections go to the support of debt services and defence. For State and local authorities the general property tax on real and personal property is by far the main source of revenue. The tax is assessed by local authorities with additions for the State or, as they are called, "Commonwealth" governments.[1] The purely local, county, and State rates are arrived at by dividing the assessed valuation of the property in the locality by the amount required for local, county, and State purposes. Thus the final tax rate upon property is arrived at by adding these rates. The assessment and the collection of the tax, however, are in the

[1] This should not be confused with the Commonwealth Government as used in Australia. In the latter case it refers to the Federal Government.

hands of local authorities. Both State and local expenditures are largely on education and roads. The greater part of State revenue is collected and expended by the local authorities, county, town, or school districts. In some of the States of the Union the inheritance tax and corporation taxes are now assigned to the State as a source of revenue, while the local authorities depend on the property tax. In California, and to a certain degree in New York, there is a separation of revenue between the State and local authorities. As a general rule it may be said that in the United States the income tax and customs are the main sources of federal revenue, the general property tax, corporation, licence and inheritance taxes of State revenue, and for local authorities such as municipalities, counties, townships, and school districts the main sources are the general property tax supplemented by local licence taxes. The framers of the admirable Constitution wisely provided that " all duties, imposts, and excises shall be uniform throughout the United States " ; that " no tax or duty shall be laid (by Congress) on articles exported from any State " ; and that " no State shall, without the consent of the Congress, lay any impost or duties on imports or exports, except what may be absolutely necessary for executing its inspection laws ". This guarantee in the Constitution has been of great value to the foreign trade of the United States.

In recent years there has been a rapid development of federal aid through the system of grants and subsidies. In 1912 the total grants from the Federal treasury exclusive of the value of land grants were eight million dollars ; in 1930 these grants were over 135 million dollars. More than one-half of the grants in the latter year were on account of arterial roads, and about one-quarter was for the National Guard. Federal aid is given for the development of agriculture, the promotion of vocational education, child and maternity welfare, and since the great depression of 1929–1935 for unemployment assistance. By means of the system of federal aid the Federal Government is able to control certain directions of governmental activity which otherwise would be outside its sphere. The Federal Government may require minimum standards and thus may insist on supervision of State plans. It may require, too, State contributions of a similar nature to federal constitutions. The subsidies have every prospect of increasing rapidly as they make possible many public activities

which but for the impetus of Federal financial assistance would not have come into being, and they combine local initiative with central direction and supervision. State governments have similarly assisted local units, counties, and municipalities. In 1925 grants from the states were about 8 per cent of total local revenue, and three-fourths of these were for education and less than one-fifth for roads. The states have not been as successful as the Federal Government in raising administrative standards. Another feature of American finance in recent years has been the unsuitability of general property taxation from an administrative point of view, especially from that of evasion, regressiveness,[1] double taxation, and its failure to reach personal property. Other sources of taxation such as motor vehicle licences and the productive gasoline tax have exceeded the returns from State property taxes in many instances. The former account for one-third and the latter for one-half of the total State tax revenue. The taxation of corporations has in recent years been a fruitful source of revenue, but with the growth of the business unit and its operation in several states the dangers of double or multiple taxation of income are obvious. Greater co-ordination in the sphere of inter-state financial relations will obviate this to a large extent.

12. The distribution of revenue heads in France is of peculiar importance. Prior to 1914 French taxes were derived from four main sources, viz. the so-called direct contributions, the so-called indirect contributions, consumption taxes, and customs duties on a large number of imports. The direct contributions were taxes levied on lands and houses, doors and windows, the letting value of houses occupied by the taxpayer, and licences for occupations. The indirect contributions were taxes upon transferable securities. Consumption taxes were levied on French produce, for example, on alcohol, wine, and sugar.

Changes in the French revenue system between 1914 and 1920 have affected not only the Central Government but also local authorities. In March 1914, just before the War, the first general income tax law passed by Parliament was placed on the statute book. Besides this general income tax there are now three other forms of taxing incomes. (1) The old direct taxes, popularly known as "the four old women", were revised by the laws enacted on 29th March 1914, 31st July 1917, and 25th June

[1] See p. 294.

1920. The direct taxes on real estate were converted into taxes on the income from real estate—5 per cent of the taxable income derived from unimproved real estate, and 4 per cent of the net income on improved real estate. Moreover, the tax was after 1st January 1915 not an apportioned tax and the quotas to be paid by departments, and communes were discontinued by the law of 31st July 1917. (2) The old taxes on doors and windows, trades and professions, and the contribution *personnelle et mobilière* (at first a tax on the letting value of real estate, but later a house tax combined with a personal tax based on the value of three days' labour) were succeeded for State purposes by schedule taxes upon industrial, commercial, and agricultural profits, and upon salaries, wages, pensions, annuities, and professional incomes. (3) The third tax on income is the tax on income from transferable securities—stocks and bonds—introduced in 1919. The tax applies to income from dividends, interest and all other income derived from stocks, bonds and interests in partnerships (*commandites*) either foreign or domestic, income from mortgages, fixed deposits, and money deposited as security. The business turnover tax, to be discussed later, is also an important tax introduced in the 1920 Budget and now one of the most prolific sources of revenue. The excise duties include those on alcohol, wines and spirits, sugar products and saccharine, salt, beer, patent medicines, chicory and other coffee substitutes. Other taxes are old taxes, such as the registration and stamp taxes, customs duties, excise duties, and taxes on transactions. These taxes are supplemented by the profits from State monopolies, the most important being tobacco, matches, and gunpowder, and the post office, the telephone, the telegraph, the mint, and printing office. Direct taxation in 1913 was 18 per cent, and 31 per cent in 1927 of the total tax revenue, while the percentage of indirect taxation was 82 and 69 per cent respectively. The taxation had risen in this period from $3\frac{1}{2}$ milliards to 36 milliards.

In regard to the receipts of local authorities it is only departments and communes that have Budgets.[1] The revenues of the departments and communes are derived mainly from three sources: (1) from collections made on their behalf by the Central

[1] See chapter "Local Taxation" (Chapter XXXI.). There are 90 departments and 37,981 communes.

Government; (2) from a share of Central Government's revenues; and (3) from direct local taxes. Since the Revolution the State collected in addition to "the four old women" an additional percentage (*centimes additionnels*) for the benefit of local authorities (departments, communes, etc.). These were in the main on carriages, horses, mules, billiards, clubs, the verification of weights and measures, and on mining rents. When the changes referred to above came into operation Government undertook to collect, until some other plan was evolved, *centimes additionnels* on the old basis for local authorities. By the law of 25th June 1920 an additional tenth of one per cent was added for the benefit of communes to the turnover tax to enable them to balance their Budgets. Other sources of revenue of the local bodies are generally public utilities like water, electricity, gas, sewers, etc., and the octroi. The city of Paris levies a special tax on amusements. It covers all kinds of amusements, and not even balls, concerts, and museums are exempted. The amount of taxation collected in 1926 by the departments and municipalities was nearly $5\frac{1}{2}$ milliards. Of this 70 per cent was from direct taxation; 16 per cent from taxes common to the State and local authorities, viz. beverages, motors, and the turnover tax; 12 per cent was from octroi and 2 per cent from other taxes.

The change in the distribution of revenue of a country is always an interesting study, but rarely is it more interesting than in France during the period 1914 to 1930. A useful lesson is afforded by the way in which local authorities have been financed.

13. It is now necessary to see how far there are, in Adam Smith's expression, "connecting principles" in the distribution of revenues. Shibboleths held for generations have been modified or discarded since the Great War. Thus the doctrine of the separation of sources which is still an article of faith among some, that direct taxes are the field of Provinces or States and indirect taxes that of Central or Federal governments, has broken down owing to powerful economic forces. The cataclysm of war compelled Federal governments to invade the field of direct taxation to a degree never dreamt of in the philosophy of public finance. Income taxation is now the chief head of federal taxation in the United States, being 36 per cent of the total federal revenue. Between 1916 and 1920 the income tax collections of the Federal Government rose from 17·2 per cent to 71·7 per cent.

States, twelve in number, levy also individual income taxes. Canada introduced a Dominion income tax in 1917, which is now relatively of the same importance in federal taxation as is the income tax in central taxation in India. There is also, as has been shown, income taxation in British Columbia, Manitoba, and Prince Edward Island. In Australia the war completely upset the Commonwealth finances, and it became necessary for the Commonwealth to impose heavy direct taxation in addition to the direct taxation on incomes levied by the States. Indeed by the legislation of 1927 a complete change in the financial relations between the Commonwealth and the States has been brought about.[1] Similarly in Germany income taxation, hitherto a State source of revenue, was undertaken by the central government by the National Taxation Law of March 22, 1920. The maritime provinces of Canada (New Brunswick, Prince Edward Island, and Nova Scotia) and the States of West Australia and Tasmania, and indeed other States of the Commonwealth, have experienced in recent years the same financial difficulties in their relations with the central government as have some provinces in India. It is impossible to reduce the problem of financial relations in constitutions to rigid principles applicable to all such constitutions. There is no ideal scheme of distribution suitable for all countries, as regard must be had for historical tradition and administrative convenience. It is true that there is much to be learnt from the comparative study of the financial relations in federal and quasi-federal constitutions. Since the time of the great Alexander Hamilton federal control has been exercised over customs in order to ensure provincial or inter-state commerce. Federations have come into existence on this account as in the case of Canada and Australia. It is, however, far from true to say that the distribution of revenue and expenditure suitable in one country may be equally suitable in another country where different conditions obtain. The character and importance of revenue and expenditure must vary according to general economic conditions and to changes in political structure. The Report of the Royal Commission on Maritime Claims (1926) pointed out that

[1] By the States Grants Act (No. 4 of 1927) the *per capita* payments under the Surplus Revenue Act (No. 8 of 1910) were repealed. The Act provided for the payment to the States on a population basis of any surplus revenue in the hands of the Commonwealth treasurer on June 30, 1928, and of each subsequent year.

"it is not possible in such an undertaking as the making of Canada, with its geographical and physical conditions, and its variety of settlement, and development, to maintain always an accurate balance, apportioning to every section of this extensive country the exact quality of benefit and quantity of advantage which would be theoretically and justly desirable. But reasonable balance is within accomplishment if there be periodic stock-taking." [1] The Report on the Financial effect of Federation on South Australia [2] says that "it is inevitable that in a Federation composed of States of different geographical and economic structure the incidence of the benefits and the cost of any general policy must be unequal. In other federations it has been recognised that policies imposed for the benefit of the whole federation are at times injurious to sections. In the Dominion of Canada and the United States of America provision is made to compensate the outlying parts for the advantages received in other ways by the more central parts of those federations."

14. A Central Government should insist that its revenues should be adequate, stable, and capable of expansion in times of national emergency. States and local authorities also require adequate and expanding heads of revenue to meet their programmes of educational and social advance. The principle of undivided heads introduces fiscal independence although it tends in practice to result in inequality among provinces with different economic conditions. An agricultural province may, as in India between 1921 and 1930, secure a larger increase of revenue than an industrial province. When this is so a radical reconsideration of financial relations between the Central and provincial governments is desirable. The Central Government may give subsidies which have already been referred to in a previous chapter.[3] The Central Government may grant a subsidy on the principle of population, of education or similar basis. It may combine these. Where the Central Government has a surplus and expanding heads of revenue such as customs and income tax it may create a national fund and distribute to provinces grants according to their "nation building" needs. The objection to this procedure is that local authorities and States are left to the caprice of the central authority and endless trouble and jealousies sometimes

[1] Report of the Royal Commission on Maritime Claims, Ottawa, 1926.
[2] Adelaide, 1927, p. 18. [3] Chapter X. p. 148. See also footnote 2 on p. 274.

result. An equitable division of heads of revenue and, if necessary, a fixed share of income or other federal taxes may be preferable. A province or State may have a separate income tax in addition to an existing federal income tax, and, as in Massachusetts, it may be collected on behalf of the provinces by the central authority. *Centimes additionnels*, or an additional percentage, may be added to the central income tax for provincial purposes. It is sometimes said with regard to the former that it is against the canon of convenience, but recent experience in the United States and Australia shows that this is often exaggerated. Every person having taxable capacity should pay a direct personal tax to the government under which he is domiciled and from which he receives protection and other benefits; tangible property, by whomsoever owned, should be taxed by the jurisdiction in which it is for the simple reason that it receives protection and other governmental benefits; business carried on for profit in any locality should be taxed for the benefits received. The application of these three principles has frequently been defective as, for example, in the United States, but nevertheless in tax legislation these hard facts have been recognised. In India to-day there are many of us living under the protection of a provincial government who pay no taxation to that government. Our taxation goes in the form both of income tax and customs duties to the Central Government. The personal income tax is levied upon persons in respect of the income from all sources and above a certain minimum; small incomes are exempted. The rates of taxation are progressive. The steepness of the progression depends upon the net income of the taxpayer. The distribution of the proceeds of the tax must be affected by local conditions. The property tax is a tax upon tangible property levied at the place where such property is located. It is on tangible property and the personal income tax reaches intangible property. Effective administration in this, as indeed in the other two taxes, is indispensable. Business taxation may be in the form of an ordinary tax based on the net income of a business, the gross receipts, the rental value of the premises, the number of employees, the consumption of raw material or similar indices of ability. If there is one tax only, such as an income tax, there is the likelihood of inequality. The committee of the American National Tax Association in its Report on a Model System in

1918 pointed out that " with the best drawn law and the very best of administration, there will always be a certain amount of inequality in the operation of any tax. If, therefore, all the revenue needed is derived from but one tax, such inequality as inevitably arises will be concentrated at a few points where it cannot be mitigated. But under a system by which the same amount of revenue is collected from separate taxes levied upon income, property and business, it is clear that such inevitable inequalities as arise in the working of any one tax may be, and to a considerable extent must be, offset or mitigated by inequalities arising under the others. By the mere law of probability, it must happen that the inequalities arising under the three separate taxes will not all be concentrated at the same point, and that some of them will to a certain extent compensate for others. This is one of the reasons why a double system of income and property taxation has worked well in certain European countries and has met with increasing favour from students of taxation and practical administrators."

15. To sum up, the distribution of public revenues between central, provincial, and purely local authorities conforms in the long run to certain general principles. Historical reasons are usually at the basis of the allocation of revenues. Revenues derived from sources in regard to which the Federal Government has the exclusive right to make laws are usually allocated as federal revenues. But the federation is empowered or required to make assignments to the Units from federal revenues. Financial assistance is laid down in several constitutions as in section 96 of the Constitution of the Commonwealth of Australia and section 142 of the Government of India Act, 1935. Some redistribution of revenue is inevitable in any Federation and especially at certain periods of its development. Federal authorities, too, possess elastic sources of revenue which Units do not have to the same degree. Thus, in Australia the Commonwealth Government was able, in the depression of 1931–34, to impose an additional tax on the income from property, surcharges on imports, and a sales tax, while the States had no new field of taxation available to them. The federal power may assign the whole or any part of the net revenues derived from any specified source such as federal excises, and in rare cases

export duties.[1] Revenues derived from sources in respect of which the Legislature of the Unit has exclusive or concurrent power to make laws or allocation are as a rule provincial revenues. The federal power may lay down the basis of distribution of certain taxes among the Units, but it should be empowered to impose and retain a surcharge for federal purposes. In other cases taxes may be shared on a prescribed basis, *e.g.* taxes on income. Customs, excise, income tax, and monopolies are, for example, particularly suited to be central heads of revenue. A general property tax, if carefully assessed, is similarly a suitable object of provincial taxation, while a tax on house rent, local assessments, and local licences are specially fitted for purely local taxation. Sources of revenue are not always separated, some being utilised for central or federal requirements, others for provincial or state purposes, and others for the benefit of purely local authorities. If carried to extremes the principle of separation of revenues may result in the divided revenues being wholly inadequate. In any federation the allocation of resources is a matter of difficulty because two different authorities, the Federal Government and the Government of the Unit, raise money from the same body of taxpayers. If the fields of taxation can be separated the problem is simplified, but even where this is possible it may not fit in with the requirements of each. A Unit's needs may become more pressing than that of the Centre as the Units have an almost inexhaustible field for the development of the social services, while the demands upon the Centre are more constant in character except in time of war, famine, or pestilence. There should be a considerable degree of fiscal independence, which, in turn, promotes self-reliance and budget certainty. Part, however, of the yield of central or provincial taxes may be, as in Germany and elsewhere, assigned to local authorities. Lump sums may be made in the form of subventions by central to provincial authorities. The separation of sources plus a division of yield when the yield is an abundant one such as that from income tax is a very workable policy, and it does not interfere with the freedom of local authorities. Total assignments or the apportionment of the proceeds of a tax and surcharges on which the Federal Government usually requires to

[1] Cf. Government of India Act, 1935 (25 & 26 Geo. V.), sections 136 to 143, and Schedule Seven, "Legislative Lists" of subjects.

place a maximum limit assists fiscal independence among the Units. Subsidies and subventions, on the other hand, are often regarded as militating against independence. Within limits, however, subsidies and subventions have not been adverse, especially when they do not form a large amount of the revenue of the Units.[1] The reverse process by which the states contribute to the support of a Federal Government has everywhere led not only to friction, but to a lack of independence and strength in the federal power. Lastly, overlapping tax jurisdictions leading to double taxation should be avoided among the Units themselves and between the Units and the Federal Government.

In the financial relations between a Federal Government and its Units there are additional principles which deserve special consideration. In the first place the Federal Government has the responsibility of seeing that no member States of the Federation fall below a certain standard of administration, as this would endanger the stability of the Federation. This minimum standard is the minimum at which a state can be expected to function effectively, while a normal standard is where a large number of states balance their budgets or in a crisis have the same deficit in proportion to population, *i.e. per capita* surplus or deficit. This normal standard is not capable of being reduced to any precise formula, and it is not necessarily the arithmetic or weighted mean of all the Units. It may be the simple average of only a few. In defining the limits of a minimum standard in regard to the social services, such as expenditure on education, health, hospitals, and unemployment relief, a more severe standard

[1] This principle is illustrated from the case of Australia where the Commonwealth Government grants special financial assistance to the States of South Australia, Western Australia, and Tasmania, and from that of India in the North-West Frontier Province, Sind, and Orissa, which are known as deficit provinces. The Australian Commonwealth Grants Commission justifies these payments as follows: "A government is not truly responsible if the normal exercise of its powers gives it more money than it needs, especially if this result is, to an extent, accidental, as in the case of a customs tariff imposed for protective purposes. Nor can the principle of responsibility be satisfactorily applied if governments receive less than they require for their essential needs. In the latter case services are starved, finances are embarrassed and drift follows. In the former, governments become extravagant. We think, therefore, that some redistribution of revenue must be accepted as almost inevitable in any Federation, and especially at certain stages of development. If the redistribution gives the recipient States considerably less than they require to raise, the principle of responsibility is not seriously affected. Experience supports this view, for in all Federations there is, in effect, some redistribution."

is necessary than the normal standard. The differences from the normal standard are not ordinarily great. The Australian Commonwealth Grants Commission, for example, in fixing a minimum standard for claimant states held that the cost of social services should not be less than 10 per cent below the normal standard and the severity of taxation should not be higher than 10 per cent. Again the policy of the Federal Government sometimes has been to foster secondary industries by means of protection, while, on the other hand, the States or Provinces have pursued a policy of rural development which has in such cases inevitably led to a conflict of interests. The imposition of burdens upon primary producers has made it necessary for the Federal Government to give assistance, and the amount of this assistance is measured through a comparison of the budgets of States or Units. The Unit or Units seeking financial assistance must show that they are making special efforts to meet their difficulties in the way of a more than average effort in raising taxation, in reducing expenditure, and in exercising a very strict economy in the administration of the services of the State. The relative financial position must be examined with much care and expert knowledge so that the position of the claimants versus the other Units may be fully understood. It must never be forgotten that a federation is a marriage of provinces or states for good or bad and the rough must be taken with the smooth. If in spite of adverse effects of federation a unit is prosperous, there can seldom be a strong case for a grant. The Federal Government does not as a rule interfere unless the solvency of the Unit is involved, and the other States, if more fortunately placed, have to shoulder the burden in the common cause of federation. A comparison with average *per capita* surpluses or deficits in measuring the relative financial position necessitates adjustments. These are: (1) omissions from the budget of expenditure that should be included. Repayment of advances or the repayment of loans are not always included on a uniform principle; (2) differences in standards of expenditure, *e.g.* (*a*) the maintenance of capital equipment, (*b*) extravagance of administration not merely in salaries but in the number of officials employed, (*c*) the scale of expenditure on the social services, and (*d*) local government activities; (3) differences in the burden or severity of taxation. Differences in the relative weight of taxation, includ-

ing local government taxation, have to be examined in the light of taxable capacity. Taxable capacity, as shown in the previous chapter, may be calculated from the total incomes for income tax purposes and for those incomes below the income tax basis from the real wage index. When the total taxation per head and the taxable capacity are known it is then possible to calculate the severity of taxation; and (4) losses caused by mistaken or extravagant loan expenditure. Further adjustments may be necessary on account of the unsatisfactory nature of the data or on account of differences in the financial history of the Units prior to the period on which the estimates are based. To any one who has made a special study of the refinements and extensions connected with this problem the difficulties are very real because Federation cannot be kept on a strictly book-keeping system.

In some cases taxes assessed from above may, as in France and Germany, have additions for local purposes. There is much to be said in favour of this as it makes, as Leroy-Beaulieu says, "the management of local finance simpler, clearer, and less costly, and gives the taxpayers much greater security against peculation and exaction". There is, however, the ever-present danger that interference with the maximum productivity of the tax may take place, a danger inherent in all single taxation. This method should not cramp local authorities and leave them without sufficient latitude to work out their own destiny. If there is a marked difference in the percentage fixed between one Provincial Government and another, shifting of capital and consequent evasion may result. The Joint Parliamentary Committee on Indian Reform were against a surcharge on personal incomes by the provinces. The reasons given are interesting as enumerating principles. These were that, "It might lead to differential rates of tax on the inhabitants of different Provinces, and although a limit would be set to the possible differences, this is in itself undesirable. The rates of taxes on income are likely also to be sufficiently high to make it difficult to increase the rate by way of surcharge, and to give the Provinces such a power might well nullify the emergency power of imposing a surcharge which we think it essential that the Federation should possess. On the other hand, the proposal would undoubtedly give an elasticity to provincial revenues, which would be very desirable until the transfer of their share of

the income tax is completed. But after balancing the considerations on either side, we are on the whole not in favour of it."

When taxes are assessed by local authorities and additions made, as in the case of the property tax in the United States, for State governments there is a tendency to under-assessment. In all cases, however, of the distribution of revenues the principles of adequacy, suitability, and administrative efficiency should not be forgotten. In short, the heads of revenue should be adequate for ordinary requirements in each case; they should be distributed according to the functions each public authority performs; and so apportioned that they can be easily and efficiently administered. The responsibility of raising revenue should go hand in hand with the freedom of spending it. The principle of independence as already noted is important, but a complete segregation is not always possible.

In connection with revenue from loans recent theory favours control in regard to the borrowing powers of the Units and local authorities. The Federal Government should have the power to borrow for any of the purposes of the Federation upon the security of federal revenues and within such limits as may be fixed from time to time by federal law. The classic instance of public borrowing in a Federal State is that of the Australian Loan Council, already referred to above. It may be laid down as a general principle that a Federal Government may grant loans to, or guarantee a loan raised by a Unit on such terms and under such conditions as it may prescribe. The Government of a Unit should have the power to borrow for any provincial purpose on the security of provincial revenues and within such limits as may be prescribed by provincial law, but the consent of the Federal Government should be necessary if there is an outstanding loan made or guaranteed by the Federal Government or if the loan is to be raised abroad. The control of capital expenditure by a concerted loan policy is always desirable, especially in the younger federations, as it is sometimes forgotten that the object of public borrowing is to increase the total productive capacity of the country.

CHAPTER XVII

THE DISTRIBUTION OF THE BURDEN OF TAXATION WITH SPECIAL REFERENCE TO PROPORTIONAL, PROGRESSIVE, AND DOUBLE TAXATION

Definitions

1. It will be convenient to define one or two terms which arise in all discussions on this subject. Graduated taxation usually means that the rate of the tax increases as the amount of income, property, etc., increases. Graduated taxation is commonly taken to mean taxation graduated upward, *i.e.* it is meant to imply progressive taxation. The greater the income or wealth, the greater is the percentage of that income or wealth taken in the form of taxation. Income tax and death duties are now progressive in almost all countries. If graduation is downward (*i.e.* the larger the taxpayer's income the less the percentage contributed), it is known as regressive taxation. Local rates are regressive as a rule because the householder with a large income pays a less percentage of his income than his less well-to-do fellow citizen. When all incomes below a certain amount are exempt from taxation or rated only in part and all above this sum are taxed proportionally on the surplus this is known as degressive taxation. The taxation of income in Great Britain is a case in point. In the British income tax the first £175 of *taxable* income (*i.e.* what remains of the assessable income after making certain allowances and deductions) is charged at half the standard rate and the remainder at the full standard rate. This form of taxation is adopted to avoid the dangers of unregulated progression. Under degressive taxation, therefore, larger incomes are taxed at a higher rate than smaller incomes, but not in a degree which involves as great a sacrifice as in the case of lower incomes. Proportional taxation means the same propor-

tion is contributed by the taxpayer on all amounts of the income, property, etc., taxed. The tax varies directly with the amount of income or wealth of the taxpayer in the case of proportional taxation.

One of the most important questions of taxation is the proper distribution of its burden. This may be viewed from two standpoints: (1) the distribution of the burden among the taxpayers within the State, and (2) the distribution between States. This latter question raises the difficult problem of double taxation between countries.

Direct and Indirect Taxation

2. Discussions on the subject of distribution usually take account of the direct but not of the indirect burden of taxation. There is no real reason why this should be so. The distribution of tax revenue between direct and indirect taxation in the usually accepted sense of the term has in recent, as compared with pre-War, years been largely in favour of direct taxation. In Great Britain in the pre-War year direct taxation was 48 per cent of the total; in 1933–34 it was 56 per cent. In the United States federal direct taxation rose from 11 per cent in 1913–14 to 48 per cent in 1932–1933. In some countries the percentage has fallen, as in India from 47 per cent in 1913–14 to 36 per cent in 1933–34, and in France from 40 per cent in 1913–14 to 28 per cent in 1932–33. In Japan direct taxation fell from 28 per cent in 1913–14 to 25 per cent in 1931–32. Where the relative percentage of direct taxation has fallen, direct taxation such as income tax brings into the Treasury very much more than was hitherto the case. The reasons for this great increase in direct taxation are mainly due to economic and social causes together with increased efficiency in tax administration. In modern states there is the unmistakable tendency to place the heavier burdens on those most able to bear them, and this cannot be done by indirect taxation. The principle of ability to pay can best be achieved by direct taxes. Countries in the earlier stages of development, especially sparsely populated countries, rely mainly on indirect taxation. When industrialisation takes place, population is concentrated, and production increases. It is then administratively easy and economical to proceed with direct taxation. In Table XVIII.

(appendix) the relative importance of direct and indirect taxation is given for nine countries.

3. There is no necessary relation between direct and indirect taxation, and in every country such relationship as exists is the result of historical influences. Those who speak of a balance between direct and indirect taxation are apt to assume that direct taxes are paid by the rich and indirect by the poor, and also that the totals paid by the rich and by the poor should be in some constant ratio. This is not borne out in practice, as indirect taxes on luxuries are paid by the rich and direct taxes on low incomes are paid by the poor.[1] Taxation cannot be divided into two distinct parts, one of which falls wholly on the poor and the other wholly on the rich, as this would be a complete anachronism. The class of indirect taxpayers is less and less synonymous with the poor, just as the class of direct taxpayers is less and less synonymous with the rich. Circumstances may arise that may make it expedient to change the existing ratio between direct and indirect taxes, even if the relative wealth of the two classes has or has not changed. With the passing of free trade and the introduction of protective tariffs in Great Britain, India, and many other countries, the proportion between direct and indirect taxation has ceased to have significance as a principle which should govern more or less rigidly the conduct of the fiscal system. These indirect taxes have been designed to have a protective effect—many of these falling on luxury articles, such as motor-cars, silk, and similar goods, and also upon what are really capital goods—and have provided work beneath their shelter. So far from causing a rise in the cost of living the new duties in Great Britain have not prevented a fall, so that to a large extent these indirect taxes have not been taxes upon British consumers at all. It is, however, true that a large use of indirect taxes presses, other things being equal, on the poorer classes of the population, while inheritance and income taxes fall chiefly on the wealthier classes. This fact is shown in the following table, which gives the income and taxation payable by a married man with three children under the age of 16 in Great Britain. It is assumed that the income is wholly earned up to £1000, and above that limit half earned and half investment.

4. The principles of tax distribution have no special reference

[1] See also Chapter XXV.

to a particular tax taken by itself but apply to the tax system as a whole. The distributional effect of a particular tax may be counterbalanced by other taxes. Hence in imposing taxation the Finance Minister has to study the broad effects not merely of a single tax but of other taxes on the financial condition of the body of taxpayers as a whole. He is aware, too, that indirect taxes are not felt by the taxpayer in the same way as direct taxes. Indirect taxes, in short, are more easily disguised, and, as Adam

PERCENTAGE OF DIRECT AND INDIRECT TAXATION TO SPECIMEN INCOMES*

Income.	1913–14.			1925–26.		
	Direct.	Indirect.	Total.	Direct	Indirect.	Total.
	%	%	%	%	%	%
£50	..	8·0	8·0	..	..	..
100	..	5·4	5·4	..	11·9	11·9
150	0·2	4·2	4·4	..	11·6	11·6
200	0·4	3·6	4·0	..	10·2	10·2
500	2·6	1·8	4·4	2·0	4·2	6·2
1,000	4·0	1·2	5·2	8·1	2·9	11·0
2,000	7·5	0·9	8·4	17·3	2·0	19·3
5,000	8·9	0·7	9·6	28·2	1·3	29·5
10,000	11·5	0·3	11·8	38·9	1·2	40·1
20,000	12·8	0·2	13·0	48·1	0·6	48·7
50,000	13·5	0·1	13·6	57·5	0·2	57·7

* Adapted from the Report of the Committee on National Debt and Taxation, Cmd. 2800, 1927, pp 94, 95.

Smith says, the person taxed " pays them by little and little as he has occasion to buy the goods ".[1]

"I never can think", said a great Scotsman,[2] "of direct and indirect taxation except as I should think of two attractive sisters who have been introduced into the gay world of London, each with an ample fortune, both having the same parentage—for the parents of both I believe to be Necessity and Invention—differing only as sisters may differ, as where one is of lighter and another of darker complexion, or where there is some variety of manner, the one being more free and open, and the other somewhat more shy, retiring, and insinuating. I cannot conceive any reason why there should be any unfriendly rivalry between the admirers of these two damsels; and I frankly own, whether it be due to a lax sense of moral obligation or not, that

[1] *The Wealth of Nations*, Book V. ch. ii.
[2] Gladstone, Financial Statement, 1861, Hansard, vol. clxii. p. 584.

as a Chancellor of the Exchequer, if not as a Member of this House, I have always thought it not only allowable but even an act of duty to pay my addresses to them both. I am therefore as between direct and indirect taxation perfectly impartial. But then I must say, that with regard to the remission of indirect taxes, I hope that the memorable history of the last twenty years [1] will never be forgotten; for I do not scruple to state that if you look to its economical profits on the one hand, and then to its political, social, and moral results on the other, it is difficult to know which to give the palm in point of magnitude. If we had not gained one single shilling by the remission of indirect taxation it would have been worth having for the sake of the manner in which it has knit together the interests and feelings of all classes of the community from one end of the country to the other. If, on the other hand, it had had nothing to do with any question of moral and social results, still the merely economical results in promoting the material well-being of the people have been so signal and extraordinary that we may well rejoice to have lived in a period during which it has been our happy lot to take part in bringing about such changes. But, Sir, there cannot be a grosser delusion than the supposition that the work of Parliament, during the period I have named, has been to destroy indirect taxation. The hand of Parliament has wrought a pruning—not to destroy the tree but to strengthen the stock. The aim of the operation has been to give it greater size and vigour; and the consequence is that at this moment, when indirect taxation has been destroyed as the fashionable phrase is, not once but four or five times over, indirect taxation is larger and more productive—I do not mean in this particular year, but in any ordinary year, and upon the average of the last two or three years—than at any former period of our history. Its condition recalls to my mind the tree of golden leaves which has been described by Virgil, from which his hero was ordered to pluck a branch, and on whose trunk, the moment one branch had been plucked, another took its place."

It is expedient to have balance between direct and indirect taxation. Indirect taxation, therefore, prevents exclusive concentration on the important direct taxes and preserves the golden rule that the collection of a State's revenue should be on as broad

[1] When the number of indirect taxes was greatly reduced (see below).

a basis as possible. Too heavy taxation, direct or indirect, at any point or points will tend to evasion, and to the interference with and the crippling of industry. When Sir Robert Peel abolished over 600 customs duties and reduced over 1000, the decrease in the annual customs revenue of the United Kingdom was in the long run comparatively small. The taxation of raw materials and of goods that aided production was gradually done away with, as these were hard to collect and expensive in their effects on the consumer, who has to pay in addition to price for the tax and the interest on the tax advanced by the producer. An excise on iron and steel would raise the price of one of the essential articles of production, and should for revenue purposes be avoided in favour of articles ready for direct consumption. In short, the greater the complexity of indirect taxation, the greater the evasion, and the greater the tendency to a large part of the yield being swallowed up in the cost of collection.

In view of the fact that progressive taxation by which income as it increases is taxed at a higher rate makes allowance for increased taxable capacity it may be regarded as the best means of securing fairness between individual taxpayers. At the same time the steepness of progression cannot be carried too far as it would then be unfair against the higher incomes.

In a workman's family budget the expenditure on articles indirectly taxed, such as tea, sugar, salt, and spirits, is relatively greater than in the family budgets of the well-to-do. No allowance is of course made, as in the case of direct taxation, for family responsibility. The head of a family has to pay more than the bachelor and no differentiation can be made between earned and investment income. Indirect taxation is regressive in character, and ordinarily falls more heavily on the poor than on the rich, because the poor are the largest consumers. The burden then varies inversely with ability. If a specific duty is levied, say at so much per lb. regardless of quality, there may be double differentiation against the poor. Thus a tax of eightpence on each pound of imported tea would be $33\frac{1}{3}$ per cent on tea valued at two shillings, and only $13\frac{1}{3}$ per cent on tea valued at five shillings. In such cases indirect taxation is doubly regressive. Regressive taxation, therefore, by which the rate decreases with an increase in income through indirect taxation would seem to be inequitable. This, however, is not so. Indirect

taxation must have a place in any tax system, notwithstanding that it may be regressive, because it is the best method of levying taxes from wage-earners. Much direct taxation flies over the heads of wage-earners, and Governments in all countries have had to depend on indirect taxes for a considerable part of their revenue. The direct taxation of wages is usually prohibitive on account of the cost of collection, and wages contain a taxable element. Indirect taxation, in short, prevents the raising of the revenue from a mere fraction of the population. An income tax on all classes, including wage-earners, would be difficult from an administrative viewpoint as well as vexatious and unpopular. Indirect taxes even when regressive have advantages. Tobacco and alcohol duties in many countries raise a large revenue from all classes of the community without affecting their personal efficiency. In Great Britain the heavy duties on beer and spirits, combined with the War-time restrictions, which have altered habits, have curtailed consumption. The results have not been harmful to the consumer or on the whole to production. Indirect taxation enters into prices and may curtail consumption. They are normally collected from the home manufacturer, as, for instance, in the case of excise duties, or from the importer or exporter as in customs duties, they are shifted on to the shoulders of the consumer in the shape of higher prices for the goods consumed. Here the articles selected for taxation should be those of very general consumption, the demand for which is relatively inelastic. Indirect taxes are so unobtrusive that they are not ordinarily realised by the taxpayer. In most countries indirect taxes are confined to such articles as tea, sugar, tobacco, spirits, wines, salt, and, as in Germany before the War, on food-grains imported. The articles taxed will vary from country to country according to the consumption of the inhabitants of the country. Otherwise the productivity of these taxes would suffer and the State would not get the maximum revenue with the minimum effort. During the War, attempts were made to tax all kinds of luxuries, but it was found extremely difficult to define luxuries. Clothing, shoes, etc., become articles of luxury when bought by the individual for his own use in large numbers. When the expensive grades of goods were taxed, it forced consumers to buy the cheaper ones. Cost of collection and evasion had also to be considered. The main criticism of the taxation of necessaries, including con-

ventional necessaries, is that the burden falls more heavily on the poor than on the rich, just as taxes on luxuries press heavily on the rich. If the taxation of necessaries is extended too far the poorer classes will suffer, and it is for this reason that Labour Governments favour direct rather than indirect taxation. The first Labour Government in Great Britain reduced in its first Budget (1924) indirect taxes, including all the food duties, especially those on tea, coffee, chicory, sugar, dried fruits, sweetened table waters, and abolished others, such as the inhabited house duty, while leaving the main direct taxes—income tax and death duties—as they were.

5. Direct taxation, if heavy, may affect the standard of living of the class of income tax payers and especially those with moderate incomes, and for the greater part earned incomes. If this taxation is imposed for meeting internal debt charges a certain portion of the yield of the tax is transferred in the form of interest charges on War loans from taxpayer to the investor in Government securities. The community does not get any real return such as would have been possible if the savings had been put, not into unproductive debt, but into productive industry. The saving power of the community is not checked in the sense that a transfer of funds raised by income taxation is made to members of the community in the form of interest. It is checked, however, in the sense that no real return is received on the investment, and thereby the power to spend and save is curtailed. The portion of the income of persons liable to super-tax in Great Britain—the income is approximately £500 millions—paid by themselves to themselves as interest on debt cannot be any spending or saving power. This direct taxation levels down higher incomes and redistributes saving power in favour of those who have moderate and low incomes.. People of the latter class do not as a rule invest in risky concerns but in gilt-edged or quasi gilt-edged securities, and in this respect the supply of capital to speculative enterprise is restricted. There is an advantage in favour of trustee stocks, debentures, and preference shares at the cost of investments in ordinary industrial shares.

To sum up, direct taxation has several advantages as compared with indirect taxation. It is in the first place economical as the cost of collection is usually quite low notwithstanding the complexity of the concept of income in modern taxation systems.

The tax is certain because the taxpayer knows exactly what he must pay the State, and the State in turn knows what it is likely to receive during the financial year. Thirdly, the broad shoulders bear the heavier burdens under any reasonably progressive system of taxation. Fourthly, in times of stress the yield may be increased: in fair weather, too, with the increase in wealth and in population the returns grow. In short, the tax is elastic. Lastly, it is a good thing to stimulate civic consciousness, and the imposition of a direct tax like the income tax is useful in this respect. It is a stimulant to civic consciousness. The disadvantages of a direct tax are: (1) that it is a tax on honesty, and fraudulent evasion results; (2) that it sometimes bears heavily on some classes, especially if they are illiterate and do not keep careful accounts; (3) the returns are not always easy to make, and also as the payments are made in lump sums they often have the characteristic of inconvenience. Payments by instalments and simplification of forms tend to mitigate the inconvenience of such a tax. It is quite true that some, especially Eastern peoples, prefer to be taxed in the dark, *i.e.* they prefer indirect taxes which are usually paid in driblets at the time of consumption and from the State's viewpoint are easy to collect, as they are collected at the time of import or manufacture.

The financier always attempts, sometimes without success, to make the real burden as light as possible. This raises the principle of minimum sacrifice, to which we shall shortly return.

Twentieth-Century Changes in Theory and Practice

6. The problem of distribution is an ethical question, but it raises financial and economic issues of no small importance. Towards the closing years of the nineteenth century the problem of the proper distribution of the burden of taxation received new life owing to the work notably of Seligman [1] in America, and of Italian writers like Mazzola,[2] Mase-Dari,[3] Graziani,[4] and Ricca-Salerno,[5] and of Dutch writers like Cohen-Stuart [6] and Pierson.[7]

[1] *Progressive Taxation in Theory and Practice*, 1894.
[2] *L' Imposta progressiva*, 1897.
[3] *Ibid.*
[4] *Istituzioni di scienza delle finanze.*
[5] *Passim.*
[6] *Bijdrage tot de Theorie der progressieve Inkomstenbelasting.*
[7] *Political Economy*, vol. ii. (translated by Wotzel), Macmillans.

The work of Edgeworth on *The Pure Theory of Taxation*[1] was also of high value. In Germany the principle of progression dates from 1891. In Great Britain there was an element of degression in the income tax and progression in death duties which date from 1894. Real progression, however, in the British system dates from 1909 with the introduction of super-tax. The spread of graduation in taxation is, of course, the natural result of the marginal theory of value. £100 from an income of £1000 requires greater sacrifice than £100 from an income of £10,000. With every increase in income and wealth there is diminishing satisfaction. On 25th February 1913 the ratification of the Sixteenth Amendment of the American Constitution provided as we have seen for the foundation of a Federal income tax: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration". In that code of taxation, the British income tax, the principle of graduation was definitely adopted in 1909 after a long struggle, and in the Finance Act of 1914 a further attempt was made at a more complete graduation. In August 1918 the Income Tax Act was passed by Parliament, and 13 Acts and parts of 39 others were repealed by this consolidating Act.[2] Various Finance Acts from 1919 to 1935 relate to income tax and super-tax and must be considered in this connection. The twentieth century has witnessed a considerable advance in practical finance. The problem of distribution must be discussed from the viewpoint of the tax system as a whole, not from that of any particular tax. The Finance Minister who imposes a new tax does not consider so much the burden of the new tax in regard to its distribution as the distribution of the new tax and old taxes together. If a new tax is introduced and if A and B living in similar economic circumstances are affected by the old system equally, then the new tax should fall on both equally, but if it pressed on them unequally the new tax should be levied as to balance the effects of the former system. In Marshall's words, "Onerous taxes, imperial and local, must be treated as a whole. Almost every onerous tax taken by itself presses with undue weight on some

[1] *Economic Journal*, vol. vii., 1897.

[2] *Vide* "The Income Tax Acts", H.M. Stationery Office (1925), Schedule 7, page 489.

class or other, but this is of no moment if the inequalities of each are compensated by those of others, and variations in the several parts synchronise. If that difficult condition is satisfied, the system may be equitable, though any part of it regarded alone would be inequitable." [1]

Theories of Just Distribution

7. Three theories on the just distribution of the money burden of taxation are usually put forward: (1) the taxation should be measured by the cost of service rendered to individual taxpayers by the public authority; (2) by the benefit to individual taxpayers of such service; and (3) by the individual ability to pay taxation. The cost of service cannot be applied to services paid for out of the proceeds of taxes as against prices. The cost, as pointed out in the definition of taxes, prices, and fees, cannot in the case of taxes be determined. A tax is a compulsory levy taken from all alike and without any regard to the use by the individual of the services supplied. Thus the "cost of service" principle is not of practical application. Similarly, since the cost of services rendered to individual taxpayers cannot be determined, the benefits cannot also be determined, except in a few rare cases such as old age pensions. The pensioner would, under the benefit of service principle, have to return his pension to the Treasury. If exceptions or qualifications are to be made, then it is not clear on what principle and to what extent such exceptions should be made. The benefit theory of taxation is inadequate because it cannot explain the principles underlying tax obligation in a modern State. It is when we take the aggregate of the benefits conferred on citizens as a whole by the State and not individually that the benefit principle of taxation can be said to have some meaning. To ask taxpayers to contribute to the State in proportion to the benefit received would be impracticable, although not unreasonable. The burden of taxation would fall more heavily on the poorer classes than on the richer, as the former benefit to a greater degree from the large sums spent by modern governments on social services. The exact amount of benefit could not be measured for each taxpayer, and

[1] Marshall, Memorandum on Imperial and Local Taxes, Cmd. 9528, p. 113, quoted by Pigou, *Public Finance*, p. 75.

thus the principle of benefit breaks down. The benefit principle is applied to fees, licences, and special assessments; also in local rating, where the field of taxation is more restricted than in federal or State taxation, the rule of taxing according to benefit is the only one administratively possible. As a statement governing the relation of the taxpayer to the State it is obviously incomplete and unsatisfactory. In short, we are driven back to the "ability" or "faculty" theory.

The Ability or Faculty Theory

8. In Great Britain the term "ability" first appears in the Elizabethan poor law, where the taxes are fixed "according to the 'ability' of the parish". Faculty is the old mediæval word, *e.g.* "juxta bonorum facultatem" or "pro bonorum facultate". Ability or faculty meant at first property and then income. Under a statute of 1601 the relief of the poor was charged upon each parish, the money was raised "by taxation of every inhabitant, parson, vicar, or other, and of every occupier of lands, houses, tithes impropriate, propriations of tithes, coalmines, or saleable underwoods". The exact method of distributing the tax was not laid down in the statute, but by long usage and a series of judicial decisions culminating finally in an Act of Parliament the rate was payable solely in respect of immovable property, and it was to be paid by the occupier as opposed to the owner. In the Parochial Assessment Act of 1836 the measure of rateable value was defined as the net annual value of any hereditament, or in other words the rent at which it might reasonably be let for from year to year after deductions for costs of repairs and other expenses. It was a tax *in rem* laid upon a physical object regardless of the circumstances of the owner, and was similar to a motor licence. It was not a tax *in personam* which paid attention to the financial condition of the owner as in the case of income tax and death duties. Adam Smith, in his first canon of taxation, takes the term to mean "revenues". What is the method by which ability or faculty to pay is to be measured? If emphasis is laid on the subjective side, the inconvenience or sacrifice involved in the payment of taxes will be clear; if on the objective, the ability or faculty of the taxpayer (as shown by his "income") will come into prominence. "Equality of taxation",

according to Mill, "as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person towards the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his." Mill, however, also seems to flirt with the principle of least sacrifice when he says that "Whatever sacrifices it (a Government) requires from them (persons or classes) should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole".[1] Here in the same sentence Mill enunciates the two divergent principles—equal sacrifice and least sacrifice.

9. The equality of sacrifice cannot be accepted as the basis of the ability to pay, because it is not possible to measure the "inconvenience" or hurt caused to the taxpayers individually. The subjective interpretation falls to the ground and the objective has taken its place. It is taxable capacity and not the feelings of the taxpayer that the State considers to be important. The point is whether this objective basis is property or income. In the twentieth century when industrial progress has been so great and credit so advanced it may be said that property is not a fair basis of taxation according to ability. Property is held in so many forms and not merely in real estate, and the money value of these different forms cannot always be evaluated. Recourse, therefore, is now had to income as the measure of ability. Here the purely quantitative aspect of income is not sufficient because there are different elements which require consideration, as, for example, a bachelor and a married man with children earning the same incomes have not the same ability to pay taxes. If the income is uncertain, or on the contrary independent of the health of the individual, as in the case of investment income, there is also a difference. Again, the income may be a wasting asset, as income from a gold mine. It is then not pure income. The unit of measurement is not the same for all incomes. In most cases it is a year, but it may be a week or a month. This is another difficulty in taking income as the basis of ability. If the taxpayer receives a windfall in addition to his normal income and this does not affect his standard of living or expenditure, then

[1] J. S. Mill, Book V. ch. ii. sect. 2, para. 1. Cf. *Economic Journal*, vol. vii., 1897, p. 564.

this has a greater capacity to bear taxation than an equal or similar amount forming part of his regular income. Sir Josiah Stamp rightly says that "A higher rate of tax upon a legacy received from a distant relation than on a similar amount from a near relation from whom one had legitimate expectations has been justified on this principle. The excess profits duty in War time was based mainly on the principle that in a time of hardship anyone who found himself enjoying larger profits than in peace time was specially lucky and could well make a special contribution to the Exchequer." In these days of large public expenditures necessitating a plethora of taxes in various forms, progressive and regressive, it is difficult to follow the ability to pay principle alone. The Finance Minister has to obtain his revenue from many sources, and he attempts to obtain the maximum of revenue with the minimum of inconvenience, *i.e.* by recourse to practical considerations and not to any one principle such as the principles of benefit, ability, or both.

Minimum or Least Aggregate Sacrifice

10. It was left to Edgeworth to state the doctrine of least aggregate sacrifice as the one ultimate principle of taxation. It may have been suggested by Carver, whom Edgeworth quotes,[1] but the enunciation is clearly Edgeworth's. "Minimum sacrifice, the direct emanation of pure utilitarianism, is the sovereign principle of taxation. . . . Before leaving the principle of minimum sacrifice, let it be observed that, under the limitations which have been described, this principle may also be applied to justify differential taxation on the ground of differences in other respects besides size of income: for instance, difference in the permanence of the income, differences in civil state, number of children, age, and other attributes."[2] If the law of Bernoulli be assumed, that utility diminishes in

[1] "The minimum amount of repression (or check to the growth of wealth) is secured by imposing an equal sacrifice on all members of the community, but the minimum amount of sacrifice is secured by collecting the whole tax from those few incomes which have the lowest final utility. No rational writer advocates the latter plan exclusively, but many rational writers do advocate the former plan. Yet it is not beyond dispute that the former plan ought to be followed exclusively" (T. N. Carver, "The Ethical Basis of Distribution", *Annals of the American Academy*, 1895, p. 97).

[2] *Economic Journal*, vol. vii., 1897, p. 556.

inverse ratio to means, the principle of equal sacrifice leads to proportional taxation, of proportional sacrifice to progressive taxation, while the principle of minimum sacrifice to a fairly high level of exemption, combined with a somewhat steeply progressive taxation of those whose incomes are taxed. Strictly speaking, the principle of equal sacrifice and proportional sacrifice (unlike that of minimum sacrifice) make all members of the State pay something. It is indeed an ideal of taxation when all classes pay their share to the State. As a rule, however, the lowest classes are called on to contribute only through the luxuries which they consume.

11. A Government collects its taxes from the various classes of the population, and fairness or unfairness of the burden will depend, all things considered, on the least aggregate sacrifice made by the taxpayers when the taxes are paid. The less the aggregate sacrifice, the better the distribution. The aim of the Government is the greatest total happiness of its citizens or the maximum aggregate welfare. In taxing it aims at the maximum collective utility which in the long run brings the maximum utility to the individual. In other words, the total disutility should be a minimum or, in Bentham's phraseology, "All government is only a tissue of sacrifices. The best government is that in which the value of those sacrifices is reduced to the smallest amount." The principle cannot be strictly followed by governments because it sometimes happens that a greater sacrifice may result in less injury than a smaller sacrifice, as, for example, high taxation of wines and spirits or imported cloths which imposes greater sacrifice on certain classes of the community is desirable from the viewpoint of prohibition or protection. This aspect, however, is limited in its application. The fact that the ideal is minimum disutility means that the individual taxpayer's marginal disutility should be the same. This in turn means progressive taxation, the richer being taxed for the benefit of the poorer, so that equality of incomes or wealth is achieved. This might lead to a decrease in the aggregate production of wealth or to an increase in population.[1] The least aggregate sacrifice may be obtained by taxing those incomes, few in number, which have the lowest marginal utility, but not in a way to check the accumulation of wealth or to impede

[1] Sidgwick, *Principles of Political Economy*, Book III. ch. vii. § 2.

industry. The principle of minimum or least aggregate sacrifice is, as Edgeworth has said, " the sovereign principle of taxation " which " requires no doubt to be limited in practice ".

Proportional Taxation and the Classical Economists

12. Both proportional and progressive taxation may be based on the criterion of ability, and both may claim to be the ideal mode of apportionment. Proportional taxation is the more conservative, and its essential basis is that the existing distribution of wealth should not be disturbed by taxation. If it is to be disturbed, other means of effecting this should be adopted, as it is not the function of the State financier to solve social questions. His job is to secure revenue with the least possible discontent on the part of the tax-payer. Nineteenth-century teaching in England and France was on the whole undoubtedly in favour of the rule of proportional taxation. It was traced to Adam Smith's first canon of taxation,[1] that the subjects ought to contribute for the purpose of defraying public services gratuitously rendered " as nearly as possible in proportion to their respective abilities ". Adam Smith shows that the measure of abilities is the revenue enjoyed under the protection of the State. From this it was held that taxation should be proportionate to revenue. It is, however, unfair to deduce this from the canon. Elsewhere Adam Smith says, " It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion ".[2] The doctrine of proportional taxation which was first put forward against the privileged classes is now used against those who frankly wish for a change, however slow, in existing society. Even Bastable, writing in 1892, clings to the simple classical doctrine upheld by Mill, McCulloch, De Parieu, Hermann, and other nineteenth-century writers. " The result ", he writes,[3] " is that on the whole, and speaking broadly, taxation should be proportioned to revenue, by which a fair approximation to justice and a convenient basis of working are supplied." To-day such a theory is out of date and does not square with practice.

[1] *Vide* p. 216. [2] Cannan edit. vol. ii. p. 327
[3] Book III. ch. iii. p. 324.

Progressive Taxation—its Popularity

13. Next with regard to progressive taxation. The change in financial policy during the present century in regard to progression has already been noted. The change is seen in the practical application of progression in income-tax systems, in general taxes on property, and above all in inheritance taxes. The supporters of this principle are to be found even among the precursors of Adam Smith. Montesquieu, in the famous thirteenth book of *The Spirit of the Laws*, supports it. In the four classes of citizens in Athens in the time of Solon the first paid no taxes, the second were assessed at five-ninths of their property, the third were assessed at five-sixths, and the fourth or highest class at full valuation. "The tax was just, though it was not proportional. If it did not follow the proportion of goods, it did follow the proportion of needs. It was judged that each had equal physical necessities, and that those necessities ought not to be taxed; that the useful came next, and that it ought to be taxed, but less than what was superfluous; and lastly, that the greatness of the tax on the superfluity should repress the superfluity."[1] The principle of progression was adopted in France in 1793 and revived in 1848.[2] It was probably this, and the hatred of French writers such as Leroy-Beaulieu and others to socialistic tendencies, to communism rather than socialism,[3] that produced so stout a stand against the theory in the nineteenth century. Say[4] and Garnier were exceptions to this rule, as they supported progressive taxation. The classical English economists felt that progressive taxation would arrest the expansion of industry, because the rate of progression would increase until no motive remained to the individual to expand industry. In Mill's words, "To tax the larger incomes at a higher percentage than the smaller is to lay a tax on industry and economy". Experience, in recent

[1] Cf. *Esprit des lois*, Book XIII. chap. vii.

[2] "Before the Revolution taxation was proportional; then it was unjust. To be truly equitable, taxation must be progressive" (Decree of Provisional Government, 1848).

[3] Cf. pp. 66-70 Seligman's *Progressive Taxation*, where Adolf Wagner's socio-political theory is criticised. It is the duty of the State financier, according to Wagner, to bring about a more equitable distribution of wealth. Cf. also Adams, *The Science of Finance*, p. 341.

[4] "Si l'on voulait asseoir l'impôt de chaque famille de manière qu'il fût d'autant plus léger qu'il portât sur un revenu plus nécessaire, il faudrait qu'il diminuât non pas simplement proportionnellement, mais progressivement."

years, has shown that such fears had no real basis, the application of the progressive principle never having been allowed to increase to the point at which this desire to develop industry is imperilled or the accumulation of capital retarded. Again, the complexion of events has changed, especially since 1914, and the Great War forced governments to impose such taxation, and its practicableness and productiveness, especially in inheritance and other taxes, showed that many of the objections raised to progressive taxation have proved to be theoretical and untenable. In paragraphs 3 and 6 above the changes that have come about in the present century in regard to the increased popularity of progressive taxation are dealt with in some detail.

Progression and the Nature of Income

14. Should taxes be higher according to the source of income? Some incomes are derived from property and interest-bearing securities, while others are from salaries, wages, and profits of professions or from trade. The former class of incomes is frequently said to last for an indefinite period, and to yield as a rule a larger amount of economic welfare than the same amount of income from work. The latter class of incomes lasts for a less indefinite period, and at the latest comes to an end with the death of the salary or wage earner. But the difference in duration of the incomes is no real reason why there should be a concession in favour of earned incomes. The worker, it is sometimes said, has to debit himself with the disutility of the work itself in earning his living, and over and above this he has to put aside for a rainy day something for his family. This is, as it were, no part of his present income.[1] He is under a moral obligation to do so, and on this account abatements are, under certain conditions, allowed for life insurance premia. Incomes from work should be taxed at a lower rate than incomes from property if the sacrifice of the taxpayers is to be the minimum. Incomes of those who are earning their living by work are regarded even by people who have

[1] This, it might also be argued, will be taxed later, *i.e.* when it becomes part of the beneficiaries' income. If it is taxed now as well as in the future there will be double taxation of the same income. The holder of an unearned income may, however, do the same thing, and his savings may also be doubly taxed. He is not under the same stress to do so, and probably does not. All the sources of income pass presumably later to the heirs.

no socialistic tendencies to be on a different footing from those typical of the leisured class—unearned incomes. It is for this reason that unearned incomes are commonly taxed at a higher rate than earned incomes. A finance minister, too, realises, as the War has shown, the supreme advantage of raising the largest revenue with the least trouble and without making the income tax an instrument of oppression. Excess profits, and especially conjuncture gains,[1] are peculiarly suited for special taxation. Banks possessing a monopoly of business such as exchange business, and firms or companies making monopoly gains, are sometimes taken as examples. "Both ground-rents and the ordinary rent of land are a species of revenue which the owner, in many cases, enjoys without any care or attention of his own. Though a part of this revenue should be taken from him in order to defray the expenses of the State, no discouragement will thereby be given to any sort of industry. The annual produce of the land and labour of the society, the real wealth and revenue of the great body of the people, might be the same after such a tax as before. Ground-rents, and the ordinary rent of land, are, therefore, perhaps the species of revenue which can best bear to have a peculiar tax imposed upon them. Ground-rents seem, in this respect, a more proper subject of peculiar taxation than even the ordinary rent of land. The ordinary rent of land is, in many cases, owing, partly at least, to the attention and good management of the landlord. A very heavy tax might discourage too much this attention and good management. Ground-rents, so far as they exceed the ordinary rent of land, are altogether owing to the good government of the sovereign, which, by protecting the industry either of the whole people or of the inhabitants of some particular place, enables them to pay so much more than its real value for the ground which they build their houses upon; or to make to its owner so much more than compensation for the loss which he might sustain by this use of it. Nothing can be more reasonable than that a fund which owes its existence to the good government of the State should be taxed peculiarly, or should contribute something more than the greater part of other funds towards the support of that government."[2]

[1] Gains which are not due to man's own efforts but are a gift of fortune. Cf. Marshall, *Principles of Economics*, p. 623.

[2] *The Wealth of Nations*, Book V. ch. ii. part ii. art. i. (Cannan edit. vol. ii. p. 328).

The Future of Progression

15. The twentieth century has already witnessed a large growth in democracy, and in what is often called social sympathy. The demand for greater State action in education, public health, and other social services proceeds apace. The principle of progression is almost certain in these circumstances to have a wider and wider application. As a general rule progressive taxation should, if applied on a large scale, be on the *amount* of income rather than on the kind of income. The best progressive taxes are the income tax, the inheritance tax or death duties, and general taxes on property, and it is in regard to these that the principle of progression will be applied or extended.

It is perhaps unnecessary to recall that there is an element of regression, often a considerable element, in indirect taxes, particularly in those on food and drink.[1] The effect of these regressive taxes will, it seems, continue to be felt to an ever-increasing extent by direct progressive taxation. The steepness of this progression is, of course, dependent on the canon of economy. A finance minister may find that he is faced with the imposition of either an indirect tax on matches or salt or the imposition of a further direct tax on income, such as the super-tax (which makes the income tax progressive between different classes of income tax-payers). He makes a rough estimate of the aggregate advantage of the two taxes to the community as a whole. He may or may not decide that on balance the progressive tax should be made still steeper. At any rate he follows the principle of minimum sacrifice. The redistribution of net income as a result of this heavy direct progressive taxation in some countries, such as England, and the effect on the supply of capital, will be dealt with in a later chapter.

Summary

16. To sum up, in recent years the recourse to progressive taxation has been specially marked in the chief industrial countries, and has been none the less noticeable in the Dominions and in India, where the limits of practicable progression have not yet been nearly reached. Direct taxation, as the War has shown, is

[1] Cf. "The Taxation of the various Classes of People" (Rt. Hon. Sir Herbert Samuel), *Journal of the Royal Statistical Society*, March 1919.

far more expansive than was hitherto imagined. The broadest shoulders often do not bear a fair share of taxation. On the other hand, it has sometimes been said that progressive taxation in these countries means taxation of an arbitrary and uncertain nature. To some extent this is true, but this is often overstated.[1] It is, however, not more arbitrary than, say, the proportion of direct to indirect taxes. We have already dealt with the arguments that this form of taxation will lead to the checking of the accumulation of capital, and even to the export of capital. The question of productiveness in some countries, especially as a result of war-time experience, has been a matter of fact, and the growth in the popularity of progressive taxation with finance ministers and their departments tends to show that this form of taxation will become still more popular. There is, of course, the danger of evasion, and this can be overcome mainly by administrative measures. Evasion is, however, common to proportional taxation. At the same time, with high rates of taxation the tendency to concealment is increased. Drastic penalties are necessary for the making, or assisting in making, of false returns, and it may be necessary to give power to the collecting authorities to call for the production of books, accounts, and similar documents. Auditors, if required, should be obliged to state the nature and extent of their audits. Unless the machinery for compelling the production of books and documents is adequate, evasion is liable to occur fraudulently or unintentionally. The heavier the burden the sharper should be the punishment on those anti-social offenders who, whatever be the nature of the tax, enrich themselves at the expense of others. Evasion, it should be remembered, is liable to occur in all forms of direct taxation, since assessment, often difficult, is required, and this gives opportunities for evasion as it does for arbitrary official action.

Double Taxation

17. Double or multiple taxation is usually defined as the levy of more than one tax by one or more authorities on the same tax base. Thus a business may be taxed on account of its profits, its property, or a business paying a business franchise tax. The

[1] Its arbitrariness is emphasised by French economists, notably by Leroy-Beaulieu (i. 148), *L'Impôt progressif et l'impôt proportionnel.*

term is mainly used in a more restricted sense. It is restricted to cases where there is more than one tax jurisdiction. Different states in the same federation may tax the same person. One state may tax according to the residence of the taxpayer, while another according to the *situs* of the taxable object. The profits of a corporation may be taxed by more than one state, the competing tax authorities. Profits arise from a combination of factors in different places. The heavy fiscal burdens since the War brought the problem to the forefront of discussion from the viewpoint of international finance. The growth of the friendly recognition of state laws and usages among the units of federations, the decisions of the federal judiciary, and legislation of a positive nature by the Federal Government itself have also given the question of double taxation in theory and in practice new importance. The heavy taxation of income, for example, led to an arrangement in 1920 between Great Britain and most of the Dominions whereby Great Britain remits to its taxpayers the amount of the Dominion tax up to one-half of the British income tax in cases where both countries tax the same income, and the Dominions themselves adopt a similar procedure. In the case of death duties, Great Britain and Canada have agreed that succession duties payable in any province of Canada should be deducted before the payment of British estate duty, and similar reciprocity among provinces has been adopted by Ontario and New Brunswick. Similarly in Germany to-day real estate and "fixed industry" are taxed according to *situs*, and if the business of a concern is conducted in more than one of the Länder the tax is divided among the Länder. In the case of appeals the federal authority, the Federal Finance Court, decides the allocation in each case. In Switzerland the Federal Court has not only laid down principles to be followed to avoid double taxation among the cantons but it decides individual cases referred to it. In the United States, especially in regard to death duties or inheritance taxes, the Supreme Court has vetoed certain state practices, and the influence of the Supreme Court of the United States by its negative attitude has been to avoid multiple taxation in several directions among the states of the Union. The International Shipping Conference of 1921 passed a resolution that "Whilst the shipping industry recognises its obligation to bear its full share of taxation, it is economically impossible for the individual

shipowner to bear that burden in each and all of the countries to which his vessels sail. It is therefore desirable in the interests of international trade that legislation be enacted in every maritime country of the world, giving immunity from taxation in respect to the earnings of foreign shipping in all cases where similar immunity is reciprocally given." This double taxation, it is said, involves time and labour which in regard to shipping could be better employed in other ways. It is difficult to assess the earnings of a particular vessel at one of the numerous ports at which she may call in the course of her voyage. In some countries an arbitrary method is adopted of assuming that a certain percentage of the freight money received at a particular port represents profit, and therefore liable to taxation before port clearance is granted to the master of the vessel. Even if this is so, it is urged that it may in the shipowner's accounts have to be set off against a loss incurred on another part of the voyage, or against a loss incurred on account of other ships of the same line. No compensating allowance is given when the financial results of losses are debit balances. It is suggested that most of the difficulties would be avoided if earnings were only to be taxed in the country of ownership or registration, and that arrangements should be made for reciprocal freedom from taxation abroad, in order to avoid this duplication of taxation. It is urged in this and similar cases that the present system of double taxation distributes the burden of taxation unequally, and it prevents the free flow of capital.

18. The difficulty of avoiding double taxation arises when the question is asked, which governments should give up revenue and to what extent? Most countries follow the principle of taxing according to origin, on the principle, perhaps, that taxes seem to be paid by things rather than by persons. The origin or *situs* is looked on as the main principle, and residence as a purely secondary principle. The problem of double or multiple taxation arises because governments tax on the basis both of origin and of residence. The older form of taxation, objective taxation, the levying of a tax upon wealth wherever found, has not and will not be given up, in spite of the great increase in the present century of sensitive subjective taxation and of the recognition that the total ability of the taxpayer where he resides should be taken into consideration in determining his liability. This gives rise to considerable difficulties when the tax jurisdictions are politi-

cally different, as, for example, between state and state in a federal constitution or between two different nations or countries. The conflicting claims of taxing authorities cannot easily be adjusted. In the United States the states of domicile refuse to forego their claims because they hold their owners have an obligation to the Government under which they live, and the states where the industry or business is also assert their right. Thus double taxation arises. It is not the principles that are wrong but their application. In order to overcome unequal and unjust double taxation it has been suggested that the states should agree to levy a personal tax based on domicile for the support of the Government; a property tax upon tangible property based on *situs* and without regard to personal conditions; and a business tax where necessary upon all business carried on within the jurisdiction of the taxing authority. When the question of taxing the foreigner arises similar difficulties confront the taxing authorities. Where the object is a tea-garden or a cattle ranch owned by residents abroad, the Government in which the tea-garden or ranch is situated think of the benefits conferred on the foreign owners, of the profits and protection afforded to the owners. The Government in which the residents live think of the large incomes of their nationals who can pay a high rate of tax. There is again the company with headquarters, say in London, with a majority of foreign shareholders. The company's production may be produced in a country other than the headquarters of the company or the domicile of the majority of the shareholders. The company, let us assume it to be the Persian Oil Company, produces its oil in Persia, sells it in other countries, while its headquarters are in London. How in this case should the company be liable for taxation? Which country should tax the profits? It is not possible to hold with many British authorities that we should aim at taxing the resident on the whole of his income from all sources and exempt the non-resident in the country of origin. If the countries concerned were neither debtor nor creditor this might be satisfactory, as each would exempt income originating in itself and belonging to nationals of the other, and the income of residents only would be taxed. Where, however, one country was a creditor and the other a debtor this would be unfair, as the latter country would sacrifice considerable taxation on income arising within its jurisdiction

and payable to owners abroad. Taxing the foreigner by direct taxation is never an easy pastime. In the case of new investments the evils of double taxation are ostensible evils only; in the case of old investments they are not so. A tax in the country of origin will be regarded by the foreign capitalist as an item of expense, and in the case of a new investment he will take this into account in making his investments. If it is a fixed yield investment the tax in the country of origin will be amortised by being thrown back on the borrowing country. The investor will require a net return at or above the general world rate. Old investments subject to new or higher taxation will not yield the same, and thus the old investors are at a disadvantage. In most cases the imposition of a new or higher tax penalises the non-resident investor and it prevents non-resident investors from making new investments unless the terms are such that the burden of the tax will be thrown on the borrowing or taxing country. Double taxation thus is a barrier which tends to keep capital within national frontiers and to prevent it from flowing freely over such frontiers. There are, of course, certain limitations such as the necessity of sometimes making investments in existing businesses, the ignorance of investors, the question of graduated taxes, the fluidity of capital, etc. The investor in the creditor country will consider comparative yields at home and abroad after payment of the double taxation. Thus a barrier to the free movement of capital is set up and aggregate well-being viewed from the standpoint of world production may be reduced. It is therefore desirable, as the League of Nations inquiries[1] have shown, that

[1] (1) Memorandum on Double Taxation and (2) Note on the Effect of Double Taxation upon the Placing of Investments Abroad (Sir Basil Blackett, 1921). (3) Report on Double Taxation submitted to the Financial Committee by Profs. Bruins, Einaudi, Seligman, and Sir Josiah Stamp, Geneva, 1923. (4) Double Taxation and Tax Evasion—Reports and Resolutions submitted by the Technical Experts, Geneva, 1925 and 1927. (5) Double Taxation and Fiscal Evasion—General meeting of Government Experts, Geneva, 1928. (6) Double Taxation and Fiscal Evasion—Collection of International Agreements and internal legal provisions for the prevention of Double Taxation and Fiscal Evasion, 1928. Cf. *Double Taxation and International Fiscal Co-operation*, Seligman, New York, Macmillan and Co., 1928; "Double Taxation and Tax Evasion," Coates (*Journal of the Royal Statistical Society*, vol. lxxxvii. (1914), lxxxviii. (1925), xcii. (1929)); *Studies in Current Problems in Finance and Government*, J. C. Stamp, ch. ix. (London, 1924); Paul, *L'Imposition des successions en droit international et la problème de la double imposition* (Geneva, 1928); Lavagne, *La Question des doubles impositions* (Paris, 1929); Pugliese, *L' imposizione delle imprese di carattere internazionale* (Padua, 1930).

agreements among states should be made. "Since in real life", as Pigou has well said, "some states are in a stronger position for mulcting foreigners than others, a mutual self-denying ordinance, though still in the interests of all states collectively, would not be in the interests of all of them individually, unless some arrangement were made to compensate those to whom the agreement would be detrimental at the cost of those to whom it would bring exceptional advantages."[1] Owing to double taxation individuals and firms may transfer their "residence" to other countries in order to escape some part of this taxation. Thus certain jute mills which previously had sterling capital have now rupee capital and are registered no longer in Great Britain but in India, as a company resident in the former country is liable to British income tax on its entire profits wherever trading operations are carried on. The British Board of Inland Revenue has calculated that between 1915–16 and 1923–24 there were 128 cases of transfer abroad, 42 relating to private companies and 13 to individual traders and partnerships. Of the £4,653,000 aggregate income tax assessments on the 128 concerns for the last year for which they were liable, £571,000 represent assessments on these 55 private concerns. The Chairman of the Board informed the Colwyn Committee that "so far as foreign capital is desired at the present time to be introduced into the British Dominions, working through London is not so great a disability as would at first sight appear. Supposing, for example, a foreign syndicate wished to invest capital in India, it would there be subjected to 3s. 1½d. of Indian income tax and super-tax. If it works here, its total burden would only be increased by 10½d. because of the double income tax relief which exists between this country and the Dominions."[2] The arrangements made for relief in regard to double taxation between Great Britain and India[3] result in the major part of the cost falling on the British Exchequer, because nothing is payable by India up to the point at which the Indian rate exceeds half the British rate. In the case of the Indian States and the Government of India, arrangements have been come to by which an assessee who has paid on the same income in British India and an Indian State may recover the lesser of the two taxes, the cost of the refund being shared

[1] Pigou, *A Study in Public Finance*, ch. xviii. [2] Cmd. 2800, 1927.
[3] Section 49, Indian Income Tax Act.

equally between the two taxing authorities. In regard to residence abroad, the British income tax authorities are of opinion that in regard to individuals as distinct from business concerns the question has not reached any important dimensions, and in 1929, at the request of the British Chancellor of the Exchequer, a memorandum was issued to clear up the misunderstanding that arose, in this connection, especially on the part of American and other visitors. A visitor is liable to tax in respect of income arising from sources in Great Britain, with a few exceptions, but he is not liable in respect of income arising from sources outside Great Britain unless he is regarded as resident, and even when resident he is liable not on the whole of his income arising from sources outside Great Britain, but only on so much of that income as is received in or brought into the country. Residence is taken to mean where a visitor has no place of abode and when his visits are not habitual but occasional only, unless he has been in the country for a period or periods equal to six months in any income tax year (6th April to 5th April).[1] He would be regarded as resident even if he had no place of abode in Great Britain available for his use and does not remain for six months in any one year, provided that his visits become a habit and the annual visits are for a substantial period or periods of time. Normally the Board of Inland Revenue regard an average annual period or periods as substantial when they amount to three months, and as habitual when after four years. Even when he becomes chargeable to tax as a resident his liability in respect of income arising from sources outside Great Britain extends only to so much of that income as is received or brought into Great Britain. Double taxation, all things considered, is a very real hindrance, and every effort should be made to get rid of this by a reasonable system of relief such as has been suggested in the Conventions drawn up by the League of Nations. The Genoa Conference, 1922, recommended that "persons, firms, or companies, whether commercial, industrial, financial, or insurance, should not be subjected, in the event of their exercising their industry or trade or other occupation abroad, to taxes or impositions of any kind which place them in a less favourable position than nationals.

[1] If he has a place of abode, available for his use, he is regarded as resident for any year in which he pays a visit to Great Britain, however short that visit is.

. . . It is recognised that double taxation should be avoided by agreements between nations." [1]

19. There are, in brief, four methods of avoiding double taxation:

(i.) the method of exemption for income going abroad;
(ii.) the method of division of the tax;
(iii.) the method of classification and assignment of sources; and
(iv.) the method of deduction for income from abroad.

The first of these methods is based on the theory that the borrowing country cannot successfully "tax the foreigner but can only shut him out". If it is followed, all non-residents are exempted from taxation imposed on income drawn from sources within the borders of the country of origin. It is held that this has the great advantage of increasing the amount of capital from abroad and the development of borrowing countries. It is indeed the principle recommended in the Report on Double Taxation submitted to the Finance Committee of the League of Nations by Professor Bruins (Holland), Professor Senator Einaudi (Italy), Professor Seligman (United States), and Sir Josiah Stamp (Great Britain), and published in April 1923. The Report recommends the reciprocal exemption of the non-residents in regard to income tax, as this would avoid the evils of double taxation. The simple fact, however, is all too easily forgotten, and nations are frequently unwilling to shape their policy by it. Countries, in short, on a comparative plane of economic equality could afford to adopt the principle that residence (and not origin) of income should be the controlling consideration in solving the problem.

In regard to the method of division of the tax subject to mutual convention a good deal may be said. Countries are, in practice, reluctant to abandon the principle of origin, and the difficulty may best be solved in these circumstances by a system of exemption on settled lines. The Royal Commission on the Income Tax conferred in 1920 with representatives of the Dominions and of India on the question of double taxation

[1] Papers Relating to the International Economic Conference, Cmd. 1667, pp. 73, 74

within the Empire. The principle was accepted that where income tax is charged on the same income both in the United Kingdom and in a Dominion or India, the total relief to be given should be equivalent to the tax at the lower of the two rates of tax imposed. In paragraph 70 of the Report [1] the settlement suggested is as follows :

> Firstly, that in respect of income taxed both in the United Kingdom and in a Dominion, in substitution for the existing partial reliefs there should be deducted from the appropriate rate of the United Kingdom Income Tax (including super-tax) the whole of the rate of the Dominion Income Tax charged in respect of the same income, subject to the limitation that in no case should the maximum rate of relief given by the United Kingdom exceed one-half of the rate of the United Kingdom Income Tax (including super-tax) to which the individual taxpayer might be liable ; and
>
> Secondly, that any further relief necessary in order to confer on the taxpayer relief amounting in all to the lower of the two taxes (United Kingdom and Dominion), should be given by the Dominion concerned.

The Commission felt that, if their recommendation was adopted, " the British Government will have acted generously, and that the Governments of the various Dominions will afford to the taxpayer any balance of the total relief which is necessary in order to ensure that no person shall pay in all at a rate of tax in excess of the higher of the two rates (United Kingdom and Dominion). The administrative difficulties of giving effect to our recommendations will be considerable, but we believe that these difficulties will be overcome. No useful purpose would, we think, be served by reviewing questions which are matters of administrative detail, and we content ourselves with indicating by a few examples the broad lines on which the proposed relief would be effected."

The Commission gives three examples which are as follows :

> EXAMPLE 1.—A, a British resident, derives a fluctuating unearned income directly from a Dominion whose rate of tax applied to that income is 1s. 6d. in the £. A has no other income, and his rate of tax in the United Kingdom varies according to

[1] Cmd. 615, p. 16.

the amount of his income. The following figures illustrate the position :

1st Year.	United Kingdom.	Dominion.
Tax before relief . .	£1000 at 3s. 9d.	£600 at 1s. 6d.
Relief	1000 at 1s. 6d.	Nil
Tax after relief . . .	£1000 at 2s. 3d.	£600 at 1s. 6d.

2nd Year.	United Kingdom.	Dominion.
Tax before relief . .	£300 at 3s. 0d.	£900 at 1s. 6d.
Relief	300 at 1s. 6d.	Nil
Tax after relief . . .	£300 at 1s. 6d.	£900 at 1s. 6d.

In this example, although it was the same description of income assessed each year, there were wide variations in the amounts assessed in the United Kingdom and in the Dominion. This might happen owing to different methods of computing taxable profit, and the differences are intentionally exaggerated to illustrate the principles to be followed.

EXAMPLE 2.—B is a British resident receiving as shareholder an income of £900 from a British company C, which derives the whole of its income from a Dominion. In the first place relief will be given to the company C, and in order to illustrate how this is done, let it be assumed that the company's profits as calculated for the United Kingdom tax are £60,000, and as calculated for Dominion tax £50,000. Adjustment will be made to the company as follows :

	United Kingdom.	Dominion.
Tax before relief .	£60,000 at 6s. 0d.	£50,000 at 1s. 6d.
Relief	60,000 at 1s. 6d.	Nil
Tax after relief .	£60,000 at 4s. 6d.	£50,000 at 1s. 6d.

The company when paying the dividend to B would deduct 4s. 6d. in the £ United Kingdom tax, and intimate on the dividend warrant that the relief in respect of Double Income Tax was 1s. 6d. in the £.

Let it be assumed that B's dividend of £900 is his total income, so that his proper rate of charge to United Kingdom Income Tax is 3s. 9d. He has suffered Dominion tax to the extent of 1s. 6d. in the £, and his ultimate rate of United Kingdom Income Tax is 2s. 3d. in the £ (3s. 9d. less 1s. 6d.), but he has suffered by deduction 4s. 6d. in the £, and he will accordingly be repaid 4s. 6d. minus 2s. 3d. = 2s. 3d. in the £ on £900.

EXAMPLE 3.—D is a British resident receiving £900 from company C, but he has other income arising in the United Kingdom,

and his combined rate of Income Tax and super-tax is 7s. 6d. in the £. He is entitled therefore to Double Income Tax relief up to a maximum of 3s. 9d., but the whole of the Dominion tax (1s. 6d. in the £) has already been allowed to the company C, who deduct 4s. 6d. United Kingdom tax on payment of the dividends, and no further relief is due. D will therefore be assessable in respect of the £900 at 1s. 6d. in the £, viz. 7s. 6d. less 4s. 6d. United Kingdom tax deducted, and 1s. 6d. Dominion tax.[1]

In Section VII., paragraphs 79 to 83, the Commission considered the problem as it affected Great Britain and foreign countries, but found that the difficulty here was much greater owing to the absence of common interest, of the sharing of common burdens, and the natural absence of the desire for free circulation of capital within the British Empire. The Commission concluded that "no satisfactory change from present conditions could be made unless reciprocal arrangements were effected between the Government of the United Kingdom and the Government of each foreign State where an Income Tax is in force; and that it would only be practicable to arrive at such arrangements by means of a series of conferences, possibly under the auspices of the League of Nations, such as we have been happy to hold with the representatives of the Governments of the Dominions. These considerations, among others, have led us to the conclusion that in the present circumstances we cannot recommend any change in the existing situation as to double taxation of the same income by the United Kingdom Government and by the Government of a foreign State."[2]

In the Finance Act of 1920 the relief proposed for double taxation within the Empire was passed into law. This method of the division of the tax attempts to divide taxation according to the country of residence. It has the objection of placing State loans free of income tax in an obviously unsatisfactory position.

Next with regard to Method III. The method of classification and assignment of sources is best described in the words of the 1923 League of Nations Report referred to above:

By convention it might be determined to attach origin taxation speccifially and wholly to particular classes of investments or embodiments of wealth, such as rents of land and of houses and mortgages on real property, but to exempt the non-resident in

[1] Cmd. 615, p. 17. [2] Cmd. 615, p. 19.

respect of income derived from business securities. The country of residence would allow the whole of the foreign tax as a deduction from its income tax on the resident in respect of such sources of income, but would charge other sources in full. The country of origin would retain its specific origin taxes in full. It would be necessary to give the country of residence complete power of charging all sources, except for certain specified exemptions, so that the scope of its liability to remit the tax would be easily determined, and the investor, from his total income-tax demands, would be able to deduct certain specified taxes on any real property he might have. It might be desirable to impose some limit upon the power of the country of origin to levy in future specially heavy specific origin taxes, which would unduly deplete the exchequer of the country of residence.[1]

The classification of wealth according to origin includes (1) land, (2) mines, oil wells, etc., commercial establishments, (3) agricultural implements, machinery, flocks and herds, (4) vessels, and (5) mortgages, while residence includes money, jewellery, furniture, etc., and mortgages on income, corporate shares, corporate bonds, public securities, general credits, and professional earnings. In short, intangible wealth except mortgages on property would be assigned to residence, while tangible would be assigned mainly or wholly to origin.

The fourth method—the method of deduction from income from abroad—is that followed by the United States. It is opposed to general practice and places the whole burden of increased taxation in borrowing countries upon the creditor country. In the words of the experts, "Governments need no longer make provision for making the loans free of tax to non-resident investors, knowing that it will fall upon the exchequer of the creditor country. It is to be doubted whether such creditor countries as the United States, Great Britain, and the Netherlands, having regard to their interests abroad, would ever agree permanently to put their exchequers at the mercy of all the unknown increases of taxation of foreign Governments."[2]

20. The first of these four methods is the allocation of the tax to the country of residence of the investor. The second and the third are the allocation of the tax between competing tax jurisdictions. The fourth is the allocation of the tax to the country of origin of the taxable object. The Report of the

[1] P. 42 of the Report.

[2] P. 42 of the Report.

economic experts applied these four principles to death duties, taxes on property, schedular taxes of the French type, and a general income tax, and concluded that in practice the choice lay between the principle of domicile or residence and that of origin. In answer to the question which country ought to bear the burden of paying relief given for double taxation the Report stated: "A part of the total sum paid according to the ability of a person ought to reach the competing authorities, according to his economic interest under each authority. The ideal solution is that the individual's whole faculty should be taxed only once, and that the liability should be divided among the tax districts according to his relative interests in each." No uniform method, in short, such as the ideal principle in theory, the taxation of the resident on his income from all sources and the reciprocal exemption of the non-resident in the country of origin of income or wealth, is in practice possible. On account of differences in financial structure in countries, the impossibility of cutting adrift from historical facts connected with the principle of origin, the exigencies of budgets and the position of debtor countries which would stand to lose since they are on a different level from creditor countries, the principle of residence must give way to the principle of origin in many cases.[1] This Report paved the way for the two Reports of the Committees of Technical Experts which in turn made it possible for the general meeting of Government experts representative of twenty-seven countries, including the United States, the Soviet Republic, China, and Japan, to draft six conventions dealing with (*a*) the prevention of double taxation (three conventions); (*b*) the prevention of double taxation in the special case of succession duties (one convention); (*c*) administrative assistance in matters of taxation; and (*d*) judicial assistance in the collection of taxes. These Conventions follow the Reports of the Technical Experts in distinguishing between "Personal" and "Impersonal" taxes, the former dealing with an aggregate income and the latter with special categories of

[1] Resolution of International Chamber of Commerce, Amsterdam, 1929: "The best method of eliminating double taxation is the adoption of the principle of residence. The International Chamber, however, recognises the present difficulty of entirely eliminating the principle of origin from methods of solving the problem (especially as regards the income on securities), mainly because a sudden change of that nature might endanger the stability of budgets."

income. " Impersonal taxes are in most cases levied on all kinds of income at the source, irrespective of the personal circumstances of the taxpayer (nationality, domicile, civil status, family responsibilities, etc.), thus differing from personal taxes which rather concern individuals and their aggregate income. The Contracting States will themselves decide which of their direct taxes they regard, for the purposes of the Convention, as being impersonal or personal taxes." [1] To those familiar with the British system of income taxation it may seem that this is a distinction without a difference in view of the incidence of the taxes in each category. Individuals are concerned with both and impersonal taxes may take into account family responsibilities. There is, however, more than the difference that personal taxes deal with aggregate income and impersonal taxes with separate categories of income. Seligman rightly differentiates between Impersonal or Schedular Income Taxes and a Personal or General Income Tax by pointing out that " there is no room in the former for the supreme illustration of the principle of personal obligation—that of progressive or graduated taxation". [2] The principle of origin is adopted in the case of impersonal taxes and that of residence in the case of personal taxes. Where there is a personal tax on the total income the State of domicile has to pay certain deductions to the individual in respect of taxes paid in the State of origin.

21. The first Draft Convention follows the distinction between impersonal and personal taxes. Taxes on the following classes of income are classified as impersonal taxes and are levied in the State of origin: immovable property, including income from mortgages thereon; public funds, bonds, shares, or similar interests; industrial, commercial, or agricultural undertakings with the exception of shipping and air navigation; fees of managers and directors of joint-stock companies; salaries, wages, or other remuneration; and public or private pensions. The personal tax on total income is to be levied in the State where the taxpayer has his normal residence, and the State of residence is to deduct from the total income in either of the following ways whichever is the less, either the actual amount of the tax

[1] P. 10, Report of Government Experts on Double Taxation and Tax Evasion (1928, ii. 49).

[2] *Double Taxation and International Fiscal Co-operation* (Macmillan, 1928)

paid in the other contracting State on income from immovable property and industrial, commercial, or agricultural undertakings, or the amount on this income at the rates in force in the State of origin. By residence is meant the taxpayer's permanent home, *i.e.* where he resides for some time. "Even a person who stays at an hotel for several months may be considered as normally residing there. Moreover, a State is always free to tax any of its own nationals who would not be taxed because they are continually moving about." [1] An example of this method of avoiding double taxation on the lines above is as follows. If A in Great Britain has an income of £10,000, £2000 of which he derives from a ranch in South America, where an impersonal tax of £400 on this £2000 is levied, he will be taxed by the authorities in Great Britain under this scheme in either of the following ways. Let us assume that he is a married man with three children under the age of sixteen, and that therefore he will pay 30 per cent of his income if this is entirely earned,[2] *i.e.* £3000. From this, £400 will be deducted so that the tax will be reduced to £3000—£400 or £2600. Alternatively £2000 may be taxed at the British rate (30 per cent), *i.e.* £600, and this will be deducted from £3000, *i.e.* £3000—£600 or £2400. The taxing authority in Great Britain would deduct the lesser amount, viz. £400. Annuities are, it may be noted, to be taxed in the State of residence "since the recipient is free to select the country which is to be liable for the payment".

22. Draft Conventions I*b* and I*c* do not distinguish between impersonal and personal taxes but they retain the same provisions of Convention I*a*, viz. priority in taxation to the country of origin in regard to income from immovable property and industrial, commercial, or agricultural undertakings, the two great sources of income. Salaries, wages, public pensions, fees

[1] P. 14, Report of Government Experts on Double Taxation and Tax Evasion (1928, II. 49). Cf. the Report (in two volumes) of the Committee appointed by the Chancellor of the British Exchequer to draft a Bill codifying the law relating to income tax, published in April 1936, especially in regard to the meaning of residence and also the problem of Dominion income-tax relief—*vide* Cmd. 5131, 1936, pp. 34-44, 112-13, 215-20, and Cmd. 5132, 1936, pp. 5-7 and 74-81. There are, as stated in the Report, two conditions governing relief in respect of Dominion income tax in the United Kingdom, viz. (1) that the taxpayer pays both United Kingdom income tax and Dominion income tax on his income or part thereof; and (2) that he pays the two taxes for the same year.

[2] Colwyn Report, Cmd. 2800, 1927, p. 95.

of managers and directors are also to be levied according to country of origin. There is, however, one essential difference from Convention I*a* in that income from transferable securities shall be taxed by the State of domicile or residence. Abatements in regard to these movable assets will be allowed either by the State of origin (Convention I*b*) or by the State of domicile, by not levying a special tax upon the same income or by deducting from such tax the amount paid in the other State (Convention I*c*). The Convention dealing with succession duties recognises the difficulty of double taxation when States tax according to the domicile of the deceased and the *situs* of his assets. The duties are to be collected by the State of residence. The country of residence will tax the whole of the property, but the other State will tax only that portion of the property situated within its territory. The country of residence shall allow the lesser of the two following amounts to be deducted: (1) the actual amount levied by the country of residence on assets situated in another country, or (2) the actual amount of duty payable on such assets in the country in which the assets are situated. This shall be applicable to immovable property and furniture and fittings relating thereto and to any other categories of wealth which may be agreed on by the contracting States. It is provided also that debts secured on or relating to assets shall be deducted from the value of the assets.

23. The Convention on administrative assistance in matters of taxation provides for the reciprocal assistance by the contracting States in matters connected with the supply of information which will obviate taxing more than once and also evasion. The Convention does not raise serious difficulties except in the case of transferable securities. Governments do not possess as a rule an effective check in this respect as in that of other taxable wealth. The Convention on assistance in the collection of taxes, as its name applies, will, when ratified by contracting countries, greatly assist in the collection of taxes in certain circumstances and with proper safeguards. Whether the Convention is to apply to provincial or communal taxes or taxes levied by other public bodies is left for the contracting parties to decide.

24. The practical difficulties in the way of the acceptance of general principles are often very great, a fact recognised by the Committee of Economic Experts in the alternatives for the method

of reciprocal exemption. Debtor countries may be sometimes hardly hit as compared with creditor countries in bilateral double tax agreements because their Treasuries stand to lose much more than their residents gain. In debtor countries, too, income, corporation and inheritance taxation is often crude, being based on the theory of *situs* and lacking in progression as compared with similar taxation in creditor countries. But in recent years the main principles have been agreed on. It is the working out of the details that still call for solution. Thus all tangible wealth, with the exception of jewellery, money, and the like, should be taxed according to *situs* or origin, while intangible wealth, except real-estate mortgages, should be taxed according to residence or domicile. In regard to income taxation the principle of residence has in the main been accepted, and the basis of relief has been the reciprocal exemption of the non-resident. Where in some countries reciprocal exemption appears to be unworkable, alternatives have been put forward such as the method of deduction, the method of the division of proceeds, and the method of classification. By the first of these the resident may be permitted to deduct from his assessment the amount actually paid in the other country on the same item of wealth. By the second the division of the proceeds may be made in agreed proportions between the country of residence and the country of origin. By the third the various items of wealth may be treated separately, some of the proceeds being assigned to the country of residence and some to the country of origin. In domestic double taxation in recent years considerable progress has been made, notably in the United States, in the apportionment of corporation taxes, the criteria of apportionment being such factors as the relative amounts of property, gross receipts, wages, salaries and commissions paid, and the cost of goods in each State. There is still much confusion in the taxation of real estate, and dividends from corporations otherwise taxed are sometimes taxed again.

The Single Tax

25. No reference has been made in discussing the distribution of the burden of taxation to the single tax, which is, as its name indicates, the only tax on some one class of things, usually land, in a country's revenue system. The omission has been intentional,

because the single tax is outside the sphere of practical finance and is now more a question of ethics than economics. Viewed historically, it has been of advantage as a reaction against high or oppressive taxation. Adam Smith mentions Alcázar de Arriaga who propounded in 1646 the *single* Alcavala,[1] in his book *Nueva Declaracion de un medio universal para extinguir los tributos en Castilla*, or *New Declaration of a Universal Plan for Suppression of Taxes*. In 1671 another Spaniard, Centani, submitted to the King of Spain a memorial [2] in which he asserted definitely that " la tierra es la verdadera y fisica hacienda " (land is the only real wealth), and insisted on the removal of indirect taxation in favour of a single direct tax founded on an extensive cadastral survey and with no exemptions for the nobility or the Church. He has rightly been regarded as the direct ancestor of the Physiocrats Quesnay and Turgot.

The single tax of the Physiocrats (*l'impôt unique*), in the words of Quesnay, the great master of the school, was to be levied " directly on the net return (*produit net*) of land and not on wages, or on the (gross) produce, in which case it would increase the cost of production, be detrimental to trade, and destroy annually a part of the wealth of the nation ".[3] It was to be imposed on land as the ultimate source of all wealth. The *impôt unique* was not to be rigorously applied, as is sometimes thought. Mirabeau the elder, for example, was prepared to make the land tax responsible only for one-third of the revenue, the remainder being from the

[1] The Alcavala or Alcabala is really a turnover tax and had a long history in Spanish finance. It has been traced back to 171 B.C. when certain Spanish communities complained against the praetors farming out the tax irregularly. In the twelfth century it is a community tax and in 1342 became general, usually in the form of a 5 per cent tax on turnover from the producer to the consumer. From 1785 the tax was made payable on the first sale only and subsequent sales were free of tax. The Alcavala was thus a production tax. The radical reform of 1785 paved the way to its abolition by decree of June 20, 1843, and finally by the federal law of May 23, 1845. The name to-day refers to special transfer taxes such as the tax on real estate. It is doubtful if Uztariz, quoted by Adam Smith (*The Wealth of Nations*, Bk. V. ch. ii. part ii. art. iv., Cannan, ii. 383), is right when he attributes to a single cause, to the Alcavala, " the ruin of the manufactures of Spain ".

[2] Madrid, 1671, *vide* Colmeiro, " Biblioteca de los economistas españoles " (Real Academia de Ciencias Morales y Políticas, *Memorias*, vol. i. (1861), pp. 104-5).

[3] Vide *Œuvres économiques et philosophiques de F. Quesnay, fondateur du Système Physiocratique, avec une introduction et des notes par Auguste Onckeu* (Frankfort-sur-le-Main, 1888); cf. Higgs, *The Physiocrats* (London, 1897).

income tax. Turgot in his *Réflexions sur la formation et la distribution des richesses*,[1] like all practical financiers, saw that the Physiocrat doctrine was an ideal, as he was of opinion that the time had not arrived even for the abolition of the troublesome octroi. In the latter half of the same century three writers, Ogilvie, Spence, and Paine, were forerunners of Henry George. Ogilvie, a Professor in King's College, Aberdeen University, in his *Essay on the Right of Property in Land* (1781) believed that land values were made up of three values—the original natural value, the value of improvements, and the potential value. The first and third elements should belong to the community and a land tax should be levied on these : the second belongs to the cultivator. Spence, the author of *The Real Rights of Man* (1793), was in favour of a single tax on rent to be collected by parishes. Similarly Paine in his *Agrarian Justice* (1797) was a critic of private property in land and advocated the absorption of rent by taxation for social purposes. In the following century, before George's *Progress and Poverty* appeared, there were several writers who supported the essentials of his doctrine, notably Dove, Spencer, Marx, and German supporters of *Bodenreform*. Henry George, a San Francisco journalist,[2] in the eighties of the nineteenth century aimed, like his great predecessors more than a century earlier, at a single tax. He was for the appropriation of all rent by taxation and for the abolition of all taxation save that upon land values. His theory differs in many ways from the Physiocratic doctrine of the *impôt unique*, and it is unfortunate that the term single tax was adopted from this source. He held that it was the monopolisation of land that kept men in poverty ; that land was becoming scarcer and scarcer and the clutch of landlordism tighter and tighter ; that rent was an unearned increment which reduced wages and interest by its total amount ; that the grand problem, therefore, was to dispossess those enjoying the unearned increment and to free those whom he believed to be the true possessors of wealth. John Stuart Mill, it will be remembered, was in favour of taxing the

[1] A translation of this will be found in Prof. Ashley's Series of Economic Classics, New York, 1888.

[2] *Progress and Poverty* (San Francisco, 1879) ; *Social Problems* (New York, 1884) ; *The Land Question* (New York, 1888). Cf. F. A. Walker, *Land and its Rent*, 1883 ; Young, *The Single Tax Movement in the United States* (Princeton, 1916) ; *Damaschke Die Bodenreform* (Jena, 1920).

future unearned increment of land as an additional method of raising revenue, but Henry George went very much further. He advocated the abolition of all taxation save on land revenues, which was to appropriate entirely economic rent. The influence of Henry George was in the eighties of last century considerable. Millions of copies of his *Progress and Poverty* were sold. The practical result of his teaching has been in some instances to place the burden of taxation on the value of the land and not on the value of improvements made on it. Similarly a writer has recently proposed [1] an annual production tax of 10 per cent or other required amount assessable upon an employer of labour and capital, the independent worker, and owner-user (*i.e.* a person who owns capital and himself uses that capital).

A single tax has great drawbacks—(1) that it will not bring sufficient into the Treasury to balance the budget; and (2) that it would mean a very unsatisfactory distribution, all things considered, of the burden of taxation. In other respects, too, it is not satisfactory, as, for example, it would generally be relatively difficult and expensive to collect. How would valuation on such a scale be made ? Again, it is not possible to make any clear-cut demarcation between rent and profits such as the single-tax theory contemplates. " They shade ", as Hadley rightly points out, " into one another by insensible gradations. Though rent is more permanent than profits, we cannot regard it as enduring for all time, since land may lose value as well as gain by it." The theory would deprive the landowner of the surplus over the current rate of interest without compensation for his losses. Capital would then tend to be shy of schemes of land improvement. If compensation were given it might quite well do away with the gains from the single-tax system. On political and indeed on ethical grounds there are many difficulties. Is no compensation, for example, to be given for recognised rights ? How could it be applied to those whose wealth is not in land ? Composite taxation, a mixed system of taxation on the other hand, has not those drawbacks. The anomalies between persons under a single tax are corrected, and evasions more easily detected. Moreover,

[1] *Vide* " The Foundation of Taxable Capacity—A New System ", by P. D. Leake, F.C.A., read before the London members of the Institute of Chartered Accountants on Tuesday, April 24, 1923; published in the *Accountant* of April 28, 1923

under a diversified scheme of direct and indirect taxation, the ability of all classes to pay is taken into account. Indirect taxes are usually, although not always, voluntary taxes in the sense that the taxpayer, who does not consume these articles, is a non-payer of taxes. The present income tax hits marginal expenditure, and is deducted at the source, and is less felt than if it were collected otherwise, *i.e.* when the taxpayer had spent most of the tax. An inheritance tax, as we shall see, on account of the large increase of personal wealth to the beneficiaries, is paid at the time when tax payments normally take a secondary place, and is a good tax all things considered. Particular taxes like the income tax and the inheritance tax are sometimes criticised because of their complexity, but this is often unavoidable, especially where multiplicity is reduced to a minimum. After all, a finance minister has to make the Government pay its way, and his mind must be locked and bolted to this result. He cannot afford to base taxation on any one principle. A single tax is for this wholly impracticable, and he must needs have recourse to a multiplicity of taxes. He has, indeed, in taxation to live up to the principle of Martial's epigram, " Principis est virtus maxima nosse suos ". Like Gladstone in his budget speech (that took, it is said, five hours to deliver)—the speech of 1853—he has often to remove old taxes that cramp or harass trade and industry. If the finance minister comes into office after a great war or a national calamity like famine or earthquake, he has to find money for the Treasury wherever he can. But this is not all. He has to be a man who could never lose his head. As a brotherhood finance ministers are usually plain and unpretending men, gifted with indomitable wills and iron minds, tireless workers, very precise in statement and with a clear grasp of detail. In the distribution of the burdens of taxation they require to possess the genius of common sense in its highest and best development.

CHAPTER XVIII

THE SHIFTING AND INCIDENCE OF TAXATION

1. "BEAUTIFUL things are hard", says the proverb, and this applies especially to a discussion of the principles of the shifting and incidence of taxation. In this chapter it is proposed to deal with the shifting and the general laws of incidence of taxes. The subject has frequently been treated with scant justice, but some writers have treated the subject with admirable impartiality and fulness.[1] It is interesting to study the general principles in view of the mistaken theories that have been propounded even by Sir Robert Giffen and Lord Avebury. Sir Robert Giffen, for example, in discussing taxes on property and profits, said that "they are the last of a heavy burden of a similar kind, and the fact that they are the last is so far a proof that they have been distributed—that if the persons who pay them suffered at one time, they have long since been compensated. Any long-continuing tax on profits tends to adjust itself, but in the case of England during the last thirty years the adjustment has been favoured by the remarkable growth of the country under the stimulus of the removal of other taxes." [2] Lord Avebury, in his address as President of the Royal Statistical Society on Local and Imperial Burdens before the Royal Statistical Society in 1901, similarly attempted to flirt with the theory which will be referred to later as the diffusion theory. He remarked, "However unjust may be the incidence of rates or taxes in the first instance, still, when new contracts have been made, when a new generation has grown up, when other circumstances have adjusted them-

[1] Notably Seligman in his book on *The Shifting and Incidence of Taxation* (Columbia University Press, New York, 3rd edition, 1910).

[2] *Essays on Finance*, 1st series, p. 238. Cf. Avebury, "Local and Imperial Burdens", *Journal of the Royal Statistical Society*, December 1901.

selves, time has in fact done much to redress the balance and remedy the injustice".[1] Long before this the distinguished judge Lord Mansfield, towards the end of the eighteenth century, was of a similar opinion when he said, "I hold it to be true that a tax laid in any place is like a pebble falling into and making a circle in a lake, till one circle produces and gives motion to another, and the whole circumference is agitated from the centre". With views of this sort there is a pleasant prospect of misunderstanding on this important question.

Definitions

2. The necessity for the definition of the terms "shifting" and "incidence" is obvious. After the impact of the tax, or, as the Italians call it, "percussione", there is frequently the process by which the payer of the tax puts the payment on to someone else, and thus relieves himself of part or all of the burden placed upon him. This intermediate process is known as shifting or "repercussione", or sometimes "traslazione". The impact of the tax is on the person from whom the tax is collected, while the incidence is on the person by whom the tax is borne. Incidence is the ultimate result of the shifting. It is a direct money burden. Thus the problem of incidence is the analysis to determine who pays the tax, *i.e.* on whom the money burden of the tax falls or rests. The total direct money burden of any tax is the yield of the tax to the Treasury, while the total direct real burden is the effect. Thus a tax may mean a greater sacrifice of economic welfare for A than for B, B being the richer of the two. This is, however, not a question of the incidence of the tax but of the direct real burden. The question of incidence should be separated from the more general question of effects. The British Committee on National Debt and Taxation referred to the distinction thus: "In general usage the term 'incidence' covers not only the initial burden of a tax, but also the whole range of consequential effects. Economists, however, have given it a narrower meaning. For them 'incidence' is only concerned with the question on whom the more immediate burden of the tax as a tax rests. This is the first thing to be decided about any tax. It is to be distinguished from the question of further effects, which may be exceedingly important. For instance, the burden of a tax may rest upon an

[1] P. 565, *Royal Statistical Journal*, 1901

employer, and in consequence he may cut down his staff; in such a case the effects of the tax may be more serious to the employees than to anyone else, but the incidence of the tax is not said to be on them." [1] The effects of a tax may be generally to remedy social inequalities, as, for example, through the progressive taxation of incomes and death duties, to encourage particular trades through protective duties, to bring about changes in the amount of production and consumption and in business organisation, to change the rate of saving, or to discourage the use of things having undesirable social effects such as alcohol. A tax may be shifted forward from the producer upon whom the tax is assessed to the consumer or purchaser. It may also be shifted backwards from the consumer to the producer when the tax is imposed in the first instance on the consumer or the purchaser. The theory of the "capitalisation" or, as it is sometimes called, the "amortisation" of taxation must not be confused with the shifting of taxation. The purchaser of securities which are taxed may discount the value of the securities by capitalisation of the tax in order to escape it. In other words, taxes on land and securities which are more or less permanent sources of income reduce the selling value of the object taxed when they are first imposed. Subsequent buyers, however, do not have the burden transferred to them because they buy with a knowledge of what the tax is. They are said to reduce the price which they will pay. If, however, the tax were repealed the holders of the thing taxed would be the gainers through an increase in the selling value of the thing taxed as well as an increase in the income derived from it. The incidence, accordingly, of the tax would be on the owners. Similarly new purchasers of tax-exempt securities pay *pro tanto* more for them on account of the general exemption from taxation. The theory underlying amortisation rests on the fact that a tax on profits and pure rent does not enter into price and is a net deduction on the particular profits taxed, and investors look not to gross but to net yields, the income being capitalised by the market, a fact long ago pointed out by Turgot in his *Réflexions sur la formation et la distribution des richesses* in regard to land.

3. The problem of the shifting of taxes is not to be confused with tax evasion, which may be either legal evasion or illegal

[1] Cmd. 2800, 1927, p. 106.

evasion. A government may impose high protective tariffs or high excise duties and the taxpayer may refrain from the consumption of such articles that are so taxed. This would be legal evasion. It is sometimes called the minimising of taxes or the reduction of legal tax liability to the lowest possible minimum. Taxes may be avoided by transformation in cases in which the tax leads to technical improvements in the business, the value of which offsets the burden of the tax. Similarly taxes on income are legally evaded when firms and individuals in British India, for example, buy and keep sterling and dollar securities in London and New York respectively, but do not bring the interest into India for a period of three years or more. The formation of trusts according to law, especially by rich people in England in favour of their children, is also of this type. Illegal evasion, however, occurs where there is smuggling, where firms do not keep correct accounts, and where super-tax is dodged by the fictitious creation of (1) partnerships with one's wife and minor children as partners; (2) private limited companies; and (3) subsidiary trusts. An example of a subsidiary trust is the case where a Trust Corporation, a private limited company, was formed in Hongkong to finance a British Indian concern. The British Indian corporation contended that the interest paid by the latter to the former was not liable to tax although the British Indian concern is its Statutory Agent in British India. The company was held on appeal to the Privy Council to be liable for taxation. The undistributed profits of companies are not liable to super-tax in India, and it would, therefore, pay the owner of "one-man companies" to refrain from declaring a dividend at all.[1] Loans (which are not taxable) are sometimes given at a nominal rate of interest to shareholders without any intention of demanding payment of principal. Cases have been known where three sets of accounts were kept, one for income-tax purposes, another for the law courts, and a third for the owner's own use. A rich moneylender in India assessed to income tax applied for a State loan the day before his income-tax objection was heard in order

[1] Section 21, Finance Act, 1922 (p. 347, "The Income Tax Act, 1918, and Finance Acts, 1919–1925". London: His Majesty's Stationery Office, 1925), provides that in the United Kingdom if a company which has not issued shares by public invitation is controlled by not more than five persons and the number of shareholders is restricted to fifty or less, the company should be treated as a firm, and super-tax should be levied on the entire profits.

to show his seeming "poverty". Another assessee appeared in a torn coat which the Collector had recognised earlier in the day on others.[1] It is also difficult for taxing authorities to assess the speculator in business or on the racecourse because of the absence of detailed information on these speculative gains.

Early Theories

4. Modern financial theory in regard to the shifting and incidence of taxation need not go much further back than the Physiocrats, who held that all taxation, except that on rent, was necessarily shifted, as agriculture alone in their view produced a net surplus, and therefore a tax wherever imposed must ultimately rest on land. This rigorous theory is, at first glance, a complete one; but there are certain very general assumptions; for example, wages are held to be at the minimum of existence and taxes on profits drive capital away from industry. The doctrine already referred to is most completely stated in Quesnay, who holds that taxes should be imposed directly on the net produce of land because it is always paid by the land. It should be, therefore, levied proportionally to net produce and directly on this source. Quesnay also emphasises what appears to him to be the evil results of indirect taxes, and he concludes that the landowners pay the whole of the indirect taxes levied on the goods they consume as well as on their employees. The teaching of the Physiocrats had naturally a considerable influence on Adam Smith, and through him on the thought of various countries in regard to the incidence of taxation. It was through the author of *The Wealth of Nations* that the fundamental doctrine of the *produit net* was refuted.

Adam Smith

5. Adam Smith discusses the problem of incidence in connexion with an examination of the various kinds of taxes. He held that every tax must be paid finally from one or other of the three sources of income, namely, rent, profits, including interest, and wages, or all of them indifferently. His theories of incidence, like those of Ricardo, hang on the theories of rent, profits, and wages propounded by him, and in so far as these theories are now

[1] Cf. J. P. Niyogi, *The Indian Income Tax* (London: King and Co.), p. 125.

regarded as incomplete or inaccurate, the theory of incidence requires to be modified or rejected altogether. The work of Smith, and especially that of Ricardo in regard to incidence, is valuable because of its paving the way to further studies on this all-important question. Conditions, however, are often so simplified as to be extremely abstract. Competition is not perfect, nor is the mobility of capital and labour in industry. Adam Smith regarded tax on land as falling on the landowner and incapable of being shifted. The tax may be paid by the farmer, but it will finally come out of the pocket of the landlord, since the farmer must have a reasonable profit. "Though the landlord is in all cases the real contributor, the tax is commonly advanced by the tenant, to whom the landlord is obliged to allow it in the payment of rent." [1] "When a certain portion of the produce is to be paid away for a tax, the farmer computes, as well as he can, what the value of this portion is, one year with another, likely to amount to, and he makes a proportionable abatement in the rent which he agrees to pay to the landlord. There is no farmer who does not compute beforehand what the church tithe, which is a land tax of this kind, is, one year with another, likely to amount to." [2] "The more a man pays for the tax, the less, it is evident, he can afford to pay for the rent." [3] Taxes, in Adam Smith's opinion, on the produce of land are in reality taxes upon rent, a point in which Ricardo holds a different opinion. A house tax falls partly on the owner or builder, and partly on the occupier. The author of *The Wealth of Nations* divides the rent of houses into ground rent and building rent, or what he calls "the interest or profit of the capital expended in building the house". [4] What is over and above this reasonable profit is the ground rent, which is similar to the rent of land. The proportion in which the tax falls on the owner and on the occupier is not "very easy to ascertain". "A tax upon the rent of houses, so far as it falls upon the inhabitants, must be drawn from the same source as the rent itself, and must be paid from their revenue, whether derived from the wages of labour, the profits of stock, or the rent of land. So far as it falls upon the inhabitants, it is one of those taxes which fall, not upon one only, but indifferently upon all the three different

[1] *The Wealth of Nations*, Bk. V. ch. ii., Cannan edit. vol. ii. p. 313.
[2] *Op. cit.* p. 321.
[3] *Op. cit.* p. 331.
[4] *Op. cit.* p. 321.

sources of revenue, and is, in every respect, of the same nature as a tax upon any other sort of consumable commodities. In general, there is not perhaps any one article of expense or consumption by which the liberality or narrowness of a man's whole expense can be better judged of than by his house rent." [1] Taxes on wages are transferred partly to the consumer in higher prices and partly to the landlord in lower rents. A direct tax on wages could not be paid by the labourer " at least if the demand for labour and the average price of provisions remained the same after the tax as before it ".[2] The employer increases his sale price in order to meet his larger wages bill if there is a tax on wages, or the farmer, who likewise must have his profit, gives to the landlord less produce as rent. But a rise of wages, as Mr. McCulloch points out, does not necessarily raise the price of commodities or lower rent. The incidence of the tax may be on the employers themselves or it may affect the labourer's standard of living. If the lower standard of living " become congenial from habit, no check would be given to population; the rate of wages would be permanently reduced ".[3] A tax on profits, like a tax on houses, is divided into two parts. There is interest and there is a surplus over and above this interest. The former falls on the owner as in the case of land rent, while the latter is shifted to the landowner or consumer. " Like the rent of land it (interest) is a net produce which remains after completely compensating the whole risk and trouble of employing the stock." [4] Taxes falling indifferently on every species of revenue include capitation taxes and taxes on commodities—necessaries and luxuries. Capitation taxes on the lower classes are shifted, being taxes on wages, to consumers. Taxes on necessaries also tend to increase wages, and like direct taxes on wages are passed on to the consumer or the landlord. Adam Smith says nothing of the possibility of harder work on the part of the taxed to make up for the tax. Taxes on luxuries will not affect wages but will fall on the consumers of the luxuries. Adam Smith, in short, holds that a tax on wages, profits excluding interest, and necessaries is shifted, while taxes on rent, interest, and luxuries are not.

[1] *Op. cit.* p. 327.
[2] *Op. cit.* p. 349.
[3] McCulloch's note, *op. cit.* p. 613.
[4] *The Wealth of Nations*, Cannan edit. vol. ii. p. 332.

Ricardo and Mill

6. Ricardo in his *Principles of Political Economy and Taxation* (1817) devoted considerable attention to the problem of incidence. Like Adam Smith he does not propound separately any general theory of incidence. A tax on economic rent is not transferable because, the rent being the surplus over cost of production, a change in the price of the produce cannot be affected by the tax. Taxes on produce or land taxes, however, are shifted by the landlord to the consumers, unlike the taxes on pure rent. (Ricardo thus differs from his great predecessor.) "Any tax", says Ricardo, "which may be imposed on the cultivator, whether in the shape of land tax, tithes, or a tax on the produce when obtained, will increase the cost of production, and will therefore raise the price of raw produce." [1] Price is fixed by the cost of production of the marginal land, and this land is subject to a tax along with land beyond this margin. The farmer cannot deduct the tax from his rent, because at the margin no rent is paid; he cannot deduct it from his profits "for there is no reason why he should continue in an employment which yields small profits when all other employments are yielding greater". This is a good example of Ricardo's abstract method and his bias towards rapid generalisation. In discussing the incidence of tithes and the effects of agricultural improvements it cannot be assumed that demand is unaffected by a rise or fall in price. Ricardo follows Smith in distinguishing building rent from ground rent, and points out that a tax on the rent of houses may fall on the occupier, the ground landlord, or the building landlord. "In ordinary cases it may be presumed that the whole tax would be paid, both immediately and finally, by the occupier." [2]

7. Ricardo had not the faith nor the experience of the modern economist in the improvement of the working classes. He agrees with Adam Smith that the tax would be shifted to the employer of labour. "Wages never continue much above that rate which nature and habit demand for the support of the labourer." A tax on wages will have no effect on the labourer "unless it diminished the demand for labour, because it will be immediately transferred to the employers of labour, and will consequently

[1] *Principles of Political Economy and Taxation*, ch. ix., McCulloch's edit., p. 91.

[2] *Op. cit.* p. 120.

diminish the profits of stock".[1] Ricardo's theory of a tax on profits is bound up with the theory of the iron law of wages and his theory of profits, viz. "profits depend on high or low wages, wages on the price of necessaries, and the price of necessaries chiefly on the price of food".[2] On the assumption that taxes raise wages he holds that profits will be decreased. "If a tax were general, and affected equally all profits, whether manufacturing or agricultural, it would not operate either on the price of goods or raw produce, but would be immediately, as well as ultimately, paid by the producers."[3] A tax on profits in general will remain on the capitalist, but a partial tax on profits (*i.e.* on the profits of a particular trade) will be transferred to the consumers of its products. Ricardo's reasonings on profits are, as Marshall remarked in a pencil note in his edition of Ricardo's works, "up in a balloon because he regards the world as consisting for all practical purposes of capitalists and manual labourers". Taxes on commodities paid by the producer are shifted to the consumer, as in the case of the profits of a particular trade. Taxes on commodities consumed by the labourers are shifted to the capitalists employing the labourers. This, of course, assumes that wages are at a minimum and that a change in them will at once act on population. Ricardo in discussing incidence sometimes speaks of a tax falling on a consumer. Thus "A tax on raw produce would not be paid by the landlord; it would not be paid by the farmer; but it would be paid, in an increased price, by the consumer".[4] "A tax on wages is wholly a tax on profits; a tax on necessaries is partly a tax on profits and partly a tax on rich consumers."[5] "A tax on luxuries would have no other effect than to raise their price. It would fall wholly on the consumer, and could neither increase wages nor lower profits."[6] The consumer is often used in a vague sense.

8. Ricardo is often extremely difficult to follow because the subsidiary postulates and those underlying the greater part of the reasoning are never explicitly stated. "My speaking", he writes in his letters, "is—like my writing—too much compressed.

[1] *Letters of Ricardo to McCulloch*, ed. Hollander, p. 55.
[2] *Principles of Political Economy and Taxation*, ch. vi. p. 66.
[3] *Op. cit.* p. 155.
[4] *Op. cit.* ch. vi. p. 91.
[5] *Op. cit.* p. 129.
[6] *Op. cit.* p. 146.

I am too apt to crowd a great deal of difficult matter into so short a space as to be incomprehensible to the generality of readers. I am fully aware of the deficiency in the style and arrangement: those are faults which I shall never conquer." Writing to Malthus in 1920 he said, "Our differences may in some respects, I think, be ascribed to your considering my book as more practical than I intended it to be. My object was to elucidate principles, and to do this I imagined strong cases that I might show the operation of those principles." The exaggerated simplicity of the problem and the isolation of phenomena without clearly and definitely stating the assumptions upon which the reasoning is based are patent faults in the Ricardian theory of incidence. Richard Jones, Professor of Political Economy at King's College, London, and successor of Malthus in the Chair of Political Economy and History at Haileybury,[1] and Cliffe Leslie (1827–82), founders of the English historical school of economics, show how the Ricardian theory failed on account of these assumptions to get to the root of the problem. It is not possible to work out from a few fast axioms which are never quite true and in many countries may be utterly untrue, principles of incidence.

9. J. S. Mill improved on Smith and Ricardo in one or two directions, but in regard to the incidence of a tax on profits merits the criticism of Jevons, who wrote in his *Theory of Political Economy* that "the only hope of attaining a true system of economics is to fling aside, once and for ever, the mazy and preposterous assumptions of the Ricardian School".[2] On the incidence of taxes on rent and profits Mill's conclusions are those of Ricardo. He differ from Adam Smith and Ricardo both in regard to the incidence of a tax on houses and on wages. He makes a considerable advance on Ricardo when he argues that a tax on ground rent will not fall entirely on the landlord, unless there is combined with it an equivalent tax on agricultural rent

[1] Vide *An Essay on the Distribution of Wealth and on the Sources of Taxation*, 1831, by Jones, especially the Preface, and the less-known *Text-Book of Lectures on the Political Economy of Nations*, 1852 (Collected Works, ed. by W. Whewell, 1859).

[2] *Theory of Political Economy*, p. xliv (4th edition, 1924); cf. p. li, "That able but wrong-headed man, David Ricardo, shunted the car of Economic Science on to a wrong line—a line, however, on which it was further urged towards confusion by his equally able and wrong-headed admirer, John Stuart Mill".

If a tax were laid on ground rent only it would, "unless of trifling amount, reduce the return from the lowest ground-rents below the ordinary return from land, and would check further building quite as effectually as if it were a tax on building-rents, until either the increased demand of a growing population, or a diminution of supply by the ordinary causes of destruction, had raised the rent by a full equivalent for the tax".[1] Mill concludes that the ground rent in the great majority of cases forms only a small portion of the annual payment made for the house, and nearly all the tax falls on the occupier. Mill's views of the incidence of a tax on wages differs from that of Adam Smith and Ricardo because he holds that in the case of skilled labour the tax will be borne by the labourers themselves, since their wages are in his view "at a monopoly price". The tax may be borne by unskilled labour itself by a reduction in the standard of living. It may be shifted when the tax causes a fall in population, consequent on the decrease in the standard of living, and wages rise. Mill with his Ricardian vigour did much to bring into relief the principles of incidence as outlined by Adam Smith and Ricardo.

The Diffusion or Absorption Theory

10. That very comfortable theory, the diffusion theory of taxation, has already been referred to in connexion with the names of Mansfield and Avebury. This theory is in contrast to the theories which aim at investigating the complicated shiftings that settle the ultimate incidence. It denies the possibility of ascertaining these shiftings, or it assumes that these shiftings bring about a general diffusion of taxation over the whole of society equitably. In other words, the individuals from whom the tax is collected do not ultimately bear the burden but shift it on to other classes so that it is diffused over a large area. The diffusion is effected by exchange, buyer and seller in each transaction dividing the amount of tax imposed, and at every fresh exchange a division of the part of taxation transferred takes place, until ultimately the charge is spread over the whole of the parties concerned. By far the best exponent of this theory

[1] *Principles*, Bk. V. ch. iii. § 6.

is the author[1] of *An Enquiry into the Principles of Taxation, chiefly applicable to Articles of Immediate Consumption.* It was published in London in 1790, and Seligman rightly holds that it is "perhaps the most interesting and original exposition of the doctrine". The writer, although supporting this theory, has many very sound ideas as to the shortcomings of incidence as detailed by Adam Smith and his contemporaries. He points out that economic progress provides a fund for the payment of taxes, and it is from this surplus derived from the improvement of society that taxes are paid. In his own words, "it is rather the improvement and the thriving situation of the society at large that may be said to sustain the taxes than the individuals who merely pay them". He further holds that "taxes will become lighter in proportion to the number of hands through which they pass in a thriving society. . . . In order to show that improvements furnish funds for taxes it is not necessary that we should be able accurately to trace the manner in which improvements insinuate themselves through society; nor how a tax is diffused among the various classes of citizens." He concludes that "in stationary and declining societies, taxes on consumption fall universally on all ranks; and in thriving societies attach themselves to those citizens who are unprosperous at the time". Although the author limits the theory to taxes on consumable commodities, his reasoning, as Seligman points out, is equally applicable to other forms of taxes. Seligman rightly sums up the work as "a very remarkable contribution which ought not to have suffered oblivion". In the classification of all taxes he is also ahead of his time.

It is to Canard (1750–1833), whose book was published[2] in 1802, that the diffusion theory is in many ways best ascribed. He cannot, however, be called the founder of the theory any more than Hamilton. He held that the net product was applicable to

[1] Seligman appears to be quite wrong in attributing the authorship of this work to Andrew Hamilton, a professor at Aberdeen. Seligman has evidently been misled by the *Bibliotheca Britannica* (1824), by Robert Watt, and the *Dictionary of Anonymous and Pseudonymous Literature of Great Britain* (1882), by Samuel Halkett and John Laing. The ancient University of Aberdeen never had a professor of that name. The work appeared anonymously just about the time when Robert Hamilton (1743–1829), Professor at Aberdeen University (1799–1829), the author of the *Enquiry concerning the Rise and Progress, Reduction and Present State, and the Management of the National Debt*, 1813), was writing on such subjects.

[2] *Principes d'économie politique.*

labour, commerce, as well as land, and therefore taxation falls on all three, and he compares taxation of any one branch to the operation of cupping. After the taking of the blood from the vein it is not more bloodless than any of the other veins owing to the circulation of the blood through the body, so he believes it is with profits which are not diminished by a tax. The profits of all other branches flow in at once until equilibrium [1] is restored and finally the tax is borne by all. He believes that every old tax is good; every new tax is bad, as it upsets or deranges the equilibrium, but the new tax becomes good in time provided it is continuous sufficiently long. His solution of the problem is to replace all existing taxes by a tax on salt.

To sum up, the diffusion or, as it is sometimes called, the absorption theory denies the possibility of ascertaining the shifting and incidence of taxation, and it assumes that this brings about a diffusion of the burden throughout the social whole. Few will agree with Stein that taxation is always part of the cost of production, and that it therefore enters into price with the result that it is diffused throughout the community. Taxes on profits, interest, and wages are not always a part of production. It overlooks the fact that some taxes cannot be shifted, for example, poll taxes, inheritance taxes, and certain taxes on monopoly, a tax on unimproved land, not to mention income tax. The theory cannot be logically supported and it is also contrary to experience. This theory, however, although it is contrary to the world of actual fact, and although it attempts to prove more than it can, has been of considerable advantage, because it emphasises the fact that taxes do not rest where they are assessed. That is its one main redeeming feature. It rests, as Walker said, upon the assumption of perfect competition, but perfect competition cannot exist where there are ignorance, inertia, poverty, and fear in a community. The wealth of society from which taxes are paid cannot be compared to a fluid or to cupping, but should be compared, as Say rightly said, to a tree or the body,

[1] Cf. also the remarks of Alexander Hamilton in the *Federalist*, where he compares taxes on consumable articles to a fluid which will in time find its level. The representative of the National Union of Manufacturers, in his evidence before the Colwyn Committee, was "convinced that the burden (of taxation) becomes automatically distributed by a law of political economy that defies all Acts of Parliament. The difference between direct and indirect taxation", he said, "hardly exists in actual fact" (Cmd. 2800, 1927, p. 109).

no part of which can be cut out without disfigurement. The theory presents a strong contrast to that of the classical school, which realised the importance of looking into and examining in detail the "seating" of taxation, with the object of effecting legislation on conclusions arrived at in regard to the equitable distribution of taxation. The "diffusion" or "absorption" theory of incidence is a useless theory. Taxes indeed are often widely diffused. But it is nevertheless quite possible to reach definite results regarding their incidence.

General Principles

11. The incidence then of the various kinds of taxation is clearly one of the most difficult problems in the science of finance. The argument, at first sight somewhat specious, that taxes are diffused or absorbed until the burden of the tax or taxes cannot be determined and that nobody's burden is probably heavier than anyone else's, is far from sound. As has been emphasised, many taxes are, as a matter of fact, diffused, but it is certainly possible to reach definite conclusions as to their shifting and incidence and economic results. The view that taxes fall on everybody assumes that all taxes enter into the cost of production, an untrue assumption obvious to anyone who considers that taxes are levied on persons in cases where there is no idea of the relation of producer and consumer. Earlier in this chapter we have distinguished between the impact of a tax and its incidence. The original persons who pay the tax feel the impact of that tax; the persons who bear the direct money burden, or what may be said to be the equivalent of the yield of tax to the Treasury, are those on whom the incidence falls. The incidence may or may not be the same as the impact. It is, perhaps, unnecessary to repeat that taxes are paid by persons and not by goods or things. The amount of the tax is usually connected with goods or things and the relation of the person to these. In the case of houses, for example, the tax is fixed according to the capital or the annual value of the house. The property merely measures the amount of the tax which is levied on persons whose relation to the property is that of owner. A thermometer measures heat: so with taxation—taxes are placed often on things, but that is merely for the sake of measurement. They are paid by

persons, not by things. Some taxes are paid by those who feel the impact. They are direct taxes, *e.g.* on income, inheritances, and certain taxes on monopolies, while others are passed on to others indirectly, *e.g.* taxes on imports, excise duties, and the gross receipts of limited companies. In practice it is usually assumed that a tax on a commodity is always an indirect tax. If the tax, when levied, results in no rise in the price of the commodity if collected from the producers, it is in reality a direct tax. If collected from the consumers and the price is decreased to the full extent of the tax, it is also a direct tax. Similarly, an income tax may result in a rise in the rate of interest in the long run, because it produces a reduction in saving; those who are investing new savings in concerns at the higher rate have really shifted part of the incidence of the tax on to the shoulders of those who are demanding new concerns. A tax, it is often pointed out, which is proportionate to the output of a monopoly may be an indirect tax, while a tax independent of the output of the monopoly may be really direct.

Incidence then depends on several factors. Among these are the presence and the intensity or absence of competition, the nature of the tax (*i.e.* on what the tax is levied and whether it is a light tax or a heavy tax), whether the article is an intermediate good or a final good and is produced at increasing, decreasing, or constant costs per unit, whether from the viewpoint of demand there is elasticity or inelasticity. It is sometimes assumed that free competition exists when it does not and normal conditions of supply and demand are assumed when they are in reality abnormal. The greatest care, therefore, must be taken to see that the conditions regarding the levy of the tax do not differ materially from the assumptions made in the theoretical analysis. Free competition is not often met with in ordinary business and pure monopoly is rare. Under the former prices tend to correspond with the cost of production at the margin and so a tax on the costs of the marginal producer will be shifted. The theory that the taxpayer may not be able to shift the tax in the case of monopoly may or may not require qualification. Where maximum net returns rather than cost of production determine prices, the taxpayer cannot hope ordinarily to increase his prices and to obtain a larger net revenue. Shifting, therefore, is not probable. A tax upon surplus rather than on costs may influence prices

only indirectly. If the capital used in producing the article is not mobile and is not easily adapted to an alternative use, the chance of shifting is likely to be less remote than it otherwise would be. If the tax is light the taxpayer may not shift it because of the risk of a change in prices, especially if the price is a customary one. In short, in the theory of incidence care must be taken to study the effects of the tax on normal equilibrium and to see whether it affects costs of production. The problem has to be approached from the viewpoint of price, and all possible changes in supply and demand must be carefully examined. If the conclusions are to be of value, the conditions actually existing under the particular tax must not vary from the assumptions which have been made. Conclusions, for example, on the incidence of a tax on net income may be vitiated unless the tax is first of all analysed in order to see whether it is a tax on pure profit or also a tax on rent, on interest, on earnings, or on capital. At every step in the field of shifting and incidence one must walk very warily.

The Use of Statistics in Incidence

12. A caveat is necessary here in regard to the use of statistics in dealing with questions of incidence. The effect of a tax on a commodity is often of small importance in its price as compared with changes in other factors. The tax may be, in short, only a small factor as compared with other factors determining the price. In March 1923 the salt duty in India was doubled, and the actual increase in the duty was one rupee four annas per maund of 82$\frac{2}{7}$ lb. In August 1923 the increase in the price of salt as compared with February 1923 was more than the extent of the tax in various centres, and as compared with August of the previous year was less than the extent of the tax except in Madras, Allahabad, and Lahore. There are, however, other factors to be considered in dealing with the rise of salt prices besides the increase in the duty. Prices rose as they ordinarily do during the monsoon. On an average of five years it is found that in Bombay the price of salt is higher during the period June to November than in other months, as the tendency is to take delivery of as little salt as possible during the monsoon period, when the salt deteriorates quickly through moisture. In many markets the retail prices of salt had not increased by the extent

of the duty, and there were other factors at work. The incidence of a tax on a commodity cannot be determined merely by a comparison of the prices before and after the imposition of the tax either in the same country or between different countries. The greatest care is required in making deductions on incidence from price statistics, because the tax is only one factor, and often a small factor, which produces the change in prices. Incidence is, of course, a price question, and part of the wider theory of value.

THE INCIDENCE OF TAXES ON COMMODITIES

13. Taxes on commodities generally affect the prices at which the taxed commodities are sold. Indeed, the question of incidence is a part of the general theory of value.[1] As a rule a tax tends to raise the cost of production. The producer will try to shift the tax forwards on to the shoulders of the consumer by raising his selling price. Similarly a tax on the consumption of any good is shifted backwards in a greater or less degree on to its producer. If the producer does not succeed in shifting the tax, the margin between the selling price and the cost of production, *i.e.* his profit, will decrease. If A is the price before the tax and B the tax, the price after the imposition of the tax to the consumer may be A + B. This, however, is not necessarily the case. The price may continue to be the same as before, *i.e.* A, or it may be less than A + B on account of certain factors governing the incidence of the tax. It may be even lower than the original price, A, when an untaxed supply is discovered and people give up using the taxed article and take to the untaxed substitute. What then are the conditions governing the incidence of the tax?

These conditions may be summed up as follows: (1) The existence or non-existence of mobility in regard to capital and labour. Anything that checks mobility checks, too, the shifting of the tax. If there is complete mobility of capital and labour and no economic friction, taxes on commodities, other things being equal, will be shifted from producers to consumers. Where mobility is imperfect the shifting of the tax forwards to con-

[1] Cf. Seligman, *Shifting and Incidence of Taxation*, Part ii. ch. i. p. 221; Edgeworth, "Pure Theory of Taxation", *Economic Journal*, 1897.

sumers is impeded. In agriculture capital cannot be transferred quickly into other industries. Much of it is sunk in the soil or in buildings and is almost irremovable. In the Stock Exchange, however, capital moves rapidly and easily. Between these extremes there are varying degrees of mobility. Labour between one country and another may be said to be almost immobile, and even in the same country there is a larger degree of immobility between highly skilled trades. In short, where mobility is present the normal incidence of the tax will be on the consumer, and, where it is absent, on the producer. (2) There is the presence of competition or the absence of competition, *i.e.* monopoly. If a tax is assessed upon a monopoly as a unit or on the net profits of the monopoly, *i.e.* if it is independent of output, it rests where it falls. It does not affect the price which will give the monopolist the greatest monopoly revenue. If the tax is levied on gross sales, like a turnover tax, or in such a manner that the tax increases proportionately to the increase in production, it will be shifted in a greater or less degree. The tax will make it possible for him to curtail his production and to raise his price. Of course he can always raise his price in whatever way the tax is assessed to make the consumers think they are paying the tax and to induce them to agitate for its appeal. This will obscure the real incidence of the tax. The problem, however, of the theory of incidence in regard to monopoly requires further examination and is dealt with below. (3) There is the law of demand and supply. On this again depends the shifting of the tax back to the producers of the commodity. The more elastic the demand for the article taxed, the more, other things being equal, will the incidence of the tax be on the producer, while the more elastic the supply the more, other things being equal, will the incidence of the tax be on the consumer. In other words, the incidence of the tax will be divided between the consumers and the producers according to the proportion of the elasticity of supply to the elasticity of the demand for the article taxed. The more elastic the demand, the more will it tend to fall off on account of the rise in price as a result of the tax. The producers will be unable to shift the whole burden of the tax to consumers. The more inelastic the demand, as, for example, the case of necessaries, the more will a tax on these raise their price as compared with an equivalent tax on luxuries, the demand for which

is elastic. The more elastic the supply, the more will supply fall off and the less will consumers resist the rise in the price of the article taxed. Speaking generally, we may say that producers shift the tax as far as possible on to consumers by reducing the supply, and consumers shift the tax on to the producers by reducing their demand. The success of either party depends on their relative strength to carry this out with the minimum of loss. As a general rule the consumer bears a smaller part of the tax when the demand is more elastic than the supply than he does when the supply is more elastic than the demand. If there is a rise in price due to the tax the extent of the rise will be greater in the case of commodities produced under the law of increasing returns than in those produced under the law of constant or diminishing returns. The reason is that the cost of production per unit will be greater in the case of increasing returns on account of the decreased supply caused by the rise in price owing to the tax. In the case of commodities produced under the law of constant returns the cost of production will be constant and lower under the law of diminishing returns. (4) The method and amount of taxation are also important factors in determining the incidence of taxation. Is the tax, for example, to be levied on actual production, or supposed production, and at what stage in production is it to be imposed ? A tax on produce at the margin will raise the price of the whole supply, while a tax on surplus or profits would not.[1] Small additional taxation is not always easily shifted. Shifting commences as soon as the additional taxation is perceptible or can be distributed without difficulty. The producer would be unwilling to annoy his customers by shifting the tax to the consumer. If elasticity is such that the tax can be shifted without affecting the demand the producer will shift, *ceteris paribus*, the tax to the consumer, or what amounts to the same thing, he will alter the quantity sold rather than the price in order to escape the tax. A proportional tax is more likely than a progressive tax to enter into price for the reason that the progressive tax may not reach the margin at all, falling as it does more heavily on the more favourably situated producers.

Many combinations of these four main divisions may be made. Mobility, for example, or immobility may be combined

[1] See also Chapter XIX. pp. 364, 373.

with competition or monopoly, or with elasticity or inelasticity of demand and supply or with the method and amount of taxation. If mobility is A, immobility *a*, competition B, and monopoly *b*, C elasticity, *c* inelasticity, and D a tax on marginal produce, and *d* a tax on profits the combinations may be ABCD, *a*BCD, A*b*CD, AB*c*D, ABC*d*, and so on. It is to be remembered that taxes are shifted with varying degrees of difficulty. A tax on salt or sugar is shifted more quickly than a tax on houses where a lease prevents during its currency any alteration to the detriment of the tenant. If again as a direct result of the tax the price rises to the full amount of the tax, the incidence will be wholly on the consumer, and if the price does not rise at all, wholly on the producer or seller. If the price rises by less than the full amount of the tax, it will fall partly on the consumer and partly on the producer.

Modification of the Theory of Incidence in regard to Monopolies

14. In the preceding paragraph the incidence of a tax on an article produced under conditions of monopoly was briefly discussed. It is necessary to amplify this because of the peculiar difficulties of the problem. The monopolist differs from the producer under competitive conditions since he controls supply. The monopoly, however, is rarely, if ever, absolute, and the monopolist, even if he controls the supply of his own commodity, has always to consider other commodities which may be substituted in place of his. The gains of the monopolist may also be limited by public opinion or law in addition to potential competition. His aim is to sell as many units of his product at as high a price as possible, *i.e.* at a price yielding the largest net return or the maximum monopoly revenue. The fixing of this price is no easy matter. If the monopolist increases his output beyond a certain limit he reaches a point where the last unit yields neither profit nor loss. It is within this limit that his maximum monopoly revenue will lie. If the supply is increased beyond the limit the price must decrease in order to increase the consumption of this larger amount. His net revenue would then fall below the monopoly profit. If the price were increased,

consumption would be decreased and the net revenue would again fall. It is convenient to divide monopoly into three categories: (1) where a single monopolist deals with a group of customers competing among themselves; (2) where two or more monopolists control the supply of complementary products and deal with a group of customers competing among themselves. Thus a group of competing millowners may find that the land for their mills and the electric power for driving their mills are respectively held by two monopolists. (3) Where one monopolist deals with another monopolist. Monopoly thus meets monopoly. The ability to shift the tax in case (1) will depend on the mode of taxation. In cases (2) and (3) no general rule can be established as to the incidence of the tax because no law of value is applicable. Abstract reasoning can give little assistance in the last two cases because various factors determine the conditions under which a bargain will take place. These various factors are financial strength and endurance of one party to hold out against the other as in the third case, viz.: where labour is working in combination against an organised employers' association. Each party being a monopolist will look to its own interest only and will try to gain at the expense of the opposing party. It cannot be said, as we can in competition, whether the tax will rest on the monopolist who is taxed, or whether it will be shifted to the other monopolist. The purchasers of the commodity may be affected although they have had no concern with the bargain or the tax. We cannot, in short, say by whom the tax is borne. Economic theory gives no solution.[1]

It is then with the first case that we are concerned in practice, viz.: where one monopolist deals with competing consumers. The tax on the monopoly may be independent of production, *i.e.* it may be a percentage of the monopolist's net profit or a lump sum tax. It may also be dependent on production, *i.e.* it may increase with the increase in production—it may be either proportionate or progressive tax. It may even diminish with output, but this is hardly practicable. Where the tax is independent of output it will not be shifted because the output is adjusted to yield the maximum profit, and no other price will

[1] Cf. Sidgwick, *Principles*, Book II. ch. x. § 5: Edgeworth, *Papers Relating to Political Economy*, vol. i. (*The Pure Theory of Monopoly*, p. 116), vol. ii. (*The Pure Theory of Taxation*, p. 99); Marshall's *Principles*, Book V. ch. xiv. § 9.

yield as great a profit as the one already fixed. He will have a greater profit after paying the tax by leaving the selling price unchanged.[1] This reasoning applies both to a lump sum tax and to a percentage tax on profits. It is just possible that where the monopolist has unconsciously or consciously, say from benevolent motives, been charging less than the full monopoly price he may by "tightening up" or "taking in the slack" shift the tax to the consumer. Again, if the tax is so great that the monopolist feels disinclined to undertake fresh effort to earn the greatest possible profits he may shift the burden to consumers by adding to his price but at a less monopoly profit to himself. "In such an exceptional case", as the Colwyn Report points out, "he may possibly put something on to his price on account of the tax, and although it reduces his profit, he may prefer this to a rather greater profit at the expense of a greater effort."[2]

Where the tax is dependent on the volume or quantity of the output it affects all the calculations of the monopolist. A tax of this nature will add to the unit cost of production, and if the monopolist raises his price to the extent of the tax a fall in demand will take place. If the demand is elastic the fall will be considerable, but the monopolist, rather than meet a decline in sales, will bear part of the tax. If the demand is inelastic, *i.e.* if his sales are not affected the incidence will be on the consumers. The rise in price after the tax will vary according to the way in which the commodity is produced, viz.: whether it obeys the law of diminishing returns, increasing returns, or constant returns. Under the law of diminishing returns the reduction in supply will diminish the cost of production, while in the case of increasing returns it will increase the cost of production. There will be a greater rise in price as a result of the tax if the commodity obeys the law of increasing returns as in the case of commodities produced under competitive conditions according to this law. *Ceteris paribus*, the rise in the price as a result of the tax will be greater the less elastic the demand and the more elastic the supply; where the total amount of the tax diminishes with the increase in output it would lead, in certain circumstances, to an increase in output and to a lower price for the article produced. The monopolist would bear the tax entirely

[1] Cf. Marshall's *Principles*, Book V. ch. xiv. § 4.
[2] Cmd. 2800, 1927, p. 112.

and shift part of his monopoly gains to the consumer by way of lower prices. No part of the theory of incidence is so full of pitfalls as the theory of the incidence of taxes on commodities, especially those produced under monopoly conditions. There is always the danger of our forgetting the hypothesis on which the reasoning is based and of treating results on these conditions as in actual operation in the everyday world of commerce and industry.

Taxes on International Trade (Imports and Exports)

15. Taxes on imports are usually shifted, and shifted intentionally, to the consumer. They bring into the market a competitive untaxed supply, and the imported article usually rises in price to the full extent of the duty. The ultimate effect, as compared with the immediate effect, of the import duty may be a fall in price owing to the fostering of infant industries. We are, however, not concerned here with the arguments for or against protection, or the effect of bounties which are dealt with in Chapter XXVI, but with the shifting and incidence of taxes on international trade. If import duties are levied for revenue purposes only, they should be accompanied by internal taxes, such as excise duties, at the same rate on the same goods, or countervailing duties on foreign bounties such as those that have been imposed on bounty-fed sugar. It is well to remember that import duties are frankly tempting to a finance minister, because the effect of such taxes is only often slightly seen and understood, and they are a convenient method of getting revenue. In certain special circumstances it is a way, although not always a safe way, of increasing the national income at the foreigners' expense. When shifted to consumers, these taxes (*e.g.* those on necessaries, such as sugar, clothing, etc.) are apt to impose on the poorer classes a disproportionate share because their expenditures on these are much larger in proportion to their incomes than in the case of the rich.

The remarks in previous paragraphs on the taxation of commodities in internal trade apply also to custom duties on imports and exports. Take, for example, the demand by producers of iron and steel in India in 1923 for a heavy import duty on steel of 33⅓ per cent. Manufacturers of cotton piece-goods in some

centres in India would like to see a duty considerably higher than the duties imposed in the United States on goods entering for consumption—a duty in the neighbourhood of 50 per cent *ad valorem*. What would be the effect of the tax on the consumer? Who would really pay the tax?

Adam Smith, who approved of customs duties for revenue but not for monopoly, deals with the incidence of taxes on international trade in connection with countervailing duties. "There may be good policy in retaliations of this kind, when there is a probability that they will procure the repeal of the high duties or prohibitions complained of. The recovery of a great foreign market will generally more than compensate the transitory inconveniency of paying dearer during a short time for some sorts of goods. To judge whether such retaliations are likely to produce such an effect does not perhaps belong so much to the science of a legislator, whose deliberations ought to be governed by general principles which are always the same, as to the skill of that insidious and crafty animal, vulgarly called a statesman or politician, whose counsels are directed by the momentary fluctuations of affairs. When there is no probability that any such repeal can be procured, it seems a bad method of compensating the injury done to certain classes of our people, to do another injury ourselves, not only to these classes, but to almost all the other classes of them. When our neighbours prohibit some manufacture of ours, we generally prohibit, not only the same, for that alone would seldom affect them considerably, but some other manufacture of theirs. This may no doubt give encouragement to some particular class of workmen among ourselves, and by excluding some of their rivals, may enable them to raise the price in the home market."[1] Adam Smith assumes that the incidence will fall on the home consumer. Adam Smith was attacking the views of the mercantilists who desired to encourage exports of domestic produce and to discourage imports of foreign produce by a policy, in his own words, of "restraints" consisting "sometimes in high duties, and sometimes in absolute prohibitions", a policy seen in our own day in the almost total absence of export duties and the prevalence of high duties on imports. Adam Smith disagreed with the view, widely held, that taxes on foreign imports fall on the foreign producer. In the

[1] *The Wealth of Nations*, Book IV. ch. ii. vol. i. p. 432 (Cannan edit.).

long run he was right, for, as we shall see, the tax falls only in exceptional circumstances on the foreign producer. If the import duty is sufficiently high it will cut off foreign supply and the reduction in supply will lessen competition and prices may ultimately rise to the full extent of the duty. McCulloch in his *Treatise on Taxation*, 1845, showed that customs duties were, as a rule, paid by the consumers of the taxed commodities. "When a Government lays a duty on the foreign commodities which enter its ports, the duty, in ordinary cases, or when there is no sudden and extraordinary demand for the articles on which it is laid, falls entirely on its own subjects by whom they are purchased. . . . Any one, indeed, who reflects that the duties on tobacco, spirits, tea, most sorts of wine, and various other articles bought from abroad do not merely equal, but in general very greatly exceed their price in the foreign markets, will at once perceive how contradictory it is to suppose they should fall on the foreigner. And for the same reason, when a Government lays a duty on the commodities which its subjects are about to export, it does not fall on them, but on those by whom they are bought."[1] He adds that in the case of any unforeseen and extraordinary demand taking place for imported products this principle would not be true. J. S. Mill and his successors realised that the incidence of taxes on international trade was not really so simple as McCulloch appears to have thought. Mill, for example, shows that "a tax on imported commodities, when it really operates as a tax, and not as a prohibition either total or partial, almost always falls in part upon the foreigners who consume our goods; and this is a mode in which a nation may appropriate to itself, at the expense of foreigners, a larger share than would otherwise belong to it of the increase in the general productiveness of the labour and capital of the world which results from the interchange of commodities among nations".[2] Mill adds that a tax on a monopoly article will fall entirely on the producer. "A tax on rare and highly priced wines will fall wholly on the growers, or rather, on the owners of the vineyards." Mill assumes that the rise in price will diminish the demand, but it is doubtful whether

[1] *A Treatise on the Principles and Practical Influence of Taxation and the Funding System*, 1845, p. 195 ff.

[2] *Principles*, Book V. ch. iv. § 6.

the consumer would in all cases escape from the burden of the tax, wholly or partially. Marshall instances the case of heavy wines and Greek currants as examples of commodities which may be exported by one country having special advantages in their production to the other country which is the chief buyer of the article. An import duty would for a quite considerable time fall mainly on the foreign producer. In the case of two or three countries collectively selling to a few other countries a commodity such as wheat, the producers would be similarly situated. In the Memorandum on International Trade Marshall sums up in his own inimitable manner the incidence of import duties by saying "It is my opinion that, in nearly all important cases, they are borne almost exclusively by the consumer. But there is no absolute rule in the matter. Cases can be conceived on a large scale, and have actually existed on a small scale, in which a perceptible part of the burden of an import duty is borne by foreigners. And, of course, a part of the pressure of every new tax of whatever kind is apt to rest temporarily on producers, merchants, shippers, and others, until they are able to shift it to its permanent resting-place on the shoulders of consumers. The problem cannot be completely solved by a mere study of price movements."[1] Marshall always emphasised that "the observed price movement, *taken by itself*, proves nothing conclusively". It is the *urgency* of *reciprocal demand*, *i.e.* the elasticity or inelasticity, that mainly determines the incidence of the tax. Rarely does a country have such an urgent demand for the goods of another that it will pay both the import and export duties levied by the foreigner. He quotes the case of England, which was in the fortunate position of making the foreigner pay on at least two occasions, firstly in the thirteenth and fourteenth centuries, and secondly during the first half of the nineteenth century when British manufactures and also tropical products (which she had special means of obtaining) were in great demand by other countries. As demand was highly inelastic for these products, England was able to throw a considerable part of its tariff, import as well as export, on the foreigner. The demand, in other words, for English labour in general was inelastic without any similar inelasticity of demand for foreign labour on the part

[1] "Fiscal Policy of International Trade" (1903) in *Official Papers*, by Marshall, p. 370.

of England. To-day no country is in this favourable position, although the United States is stronger than most in this respect. In general, unless a country can do without the imports from other countries and if at the same time there exists on the part of other countries an inelastic demand for its commodities (*i.e.* the country possesses partial monopolies) there is no shifting of the burden on to the shoulders of the foreigner.

The producer abroad, when a heavy duty has been imposed, will not send his products unless the importer pays the tax, or unless more advantageous markets in other countries cannot be obtained. The sale of the commodity may be pushed in other markets where the sales may increase. A reduction amounting to less than the duty levied in these other markets might make it possible to continue without so great a loss as the new duty entails on what hitherto went to the protected market. The reduction in imports into the latter market might even raise prices to a point, other things being equal, at which it would not pay to divert to other markets. The rise in prices will check the demand in the protected market, and this reacts on production. If the price rose by something less than the duty the tax would be divided between the producer abroad and the consumer in the protected market.

If the taxing country has been in the habit of taking a large part of the foreign producer's supply, as in the case of India's consumption of English cotton piece-goods, that producer may be compelled to bear part of the tax to lessen his loss. If the producer has more or less a monopoly and enjoys high differential profits or produces the goods according to the law of diminishing returns, the price will not rise to the full extent of the tax. The monopolist may sometimes bear the tax by selling the commodity at the same price, but at the old price he may give less quality or even smaller measure. But it is rarely the case that a country has a complete monopoly and rarer still for foreign producers to combine completely to obtain monopoly prices. If the demand for the article is relatively small, if its supply can readily be adjusted, and if other free markets are available to the manufacturer abroad, the whole tax will fall on the consumer, and the price, owing to other causes, may even rise more than the tax. The remarks on the elasticity of demand and supply in section 13 are of importance in this connexion.

16. Next, with regard to export duties. In international trade export duties are as a rule unpopular because they are the converse of an export bounty and put the home exporter at a disadvantage. Import duties, on the other hand, are increasingly popular because they ostensibly help the home producer and are conveniently collected at the port of entry or at the land frontier. The foreign consumer may be asked to pay the export duty, but his doing so in whole or in part depends on his ability to go without the export. He may have the means of obtaining a similar class of article elsewhere. If his demand is inelastic, and he must have the commodity, he will ordinarily pay the whole of the tax. The more sharply the demand is checked by a rise of price as a result of the duty, the less easy will it be to shift the tax to the consumer abroad. If the duty is so high as to render exports impossible, the prices of that commodity may at first fall in the internal market. If this lasts for long, production will be affected. With poor prices, quality, too, may deteriorate. If the duty is not high and if the quantity exported of the articles on which the tax has been put is relatively to production high, it is not improbable that the exporting country may for a time bear the tax to prevent a fall in the exports and internal prices of the commodity. In recent years export duties have in India and in other parts of the British Empire—for example, in some African colonies —been imposed on certain commodities. An export duty in 1917 was imposed on petrol in India primarily to prohibit consumption, for War reasons. It was, however, found to be a good tax. Similarly on raw cotton exported abroad from Bombay there has been a small export duty, mainly used for local purposes. The export duty on jute from Calcutta has been as a world monopoly of much value to the Federal and to the producing Units, chiefly Bengal, which receive 50 per cent of the duty. It has been found that these duties are productive of revenue and for this reason they have been retained. Export duties, however, hinder export except where there is a monopoly or quasi-monopoly on the production of the article and where the duty is very small. The object the financier has in view is revenue, and he places duties on imports and more rarely on exports where those duties are likely to fall in with the Smithian canons of certainty, convenience, and economy, and at the same time are not likely to fall very unfairly on any class or classes of the community. Adam Smith indeed

reminds us that " in the arithmetic of the Customs two and two, instead of making four, make sometimes only one ".[1]

[1] *The Wealth of Nations*, Book V. ch. ii. part ii. art. iv. Adam Smith quotes Swift, who attributes the remark to an unnamed commissioner of Customs. " One of these gentlemen pleasantly told me that the mistake of parliaments on such occasions was owing to an error of computing two and two make four; whereas in the business of laying impositions, two and two never made more than one " (cf. p. 365, vol. ii. of Cannan edit.).

CHAPTER XIX

THE SHIFTING AND INCIDENCE OF TAXATION (*contd.*)

TAXATION OF RENT

1. TAXES on the pure rent of agricultural land cannot be shifted. These fall on the proprietors of the rent-yielding property. Since the amount of rent is not a cause of high or low prices of produce, a tax on rent is not a factor affecting that price. "Corn", says Ricardo, "is not high because a rent is paid, but a rent is paid because corn is high." In the second chapter of his *Principles of Political Economy and Taxation* he emphasises the fact that "rent does not and cannot enter in the least degree as a component part" of the price of corn, and adds in a footnote, "The clearly understanding this principle is, I am persuaded, of the utmost importance to the science of political economy".[1] In chapter x. on "Taxes on Rent" he begins by saying that "A tax on rent would affect rent only; it would fall wholly on landlords, and could not be shifted to any class of consumers. The landlord could not raise his rent, because he would leave unaltered the difference between the produce obtained from the least productive land in cultivation, and that obtained from land of every other quality."[2] A tax does not affect that particular land

[1] Gonner's edition of Ricardo's *Works* (Bell & Sons), p. 55.

[2] *Ibid.* p. 154. The *locus classicus* on the Ricardian Theory of Rent is Marshall's *Principles of Economics*, Book V. ch. ix. ff. Hadley in his *Economics* warns his readers that "The 'economic', *i.e.* 'Ricardian' sense of the word rent must not be confounded with its ordinary commercial sense. Commercial rent represents a price paid for the use of land *and improvements*. A large part of it is interest rather than rent. If we deduct the interest on improvements from the commercial rent, the remainder is economic rent" (p. 287). Gustav Cassel, who criticises the Ricardian conception of rent in his general theory of prices, nevertheless agrees with the statement made in the text when he writes, "Since natural land, as a primary

which pays no rent, and, therefore, leaves the total amount of rent including the tax as it was. Suppose Government levies a 5 per cent tax on the rent. This will affect neither the total amount of rent nor the supply of the commodity. The supply of the commodity is already fixed to yield a higher aggregate rent than either a less or greater supply would yield. In other words, 95 per cent of the rent is also greater for that supply than for any other scale of supply. The incidence, then, of this 5 per cent tax will be on the proprietors who, while the total rent yielded is the same, receive 95 per cent, or 5 per cent less than hitherto. Were the tax repealed the proprietors of the rent-yielding property would secure a direct money benefit in an increase of income. The incidence of the tax, therefore, is plainly on landlords.

The argument assumes that the receivers of rent are obtaining the highest possible rents from the land. Where the full economic rent is not obtained, the new tax may result in practice in an increase of rents, and in such instances part of the incidence will be on the tenant or occupier. In all discussions on the incidence of a tax on rent it should be remembered that pure economic rent of agricultural land is not infrequently mixed up with forms of income due to capital and labour, and is not confined to the natural qualities of the soil; actual rent, in short, contains an element of profits.[1] A tax on rent is usually a tax on pure rent paid to the landowner for the natural and indestructible powers of the soil and on profits on investment in improvements. "The term rent of land is applied to the whole amount of the value paid by the farmer to his landlord, a part only of which is strictly rent. . . . In taxing rent, as no distinction would be made between that part paid for the use of the land, and that paid for the use of the landlord's stock, a portion of the tax would fall on the landlord's profits, and would, therefore, discourage cultivation, unless the

factor of production, is both incapable of increase and indestructible, any tax laid upon the sheer rent of this land will have no influence on the market; for the same reason it cannot be shifted, but must affect the rent itself" (*The Theory of Social Economy*, vol. i. p. 259, McCabe's translation; London, Fisher Unwin, 1923). Cf. also Marshall's analysis of taxation already referred to on rent and quasi-rent in ch. ix. Bk. V. of his *Principles*, the substance of which was reproduced from answers to questions of the Royal Commission on Local Taxation in 1899 (C9528), *Official Papers* (Macmillan), p. 327.

[1] Rent in practice consists not only of pure economic rent, but also of some return to capital invested in or on the land.

price of raw produce rose." [1] In Great Britain and similar countries, when the land tax is permanently fixed or of long standing, the tax is " burdenless ". The person who purchases the land allows for the tax, paying for the land a price based on the net return after deducting the tax. The first owner pays the burden. Through ignorance or carelessness the landlord may let a tenant have the land for less than might be got by the sharpest bargaining. In a country like England, agricultural land is owned and managed for the satisfaction of social ambition as well as for immediate pecuniary return, and is not infrequently let to farmers on indulgent terms. Under such circumstances an additional tax levied on the landholder will probably lead him to look sharply at his rentals.

A tax on pure rent is hardly possible, because pure rent by itself is rarely found. It is mixed up, as already described, with other income received from lasting improvements which is in the form of profits on investment. In so far as a tax affects the profits on investment its incidence may be on the consumers, although a portion—some believe it to be a small portion—may be on those who supplied the capital for the improvements. McCulloch put it thus : " It would not, however, be possible for government, even if it were disposed to make the attempt, to abstract by means of direct taxes the gross rent of the landlords, or the total sum paid them, not only for the use of the inherent powers of the soil, but for buildings, etc. In whatever degree the rent of land may consist of interest of capital laid out upon it, in that degree, would a tax upon rent operate to raise the price of raw produce, and would, in consequence, fall ultimately on the consumer." [2] At the same time the tax would not fall so easily on the consumer as is sometimes imagined. Take the case of England where the local supplies are only a fifth of the total supplies of wheat, the imports from abroad being very large. The price being a world-wide price, a tax on rent in England to-day so far as the tax affects the profits of capital on improvements may be borne by the landlords or farmers or both and not by the consumers of wheat. Production in England would not be curtailed to such an extent as to affect appreciably the total supply of corn in England in view of the large imports, and,

[1] *Principles*, Ricardo, ch. x. (McCulloch's edition), p. 102.
[2] McCulloch's edition, *The Wealth of Nations*, note xxvi. p. 611.

therefore, most of the tax would not ultimately be, as Marshall held, " shifted forwards to consumers ".

Taxes on Building Rents

2. Adam Smith and Ricardo each analysed separately the incidence of taxes on houses.[1] Adam Smith, as shown in the previous chapter, divides the rent of a house into building and ground rents. The former is interest or profit from capital invested in building the house. " In order to put the trade of a builder upon a level with other trades, it is necessary that this rent should be sufficient, first, to pay him the same interest which he would have got for his capital, if he had lent it upon good security ; and, secondly, to keep the house in constant repair, or, what comes to the same thing, to replace within a certain term of years the capital which had been employed in building it." A tax on the rent of houses may fall on the occupier or on the ground landlord or on the building landlord. Ordinarily the tax would be paid " immediately and finally ", as Ricardo phrases it, by the occupier. Ricardo dissents from Adam Smith's view that ground rents and the ordinary rent of land are " the species of revenue which can best bear to have a peculiar tax imposed upon them ", believing " it would surely be very unjust to tax exclusively the revenue of any particular class of a community ". He shows that such taxation is contrary to one of the four Smithian maxims which should govern all taxation.

The transfer of the burden is not so easy a matter as in the case of goods readily marketable. It may fall on the owner, the occupier, and also the builder. When taxes on buildings and on the gross rent of the house are levied on the occupier, the incidence usually is on the occupier and not on the owner. There is, however, considerable friction, and the readjustment of burdens takes place slowly. If the occupier desires to shift the burden to the owner, a new lease has usually to be made. He may, however, prefer to remain where he is and bear the tax,

[1] Cf. *The Wealth of Nations*, Book V. ch. ii. part ii. art. i., "Taxes upon the Rent of Houses." Ricardo, *Principles*, ch. xiv., " Taxes on Houses." Royal Commission on Local Taxation, Cd. 638, London, 1901 ; and C9528 (1899), which contain the memoranda of various authorities. Cf. Edgeworth, *Papers Relating to Political Economy*, vol. ii. pp. 79 and 136 ; also Marshall, *Official Papers*, p. 345.

as the expense of removing and the convenience of his present house may compel him to remain where he lives. If he does remove he will select a house, having the tax in view. He may, then, succeed in shifting the tax to his new landlord. The tendency, however, is for the tax to remain where its impact took place, at least for a considerable time. This is not necessarily always the case. The occupier, if engaged in trade such as a dry goods store, may shift part of the tax to his customers, especially when the customers are of the poorer classes and unable to make their purchases outside the locality. The demand for the goods on the part of the customers in their neighbourhood is not so elastic as when they can purchase outside the area, *e.g.* from large stores centrally situated. Before it can be said that the tax falls on the occupier or on the owner or otherwise, the elasticity or inelasticity of the supply should be examined.

If the tax be on the owners it will check the increase of the supply of rentable houses, as it will, *ceteris paribus*, reduce profits. It may also reduce the expenditure on construction, as occupiers will tend to take slightly smaller houses rather than pay the increased rent as a result of the tax. The checking of house-building in turn may check the demand for sites. The owners for the time being may pay the tax, as they cannot raise the rents during the currency of the lease, the supply of and the demand for houses remaining constant. If they sell their property, the new owners will purchase with the tax in view. These new purchasers aim at making their investments similar in yield to others with corresponding risks. Owners may find that tenants prefer to take less accommodation than pay the higher rent. Tenants may even be able to go to neighbouring districts, so that the owners may again be prevented from raising rents. After a period, however, rents may rise, and the owners may shift the taxes on to occupiers because the supply of houses may be adjusted to meet the changed circumstances. Thus it is clear that a tax on annual rental values is frequently only imperfectly readjusted, and that too only after a period of friction. The incidence, in short, may fall partly on the owner, partly on the occupier, and also on the builder. In some cases the occupier if in trade may shift part of the tax from his shoulders to those who purchase his products. Occupiers bear a considerable part

of the tax. Where the tax is imposed on the occupier more of it will be borne by him than when it is assessed on the owner. That experience undoubtedly proves.

The Incidence of Rates

3. Rates are local taxes, the payment of which is apportioned among the payers in a locality in relation to the annual or capital value, generally speaking, of immovable property such as land and buildings. "In general", said Adam Smith, "there is not perhaps any one article of expense or consumption by which the liberality or narrowness of a man's whole expense can be better judged of than by his house rent." [1] Part of rating is beneficial as, for example, payments for benefits received in water supply, and part is onerous as in the case of an education rate where the individual ratepayer may not receive a direct or any equivalent gain at all. Rates, unlike central or state taxes, vary widely from locality to locality owing to the variation in benefits given by public authorities, the efficiency of local administrations, the amount of capital invested in the past, geographical situation, endowments, and the cost of maintaining local services, such as education, poor relief, and police. Rates again are in many countries unscientific, since they are payable by industries, mines, and agriculture, regardless of the fact whether these are making a profit or a loss. As these rates enter into cost of production a vicious circle may be set up in areas where industry is especially hit. The greater the depression, the greater the unemployment and the higher the rates. The higher the rates, the greater the cost of production and the greater the unemployment.

The incidence of rates cannot be determined with accuracy as the proportions in which the burden falls on the occupier and owner or owners, or in the case of trade premises on consumers of goods, depend on many factors, such as the comparative bargaining power of the parties, the extent of economic friction, and the supply of and demand for the building or object on which the rates are levied. The rate may be paid by the landlord but the incidence may be on the occupier. It sometimes happens that the landlord pays the rates by including them in the rent of the house or tenement. Indeed, it has been suggested that the land-

[1] Cunningham used to quote an adage—"Dress above your means, feed below your means, have a house according to your means."

lord should present in his bill or demand note the amount charged for rent and for rates in order that the incidence of rates should be seen, especially in regard to site values. This would also show the occupier how much he is paying for local social services. The occupier of business premises may bear the greater part of the tax if he is unable to obtain owing to scarcity of shops an equally suitable place of business. Locality is of great importance to him. The incidence of a rate on trade premises falls, as Edgeworth points out, "*ceteris paribus*, more upon the customer the greater his preference for dealing in the particular locality; on the trader the greater the loss incurred by him in moving to another place (of business); on the owner the longer his term" (of lease).[1] Similarly the burden of a rate may fall on someone remotely connected with the hereditament, if the physician, for example, is able to pass it on to the patient in the form of higher fees. The annual value on which British rates are levied includes site value and building value, which are, of course, not separately levied. It has frequently been suggested that a larger share of rates should be transferred to the site value of the land, and not, as at present, fixed on the composite value of the land and buildings. The owner of the site finds his property increased or increasing in value owing to no effort on his own part but on account of the community. He may find it to his advantage financially not to develop the site but to leave it as it is, because the rates are not upon the real value of the site but what it yields annually, and in these cases the incidence is usually on the occupier and not on the landlord. If the value of the site, based on the price which it would sell at in the open market unencumbered, were separately assessed by a percentage of the annual capital value quite apart from the buildings on it, a larger portion of rates than at present would fall on the unimproved site values and thus on the ground landlord. A rate, however, on the site value tends to fall on the owner of the land, the ground landlord, since the tenant can avoid this rate by going to another area where the site value is low or negligible. The occupier will have to bear that part of rates which falls on building value. He may be able to shift on to the owner part of the rates, even on building value, when the rates are exceptionally high, since very high rates drive away population and trade. Those who own property there will bear part of the rate. The burden

[1] *Papers Relating to Political Economy*, vol. ii. p. 139.

of high onerous rates is shifted by the occupier, other things being equal, on to the owner. The occupier, however, from ignorance or from a desire to be near his work or preference for the particular area, may bear the high rates and not try to evade them by going to areas where they are lower. As a general principle it may be laid down that the occupier or tenant bears the rate which he cannot avoid wherever he goes, while the owner bears the rate which the tenant could avoid by going elsewhere. In short, the owner bears the burden of the part of rates proportionate to the value of the site, and also probably of any exceptionally high rates. The occupier generally bears the burden of beneficial rates. Unforeseen increments of rates fall on the lessee for the time being, but tenants in making a new contract would take the rates into account before they made a contract. In the long period the mode of collection of the rate is of little or no importance. In the short period, however, after an increase has taken place the mode of collection is important because it affects the incidence. The occupier in the latter case bears a greater burden than he would if part of the rates were collected from the owner, or if the occupier in paying his rent were permitted to deduct a part of this increase. Owners, however, in the case of new rates, may find themselves compelled to pay the increased rates or to have their buildings unoccupied. The owners of old buildings may have to bear part of the new rates for long periods, especially if the rates are higher than neighbouring suburbs. Occupiers will, without much difficulty, evade the tax in this way, while owners of the buildings cannot, as buildings cannot be lifted and erected quickly elsewhere. On the whole, investors who build houses will shun the district, and the differential rate will fall on the ground landlord. In short, then, while the taxes or rates on site values tend, *ceteris paribus*, to fall ultimately on the ground landlord, those on building values fall ultimately on the occupier or consumers. Economic friction takes place, and occupiers who in England and Wales bear the rate may, unless they are able to move to an adjacent area more lightly rated and evade the rate, bear the burden of increased rates for a considerable time, especially if there is a scarcity of houses. Where, as we have seen, rates in one district are higher than in a neighbouring district the ground landlord bears ultimately the whole differential burden.

The Taxation of Capital and Interest [1]

4. In the paragraphs on double taxation we had occasion to refer to Adam Smith's remark that "the proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country." He believed that interest could not be taxed like rent because "The quantity and value of the land which any man possesses can never be a secret, and can always be ascertained with great exactness; but the whole amount of the capital stock which he possesses is almost always a secret, and can scarce ever be ascertained with tolerable exactness. It is liable, besides, to almost continual variations", and "land is a subject which cannot be removed; whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which his estate lies." [2] The proprietor of stock is very different. These arguments are not of the same force as in Adam Smith's time. Many countries tax interest by a general income tax. Thus in Great Britain interest is taxed under Schedule C and D (interest on dividends) and under Schedule A (interest on mortgages, which is included under income from the ownership of lands, houses, etc.). The separate taxation of interest apart from income taxation is rare, but it is right that all forms of wealth should contribute to the revenue. Capital must contribute its proper share. If there is a tax on interest, theoretically there is a tendency for the capital to be sent abroad, and this will leave, *ceteris paribus*, less capital in the taxing country. The tax will also be an impediment in regard to the accumulation of capital by the owners in two ways, viz. by affecting their *will* to save and also their *power* to save. There are various impediments which check the mobility of capital. These may be social, patriotic, and legal. Custom and patriotism may prevent the owner of capital from investing abroad. There are also restrictions imposed by law, especially in a state of war. Interest, of course, is one of the factors which determine the accumulation of capital. The reduction in the volume of capital would increase its marginal productivity, and the less productive concerns would receive scantier supplies or no supplies at all. Industry's productive

[1] By interest is meant the return to waiting as well as the return to risk-bearing.

[2] *The Wealth of Nations*, Book V. ch. ii. art. ii. (Cannan edit.), vol. ii. p. 333.

power, therefore, would be decreased. The rise in marginal productivity would increase the rate of interest, and the burden of the tax in these circumstances would be transferred from the owners to the users of capital. After some time the users of capital would shift the tax to the consumers of their goods. The main part of the direct money burden would not permanently fall on the owners of capital, the receivers of interest, but it would be passed to users of capital and ultimately to consumers. A tax on capital is not always a tax on the capitalist. It will be generally shifted to the borrower unless mobility of capital is hindered so that the lender of capital may bear the tax. A tax on a mortgage will lower the rate of gain from mortgages, and the burden will ordinarily be forced on to the debtor or landowner or mortgagor. If the mortgagor does not pay he may not get the mortgage or capital would go elsewhere. If, however, the tax is very small, the demand for capital in comparison with its supply low and the rate of interest on mortgages relatively high, the shifting of the tax will be impeded. If the tax on interest does not fall on the interest yield of all kinds of capital, capital will go into channels that escape taxation. In theory the marginal productivity of the untaxed forms will be lowered and of the taxed forms raised by this until the net yield to the owners becomes equal. Insurance against risk or the return to risk-bearing is a part of the total return to capital, and the tendency is for a tax on risk-bearing to fall on the borrowers of capital and again ultimately on the consumers. Taxes on interest may encourage the creation of consumers' capital in the sense used by Sidgwick at the expense of trade capital, by decreasing the inducement to save. In short, a tax on interest will be shifted by the owners of capital to the borrowers if there is complete mobility of capital. Rarely, however, is capital free from economic friction which impedes its mobility. The shifting, therefore, is incomplete. Indeed sometimes it may be so strong as to prevent the shifting of the tax so that the owner of capital would bear the burden.

The Taxation of Profits

5. The problem of the incidence of taxes on profits has in recent years received considerable attention, especially in connection with the incidence of income tax, part of which is assessed

on profits. The difficulty of the problem arises largely from the fact that profits are generally never regarded as an economic unit. The majority of economists now regard profits as composed of interest on capital, insurance against risk, and earnings of management. The fine analysis of recent writers shows that the elements of which profits are composed differ in various industries and even in the same industry at the same time. There is in the world of commerce and industry no uniform practice and no agreement is possible. In a joint stock company or corporation profits include the remuneration of capital and remuneration for risk, but exclude the earnings of management, such as salaries, fees, and commissions, while in private enterprise carried on by individuals or partners there is the additional element of the earnings of management. Adam Smith does not include the earnings of management perhaps because in his own day the entrepreneur was also a capitalist. "The whole drugs", wrote the author of *The Wealth of Nations* in a very well-known passage, "which the best employed apothecary in a large market-town will sell in a year may not perhaps cost him above thirty or forty pounds. Though he should sell them, therefore, for three or four hundred or at a thousand per cent profit, this may frequently be no more than the reasonable wages of his labour, charged, in the only way in which he can charge them, upon the price of his drugs. The greater part of the apparent profit is real wages disguised in the garb of profit. In a small seaport town a little grocer will make forty or fifty per cent upon a stock of a single hundred pounds, while a considerable wholesale merchant in the same place will scarce make eight or ten per cent upon a stock of ten thousand." [1] Although the apothecary makes only an "*apparent*" profit, the greater part of it is "real wages disguised in the garb of profit". He would not agree with J. B. Say and many continental writers and Frances Walker that profits are the special remuneration of the entrepreneur. "The profits of stock, it may perhaps be thought, are only a different name for the wages of a particular sort of labour, the labour of inspection and direction. They are, however, altogether different, are regulated by quite different principles, and bear no proportion to the quantity, the hardship, or the ingenuity of this supposed labour of inspection or direction. They are regulated altogether by the value of the stock employed, and are greater or smaller in proportion to the extent of this

[1] *The Wealth of Nations*, Book I. ch. x. (Cannan edit.), vol. i. p. 113.

stock." [1] In short, the difficulty of definition and the fact that the elements of profits obey different laws make the incidence of profits a very difficult question. The assumptions, too, of Adam Smith and Ricardo, regarding the prevalence of untrammelled competition and the mobility of capital preclude general conclusions which were taught by the older Classical Economists.[2] The taxation of net profits of the monopolist, as shown in the preceding chapter, will not normally be shifted, but will, like a tax on the owner of unimproved land, remain at the point of impact since the supply is not affected by the tax.

Profits are a surplus which the producer obtains owing to certain advantages enjoyed over the marginal producer. A tax on profits, therefore, is a tax on surplus and cannot be paid out of income representing necessary costs. At first sight it may appear that the tax would be part of cost, but things are not as they sometimes appear. The sun rises in the east and sets in the west, but we know that the sun does not revolve round the earth but the earth round the sun. The market price will depend on the marginal producer. In the market there is only one price at a given time, fixed at the highest cost required to produce the last portion of the supply actually sold. Some producers are able to produce the commodity at a relatively low cost owing to their efficiency in production or advantageous situation. The difference between the actual or normal price and the cost of production of intra-marginal producers working under more favourable conditions than the marginal producer or producers will be the producers' surplus or profit. The price is fixed by the marginal producers who pay no tax because the producer at the margin has little or no profit. The producer cannot fix his price irrespective of competition and demand. "The producer is always endeavouring to keep the final unit within the profit sphere, but in his search for additional business and additional profit he is constantly approaching the marginal line at which no profit will result, and often he will find himself carried over the line into region of loss on his marginal units. . . . In these conditions (the actual conditions of life) the temporary positions of demand and supply are the governing factors, and price is determined by the cost of the marginal products, the sale of which

[1] *The Wealth of Nations*, Book I. ch. vi. (Cannan edit.), vol. i. p. 50.

[2] Little use of "marginality" was made as this came in with the rent of land and took some time to go further.

yields no profit, and may indeed yield a loss." [1] A tax on profits would, like a tax on rent, not, as a general rule, be shifted.

The problem, however, is complicated from the fact that taxes on profits may be general or uniform and special or partial. "When a tax", says Adam Smith, "is imposed upon the profits of stock in a particular branch of trade, the traders are all careful to bring no more goods to market than what they can sell at a price sufficient to reimburse them from advancing the tax. Some of them withdraw a part of their stocks from the trade, and the market is more sparingly supplied than before. The price of the goods rises, and the final payment of the tax falls upon the consumer." [2] Ricardo agrees with Adam Smith as to the incidence of such a tax.[3] These writers in their search for connecting principles assumed free competition, and this vitiates a considerable part of their theory. The limiting conditions have been referred to in the incidence of taxes on commodities. If a tax is placed on one industry and not on others, the producers of the taxed industry are put to such a disadvantage as compared with others that capital will be withdrawn slowly, since in industrial competition capital is not very mobile, and not nearly so mobile as in commercial competition. The shifting of a special tax may also be impeded by the elasticity of demand and supply, the law of substitution, the law of monopoly, etc. At the same time an exclusive tax on the profits from land or investments if not shifted will tend to be capitalised. He will pay a lower price and will not bear the burden of the tax. A general tax will, as a rule, not be shifted except in rare cases where prices are rising rapidly and the demand for the goods is great. The old marginal producer will now reap large profits, as the price of his goods has considerably risen above cost. As he is able to sell all his goods he will not be tempted to reduce his prices in order to increase his sales. In these rare circumstances a tax on profits will be shifted on to the consumer in higher prices. "But after all", says Seligman with much truth, "the tax will then be an excuse for, rather than a cause of, the higher prices which he would probably have been led to demand in any event. And at best, such

[1] Coates, Appendix XI. p. 68, appendices to the Colwyn Report, 1927, quoted in paragraph 306 of the Report, Cmd. 2800.

[2] *The Wealth of Nations*, Book V. ch. ii. (Cannan edit.), vol. ii. p. 340.

[3] Ricardo, *Works* (McCulloch's edition), p. 357.

business conditions can be only temporary." [1] Fresh capital will seek investment, and new competitors will come into the field until the tax can no longer be shifted.

If the taxation of profits is in the form of a licence duty of fixed amount the incidence will generally be on the producer and not on the consumer, because the large producer will find ordinarily the tax so small as to make it worth his while to bear the tax and to aim at increasing his sales by way of compensation. In some cases when the licence tax is especially high, the marginal producer will no longer be able to produce and thus will be compelled to leave the market. His place will be taken by the larger producer who will bear the tax, being more than compensated for the tax by increased business.

A tax on quasi-rent [2] is, in the short period, similar to a tax on economic rent. Quasi-rent is the total return a machine and durable goods like houses earn when the supply is inelastic over a short period, and a tax can only be shifted forward if the supply can be quickly adjusted. In the long period, however, a tax on quasi-rent is similar to a tax on interest. The supply can be adjusted in the long period, and producers will not bear the tax. A tax on quasi-rent would reduce the inducement to invest in that particular agent of production. The tendency of quasi-rent is to diverge from interest in the short period, but in the long period to coincide with it. Thus if the quasi-rent from a house was £60 when there was no tax, and a tax were imposed of say 20 per cent, the quasi-rent obtained by the owner would then be only £48. If this is below what normally is obtained from other investments, then the owner would so contract the supply of houses whenever possible (*i.e.* over the long period) as to bring up the rate of return to the average level, or the marginal individual net product.

The Taxation of Wages

6. With the exception of John Stuart Mill, the last of the

[1] Seligman, *Studies in Public Finance*, p. 76.

[2] Quasi-rent is sometimes misunderstood and defined as the *surplus* profits secured by owners of a factor of production, say a machine or a house, when that factor can only be slowly increased in quantity. This is not so. It is not a *surplus* return but the *total* return which the owner gets from an agent of production when the supply is inelastic over a short period. Quasi-rent may be a surplus or a deficit. Cf. Marshall's *Principles*, Book V., especially chapters viii. and x., and *Economics of Industry*, Appendix C, p. 426 (3rd edition).

Ricardians, the classical school of economists, with their worthy representatives abroad,[1] held that wages were generally immune from taxation. Labourers could not be taxed, as they got no more than the minimum to support themselves and their families. Taxes, therefore, imposed on labourers were shifted on to others. Some held, as we shall see, that the taxes (which had the effect of raising wages) were paid by the employer out of profits, just as taxes on necessaries for the same reason had to come out of the same source.

There was a sound stratum of historical truth in this theory. The history of the *esne*[2] or slave who worked for hire, and of serfdom generally, shows that the incidence of the tax would in these far-off times not have been on those on whom the tax was levied. There was in addition to that historical fact the doctrine of the normal or natural rate of wages emphasised by Ricardo and Von Thünen. the latter of whom described natural wages as the square root of ap where a represents the necessaries of life and p the product of capital and labour. The iron law of wages is based on the conception of a standard of living which is maintained in such a way that if earnings are increased above the amount required to secure this standard population will increase, and if earnings are decreased below this level population will decrease. Under this "iron and cruel law" a tax would be completely shifted. Lastly, the condition of the labourer in Europe in the last quarter of the eighteenth and the first half of the nineteenth century, especially after the Napoleonic wars, when wages seemed to be at the minimum of subsistence, lent further colour

[1] By "classical economists" is usually meant those economists of the first half of the nineteenth century like Ricardo, Senior, James Mill, and McCulloch, who developed the deductive and hypothetical method and treated economics as a body of doctrine immediately applicable to actual life. Bonar defines this nineteenth-century term in England as meaning the followers of the classical tradition proceeding from the *Wealth of Nations*. Most of the writers belong to the half century 1770 to 1820. In Germany, Von Thünen (1780–1850) and Hermann (1795–1868) are good examples. (Von Thünen discovered the modern "marginal" theory of interest.) In France, Say, Dunoyer, and the brilliant Cournot are worthy representatives. The newer deductive school, represented by Cairnes, Bagehot, Jevons, and Marshall in England, by Bastiat, Gide, Leroy-Beaulieu, and Guyot in France, and by the Austrian school, are less dogmatic than the older school. In the text above Adam Smith is included as a classical economist. Adam Smith, however, combines deduction with induction to a degree unknown in the work of his less skilful successors.

[2] Stubbs's *Constitutional History*, i. Cf. Hasbach's *History of the English Agricultural Labourer*, translated by Ruth Kenyon (London, King & Co.).

to the truth of this theory. Hasbach speaks of the " demoralisation of the labourer ",[1] and Gibbins [2] shows that of the increase of wealth produced by the Industrial Revolution little went into the hands of the labourers, but " went almost entirely into the hands of the great landlords and new capitalist manufacturers, or was spent in the enormous expenses of foreign war ". In addition, the burden of the continental wars fell heavily upon him because " taxes had been imposed on almost every article of consumption, while at the same time the price of wheat had risen enormously. Moreover, labour was now more than ever dependent on capital, and the individual labourer was thoroughly under the heel of his employer." Wheat per quarter rose from 49s. 3d. in 1793 to 113s. 10d. in 1800, and at the same time wages were falling. In the year previous to the publication of Ricardo's *Principles of Political Economy and Taxation* riots broke out everywhere in England—in Kent, for example among agricultural labourers, in the Midlands among the miners, and at Nottingham among the artisans. With this somewhat portentous proem we may now plunge *in medias res*.

Adam Smith in the well-known chapter on " Taxes upon the Wages of Labour " [3] differentiates between the wages of ordinary labour and " the recompense of ingenious artists and of men of liberal professions ". A tax on wages must, he believed, raise wages by somewhat more than the tax. " Let us suppose, for example, that in a particular place the demand for labour and the price of provisions were such as to render ten shillings a week the ordinary wages of labour ; and that a tax of one-fifth, or four shillings in the pound, was imposed upon wages. If the demand for labour and the price of provisions remained the same, it would still be necessary that the labourer should in that place earn such a subsistence as could be bought only for ten shillings a week, or that after paying the tax he should have ten shillings a week free wages. But in order to leave him such free wages after paying such a tax, the price of labour must in that place soon rise, not to twelve shillings a week only, but to twelve and sixpence ; that is, in order to enable him to pay a tax of one-fifth,

[1] *History of the English Agricultural Labourer*, ch. iii.

[2] *Industry in England* (10th edition), London, Methuen & Co., ch. xxiv., " The Condition of the Working Classes ".

[3] *The Wealth of Nations*, Book V. ch. ii. part ii. art. iii. (Cannan edit.), vol. ii. p. 348.

his wages must necessarily soon rise, not one-fifth part only, but one-fourth. Whatever was the proportion of the tax, the wages of labour must in all cases rise, not only in that proportion, but in a higher proportion. If the tax, for example, was one-tenth, the wages of labour must necessarily soon rise, not one-tenth part only, but one-eighth." Adam Smith then holds that the rise in the wages of labour in industry would be advanced by the employers and paid by consumers owing to the rise of wages raising, as he thought, general prices; the rise in agricultural wages would, for similar reasons, be advanced by the farmers and paid by the landlords. A tax on skilled employment, *i.e.* on the earnings "of ingenious artists and of men of liberal professions",[1] would be shifted, because their earnings are in "a certain proportion to the emoluments of inferior trades. A tax upon this recompense, therefore, could have no other effect than to raise it somewhat higher than in proportion to the tax. If it did not rise in this manner, the ingenious arts and the liberal professions, being no longer upon a level with other trades, would be so much deserted that they would soon return to that level."

Ricardo in his *Principles*, which, it is to be remembered, is rather a series of notes than a treatise, argued that taxes on wages are paid out of profits and, therefore, that a tax on wages is in fact a tax on profits.[2] He has no difficulty in showing from the Ricardian theory of rent that all taxes paid by the farmer cannot be supposed necessarily to fall on the landlord by a deduction from rent. He demonstrates that in regard to Adam Smith's theory that a tax on wages will fall on consumers "this rise in the price of goods will again operate on wages, and the action and reaction first of wages on goods, and then of goods on wages, will be extended without any assignable limits. The arguments by which this theory is supported lead to such absurd conclusions that it may at once be seen that the principle is wholly indefensible."

John Stuart Mill in his *Principles*,[3] that admirable exposition

[1] Curiously enough, salaried officials of Government were excluded by Adam Smith, because "the emoluments of office are not, like those of trades and professions, regulated by the free competition of the market, and do not, therefore, always bear a just proportion to what the nature of the employment requires".

[2] *Principles*, ch. xvi. "Taxes on Wages".

[3] *Principles*, Book V. ch. iii. § 4.

of mid-nineteenth century economics, marks a great advance on Adam Smith and Ricardo in the incidence of taxes on wages. Like Adam Smith, he makes a difference between the wages of ordinary unskilled labour and the earnings of "skilled or privileged employments, whether manual or intellectual". The latter were, in fact, monopolists, and would bear the incidence of the tax. "They have", according to Mill, "no means of relieving themselves at the expense of any other class." The wages of ordinary labour depend on the standard of living to which they have been accustomed, and if this is lowered they will not increase in numbers. He disagrees with Adam Smith's view that a tax will fall on consumers because general prices will not necessarily be raised by a rise of prices, since general prices depend on other causes, and do not rise through any cause which equally affects, according to Mill, all other kinds of productive employment. A rise of wages owing to the tax, just like any other increase in the cost of labour, will be defrayed from profits. The taxation of these wages is, in other words, a tax on the employers of common labour, "unless the tax has the much worse effect of permanently lowering the standard of comfortable subsistence in the minds of the poorer class. We find in the preceding considerations an additional argument for the opinion already expressed, that direct taxation should stop short of the class of incomes which do not exceed what is necessary for healthful existence. These very small incomes are mostly derived from manual labour; and, as we now see, any tax imposed on these, either permanently degrades the habits of the labouring class, or falls on profits, and burdens capitalists with an indirect tax, in addition to their share of the direct taxes."

In practice a tax on wages may or may not be shifted. If the supply of labour is inelastic and the demand elastic the tax tends to rest at the point where its impact took place. The twentieth century with its labour disputes in plenty and with its legislation for the avoidance or curtailment of such disputes shows that the assumptions that the taxation of wages will always be shifted are not always correct. Labourers may, owing to weak bargaining strength, as compared with employers, be compelled to accept a reduction in the standard of living. The history of many countries since 1920 shows this to be only too true. The employer does not always increase wages to the

extent of the tax, and the labourer is unable to reimburse himself by higher wages to cover the tax. The movement of wages is not so rapid as that of prices, and even assuming wages may ultimately be shifted to profits he may have to bear the tax temporarily. The direct money burden of the tax would be entirely on the wage-earner if the lowering of his wages (*i.e.* after payment of the tax) did not impair his efficiency, and if it did not influence the number of wage-earners in the occupation or industry. Lower net wages may lead to the retirement of workmen or even, in rare cases, to commencing business on their own account. This would tend, other things being equal, to decreased production and higher costs. Profits would fall, and in this respect taxes may be shifted. If the worker's efficiency is impaired this would raise the cost of the worker's product and the consumers would have to pay more. Some share of the burden would be thrown on these classes. Workers, however, do not escape the incidence of the tax if it is thrown on consumers because workers form an important part of the consuming classes. They will, therefore, bear the consumers' part of the tax which as wage-earners they shifted. If the goods are consumed by the wealthier classes these will bear part of the burden of the tax. Wages are nowadays not so close to the minimum as the older economists believed. They bear indirectly taxes on food and on other articles consumed by the labouring classes. Directly they are not taxed, for the simple reason they are expensive to collect. In the higher scales of wage-earners it is doubtful, even improbable, that taxes would be shifted. Earnings here are both customary and monopolistic. There is indeed an element of quasi-rent in their earnings. They are possessors of differential gains and as such do not succeed in shifting the taxes. Adam Smith himself argued that a tax on Government officers would not raise salaries.

To sum up. The imposition of a direct tax on wages is injurious to the workman if it reduces his standard of living. In many countries to-day the condition of labourers has greatly improved, and the assumption of the Classical Economists [1] that wages were at, or near, the minimum of subsistence is no longer true, except in poor or backward countries. A tax on wages would be borne by the workers where the supply of labour is

[1] Adam Smith, however, says this is not true of English wages.

inelastic and where the tax is general. For example, in Great Britain, National Health Insurance covers practically the whole, and Unemployment Insurance two-thirds, of the wage-earning population, and workers' contributions, which are in the nature of a tax on wages, would fall on the wage-earner. The more elastic the demand for labour the greater will be the incidence on the workers and *vice versa*. If the tax were a special tax on the wage-earners of a particular trade it would be shifted, provided the supply of labour in the trade was elastic and the demand inelastic. The employers' contributions to social insurance are not a tax on wages, but a tax on employment, *i.e.* on the number employed, which may or may not be shifted according to the relative strength of employers and employees. Taxes levied directly on wages or on wage-earners do not ordinarily exist, because they are difficult to collect and their cost of collection is high. Indirect taxes are levied on necessaries for existence, conventional necessaries, and luxuries, which labourers pay, usually unconsciously, in common with other consumers. The main value at the present time of discussions on the incidence of direct taxes on wages lies in the importance given to the standard of living, and the necessity of avoiding the taxing of the wage-earner in such a way as to encroach on the minimum. The trade depression in Europe in the years 1929–34 is illustrative of this, for at no period did the standard of living, or, as it is sometimes termed, the standard of comfort, receive such careful examination from taxing authorities and from Governments generally.

The Incidence of an Income Tax

7. The incidence of an income tax is often misunderstood, for three reasons. In the first place, the incidence of the tax is sometimes confused with the effects of the tax, or reactions as they are sometimes called. "There are", as Ricardo said, "no taxes which have not a tendency to lessen the power to accumulate", and a high tax on income may sometimes curtail the desire to take risks or to work for a less net reward, at any rate for a short period, and thus be in a sense repressive to production. On the other hand, high taxation may lead to increased effort to maintain the standard of living. Industry may adjust itself to changes in the long period, so that the result of high taxation may be over-

come. These are, however, the effects of the tax, and although from a practical view they may be of great importance, they do not affect the incidence of the tax. In the second place, business men cling to the delusion that income tax is an overhead charge which thus enters into costs. It is unnecessary to deal with this idol of the market-place. We have already made a long ramble through rough country to show that there are conclusive and compelling reasons why income tax falls on the income tax payer, remaining where it is levied and not shifted to consumers in the form of higher prices, why, in other words, the tax does not enter into price. The view held frequently by business men that the manufacturer is able to fix his price without consideration of demand or of competition overlooks the fact that price is determined by the cost at the margin, and this is not affected by the amount of income tax which manufacturers have to pay. Under conditions of monopoly, pure monopoly or partial monopoly, the producer fixes a price which will not be normally affected by income tax at all.[1] Indeed, it is independent of the fact that the monopolist pays any income tax. Income tax, in so far as it applies to business incomes, is a tax on surplus. It is the result not the cause of price. "A tax on business profits is not a part of cost, as is a tax on business products. The latter can be shifted; the former cannot be shifted."[2] Thirdly, the distinction between a uniform or general tax on all income, and a special or partial tax on only certain constituents of income is not always realised, with the result that the incidence of both is not completely understood. A special or partial tax may be shifted in certain circumstances, as, for example, in the case of a tax on income arising from wages, while it will not be shifted in the case of a tax on income arising from profits or rent. In the case of a general income tax no shifting will take place, because the whole field of income is subject to taxation, and there is no field left untaxed. The income tax payer would not escape the tax were he to transfer his occupation or capital as a result of the tax from one occupation or investment to another occupation or investment. The diversion *ceteris paribus* would not on account of the tax be worth while, since the new field would have a commensurate burden with the old.

It has been pointed out that an increase of 328 per cent in the

[1] *Vide* Chapter XVIII. paragraph 14.
[2] Seligman, *Studies in Public Finance*, p. 75.

British Income in 1922–23 as compared with 1912–13 had not increased the rate of profit on turnover which would have been necessary had the tax entered into price to yield the same net reward. On the contrary, the earnings of industry as a whole before payment of income tax when related to the turnover were practically the same in both years.[1] Income tax on real and personal property is similar to a tax on rent and poll taxes, and is likely to remain on the taxpayer. In regard to wages and salaries it is clear that most wage-earners do not pay income tax, and even if some do the employer could not take this into consideration in paying employees as a whole. Some English banks pay salaries free of income tax, and in this respect the tax may enter into cost of production. "This, however," says the Colwyn Committee Report, "is very far from saying that, even within these limits, the tax is reflected in higher prices. The only clear case where a trader might be able to put up his charges with impunity would be the case where all his competitors had similarly agreed to pay salaries covering income tax. Where the individual trader who pays higher salaries on account of the income tax is in competition with other traders who do not follow the same practice, he is in no better position to increase his prices on account of the tax on his employees' salaries than on account of the tax on his profits." [2]

The incidence of this tax is on the point where it is levied. It is not shifted in the form of an addition to price, but is, with unimportant exceptions, on the payer of the tax or the recipient of income. "The broad economic argument is true over practically the whole field and for practically the whole of the time, any exceptions being local or temporary and insufficient to invalidate it." [3] If the tax, graduated as it is in Great Britain with allowances and differentiation between earned and investment incomes, did add to price, it would no longer be what it is recognised to be in modern systems of taxation, a good tax from the canon of ability to pay.

[1] Cmd. 2800, 1927, Appendix XI. p. 96.

[2] Paragraph 298, *op. cit.*

[3] Paragraph 324, *op. cit.*, cf. paragraphs 293-324 and Appendices XI. and XII. Appendix XI. gives interesting statistical proofs based on the British Income Tax returns. The latter is Professor Seligman's Paper on "Income Taxes and the Price Level", reprinted from *Studies in Public Finance*, ch. xii.

The Incidence of Death Duties

8. The incidence of death duties raises the question whether the burden falls on the testator or on the inheritor or on both. Duties on inheritance or succession are now so common that the incidence of the duties is a question of great importance. In Great Britain, for example, the tax is chiefly in the form of an estate duty. There are minor duties—the legacy duty, and the succession duty. The estate duty is steeply graduated, and forms an important place in the taxation system. The minor duties are acquisition taxes on beneficiaries, the rates varying according to relationship. No circumstances connected with the size of the successor's income and his family responsibilities are taken into consideration in the levying of these minor duties. It may be argued that the estate duty falls on the testator because it falls on the property accumulated by the deceased. It prevented his leaving more to the inheritor than would otherwise have been possible. The testator may deliberately save in order to meet the charge, and it may be said that the duty falls on him. The testator in his lifetime knows that his estate will be liable for the duty, and he knows approximately what the burden will be, assuming the present rate and estate valuation to be the same at death as when he makes his estimates. He, therefore, saves to pay for this and indeed insures against the tax. The incidence is clearly then on the testator, as was the intention of the legislature when it was imposed. On the other hand, the testator does not, it is argued, pay the tax because he is dead before the tax is levied. The inheritor would have been richer by the amount of the tax if it had not been laid. The fact that the inheritor pays is no argument. Mill was wrong when he said that a tax must be considered as paid by "those who would be benefited if it were taken off". The beneficiaries might easily be those who did not bear the tax, as indeed Mill thought when he wrote on the land tax that "all who have bought land since the tax existed have bought it subject to the tax. There is not the smallest pretence for looking upon it as a payment exacted from the existing race of landlords."[1] It is the extra amount that the testator would have enjoyed, had there been no tax, that measures the burden, and not the additional sum which the

[1] *Principles*, Book V. ch. ii. § 6.

successor inherits. The testator would not have had the burden of extra saving to meet the capital liability of the tax. "The mere fact that the duty diminishes the property into which the successor may enter is no proof of its incidence being on the successor. There is no absolute distinction between the estate duty and the income tax in this respect; the income tax, so far as it takes away income which would have been saved, is a tax on potential capital, retarding the accumulation of wealth and diminishing the estate which can be left on death, yet no one hesitates to ascribe the whole of its incidence to the predecessor." [1]

It is difficult to lay down any general principle, as the action of the testator cannot be generalised. Different persons in different circumstances will not act alike, and it is better to regard the incidence as indeterminate. The Colwyn Committee came to the conclusion accepted by most writers on finance to-day that "when one compares the income tax with the estate duty, regarding the latter as a kind of postponed income tax, one sees clearly the solidarity of the interests of predecessor and successor. The income tax, in a concealed way, hits the taxpayer's son as well as the taxpayer himself, and may hit him just as severely. But the damage is separated by a time-gap. In the case of the estate duty the time gap is bridged, and the damage is at once apparent. On the whole, we think we have good support for giving primary but not exclusive place to the notion that the incidence of the duty is on the predecessor." [2] In regard to the legacy and succession duties the Committee point out that the intention is that they should fall on the beneficiary, and, "in fact also, the burden should generally be regarded as falling upon him".

[1] Cmd. 2800, paragraph 457.
[2] *Op. cit.* paragraphs 458 and 459.

CHAPTER XX

THE TAXATION OF LAND

THE general principles of taxation have now been discussed. It remains to complete this branch of the subject by an examination of the main characteristics of the various taxes, such as land taxes, income taxes, customs duties, and inheritance taxes. The present chapter deals with the taxation of land, a subject which is difficult to treat with adequate fulness and clearness.

GENERAL CHARACTERISTICS OF LAND TAXES

1. The taxation of land may be said to be almost universal. There were land taxes in China two thousand years B.C. and in early Egypt. Some believe land taxes to be the earliest of taxes, while others hold that poll taxes and the primitive hut taxes are possibly of older origin. To-day in parts of India, as in the wild hill districts of Assam, a poll tax and a hut tax are to be found, but throughout India the taxation of land is everywhere to be found. It is still one of the chief forms of taxation. Poll taxes equal in amount for all persons or assessed in an arbitrary fashion were, according to one authority,[1] unknown in England before 1377. Land taxation is to be found in a tax of the latter part of the tenth century.[2] It is unnecessary to pause over discussions on the antiquity of land taxes. Our object is practical rather than historical.

[1] Dowell, *History of Taxation and Taxes in England*, vol. iii. chapter i. (Longmans, Green & Co., 1884).

[2] Land taxation in England dates probably from much earlier times. Dowell (*op. cit.* vol. i. ch. i.) holds that in Roman Britain many of the taxes were taxes in kind on the produce of the land, usually a tenth, which had to be delivered at the fiscal granary. Owing to lack of good roads and the distance of transit, the delivery of the produce was a heavier burden than the levy itself.

Land taxes are an important source of revenue for central, provincial, and local authorities. The taxation of land is by the land tax proper (the *grundsteuer* or *l'impôt foncier*) and also by the general income tax, the latter being often more productive than the land tax *per se*. There is a tendency in some countries, as in Finland in 1924, to abolish the land tax and to tax agricultural income or the income from land by means of the machinery of the income tax with its annual assessments. In Germany, Holland, and in one or two other countries it is used as a supplement to the income tax, the income from property being taxed twice. It thus attempts in a clumsy fashion to differentiate between earned and unearned income by a variation of rate, common to most countries. All incomes are taxed at one rate and an additional tax is imposed on property. Surtaxes or additions to the land tax are frequently levied, especially by municipalities. Thus in the United States counties and minor divisions rely on land to the extent of nine-tenths of their total revenues. Japan follows the example of France and relies on surtaxes in raising revenue for prefectural and municipal purposes. The methods of levying the taxes vary considerably in different countries according to the basis on which they are assessed. The taxes may be based on (1) the capital value of the land which is usually determined by the sale value from time to time ; [1] (2) the annual or rental value ; (3) the unimproved or public value, that part of the capital value which is not due to the efforts of the owner or occupier, but to the prosperity of the community and other external causes quite unconnected with the activities of such owners and occupiers ; (4) the net income of the farmer, the total of the earnings of management and of the value of the labour of the farmer and his family ; and (5) the net produce, *i.e.* the gross produce minus the expenses of production. Capital value is the rule in the United States and annual value in Great Britain. In new countries, such as Australia and New Zealand, unimproved values are the basis of land taxation. Net income is the method

[1] The income from land for seven to ten years preceding the sale, experience shows, is a good index of the capital value. The best formula is $V = \frac{a}{r} + (\text{or} -) \frac{i}{r} 2$ or simply $V = a/r$, where V = the value of the land, a the annual income, r the rate of interest, i being the expected annual increase or decrease. In Great Britain the value of the land is 20 or 25 years' purchase of the annual rent. In the United States, where population and the uses of land are more variable, there is no close relationship between rent and capital value.

of assessment usually followed where the income from land is taxed in the form of an income tax, as in Sweden where there are no land taxes so far as the Central Government is concerned. The net produce is usually the basis of land taxation in India. Land taxes are sometimes, as in France before 1915, apportioned and not rated, the quotas being paid by authorities according to fixed shares. The usual method of levying these taxes is to make them rated or assessable on so much per cent of the capital value of the land. This latter method is fairer, more elastic, and more suited to modern practice. The basis of land taxation may have at first been area. Thus the taxes on jugera in Rome and on the hide or hundred acres were based on this. According to some the taxation of the produce is of equal if not greater antiquity. Productivity or fertility and proximity to markets raise the question of a survey according to a land register which the French call a *cadastre*, the object of which is to avoid inequalities of taxation. These cadastres are very frequently out of date, and the values of the land bear no relation to present-day profits earned from the lands. The tax may be, as we shall see, fixed for a period of years as in India. A preferable method is to fix the tax, as in Japan, on a percentage of the assessed or capital value of the land or simply on a percentage of the rent at which the land is annually let. This percentage may be varied from year to year according to the requirements of the taxing authorities, central, provincial, or local. The taxation of land for local purposes is in all countries a good source of revenue, as the benefits of local expenditure affect real estate and increase the faculty of the owner. It may be quite independent of the central or provincial governments. It may, nevertheless, be levied as an additional tax or cess. In most countries an additional tax is levied by local bodies, and the burden of the rate is often greater than that of the central or provincial land tax. In Austria the land tax is entirely a local source of revenue, the Government taxing income from land through income tax only.

The Taxation of Unearned Increment (or Public Value) of Land

2. The taxation of land has up to the present century referred mainly to the taxation of land for agricultural purposes. This

has tended to obscure the taxation of non-agricultural land, such as urban land, which is an important aspect of the problem. The taxation of land, for example, at a high proportion of the possible rental value, *i.e.* the value which would be derived by putting the land to the use for which it is in demand, and not the rent actually received from its present undeveloped use, promises to be one of the best solutions of the housing problem. The owners would try to bring their land under the best possible use to which it could be put. Modern theory stresses the peculiar taxable capacity of land, since its increase in value is often due to no expenditure of capital and to no effort on the part of the owner, but to the growth of population and the extension of towns. Thus in London at Golders Green land has recently risen owing to railways from £200 or £300 per acre to £3000 per acre. Similarly, owing to the construction of an arterial road a farm at Rochford rented at £80 was sold for £6600. Einaudi has given many similar instances.[1] Adolph Wagner put the case for betterment taxes by taking a piece of land which is supposed to have changed hands for 100,000 marks and after a short period to have been sold again for 150,000 marks, an improvement in the meantime having been made at a cost of 10,000 marks. " There remains ", he said, " of the 150,000 marks 40,000 : that is the unearned increment (*conjuncturgewinn*). This 40,000 marks has the owner produced by his own efficiency and labour ? No ! Has he paid for them ? No ! . . . This 40,000 marks then is to be drawn on for purposes of taxation (*gilt es zur Besteuerung heranzuziehen*). You cannot put the rate high enough in my opinion. I would leave something to the owner who has gained under such circumstances, say, 10 per cent, or as such a measure could not yet be carried through, say 50 per cent, or so far as I am concerned, 30 per cent." [2] The increase in land values created by public improvements goes not to persons or corporations undertaking the expenditure but to the owners of the land, and the owners of land which has thus acquired " public value " should contribute at least a part of this for the general good. The Chairman of the Underground Railway group in London pointed out in 1927 that near London railway enterprise was restricted, and suggested " some means by which the increment in the value of the land could be appro-

[1] Article in the *Riforma Sociale*, August 1900.
[2] *Kommunale Steuerfragen* (1904); cf. Edgeworth, vol. ii: p. 217.

priated to pay some share of the enormous cost attending the construction of Underground Railways in Greater London ".[1] The taxation of land values has come into prominence in the present century especially on account of the experience of Germany and Australia. The principle was recognised in London and New York as early as the second half of the seventeenth century. In Great Britain it died out while the idea in New York spread throughout the United States.[2] The special fitness of land for the " peculiar taxation " was noted by J. S. Mill in 1848 in his *Principles*: "The ordinary progress of a society which increases in wealth, is at all times tending to augment the incomes of landlords ; to give them both a greater amount and a greater proportion of the wealth of the community, independently of any trouble or outlay incurred by themselves. They grow richer, as it were in their sleep, without working, risking, or economising. What claim have they, on the general principle of social justice, to this accession of riches ? . . . The first step should be a valuation of all the land in the country. The present value of all land should be exempt from the tax ; but after an interval had elapsed, during which society had increased in population and capital, a rough estimate might be made of the spontaneous increase which had accrued to rent since the valuation was made. . . . I see no objection to declaring that the future increment of rent should be liable to special taxation ; in doing which all injustice to the landlords would be obviated, if the present market price of their land were secured to them ; since that includes the present value of all future expectations." [3]

The taxation of unearned increment may be done in one of four ways. In the first place, the increment may be taxed from a fixed date in the past. This method has two disadvantages. Firstly, it is difficult to ascertain the value of land at a fixed date in the past. Again it is quite probable that the increment may

[1] *Britain's Industrial Future*, p. 295.

[2] Cf. " Precedents of Assessment according to Benefits " (London County Council, 1893) quoted by Seligman (*Essays in Taxation*, 1911, ch. xi. p. 341). The Act of 1662 for widening certain streets in Westminster provided that if voluntary contributions were insufficient, owners of properties were to pay ' such competent sum or sums of money or annual rent, in consideration of such improvement and renovation as in reason and good conscience they (*i.e.* a jury) shall judge and think fit ".

[3] Book V. ch. ii. § 5.

have been amortised on each occasion when it changed hands. It would be unfair, therefore, to tax the present holder. The second method is to tax past increments accruing to persons at the time of purchase or exchange. This is the method followed in many German cities. Since the beginning of the nineteenth century in Frankfurt there has been an *ad valorem* tax on changes of ownership of real property irrespective of its increase in value. The increment tax, the *wertzuwachs-steuer* of 1904, is levied in addition to this tax when land changes hands by purchase or exchange but not by inheritance. Its sale price is taken as a rule as proof of its value. This tax varies according as (1) the land is or is not built on ; (2) the period since the last sale ; and (3) the amount of increment that has accrued. Where the land has been built on and has been in the possession of the same owner for a minimum period of twenty years the increment tax is levied on the selling price of lands and buildings together at the time of the last sale. The tax rises with the length of the period since the last sale. In New York, Boston, and some other states in the United States site and building are separately valued, but the tax is levied on the capital value of the whole and not on the site value alone. Unbuilt land in Frankfurt which has not changed hands for twenty years pays a similar tax as in the case of land built on, but the rate is higher. No tax is levied if the owner can show that the present price is not higher than the previous price, when account is taken of the cost of any building made in the interval or where the tax would equal the amount of the increment. If the increase is less than 15 per cent no tax is levied; but in other instances from 2 to 25 per cent of the increment is taxed by the municipality, the greater the increment the higher the tax. The example of Frankfurt was followed by Cologne, Hamburg, and other cities. The third method is to tax only future increments. This necessitates the valuation of land and buildings by expert valuers. Thus the scheme which became law in the United Kingdom by the Finance Act, 1910, involved the valuation of 11 million units of land, especially the site value, which meant the market value of land less the value of buildings and improvements on it. It is the practice to tax usually the incremental value of sites only, but it is not unusual to include the value of buildings and sites. Indeed much is to be said for including both. The scheme of 1910 in the United Kingdom

broke down owing to complicated provisions for separating the value of the site from the value of buildings and other improvements. A tax to absorb 20 per cent of all increase beyond 10 per cent in land values after 30th April 1909 was imposed, and was payable each time the property changed hands by sale or on death. The costs of valuation were high and the proceeds of the tax at first low. Its abandonment in 1920 cannot be said to have been taken after a fair trial. It is, all things considered, preferable to tax the increase in the value of both the site and building after making the necessary deductions for improvements. On grounds of uncertainty and expense it is difficult to separate these two values, although their separation is not impossible.[1] The improvements, such as roads and drainage, should be valued at their cost to the owner. It is the cost of the improvements that should be valued, not the effect of them. Sometimes the expenditure may be of such a nature that it does not increase the selling value of the land to the full extent of the cost of the improvement, so called. In such a case the "improvement" should be valued only in so far as it increases, if at all, the selling value of the land. The greatest care must be taken in the application of principles and in seeing that a tax on unearned increment is levied if such increment does not bear its fair share in existing taxation. The land taxation legislation introduced in 1931 in the British House of Commons and subsequently dropped is in this regard of interest. The site value on a particular date (1st August 1931) was to have been taken as the taxable value. This was to have been the price which the land would have fetched in the open market if the plot under valuation were stripped of buildings and if the surrounding land were in its actual state. This valuation was to include any value given to the land by privately constructed roads or drainage. The tax of one penny in the pound of taxable value was to be paid by the owner of the land beginning from the year 1933–34, unless the land was held by a tenant for over fifty years, in which case the tenant was then deemed to be the owner. The tenant was in this case to pay the tax after deducting not more than one-twelfth of the ground-rent. Public land, however used, was to be exempt unless held by a

[1] Cf. Final Report of the Royal Commission on Local Taxation, England and Wales (Cd. 638), 1901, where the controversy regarding the taxation of site values alone is discussed; cf. pp. 431 (Majority Report) and 167 ff. (Minority Report).

tenant on a lease of fifty years. The sites of hospitals (but not their estates), churches, and also land of a value of less than £120 were to be exempt. The proposals of the Bill were exhaustively canvassed and condemned because, among other reasons, (1) it was held that the tax was not in reality an increment duty. It was a tax upon certain kinds of improvements as the valuation subject to tax included much of the expenditure of the owner in developing his estates. It also assumed that the owner made or could make the most profitable use of the land which the environment permitted. The valuation was based on the principle that all kinds of development are equally good at all times and in all places. Why the land is undeveloped was not considered, as the Council for the Preservation of Rural England pointed out. The tax was also not in harmony with the Town Planning Acts under which increased profits in development can be taxed; (2) the tax was a tax on cost of production and would worsen the competitive position of British industry and would drive the marginal factory, the factory hovering between a profit and a loss, out of production. It would be a tax which must be paid regardless of profits, and taxation of this nature which does not fall on actual or potential profits is pernicious. Agricultural land, however, was given special exemption. Land taxation in any form raises the cost of production and curtails the net income from land. It is generally the case that the burden of a land tax cannot be as a rule shifted to the consumer; (3) the income of universities and hospitals paying the tax would be affected and education and healing made more expensive or more restricted; and (4) the valuation owing to its complexity would be out of date when the tax was imposed. It was, in short, a tax penalising private ownership and not a contribution on account of public development. The last method is to tax increment in particular cases, as, for example, when the increment is due to some new development scheme such as a new railway line, roads, or town extension schemes. Betterment taxation in this case is easy, as the value before the scheme is undertaken and after its completion can be correctly ascertained. An annual betterment tax on the increase in value resulting from such public undertakings meets part of the cost and it is, from the view point of social justice, fair that people whose property has increased in value by an improvement undertaken by public bodies should be special contributors to the

cost of the improvement. As a principle it is unchallengeable. The methods of giving effect to this principle are not without difficulties. In the United States, however, to levy such betterment taxes is easy, as the local taxes on real estate are imposed on the owner and not, as in Great Britain, on the occupier. In the United States lands of all kinds are assessed, while in Great Britain only productive or rent-yielding land is assessed. It is, therefore, more difficult in Great Britain to reach the owner, as it means a difference in the method of assessment. From the viewpoint of minimum sacrifice and provided the tax is not very high it is ideal. The tax may or may not be levied on small plots of land and may be graduated so that large areas pay a higher rate of tax. In all countries, even in Great Britain, the principle in the twentieth century has been accepted, and to-day the taxation of unearned increment or of the public value of land is becoming of greater importance everywhere, especially in the sphere of local finance.

Land Taxes in Rome

3. In the Roman Republic the land of conquered communities passed in legal theory into the ownership of the State. Revenue was raised in practice by land taxes in the form of tithes (*decumae*) or money payments (*stipendia*). In some provinces payment in kind was preferred in order that corn might be distributed free in Rome. The collection of taxes was farmed out to groups of contractors (*societates vectigales*). These rapacious tax-gatherers or *publicani* paid a fixed sum to the public authorities and squeezed as large an amount as possible from the taxpayers in the provinces. The Senate under the Republic was the authority in charge of finance, with the censors as finance ministers and the quaestors as secretaries of the Treasury. Under Augustus assessment was based on an imperial census or valuation throughout the Empire. The land tax was collected regularly, and the wasteful plan of farming this source of revenue was done away with and the tax was paid to imperial officials or to local authorities responsible to them. The rate of the tax was fixed by the Emperor, and remissions, Tacitus[1] tells us, even in senatorial provinces rested with him. In the census or survey the area,

[1] *Ann.* ii. 47.

the mode of cultivation, and the out-turn of each holding were stated, the average of ten preceding years being taken as the standard. When Diocletian (A.D. 245–313) reorganised the land revenue system about the close of the third century, fifteen years (the *interdictio* [1]) was regarded as the period for resettlement or revaluation.

Land Taxes in Great Britain

4. In Anglo-Saxon times the revenues of the kings were from their great estates, from fines, and from certain taxes to which every landowner was liable. These taxes—the *trinoda necessitas* —were for repelling the enemy (*heregeld*), for repairing a fort, town, or public defence (*burgbote*), and for repairing or building bridges (*brig-bote*). At first these taxes were paid in kind but subsequently in money. These sources of revenue were insufficient to keep out the Danes. A special tax (*Danegeld*) was levied at so much a hide, *i.e.* about one hundred acres. The feudal aids of Norman times were mainly on land and may be regarded as a form of land tax. Restrictions were placed on these by the Magna Charta, which limited their imposition to certain important occasions, as, for example, the ransoming of the king's person, making his eldest son a knight, and the marriage of the king's eldest daughter to provide her with a dowry. These aids were subsequently known as subsidies, under which the land tax was included. In the fourteenth century we find the taxation of land referred to from time to time. Thus in 1312 the Royal Council, acting under the advice of Walter Langton, attempted unsuccessfully to levy a tallage of a tenth of rents as well as a fifteenth of movables. Later in the second quarter of the same century tallage fell into disuse when Parliament granted tenths and fifteenths—a tenth from cities, towns, and demesne, and a fifteenth from the counties outside demesne. In 1382 landowners undertook to pay the whole tax of tenths and fifteenths, but only for this occasion, "for reverence of God and for the support, aid, and relief of the poor commonalty, who appeared to be weaker and poorer than theretofore".[2] In the following year

[1] This may have been used as early as the time of Hadrian (A.D. 117–138).

[2] Par. Rolls, iii. 134. Cf. Dowell's *History of Taxation and Taxes in England*, vol. i. p. 116.

Parliament granted two half-fifteenths and tenths levied "in the ancient manner".[1] During the Commonwealth period these subsidies were changed from yearly and half-yearly payments into monthly assessments. These formed the connecting link between the subsidies of the Tudor period and the annual land tax of the Revolution.[2] An annual land tax was introduced in 1692. By the Land Tax of 1797 a total sum of £1,905,077 was levied on "real estate", and in the following year this was fixed by Pitt permanently and subject to redemption. In this connexion one is apt to forget that parliamentary government in Great Britain in the seventeenth and eighteenth centuries could only mean the rule of the landed gentry. Illiteracy, except perhaps in Scotland, was disgracefully great. This class by personal interest and political zeal tightened and widened their hold upon the land while at the same time they exerted their great influence on land taxation.[3] It is interesting to note that the fixing of the land tax permanently in Great Britain took place in the same decade as the fixing of the land revenue for all time in Bengal, parts of Bihar and Orissa, of the United Provinces and of Madras. Pitt converted the land tax into a redeemable rent charge with permission to persons interested in lands to buy up and become themselves entitled to an amount of rent charge equal to the tax. Since 1798 the amount unredeemed of the land tax has been regarded as a fixed charge on properties subject to which they are bought and sold. In England and Wales the parish is the assessment area, and in Scotland the counties and boroughs, for which quotas were fixed in 1798. The land tax does not extend to Ireland. The number of parishes in England and Wales which contributed to the tax in 1798 was 16,104; up to the 24th March 1934 the quotas of 1429 of these parishes had been extinguished. The aggregate of the unredeemed quotas in Great Britain on the 24th March 1934 was £861,052. For the year 1933–34 the net receipts after allowing for deductions were £583,825 out of a total tax revenue of £709 millions or only 0·08 per cent. A large part of the tax has been redeemed at 30 times the annual charge, but since August

[1] Par. Rolls, iii. 151. Cf. Dowell, p. 116.

[2] Dowell, pp. 81-82.

[3] Cf. Sir W. J. Ashley, "Comparative Economic History and the English Landlord," *Economic Journal*, vol. xxiii. (1913).

1921 the rate for redemption is 25 times the tax assessed. All holdings have, *ceteris paribus*, had their capital value increased where the tax has been redeemed by the sum paid for redemption. Similarly the selling value of land which has not been so exonerated is depreciated by the capital value of the tax. The maximum rate leviable is 1s. in the £ on the annual value of the unexonerated property as determined for income tax, Schedule A. Where this is insufficient to produce the full amount of the unredeemed quota the balance is remitted. The approximate amount remitted under this head in 1933–34 was £63,152. Total relief from land tax is granted to owners of unexonerated property whose total income does not exceed £160 per annum, and an abatement of one-half the tax is allowed to owners whose total income does not exceed £400 per annum provided the relief is claimed before the payment of the tax. The approximate amounts remitted under these heads were £146,488 and £68,350 respectively in 1933–34. Crown property is not exempt from land tax, but the tax charged on such property, when occupied by the Crown for State purposes, is not collected. The amount of tax not collected under this head was £3243 for 1933–34. Any excess of tax collected over the unredeemed quota is applied as capital in the reduction of that quota. In 1933–34, £37,148 was so applied.

In addition to the land tax there are other and more important land taxes in Great Britain, viz. Schedule A and Schedule B of the income tax. Schedule A includes income from the ownership of lands, houses, buildings, and certain miscellaneous hereditaments (tithes, ecclesiastical dues, manorial profits, certain sporting rights, etc.). The expression "lands" includes farmhouses occupied by tenant farmers and also farm buildings. The gross assessment is the annual value or gross income, *i.e.* the rent at which the property is let or is worth to be let by the year, and certain statutory allowances or deductions are made from this to arrive at the actual income. Schedule B is profits from the occupation of lands and relates mainly to farmers' profits. The assessment, as we shall see in the chapter on income tax, is on a conventional basis which assumes that profits bear a relation to the annual value of the lands occupied. There is also the Mineral Rights duty which was first imposed

in 1909–10,[1] and the rate of duty has been 1s. in the £ on the rental value since that date of all rights to work minerals and of all mineral wayleaves. The term "minerals" does not include common clay, common brick clay, common brick earth, sand, chalk, limestone or gravel, or any substance coming within these descriptions. The person assessed is either the proprietor who works his own minerals, or the direct recipient of the rent paid by the person who is working the minerals in the last working year. The main feature of all these taxes, with the exception of the old land tax proper, is their elasticity. They can be raised or lowered as occasion demands, being levied at so much in the £.

Land Taxes in the Dominions

5. In the nineteenth century the Dominions, the United States, and the Argentine Republic had large areas of unoccupied land. Both Canada and the United States strove to open the land freely to the people, and the result has been the system of free homestead allotments under conditions of residence and improvement. The two great dangers are land speculation and monopoly, and the crushing out of the small proprietor by capitalist agriculture or pasturalisation. The history of land policy in Australia is a case in point, and it is sometimes suggested that the probable solution of the land question there will be the compulsory repurchase by the State of land in private hands for the purpose of settling the landless small farmer. The half-acre blocks sold at public auction in Melbourne in 1837 for £1073 in all were, even thirty years ago, valued at over £5,000,000.[2] By the end of last century in Australasia no less than 125,000,000 acres of land had been alienated in fee simple among nearly four millions of people, companies, and individuals, by cash sales and deferred payments, while an area of 751,000,000 acres in addition

[1] The other three duties imposed by the Finance Act, 1910—the Reversion duty levied at the rate of 10 per cent on the value of the benefit accruing to the lessor on the expiry of long leases, the benefit being generally the difference between the value at the commencement and end of the lease, the Undeveloped Land duty at the rate of ½d. in the £ on the site value of undeveloped land (*i.e.* land not used for agriculture, business, or building purposes but suitable for building on) except public parks, recreation grounds, woodlands, and gardens, and the Increment value duty levied at 20 per cent on the increase in the site value of the land accruing after 30th April 1909 on every occasion of sale or transfer of land—were repealed by the Finance Act, 1920.

[2] *Land Systems in Australia* (Epps), London, Swan Sonnenschein & Co., 1894

had been leased to Government tenants. Of these 125,000,000 acres only 16,000,000 or 17,000,000 acres were under tillage or artificial grass. In Queensland 130,000,000 acres were owned by 45 financial institutions. In New South Wales 40,000,000 acres of the best land had been disposed of by 1884, and in 1891 the process was going on at the rate of 1,000,000 acres a year. Nearly one-half was owned by 67 companies or individuals, and large estates had been built up. This record of alienation is probably unparalleled in modern history, and it has ended in the creation of large freehold estates. The first tax on land in Australia was imposed by Victoria in 1877, at the rate of 1¼ per cent of the capital value, with exemptions up to £2500. The example was gradually followed by other States. The new land taxes are on the unimproved value of the land, the value of the buildings and other improvements being excluded from assessment, and in Queensland, South Australia, and Tasmania are graduated. These vary from 1d. to 8d. in Queensland, from ¾d. to 1½d. in South Australia, and from ¾d. to 3¾d. in Tasmania. The Commonwealth Government in 1910 levied a federal land tax graduated at rates varying from 1d. to 6d. in the £, and in 1926 the rates were from 1d. to 9d. in the £. In Western Australia, Victoria, and New South Wales land taxes are levied at a flat rate. Except in New South Wales, where the land tax was ·02 per cent of the total state taxes, land taxes were in 1931–32 about 8 per cent of the total state tax revenue. The general features of the taxation of land in Australia and New Zealand are (1) the taxation of unimproved ground values and the exemption of improvements from taxation; (2) the exemption of small landowners from taxation and the withholding of the exemption limit from companies, absentees, and large landowners; (3) the extra taxation of absentees and companies. In South Australia, for example, absentees pay an additional 20 per cent over the usual taxes; and (4) the additional liability of income from land to the general income tax, both state and federal. By unimproved value is meant in the Commonwealth Acts the capital sum which the fee simple of the land might be expected to realise if offered for sale on reasonable terms, assuming that improvements had not been made. Absentee in the Commonwealth legislation means a person who does not reside in Australia, or is absent therefrom when the ownership

of his land is determined, or has been absent during half the year preceding that date. Under Section 51, Sub-section (ii.), of the Constitution the Commonwealth Parliament is given power to make laws in regard to taxation, but not so as to discriminate between States or parts of States. The Constitution itself gives the Commonwealth Parliament full powers of levying direct and indirect taxation.[1] Local bodies may in certain cases tax land in addition to the Commonwealth and the States. Thus several States of the Commonwealth have passed a local option law leaving it to local bodies to determine whether they should have land taxation as a system of rating for local purposes. New Zealand is often regarded as a model for land taxation. There is justification for this distinction. The land-tax is restricted to unimproved value and is a graduated tax. In 1885 the size of estates was limited for the future to 2000 acres in all. Thirty-year leases of land were also granted, with the right to perpetual renewal at re-appraised rentals. Unfortunately in 1892 leases were also given in perpetuity at a rental equal to 4 per cent on the cash price of the land. Before 1896 there was no systematic valuation of land, and the methods adopted varied in different places. In 1896 the confusion was ended by the creation of a State department which does the work on a uniform basis. Rating for local purposes was also authorised by the local option law of the same year. Land is assessed on its unimproved value after deducting certain exemptions on account of low value. Increased exemption on account of mortgages was abolished since 1st April 1923.[2] The scale of taxation is graduated and varies from 1d. to 7½d. in the £, and a super-tax of 33⅓ per cent is also imposed. Lands not improved to the extent of £1 per acre, or equal to one-third of the unimproved value, are since April 1921 subject to a tax of 50 per cent more than the rate fixed by the annual taxing act for other land.[3] Income derived

[1] *Official Year Book of the Commonwealth of Australia*, No. 14, p. 670. On p. 732 a convenient conspectus is given of Land Tax Acts in force in Australia, 1921 (A. J. Mullet, Government Printer, Melbourne).

[2] Mortgaged real estate should not escape all taxation by not being assessed at its full value. If not taxed, loans on real estate do not bear their fair share of taxation, and the holder of the unmortgaged real estate is more heavily taxed by having to pay a higher rate of tax than he would have had no such deductions been allowed.

[3] *The New Zealand Official Year Book*, thirtieth issue (1921–22), p. 416 (Government Printer, Wellington).

from mortgages of land has been since 1917 assessed under income tax instead of land tax as hitherto. Landowners are liable to income tax in addition to the land tax as in Great Britain.

In Canada, under section 92 of the British North America Act, 1867, " Direct Taxation within the province in order to the raising of a revenue for provincial purposes " is one of the exclusive powers of provincial legislatures. The Dominion Government has no direct tax on land *per se*, but it receives in the three prairie provinces (Manitoba, Saskatchewan, and Alberta) and part of British Columbia, a relatively small revenue in the form of sales and rentals from Crown lands. Land is taxed in the majority of the provinces for state purposes, Quebec being a notable exception. In some of these the land tax is a large proportion of the total provincial revenues, while in others the yield is unimportant. In Prince Edward Island, for example, it is 60 per cent of the total tax revenue, while in Nova Scotia it is about 8 per cent. In British Columbia the real property tax includes the taxation of land. In some provinces, viz. in British Columbia and Prince Edward Island, the land tax is supplemented by a tax on income and in almost all provinces by a tax on corporations. Cities and towns tax land to a large degree, and in Western Canada considerable use is made of unimproved land values for taxation purposes.

In South Africa the system of land taxation is briefly as follows : In the Orange Free State, the Transvaal, and the three old Transvaal districts annexed to Natal after the Boer War there is a land tax on all occupied land. In the Orange Free State the tax was based on the extent and not on the value of the land. It is similarly levied in the Transvaal, where, however, the rate is higher on quitrent tenure than on land held in freehold. The cost of collection is high, and it has been suggested that it should be converted into a redeemable rent charge. In the Cape and Natal such taxes do not exist, although the Union Government obtains a small revenue from these provinces in the form of rent or quitrents. In 1919 the Transvaal Provincial Council agreed to the imposition of an " increment value duty " which varied from 5 to 25 per cent on " profits realised on the sale, cession, exchange, donation, or any other disposal of fixed property with the exception of the disposal of fixed property by

an ecclesiastical, charitable, or educational institution of a public character, or by a person who became entitled thereto by way of legacy or inheritance, the amount of duty being subject to an abatement of 2½ per cent in respect of each completed year from the date of acquisition".[1] The tax was, in spite of its productivity, repealed in the following year. The principal local tax of the Union is the immovable property tax levied at a uniform rate on the combined value of land, buildings, and other immovable property. In some municipalities rates are levied on the site value alone irrespective of buildings and other improvements, *e.g.* in Johannesburg, or on the site value at a higher rate than on improvements, *e.g.* in Pretoria. In one province only, Cape Colony, is this tax used for provincial purposes. The farming community in South Africa is strong numerically, and this, added to the fact that the industry is precarious owing to the liability of drought, probably accounts for the absence of land taxation on lines similar to those in Australia and New Zealand. In South-West Africa a land tax leviable on all landed property, rural and urban, is collected in accordance with the ordinance that obtained when the country was under German rule.

The main lessons from the history of land taxation in Great Britain and the Dominions are: (1) the desirability of a systematic system of land valuation, which should be up-to-date; (2) the assessing of land taxation on a percentage of the capital value, which should be capable of adjustment from year to year, *i.e.* the tax should be elastic; (3) where the tax has been, as in Great Britain, fixed permanently, there should be other means of taxing land; this has been successfully surmounted by Schedules A and B of the British income tax system; (4) local authorities may levy rates or taxes on land for local purposes; and (5) the taxing of unimproved land and the extra taxation of absentees and companies, as in Australia and New Zealand, has proved to be successful.

Land Taxes in France

6. The land tax in France was based originally on a cadastral survey which was begun in 1807 and completed in 1850. Between

[1] Transvaal Ordinance 5 of 1919, §§ 2, 3, and 16; cf. *Finances of the Union of South Africa*, by M. H. De Kock (Capetown: Juta & Co.).

1907 and 1914 a reform in land taxation was introduced, as the old system had become obsolete on account of the out-of-date nature of the cadastre. According to the new plan the tax was a uniform rated tax assessed at 4 per cent, increased to 5 per cent from 31st July 1917 and subsequently from 25th June 1920 raised to 10 per cent. Lands are divided into thirteen groups for purposes of assessment. Agricultural lands are again subdivided into not more than five groups according to the fertility of the soil, the value of the produce, and the situation of the land. The Controller of Direct Taxes who is assisted by the maire and classifiers appointed by the prefect take the actual rent paid as the most important fact in determining this classification. If the cultivator is the owner the competitive rent for similar land is the basis of assessment. In addition to the land tax proper there is the income tax, an agricultural profits tax (*impôt sur les bénéfices de l'exploitation agricole*), combined with a general or supplementary income tax (*impôt général sur le revenu*). The agricultural profits tax is levied on rental value and the rate is 12 per cent. It is calculated by adding 75 per cent to the rental value and multiplying by 3 (or by 2·5 for wheat lands and 5 for market gardens and woods if worked commercially) or by taking the actual profits of the preceding year, whichever is less. 2500 francs is the exemption limit, and also the abatement with partial abatements for all incomes from agriculture between 2500 and 8000 francs. The general or supplementary tax has an exemption limit and abatement, 7000 francs, with allowances for wife, children, and dependents. There is an increase of 25 per cent in the general income tax if the taxpayer is unmarried or divorced and is over 30 and without a child or dependent, and of 10 per cent if married and over 30 and without a child or dependent after two years of married life. The tax varies between 1·2 per cent on the income between 7000 and 20,000 francs, and rises to 30 per cent on the portion above 550,000 francs. Agricultural income is not fully taxed, and in a recent year the tax on land and the tax on agricultural profits were of the land tax and total income taxes on all classes of income only 14 and 1 per cent respectively, as against 33 per cent, the tax on industrial and commercial profits. It is argued, and not without reason, that while agricultural profits form a large part of the national income, they are not so in the income tax receipts and, therefore, that

agriculture does not bear its fair share of taxation. The French peasant, like the Frenchman in general, dislikes direct taxation, and this may explain in part why agricultural income is not bearing its proper share of national burdens. Local authorities, such as the department and the commune, also receive a large part of their revenue from the taxation of land by the addition to the national tax of so many hundredths or centimes additionnels. The whole of the tax is collected by the national authority and paid over to local authorities, the majority of which are not in a position to collect the taxes independently. Thus in a specific instance the land tax showed in the demand note that the principal or share of the national authority was 48 per cent, 40 per cent was that of the department, and 12 per cent that of the commune. The amount that can be added by each local authority to the national tax is prescribed by law.

Land Taxes in Italy and other European Countries

7. The taxation of land, as in France, is achieved by means of a land tax proper and by the machinery of the income tax. The land tax (*imposta sui terreni, imposta fondiaria*) is assessed on rental value and is distinct from the agricultural profits tax. The rate is now 7½ per cent and is fixed according to a system of cadastres, revised periodically according to the law of 1886. If land is let to a farmer the proprietor himself pays the land tax. The taxation of agricultural profits is by means of a tax on income assessed on the basis of declarations by a commission in each district, and these are assessed at half the standard rate, 14 per cent, *i.e.* 7 per cent. There is in addition the general or supplementary income tax (*imposta complementare globale progressiva sub reddito*). The exemption limit is 6000 lire before allowing for a 5 per cent abatement for each child or dependent excluding wife, and 3000 lire after allowing for them, and the rates vary from 1 to 10 per cent. As in France surtaxes for local purposes, for provinces and municipalities are added to these taxes and are not to exceed as a maximum 150 per cent of the basic rate of the land tax. Local surtaxes may also be levied on the state income tax as well as on the land tax. Thus a farmer with an income of 100,000 lire (£1081) cultivating his own land would pay 7½ per cent land tax, 7 per cent on agricultural profits, 2 per

cent on supplementary income tax, 11¼ per cent (maximum 28 per cent on the land tax) together with 2 per cent on the state income tax, or roughly a total state and local taxation amounting to 30 per cent. In Hungary and Czechoslovakia there is a state land tax, a general income tax, a capital tax and surtaxes for local purposes by local bodies. In Austria since the War the land tax has been entirely local, the Central Government taxing income from land only through a general income tax and a capital tax. In Sweden the land tax was abolished at the end of the last century, and the Central Government taxes income from land through income tax. All taxable land is valued every five years, and the landowner or the farmer is given the alternative of declaring his income or being assessed on income calculated at 6 per cent of the valuation. When the owner himself is farming the land the rate is 12 per cent. Local taxes are levied on the same basis, and the rates vary from 4 to 16 per cent. In Bulgaria the land tax was abolished in favour of an income tax in 1921, but reintroduced in 1923 as peasants did not declare their incomes. The income tax in 1923 was modified to exclude income from land.

Land Taxation in India

8. Land taxation in India, known usually as land revenue, is of immemorial antiquity. The question whether land revenue is rent or a tax is now usually regarded as not worth arguing. It certainly is not, except in the rarest of cases, pure rent, and, like similar imposts on land in other countries, is best classified as a tax.[1] It has all the characteristics of a tax, and its classification as rent or as a tax does not in any way affect its incidence [2] or its effects. There are some, however, who prefer to keep to the theory that the land revenue of India is rent. Of the value

[1] In the answer to a question in the House of Commons on 24th March 1920, land revenue was classified rightly as a direct tax. On p. 236 of the *Statistical Abstract for British India* (No. 2196 of 1930. Calcutta, Superintendent Government Printing) it is somewhat inaccurately stated, however, "Land Revenue is not properly taxation". For a compendium of views on the nature of Indian land revenue see App. IV. vol. ii. of Indian Taxation Enquiry Report, 1926. The State has conferred proprietary rights in permanently settled areas, and it does not preclude sales and mortgages in land in ryotwari areas. The state has not claimed universal ownership.

[2] Chapter XIX.

of the gross produce it forms only a small percentage, a percentage that shows a remarkably steady decrease in the last forty years. In 1881 land revenue was 6·2 per cent of the gross value of agricultural produce; in 1898 it had fallen to 5·9 per cent; in 1902 it was 5·9 per cent. By 1911 the percentage had fallen to 2·6, and in 1926 it was 2 per cent. In the Hindu era one-sixth of the gross produce was said to be the traditional share.[1] This in Mohammedan times was one-third, in some cases much more, and it was assessed largely in cash. The proportion of land revenue to gross produce has decreased, but in estimating the actual burden other factors have to be considered, such as an increase in the cost of production and the fall in the purchasing power of money.

In taking this proportion which the tax bears to the total *gross* value of the agricultural produce, we should not be taken to mean that this is in any year an index of the burden of the tax, which is measured by the percentage or proportion it bears to the difference between the gross value and the cost of cultivation. One does not tax a shopkeeper on his gross receipts, and the same applies to every agent of production.

If A = the cost of production,
B = the economic rent, and
C = the value of the produce, then
A + B = C.

Under cost of production there are a number of factors, viz. the price of labour (wages), the price of capital (interest), earnings of management, and the cost of materials (seed, etc.). The fact that wages have increased does not necessarily imply that the cost of production has increased at the same rate. Economic rent may increase even though the value of the produce increases less than the cost of production. It is, in other words, clear that the cost of production or one factor in the cost of production, say wages, may increase more rapidly than the price of the produce, without decreasing the economic rent in any way. Thus an increased tax on rent (or land revenue) may be quite justified, in spite of a rise in the cost of production. To put the matter in another way, the wages bill in 1911 in the Bombay

[1] "Taking from his subjects a sixth part of their riches, he should protect them all" (ch. 139, *Santi Parvam of the Mahabharata*).

Presidency for agriculture was estimated at Rs.23 crores as compared with Rs.46 crores a decade later. The value of the produce in the former year was Rs.133 crores, and in 1922 Rs.208 crores. There was an increase of 100 per cent in wages, and 56 per cent in the gross produce. Wages in India at the present time are a large item in the cost of production, and we may assume that wages in the illustration above is the equivalent of the cost of production. Now

$$\begin{aligned} B &= C - A \\ &= 110 \text{ crores}^1 \text{ (1911)} \\ &= 162 \text{ crores}^1 \text{ (1922).} \end{aligned}$$

Therefore B (*i.e.* economic rent) has increased, although the value per cent of the produce increased less than the cost per cent of production. An increase of the tax on "B" would be quite justified in these circumstances. This point has been raised because it is sometimes argued that if the cost of production increases more than the value of the produce, the State should not take more as land reveune.[2]

Land revenue is a right of the ruler or the State to a share of the produce of the land, a right that has been recognised for centuries throughout India. During the Moghul period land revenue was collected mainly through a system of farming, as is the case in China to-day. Akbar used an alternative system,

[1] One crore = 10 million rupees = £750,000.

[2] Mr. W. H. Moreland, C.S.I., C.I.E., formerly Director of Land Records in the United Provinces, writes with regard to the peasant's payment thus: "His payment is fixed in terms of the Producer's Surplus at the time of assessment; it very rarely, if ever, amounts to the whole Surplus, but ordinarily leaves part of it to the peasant, and this part ordinarily increases between assessments. This view is not merely true, but fruitful, because it directs attention to one of the most important questions in India, the use made by peasants of their margin. Politicians may deny that the margin exists, but it is a fact which has to be realised by students of economics. If the peasant employs the margin in (*a*) improving his holding, or (*b*) in raising his standard of life so as to increase efficiency in business, or (*c*) invests it outside his business, then India is laying foundations for a progressive and cumulative increase in the National Income: if he (*d*) hoards it, or (*e*) spends it on things not conducive to efficiency (particularly excessive leisure), then there is no economic justification for leaving him a margin. In point of fact the margin is distributed in all these channels. A sinks a well. B eats wheat instead of millet. C buys Savings Certificates. D buries coins in the ground. E takes to drink, or (what is far worse) sublets his land, and sets up as an Intermediary. The balance between these lines of action will go far to determine the movement of the National Income."

viz. direct administration. His ideal was the payment of salaries to officials from the Treasury—the modern practice. In his time, and also to a greater degree in the time of his successors, the system of payment by assigning to the official the revenue yielded by a tract of land, a jagir, was prevalent. Akbar's land revenue was charged not on the land occupied but on the land cultivated, no payment being made for land which lay fallow. This was the system traditionally followed of taking a share of the produce of the land cultivated. During the period from Akbar to Aurangzeb the cultivator's liability to the State increased from one-third to one-half of the gross produce. The cultivator might pay more than this, as it was left to the assessor to determine the amount of land to be cultivated. About 1594 land revenue yielded Rs.860 lakhs (£5·7 millions); on the accession of Shah Jahan it was 29 per cent higher, the increases being due partly to extended cultivation and partly to the rise in the standard of assessment.[1] Regulation II. of 1793 states that Government's share of the produce is fixed by estimating the rents paid by the tenants, deducting the cost of collection, allowing to the landlords one-eleventh of the remainder as their share, and the State appropriating ten-elevenths as its share. Regulation XIX. of 1793 showed that by the ancient law of the country the ruling power has always been entitled to a share in the produce of the soil. The payment of this land revenue or tax is a recognition of permanent rights over land, and it is to-day no uncommon experience for men, widows, and even minors to ask to be allowed to pay the demand since this is regarded as an outward sign of title to the land. The payment of land revenue, in short, is in the eyes of the cultivator a cardinal factor in village polity.

During the last sixty to eighty years the system has been elaborated with care, and the cultivator has been viewed with great sympathy by Government. A detailed code, for example, regulating the remission or suspension of revenue on the failure of the crops obtains in all provinces. The assessment, too, tends to leniency. "Those who are familiar with the realities of assessment know well that among Settlement Officers there is a growing inclination towards leniency of assessment. . . . The more the officers of Government know of the people, and the

[1] Cf. Moreland, *Akbar to Aurangzeb*, p. 323 (London, Macmillan, 1923).

more intimate their mutual relations become, the less likelihood is there of severity in the enforcement of public dues. In no official relation does a member of the Public Service come into such close contact with the people as in settlement work, and it cannot be his desire to aggrieve those among whom he is spending some of the most laborious years of his life, or to initiate a settlement which, after a short interval, will break down. Every natural instinct and every recent injunction of the Supreme Government urge him to reasonableness and moderation."[1] This is no paper injunction, and steps are actually taken to ensure leniency, reasonableness, and moderation by Settlement Officers. The Mohammedan rulers carried on the system of their Hindu predecessors. This was developed, especially in the time of Akbar, by his famous Hindu finance minister, Raja Todar Mal. An interesting account of this is given in the *Ain-i-Akbari*, written by Akbar's minister, Abul Fazl. When in 1765 the British assumed the Dewani of Bengal, Bihar, and Orissa, the system was given a new lease of life, but its foundations date at least from Akbar's time. Broadly speaking, there are two systems of land revenue settlement: (i.) the permanent settlement and (ii.) temporary settlements, the rates in which are revised from time to time, at present once in about thirty years.

9. The permanent settlement was initiated in 1793 by Lord Cornwallis, who was Governor-General from 1786 to 1793. This was under the orders of the British Government, and in opposition to experienced Indian officials such as Sir John Shore (afterwards Lord Teignmouth and Governor-General from 1793 to 1798) and Sir Thomas Munro. It has already been pointed out that this was effected in the same decade as witnessed the fixing for all time of the English land tax. The permanent settlement applied to the greater part of Bengal, Bihar, and Orissa, and to parts of the United Provinces, Madras, and a few other isolated tracts. The East India Company, when it succeeded to the dewani or revenue administration of Bengal in 1765, was confronted with the scramble for squeezing out of the land the maximum of revenue consequent on the chaos that took place on the break up of the Moghul Empire and the weakening

[1] *Land Revenue Policy of the Indian Government*, 16th January 1902 (Calcutta, Superintendent Government Printing, 1920). It is no secret that the Resolution was written by the Governor-General himself (Lord Curzon).

of central authority. After the failure of several schemes the permanent settlement was decided on by the Company 28 years after its assumption of the dewani. The Government fixed the land assessment permanently, and agreed not to levy further charges except the right was reserved to reimpose Sair or minor duties abolished in 1790.[1] The Directors of the Company stated that the permanent settlement was "not a claim to which the land-holders had any pretensions, founded on the principles or practice of the native government, but a grace which it would be good policy for the British Government to bestow on them".[2] At the time of the settlement the Government share of the rental was assumed to be 90 per cent, and the gross rental of the province of Bengal was Rs.4½ crores. The rental in 1899–1900 for what then was included in Bengal, Bihar, and Orissa amounted to Rs.16½ crores.[3] This came to Rs.25·35 crores in 1922–23. The increase is due partly to actual increases in rents and partly to revised methods of calculating cess. This was the rental as valued for the purpose of determining the local rates and cesses from which is mainly met the cost of district roads, primary education, and rural dispensaries.[4] If the existing standards in neighbouring temporarily settled tracts are applied to the area under permanent settlement in Bengal, Bihar, and Orissa, and the United Provinces (*i.e.* what in 1793 constituted Bengal), the total land revenue would be

[1] Cf. Indian Taxation Committee's Report (1926), vol. i. p. 42, and Bengal Permanent Settlement Regulation I. of 1793. When income tax was first imposed in 1860 agricultural incomes were not exempt. Government always retained the right to impose a general tax.

[2] Cf. Banerjea, *A History of Indian Taxation* (Macmillan & Co.), p. 401.

[3] *Land Revenue Policy of Indian Government*, p. 56.

[4] Local rates are also in force elsewhere. "In the ryotwari provinces of Bombay and Madras and in Coorg the incidence of the Local Rates (for roads and schools) is precisely that in force in Bengal. This comparison involves the assumption that ryotwari revenue is the equivalent of rent; but, as a matter of fact, the extent to which sub-letting prevails in ryotwari provinces indicates that the revenue is substantially below the rental value, and the Local Rates are consequently below the Bengal level. In Lower Burma the Local Rates amount to 10 per cent and in Assam to 8·3 per cent on the ryotwari revenue. In the Punjab they are equivalent to 5·2 per cent on the rental value. In no other provinces do they exceed 4 per cent. In the North-West (*i.e.* the United Provinces) they are charged at 6 per cent, but two-fifths of the proceeds are devoted to the maintenance of the village watch, which in Bengal and other parts is a charge upon special contributions assessed and collected apart from Local Rates" (*Land Revenue Policy of Indian Government*, p. 25, para. 24).

Rs.8·28 crores (£5·5 millions). In other words, the permanent settlement in these parts alone is even on present ryotwari rates a bounty of Rs.4·38 crores (£2·9 millions) to a minority of landowners as a result of the action of Lord Cornwallis. For all the permanently settled tracts in India the annual loss is in the neighbourhood of Rs.6·04 crores (£4·3 millions).[1] This huge concession means that much money, so necessary for removing the blight of illiteracy and for increasing the production of wealth, slips year by year through the hands of the State.[2]

10. Next with regard to the temporary settled tracts. The two subdivisions are (*a*) the "zemindari", "malguzari", or "talukdari", and (*b*) the "ryotwari", ryot being an Arabic word for a subject and used in India for a cultivator. Under the former system the landlord pays the land revenue to the State whether he cultivates the land himself or by means of rent-paying tenants; in the latter the cultivator pays directly to the State. The assessments are ordinarily readjusted once in the lifetime of each generation, *i.e.* once in about thirty years. In Bombay the thirty years' period was introduced by the East India Company so far back as 1837. In 1895 the Secretary of State decided after exhaustive examination that "30 years should continue to be the ordinary term of settlement in Madras, Bombay, and the North-West (now the United) Provinces, that in the Punjab 20 years should be the general rule (30 years being admitted in some cases), and in the

[1] This total is made up as follows: Bengal, Rs.2·12 crores; Bihar and Orissa, Rs.2·12 crores; Madras, Rs.1·18 crores; Assam, Rs.0·47 crore; United Provinces, Rs.0·14 crore, and Ajmere-Merwara, Rs.0·01 crore (*Statistical Abstract*, 1920–1921).

[2] Cf. Report of the Indian Statutory Commission (Cmd. 3569, 1930), vol. i. p. 340: "Whatever may be said for the wisdom of the policy carried out by Lord Cornwallis, and however absolutely the guarantee then given to the zemindars and their heirs must be fulfilled, the consequences at this time of day are remarkable. There is land in the City of Calcutta, the owner of which pays in land revenue a little over a quarter of a rupee per acre, although the annual value of the land runs into thousands of rupees. Most of the up-country towns in Bengal are built upon permanently settled land, which, thanks to the settlement of 1793, escapes any increased land revenue and pays only a fraction of a rupee per acre. There are large areas which in 1793 were not under cultivation at all and to-day are producing valuable crops of jute. The owners of these portions of land pay practically no land revenue and claim that they can never be required to do so. One result of this is that the districts near Calcutta which were fully developed 130 years ago contribute much more by way of land revenue than some far bigger and far richer districts in remoter parts of Bengal."

Central Provinces 20 years also. A 30 years' term has been adopted for the recent resettlement in Orissa. In backward tracts, such as Burma and Assam, and in exceptional circumstances such as exist in Sind, shorter terms are permitted. The reasons for this differentiation are familiar and obvious. Where the land is fully cultivated, rents fair, and agricultural production not liable to violent oscillations, it is sufficient if the demands of Government are readjusted once in 30 years, *i.e.* once in the lifetime of each generation. Where the opposite conditions prevail, where there are much waste land, low rents, and a fluctuating cultivation, or again, where there is a rapid development of resources owing to the construction of roads, railways, or canals, or to an increase of population, or to a rise in prices, the postponement of resettlement for so long a period is both injurious to the people, who are unequal to the strain of a sharp enhancement, and unjust to the general taxpayer, who is temporarily deprived of the additional revenue to which he has a legitimate claim."[1] The assessments are so framed that they leave to the proprietor or to the cultivator that margin of profit which should enable him to save in ordinary years and to meet the strain of bad years. The landlord's enhancement of the tenant's rent has been limited under the zemindari settlements for the protection of the ryot.[2] Government have also limited their own share. We have already referred to the demand at the end of the eighteenth century being the equivalent of 90 per cent of the net rental. As much as 75 per cent and over was inherited from Mahratta rule.[3] In the United Provinces between 1820 and 1840 the standard was five-sixths. This was lowered to two-thirds in the latter year and one-half in 1855. The Saharanpur Rules of 1855 prescribed that "the Collector will bear in mind that about one-half, and not two-thirds as heretofore, of the well-ascertained net assets should be the Government demand". This has been in practice the maximum limit. The standard rate of assessment is not to exceed half the net assets, that is, the rent when the land is

[1] *Land Revenue Policy of Indian Government*, p. 8, para. 18 (Government Printing, Calcutta).

[2] The Bengal cultivator was rackrented and oppressed under the permanent settlement, and legislative measures such as the Bengal Tenancy Act of 1859, the Act of 1885, and similar measures of more recent date had to be passed to place him in a position of greater security and to prevent the abuses of the permanently settled system.

[3] *Land Revenue Policy of Indian Government*, para. 12.

let on payment of a cash rent. When the land is cultivated by the owner the net profits can be measured by the rent paid for other lands. These net profits must be as large or larger than the normal cash rent. If it is not the owner will not cultivate it. He will cultivate for wages probably someone else's land. The cash rent, of course, depends on other factors than the gross quantity of the produce; it depends on the money value of the produce after allowing for costs of production. It has also been suggested that there should be a minimum limit on the net rental.[1] Since 1855 the standards have been further reduced. In the Punjab, for example, with the great increase in agricultural assets the proportion has been about one-fourth in place of one-half. There is nothing *in law* to prevent Government from taking at the next settlement of land revenue 75 per cent or more of the economic rent. The whole system of assessment and rates of claim are based on executive order, and the jurisdiction of the ordinary courts is barred. The margin of profits to the landlord and the ratio of the produce left to the cultivator have increased, because Indian agriculturists in the view of Government will increase in efficiency the more capital returns to the land and the higher their standard of living is. Care must be taken not to confuse rent with revenue. A proportion of rent or of produce which would leave a wide margin of profit in one part of India may be vexatious elsewhere. It is not possible to reduce revenue to an exact mathematical proportion either of gross or of net produce. This, if put in force, would place burdens on people who under a less rigid system, sympathetically administered, are free from such difficulties. Permanent agricultural improvements, it should be remembered, are expressly exempt from any enhanced assessment in Bombay and Madras for ever, and in other parts of India for a period, irrespective of the term of settlement and sufficient for the capital sunk to be fully recouped from the additional assets created. If this were not done and if the cost

[1] Rental value is by itself an insufficient basis. Statistics of rentals are few in a province where the majority of revenue payers are cultivating owners, and therefore such statistics are to be used with the utmost caution, especially in averaging of rentals, for arriving at a basis for assessment purposes. Other factors must be considered, *e.g.* (1) the state of communications during the previous settlements; (2) the proximity of markets; (3) the trend of prices; (4) the general economic conditions and history of the tract; and (5) the results of crop experiments. Rental statistics are only of value where the land is held by large landowners and cultivated by tenants.

of improvements were swept off at revision, the temporary or zemindari system would be as blundering as the permanent revenue settlement.

India is to-day perhaps unique in the up-to-dateness of its cadastre or survey. Each field is measured up and the local official keeps the details of the crops sown. The various entries prescribed in the land revenue codes are checked by inspecting officials. This applies to all tracts which have not been permanently settled. The actual details of settlement vary from province to province, although there is a family likeness common to all. In Bombay, for example, the basis of settlement is the survey number, which is a convenient unit block of land, never supposed to exceed the area which one man could cultivate with a pair of bullocks but frequently is much smaller than this. Arable land is divided into these survey numbers and the area is carefully surveyed. The soil of each survey number is classified according to the depth and texture of the soil. This is the chief factor which determines the assessment of each field. Sixteen annas (the number of annas in a rupee) represents the best soil, and the soils below this in quality are fixed at so many annas. The measuring and classification or soil valuation have, of course, nothing to do with the assessment, but are only the means of distributing the assessment over the holdings in the ryotwari system. This operation of valuing relatively the soils is now complete, and however much in future the total amount of the assessments is changed, this classification remains unalterable, *i.e.* the distribution between field and field will be the same as at present. The rates of assessment are worked out for groups into which the taluka or subdivision of the district is divided according to economic circles. Physical homogeneity, and climate, rainfall, general fertility, communications, are considered in this grouping. For each of these groups maximum rates are fixed. These maximum rates are leviable upon fields the soil valuation of which is sixteen annas.[1]

Thus, if the maximum rate be Rs.3 per acre of a sixteen-

[1] In Sind the assessment is fixed on each survey number at rates varying according to the method of irrigation. If the field is fallow nothing is collected subject to the liability of land to pay assessment once in five years. In other parts of the Presidency land pays land revenue whether in cultivation or not. Water is scarce in Sind.

anna field, the assessment per acre on a field valued at eight annas would be Rs.1.8.0. Before fixing the maximum assessment rates the Settlement Officer reviews prices, wages, rents, rainfall, the selling, letting, and mortgage value of the land, and similar factors. The cash rents paid and the selling value of the land are of supreme importance as a guide, although sometimes neglected. Upon an examination of the factors he bases his proposals for enhancement or reduction of assessment. If he finds that the condition of the countryside has not been improving and prices have been stationary, he will not propose any enhancement. If he thinks that cultivation has been contracted and the land revenue difficult to collect, he will suggest a reduction in that area. If, on the contrary, there has been a large increase in cultivation, if the letting and mortgage values of the land have increased, if the assessment is paid with ease, he will propose an increase of assessment. When once a settlement has been done—Bombay owes much to Pringle, Wingate, Davidson, and a large and honoured band of Settlement Officers—a revision is not a difficult matter. The method of revising the maximum rates applicable to each field, according to the classification of the soil, brings about a result the effects of which are equitable through each group, village, and field. In Madras and other provinces there are differences in detail, but it is fairly clear that not even in the Roman Empire or in the Domesday Book was there so detailed a cadastre as in India to-day.

The incidence per acre fully assessed varies, often considerably, from province to province, and from Indian State to Indian State.

RATES PER ACRE (total area)

	Permanent Settlement.	Temporary Settlement.	
		Zemindari.	Ryotwari.
	Rs. A. P.	Rs. A. P.	Rs. A. P.
Madras	0 10 8	..	1 15 0
Bengal	0 9 9	1 13 7	..
Assam	0 1 6	1 12 10	2 4 5
United Provinces	0 15 3	1 2 7	..
Bombay	..	0 10 0	1 5 6
Punjab	..	1 4 4	..
Central Provinces	..	0 7 1	1 0 10

The above table shows the incidence per acre in the permanently settled tracts, together with the temporarily settled tracts.

To any one who knows the capital value of the land these figures are low, especially since the beginning of the present century, when India became closely knitted up in her economic solidarity to the outside world. In 1832 the selling value of inherited (*miras*) land in the Deccan was no more than two or three years' purchase. Land yielding Rs.200 gross produce could seldom be mortgaged for more than Rs.100. The selling value of land in the talukas of the Bombay Presidency that were settled in the quinquennium ended 1901 was 24·8 times the assessment. The mortgaging value of the land was about 19 times the assessment. The letting value, *i.e.* the average rate of rent, was 3·2 times the land revenue. An examination of recent settlement reports [1] shows that land in the Bombay Presidency has been selling for about 80 times, and has been mortgaged for about 40 to 50 times, the assessment. The letting value was about 6 times the land revenue. Thus the settlement reports of Sholapur (Malsiras), East Khandesh (Jamner, Bhusawal, Erandol, and Parola), and the Upper Sind Frontier (Shahdadkot), show that the selling value was 93·23 times the assessment in Erandol, 86 times in Bhusawal, 81 times in Malsiras, 78 times in Jamner, 61·56 times in Parola, and 19·3 times in Upper Sind. These values of land subject to full Government assessment, especially in view of the high rates of interest, are very illuminating.

While other taxation has increased, land revenue has been almost constant, and indeed in 1932 was actually less than in 1914. Taxation including land revenue *per capita* was in 1913–1914 (the pre-war year), Rs.1-10-9 and in 1931–32 Rs. 4-12-6, an increase of 186 per cent, while land revenue *per capita* in the same years was Rs.1-5-3 and Rs. 1-2-10 respectively, a decrease of 12 per cent. It is not possible to estimate the costs of collection, but were this available the net yield of land revenue would show an actual decrease. In short, this source of revenue is inelastic and unsuitable in its present form to meet the increasing costs of administration, and especially those of national building departments like education. The cultivator or the landlord, on the other hand, has gained greatly.

[1] 1911–1920.

The burden of land revenue cannot be estimated merely from the amount of revenue collected, as prices fluctuate, or, in other words, the purchasing power of money does not remain stationary at different periods. During the last twenty years land revenue, when it was not permanently fixed under the Permanent Settlement, increased only at an average rate of 1 per cent per annum. Until the Reforms no real attempt was made to look for new sources of public income. In some provinces, notably, for example, Bihar and Orissa and Bengal, the land tax is totally insufficient for provincial needs, which must continue to expand. While the land revenue is no longer one of the chief sources of central finance, it is still so of provincial finance. In Bombay, for example, the administration has to be paid for mainly from two main heads of revenue—land revenue and excise—both of which are liable to vary greatly owing to a failure of the rains or other calamity. This is a serious matter when large recurring expenditure on education and other social services has to be met. The question, therefore, of the best method of taxing land is a pressing one in this country. There is as yet no income tax on income from land and agricultural profits as in Schedules A and B of the British Income Tax.[1] Moreover, income tax is a central, not a provincial, head of revenue, and when a general inquiry into taxation is undertaken by the Government, as it must do in the very near future, the system of land taxation now in force must needs come under scrutiny. Before 1917, when income tax was systematised as well as overhauled, direct taxation meant little else than land revenue, and finance was in fact simply the most cheeseparing and rigid economy which was intended to keep the cost of government within an inexpansive system of taxation. An over-cautious Government, unwilling to look for new sources of income, was like the worker in a Bombay mill, ignorant of a banking account and of finance except as expressed in terms of an inadequate income against a low expenditure or standard of living. With the Constitution of 1919 all was changed, and in the near future the weakest part of the Reforms, the field of public finance, will require scrutiny. Indeed, federal and provincial

[1] The Indian Statutory Commission (Cmd. 3569, 1930) recommends the taxation of agricultural incomes for provincial purposes and estimates the yield at approximately Rs.5 crores.

finance are delicate pieces of furniture, the cobwebs of which cannot be removed by a Turk's head mop.

11. What then, it may be asked, is to be the future of land revenue in India—that ancient seignorial claim of the State universally recognised as a liability and as an obligation attaching to rights in land throughout the country ? The Joint Committee of Parliament in their Report on the Government of India Bill, 1919, recommended that the principles governing this source of revenue should be reduced to statutory form so far as this has not been done. In other words, the Committee suggest that land revenue should no longer depend with its honeycomb of codes and rules on executive fiat but on legislative authority.

Legislative provision in the opinion of the Committee should be made for (1) the main principles by which land revenue is determined ; (2) the method of valuation ; (3) the pitch of assessment ; (4) the periods of revision ; and (5) the graduation of enhancements. Land revenue in many provinces is levied by executive action without any limitation by statute of such matters as the rates of enhancements or methods of assessment. Since the Reforms the Councils have been predominantly agricultural, and land tax enhancements have given rise to more criticism than almost any other matter. This head of revenue has become almost inelastic. Excluding revenue due to irrigation, land revenue has increased since the pre-war year by only $7\frac{1}{2}$ per cent as against a threefold increase in the same period in customs. Some provinces have lengthened the period of resettlement to 30 or 40 years ; the percentage increase at any one resettlement has been limited as in Madras, where the maximum increase is $18\frac{3}{4}$ per cent ; and the percentage of the net assets of the land that may be taken by this tax has been restricted, for example, to a minimum of 30 and a maximum of 40 per cent in the United Provinces. The tax, in short, cannot be increased to meet exceptional circumstances, and it is, thereby, unsuitable as a means of providing for the increased expenditure in provinces.

In the permanently settled tracts the solution will be an income tax on landlords enjoying the present bounty of nearly Rs.6·04 crores or £4·3 millions per annum—an income tax on agricultural incomes similar to Schedules A and B of the British Income Tax, by means of which the difficulties of the English permanent settlement of 1798 fixing the land tax for all time have been on the whole

successfully solved. The possibility of buying out the landlords created by the permanent settlement of 1798 is altogether outside practical finance. In regard to the temporarily settled tracts one or two points stand out as clear as the noonday. The revision of the present system modified to suit changed conditions, and the extension of the income tax to agricultural incomes, appear to be the best course of action. If the present scheme, a very old one, is retained, (1) an increase in the pitch of assessment on land (land revenue, the main head of provincial revenues) will be required to enable provinces to proceed with compulsory and universal primary education and other social services ; (2) a shortening of the period of temporary settlements may be deemed necessary from the financial point of view to meet the cost of those charges. There may be opposition to the shortening of the period, and some writers, like Lord Meston, believe that there will be " the almost certain abolition of periodical revisions of the land revenue, at least in the provinces where there are landlords intermediary between the cultivator and the State ".[1] There are others who are of opinion that the period of temporary settlements may be extended ; (3) the extent of the enhancement imposable at each successive settlement may have to be reviewed and probably, on the whole, increased. In some areas, of course, where considerable changes take place economically, a reduction may be even necessary. The enhancement should depend not on any arbitrary percentage limit but on local circumstances, including prices, rental, and sale statistics. Too great care cannot be taken in order to discover the rental of the landlord and the share that may be rightly claimed by the State. If these measures are not possible of adoption, it will be necessary to impose a tax on the income of landlords from agriculture, as in Schedules A and B of the British Income Tax. This would be lower than that in permanently settled areas, since the permanently settled areas would have to bear for provincial revenues an additional tax to bring up the rate paid by landlords to that corresponding in ryotwari tracts. The alternative scheme of abolishing land revenue and of having in its stead a detailed system of income tax on agricultural incomes and profits loses,

[1] *The New Constitution of India*, p. 171. Ilbert and Meston. (London University Press, 1923.)

it is argued, the claim of the State, which is not a demand in virtue of its taxing power but a claim attaching to rights in land from ancient times. Preferably it is advisable to keep the present system and to add the taxation of agricultural income and also, where necessary, surcharges to land revenue. The redemption of the annual land revenue by the payment of the capitalised amount or, alternatively, the extension of the system of permanent settlement is Utopian. Land revenue at the moment is not an elastic source of revenue. The Japanese system of fixing annually a percentage on the capitalised value of the land is very attractive, as it makes for elasticity, but would be historically and administratively a new departure in the taxing of land in India. In the Russo-Japanese War we have seen Japan was able to increase the percentage without difficulty. These problems require the best brains of the country. The placid contentment with the present system is, in some quarters, regarded as no reason for delay in an examination of the land revenue system and of the basis of local rates or cesses. In the memorable words uttered in the House of Commons on that August afternoon of 1917, our goal is " the gradual development of self-governing institutions with a view to the progressive realisation of responsible government in India as an integral part of the Empire ". This means much provincial expenditure on, for example, more and better education, and that in turn demands an examination of our system of land taxation, a system which is a matter of the most intimate concern of Government, since on it the prosperity of the masses to a large degree depends.

China

12. In China land taxes are, with the salt duty and customs, the mainstay of Chinese revenue. In recent years the salt gabelle has become more important than the land tax. In 1713 the poll tax on adult males was combined with the land tax, and at the same time it was decreed that the amount of the land tax should be permanent. The tax to be collected from each district was henceforth based on the returns of that year. The amount of tax due on each plot of land is entered on the title-deed, and once entered cannot be changed. As in India, tem-

porary remissions of revenue are granted on account of famine or floods, and in China rebellions have also been the cause of temporary remissions. The tax is a compound tax made up of the original land tax, a poll tax, a grain tribute originally a part of the land tax but afterwards a distinct charge on land, with surcharges. Since 1713 the land tax has increased considerably by the levy of certain surtaxes such as collectors' fees, meltage and wastage charges, and other clever devices.[1] These surtaxes were at first extra-legal but were subsequently fixed by law. When thus fixed they were to be remitted by the collectors to the provincial authorities, who were given power to use them for provincial or local purposes. The collectors, however, in the district raised the amount of surcharges in order to meet the additional revenue to be remitted to provincial authorities. The burden was increased to the cultivator, and the amount paid by him was many times greater than the rate of 1713. After the establishment of the Republic in 1911 all provinces, Kiang-su and Cheh-Kiang not excepted, paid their tax in silver in place of grain and silver, although it might be assessed in both. The value of the grain forwarded, usually called tribute rice, is about taels 6,500,000. The payments in silver amount to taels 25,000,000. Thus the total yield of the tax to the Central Government is taels 31,500,000, or nearly £2,300,000. For a country one-third larger than India, with a population in the neighbourhood of 400 millions,[2] and with a more fertile soil, this is at first sight small. This, however, is only a fraction of the amount actually paid by the cultivators. It represents, in short, only the amount for which the various magistrates have to account. Nothing is allowed for the cost of collection, which has to be added. "This", writes a distinguished public servant of long experience in China, "they usually do by declaring the taxes leviable not in silver, but in copper 'cash', which indeed is the only currency that circulates

[1] Cf. "I spent a year in that province (Szechuan) and found that the customary ratings, allowances, etc., practically made the land tax in some districts ten times its nominal charge" ("The Financial Capacity of the Chinese", *Journal of the Asiatic Association*, vol. xxx. 1896), quoted by Han Liang Huang, *op. cit.* p. 153.

[2] Various estimates have been made. One for 1926 put the population as high as 433,000,000 or 450,000,000. A former American Minister at Peking, writing in 1912, says it "is much smaller than we have been led to believe, and in the last century it has been increasing very slowly, if at all". Professor Willcox of Cornell University puts it at not exceeding 323,000,000.

in country places, and by fixing the rate of exchange to suit themselves. Thus while the market rate is, say, 1500 cash to the tael, they declare by general proclamation that for tax-paying purposes cash will be received at the rate of 3500 or 4000 to the tael. Thus while the nominal land tax in silver remains the same it is in effect doubled or trebled, and, what is worse, no return is made or account required of the extra sums thus levied. Each magistrate or collector is in effect a farmer. The sum standing opposite the name of his district is the sum which he is bound to return under penalty of dismissal, but all sums which he can scrape together over and above are the perquisites of office less his necessary expenses. Custom, no doubt, sets bounds to his rapacity. If he went too far he would provoke a riot; but one may safely say there never is any reduction, what change can be effected being in the upward direction. According to the best information obtainable, a moderate estimate of the sums actually paid by the cultivators would give two shillings per acre. This on an estimate of the area under cultivation should give for the eighteen provinces £19,000,000 as being actually levied, or more than four times what is returned." [1] Sir Robert Hart, in his "Memorandum on Land Tax Reform", estimated in 1904 that the tax should yield 400 million taels in place of 25 millions.

The main defects of land taxation in China are the very great complexity of the rates and the irregular and corrupt methods of collection. To overcome these is a Herculean task. There are wide differences in rates not merely between provinces and provinces or districts and districts, but even in the same district or hsian. This defect is intensified by the fact that the tax is very often assessed in two parts—one in money, the other in kind. One piece of land may be assessed at a high rate in money

[1] Sir G. Jamieson, C.M.G., M.A., formerly Consul-General at Shanghai, and Consul and Judge of the Supreme Court, Shanghai. Cf. *Encyclopædia Britannica*, 11th edition, vol. vi. p. 186; also his "Land Tax in the Province of Honan" (British Diplomatic and Consular Report, 641, 1905); "Land Tenure in China and the Condition of the Rural Population" (China Royal Asiatic Assoc., vol. xxiii.); "The Revenue and Expenditure of the Chinese Empire" (British Diplomatic and Consular Report, No. 415, 1897); Hart, "Memorandum on Land Tax Reform" (Maritime Customs Series, 1904); chapter xxv., "Finance", in the *China Year-Book*, 1923 (Tientsin Press, Tientsin). Cf. "The Land Tax in China", by Han Liang Huang and "The System of Taxation in China in the Tsing Dynasty, 1644–1911", by Shao-kwan Chen (Columbia Univ. Series, Nos. 143 and 187).

and a low rate in kind, and another at a high rate in kind and a low rate in money. The chaotic condition of the currency and the multiplicity of the units of measurement add to these difficulties. It has been suggested by some that the land tax should be assigned to local authorities, and that it should be based on the capital or selling value of the land.[1] The former is not possible, because of the necessities of both the central and provincial governments and the historical background of the tax. The best reform that could take place postulates an efficient form of government by which the collection of the tax would be stripped of the unsatisfactory features already noted. The tax could be increased several times without imposing a heavier burden on the people, as in the case of the reorganisation of the salt gabelle, which increased fourfold in three years. The possibilities of the land tax are equally great.

JAPAN

13. The taxation of land in Japan is in marked contrast to that which obtains in China. It is based on the capital value of land, which is arrived at by capitalising the annual rental of the land whether for residential or cultivation purposes. The State imposes a land tax of 2·5 per cent on residential land, 4·5 per cent on rice and other cultivated land,[2] and 5·5 per cent on land other than residential and cultivated land. In Hokkaido, however, the rate for cultivated land is 3·2 per cent, and for other land, except dwelling land, 4 per cent. As the cadastre is out of date these percentages do not reflect the actual burden. It is roughly $\frac{1}{4}$ per cent of the capital value. Cultivated land of a value below 200 yen, not tenanted but situated in the same city, town, or village where the owner lives or in the neighbourhood is free from the tax. Prefectures, cities, towns, and villages are permitted as public bodies to levy an additional tax (*fukazei*) on the land tax for purposes of revenue. The

[1] Willoughby, "Adjustment of the Financial Relations between the Central, the Provincial and Local Bodies" (*The Chinese Social and Political Science Review*, 1917).

[2] Land is, in addition, subject to income tax. In the case of rice fields or dry farms the average surplus of receipts over necessary disbursements during the last three years is liable to income tax. In the case of lands left uncultivated the income is assumed to be the same as that for adjoining farms of similar grade (see Chapter XXI.).

rate of this additional tax is by no means uniform but varies according to local financial conditions. In the event of the tax exceeding a certain limit, the sanction of the Central Government has to be obtained. A Water Utilisation Association (which must be a juridical person) carries out irrigation or drainage works, and may charge its expenses against the land benefited. This is not included in the additional tax (*fukazei*) above.

At the time of the abolition of feudalism in 1871 the land tax constituted nine-tenths of the feudal revenues, and it was necessary to replace the various rates by a uniform system. For this a reassessment was imperative, and it could not be delayed. It was roughly made in the space of two years, and was improved on in the following years. It was completed in 1889. This survey was extremely liberal to the agriculturist, whose land is assessed at certainly not more than one-half of the market value. By the change the agriculturist acquired the fee simple of his land on payment of the annual land tax to the Government. The capital value of land has increased very greatly, as compared with rates fixed some fifty years ago, and the assessed values therefore differ widely from the capital values. Nevertheless, these have been for the present retained, except for residential land. The capital value of cultivated land for assessment purposes was arrived at by capitalising the net earnings or the rental value. The net earnings were calculated by deducting from the produce the cost of seed and manure, rates, and taxes. The amended official value of residential land is taken as ten times the annual rental. The real (or as it is sometimes called, the "legal") value of the land is, when required, obtained by comparing the land with other land the value of which has been established.

Japan is an example of the differentiation of tax rates according to the nature of the crop, rice being grown on wet land. The value of wet land per acre in the last quinquennium was approximately yen 143 (Rs.190), and of dry land, yen 37 (Rs.49). The average land tax would thus work out to yen 6·4 or Rs.8-8-0 for wet land, and yen 1·7 or Rs.2-3-0 for dry land, or an average of something like Rs.5 per acre. The superiority of the Japanese land tax over that of India lies in its elasticity. Thus in an emergency (as in the Russo-Japanese War) the tax could be raised without difficulty by increasing the percentage payable

on the assessed value of the land. In addition there is the income tax on agricultural incomes, which can be increased in such a contingency.

Land Taxation in the United States

14. Land taxation in most of the 48 states of the Union is the main source of provincial or State revenue.[1] It is not usually a progressive tax, as in the Swiss cantons, but a tax of 1½ to 2 per cent on land and also on buildings. A feature of the American tax is the system of apportionment by which a given sum is raised among the counties in proportion to their assessment and the valuation of property.

The taxation of land was one of the earliest taxes in the United States and dates from the Colonial period, when the inhabitants of the New England, Virginia, and other colonies had to raise money for the making of roads and bridges and for supporting schools. The Federal Constitution restricted direct taxes for state and local governments, and land taxes after a period became the general property tax, a tax which is, as the term implies, a tax on property in the mass and levied throughout a given area at a uniform rate, or as some state constitutions have it by a "uniform rule", except on property specifically exempted. Originally the idea was that each citizen should contribute to the upkeep of government according to his ability, and this ability was, it was thought, adequately measured by the amount of property in general, an assumption probably sound in a pioneer community but inequitable in an advanced community. It assumed that property was a sufficiently good index of taxable capacity. The general property tax is now quite out of date, ossified to a degree, and wholly out of contact with the real taxable capacity of the United States of to-day. It is not possible to apply a uniform tax to different classes of property

[1] About 55 or 60 per cent of the net revenue receipts of states or provincial governments are from property taxes; 20 per cent from business and non-business licence taxes; 11 per cent from earnings of general departments; and 6 per cent from highway privileges, rents, interest, and earnings of public service enterprise: the remainder is from special taxes and fines, etc. In 146 cities the general property tax is 66 per cent of the net revenue receipts, the next most important source being earnings of public service enterprises (10 per cent), and the remainder other taxes, subventions, and special assessments.

which vary greatly in composition. There was thus a serious defect in the principle underlying the tax. At the present time the tax is rather a tax on ownable goods than on the owners themselves. The general property tax is primarily a tax upon real estate. Thus in 1932 real estate was 77 per cent of the total assessments subject to state general property taxes, while the value of personal property assessed was 19 per cent of the total. The remaining 4 per cent was railway, telegraph and other corporation property which in certain States was not classified as real or personal but treated as a single total. Although relatively in recent years this source of revenue for state purposes has been declining owing to development of other sources, in 1932 the states received 17 per cent of their net revenues from this tax, which is levied with a few exceptions in every state and territory. In Pennsylvania, North Carolina, and California the state governments levy no general property tax, but in the political subdivisions of all states—counties, cities, towns, schools, and other districts—it is of course the main source of revenue. Cities, towns, villages, and boroughs collected in 1932 no less than 62 per cent of their revenues from this tax, and more than 66 per cent revenue of counties were from the same source. The tax is levied by assessment districts in each state, and these districts may be as small as a single township or ward in a city, or it may extend over a large area, employing a whole-time assessor with an expert staff which prepares maps showing each piece of real property and books in many volumes called the assessment roll or book or duplicate, which are supposed to give the market value of the property. It is customary, however, in these rolls, which should be written up yearly, to assess at much less than its full market value. In most states the owner of the property is required to file a statement under oath. This, however, is not of much value, in so far as it is already recorded by the assessor, but it is of use to check up personal property. It has been pointed out by many scholars of American Finance that this has added to the evil of tax evasion the greater evil of perjury. Moreover it is difficult to assess. When the assessor has computed his work, the assessee may, if he objects, appeal to some board of review or, as it is called, of equalisation such as the county boards or the city fathers. The auditor receives

after this the roll and fixes the amount each person has to pay, and this is collected by the tax collector. The tax is expressed at so many cents or dollars per 100 dollars or at so many mills on the dollar of the assessed value, and is arrived at by dividing the sum required for the year by the assessment value. Alternatively rates are fixed individually for schools, roads, hospitals, or for the state, county, village, or school districts, each confining its expenditure to the amount raised by these rates. A person, therefore, may have to pay, for example, 40 cents state tax, 40 cents county tax, 50 cents city or town tax, 20 cents school district tax, and 5 cents high-school district tax. Cities may and usually do keep a separate assessment in addition to the assessment made for other branches of government. In order to prevent differences between localities or districts, state boards were established, but to-day State Tax Commissioners are performing the work more satisfactorily by supervising closely the work of assessors in all localities. Owing to the difficulty of assessing banks, insurance companies, railways, public utility companies, and other large corporations, the State Tax Commission assesses for the whole state these separately, or takes over the taxes from these entirely for state purposes, the amount of state tax to be apportioned locally being thereby reduced. A proportion of these special heads in property tax combined with other taxes such as licences, is often so great that the state share of the general property tax proper is almost negligible. It is not possible to assess the land from improvements except in a few cases. In New York City, for example, the land valuations for the year 1927 amounted to $6982 millions; while improvements were $6729 millions and over 70 per cent of that city's revenue were from real estate taxes.

Criticisms of the property tax are thick as the leaves of Vallombrosa. Almost all writers on American public finance have pointed out the defects of the tax, although even to-day there are some who regard it as almost perfect. We have already referred to the impossibility of levying a uniform tax burden on different classes of property that exist in the modern world. No one will say that the general property tax in the various states of the Federation to-day is equal in its burden, and many able to contribute to the cost of government can evade the tax. The evasion is possible by the investment of tax-exempt secur-

ities, and there are many such securities to-day in the United States, as federal bonds are exempt from local taxation, and nearly every state exempts its own bonds as well as those of its local subdivisions. The increase in tax-exempt securities has been indeed so great in recent years as to cause anxiety to those concerned with this method of evasion. There are others who evade the tax by living in a state where the tax is low, specially on intangibles. Others, even millionaires, keep a residence in a district for other than sentimental reasons. They spend sufficient time there annually to get their property listed in a lightly assessed tax colony, rather than in a city where they make their income. A few wealthy people in such a tax colony can reduce the assessment to a low rate, and the result is, in the words of a Senate Document, " the most lavish expenditure for highways and other improvements in order to have any tax rate whatever ".[1] There is also the well-known tendency to undervalue properties, and this has the effect of making the tax regressive, as it presses hard on farmers whose realty and personalty are easily assessed, while those often with huge incomes who derive their income from large real estate and from industrial and commercial concerns escape scot free. It leads to double taxation, because in some cases both the debtor and the creditor are charged for the same sum, and a tax on corporations is again taxed when it becomes intangible personal property to the owner. " In New York ", says one writer,[2] " any one who is dissatisfied with the tax collector's demands on him not only declares his real debts but cooks up a debt if necessary ; perhaps swears to one that does not exist or salves his conscience (men do such things) by getting a friend to become *pro forma* a creditor. The process of ' swearing-off ' the assessments of personal property is carried so far in New York as to make this part of the tax system a farce." These criticisms do not all apply to the property tax in certain Swiss cantons where the tax is also an important head of revenue. They show, however, some of the dangers to be met in the taxation of property.[3]

It is sometimes argued that the tax upon real estate is

[1] Senate Document No. 313, 1919, p. 44 ; cf. Lutz, *The State Tax Commission* and also *Public Finance.*

[2] Taussig, *Principles of Economies*, vol. ii. p. 531 (Macmillan).

[3] Cf. Seligman's *Essays in Taxation* (1921), p. 19 (Macmillan).

justified, because public expenditure usually increases its value, and that land values really are social values belonging to the states. The taxation of real estate is often said to be capitalised, as future purchasers buy the land tax free. On the other hand, land owners, notably farmers, argue that the taxes are burdensome, take a large amount of their income, and are discriminatory in their effect. It is doubtful, however, whether this is true, as the total burden of property and other taxes was in 1925–26 6·6 per cent of gross income ; 12·1 per cent of net income before deduction of taxes ; and 30 per cent as the proportion of net profits before deduction of taxes.[1] It should be, however, noted that farm taxes based on property values are constant, while farm income varies widely from year to year according to the season, and property taxes, being the main source of state and local tax system, fall more heavily upon the farmers than upon other economic groups because of the relatively low rates of farm income to the value of farm properties. Again property is becoming less and less satisfactory as a criterion of ability and therefore of justice. In recent years attempts have been made to introduce a model system of state and local taxation, but without much success, owing to the fact that the general property is largely for historical reasons a permanent part of the American financial system. One longs for the time when a great driving force, a real financial genius, will summon the states of the Union to a Round Table Conference and then succeed in carrying through a project which is so long overdue—the reform of the general property tax. It is quite impossible to remodel entirely the system afresh. The good work, however, of Tax Associations may yet bear fruit. The National Tax Association has put forward a well-considered scheme based on a study of the tax laws of the American states.[2] It is a scheme which is productive, administratively practicable, adaptable to a federal form of government, and therefore meeting the diverse claims of several states. It is also constitutionally possible and in no way contrary to the ideas of the American people. It is based on three principles for state and local taxation. (1) " That every person

[1] Cost of Government in the United States, 1925–26 (National Industrial Conference Board, New York), p. 108.

[2] Preliminary Report of the Committee appointed by the National Tax Association, 1918 (Reprinted 1923).

having taxable ability should pay some sort of a direct personal tax to the Government under which he is domiciled and from which he receives the personal benefits that Government confers"; (2) "tangible property, by whomsoever owned, should be taxed by the Jurisdiction in which it is located, because it there receives protection and other governmental benefits and services"; and (3) "business carried on for profit in any locality should be taxed for the benefit it receives". The Committee attempted with success to adjust the conflicting claims of independent taxing authorities. In order to eliminate the inequalities of the property tax it was recommended by the Committee that a property tax should be levied upon tangible property at the place where such property was located and that intangible property of all descriptions be exempt from all taxation as property; that distinction should be drawn between real estate and tangible personal property, and that the latter should be separately classified, and the taxation of tangible personal property which did not require as much government expenditure as real estate should not exceed 1 per cent or $1 per $100. A uniform tax rate throughout the Federation and uniform methods of valuation supervised by a State Tax Committee are desirable. The Committee points out that under the plan proposed only the tangible property of corporations should be taxed, and that the taxation of gross receipts and the *ad valorem* taxation of corporations as going concerns should be discontinued. They consider also the question of separate taxation of banks, mines, and forests. In Minnesota, Montana, and Utah mines are taxed at rates different from other property. In Minnesota farm and urban land are taxed at different effective rates, a system not followed in other states. Forests are assessed differently from agricultural land in twenty-six states. It is difficult to forecast the future of the property tax in the United States. It seems with the development of the income tax and the taxation of corporations it will be a tax on real property only.

Summary

15. We have discussed the general features of land taxation, and in subsequent paragraphs have referred to some of the systems in force in regard to it. In all modern countries the taxation of land is an important part of a diversified tax system,

for the simple reason that land cannot be removed, and the owners of the land have to submit to the taxation which is imposed on them. The taxation is usually in the form of a land tax, based on capital or annual value ; a progressive income tax on agricultural income ; and rates, cesses, or surcharges for local purposes. Land is particularly suitable as a source of revenue for local taxation and these surcharges are often levied both on the land tax and income tax. In the United States taxes on land are usually assessed on the capital value. Thus in the United States there is frequently a tax on real property of, say, \$1.50 per \$100 of the selling value, or $1\frac{1}{2}$ per cent on the owner's capital. In Great Britain the tax is, say, 5s. in the £ rental value on the occupier, *i.e.* 25 per cent of the rental. In the former system land is forced into use much more quickly than in Great Britain, where land comes more slowly into the market and where under the feudal system land could not then be bought or sold. The rental basis was therefore adopted and the property tax was accordingly a tax on rentals. Land taxation by the latter system responds more quickly than the former to changing economic conditions, while the American system takes account of the so-called unearned increment and is less elaborate. In America, for example, the owner, being taxed on the capital or selling value of the land, is forced in his own interests to make the rental of the land the same as the potential economic rent.

In Italy and many other countries the characteristic of the land tax is that the flat rate is low for central or state purposes. In a few countries, such as Holland and Germany, it is a minor source of revenue used to supplement the income tax. It thus achieves in a somewhat cumbrous way the now common differentiation in income tax systems between earned and unearned income tax. Ten per cent of the economic rent is levied in Italy, while in Japan the rate is much under 1 per cent of the capital value. For local purposes, however, an increasing share has been levied on land. In Austria the land tax is now local. In Italy as much as 15 per cent of the economic rent may be taken by local bodies. In England, the overseas Dominions, and the United States by far the greater part of taxation for local purposes is on land. Since the Great War the principle of graduation in land taxation has been introduced in German and Polish legislation. Since 1917 it has been a characteristic of the Italian land tax.

The principle of progressive taxation combined with differentiation according to the type of farming cannot be said to be due entirely to fiscal reasons. In Australia and New Zealand, for example, differential rates are levied to discourage large estates, tenant farming, and absentee landlordism. In addition to these characteristics of land taxation (viz. the flat rate, the tax on income from agriculture and the local rate) must be mentioned the increasing popularity of taxing the unearned or public value of land. If a low rate of tax on unearned increment is levied it cannot be evaded by the owner; nor is it bad distributionally, as it does not penalise to any large extent persons who have their wealth in land as opposed to those possessing it in other forms. Only if there is a high rate can there be said to be a danger of the owner being penalised, because when he sells the land the tax may be amortised. In the present century the taxation of land for central or state purposes is losing its position at the cost of customs, income tax, and general consumption taxes such as turnover taxes. The tax on land fails to respond, especially over long periods, quickly to the upward movement of the general price level in most countries, and its comparative stability means that its real value in the cost of government has diminished.

CHAPTER XXI

THE TAXATION OF INCOME (HISTORY)

1. THE spur of taxation has nowhere been more clearly seen in the twentieth century than in the system of taxation known as the income tax. The income tax is a corpus or code of taxation rather than a single tax, and every well-balanced financial system nowadays derives a large part of its receipts from direct taxation, mainly income tax.[1] If this were not so, the burden of taxation would be unfairly distributed. It is a tax on the income of the taxpayer and is essentially a phenomenon of the modern industrialised world which regards income a flow of wealth, and not capital a fund or property, as the true index of taxable capacity. It is usually taken in the sense of a general income tax, *i.e.* on the entire income, but it is also taken as a special income tax, *i.e.* on a particular source of income, supplementing other taxes, notably in the United States, where there is for local purposes a tax on income from wages and professions, or from corporations or from some other source of income. We have the same contrast in the general as opposed to the specific property tax. It began as a war tax as, for example, in Pitt's income tax of 1798 and in the United States income tax of 1864. It next became a supplement not to extraordinary but to ordinary revenues, as in England in 1842 when Peel reintroduced the income tax for three years to get rid of a growing deficit and to compensate for the loss of revenue consequent on his reforms abolishing about two-thirds of the duties on imports, especially raw materials. Lastly, it became a permanent feature of the tax system, until in the present century it has become the chief source of revenue in many countries. Since the War income tax has become a great engine of revenue,

[1] For the proportion of direct and indirect taxes in certain countries see Table XVIII., App.

especially for the balancing of budgets. The increases during the difficult times of the last few years have almost been phenomenal. In Great Britain the percentage of revenue from income tax to total tax revenue has increased from 29 per cent in the pre-War year to 40 per cent in 1933–34; in India [1] from 4 per cent to 14 per cent in the same period; and in the United States from 11 per cent of the Federal tax revenue in 1914–15 to 50 per cent. In Japan the pre-War percentage was 9, and it is now 15.[2] Before the great trade depression of 1929–33 the percentages were considerably higher. In 1927–28, for example, in Great Britain, India, the United States, and Japan, income tax was 45, 20, 64, and 20 per cent respectively. Only in the rarest of instances has the income tax borne a less proportion of total tax revenue than in the pre-War period.

There are other reasons why the income tax has been given a deservedly high place in the treatment of the science of public finance. It has become universal in all the chief industrial countries. In the United States, for example, as we have already seen, the foundation of the Federal income tax was laid in February 1913, when the Sixteenth Amendment was ratified. In Great Britain a Departmental Committee, and subsequently a Joint Select Committee of the House of Lords and the House of Commons, surveyed the whole field of income tax, and as a result 13 Acts and parts of 39 other Acts were repealed by a Consolidating Act, the Income Tax Act of 1918 (8 & 9 Geo. V. c. 40). This Act was passed on 8th August 1918 and came into effect from 6th April 1919. The Report of the Royal Commission [3] is undoubtedly

[1] Central revenue only. [2] See Table XVIII., App.

[3] Cmd. 615. The Report and Minutes of Evidence are published in 9 volumes. The numbers of the minutes of evidence are as follows: 288, 1 (1919), 1st instalment; 288, 2 (1919), 2nd instalment; 288, 3 (1919), 3rd instalment; 288, 4 (1919), 4th instalment; 288, 5 (1919), 5th instalment; 288, 6 (1920), 6th instalment; 288, 7 (1920), 7th instalment; 288, 8 (1920), index. Cf. *The Income Tax Act, 1918, and Finance Acts, Years 1919 to 1925, so Far as They Relate to Income Tax and Super Tax* (London, 1925); Dowell, *The Acts Relating to the Income Tax Laws* (9th ed., by Smyth, London, 1929), with supplements; Konstam, *A Treatise on the Law of Income Tax* (5th ed., London, 1931); Report of the Income Tax Codification Committee (Cmd. 5131 and Cmd. 5132—1936), which contains a draft Bill of 417 provisions and eight schedules codifying the law relating to income-tax, together with an elaborate commentary. This great State paper codifies the existing law, which now consists of nearly 800 separate provisions embodied in nineteen different Acts of Parliament apart from the vast and complex body of case law comprising about 1800 judicial decisions and numerous administrative expedients which the Department of Inland Revenue has evolved to overcome some of the

a *locus classicus* on the subject of taxation of income. The terms of reference were " to inquire into the income tax (including super tax) of the United Kingdom in all its aspects, including the scope, rates, and incidence of the tax; allowances and reliefs ; administration, assessment, appeal and collection; and prevention of evasion ; and to report what alterations of law and practice are necessary or desirable and what effect they would have on rates of tax, if it were necessary to maintain the total yield ". The object of the Commission was limited to this : to improve the equitableness of the tax without, in any way, making it less effective. The evidence and appendices to the Report on the history of the income tax system in its various aspects, especially in regard to graduation, abatements, and differentiation, taxation at source and evasion prepared by the Board of Inland Revenue, as well as the statistics in the reports, are a mine of information applicable in a large degree to all countries where an income tax obtains. In India the system of taxation of incomes has hitherto been undeveloped, but with the passing of the Indian Income Tax Act (No. XI. of 1922) and the formation of a Board of Central Revenue, the income tax has been given a greater importance than in any period of its history from the date when it was first introduced in 1860. In Japan the income tax introduced in 1887 and modified in 1899 was completely revised in 1920. We have seen elsewhere how in France a general income tax was put upon the Statute Book just before the outbreak of War, how the old direct taxes on real estate were converted into taxes on income from real estate, and how the income tax from industrial, commercial, and agricultural produce, as well as salaries, etc., took the place of the old taxes on doors and windows, trades and professions.[1] It would be tedious to review the detailed changes made during the present century in other countries of Continental Europe. The words of Gladstone in the British House of Commons uttered over eighty years ago are truer than ever. " I for one ", he said in his first Budget speech,[2] " am bold enough to hope and to expect that in reforming your own fiscal and commercial system, you have laid the foundation of similar reforms—slow, perhaps, but certain in their progress—through every country of the civilised world."

anomalies of the law. For the first time a uniform and clearly defined terminology is established and precise rules are laid down.

[1] *Vide* § 12, Chapter XVI. p. 282.

[2] 18th April 1853.

Before dealing with principles it will be convenient to examine in some detail the history of the income tax in certain countries. We have to look to the general effect on the whole system, especially in times of stress and strain, when budgets have to be balanced. The principles underlying the tax are sound and we shall see that, as the Colwyn Committee pointed out, the harm which it inflicts on industry is very small in relation to the revenue raised. The taxation of corporations may or may not be discussed under income taxation. The case for a discussion in this connection is the growing tendency in most countries to tax corporations on their income, and not on any other basis. On the other hand, corporations are taxed because of their privilege to be corporations and to do business as corporations and, in some cases, to do it in a particular way. In the eyes of the law a corporation is a person who exists although the individual shareholders may die. It has, in other words, a juristic personality. It also has the right of limited liability, a term too well understood to require explanation. Sometimes corporations are taxed on the basis of their income, sometimes on the value of their property or the volume of their business. All things considered, it is advisable to postpone a detailed consideration of a corporation tax to a subsequent chapter.[1]

Great Britain

2. In few countries of the world is the movement towards personal taxation, an outstanding feature of fiscal science in the last twenty years, so well illustrated as in Great Britain. The British income tax is elastic and productive. In 1933–34 it produced five times more than in the pre-War year 1913–14. It is, in the words of the Royal Commission on income tax, "a financial instrument of extraordinary complexity, subtlety, and power". Ninety per cent of the British income tax is derived from the incomes of individuals; the remainder is from the income belonging to and retained by corporations (*e.g.* undistributed profits of limited liability companies) or from the income of persons resident abroad. It is of interest to note the small number of individuals who are called on to pay income tax and surtax. In 1933–34 only 3,400,000[2] in Great Britain and Northern Ireland

[1] *Vide* Chapter XXIV.

[2] There were also 4,400,000 with incomes above the exemption limit, but these were entirely relieved by abatements and allowances.

were chargeable with tax. The number of persons assessed for surtax in 1932–33 was only 84,175. The tax is on the total income of a person imposed at a standard rate for a year of assessment, *i.e.* from the 6th April in one calendar year to the 5th April of the following year.

The tax may be traced from the tallages, the "fifteenths" and "tenths", the Commonwealth "monthly assessment", the eighteenth-century land tax, the assessed taxes including the triple assessment of Pitt, to the income tax of the period 1798–1816, and finally the tax as revised by Peel in 1842. At the beginning of the 13th century there was a tax on movables to assist the king in finding funds for crusades.[1] In 1435 we find references to a graduated income tax. This was granted with the fifteenth and tenth, and all annuitants and persons deriving incomes from offices and freehold had to pay the tax. In 1450 an income tax was similarly levied on lands, tenements, rents, services, annuities, offices, fees, profits, or commodities.[2] It is, however, wearisome and unnecessary to trace the earlier history of these taxes, until we come to Pitt's assessed taxes, *i.e.* taxes on houses, carriages, men-servants, saddle, carriage and race horses, hair powder, watches and clocks, and in 1798 in place of watches and clocks armorial bearings, which depended on the amount of income of the assessee, provided the income was £60 or upwards.[3] This was repealed in 1799. Pitt divided the assessed taxpayers into two new classes, (1) those who were assessed to the duties on carriages, male servants, saddle and carriage horses; and (2) taxpayers assessed to the duties on houses—the inhabited house duty was first levied in 1798—windows, the duty on which was first imposed in 1696, dogs, clocks and watches. Persons in the first class had to pay not less than three times the duty on the last assessment, and it was for this reason, and not that there were three classes of assessment, that the plan was called the Triple Assessment. The duty was for the first class three times the existing rate under the amount of £25, three and a half times if £25 and under £30, four times if £30 and under £40, four and a half times if £40 and under £50, and five times if £50 and over. Persons in the second class

[1] Dowell's *History of Taxation and Taxes in England*, vol. i. p. 68 (Longmans & Co.).

[2] Dowell, vol. i. pp. 115, 123, and 127, and vol. iii. p. 103.

[3] *Op. cit.* vol. iii. p. 173, cf. 38 Geo. III. c. 16.

if assessed to an amount less than £1 were exempt from any additional duty, but from £1 and under £2 one-fourth was added, from £2 and under £3 one-half, from £3 and under £5 three-fourths, and from £5 and under £7 : 10s. the amount of the duty. Over £7 : 10s. to £50 and upwards the additional amount to be paid increased from one and a half times to five times. Special provision was made for shopkeepers and lodging-house keepers. They were exempted if assessed to less than £3 to the duties on inhabited houses, windows, dogs, and watches, and were taxed more lightly in the higher ranges of existing rates. The additional duties were to be paid in six instalments annually, and to prevent evasion were based on the assessment of the previous year, *i.e.* on past and not future assessments. Persons with an income of less than £60 were exempt from the additional duties and over £60 abatements were allowed according to twenty-nine gradations of income. At £200 and upwards, for example, the tax could be reduced to one-tenth of net income. While at the lowest end of the scale, *i.e.* between £60 and under £65, an abatement to reduce the tax to 120th part of net income was allowed. To obtain an abatement a signed declaration attested by two witnesses in a prescribed form was required, and this claim had to be verified on oath or affirmation, the claimant having to appear before Commissioners appointed for this purpose. The schedule appended to the Act not only contains the form for the appeal but also rules regarding the calculation of " fair " income. In other words, a taxpayer seeking abatement or exemption had to disclose his income in regard to this graduated tax. The tax brought into the Treasury only about £5,000,000, or half what Pitt had anticipated, and was abolished in the following year in favour of a direct income tax. The Triple Assessment is of importance because of the introduction of a new principle, the principle of graduation in such taxation. The failure of the tax did not affect the assessed taxes, as these continued as before, and owing to the War were raised by the Consolidation Act of 1808 to a very high level. It is interesting to note that on three previous occasions an additional tax of 10 per cent had been levied without, of course, recourse to graduation such as the scheme of 1797 contemplated. This gave way by the same Act to a system of income tax which imposed in January 1799 a duty of 10 per cent on all incomes from whatever source derived, incomes under £60

a year being exempt, and reduced rates being charged on incomes between £60 and £200. The tax on an income between £60 and £65 was a 120th part of the income, but it gradually rose to a 10 per cent tax on incomes of £200 and over. A general statement of income was required from taxpayers in a form given in the Act. The tax was payable by residents in Great Britain in respect of all income arising in Great Britain or elsewhere and by absentees from income arising from property in Great Britain. Residents included companies as well as persons. A person in Great Britain for some temporary purpose only, a person who had no intention of establishing a residence, was not regarded as a resident. A British subject ordinarily living in Great Britain but absent for a temporary purpose only was to be included. Abatements of tax were allowed for children and for allowances to children and also for life assurance praemia. Friendly and other societies of a charitable nature were exempt from the tax. The Commissioners were selected from the land tax commissioners but, in addition, for the assessment of incomes from commerce and industry in the larger towns, commercial commissioners were appointed. The assessment and collection of the tax was local and not official. It was in the hands of local assessors and collectors, but a surveyor of taxes with full power to surcharges safeguarded the interests of the revenue. This tax was a shade over £6 millions for the first year as compared with £4 millions produced by the earlier tax. On the Peace of Amiens this income tax was repealed, only to be renewed, under the name of a property tax, in the following year when war broke out in 1803. When the tax was thus reimposed the previous general return of income was done away with, and particular returns in five schedules A, B, C, D, and E were introduced for particular sources of income.[1] The Act, therefore, differed from that of 1799 in so far that no return of *total* income was required as this was regarded with disfavour as being inquisitorial. In place of this, particular incomes from particular sources were required according to the five schedules. Schedule A was the return of the owners of land including houses, Schedule B the return of farmers including owners of land in occupation, Schedule C was in regard to their additional profits by such occupation, in respect of profits arising from annuities paid from public revenues, with an exemption (on Pitt's suggestion) for non-British subjects

[1] 43 Geo. III. c. 122.

living abroad, Schedule D was for income from sources other than income charged under the other schedules. This schedule included income belonging to all residents in Great Britain in respect of profits arising in Great Britain or elsewhere from property, professions, trades, employments or vocations, and in regard to non-residents in Great Britain from property in Great Britain, and all profits on professions, trades, employments, or vocations exercised in Great Britain. Schedule E dealt with the income from any public office or employment and included persons receiving any annuity, pension, or stipend payable by the Crown or out of public revenues. The term public office or employment was given a very wide meaning to include public investments, municipalities, corporations, companies, etc. Those who paid the salary annuity, etc., were responsible for payment of the tax and were entitled to deduct it at the time of paying the Officer. The schedule extended not merely to municipal corporations but to any company or society corporate or incorporate. This collection at source prevented evasion. These five schedules introduced by Lord Addington exist in our own day.[1] A rate of 5 per cent was imposed on all incomes of £150 a year and over, with graduation on incomes between £60 and £150. The Act of 1803 also gave allowance for more than two children in a family. A reduction of 4 per cent for each child was given on incomes between £60 and £400, and 3 per cent on incomes between £400 and £1000, and 2 per cent between £1000 and £5000, and 1 per cent on all incomes above £5000. In the Act of 1805 25 per cent was added to the income tax, and in 1807 it was raised to 2s. in the £ on schedules A, C, D, and E, and to 18d. in England and a shilling in Scotland on the annual rental of tenancy in schedule B. The exemption was reduced to £50, and an abatement of a shilling in the £ was allowed between all incomes between £50 and £150. Deductions for children, however, as in the Act of 1803, were not allowed as they were held to be impracticable. It was considered impossible to check the accuracy of these exemptions and it gave rise to much trouble both to claimants and to tax collectors. For a similar reason no allowance was made for repairs under schedule A in estimating the tax payable, as previously fraudulent returns were made in

[1] The Income Tax Codification Committee (Cmd. 5131 and Cmd. 5132 of 1936) proposes to do away with the schedules and to classify all taxable income under fifteen heads, and the treatment of each class is clearly set out in different groups of provisions in the draft Bill.

some cases by which repairs done by tenants were demanded by landlords. Labourers whose earnings were less than 30s. a week were exempted from the tax. This income tax of 5 per cent was collected at its source, and yielded nearly as much as the previous tax of 10 per cent collected direct from each taxpayer. The tax was continued from year to year with variations in the rate until the close of the war in 1816, when it was repealed with effect from 6th April of that year. Sir Robert Peel revived it in 1842, and since that date it has been a permanent feature of the British system of taxation. In 1874, it is true, Mr. Gladstone, in an appeal to his constituents on the dissolution of Parliament, proposed to do away with it, but being defeated he resigned. The Act of 1842 was based on the Act of 1806, except that exemption was granted to those with incomes from any source under £150. In schedule B the income of farmers and persons in occupation of lands was charged on a presumed profit of half the rent paid in England and one-third of the rent paid in Scotland, in place of three-fourths for England and one-half for Scotland in 1806. Under schedule D income from trades and professions, persons were permitted to be assessed by special commissioners appointed by Government in order to preserve secrecy in place of assessment by neighbours who were the general commissioners for the district. A special commissioner was also appointed to investigate claims for repayment, including abatement claims, claims for life insurance praemia and payment on behalf of charities. The rate of tax was 7d. and the actual yield in 1843 was over £5·5 millions as against £3·8 millions, the estimated figure. The rate of sevenpence remained until 1853 and the productivity of the tax increased from year to year. In 1853 Gladstone brought forward his reforms and was able gradually to revise by the help of the income tax the tariff and the old assessed taxes. The tax was extended in 1853 to Ireland. The limit of exemption was reduced to £100 and an abatement of tax was allowed on incomes between £100 and £150, so that the rate of duty on such incomes did not exceed fivepence. In 1854, on account of war with Russia, the rate was raised by 7d. to 1s. 2d., and was again raised by twopence in 1855. This 1s. 4d. rate was reduced in 1858 to 7d. Gladstone's successor, Disraeli, in 1875 reduced the tax to 2d., the low-water mark of British income taxation. The lightness of the rate of tax is particularly striking in the latter half of the nineteenth century.

In the two decades beginning 1842–43 the rate was 7d.; in 1862–1863, 9d.; 1872–73, 4d.; 1882–83, 6½d.; 1892–93, 6d.; and in 1902–3, 1s. 3d. In 1912–13 it was 1s. 2d., the same rate as in the pre-War year in comparison with the rate of 1s. 8d. in 1914–15, 3s. in 1915–16, 5s. in 1916–17 and 1917–18, 6s. from 1918–19 to 1921–22, and 5s. in 1922–23; 4s. 6d. in 1923–24 and 1924–25; 4s. during the five years 1925–26 to 1929–30; 4s. 6d. in 1930–31; 5s. from 1931–32 to 1933–34, and 4s. 6d. in 1934–35.

Changes in regard to income tax took place in the last decade of the nineteenth century and the first few decades of the twentieth century, the most important of them being found in the Finance Acts of 1894, 1898, 1907, 1909, 1914, 1920, and 1930. The Finance Act of 1894 fixed the limit of exemption at £160 per annum, and provided for certain abatements in the case of persons whose total income did not exceed £500 per annum. The Finance Act of 1898 revised the scale of abatements and extended it to incomes not exceeding £700 per annum. In 1906 a Select Committee [1] which had been appointed to inquire into the practicability of graduating and differentiating the income tax reported that (1) graduation of the income tax by an extension of the existing system of abatements was practicable; (2) graduation by a super tax was also practicable; (3) collection at the source should be continued, and the principle of direct personal assessment of the whole of each person's income was not expedient; (4) differentiation between earned incomes and unearned or "lazy" incomes was practicable, especially if it be limited to earned incomes not exceeding a certain sum a year, earned income being charged at a lower rate of tax; and (5) a compulsory personal declaration by each individual of the total net income on which the tax was payable was necessary, and would do much to prevent evasion. Following the report of this Committee the Finance Act of 1907 for the first time differentiated between earned and unearned income by providing that where the total income did not exceed £2000 the earned portion of such income should be chargeable at a reduced rate, viz. 9d. in the £ as compared with a standard rate of 1s. In 1909 the principles of graduation and differentiation were extended. The abatements in respect of incomes not exceeding £700 were left unchanged, but a super tax was imposed on all incomes exceeding £5000 per annum. This tax, which was at the

[1] Cmd. 365 of 1906.

rate of 6d. in the £, was levied, not on the total amount of the income, but on the amount by which such income exceeded £3000. Differentiation in respect of earned income was also extended to persons with a total income not exceeding £3000 per annum, the rate on earned income being 9d. in the £ where the total income did not exceed £2000, and 1s. where the total income lay between £2000 and £3000 as compared with a standard rate of 1s. 2d. in the £.

Other changes of some importance were also introduced into the Finance Act of 1909. A special abatement [1] of £10 for every child under the age of sixteen was allowed in the case of incomes not exceeding £500 per annum. Moreover, the exemptions and abatements which had previously been allowed to persons not resident in the United Kingdom were withdrawn, except in the case of certain public servants and persons resident abroad on account of their health. In 1910, in short, the rate of tax was 14d. in the £ and the exemption limit was £160. Earned income paid at 9d. in the £ if the total income did not exceed £2000, and 12d. in the £ if the total income did not exceed £3000. All unearned income paid at 14d. in the £, and earned income paid at the same rate where the total income was in excess of £3000 per annum. Graduation was effected partly by a series of abatements and partly by the super tax. Abatements were £160 for individuals whose incomes did not exceed £400; £150 for individuals whose incomes did not exceed £500; £120 for individuals whose incomes did not exceed £600, and £70 for incomes not exceeding £700. The super tax was charged on incomes exceeding £5000 at 6d. in the £ on every £ by which the income exceeded £3000. In 1910, it will be seen, the principle of graduation was imperfectly applied. Between £701, where the abatement ceased to apply, and £5000, where the super tax began, there was no graduation at all. Until the Finance Act of 1914 increased the rate to 15d. there was practically no change. In 1914, however, the rate on earned income rose by five steps instead of three to the maximum rate. The maximum rate came into force on incomes above £2500. Unearned incomes, graduated now for the first time, rose by three steps to the maximum rate. The maximum rate was charged on incomes above £500. The super tax limit was reduced from £5000 to

[1] These abatements were increased under the provisions of subsequent Finance Acts.

£3000, and was no longer charged at a flat rate of 6d., but was charged at seven rates varying from 5d. to 16d. in the £ on successive slices of income. The children allowance was increased to £20. Owing to the War the second Finance Act of 1914 increased the rate of tax from 15d. to 20d.; the first Finance Act of 1915 increased this to 2s. 6d., and the second to 3s., while in 1916 it rose, as has been shown, to 5s., and in 1918 to 6s. in the £. In 1918, the year of the Armistice, the super tax limit was reduced from £3000 to £2500, the super tax being leviable on the amount of income in excess of £2000, with a new scale of charges running up to 4s. 6d. in the £. Besides these changes in the rates, the exemption limit of income tax was in 1915 reduced to £130, which brought within the net wage-earning classes which hitherto had been unaccustomed to the payment of any annual tax. In order to meet this class it was decided to assess quarterly, and to collect the tax quarterly from weekly wage-earners employed by way of manual labour, and administrative arrangements were made under which the tax was collected by means of stamps purchased at a Post Office and affixed to a card which was ultimately handed to the Collector of Taxes. During the War special reliefs were given to those who were soldiers and sailors; a further increase in children's allowance, and the grant, for the first time, of an allowance for a wife in order that the heavy burden of taxation may be more fairly distributed in the case of married men as compared with the bachelor, came into force. Since the War the net produce of the tax and the incomes on which the taxes were received (*i.e.* after the deduction of allowances and reliefs) and the normal rates of tax are shown in the following tables.

In the Finance Act of 1920 effect was given to certain recommendations of the Royal Commission presided over by Lord Colwyn. The Report, it may be mentioned, was signed by all the twenty-three Commissioners, the reservations being of relatively small importance. A new plan of differentiation, graduation, and allowance was adopted on the lines proposed by the Commission, and the relief proposed for double taxation within the Empire was passed into law. At the same time incomes exceeding £2000 were made liable to super tax, and the super-tax rates were increased in general conformity with the recommendations of the Royal Commission.

INCOME TAX (EXCLUDING SUPER TAX)

Number of Persons chargeable.	Percentage of Total Population.	Yield of the Tax.	Taxable Income.	Rate.
Thousands		Million £.	Million £.	s d
1918–19 . . 3547	7 7	304	1287	6 0
1919–20 . . 3900	8·3	337	1416	6 0
1920–21 . . 3000	6·3	353	1357	6 0
1921–22 . . 2600	5·5	346	1308	6 0
1922–23 . 2425	5·5	295	1315	5 0
1923–24 . . 2375	5·3	263	1323	4 6
1924–25 . 2400	5·4	273	1349	4 6
1925–26 . . 2200	5·3	236	1312	4 0
1926–27 2250	4·9	234	1324	4 0
1927–28 . 2200	4·9	227	1301	4 0
1928–29 2200	5·7	236	1346	4 0
1929–30 . . 2250	5·6	234	1347	4 0
1930–31 . . 2200	4·9	247	1308	4 6
1931–32 . . 3600	7·8	275	1324	5 0
1932–33 . 3500	7·6	250	1206	5 0
1933–34 . . 3400	7·3	238	1160	5 0

Note —Figures of the taxpayers and income are not strictly comparable, owing to changes in the effective exemption limit introduced by various Finance Acts.

SUPER TAX

Year	Yield of Super Tax.	Total Income assessed.	Income chargeable
	Million £	Million £	
1918–19	36	350	exceeding £2500
1919–20	42	406	,, ,,
1920–21	56	530	exceeding £2000
1921–22	61	590	,, ,,
1922–23	64	525	,, ,,
1923–24	62	547	,, ,,
1924–25	63	555	,, ,,
1925–26	68	566	,, ,,
1926–27	66	568	,, ,,
1927–28	60	578	,, ,,
1928–29	56	594	,, ,,
1929–30	57	592	,, ,,
1930–31	68	543	,, ,,
1931–32	77	464	,, ,,
1932–33	60	414	,, ,,
1933–34	52	..	,, ,,

The super tax was charged for the last time for the year 1928–29, and has been replaced by the surtax, which is imposed upon the total income as computed for income tax purposes for the year of assessment, and is payable on the 1st of January in the year following the year of assessment. The taxpayer now makes

INCOME TAX AND SUPER TAX, Standard rate of tax 5s. in the £ (1933–34)

(Amount and Effective Rate [1] of Tax on Specimen Incomes)

Total Income	Single Persons.				Married Couples without children.			
	If Income all "earned" income.	Effective Rate	If Income all "investment" income	Effective Rate	If Income all "earned" income,	Effective Rate.	If Income all "investment" income	Effective Rate
£	£ s. d.	s. d.	£ s. d.	s. d.	£ s. d.	s. d.	£ s. d.	s. d.
250	12 10 0	1 0	18 15 0	1 6	6 5 0	0 6	12 10 0	1 0
300	17 10 0	1 2	28 2 6	1 10½	11 5 0	0 9	18 15 0	1 3
500	53 2 6	2 1½	78 2 6	3 1½	40 12 6	1 7½	65 12 6	2 7½
1,000	153 2 6	3 1	203 2 6	4 1	140 12 6	2 10	190 12 6	3 10
1,500	253 2 6	3 4½	328 2 6	4 4½	240 12 6	3 2½	315 12 6	4 2½
2,000	378 2 6	3 9½	453 2 6	4 6½	365 12 6	3 8	440 12 6	4 5
3,000	690 0 0	4 7	765 0 0	5 1	678 0 0	4 6	753 0 0	5 0
5,000	1,465 0 0	5 10	1,540 0 0	6 2	1,453 0 0	5 10	1,528 0 0	6 1
10,000	3,897 0 0	7 10	3,972 0 0	7 11	3,885 0 0	7 9	3,960 0 0	7 11
50,000	28,335 0 0	11 4	28,410 0 0	11 4	28,323 0 0	11 4	28,398 0 0	11 4
100,000	61,460 0 0	12 4	61,535 0 0	12 4	61,448 0 0	12 3	61,523 0 0	12 4

[1] The effective rate of tax is defined as the sum which bears to £1 the same ratio as the total amount of tax payable (income tax and super tax) bears to the amount of the total income.

one return only, in which he shows the various sources of income and the amount derived from each source for the preceding year. The surtax rates on successive slices of income were in 1933–34 as follows, plus a surcharge of 10 per cent of each rate :

							s.	d.
In respect of the first £2000 of the income						.	nil.	
In respect of excess over £2000—								
For every £1 of the first £500				of the excess	(to £2,500)	.	1	0
„ £1 of the next £500				„	„ (to £3,000)	.	1	3
„ £1	„	£1,000		„	„ (to £4,000)	.	2	0
„ £1	„	£1,000		„	„ (to £5,000)	.	3	0
„ £1	„	£1,000		„	„ (to £6,000)	.	3	6
„ £1	„	£2,000		„	„ (to £8,000)	.	4	0
„ £1	„	£2,000		„	„ (to £10,000)	.	5	0
„ £1	„	£5,000		„	„ (to £15000)	.	5	6
„ £1	„	£5,000		„	„ (to £20,000)	.	6	0
„ £1	„	£10,000		„	„ (to £30,000)	.	6	6
„ £1	„	£20,000		„	„ (to £50,000)	.	7	0
„ £1 of remainder of the excess					(above £50,000)	.	7	6

3. Before proceeding to deal with the more or less technical points connected with the recommendations of the Royal Commission it may be convenient here to refer briefly to the various schedules in force, as these are older than any other schedules in modern taxation, dating, as has been noted, from 1803.

Schedule A includes income from the ownership of lands, houses, tenements, etc. In the case of the administrative county of London, the annual value is arrived at under the Valuation (Metropolis) Act, 1869, where the valuation serves both for the purposes of income tax and the rates levied for local purposes. In the areas in Scotland where the Valuation Assessor under the Lands Valuation (Scotland) Act of 1857 is the Inspector of Taxes, the annual value as determined under that Act is binding both for income tax and for the purpose of local rates. In Ireland the determination of annual value is governed, subject to certain exceptions, by poor-rate valuations. Subject to these qualifications, a periodical valuation, normally once in five years, is made throughout the country and the annual values then ascertained are continued during the intervening years. Owing to the War, however, no such general revaluation was made between the years 1910–11 and 1923–24. The annual value fixed is subject to increase in the case of structural alterations to any property,

and new properties are assessed at their appropriate annual values. In the county of London reductions of annual values follow reductions in the values for rates, but elsewhere reductions are made on proof that the annual value has diminished. Certain statutory allowances or deductions are permitted. In the case of lands inclusive of buildings the gross assessment is reduced by one-eighth, and in the case of houses or buildings (except a farmhouse or building included with lands in assessment) the gross assessment is reduced according to the following scale :

(*a*) Where the amount of the assessment does not exceed £40.	A sum equal to one-fourth part of the amount of the assessment.
(*b*) Where the amount of the assessment exceeds £40 but does not exceed £100.	A sum equal to one-fifth part of the amount of the assessment.
(*c*) Where the amount of the assessment exceeds £100.	£20, together with a sum equal to one-sixth part of the amount by which the assessment exceeds £100.

A further allowance to owners of lands and houses is permitted in respect of the excess of the annual average expenditure for the five preceding years for the cost of maintenance, repairs, insurance, and management over the flat rate repairs allowance in the case of all lands and of houses the annual value of which does not exceed certain fixed limits. A remission of tax is also allowable in respect of any part of the year of assessment during which the houses are unoccupied. The annual value of colleges and halls in universities, hospitals, public schools, and almshouses is brought into assessment but the taxes are remitted, while certain classes of property are not assessed at all, viz. property vested in and in the occupation of the Crown, cathedrals, churches, etc. Certain concerns like railways, mines, gasworks, waterworks, docks, quarries, etc., which are akin to trading concerns, were, until the year 1926–27 inclusive, included in Schedule A, but their annual value was measured almost entirely by the amount of profit under Schedule D. For the year 1927–28 and onwards the assessment of the profits of these concerns was definitely transferred from Schedule A to Schedule D.

Income tax under Schedule B is charged in respect of lands

occupied, and the assessment is made on a conventional basis which assumes that profits bear a relation to the annual value of the lands occupied. One-third of the annual value was taken as the basis of profits from 1896–97 to 1914–15, the annual value for the years 1915–16 to 1917–18, and from 1918–19 to 1921–22 twice the annual value with certain exceptions. From the year 1923–24 the basis is equal to the annual value in respect of lands used for the purpose of husbandry only or mainly for those purposes. In the case of all other lands on one-third of the annual value. The farmer occupying lands for the purposes of husbandry may be assessed on the conventional Schedule B basis, or he may elect to be assessed under Schedule D in the same manner as profits arising from trade. He may also, if at the end of the year he finds that his profits have fallen short of the amount of the assessment on the conventional basis, require the assessment to be reduced to the actual amount of such profits. The profits of nurseries and market gardens are brought into assessment under Schedule B, but they are calculated according to the rules of Schedule D. The profits from the occupation of woodlands are also brought under this schedule, but the occupier managing woodlands on a commercial basis may request to be assessed under Schedule D.

Income tax under Schedule C—income from dividends or annuities from public revenue (Government stocks, etc.)—is collected at the source, the Bank of England or other agent making the deductions at the standard rate in force at the time of payment. There are a few exceptions to this. The interest on many of the securities issued during the later stages of the War was paid without deduction of tax at the source and was assessable on the recipients under the rules of Schedule D, and in some cases securities were issued subject to the condition that the interest should not be liable to income tax or super tax if the securities were proved to be in the beneficial ownership of a person not ordinarily resident in the United Kingdom. Some securities during the War period were issued on which income tax was compounded by means of a lower rate of interest. Interest on these securities is thus free from assessment to income tax although liable to super tax. War Savings Certificates and National Savings Certificates which are issued subject to a limitation on the total amount of the certificates that may be held by any one individual

carry accumulated interest at the date of their maturity and are free from income tax and super tax in respect of that interest. Small sums under £2 : 10s. payable through the Bank of England out of any public revenue are not taxable at source, but are assessable on the recipient under the rules of Schedule D.

The charge under Schedule D comprises profits from trades and professions and from foreign and colonial stocks, shares, securities, and possessions, and is dealt with under six heads or cases.

I. Profits of trades, manufactures, adventures or concerns in the nature of trade.

II. Income from professions, employments, or vocations (excluding employments which are assessable under Schedule E).

III. Interest paid in full and assessable directly upon the recipient, including interest on certain British Government securities.

IV. Income from Dominion and foreign securities (except that from Government securities chargeable under Schedule C).

V. Income from Dominion and foreign possessions.

VI. Profits from sources not falling under any of the foregoing cases or under any other schedule.

As already explained, railways, ironworks, mines, canals, docks, quarries, etc., are included under Schedule A, but chargeable according to the rules of Schedule D, and are dealt with for statistical purposes under Schedule D. Schedule D is by far the most important of the five schedules, and it constitutes the great problem of income-tax administration. The profits of professional men are in the aggregate small as compared with those of trades, the yield of the duty in respect of trade profits representing approximately one-half the total yield of income tax. In recent years considerable attention and care have been bestowed on obtaining returns as accurately as possible of profits from trade. Trade profits are taken to mean the difference between the gross receipts and the expenses incurred wholly for the purpose of business, *i.e.* excluding deductions in respect of capital charges, lost capital, losses unconnected with the business, and private and domestic expenses. The following expenses may not be deducted under the system of collection at the source although they may be normally looked on as commercial expenses: annual interest on borrowed money, annuity, or other annual payment payable

out of profit and any royalty in respect of patents ; debts which are proved to be of a doubtful nature, debts which are proved to be bad, and any excess profits duty or corporation tax which has been paid in respect of the business are regarded as expenses incurred exclusively for the purpose of the business. The net amount upon which tax has been paid under Schedule A in respect of lands and buildings owned by the trader and occupied for the purposes of his business is also deducted in arriving at the profit, in order to avoid a double charge of tax on that part of the total profit of the business. An allowance is made of such an amount as the Commissioners may decide to allow for diminution in value by reason of wear and tear during the year of assessment of any machinery or plant used by the trade and owned by the trader. A reduction is made in respect of replacement of obsolete machinery. A reduction in respect of wear and tear of buildings which are used by their owner as mills, factories, etc., is allowed up to one-sixth of their value. On payment of interest, royalty, etc., the income tax may be deducted at the standard rate of tax by the trader, so that he recovers the tax relating to that part of the profits paid away to other persons.

The charge of income tax under Schedule D in respect of trade profits was, up to and including the year 1926–27, based on the average of the three preceding years, but, in common with nearly all other categories of income chargeable by way of direct assessment on the recipient, the basis was changed to the profits of the preceding year by provisions in the Finance Act, 1926, which first came into operation for the year 1927–28. By the same Finance Act it was provided that the profits of railways, ironworks, gas works, canals, docks, quarries, etc., in the United Kingdom should be assessed under Schedule D instead of under Schedule A. The taxation of the profits of mines, etc., was also transferred from Schedule A to Schedule D.

GROSS INCOME FROM SCHEDULE D IN 1932–33

Income from	Percentage to Total.
Manufactures	31
Transport, etc.	37
Professions	16
Interest on securities . . .	16
Total	100

Income tax under Schedule D is, it will be seen, charged on the annual profits arising or accruing to any person residing in the United Kingdom from property wherever situated, but not assessed under Schedule A, or from any trade, profession, employment, or vocation wherever carried on, and from any income arising to any person not resident in the United Kingdom from property in the United Kingdom not assessed under Schedule A, or from any trade, profession, employment, or vocation exercised within the United Kingdom, and also from all interest of money, annuities, or other profits not charged under any other schedule and not specially exempted from tax.

Income tax under Schedule E is charged on individuals in the service of Government, of public bodies, and of limited liability companies, and, as already noted, from 1923–24, all employments, including those of weekly wage-earners. The amount brought into assessment was the full salary or other emoluments of the year of assessment, but for 1927–28 and subsequent years the basis of salaries was changed to the emoluments of the preceding year. Expenses wholly, necessarily, and exclusively incurred in the performance of his duties by an employee are deductible in arriving at the amount of the salaries assessable.[1]

Method of Assessment and Collection

4. It is necessary to go into the question of administration in some detail, because much of the success of the income tax depends on its administration. The income tax of Peel introduced in 1842 took as the unit of area the county division. Local and unpaid Commissioners for each county were appointed, and these Commissioners appointed assessors, made assessments, heard appeals, certified to the Treasury authorities the amounts of duty they had charged, appointed collectors, examined the collectors' accounts, and certified amounts that for any reason remained unpaid. The local representative of the Crown corresponding to the Inspector of Taxes had the powers of inspection, objection, and surcharges. In course of time, however, the exercise of the theoretical powers of the Local Commissioners was

[1] For a description of the fifteen schedules of income, eleven of which deal with United Kingdom income and four with foreign income to replace the existing schedules, as proposed by the Income Tax Codification Committee, 1936, *vide* clauses 10-63 of the draft Bill, Cmd. 5132, and the commentary on these, Cmd. 5131, pp. 122-178.

transferred to the Inspector of Taxes, and the recommendations of the Royal Commission of 1920 were mainly directed towards the giving of legal sanction to the practical developments in the working of the tax.

The Board of Inland Revenue are by statute specifically entrusted with the " care and management " of the income tax. They control the Inspectors of Taxes and secure general uniformity of procedure by prescribing the forms that are to be used for income-tax purposes and making arrangements that are applicable to the tax as a whole, and ensure the consistent and continuous application of the machinery of local administration through their inspectors in association with the Local Commissioners, and draw the attention of Local Commissioners to new legislation. The work of bringing under review annually the financial position of 6,000,000 people for determining the amount of income tax to be paid by them and the control necessary to accomplish this end are most efficiently done. The Royal Commission suggested that the Inspectors of Taxes should no longer be appointed by the Treasury but by the Board of Inland Revenue itself, as they work under and are directly responsible to the Board.

The General Commissioners are an unpaid body of men, usually seven in number, selected from among the Land Tax Commissioners. They are sometimes known as the Commissioners for the general purposes of income tax. In theory they are responsible in their respective divisions for the assessment and collection of the tax and they are independent of the Board of Inland Revenue. Everything that is not specifically directed to be done by some other authority was to be done by the General Commissioners, although by statute the income tax is under the " care and management of the Board of Inland Revenue ". In practice, generally, the Commissioners confine themselves to the hearing of appeals, but few disputes go to them for decision, as most of them are settled between the taxpayers and the Inspectors of Taxes. The Report of the Royal Commission shows that in twenty-two divisions the number of appeals actually heard by the Commissioners was 1263, although the number of assessments adjusted was 67,796, the remaining 66,533 cases being settled between the taxpayers and the Inspectors of Income Taxes. The General Commissioners are specially fitted for the

hearing of appeals in normal cases by reason of their local knowledge. The Additional Commissioners are an unpaid body of persons appointed by the General Commissioners for the division, and are independent of the Board of Inland Revenue. Their duties are to consider the returns made by taxpayers for assessment under Schedule D. In some cases the General Commissioners are to act as Additional Commissioners, but the General Commissioners who have actually made the assessments are not allowed to hear the appeals against assessments. In Ireland there are no Additional Commissioners, their place being taken by the Inspectors of Taxes. While the General Commissioners, of course, deal with Schedules A, B, and E, the Additional Commissioners are appointed by them for making assessments under Schedule D, and they are also a body of unpaid men intended to make use of their local knowledge for making proper assessments. The Special Commissioners are whole-time officials composed of experienced Inland Revenue officers and lawyers. The members of the Board of Inland Revenue are *ex-officio* Special Commissioners, but they do not take an active part in the latter's work. The functions of the Special Commissioners are to assess under Schedule D taxpayers who prefer not to be assessed by the Local Additional Commissioners, to hear appeals against Schedule D assessments, to administer the super tax, to assess the railways, to collect income tax from foreign and colonial dividends, and deal with repayments of income tax, etc. They are a centralised body in London, but go on circuit in order to dispose of appeals. The Royal Commission recommend that the Special Commissioners should continue to be appointed as at present, but that new appointments should be made only from amongst practising barristers, solicitors, or chartered or incorporated accountants of not less than ten years' standing, and Civil Servants with considerable Inland Revenue experience; members of the last-named class not at any period to exceed one-half of the number of Special Commissioners. The Commission was also of opinion that the Special Commissioners should be divested of the bulk of their administrative work and their activities restricted mainly to the judicial side, that is to say, to make them an appellate tribunal and little else. The Commission suggested that a central assessing authority should be set up, composed of Senior Revenue

Officials nominated by the Board of Inland Revenue. This body should take over the assessing duties of the Special Commissioners. Any appeal from an assessment made by the Central assessing authority should be heard by the Special Commissioners. A Clerk is appointed to the General Commissioners as a part-time official generally working for the General as well as Additional Commissioners. The Clerks to the Commissioners are solicitors appointed by the General Commissioners. They act as legal advisers to the Commissioners, perform certain secretarial duties, and do clerical work in connexion with assessment and collection. The Assessors, as their name implies, do the work in connexion with the issue of forms of return for assessment, but the more technical part of the work is done by the Inspector of Taxes, until recently called Surveyor of Taxes. The Inspector of Taxes is in practice the pivotal figure in the income-tax administration. His detailed knowledge of income-tax law and practice in all its intricacies has rendered him eminently fit for discharging the functions assigned to the Commissioners by statute. In theory he has only the power of inspection, objection, and surcharge. In practice, however, he wields many of the powers vested in the Commissioners. The decision of the General or Special Commissioners, as the case may be, on appeal is final and conclusive on all questions of fact. If, however, the appellant is dissatisfied with their decision, as being erroneous in point of law, he may express dissatisfaction and require a case to be stated for the opinion of the High Court, and an appeal lies from the decision of the High Court to the Court of Appeal and thence to the House of Lords. Reports of the judgments of these Courts are printed and published by the Board of Inland Revenue. These constitute an extremely valuable source of information on difficult points of law.

British Dominions

5. In the British Dominions, India, and most of the islands of the West Indies the income tax follows mainly (but by no means entirely, as in India) the principle that is followed in the mother country. The British schedule is rarely followed in detail, but there is a strong family likeness to the British system in regard to the year of assessment, graduation, super or surtax, a minimum exemption limit and abatements for the taxpayer himself, his wife and children. As a rule the tax is levied upon the total

income irrespective of the different components of income. Taxation at source is not uncommon, especially in regard to the dividends of companies. In some cases graduation is extended even to companies.

The Canadian income tax was imposed in 1917. It provided for two rates of exemption, $2000 as the minimum taxable income in the case of unmarried persons and widows and widowers without children, and $3000 in the case of other persons. In the same year a super tax was also imposed on incomes exceeding $6000. In 1918 a surtax was introduced in addition to the income tax and the super tax. The surtax was calculated as a percentage of the combined total of the income tax and the super tax. For example, a person with an income of $7000 would pay income tax at 4 per cent, super tax at 2 per cent on the excess over $6000, and surtax amounting to 5 per cent of the income and super taxes. Corporations were not liable to either super or surtax.[1] In 1920 shareholders' bonuses were brought under the tax. In 1926 the yield of the income tax approximated to one-half of the yield from customs as compared with three-fourths in 1922. The receipts from income tax have tended to decrease owing to the revision of rates and exemption limits. Canadian income taxation is capable of considerable development. The rate of tax on individual incomes is graduated from 3 per cent to 56 per cent on incomes in excess of $1000 or $2000, plus allowances for dependents as the case may be. Where the income is in excess of $5000 an additional 5 per cent on the amount of the tax is added. Companies pay $12\frac{1}{2}$ per cent upon income. The provincial income taxes of Ontario and Manitoba are of interest. The income derived within or without Ontario by any person (including a corporation) resident in Municipalities is levied on all individuals on all income except such income as is exempt from taxation and is levied equally upon all assessments, the rate being fixed locally to meet budget requirements. Rents from property in Ontario and dividends from mines in the Province are exempted. Married persons are exempt on $3000, plus $400 for each dependent. Single persons and corporations are exempt on $1500. Corporations do not pay on income derived from business on which business tax is levied according to the nature of the business—insurance companies,

[1] P. 756, *The Canada Year Book*, 1926.

banks, gas and electric companies, railways, express companies, race tracks, etc. In New Brunswick, Nova Scotia, and Manitoba companies are assessed differently according to the nature of the business of the company. The Provincial income tax of Manitoba varies from 2 to 50 per cent on each $1000 of net income, $1500 is the exemption limit of persons with dependents, and all other persons liable to tax $750. An allowance of $500 is given for each dependent. A surtax of 5 per cent is payable where the net income is $5000 or over.[1]

In Australia all the seven states impose an income tax on personal incomes, and this tax is the most important source of revenue in the states of the Commonwealth, yielding nearly 30 per cent of the total state tax revenue. The Commonwealth entered the field of direct taxation in 1915–16 and the yield is 25 per cent of the Commonwealth tax revenue. With effect from 1923 all the states, except Western Australia, entered into an agreement with the Commonwealth that for a period of five years and thereafter until six months' notice was given, the federal income tax and state income tax would be collected together by the same agency. A joint form may be used where the income is derived in one state only. In Western Australia the Commonwealth under a separate arrangement collects the state income tax. In Australia income tax is collected in addition to the land tax, and it may be noted that absentees are taxed at a higher rate. In 1930 the Federal Income Tax Assessment Bill was introduced providing for the taxation of remittances sent abroad for film interests and the special taxation of insurance companies whose headquarters are not in Australia. The taxation of remittances sent abroad for film interest applies not only to concerns controlled principally by foreign companies or persons residing outside Australia but also to companies, the majority of shares in which are held on behalf of a foreign company. The taxable income of any person outside Australia or any foreign company is taken only at 30 per cent of the total income derived from Australia. Double taxation is avoided by the provision that if the income affected is taxed by the country in which the assessed person lives he

[1] By the Special Income Tax Act, 1933, 2 per cent was levied on gross wages and other incomes except wages and other income of a married person or person with dependent earning less than $960 per annum, or a single person earning less than $480 per annum.

shall be exempt from the Australian tax. In all the states the tax is graduated and there is differentiation. In New South Wales the tax is 7d. in the £, rising to 35d. in the £ on £7000 and 60d. in excess of £7000 on personal exertion incomes derived in New South Wales unless exempted. The exemptions include incomes of residents under £250, official salaries of representatives of other countries, incomes of local bodies and charitable institutions. Deductions to residents include £50 for wife and for each child under 16 years, and a general exemption of £250 less £1 for every £8 of taxable income over £250. Income from property is taxed from 9d. in the £, 42d. on £5500, and 60d. per £ in excess of £5500. There is a 5 per cent deduction in both property and personal exertion income. Companies are taxed from 18d. to 30d. in the £. In Victoria the rate of tax on "personal exertion incomes" is from 6d. to 10¾d. in the £, and property is taxed at double rates. There is a super tax varying from 10 to 25 per cent on incomes over £800. An exemption of £200 is allowed on incomes up to £500. Companies pay 21d. in the £. In South Australia the rates for personal exertion income vary from 18d. to 68d. in the £, and as in New South Wales and Victoria the rates differ from those on property income. Rates for married persons are lower than rates for single persons over 21 years of age. There is a special tax on the dividend income of any resident from companies whether registered in South Australia or not, and whether such income arises or accrues in or from the state of South Australia or not. The rate is 6d. in the £. Companies pay from 11d. in the £ plus taxable income 0·005d. up to £5000, then 36d. in the £, and are subject to a 10 per cent super tax. Casual shipping is taxed at 24d. in the £ on 5 per cent of gross passage moneys, mails, and freights taken by any carrier by sea out of any port in South Australia to any other port in the state or to any port out of the state. The other states tax personal exertion income on similar lines, but in Queensland the rate on companies rises to 87d. in the £, plus a super tax of 20 per cent from 21s. For individual incomes in Queensland the rate, excluding super tax and a special additional tax in certain cases, varies from 6d. to 60d. There is a 5 per cent income tax on lotteries on the selling price of each ticket with a minimum of threepence.

In New Zealand absentees pay the full rate of income tax without any deductions. The maximum deduction on account

of life insurance is 15 per cent of the income as against 16·7 per cent in India. The principle of differentiation was introduced only in 1920. One important feature of the New Zealand income tax is that companies are also liable to a graduated tax. The rate begins at 7d. in the £ on taxable incomes up to £300, and reaches a maximum rate of 4s. 6d. in the £ on £8700 and over. There was in 1934 an additional tax of 30 per cent in respect of all tax. Incomes of individuals are taxed at the same rates as limited companies, only 33⅓ per cent is added for so much as is " unearned " income, and 4d. for every £ on incomes in excess of £500 is added as an additional income tax. The Committee appointed to inquire into the taxation of the Dominion of New Zealand in 1922 condemned this as a penal rate far beyond any other in the British Empire. Super taxes are levied both in Australia and New Zealand.

In South Africa prior to the Union the taxation of income or profits was to be found only in Cape Colony and Natal, where it was introduced in 1904 and 1908 respectively. When the Union Act was passed in 1910 there was no taxation of income, Union or provincial. The need, however, of additional revenue by the Union Government made it necessary to levy in 1914 a tax on income. To-day the normal tax (or the income tax) and the super tax form a large part of the Union tax revenue. The tax is levied only on income arising in the Union, and not on all income which accrues to residents in the Union, and thus liability to income tax depends on the source of income and not the residence of the recipient of income. The normal tax is levied on individuals and companies, and the rate of tax is 12½ per cent. In the case of individuals it is slowly progressive, while in the case of companies there is a flat rate of 3s. in the £ for gold and diamond mines and 2s. 6d. for other companies. The super tax is on personal incomes and is highly progressive. £300 is the exemption limit for unmarried persons and companies, and £400 for married persons. There are abatements in respect of children, dependents, and insurance premiums. Indeed, abatements are large. In 1925–26, £27 millions out of a total taxable income of £86 millions were granted as abatements, which show the importance of these abatements. In addition to the Union Income tax there is a provincial tax on income in all provinces except in the Cape Province where the tax is levied on the incomes of companies only.

India

6. Income tax in India is not a new form of taxation, as it was first imposed as early as 1860 for five years. Before this there were assessed taxes upon individuals in respect of their incomes or means of livelihood. These taxes on professions were abolished in Bengal in 1836, in Bombay in 1844, and in Madras in 1860. On account of the financial stringency brought about by the Mutiny, that distinguished financier, James Wilson, introduced a tax at the rate of 2 per cent upon incomes between Rs.200 and Rs.500 a year and 4 per cent upon incomes above Rs.500. Of this 4 per cent 1 per cent was apportioned to roads, canals, and other productive works. This tax applied to all incomes, including agricultural incomes.[1] It included income from investments as well as from trades and professions.

The model of the first Indian Income tax was British. There were four schedules under which the income was chargeable, viz. incomes from real property; incomes from trades and professions; incomes from public funds; and incomes from public salaries. There was no schedule for farmers as in Great Britain, although incomes from agriculture were taxed under schedule 1 except in the case of those owning or cultivating land who paid less than Rs.600 annually either in the form of land revenue to the Government or as a rent to a landlord. It was suggested that the tax in place of being at a uniform rate should be graduated, but Wilson, like others of his time, set his face against this and said that it was " no part of the functions of fiscal arrangements to equalise the conditions of men ", a statement which hardly any student of finance in the present century would support. The assessment of the tax was intended to be annual, but for the next four years the original assessment was maintained. The exemption limit was raised in 1862 from Rs.200 to Rs.500 per annum, and in the following year the rate was reduced from 4 to 3 per cent. In 1865 the tax was allowed to lapse. A licence tax on trades and professions was imposed in 1867 and continued in an improved form known as a certificate tax in 1868. In 1869 the Government of India decided that the income tax should be

[1] *Vide* Rt. Hon. James Wilson's Financial Statement, Feb. 18, 1860. Sir Charles Wood's Financial Statement, 1860–61, House of Commons, Aug. 13, 1860.

a permanent feature of the tax system in India.[1] The tax was levied at a general rate of 1 per cent on all incomes, including incomes from agriculture. In the middle of the same year it was increased to 1½ per cent and in the following year to 3⅛ per cent. In 1870 the percentage rate was abolished, following the English practice, and the tax was levied at 6 pies in the rupee. This change in method, however, made little difference. In 1871 the tax was reduced from 6 pies to 2 pies in the rupee, and the taxable limit was raised from Rs.500 to Rs.750 a year. The limit was raised to Rs.1000 in 1872, but the tax was not renewed in 1873. The licence tax was revived in 1877, and continued with variations up to 1886, when Government had again recourse to an income tax. From 1886 the tax became a permanent feature of the Indian tax system. Act II. of 1886 taxed all incomes except those from agriculture. Incomes were divided into four groups, viz. profits of companies, salaries, and pensions, interest on securities, and other sources. The rate for the first group (profits of companies) was 5 pies in a rupee or 2·6 per cent on any amount exceeding Rs.500, while for the other groups there were two rates, (1) of 4 pies or 2·1 per cent on incomes between Rs.500 and Rs.2000 per annum, and (2) of 5 pies if the income was above Rs.2000. Act XI. of 1903 made the minimum taxable income Rs.1000. The tax remained unaltered in its main principles till 1916–17, when in the general scale of increased taxation imposed in 1916–17 to meet the deficit resulting from abnormal war conditions the income tax was completely revised, raised, and graduated. The tax was made more progressive by applying different rates on incomes above Rs.5000 per annum, and the maximum rate was one anna or 6·25 per cent on incomes of Rs.20,000 and above. In 1918 an attempt was made to tax agricultural incomes as was done before 1886, but the proposal was defeated in the Legislature. In 1920 legislation was passed by which one-fourth of the profits of tea plantations were regarded as due to manufacture and liable to taxation. Hitherto tea companies had been exempt from taxation, as it had been held

[1] " We are of opinion ", said the Government of India, " that a moderate income tax is essentially necessary for the present in reference to the general condition of Indian finance as it has been in the immediate past, and as it must be in the immediate future." (Despatch to the Secretary of State dated 10th November 1868.)

that they came under the head of agriculture. This proportion was raised to two-fifths in 1927.

The taxation of income in India is at present governed by the Indian Income Tax Act of 1922 (Act No. XI. of 1922), as amended by the Amending Acts of 1933 and by provisions regarding rates of taxation contained in the Finance Acts of subsequent years. Assessments are no longer made on different sources of income but on all sources combined. The following varieties of income are not taxable, viz. income from property held under trust for religious or charitable purposes, income of religious and charitable institutions and of local authorities, commutation of pensions, legacies, and casual receipts. A feature of Indian income tax is that agricultural income is not at present chargeable to income tax. It is doubtful whether this anomaly will be permitted to continue, especially in view of the general need of funds in the country. Income accruing and received in British India was taxed under the Indian Income-tax Amendment Act, 1933. This amendment is not retrospective and does not apply to " income, profits or gains " accruing before 1st April 1933 unless these are brought into British India within three years of the end of the year in which they accrued. The classes of income chargeable to income tax are six, viz. salaries, interest on securities, income derived from property (mostly houses), income derived from business, professional earnings, and income derived from other sources, excepting those specially exempted. In computing the income assessable to income tax certain deductions are made as in Great Britain. For example, although salaries are taxed, special allowances " granted to meet expenses wholly and necessarily incurred in the performance of the duties of an office " are exempt from taxation. From the income derived from house property one-sixth of the annual value is deducted on account of cost of repairs, as also insurance (fire) premia, interest on mortgages, land revenue, collection charges, and vacancy allowances. The rate of income and super tax was raised by one pie with effect from 1930 on personal incomes above Rs.15,000 per annum. The rates of income and super tax were further raised in 1931. The flat rate of super tax on companies was left untouched. In the case of every company and registered firm the rate of tax is two annas and two pies in the rupee whatever its total income, but this is subject to abatement, or exemption in the case of individual

shareholders who can show that their total income is such as to warrant a lower rate of taxation than this amount (two annas and two pies) or none at all. Professional earnings are assessed only after deducting necessary (but not personal) expenses. The general exemption limit is Rs.2000 in India, with effect from 1st April 1919 (lowered temporarily to Rs.1000 from 1931[1]), but incomes of Rs.2000 and over are liable to income tax on the whole amount and not on the surplus above an exemption limit only. In arriving at the income taxable from business allowances are made in respect of (1) depreciation of plant, machinery, building and furniture at rates fixed by the Central Board of Revenue varying from 2½ per cent to even as high as 33 per cent according to the nature of the business; (2) worn-out machinery or plant; (3) current repairs and insurance premia; and (4) rent paid for premises, land revenue, local rates or taxes paid in respect of the premises used for business purposes. An allowance for depreciation can be carried forward to subsequent years without a time limit if there are no profits during the year or if the profit is less than the allowance. The Indian Income-tax (Second Amendment) Act, 1933, extends depreciation to professional men, and not merely as hitherto to persons deriving income from business. The same Act provided against concealment of income derived from interest, especially interest paid on deposits with banks. Bankers and others are compelled to furnish annual statements of interest paid to anyone in respect of deposits held for six months or more. The Act enables (1) assessments to be made immediately on those from whom it is difficult to recover the tax after they have left the country as in the case of theatrical companies and foreign touring circuses; (2) payments of tax of a deceased person to be recovered from his representatives; (3) refunds; and (4) appeals to a High Court. A surcharge of 12½ per cent was levied in 1931–32 and raised to 25 per cent in 1932–33 on all incomes above Rs.1999.[2]

In India graduation is effected mainly by varying the rates of tax leviable on different incomes according to their size. The rates in force at present vary from 6 pies to two annas and 2 pies in the rupee. When the total income is Rs.2000 or upwards

[1] In 1931–32 by the supplementary and extending Finance Act incomes between Rs.1000 and Rs.1999 were taxed at the rate of 2 pies per rupee. The rate was 4 pies in 1932–33. In 1933–34 the rate was reduced to 2 pies on incomes below Rs.1500. In 1935–36 the rate was reduced by one-third..

[2] Reduced by one-third in the 1935–36 budget.

but is less than Rs.5000 the rate is 6 pies in the rupee, when it is Rs.40,000 and less than one lakh the rate is 2 annas and 1 pie in the rupee. For incomes of one lakh and over the rate is 2 annas and 2 pies. The principle of differentiation is not followed except perhaps in regard to companies or registered firms which are taxed at the maximum rate of income tax whatever its total income. Rebate is granted in respect of life insurance premia, subject to the maximum of one-sixth of the assessees' total income. The principle of the assessees making their own individual returns and of taxation at the source are followed. The basis of assessment is usually the preceding year.

In 1917 a graduated super tax was imposed on all incomes exceeding Rs.50,000. The rate of the tax varied from one anna in the rupee on the first Rs.50,000 of taxable income to 3 annas in the rupee on Rs.2 lakhs and above. In 1920 the exemption limit was raised from Rs.50,000 to Rs.75,000 for joint Hindu families, and a flat rate of one anna was levied on the income of companies. The maximum rate imposed on incomes above Rs.3½ lakhs was 4 annas or 25 per cent. The rates were completely revised in 1922. They were graduated from one anna or 6·25 per cent to 6 annas or 37·5 per cent. The super tax differs from the income tax in India in that it is levied on different slices of income, and not at one rate on the total income as in the case of income tax. The rate was increased, as already noted, by one pie for all grades of incomes, except for companies in 1930. The rates have been further increased from 1931 and incomes in excess of Rs.30,000 are subjected to super tax in certain cases. The rates for various slices of income under super-tax legislation in operation in 1934–35 vary from 9 pies to 6 annas 3 pies in the rupee. Companies pay no super tax for the first Rs.20,000 of the excess over Rs.30,000, but above this pay a flat rate of 1 anna in the rupee. The burden of income and super taxation is far heavier than it used to be. An income the equivalent of £1000 pays about 6·3 per cent, and that of £2000 about 10 per cent, as against 10 and 13 per cent respectively in Japan. In the higher incomes there is a considerable degree of graduation. Differentiation is noticeably absent.

In India both income tax and super tax were central heads of revenue, and there are no provinces in which there are in addition provincial taxes on income as in Australia and the United States.

It was arranged in the Reforms introduced in 1921 that three pies on each rupee in excess of a certain datum line in respect of which income tax had been collected within the jurisdiction of each local Government, should be given to the local Government. The purpose of this rule was to secure to the larger industrial provinces a share, indeed a very small share, in the growing revenue from income tax. The proposal, however, has entirely failed in its purpose. Under this system, moreover, the provinces do not benefit by any increase in the rate of the income tax nor do they receive any share in the super tax. A strong case was made out for granting a share to the provinces in the proceeds from income tax in the discussions which proceeded the framing of the New Constitution of 1935, and the sharing of the proceeds of the taxation of personal incomes and the levying of surcharges by the Federal Government has been referred to in Chapter XVI., pages 270 to 274.

United States

7. In the American Colonies before the middle of the seventeenth century there was a tax on gains and profits derived from personal ability as distinct from property. Until 1861, however, no general tax on income was in use in the United States. The Civil War, however, necessitated the introduction of the tax, which taxed incomes upwards of £160 at the rate of 3 per cent. The rates of tax were subsequently increased until the tax was dropped in the year 1872. In 1894 the rate was 2 per cent with an exemption limit of £800 or 4000 dollars. The tax was declared unconstitutional and withdrawn,[1] but the demand for income tax greatly increased, until on 25th February 1913 the foundation for the Federal system of income tax was laid at moderate rates, 1 per cent on all incomes above $3000 or $4000 in case of married persons, and a graduated surtax of 1 per cent on incomes of $20,000 with a maximum rate of 6 per cent on incomes of $500,000

[1] Section 2, Article 1, of the American Constitution provides that ". . . direct taxes shall be apportioned among the several States according to their respective numbers ". This led to the 16th Amendment of the Constitution, proposed by Congress on 31st July 1909 and proclaimed adopted on 25th February 1913, when it was ratified by the requisite number of States to make it a part of the Constitution. The 16th Amendment provides that " Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration ".

or more. These rates were increased to the maximum of 12 per cent and 65 per cent respectively during the War. The normal tax, therefore, was originally a proportional tax and was graduated only in 1918. The normal rate in force for the year 1935 was 4 per cent on net income, *i.e.* after exemptions and deductions. The rate for surtax for the same period was 4 per cent on net incomes in excess of $4000 with a maximum of 75 per cent. Personal exemptions of $1000 for a single individual, $2500 for a married couple or the head of a family, and $400 for each dependent (including children under 18) are granted, and are high as compared with other countries. The rate of tax for domestic and foreign corporations is $12\frac{1}{2}$ to 15 per cent on the net income. The following table shows the most important characteristics of the Federal income tax, especially its remarkable elasticity :

PERSONAL INCOME TAX IN THE U.S.A.

	1913.	1923.	1926	1931.
Total number of taxable returns . . .	357,598	7,698,321	4,138,092	3,225,924
Total net income (millions)	$3,900	$24,777	$21,959	$13,605
Total tax yield (millions) .	$28	$662	$732	$246
General average rate (per cent) all incomes . .	0·72	2·68	3·33	1·81
Personal exemptions :				
To individual . .	$3,000	$1,000	$1,500	$1,000
To head of family .	$4,000	$2,500	$3,500	$2,500
For each dependent .	..	$400	$400	$400

Taxes on corporations which are not made on the basis of their income alone will be dealt with in a later chapter. The most important characteristic of the Federal income tax is its productivity. Even in the year ending 30th June 1933 when the country was in the throes of the trade depression the income tax produced 746·8 million dollars, of which $394·2 millions was from corporations and $352·6 million from individual incomes, as compared with $250·7 millions from customs and a total tax revenue of $1862·8 millions. Only a small proportion of the population is directly affected in industrial states. The rates are high on larger incomes as compared with other countries, and on smaller incomes they are low. Other characteristics are the high personal exemptions or deductions [1] and the

[1] Vide *Tax Systems of the World* (1935), Tax Research Foundation : Chicago, Commerce Clearing House, Inc. Corporation Trust Company, 205 W. Monroe Street.

taxation of gains from the sale of capital assets. The tax, however, has a weak point in that it does not reach, for constitutional reasons, municipal bonds and other tax-free securities. No relief is allowed in the case of earned incomes, and excessive surtaxes have led to the investment of capital in tax-exempt securities. It is unwise on the part of a Government to levy taxes running up to 75 per cent of an individual's income while tax-exempt securities paying a high rate of interest are available in abundance. Information at source has been substituted for collection at source. There are other criticisms of the working of the Act; for example, the deducting from the tax due from its citizens any tax paid by them on their income from abroad. This is made entirely at the expense of the investor's home exchequer.

About half of the states of the Union levy State income tax, which is in addition to the Federal income tax. Twelve of these levy the tax both on personal and corporate incomes under the same Act;[1] seven on corporate and personal incomes under separate Acts; two tax personal incomes only; and four tax corporate incomes but not personal incomes. Most of these states, beginning with Wisconsin, in 1911 introduced an income tax administered by a State tax commission in place of the unsatisfactory property tax, especially on intangibles, and the corporation franchise tax, the taxation in regard to the latter giving rise to many jurisdictional difficulties. It was indeed a new chapter in American taxation. The basis of the tax is, as a rule, the Federal income tax return with exemptions in whole or in part in the case of income received from property in other states or from business carried on outside the jurisdiction of the state. It is a progressive tax with a moderate exemption limit. In Massachusetts income of residents in the state from intangibles, taxable as property under the law before the passing of the Act, is taxed at 6 per cent; net gains from dealings in intangibles are taxed at 3 per cent and incomes derived from annuities, trades, and professions at 1½ per cent.[2] Exemptions are granted under the Act if the business or profession does not produce $2000 per annum, and if the income from all sources does not exceed $600—annuities were exempted up to

[1] *Op. cit.* pp. 130-139.

[2] *General Laws of Massachusetts, relating to Taxation and Special Assessments* (Revised 1929), ch. 62.

$300. The administration of the tax is centralised in the hands of the State tax Commissioner. The proceeds, less the cost of administration, are distributed locally. In New York the total income of the resident is taxed even although it arises in another state. That part of the income of a non-resident which is derived from sources within the state is taxable. Exemption is granted in respect of income tax paid in other states of the Union provided reciprocal exemption is granted.[1] The well-known Wisconsin income tax first enacted in 1911 is levied on income from all sources in the case of residents, and income arising within the state in the case of non-residents. Personal exemptions are granted from tax only, for example, $8·00 to unmarried persons; $17·50 to married persons, and $4·00 for each child under eighteen or dependent. In other states deductions on net income are allowed—$1000 for single persons, $2000 for married persons, $400 for minors—while in one or two states no exemptions are permitted. States also allow deduction for business expenses, interest on indebtedness, bad debts, depreciation, realised capital losses, and gifts to charity.[2] The rate of state income taxes are much lower than the Federal tax and are not in reality a serious burden except on the larger incomes. The existence, however, of state income tax in addition to the Federal tax has brought into prominence questions of jurisdiction, assessment, and multiple taxation. Many of the states which levy income tax pay a portion of the tax to county or local authorities.

JAPAN

8. Japan, it will be remembered, followed, within a year, India by introducing an income tax in 1887. The tax was altered in 1901, 1905, 1913, and 1918, but it was revised thoroughly on two occasions only—in 1899 and 1920. The three main classes of income taxed are income of corporations, income from securities, and income of individuals from salaries and other sources. Persons engaged in the agricultural warehousing business are exempt from taxation, as are also the salaries of Army and Navy officers

[1] *Laws of New York*, 1932, ch. 52; cf. Cahill's *Consolidated Laws of New York*, 1930, ch. 61.

[2] Cf. Wisconsin Statutes, 1920, ch. 71; Laws, 1931, ch. 448 and 453.

while engaged in war, allowances to widows, orphans, the sick and the wounded, etc. In Japan the principle of graduation is brought into force by granting certain abatements for earned income, allowances for family responsibility, and by variations in the rates of tax. The income of all corporations is liable to tax on net profits, and since 1926 there has been also a business profits tax of 3·4 per cent on corporations other than those of iron and steel, stock or produce exchanges, mining, and the sale or manufacture of agricultural products. The interest on securities except those exempted is assessable from 4 to 7·5 per cent. Earned income is differentiated by granting abatements when the total income is below a certain limit. Abatement on account of family responsibility are variable according to the size of the income, and are granted in respect of non-earning members of the family under 18 or over 60 years and disabled or invalid dependents. The abatement varies between 50 to 100 yen per dependent according to the amount of income. Income tax is leviable on individuals only if the income after all these deductions are made exceeds 800 yen. Inclusive of the abatements the minimum liable to taxation comes to about 1250 yen, a sum closely corresponding with the limit in India. The tax on the income of individuals is graduated from 0·8 to 36 per cent according to the size of the taxable income. Thus on incomes exceeding 800 yen but falling below 1000 yen the tax is 1 per cent, and on incomes exceeding 4,000,000 yen it is 36 per cent. The income tax from Class I. (corporations) is collected at the end of every business year, from Class II. (securities) at the source, and from Class III. (personal incomes) in four equal instalments payable on 30th September, 1st November, 1st January, and 1st March. The tax of Japan bears a family resemblance to that in India. The tax differs, however, in two main respects from the taxation in India: (1) the income from land is taxed, and (2) the income of certain companies like iron foundries is exempt from taxation under the Iron Foundry Encouragement Law. It is also provided that for those who are manufacturing staple commodities as specified by Imperial ordinances the tax is wholly remitted for three years from the year of starting business, and from the fourth year it is partially remitted from their incomes derived from the business as determined by order.

France and Italy

9. In France the income tax may be grouped under two heads; (1) a subsidiary income tax levied in seven schedules [1] on the income of individuals and companies, arising, as a rule, in France, and (2) a general income tax (l'impôt général sur le revenu). The general income tax came into operation in 1916 under the Act passed on 29th December 1915. The scheduled taxes (les impôts cédulaires) were added to the general income tax in 1917. These taxes replaced three out of "the four old women", the exception being the real estate tax. The general income tax is graduated and levied on income exceeding 10,000 francs. The tax applies to all incomes chargeable under the seven schedules, including income from home and foreign securities. It is graded in "steps" with a rate of 0·96 per cent on incomes between 10,000 and 20,000 francs. The maximum rate is 24 per cent, viz. on the portion of income above 550,000 francs. Foreigners, residing in France but domiciled abroad, are assessed upon five times the rental value of their residence in France unless their income from French property or professions exceeds that amount, in which case this latter is used as the tax base. Persons having neither a domicile nor a permanent residence in France are not taxed even on that portion of income which arises in France. In addition to the exemption or abatement limit of 10,000 francs, there are allowances for a wife, children, and dependents. The tax is increased by 25 per cent when the taxpayer is over thirty and unmarried or divorced, and having no children or dependents. If he is over thirty and at least two years married but without children or dependents he is charged 10 per cent more than the normal rate. The preceding calendar or business year is the year on which the tax is assessed. Allowances are permitted in scheduled taxes in addition to those allowed under general or supplementary income tax. The tax on

[1] The seven schedular taxes are as follows: (1) Industrial and commercial profits tax (Impôt sur les bénéfices industriels et commerciaux); (2) Agricultural profits tax (Impôt sur les bénéfices de l'exploitation agricole); (3) Salaries, etc., Pensions and Annuities tax (Impôt sur les traitements, etc., salaires, pensions et rentes viagères); (4) Non-commercial professional profits tax (Impôt sur les bénéfices des professions non-commerciales); (5) Immovable property tax (Impôt foncier); (6) Dividend and interest, etc., tax (Impôt sur les revenus des valeurs et capitaux mobiliers); and (7) Mine levy (Redevance proportionnelle des mines).

industrial and commercial profits is payable on profits realised from enterprise carried on in France and is at the basic rate of 12 per cent of the net profits. There is a special rate for profits not exceeding 10,000 francs. Profits of individuals domiciled in France or of companies having their headquarters in France arising from establishments abroad are not subject to the tax. Foreign companies, however, have to pay on the profits arising from the conduct of their businesses in France. For agricultural profits variable coefficients are applied to the cadastral rental value of the lands on 1st January preceding the tax. Deductions are made for family expenses and location and the tax is levied on the excess of 2500 francs. Between 2500 francs and 10,000 francs the rate is 6 per cent, and over 10,000 francs the rate is 12 per cent. Companies whose operations include agriculture are taxed on the basis of their net profits. Salaries, pensions, and annuities are taxed on the preceding year even if these are received from abroad, but are not taxed although arising in France if sent to a person who lives in a foreign country. The tax applies to the fraction of the income which after deduction of certain allowances for family expenses exceeds the sum of 10,000 francs. The fraction between the minimum exemption and 20,000 francs is counted only as one-half, and the fraction between 20,000 francs and 40,000 francs as three-fourths. The tax rate is 10 per cent. The principle of taxing gains from non-commercial professions is similar. The rate is 12 per cent. The tax on real property is on the rental value less 25 per cent for houses and 40 per cent for factory buildings as an allowance for depreciation and maintenance. The basic rate is 12 per cent, and to the basic amount which goes to the State additions are made for departments and communes, the amount varying with the locality. For unimproved property the basis of the tax is the net income equal to four-fifths of the rental value. Mining rentals are taxed on the basis of the number of hectares leased, the rate being one franc per hectare, and in addition there is a tax on profits under the industrial and commercial profits law of July 1934. The characteristic of French income tax has been its low yield. It yielded 21 per cent of the total revenue as compared with 46 per cent for Great Britain and 57 per cent for the United States (Federal) for the year 1926–27. The reason for this is probably the low return from agricultural incomes and also the dislike

on the part of French, shared with Indians, for any form of direct taxation.[1]

The system of income taxation in Italy is similar to that of France.[2] There is a general income tax with subsidiary income taxes. These subsidiary taxes include the land tax (imposta sui terreni, imposta fondiaria), the buildings tax (imposta sui fabbricati), and the movable property income tax (imposta sui redditi di ricchezza mobile). There is also a contemporary tax on the total income of the individual, including that of his wife and minors at home, which varies from 1 to 10 per cent according to the size of income. The land tax is distinct from the tax on agricultural incomes. The buildings tax is on rental value except for industrial premises, which are taxed under the movable property tax. The rate of the land tax is 10 per cent on rental values and that of the buildings tax 10 per cent on assessed rental value. In addition there are surcharges for provinces and communes both for the land tax and buildings tax. All income not charged to these two is brought under the general income tax, which is subdivided into classes.[3] There is a tax on bachelors, except foreigners and clergymen, between the age of twenty-five and sixty-five.[4] There are exemptions and abatements both in regard to subsidiary or scheduled taxes and the general income tax. The schedular taxes are called normal taxes

[1] Cf. *Traité pratique des impôts cédulaires et de l'impôt général sur le revenu* (Paris, 1928), with supplements. *L'impôt sur le revenue cédulaire et général* (3rd ed., Paris, 1926).

[2] Cf. *L'imposta sui redditi di ricchezza mobile* (Aloisini, 1927). *L'imposta normale sui redditi*; *l'imposta complementaire Falzoni* (Turin, 1921); cf. p. 216, *Tax Systems of the World* (1934), Chicago: Corporation Trust Company.

[3] Schedule A (interest on loans), 20 per cent on gross income; Schedule B (incomes from commercial and industrial enterprise), 14 per cent on the net income in excess of certain exemptions. Under this Schedule are incomes from agricultural loans taxed at 7 per cent; under Schedule C incomes from the professions are taxed on net income in excess of certain exemptions at the rate of 12 per cent; salaries, annuities of clerks, specialists and others in private employment, 9 per cent on net income in excess of exemptions; Schedule D, 8 per cent on the total income from salaries and pensions paid by the state, provinces, communes, public bodies, etc., to their employees; and 4 per cent on the total wages of labourers in the employment of the state; and in the case of wage-earners in the employment of provinces, communes, public bodies and utilities, etc., provided that the wages exceed 2000 lire, 4 per cent.

[4] The tax varies according to the age (25-35, 17 lire; 35-50, 100 lire; 50-65, 50 lire), plus a variable rate of 50 per cent of the complementary tax, and if the bachelor is not subject to this tax, this extra tax is determined by a method similar to that of the complementary tax.[4]

on incomes (imposta normale sui redditi) and are supplemented, as we have seen, by the general or complementary tax on the entire income.[1]

GERMANY

10. An imperial tax in Germany was levied for the first time in 1913, at a progressive rate varying from 1 to 8 per cent. Before this there existed in Prussia from 1891 a state income tax. Since 1920 the Imperial income tax is levied by the Reich on incomes of individuals and partnerships and also on corporations. Income tax is levied on the net income of residents, while in the case of non-residents the part of the income arising in Germany is taxable by the Reich. The scale is a progressive one fixed by schedule annexed to the Law of October 16, 1934, giving the exact tax for a slice of net income. Unmarried persons are taxed more heavily than married persons, and the allowances for children are on a generous scale. For unmarried persons the income tax starts at R.M.560 with a tax of R.M.10; for married persons with three children from R.M.1925 with a tax of R.M.14, and with five children from R.M.3800 with a tax of R.M.13. With a net income of R.M.75,000 and more the tax is 50 per cent in the case of unmarried persons, and 40 per cent for married persons with or without children. The taxation of the net income of corporations depends on the nature of these corporations. If these are small companies and co-operative societies with capital not exceeding R.M.50,000 the rate is 10 per cent, and it is graduated upwards. Twenty per cent is the general rate. The maximum rate of taxation for corporations never exceeds 20 per cent. As pointed out elsewhere, by far the greater portion of the income tax is paid over to the states (Länder) and local authorities (Gemeinden). The Reich retains only 26 per cent and 74 per cent is distributed to the states, and each state distributes at least 50 per cent of its share to local authorities according to need.[2]

[1] The rates of income taxation in the text above for Italy refer to the position on January 1, 1935.

[2] *Staatslexikon* (5th ed. Herder, Freiburg), sub. "Finanzen des Reichs, der Länder und Gemeinden"; "Das Einkommensteuergesetz" (Pissel und Koppe, 2nd ed. 1928); "Das Körperschaftsteuergesetz" (Rosendorff, 1925). For personal income (Einkommen), *vide* Law of Oct. 16, 1934 (I. 1005). For the tax on corporations (Körperschaft), Law of Oct. 16, 1934 (I. 1031).

CHAPTER XXII

THE TAXATION OF INCOME (GENERAL PRINCIPLES)

1. THE previous chapter has been descriptive of the income taxes in the principal countries of the world. It is necessary now to turn to the principles underlying the taxation of income such as the scope of the tax, graduation, differentiation, abatements, collection at the source, the period on which the tax should be calculated and the question of evasion. The incidence and effects of the tax have already been discussed in Chapter XIX. There are, broadly speaking, three main types of a general income tax. There is the unitary type such as that of Great Britain, the United States, and Germany. This is the most common type of tax. The returns are arranged by schedules or categories and the income in these is added together and the rate applied to the resulting total income. The schedules are for administrative convenience and the tax is almost a purely personal tax. Thus in the five British schedules there is, except in regard to agricultural income, no difference among the schedules in rates and abatements but only in the resulting total income. The tax is in reality a personal tax. The second main type of general income tax is the composite income tax such as that of France and Italy. In France when the income tax was adopted in 1917 six schedules were introduced with a rate on the net income from each of the six sources. No great attention in the schedules is paid to graduation, although ability is in some degree allowed for in regard to exemptions for family expenses and for position as in the case of the French schedular tax on salaries. In addition to these so-called quasi-personal taxes there is a general income tax obtained by the combination of the results of the schedular taxes, and in this attention is paid to graduation and abatements, exemptions, and allowances. The combined general tax is a

personal tax. Similarly is the case with the six schedules of the Italian taxes which are known as normal taxes on incomes. These are supplemented by what is called a complementary tax on income where progression and exemption are allowed for. In the second type of tax there is a combination of quasi-personal taxes on incomes with a personal tax. As compared with the unitary income tax the composite income tax is more complicated, but on the other hand it has the advantage, as Seligman has pointed out, of a finer differentiation in rate. It is sometimes held that there is an advantage in collection, viz. the best method of collection is possible in each schedule. But this applies also in varying degree to the unitary income tax. The third type of general income tax is that usually known as the presumptive income tax, such as was introduced in Greece in 1921 and in Belgium in 1930. It is in use also in France in the case only of resident foreigners, where, as noted in the previous chapter, the income is equal to five times the rental value of the residence which they possess in France, unless the income of French origin is greater than this amount, in which case this income is used as the tax basis. The Triple Assessment of Pitt in 1798 was of this nature and it was abolished because of fraud. The usual criterion to-day of such a presumptive general tax on income is house rent, but other criteria are sometimes used, such as furniture, servants, motor cars, and horses. This form of general income tax is only suitable for countries where conditions of administration are considered to be unsuitable for the obtaining of actual income. Its great drawback is the danger of evasion. A further classification is that of taxes on the whole income and, on the other hand, taxes on part of the income only or partial income taxes such as taxes on professions or on intangible property or on corporations or profits. The best example of the latter is the tax in some states of the American Union where a partial income tax is levied on intangible property to replace or to supplement the property tax.

Scope of the Tax

2. The taxation of income usually affects non-residents as well as residents,[1] but not in all cases, as in France. It is custom-

[1] Cf. clause 5 of Income Tax Codification Committee's draft Bill (Cmd. 5132—1936), which well sums up the position: "5—(1) A person whether

ary, as has been shown, to tax residents on their income arising inside and outside the country, and non-residents on income arising inside the country. In certain cases, as in South Africa, income arising in the country only is taxed. It is the source of income and not the residence of the income receiver that determines tax liability in such cases. On the other hand, as we have seen under the French general income tax, persons having neither a domicile nor a permanent residence in France are not taxable in that country, notwithstanding the importance of their income of French origin. Under the French profits tax a tax is levied on the net profits of concerns carried on in France. But, as has been shown in the previous chapter, profits from the conduct of establishments located in foreign countries and accruing to companies with their headquarters in France or to individuals domiciled in France, are not taxed. But profits realised by enterprises with headquarters in foreign countries are taxed on profits arising in France. In most countries income tax extends to the income of individuals and also of companies and other bodies or persons who are residents in the country or who receive income which arises in that country. Net income from all sources, foreign as well as domestic, is, as a rule, taxed, but there are, however, as has been shown, exceptions to this rule. In the case of companies in Great Britain residence is determined according as the direction of control is centred in Great Britain or abroad. Non-residents may in the case of Great Britain and Northern Ireland recover income tax from interest and colonial securities, and also certain British War loans. Although non-resident, they have to pay income tax on income arising in the United Kingdom, such as income from industrials, railways, and banks. British subjects not resident in Great Britain and Northern Ireland are entitled to reliefs in the form of abatement and allowances to which those resident in Great Britain and Northern Ireland are eligible. Other non-residents are liable at the full standard rate without allowances and reliefs. The British Revenue authorities have recently interpreted more strictly than hitherto the law in regard to residence. The taxing authorities now have to be certain that not only has the taxpayer abandoned his British residence,

resident in the United Kingdom or not shall be liable to bear tax in respect of United Kingdom income; (2) A person if resident in the United Kingdom in the year of charge, but not otherwise, shall be liable to bear tax in respect of foreign income".

but that he has actually established a definite residence abroad. Thus in the words of a memorandum [1] of the Board of Inland Revenue, London, " a British subject, whose ordinary residence has been in this country, notwithstanding that he may reside abroad for more than six months of the income tax year, remains chargeable to British income tax for that year as a person resident and ordinarily resident in this country, unless he has gone abroad in such circumstances that he cannot be said to have left this country for the purpose only of occasional residence abroad ". Thus civil servants from India and the Colonies residing in Great Britain for less than six months and establishing no residence are not liable to British income tax on income arising abroad, and they therefore enjoy the relief according to non-residents. An English visitor to Cannes, however, who spends six months abroad, but is unable to show that he is ordinarily or principally resident abroad like the civil servants above, would be liable for tax. Under the British system a man, for example a civil servant of India or the Colonies, is regarded as resident in Great Britain in any year that he lives in the country if he has a house or dwelling for his occupation, although his visit be of a few days' duration, say to see his wife and family. He is regarded as resident for any year in which he pays a visit, however short, to the United Kingdom. The British Royal Commission on the income tax recommended that all remittances from a husband abroad to his wife in Great Britain should be chargeable to income tax.[2] In the event of his being held to be resident he would be chargeable on his remittances to the United Kingdom, but his wife's and his own income would be aggregated. He would receive the ordinary allowances as a married man while his wife would receive none. A visitor to the United Kingdom is liable not on his total income arising from sources outside the United Kingdom, but even when " resident " only on so much of that income as is received in or brought into the United Kingdom. We have shown elsewhere that a visitor who is not domiciled in the United Kingdom is liable to tax in respect of income arising from sources in the United Kingdom

[1] Circulated to bankers, etc., in Great Britain and Northern Ireland in January 1924, cf. Memorandum dated February 1929. Cf. Report of the Income Tax Codification Committee, 1936, vol. i. Cmd. 5131, pp. 34-35, 112-113, where the meaning of " residence " in income tax legislation is dealt with.

[2] *Report of the Royal Commission*, p. 7, Cmd. 615, 1920 (H.M. Stationery Office, London).

with a few exceptions, *e.g.* interest on certain Government securities such as War Loan, but he is not liable in respect of income arising from sources outside unless he is "resident" in the income tax sense in the United Kingdom. A visitor is "resident" if he maintains a place of abode in the country and visits the United Kingdom even for a day. He is "resident" although he has no abode, but remains for a period or periods equal in the whole to six months in the Income Tax year (beginning 6th April). He is also "resident" if he makes his visits year after year, so that these are part of his habit of life, and are for a substantial period or periods of time. The Board of Inland Revenue normally regards an average annual period or periods as substantial if they amount to three months, and they are "habitual" after four years.[1]

Should money income or real income be taken? Clearly real income should be taken, but it is extremely difficult to evaluate, and, as a rule, money income is taken except in the case of lands and houses. The British Royal Commission recommended that

[1] Cf. Income Tax Codification Committee's draft income tax Bill, Cmd. 5132–1936, clause, 6 which reads:

(1) An individual shall be treated as being resident in the United Kingdom in a year of charge if he—

(*a*) is in the United Kingdom in the year of charge for a period or periods amounting in all to 182 days or more; or

(*b*) maintains or has maintained for him a dwelling-place in the United Kingdom for a period or periods amounting in all to 91 days or more in the year of charge, and is in the United Kingdom for any time in the year of charge; or

(*c*) is in the United Kingdom for any time in the year of charge with the intention of setting up a dwelling-place therein, and in that or the following year of charge sets up such a dwelling-place; or

(*d*) having within the four years preceding the year of charge been in the United Kingdom for a period of, or for periods amounting in all to, 365 days or more, is in the United Kingdom for any time in the year of charge, otherwise than on an occasional or casual visit.

Clause 6 (2) defines "principally resident" in the United Kingdom, *i.e.* if in the year of charge he has a dwelling-place or place of business in the United Kingdom but neither a dwelling-place nor a place of business elsewhere, *or* has not a dwelling-place or place of business in any country but is domiciled in the United Kingdom, *or* if in view of all the circumstances of his case such as domicile, nationality and habits of life he appears to be so resident. A company is resident "if it is controlled in the United Kingdom or if it maintains an established place of business in the United Kingdom and any substantial part of the activities of the company, whether administrative or other, is conducted in the United Kingdom, but a company shall not be treated as so resident by reason only of the fact that it has a registered office in the United Kingdom at which is transacted such administrative business only as is necessary to comply with the requirements of the Companies Act 1929" (Clause 7).

when part of the regular remuneration is in kind it should be brought under assessment, and this is now done in regard to houses owned and inhabited by owners. Speaking generally, we may say that while it is possible to value the letting value of a house in which the owner lives and to tax him accordingly, it is not feasible to extend this. It is, therefore, confined mainly to houses and lands. Then, again, there are the distinctions between gross and net income and between income and capital. While the taxation of net income is the ideal, it is only possible, as we shall shortly see, to allow for those expenses immediately connected with the work from which the income is obtained. In regard to the distinction between income and capital it may be said that, the tax being an income tax, no account should ordinarily be taken of losses or gains of capital. If losses were allowed this is apt to raise several difficulties. It predicates the existence of almost a perfect system of administration as the state is apt to lose owing to the exaggeration of losses and losses are likely to be specially exaggerated in times of depression when government requires funds. With a suitable administration losses may in certain cases be permitted to be carried forward. The practice of allowing for wastage which is unavoidable in the production of income is customary, and rightly so.

Bonus shares arise from capitalising profits of the current year or the undistributed profits of previous years, the increased value of capital assets or the gains on the sale of capital assets. The profits of the current year or the undistributed profits of previous years are already taxed before conversion into capital, and therefore to tax them again as bonus shares seems unfair, notwithstanding the increased standard rate of tax in the subsequent year. The House of Lords decided that a resolution of a company converting into capital what was originally income is "good as against the whole world, including the Crown, claiming or taxing for any other purposes". Bonus shares arising from the increased value of capital assets or the gains on the sale of capital assets are usually exempted from taxation because they are of capital origin.

The taxation of non-recurring or occasional profits arising from transactions that do not form part of the ordinary business of the person who makes them has sometimes been held to be outside the scope of the income tax. Any profit, however, made

on a transaction in which the subject matter was acquired with a view to profit should be assessed to income tax and not treated as an accretion to capital. Thus speculation, betting, gains from company promotion, and occasional cash sales should be liable to income tax. Chance gains, occasional earnings, and lottery prizes are included in income for fiscal purposes in most countries; inheritances are not because they are separately taxed. It is sometimes argued that casual profits should not be taxed because of the extreme difficulty in tracing transactions and in preventing evasion. With increased efficiency in administration this difficulty should not be altogether insuperable. Capital gains are taxed, as a rule, only when realised through sales or in some other way when disposed of. Most countries to-day refuse to regard capital gains as income although taking occasional or chance receipts during the year. The case for the taxation of capital gains is that they increase the ability to pay and should, therefore, be taxed. It is better, however, to tax capital gains by an unearned increment tax, or if personal property is to be taxed, by an increment property tax, and this is a tendency in fiscal practice at the present time. Capital gains, however, in Germany from speculative transactions are still by law taxable, and so are the gains arising from the sales of any concern. In France, too, capital gains on securities are taxed in the schedular tax but not in the general income tax. In most countries corporations as well as individuals are taxed. In the case of Great Britain, for example, the taxation of companies is merely in order to prevent evasion by individuals. It is left to the individual to recover income tax which has been paid in excess at collection at source. In other countries the object is to tax not merely individuals but corporations. In this latter case dividends are sometimes exempted from normal personal income tax only as in the American federal tax, or dividends are exempted from both normal and super or surtax. No exemption is sometimes given for personal income tax, both corporations and individuals being taxed as in New York. Underlying these variations in practice there are one or two theories. For example, it is held that the income of the corporation is really the income of the shareholders, and therefore to tax the corporations is the same thing as taxing the shareholders. There is, in other words, double taxation. If only the corporations were taxed this would be most unfair from the view-

point of personal taxation, because the individual by escaping taxation on investment income would pay a much lower rate on this total income than would be justified. It is usual, therefore, to tax a corporation which pays a normal tax and to tax the personal income taxpayer on surtax, or to leave him to recover any excess paid by the corporation paying the normal rate. This is, as Seligman points out, quite defensible in theory provided that income is regarded as the income of the person only, and in the United States where corporate income is recognised this could not be defended in a similar way. It may, however, be argued that a corporation tax is quite independent from a tax on personal income, the former being a semi-personal tax or a tax *in rem* just like a land tax.

The case for the inclusion of bonus shares in income is, in short, that the granting of these shares is an element of taxable income in that it means an increase in future income ; that stockholders escape taxation and unless taxed there is discrimination. On the other hand, such a grant of shares is an unrealised gain, and the income tax payer is no richer in the year under review than before, and to become real income the shares must be realised. Here again it is best if such bonus shares were reached as in the case of capital gains under an increment property tax.

GRADUATION

3. Twentieth-century legislation has accepted the principle of graduation almost without exception as a characteristic of the tax. Graduation according to the size of income is known as graduation or progression. In other words it means the levying of a heavier rate as percentage upon large incomes than upon small incomes.[1] The rate increases as the income increases. The term is usually used in contrast to proportional taxation, which implies the principle of the universal flat rate of tax applicable to all incomes regardless of their size. There may be graduation downwards by reduction of the standard rate to lower incomes, and upwards by means of an additional income tax chargeable as

[1] It usually means a change in the rate for a change in the amount. Sometimes in the case of inheritance taxes it is used to denote a differential rate for the same amount going to different persons, *i.e.* according to the degree of relationship of the heir.

super tax, or surtax. Graduation is ordinarily used in the sense of progressive taxation and must not be confused with differentiation of the tax where a different rate of tax is levied on different kinds of income. Ordinary graduation means a changed rate for altered amounts. In the case of inheritance taxes, however, when different rates are levied according to the degree of relationship of the heir or heirs the tax is also called graduated, and here it is used in the sense of a differentiated rate for the same amount which goes to different persons. The Select Committee on Income Tax of 1906 pointed out, there are three possible ways of effecting graduation, viz. (1) a graduated rate of tax according to the total net income of the individual, (2) a super tax, *i.e.* a tax supplementary to and distinct from the income tax leviable on individuals by direct personal assessment, and (3) graduation which might take the form of extending the system of abatements or charging a lower rate of tax on lower incomes. It is sometimes said that the first of these is likely to lead to the abandonment of the principle of taxation at source, and the second is practicable although subject to some of the inconveniences of the first, and that the third is convenient but within certain limits only. The Royal Commission of 1920 recommended that graduation should be effected with reference to the size of the income solely by a variation of the real effective rate of tax and their recommendations regarding the application of a smooth scale of graduation were adopted in the Finance Act of 1920. The principle of graduation was known in ancient Athens, as in Solon's legislation of 596 B.C., in the mediaeval poll tax in England,[1] in the decima scalata of Florence, and Pitt's "Triple Assessment" contained elements of graduation confined to the lower ranges of income as has been shown in the previous chapter. The Acts of 1799, 1803, 1806, and 1842 had also elements of graduation. Gladstone's first Budget in 1853 fixed the exemption limit at £100, and an abatement of tax was allowed on incomes of less than £150. Gladstone, however, was no friend of the system of graduated taxation, and he held that it tended to communism. Even John Stuart Mill regarded graduated income taxation as graduated robbery. In the twentieth century, however, the attitude towards graduation completely changed, and a system of graduation in most

[1] The graduated poll taxes of 1379 and 1380 repeated in 1513 and 1641. Cf. the graduated income taxes of 1435 and 1450.

countries was adopted by (1) abatement, (2) by a sliding scale of income-tax rates which formerly existed in Great Britain, and (3) by a super tax or "surtax". In India, for example, graduation is effected by the general exemption limit and the varying rates of income tax and super tax. In the United States varying rates are applied, not to the whole of incomes after deducting any general abatement, but to the slices of income lying between specified limits. This slice method is also true of the super tax in the United Kingdom and in India of income and super tax. The method followed in the case of surtax is not applied to income tax in Great Britain, as it involves much trouble. The surtax method is to tax each £ of the first £100 at so much, the second £100 at so much, and so on throughout. Surtax in the United Kingdom is paid on the total income of the previous year without deductions for earned income, personal allowance, marriage, children and dependent relations, and life insurance, as these have already been deducted for income tax. The "slice" sytem by which progressive higher rates are charged upon successive slices of income was first used for income-tax purposes in France. This method presupposes that the exact total income of individuals before assessment is known. The difficulty of obtaining this information for all the millions of incomes that have to be assessed constitutes an insuperable obstacle that stands in the way of the adoption of this method in preference to the present method. In the United States, however, this difficulty does not arise, as information at source has been substituted for collection at source. In the Dominions, mainly in Australia, New Zealand, and South Africa, the rate of tax charged changes with each small increase of the total income, subject to a maximum rate on large incomes. Briefly, the principle of graduation is based on the law of diminishing utility. The hurt caused by obtaining Rs.10,000 of additional revenue by means of levies of Rs.50 from each of 200 incomes of Rs.500 is undoubtedly greater than that caused by taking it from one income of Rs.100,000.

Differentiation

4. Differentiation of tax is made when the tax varies with the nature of income. Some incomes may be temporary or pre-

carious, others permanent or fixed; some earned, others investment incomes. The principle of differentiation was introduced into the British system in the Finance Act of 1907, when the rate of duty on the earned income of any person whose total income did not exceed £2000 was reduced, a relief which was extended in later years. The Royal Commission on British Income Tax (1920) recommended that relief of this nature should be given by excluding from assessment a certain proportion of the earned income and not by a reduction in the rate of duty. This was given effect to in the Finance Act of 1920, and at the present time one-fifth of earned income (with a maximum of £300) as deduction is permitted. Although the question of differentiation dates from 1798 in the English income tax, it did not come into practice until 1907. It is interesting to note, however, from the point of general principles that this was considered over and over again by responsible authorities. A member of the House of Commons, for example, in December 1798[1] declared that "a man who had an income of £1000 per annum arising from capital, and the man who gained the same annual sum by a profession or by business, surely ought not to be assessed in the same degree". Pitt, however, considered that this was revolutionary, and said "to complain of this inequality is to complain of the distribution of property; it is to complain of the constitution of society. To attempt to remedy it would be to follow the example of that daring rabble of legislators in another country." The Select Committee of 1851 and also the Select Committee of 1861 considered this, but were unable to make any practical suggestion for differentiation in favour of earned income. To-day the expression earned income is sometimes known in the Dominions as income derived from personal exertion as opposed to income derived from property. In France the expression is "revenu gagné" or "revenu le produit du travail" as opposed to "revenu provenant du capital". In Italy the expression "labour income" ("redditi di lavoro") is used as opposed to "redditi di capitale", and in German phraseology ("fundiert") funded as opposed to unfunded income ("unfundiert"). Other terms sometimes used to indicate the distinction are "permanent" and "precarious", "spontaneous" and "industrial", "unearned" and "earned", and "investment" and "earned income".

[1] Mr. Hobhouse, pp. 24-25 of Hansard, vol. xxxiv., 3rd Dec. 1798.

Of these the term "unearned" is objected to as casting a reflection on income from investments. The Royal Commission of 1920, therefore, recommended the adoption of the term "investment income" in place of "unearned income". It is sometimes said that the distinction between earned and investment income is inappropriate, as it is hard to define and excludes many cases of mixed incomes. That may be so, but the distinction is only a working solution of a difficult problem, and it does not penalise thrift and economy and entail a loss to the State owing to the exemption of persons with low unearned incomes. Investment income is independent of the existence of the investor, while income from professions, trade, etc., depends on the worker's healthy life. The worker is, moreover, tied down to a place and cannot move about like a large investor. The difference between earned and investment incomes is very well brought out by the Secretary of the U.S.A. Treasury, in his letter to Congress dated the 10th November 1923. He says: "The fairness of taxing more lightly incomes from wages, salaries, and professional services than the income from a business or from investment is beyond question. In the first case the income is uncertain and limited in duration; sickness or death destroys it, and old age diminishes it. In the other the source of income continues; it may be disposed of during a man's life and it descends to his heirs." There is, therefore, a substantial difference between the two classes of income, and the continuance of the distinction is highly desirable. In Great Britain the hardship of persons with small earned incomes has been mitigated to a large extent by the abatement of one-fifth of the earned income subject to a maximum of £300. Differentiation is, in short, a workable proposition. The taxation of property by means of estate or succession duties is often regarded as effecting a measure of differentiation in favour of incomes derived from personal exertion. The effects of this differentiation are generally undesigned, remote, uncertain, and little understood. Differentiation in favour of earned income is, as we have seen, made in Great Britain by the deduction of one-fifth of the earned income in order to arrive at the assessable income. This deduction is granted irrespective of the amount of the total income, but it must not exceed £300 for any one individual. By assessable income is meant the

total income as computed for income-tax purposes after making the appropriate deduction in respect of any earned income. Taxable income, on the other hand, in the British system means that part of the assessable income upon which income tax is actually charged, or assessable income less the various deductions such as personal allowance for self, increased personal allowance where wife has earned income, and deduction for housekeeper, children, and dependent relatives.

On the Continent differentiation of tax on different kinds of income is achieved in various ways. In the first place particular kinds of income are taxed at various rates according to the sources of income, and in addition, a general or globule income tax is levied. This is the French and also the Italian method. Secondly, in addition to the general tax on incomes there is a property tax on the capital value of the property. The Dutch property tax (vermogensbelasting) and income tax (inkomstenbelasting) are of this nature. A third method is to add to the income a certain fraction of the value of property before the income is arrived at.

Abatements

5. In modern fiscal science the standard of living has been the subject of careful investigation, and the question of family responsibilities is receiving increasing attention, as for example, in the British system where allowances for children's education are permitted and for doctors' bills and maternity expenses in the German system. The widespread exemption in the case of insurance premia is also another example. The exemptions for charitable benefactions not made to individuals and restricted to a maximum in any one year, interest on war damages, and, as in Germany, gifts to political parties, are further examples of the movement towards abatements. The negative abatement is seen in a higher rate of taxation for those without children, or as in France, divorced persons, and as in Italy the special taxation of the income of bachelors. It seems that the reverse of the movement suggested by John Stuart Mill, and more recently by Einaudi and others, for the freeing of the taxation on savings has been forgotten, and the drift is in favour of remitting the tax on expenditure as far as this conduces to social development. In

other words, at the present time the concept of clear income which is the income over and above the socially legitimate expenses incurred in obtaining it, is appreciated, and the taxation of this is everywhere being carefully considered. In addition to exemptions and deductions such as allowances for depreciation, wear and tear, there are also other allowances which have been permitted in recent years from assessable income. The personal allowances and deductions usually take the form of (1) a personal allowance, (2) an increased personal allowance where the wife has earned income—the personal allowance for the individual is higher in the case of a married man living with his wife than for a bachelor, (3) deduction for children. In Great Britain, for example, a personal allowance is allowed of £100 for a bachelor and £150 in the case of a married man whose wife is living with him.[1] Where the wife has any earned income, the personal allowance of £150 is increased by a sum equal to four-fifths of the amount of such earned income subject to a maximum additional allowance of £45. It is sometimes pointed out that the system of "pooling" for income tax and super tax the separate incomes of husband and wife, with the illogical and inequitable result that the aggregate demand upon them is thereby increased, is in fact a tax upon matrimony. There is no similar pooling when a brother and sister or two or more bachelors or spinsters live together in one establishment and share the expenses; the married couple, very probably with children to provide for, may be said to have a greater rather than less claim for consideration and for the removal of this invidious distinction. Although pooling leads to an unfair taxation of married couples, it is not a deterrent to matrimony. This consideration does not influence anybody in solving the problem "to marry or not to marry". The married woman's status should be no less than her single sister's, especially as the law has ceased to regard the individuality of the wife as merged in that of her husband. Government cannot afford to remove this distinction unless individual incidence is correspondingly revised. The separate assessment of husband and wife would result in a loss of £35,000,000 to the British revenue annually. That the revenue will suffer if the husband's and the wife's incomes are taxed

[1] Subsequently raised to £170, and from 1936–37 to £180.

separately cannot, of course, justify an unjust law, but equity is not the final determining consideration in public finance and is not so important as productivity. In favour of the present system it may be urged that in actual life the incomes of the majority of married people do constitute a common purse, that a married couple spend less than two persons living separately and consequently have more tax-paying ability, and that a system of separate assessment would result in an invidious distinction between married couples according as the total income is entirely contributed by one of the spouses or equally by both. In the former case the tax would be high and in the latter less. Income may otherwise be so transferred between husband and wife as to reduce the rate on such income to a minimum.[1] In Great Britain a deduction is permitted in respect of one child of £50, and £40 in respect of each additional child for whom the relief is due.[2] No deduction is, however, allowed in respect of any child or adopted child receiving an income of its own exceeding £50 a year. (4) In rarer cases deductions for a housekeeper, dependent relatives, etc., are allowed. The method by which the abatements in Great Britain are made may be illustrated for any year, say 1932–33.

INCOME TAX—SCHEDULES A, B, C, D, AND E.

Assessments made in 1932–33.

Items.	United Kingdom. £ (millions).
(*a*) Gross income	3201
(*b*) Exemptions :—	
Incomes below the effective exemption limit	48
Charities, colleges, hospitals, schools, friendly societies, etc.	41
Dominion and foreign dividends belonging to persons not resident in the United Kingdom	4
(*c*) Reductions :—	
Repairs—lands and houses and buildings	105
Wear and tear of machinery or plant	89
Other reductions and discharges	363
Total (*b*) and (*c*)	650

[1] *Vide* page 80, vol. i. of the Income Tax Codification Committee's Report (Cmd. 5131—1936) for a discussion on husband and wife in income tax law, and compare clause 159 of the Draft Bill (Cmd. 5132—1936), page 107, and the commentary thereon, page 241 of Cmd. 5131.

[2] From 1936–37 increased to £60 for each child. Cf. clause 81 of Draft Bill (Cmd. 5132—1936) and commentary thereon, Cmd. 5131, page 194.

Items.	United Kingdom. £ (millions).
(*d*) Actual income (viz. gross income (*a*) less exemptions (*b*) and reductions (*c*))	2554
(*e*) Earned income allowance (including age allowance)	312
(*f*) Assessable income (viz. (*d*) minus (*e*))	2242
(*g*) Personal allowances, deductions, and reliefs :—	
Married persons, £150	706
Other persons, £100	229
Allowance in respect of wife's earned income (max. £45)	7
Relief in respect of housekeeper	6
,, ,, children	78
,, ,, dependent relatives	10
Total (*g*)	1036
(*h*) Taxable income (viz. assessable income (*f*) less allowances (*g*)) :—	
(i) At half standard rate (2s. 6d.)	311
(ii) At standard rate (5s.)	895
Total (*h*)	1206
(*j*) Tax chargeable thereon	261
(*k*) Allowances of tax in respect of life insurance premiums	7
Dominion income tax relief	4
(*l*) Net produce of the tax	250
(*m*) Net produce for each penny of the normal rate of tax (5s.) (*i.e.* one-sixtieth of the total (*l*))	4·2
Average effective rate of tax levied on each pound of actual income (*d*)	23·5

The underlying principle in the case of abatements on insurance premiums is the mitigation of the taxes that are encroachments upon savings, and in the case of allowances for wear and tear, depreciation and obsolescence of plant and machinery, the tax is charged on the net income rather than gross income as far as practicable. To the case of family responsibility some regard is paid. The married man with or without children and the bachelor are never on the same footing, as it is obvious that a bachelor can afford to pay more than a married man. A general exemption limit for all incomes is fixed mainly for two reasons: (1) the cost of collection would be abnormally high if there were no such limit, and (2) it is not desirable to tax heavily those whose income is below or at the subsistence level.

At the same time wages do contain a taxable element, and this, as will be seen in a subsequent chapter, is reached mainly through indirect taxes. It is desirable that the exemption limit when once fixed should not vary before the lapse of a considerable period, and it should be varied only when there is a very substantial change in the cost of living. It should not fluctuate from year to year and should be uniform for all classes, regardless of their conventional standards of living.

Collection at Source

6. A great principle in income tax is, as far as possible, the collection at the source of income. It is not a universal principle, but it has attained a peculiar importance in many countries. The tax is deducted before the income reaches the person earning it. Thus when a person has shares in a limited liability company, the income which he derives is taxed at the full standard rate before he gets it. If the rate proves to be higher than he ought to pay, he can have this adjusted by claiming a refund. The companies' profits are always taxed at the maximum rate so that the revenue may not suffer in any way, and the burden of claiming refunds rests on the taxpayer. Assessment is made on each source of income by itself, and it simplifies the collection of the tax as a whole as well as increases its yield. At the same time it makes, as we shall see, graduation on total incomes far from easy. The persons who pay the tax sometimes deduct it from payments belonging to other persons. Thus in the case of rents arising from lands or buildings which are let it is to be paid in Great Britain by the occupier, who in turn deducts it from the rent paid to the landlord. The landlord, if the property is mortgaged or subject to a ground rent, may deduct the tax from the amount which he pays. Similarly a limited liability company is assessed to tax at the standard rate on the whole of its profits without reference to the ultimate destination of those profits. On paying interest to its debenture-holders or dividends to its shareholders a company is entitled to deduct and to retain the amount of tax payable on the interest paid or dividend distributed unless it decides to pay dividend interests and debentures free of income tax. In this connection a considerable amount of income tax

is paid very often which is not reclaimed from the authorities. Small investors who have placed their savings with companies are paid interest less income tax. They do not understand, or at least never claim, the right of refund, although they are not bound to pay any income tax.

The principle of stoppage at the source has been of immense benefit to the revenue in most countries and avoids the friction between the tax collectors and the taxpayers which is otherwise liable to be engendered. The taxpayer feels least the burden of a tax which is deducted without the money actually passing through his hands. We have seen above that the 5 per cent tax of 1803 collected at the source yielded nearly as much as a tax of 10 per cent did in Great Britain during 1801 under the system of direct personal assessment. It is sometimes urged for purposes of securing a smooth graduation curve that the principle of taxation at the source should be abandoned. Smooth graduation requires the progressive adjustment of the rate of tax to the size of the income, *i.e.* without abrupt jumps or without proportional rates. This is somewhat difficult, although not impossible, under a system of collection at the source, since the total incomes of the individuals taxed are not known at the time of deduction at the source. As Sir Josiah Stamp well put it before the Royal Commission, " with no taxation at the source, and with a smooth graduation, a defective memory is doubly endowed ; first, by the tax on the item omitted, and, secondly, by the reduced rate on the income shown ".[1] These critics in favour of the abandonment of the principle of collection at the source may be answered in the words of Sir Josiah Stamp: " The wanton and bigoted way in which persons obsessed with certain mathematical ideas urge the sacrifice of all practical points to their lust for algebra would be a serious public danger if their influence became great. . . . We should as a people make a very bad bargain if we sacrificed the principle of taxation at the source for the doubtful boon and inconclusive virtues of a curve even of most elegant functions and unimpeachable suavity. Not one per cent of the taxpayers would be any happier or pay their taxes any more cheerfully for a logarithmic demand note." [2]

[1] Paragraph 9582 (12) (4), *Minutes of Evidence of the Royal Commission on the Income Tax*, 1919 (Cmd. 288, 3), p. 458.

[2] Paragraphs 9610 and 9611, *Minutes of Evidence of the Royal Commission*, 1920, part 1, pp. 463 and 464.

If taxation at source were abandoned, each income taxpayer would furnish a return of his total income on which he would be taxed, and this would lead to smoother graduation by the adjustment of the rate of tax to the total income. At the same time smoother graduation can be obtained by retaining collection at source in conjunction with information at source. Both collection at source and information at source, predominantly the former, are used in the United Kingdom and in some other countries. It will be remembered that the British system of taxation at source which dates from 1803 and resulted in doubling the productivity of the tax has as its object the protection of the honest taxpayer and also of the Revenue. This stoppage at source is in contrast to the alternative method sometimes called "information at source" followed in Germany, Italy, Switzerland, and other continental countries. In the United States when the tax was levied after the civil war "information at source" was followed. In 1913, when reintroduced by the Federal Income Tax, stoppage at source was used in a more thorough-going manner than existed in England. The Law provided that "all persons or firms, copartnerships, companies, corporations, joint-stock companies or associations in whatever capacity having control, receipt, disposal, or payment of fixed or determinable annual or periodic gains, profits, and income of another person, subject to tax", were with three exceptions required to deduct the tax from all "interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable annual gains, profits, and income of another person" exceeding a certain sum for any taxable year. The tax was to be deducted irrespective of whether or not the payments amounted to this sum in interest payments on bonds and mortgages, or in payments of trust or similar obligations of companies or corporations or in interest or dividend payments of foreign bonds and stocks. The "withholding agent" was practically everyone through whom money or payments, provided these were "fixed or determinable", were made. Failure to deduct made the individual or corporation personally liable. Those who collected foreign payments of interest or dividends by means of coupons, cheques, or bills of exchange had to have a licence from the Commissioner of Internal Revenue and to give security. These licensees had to keep other books open for inspection by officials

and to submit monthly a list of names of the persons from whom items had been received, the amount of deductions, and the sources. Even when the Bill was introduced into Congress there were many in favour of " information at source ", a scheme by which detailed reports would be submitted to Government with information regarding the names and addresses and the amounts paid. In the 1917 Act the collection at source except in regard to non-resident aliens and interest on bonds containing a tax-free covenant [1] was modified in view of the fact that the burdens on the disbursers of interest, salaries, and wages and on many tenants, lessees, and fiduciaries were held to be burdensome and irritating. The British system did not go so far as the American system. The tax is levied at the source and deducted at the time of payment of dividends, interest, annuities, and other annual payments, rents, salaries, and pensions paid by Government and Railways. Wherever possible income tax is deducted before the income reaches its owner. Thus a company pays the tax at the standard rate on its entire profits, but on paying dividends to its shareholders it may deduct the amount of income tax appropriate to the amount distributed. The shareholder, when he receives his dividends, finds them subject to this deduction of Income Tax, and it is for him to recover the excess amounts, the difference between the tax at the standard rate and the tax at the rate appropriate to his income. In short, the system provides for (1) refunds to shareholders whose income, including the dividend, is below the exempted amount, (2) rebates to those whose personal tax is less than the company rate, and (3) additional payment by shareholders whose rate is higher than the rate paid by the company. No hard and fast rule can be laid down as to the excellence of one method over the other, as so much depends on the history and experience of the tax in the country concerned. Thus the British Royal Commission on the Income Tax, 1920, held that " Taxation by deduction at the source is of paramount importance, lying as it does at the very root of our Income Tax system. . . . We are convinced that to abandon taxation at the source now would involve an enormous loss of revenue, and would throw upon scrupulous, honest, and careful taxpayers an unfair share of the burden imposed by the taxation necessary for the country's needs. We are not satisfied that any

[1] Montgomery's *Income Tax Procedure*, 1919, p. 19.

system of information at the source would be a practical and efficient substitute for the present system, and it would be a source of trouble and irritation to the community in general." The same system when worked in the United States was held in 1917 to be "so technical and annoying that its abandonment was inevitable". It gave cause for "considerable complaint from those charged with the duty of withholding the tax".[1] Thus the expense and trouble connected with the withholding of the tax, especially the preparation of accounts for the revenue authorities, may have made the tax inconvenient and uneconomical in collection. Collection at source in the British system is said to have the following clear advantages: Evasion is prevented, as the taxpayer whose rate is less than the company rate has to submit a full return of all his income in respect of which tax at source has been collected. The taxpayer cannot by fraud, ignorance, or carelessness evade his payment of tax. The British Inland Revenue authorities in evidence before the Royal Commission stated that if the principle of taxation at source were abandoned there would be the loss of about £50,000,000, equivalent to 20 per cent of the whole income tax revenue. The prevention of evasion makes for equality. Taxpayers in claiming rebates disclose fully their income, and the Revenue gets into touch with persons who should pay tax but who might not pay were it not for this.

The tax is convenient, certain of collection, and, it may be argued, as compared with special inquiries necessary under the information at source, not more expensive and, therefore, not less economical. The disadvantages are that the State collects large amounts to which it has in certain cases no right to retain and in others in excess of what it is entitled to retain. This inconvenience is, however, limited in its effect. Another disadvantage is the failure of the taxpayer, through ignorance or neglect, to claim refunds; but if companies were required to issue to each shareholder a note, together with the dividend warrant, explaining the conditions under which he is entitled to a refund this could be prevented. Stoppage at source does, however, as we have seen, impede the principle of progression, as the tax is assessed by different schedules and collected at source, thus making the tax less progressive than it would be under a lump

[1] Cf. Montgomery, *Income Tax Procedure*, 1919, especially ch. vi.

sum tax based on total income under the "information at source" method. In four of the Australian States companies' profits are taxed at the full rates, but no rebates are allowed to the individual taxpayer who excludes his dividends from his returns of income tax. This apparently simple system is not on the whole a good one, because a man with an income of say £500 of which £250 is investment income is made to pay on half his income at the full rate, the remaining half being taxed at the rate appropriate to his income. In Great Britain the whole income (earned and investment) is included in the return, and the taxpayer receives rebates on that portion which has already paid income tax at the standard rate, viz. from dividend income. Information at source makes the taxpayer meet the burden from the money which has already reached his pocket. He would feel the tax less had it been deducted from funds before these reached him.

The Basis of Assessment

7. The ability of the income tax payer is measured by the income which he receives over a period of time as well as by the nature of that income (*e.g.* its precariousness or the reverse, earned or investment income, and gross or net income), and by family circumstances which permit of abatements in order to arrive at the income on which the tax must be paid. The problem of the period for which the income should be taxed is indeed a difficult one. In other words, the time element is of importance, especially in view of the high rate of tax that obtains in several countries, mainly on account of national debt charges. Should the base of the tax be the current year, the preceding year, an average of years, a quarter or any other period? An average of years was a feature of the British system from 1842, and previous to the simplification of the British system in 1926 and 1927 more than three-fourths of the total yield of income tax was determined by averaging three or more years. In some cases income was assessed on the immediately preceding year; in others on the current year, or on the average of three, five, and even seven years, and by the half year since 1925 in the case of weekly wage-earners. There are also special rules for fixing the amount due from agriculture which is proportionate to the rent paid and irrespective of the actual income of the farmer, miscellaneous

profits from lands not in occupation of the taxpayer, the profits of singleship companies and persons owning shares in such companies, and a few other special sources of income which were "assessed on such average or basis as appears just and equitable". There was an embarrassing multiplicity of assessments which resulted in the issue of many forms for the various sources of profits. There was, in short, exasperating confusion in assessments. The decision of the House of Lords in the case of Whelan *v.* Henning in January 1926 brought to a head the necessity for amending basis of assessments in the British system. The judgment was actually restricted to what was known in income tax parlance as "Schedule D case v.", but it involved a larger principle, namely, that where a source of income during a particular year had dried up there could be no assessment, even if bumper dividends had been paid in the two preceding years. "No income, no tax" knocked the bottom out of the three years' average. The Royal Commission on Income Tax which reported in 1920 and the Revenue Bill of 1921 proposed the abolition of the three years' average, but the measure was dropped in the latter year and was not again seriously considered until the golden opportunity of the decision of the House of Lords made it possible and urgent to reform and simplify the basis of assessment. In 1926 the year-to-year assessment based upon the profits of the preceding year, the general practice on the Continent, was introduced for schedule D, and in the following year salaries under schedule E were similarly assessed. The preceding year was also taken for super tax, the year to which it rightly belonged, and the income tax and the super tax became a single graduated tax on a single annual return on income. The reform was in harmony with the majority of the Smithian canons of taxation, as it made for greater convenience, greater economy in collection as well as for greater certainty, simplicity, and intelligibility. Owing to the fact that the foundation of the British income tax is deduction at a standard rate at the source from every form of income capable of being so treated, there must be always a considerable amount of adjustments and repayments which put limits to simplification.

The general principle to be followed is that the tax should be levied and collected as quickly as possible after the income has been earned. As one writer puts it, "The base of the tax

must be a long enough period to give a fair average indication of means—the base upon which a man's household and conditions of life are naturally laid out—but it must not be so extensive that the time for paying a tax does not follow closely upon the period over which it has been computed ".[1] In recent years the average method has been rejected by many countries as being against the principle enunciated above and is no longer popular. It is, however, true that it has the advantage of gauging an individual's taxable capacity better than a single year's income which insulates one yearly period from every other period. In the case of widely fluctuating incomes to take one year and to segregate it from its neighbours may result in considerable unfairness, as one year cannot be said to determine the taxable capacity of the individual. A business man fixes the standard of his expenditure or his standard of living over an extended period and not on a single year, just as a captain of a liner determines his course and speed not by his latest reckoning only. From the point of view of " ability " it may thus be said that the averaging method has advantages of its own, but it is, from the point of view of convenience, unsatisfactory, because in a year in which the income is low as compared with the average income the taxpayer would feel the burden of the tax sometimes severely. On the other hand, when the income is high as compared with the average he gains, but human nature being what it is he does not ordinarily provide for future payments. In short, the averaging method may be said to determine satisfactorily the taxable capacity of the income tax payer subject to fluctuations in income in different years and, therefore, the appropriate rate of tax. Secondly, it lightens the burden of the tax if incomes are progressive from year to year. Thus if the income in year one is £1000, in year two £5000, and in year three £9000, the rate of tax would be lower on the average (£5000) than on the previous or current year basis. Thirdly, it possesses the slight convenience for budgetary purposes of reducing the margin of error in estimating revenue. On the other hand, these advantages are outweighed by the following disadvantages. In the first place, it is complicated both for the taxpayer who prepares the returns and for the Revenue authorities which may have to check these. The checking of returns for a period of years being difficult,

[1] Stamp, *Principles of Taxation* (Macmillan, 1923), ch. ii. p. 27.

evasion, illegal as well as legal, is possible. There were several cases on the London Stock Exchange and at Lloyd's of men who, after making very large profits in an exceptionally good year, retired from business in order to escape taxation under the three years' average that would otherwise have had to be paid. Again the inconvenience of the average system has already been referred to, as the liability for payment hangs over the head of the unhappy taxpayer for years. It is sometimes pointed out that the hardship under which fluctuating incomes are taxed at a higher rate over a series of years than constant incomes can only be remedied by making the statutory income the average of a series of years, which will counteract fluctuations, or if the statutory income is the income of a single year by applying to it a rate which represents the rate applicable to the average income over a series of years.

The year of assessment basis or the current year is perhaps the ideal basis. It would, as in the income tax of wage-earners assessed half-yearly, secure the tax at the earliest possible moment after the income had been earned and ascertained. It would, however, mean delay until the end of the year of assessment for the taxpayer's return of income, and this would mean delay in assessing. If the tax is collected on the actual income of the year according to an estimate of income this will require adjustment later, a method which breaks the canons of convenience and economy. Salaries were assessed under schedule E up to 1927 on the income of the current year, but in practice, especially in the case of commissions and bonuses, this was found to be difficult to carry out. Up to that year (1927) the Revenue accepted the figures of the preceding year. The chief advantages of adopting the preceding year as the basis of assessment are that the income assessed corresponds much more closely in point of time with the amount of income actually earned. It avoids most of the inconveniences of the other two methods. It is convenient and applicable to all types of income. It is administratively simple, and it eliminates unnecessary correspondence. The Royal Commission on Income Tax, 1920, in recommending the abolition of the average system suggested that where losses occur these should be set off for six years if the preceding year's profit was taken as the basis of assessment. This period was selected as corresponding with the period fixed under the Statute

of Limitations. The Income Tax Act, 1918, already provided that losses occurring during the year which was the subject of assessment may be set off against the profits of that year. The Finance Act, 1927, gave effect to the Commission's recommendation for setting off heavy losses in any one year which could not be extinguished for two or more subsequent years. The Act made provision for setting off losses on transactions, any profits from which would have been assessable under Case VI. of Schedule D, against profits on any other transactions assessable under Case VI. for the same year, and for the carrying forward of such losses, if necessary, for the six following years of assessment as a deduction against any profits assessable under Case VI. for those years. Relief was also given in respect of losses incurred in a business subsequently transferred from an individual proprietor or a partnership to a company in exchange for shares in the company, such shares being the sole or main consideration for the transfer. As a general rule it may be laid down that a loss sustained in any year may be allowed to be set off against the profits in the next subsequent year or next two subsequent years only, and any assessee should prove the claim by producing his accounts as soon as possible after the end of the year in which the loss is made. The carrying forward of losses means a loss to the revenue, but the loss appears to be less in practice than under the averaging system.

Evasion of Taxation on Income [1]

8. The question of evasion in the taxation of income has assumed a new importance in most countries since the War. Many, such as Great Britain and the United States, have recently imposed stiff penalties against those who are so unscrupulous as to be culpable of fraudulent avoidance of the income tax. The assessee in the British system who defrauds the Revenue is liable to be imprisoned for six months [2] and to pay treble the tax due,[3] the abettor to a fine of £500 [4] and to a similar term of imprisonment,[5] and the assessor or surveyor of taxes guilty of fraudulent, corrupt, or illegal purposes to a penalty of £100 and

[1] Cf. p. 335, Bk. III. ch. xviii.

[2] S. 227 Income Tax Act, 1918 (*vide* The Income Tax Acts, 1925, London, His Majesty's Stationery Office).

[3] *Op. cit.* s. 132. [4] *Op. cit.* s. 132. [5] *Op. cit.* s. 227.

on conviction to dismissal.[1] Moreover, "The provisions of this Act shall not affect any criminal proceedings for any felony or misdemeanour".[2] In spite of these provisions fraud does take place from time to time. Some are so devoid of civil feeling that they think that it is "fair game" to defraud that intangible entity, Government, just as they sometimes would defraud a railway by taking a dog without a ticket or travelling first class with a third class ticket. They would not dream of similar action in regard to a friend, as, for example, stealing his silver spoons at dinner. The fact that the assessee is his own assessor in the first instance puts a considerable strain on his honesty. It is, therefore, necessary for Governments to watch with an eagle eye for loopholes and to propose remedial measures from time to time. It was Lord Sumner who propounded the well-known dictum, "The highest authorities have always recognised that the subject is entitled so to arrange his affairs as not to attract taxes enforced by the Crown, so far as he can legitimately do so within the law".[3] The avoidance of supertax by the formation of the one man company, the sale of securities cum dividend and their immediate repurchase and the subscribing to charities had, for example, to be considered by His Majesty's Treasury.[4] Illegal evasion is done by inaccurate and partial returns and by false balance-sheets, especially the undervaluation of stocks in a profit and loss account. Thus a firm of wholesale clothiers in Leeds was prosecuted in 1927 as the result of investigations of the defendant's

[1] *Op. cit.* s. 226. [2] *Op. cit.* s. 224.

[3] Cf. the remarks of the Lord President of the Court of Session, Edinburgh. "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow—and quite rightly—to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue." (Ayrshire Pullman Motor Services and D. M. Ritchie *v.* C.I.R. (1929) 14 T.C. 754.)

[4] The Finance Act of 1936 restricts the opportunity for legal evasion. Clause 16 deals with transactions resulting in the transfer of assets to persons abroad. If the individual acquires rights over the foreign company which enable him substantially to enjoy its income, then the income of the foreign company is treated as the income of the individual for tax purposes. Clause 17 is concerned with the one-man company (first dealt with in the Finance Act of 1922) and tightens up the expression 'control by five or fewer persons". Clause 18 on similar lines deals with investment companies. Clause 19 on educational trusts provides that where a person makes a settlement in favour of his minor children the income derived by the settlement shall be aggregated to his income for income tax purposes.

business showing that sales to the extent of £19,111 had been omitted and fictitious purchases amounting to £13,437 had been entered in the books of the business during the period covered by the charge. The firm's accounts understated the profits by £32,429. The head of the firm was, therefore, charged for sixteen offences, one of which was of wilfully procuring a statement false in material particulars, four of delivering false accounts to His Majesty's Inspector of Taxes, and eleven of making statements false in material particulars. The Inspector of Taxes discovered the frauds by noting that the rate of gross profit shown appeared to be rather small in comparison with the turnover and that the personal drawings of the defendant from the business appeared to be rather small in comparison with the size of the business. The defendant had deposited with the Midland Bank parcels of banknotes, the proceeds of the irregular transactions, although the bank had no idea what the parcels contained.

The principle is universally held that nobody should be allowed to escape, whether fraudulently or unintentionally, his share of the income tax, provided he comes within the range of income tax. The heavier the burden the sharper should be the punishment on these deliberate cheats, weaker vessels, or anti-social offenders who enrich themselves at the cost of others. The annual defalcations cannot be ascertained with strict accuracy. In Great Britain they have been conjectured to be as much as £100,000,000 annually, but when this figure was put before the Royal Commission on Income Tax in 1920 it was forthwith repudiated as an impossibility. Competent opinion seems to place the deficiency not higher than £10,000,000 a year. In many other countries unfortunately the deficiency is much higher. In countries where the income tax is of more recent origin, there is no legitimate pride in the conscientiousness with which the inhabitants meet the impost. Income taxpayers are sometimes classified into the following grades: half of them are probably straightforward in their dealings and, of course, suffer from the dishonest practices of their competitors. Of the remaining half, it may be said, one-half give themselves the benefit of the doubt, while the other half do not hesitate to make a deliberate fraud. The "snowball" system of valuing stock is not unknown in the commercial world. A diamond merchant, for example, was convicted of returning no profit whatever in a twelvemonth, on the ground that he has not sold the whole of his stock and is uncertain whether there will be

a profit after the sale of the entire stock. The remedy is increased efficiency in detecting these frauds and evasions. This applies to Britain. In India frauds sometimes take place in various ways, viz., deposits may be placed with the banks in the name of the owner or frequently some other person, so that it escapes proper income tax. Again accounts may be kept somewhat loosely, and by living in Native States the owner of the property in British India may succeed in evading his full share of taxation. This is, however, not peculiar to India. The checking of " bad debts ", an item which often covers a multitude of sins, is extremely difficult, as these are inserted sometimes to reduce income tax liability. Moreover, there is the case of bogus companies. Some time ago the Government of India pointed out that bogus firms and private companies were formed in which the proprietors, partners, and shareholders were the wives and children of the owners of the business concerned, and thus liability to super tax was greatly diminished or totally avoided. This was common in England until legislation minimised it. There is also, as we have seen,[1] the case of granting loans with a nominal rate of interest to the principal shareholders of private companies—a procedure which is in reality a distribution of profits as repayment is not intended. Governments have taken other measures to put an end to these abuses. In most industrial countries it is found advantageous to set up an efficient staff of collection and to establish a special investigation branch to deal with evasion and to provide for the production of books and documents. For surtax or super tax payers it is advantageous to the Revenue to have a separate file or dossier for each payer so that his complete income compiled from various sources can be maintained.

In Great Britain a foreign trader conducting business in the country may arrange the course of business by invoicing goods to the English branch at an unduly high price, and thus the English profits may be reduced considerably. In such a case it was provided by Rule 7 of the All Schedules Rules of the Income Tax Act of 1918 that, where a non-resident person not being a British subject or a British Indian Dominion or Colonial firm or company carries on business with a resident person and that, owing to the close connection between the two and to the substantial control exercised by the non-resident person over the resident, the course

[1] *Vide* Chapter XVIII. p. 335.

of business is so arranged that no profits or loss other than the ordinary profits which might be expected to arise from that business, accrue to the resident person, the non-resident person shall be assessed in the name of the resident, as though the latter were his agent.[1] In other words, the relation of buyer and seller may be ignored and the non-resident person treated as though he were selling direct to the British customers through his branch or agent. Under Rule 12 it is possible to fix the rate of profit on an equitable basis, fixing it at the same rate as the indigenous merchant or a retail dealer in the country can reasonably expect to make.[2] A similar provision exists in the Indian Income Tax Act. Before the passing of section 21 of the British Finance Act of 1922 it was possible for owners of large estates to evade the payment of super tax and to reduce their liability to death duties by converting themselves into one-man companies. The best method of preventing evasion by the formation of private companies and the withholding of dividends is to empower the Revenue to treat such companies as if they were registered partnerships. The British Income Tax Act, 1922, section 22,[3] deems the income of a company even if undistributed to be the income of its members in certain cases where (1) the number of shareholders is fifty or less, (2) where there is a restriction of the right to transfer shares, (3) where there is no public invitation to subscribe for shares; and (4) when the control is in the hands of not more than five persons. Provision on somewhat similar lines has since been made in the Indian Income Tax Act.

Pitt in his famous speech of December 1798 introduced the income tax in order "to repress those evasions so disgraceful to the country, so injurious to those who honourably discharge their equal contribution, and, above all, so detrimental to the great object of national advantage which it is intended to promote ".[4] Gladstone in his first Budget speech[5] said, "There are many cases, in trade, in which it is a matter of extreme difficulty to know what return to make, what really is chargeable as profit; and I believe that in not infrequent cases the doubt is solved by the honourable trader against himself, and that he returns his profits greater than they really are. Let it not be supposed that I am going to impute to the trading classes of England generally the conduct which is

[1] "Income Tax Acts, 1925", H.M. Stationery Office, p. 263.
[2] *Op. cit.* p. 264.
[3] *Op. cit.* pp. 346 and 348.
[4] Page 4, Hansard, vol. xxxiv. 1798–1800.
[5] 1853.

pursued by some individuals. I am going to state an extreme case. It is an example, not of what has been generally done, but of what can be and has occasionally been done upon the scale I am going to show, and of what, I fear, on a smaller scale is often done. I will mention no names—I will violate no confidence—but I will state what happened in a great town where a new street was to be built. The persons who lived and carried on business in the old street, which was pulled down to make way for the new one, had been charged at a certain amount to the income tax. They had also, of course, made returns at a certain amount under the income tax. When the new street came to be built they claimed compensation for the loss of their business. The amount had to be assessed by a jury. Without wearying the Committee with details I will state the amount of compensation which these persons—in number twenty-eight—claimed; the amount awarded them by the jury, which may be taken as, on the whole, an approximation to the real value; and the amount at which they returned their profits under the income tax. Were I to descend to individual cases it would be almost impossible adequately to describe the partly ludicrous and partly shameful aspect which they assume. I will therefore deal with the matter generally and say that twenty-eight persons in all claimed the sum of £48,159 as compensation for their profits for a single year. The amount of compensation awarded by the jury was £26,973 or a little more than half what was claimed. But what was the amount at which they had returned their profits for assessment to income tax? They claimed £48,000; they got from the jury nearly £27,000; but the return of profits for the assessment to the income tax which they separately made had amounted only to £9000. I deeply regret that the great body of honourable men who have made the name of British commerce famous throughout the earth, less even for its energy than for its truthfulness, should be degraded by association with persons who could perpetrate frauds like these. But at the same time frauds of this kind, and in many other cases, do exist; they are inseparable from the character of the impost, human nature remaining as it is; and it is impossible, when you are called upon to consider the question of the readjustment of the tax, wholly to dismiss them from consideration." This would, of course, hardly be possible in England to-day, but it is a lesson to countries with less experience in income-tax procedure and practice. The solution

is increased efficiency in administration. Steps, for example, were taken in India to improve the administration by the creation of a Central Board of Revenue, as all efficient systems of income tax depend upon central rather than on local administration. Local administration or assessment gives rise to political or local pressure and income is nowadays difficult to localize. Moreover domicile can be shifted to evade taxation as is sometimes done in the United States for evading state taxation. Local administration, however, in some degree is helpful as, for example, where detailed knowledge and experience such as is possessed by local assessors are helpful.

At the same time, while the income-tax authorities are carrying out with care and management all the acts, it is fair only to say that as the tax is exacting and inquisitorial the tax collector has to avoid as far as possible any invasion on his part and should assist the taxpayer as far as it lies in his power. In some cases it is his duty, for example, to point out cases where the assessee should claim rebate. It also lies with the assessee to recover taxation: a matter often forgotten. The full rate of income tax is deducted from incomes whether liable to income tax or not, and the sufferer is left to recover it if he or she can. It is doubtful whether 50 per cent of those entitled to relief are aware of the fact, and therefore it is desirable that every possible information and assistance should be given by the taxing authorities to enable the public to ascertain their rights and liabilities. Too great emphasis cannot be laid on the importance of obtaining adjustments promptly, as otherwise the taxpayer is exasperated, the machinery of income tax is brought into disrepute, and the tax becomes unpopular. Special attention should be given to the issue of up-to-date and simplified forms. One important method of simplification is to substitute, as indicated in paragraph 7, the last completed year for the current year as the basis of assessment, except in the case of salaries. Efficiency is the pure milk of income-tax administration.

Evasion is to some degree due to a feeling of distrust of the taxing authorities, which is encouraged by the fact that the revenue authorities collect as much as they can. In fact the higher rates of income tax in some countries have produced a sense of inequity, and the Government authorities have called the game and the rules are " Keeping strictly to the law, you dodge me and I dodge you ". It is necessary to ensure, as we have seen, that all permissible allowances are given by the

revenue authorities in arriving at the assessments. Taxpayers are ignorant. On the other hand, the law is complex. A simplified income-tax law will materially reduce the earnings of lawyers and accountants whose help is at present in constant requisition. At the same time it cannot be denied that the clamour for a simple income tax is absurd. A tax which reflects difference in ability based on the amount of income, marital condition, family responsibility, and also origin and source of income, is bound to be a highly complicated tax system.[1] Assistance should, as already noted, be given by officials to prevent the possible faults often noticed on the part of taxpayers, and the machinery for the recovery of money due to the taxpayer should always be efficiently brought out. In short, there must be no invasions of the tax collector if there are evasions of the taxpayer. As is well said, a false sense of sport that regards Government as fair game, quite as much as deliberate fraud, has been responsible for evasion.

Pareto's[2] Law and Evasion

9. To test the accuracy of income-tax returns the well-known law of Pareto is sometimes applied. Briefly expressed, the law is that if N represents the number of incomes above a certain amount X per annum, and a and A are constants,

$$N = \frac{A}{X^a},^3$$

and therefore $\quad \text{Log } N = \text{Log } A - a \text{ Log } X.$

In other words, if the logarithms of the numbers of persons in receipt of incomes above definite amounts are plotted against the logarithms of the amounts of these incomes on a chart the points so obtained will be on a straight line, whose slope with the log X axis

[1] Cf. Sir Josiah Stamp's evidence before the Royal Commission, paragraph 9581 (11), p. 457, vol. 3, Cmd. 288-3, H.M. Stationery Office, London, 1919.

[2] *Cours d'économie politique* (Lausanne, 1906); cf. *Manuale di economia politica* (Milan, 1906). See my paper on "The Pareto Law and the Distribution of Income", *Economic Journal*, December 1935; cf. Pigou, *The Economics of Welfare*; Stamp, *British Incomes and Property*; *Wealth and Taxable Capacity*; *Income in the United States—its Amount and Distribution* 1909–1919 (New York: National Bureau of Economic Research, 1922).

[3] This relation in which N is cumulative from the higher to the lower incomes is usually given as Pareto's law. The non-cumulative distribution is given by $\frac{-dN}{dx} = y = \frac{Aa}{x^{a+1}} = \frac{B}{x}$, and is of the same form as the cumulative distribution.

will be α, strictly $-\alpha$. The slope of the straight line in all countries and at all times is approximately the same, *i.e.* the inclination of the line with the log x axis did not generally differ from 56° by more than 3° or 4° or the value of the slope differed but little from 1·5. This is the Law as given in 1896. In his later work, *Manuale d'Economia politica*, 1906, he regarded the Law as stated by himself a decade earlier with far less dogmatism. "Some persons would deduce from it a general law as to the only way in which the inequality of incomes can be diminished. But such a conclusion far transcends anything that can be derived from the premises. Empirical laws, like those with which we are here concerned, have little or no value outside the limits for which they were found experimentally to be true." [1] In the *Cours d'économie politique* (1896), he stated: "To raise the level of the minimum income or to diminish the inequality of incomes, it is necessary that wealth should grow more rapidly than population. Hence, we see that the problem of improving the condition of the poorer classes is before everything else a problem of the production of wealth," [2] and "We may say generally that the increase of wealth relatively to population will produce either an increase in the minimum income or a diminution of the inequality of incomes, or both these effects in combination ".[3] Pareto's aim was, in short, to frame a law of the distribution of income true of every country, viz., that if national income increased the increase would be relatively proportional among all classes. This is far from true. Pareto did not realise that the income curve was the mere end of a frequency curve. One who is accustomed to the use of charts drawn on a natural scale might be at first blush inclined to say that the data points follow the "straight line law", but when the double logarithmic scale is used, as is done by Pareto in the case of plotting the income tax returns, data of the incomes of large size paying income tax and of large numbers of income receivers are greatly compressed. Care has, therefore, to be taken in observing that there is a straight line and not a curve with hollows or bumps. We are specially concerned with this fact because if it is not a real "straight line law" then it cannot be used as a test for evasion or the reverse over assessment.

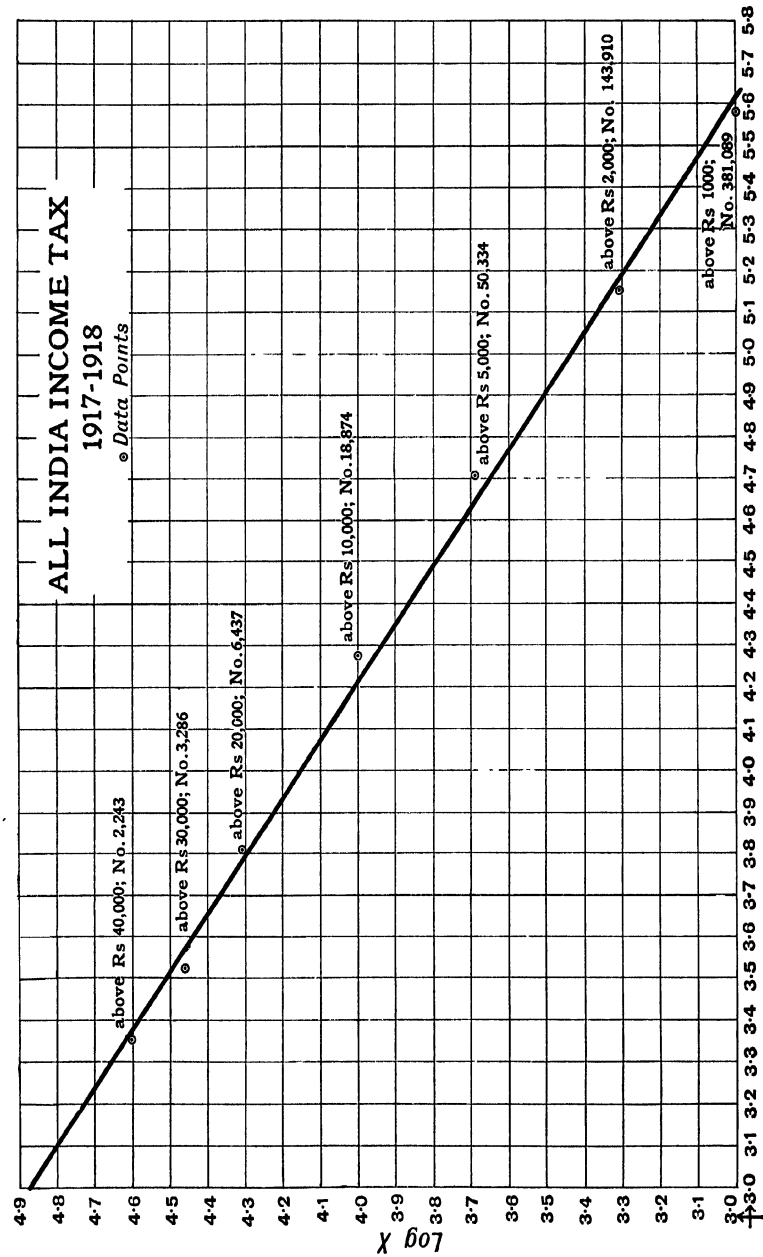
Pareto arrived at his law from an analysis of the statistics of income of some countries in Europe. His lowest figure for the

[1] Page 40 [2] Page 429. [3] Page 336.

value of a was that of Basle in 1887, viz. 1·24, and the highest that of Prussia in 1852, viz. 1·89, and in 1906 the inconstancy of the slope of the curves must have appealed to him when he insisted that his formula was purely empirical. Stamp applied the law to super tax statistics in 1913 and found that over a thousand taxpayers were evading income tax in the lowest class (then £5000 to £10,000). In his own words " In 1913, when the super tax statistics were first published, following upon the introduction of that tax, they gave us for the first time an official statement about total incomes over a certain range. I was eager to apply the Pareto rule or formula that I had seen used for other countries to know how it compared with other figures. I annoyed my colleagues at the Revenue in charge of this administration very much by telling them that they had ' missed ' over 1000 payers in the lowest class, £5000 to £10,000, and they thought I should be much more usefully employed in telling them *who* they were ! However, they promptly went and found them, and now you will find that the £5000 fraternity ' toe ' the Pareto line quite nicely. As a matter of fact, you frequently find that the Pareto test with any such set of income statistics drops off a little at the bottom. When I got to the £5000 point I thought it ought to have been on the line, but it was not. So on the theory that in fact it really *was* there, I gave the number of missing incomes ".[1] Stamp, therefore, considers the law as useful as a formula for interpolation and for the purpose of finding evasions. It is not clear whether the analysis was made by the method of least squares as Pareto did, and it is not stated whether this analysis has been repeated for other years and for incomes other than super tax. Accordingly a detailed inquiry was undertaken of Indian income tax statistics for the years 1913–14 to 1917–18 and for 1923–24 to 1929–30 for all India and for each of the nine provinces of India for 1928–29 and 1929–30. The All-India super tax data from 1923–24 to 1929-30 were also examined. India has a developed system of income tax and with its large population is of special interest. The All-India Income Tax sample data collected for this inquiry fall into two periods, that from 1913–14 to 1917–18, roughly the war period, and the period 1923–24 to 1929–30, years when in efficiency the Income Tax Department was very greatly improved. The graphs for both

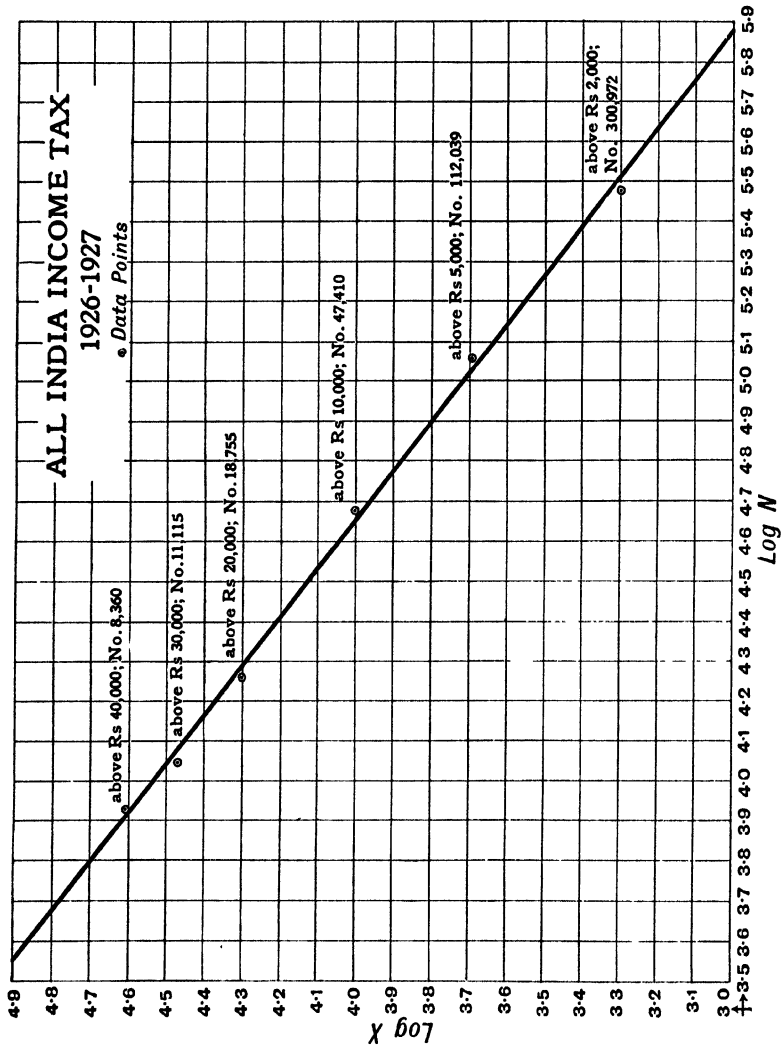
[1] *Wealth and Taxable Capacity*, Stamp. p. 82.

CHART I


ALL INDIA INCOME TAX
1917-1918
Data Points
above Rs 40,000; No. 2,243
above Rs 30,000; No. 3,286
above Rs 20,000; No. 6,437
above Rs 10,000; No. 18,874
above Rs 5,000; No. 50,334
above Rs 2,000; No. 143,910
above Rs 1000; No. 381,089
Log χ
Log N

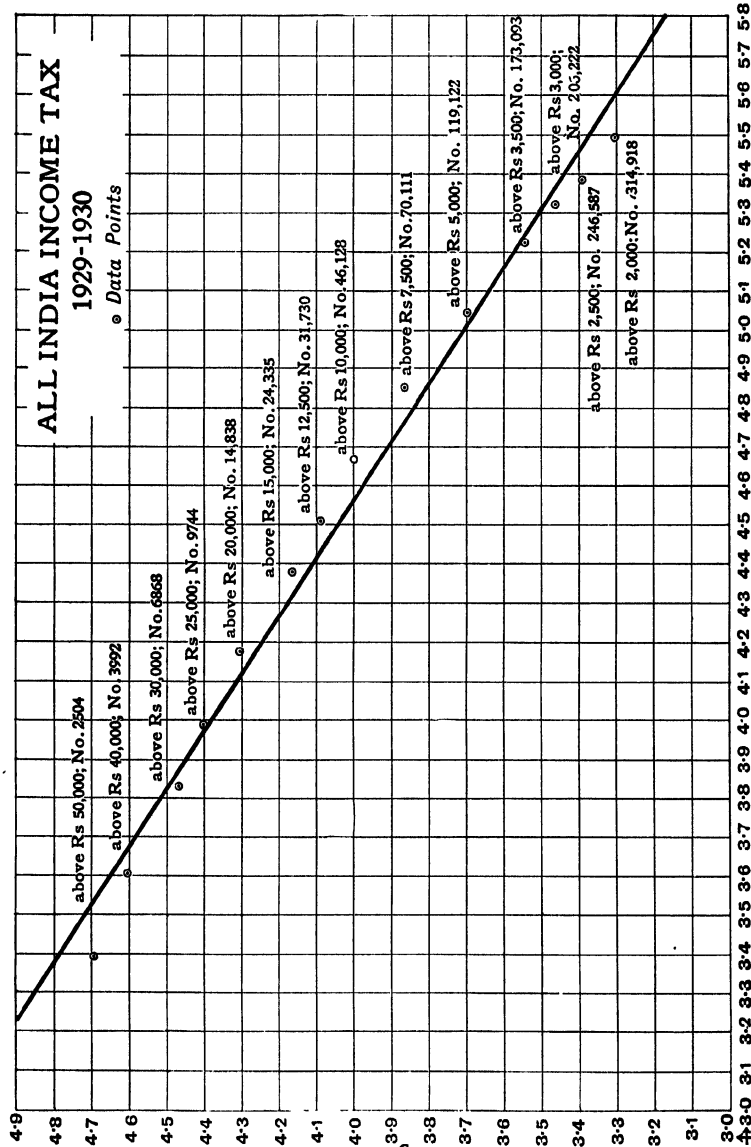
those periods were drawn and the Pareto lines were fitted to the data by the method of least squares. It was observed from the

CHART II



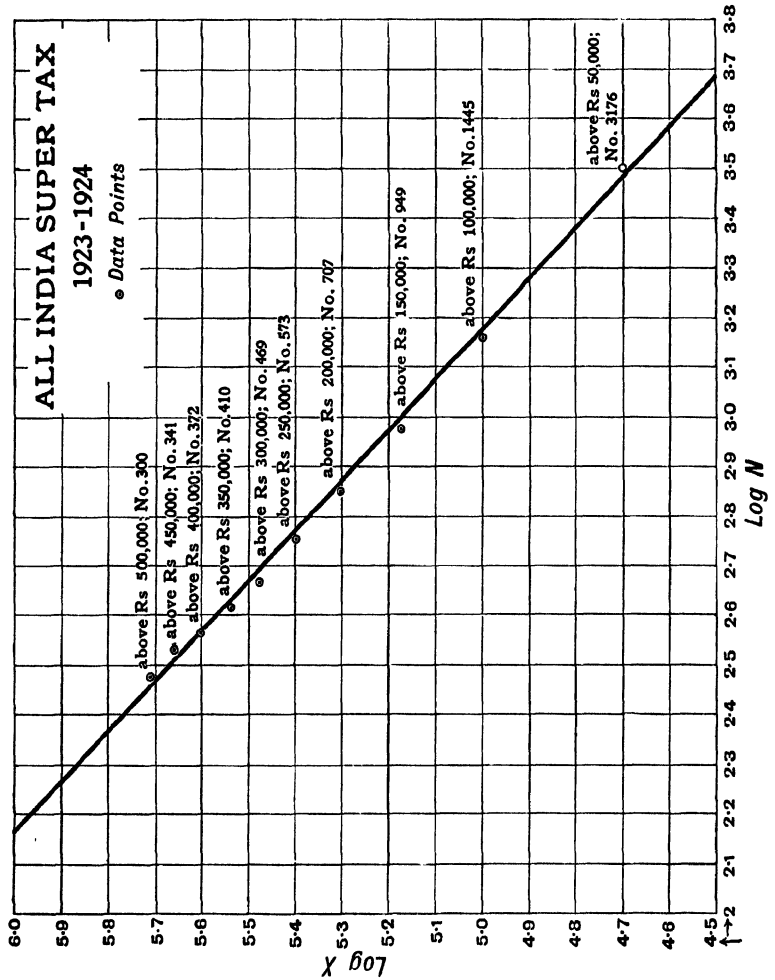
graphs of the period 1913–14 to 1917–18 that none of the points corresponding to the data lie on the Pareto line. Two of the lowest points (corresponding to Rs.1000 and Rs.2000) lie below the Pareto line, three middle points above the line, and the

CHART III


ALL INDIA INCOME TAX
1929-1930
⊙ Data Points
above Rs 50,000; No. 2504
above Rs 40,000; No. 3992
above Rs 30,000; No. 6868
above Rs 25,000; No. 9744
above Rs 20,000; No. 14,838
above Rs 15,000; No. 24,335
above Rs 12,500; No. 31,730
above Rs 10,000; No. 46,128
above Rs 7,500; No. 70,111
above Rs 5,000; No. 119,122
above Rs 3,500; No. 173,093
above Rs 3,000; No. 203,222
above Rs 2,500; No. 246,587
above Rs 2,000; No. 314,918
Log χ
Log N

highest two points (Rs.30,000 and Rs.40,000) below the line. Chart I. for 1917–18 illustrates this feature of the period. In the latter part of the second period the income groups were increased.

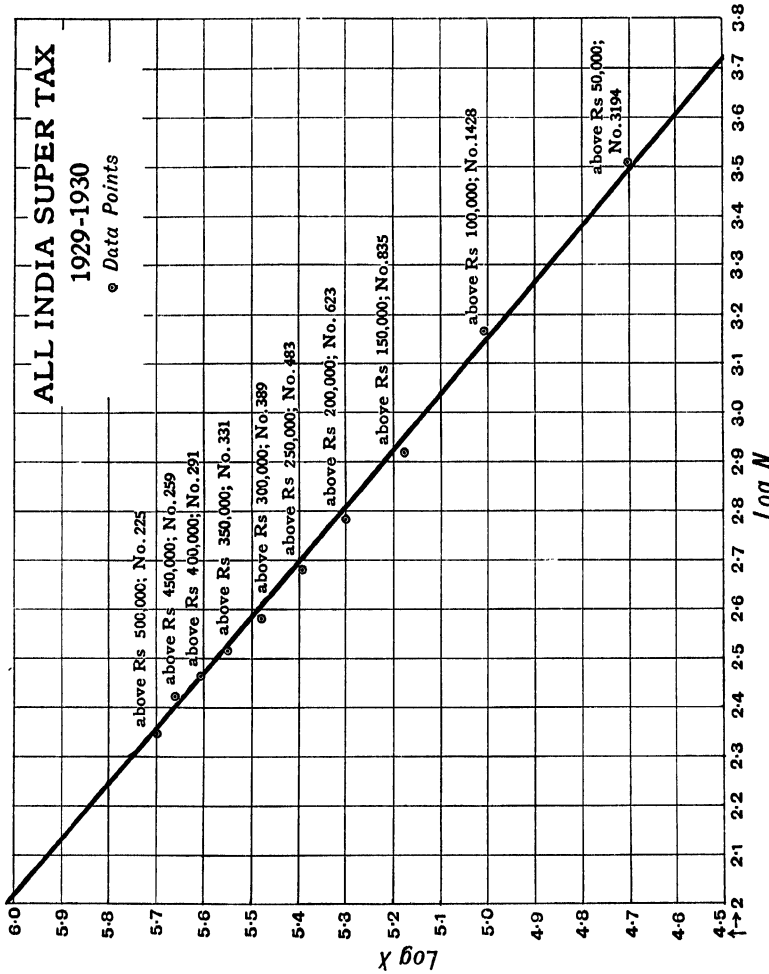
CHART IV



For the period 1923–24 to 1926–27 there are six income groups and from 1927–28 to 1929–30 fourteen groups. In the former of these two groups the lowest income point lies below the Pareto line, the next two points above the line, the following two below the line and the highest above the line. This feature is shown in

sample graph II. which relates to the year 1926–27. In the latter of these two groups the four lowest points are below the Pareto line, the middle seven above the line and the highest three below

CHART V



the line. Graph III. for the year 1929–30, typical of this period, is illustrative of this. If the fit had been close the data points would have fluttered from one side to another of the Pareto line and would not have cut it at angles as they have done. The deviations, moreover, of the points from the Pareto line are too

large to account for any inaccuracy of the income tax returns. The deviations are large not only for any one year but for all the years of each group and indicate that if the points had a tendency to be on a straight line they would not have formed such bunching in sets about the Pareto line, but the points would have been irregularly closer to the line on either side of it. In short, the conclusion must be that the points yielded by the cumulative income tax data do not have a tendency to form a straight line as required by Pareto's Law and therefore that the law can

TABLE I.—INCOME TAX. SLOPES OF THE PARETO LINES

Year.	Slope.	Year.	Slope.
1913–14	1·45	1924–25	1·23
1914–15	1·46	1925–26	1·22
1915–16	1·46	1926–27	1·22
1916–17	1·44	1927–28	1·47
1917–18	1·39	1928–29	1·52
1923–24	1·13	1929–30	1·48

TABLE II.—SUPER TAX. SLOPES OF THE PARETO LINES

Year.	Slope.	Year.	Slope.
1923–24	1·01	1927–28	1·18
1924–25	1·13	1928–29	1·14
1925–26	1·12	1929–30	1·15
1926–27	1·16		

no longer be used as a test for evasion. The non-cumulative distributions for the sample years 1917–18, 1926–27 and 1929–30, for which the graphs on a cumulative basis are given were plotted, and it was found that the distributions were not at all linear. This further confirmed the view that Pareto's Law did not hold.

Two additional tests for the law are (1) the slope of the lines for not only income tax but super tax; and (2) the extent of the evasions of income tax and super tax on the assumption that the Pareto Law was correct. The slope of the Pareto lines for Indian income tax are given in Table I. above.

The slope in Table I. varies from 1·13 to 1·52. It is clear that

there is a very large variation in the distribution of Indian national income from year to year. The *relative* incomes, therefore, of the poorer and richer classes do change with the change in the economic conditions in different years. In super tax the variation is from 1·01 to 1·18 and therefore the slopes even for super tax are

TABLE III.—EVASION (+) AND OVER-TAXATION (−)

Rs.	1927–28.	1928–29.	1929–30.
	%	%	%
2,000– 2,500	+ 35·3	+ 42·3	+ 39·1
2,500– 3,000	+ 42·2	+ 47·5	+ 40·6
3,000– 3,500	+ 25·3	+ 32·0	+ 26·7
3,500– 5,000	+ 21·0	+ 25·2	+ 24·5
5,000– 7,500	+ 0·4	+ 3·7	− 5·3
7,500–10,000	− 16·4	− 14·9	− 22·4
10,000–12,500	− 36 5	− 36·6	− 38·3
12,500–15,000	− 14·8	− 13·7	− 18·2
15,000–20,000	− 28·6	− 31·2	− 35·3
20,000–25,000	− 39·0	− 37·3	− 37·4
25,000–30,000	− 27·1	− 29·8	− 28·1
30,000–40,000	− 12·4	− 16·7	− 13·7
40,000–50,000	+ 1·4	− 9·3	− 12·1

TABLE IV.—EVASION (+) AND OVER-TAXATION (−)

Rs.	1923–24	1924–25	1925–26	1926–27	1927–28	1928–29	1929–30
	%	%	%	%	%	%	%
½–1	− 13·4	− 7·9	− 6·5	− 7·9	− 0·5	− 2·7	− 3·1
1 –1½	+ 1·7	+ 2·2	− 1·9	− 0·6	− 5·0	− 8·1	− 13·4
1½–2	+ 4·0	+ 6·6	+ 5·7	+ 1·3	− 3·5	+ 0·8	− 15·6
2 –2½	+ 10·1	+ 6·5	− 9·0	+ 1·5	+ 5·3	− 2·1	+ 0·7
2½–3	− 4·0	− 7·7	+ 1·2	+ 30·6	− 7·1	+ 1·1	− 1·1
3 –3½	+ 16·9	+ 3·2	+ 11·7	− 21·7	+ 5·1	+ 15·9	+ 9·4
3½–4	+ 29·6	+ 29·2	+ 23·9	− 11·6	0·0	− 4·3	+ 16·7
4 –4½	+ 24·4	− 22·9	+ 29·9	+ 30·3	+ 12·1	+ 17·1	+ 11·1
4½–5	− 24·2	0·0	+ 3·7	− 3·8	+ 4·0	0·0	− 21·4

not constant from year to year. The distribution of income even among the rich (*i.e.* super tax payers) is not constant.

If the Pareto law were assumed to be correct the evasions of income tax and super tax can be calculated for each income group for all years analysed. Owing to reasons of space only the above sample tables are given and they show evasion and over-taxa-

tion to be so great that the law cannot be said to be a law at all. The whole of the data shows that for income tax there is over-taxation in the middle intervals. For the years 1927–28 to 1929–1930 in Table III. there is evasion up to Rs.5000 and over-assessment throughout the whole range of income tax above Rs.5000, reaching to a maximum of 39 per cent. Moreover the distribution of the percentages of evasions or over-assessments in the various income groups differs from year to year. Anyone who knows the system of income tax administration in India would agree that such conclusions are altogether impossible. If there is any chance of over-assessment it would be in the case of presumptive income *i.e.* in the cases of small shopkeepers and illiterates who do not keep books, *i.e.* in the lowest incomes below Rs.5000. In the assessment of super tax the evasion for the year 1926–27 is as high as 30·6 per cent and this is, in the facts of the case, more than improbable. The sample graphs for 1923–24 and 1929–30 super tax are given in Charts IV. and V. It will be seen from the charts that the distribution is not linear because (1) none of the points lie on the Pareto line, (2) they cut the line at small angles in sets, (3) although the fit of the points with the Pareto line appears to be closer than in income tax, it is found merely superficial on the analysis of evasions and over-assessments given in Table IV. Pareto's Law, therefore, does not hold with regard to the super tax. The super tax data for 1929–30 were also plotted on a non-cumulative basis, and it showed hollows and bumps even in the middle interval of the data. The non-cumulative distribution was therefore not at all linear, thus further confirming that Pareto's Law did not hold with regard even to super tax. The graphs for the nine provinces of India for the years 1928–29, 1929–30 were also plotted and the Pareto lines obtained. The slopes of the lines vary a great deal, the maximum being 1·71 for Assam and the minimum 1·29 for Burma. Also it was observed that there was a good deal of evasion between Rs.2000–5000 and over-assessment between Rs.5000–50,000 if the law was assumed to be true. Thus the results for the provinces are similar to those obtained for the income tax and super tax for the whole of India. The Pareto formula does not apply to any of the provinces. The so-called Pareto law cannot, therefore, be a mathematical law true for all countries and for all times in any sense of the term.

Conclusion

10. The problem of double income taxation has been dealt with in a previous chapter.[1] It remains to summarise the conclusions to which this analysis has irresistibly led. The last century witnessed the income tax on trial; the present century has seen the excellence of the income tax as an elastic source of revenue, and the triumph of its principles and methods in the turmoil and stress of war and post-war finance. During the Great War the experience which England gained in the Crimean War was repeated. The income tax proved to be an excellent fiscal reserve to Great Britain as well as to the United States. It enabled these countries to meet war expenditure of almost incredible amounts, when men do not stop to inquire into details of taxation lest they should lose the mass and the substance. France and Imperial Germany, long before 1914, had not realised the importance of this great engine. Many of France's post-War problems are due to the fact that she developed the taxation of income too late. Imperial Germany found indirect taxation wholly inadequate for her requirements, and she was precluded in the War from using direct taxes, the prerogative of the States and not of the Federal Government. Far otherwise is the case to-day as France, Germany, Italy and other countries now regard the income tax as a constituent of a composite tax system, income in short being an important, if not the most important, criteria of faculty, although faculty or ability necessitates supplementing by the principle of benefit which can be achieved by taxation of quite a different nature. India and the Dominions have realised the importance of the taxation of income, Australia having a State income tax in addition to a Federal income tax. Indirect taxes, such as excise duties, cannot be as a rule developed until administrative arrangements have been made, often requiring extra staff and money. With the income tax it is not so. The administrative machinery, when once in order, does not require corresponding increases when the rate of income tax is increased, and thus the yield can be increased rapidly. This elasticity is a great practical advantage when revenue is suddenly required. At the same time the income tax is much exposed to the consequences of depression when income falls rapidly, and it is just at this tim

[1] Chapter XVII.

that public expenditures may increase because of the additional requirements for unemployment and similar social services. Indeed it has been justified that reserve funds might be built up to equalise the returns. But in larger countries such special reserves have not yet been adopted. In Federal constitutions income tax is either (1) wholly Federal or (2) partially Federal and partially State or provincial. In the United States the income tax is Federal. And since Wisconsin in 1911 began a new chapter in American taxation by the introduction of a state personal income tax there has been, especially in recent years, a considerable development of this form of income taxation. The disintegration of the private property tax accounts, perhaps, for this. The property tax is no longer suitable as a tax on wealth in general and it must give way to the personal income tax par excellence although it may continue as a semi-personal tax on that form of wealth called real estate. The property tax is regarded to-day as a semi-personal tax, as the land tax in Germany, an *ertragssteuer*, or the *impôt réel* in France. It is indeed for this reason that income from real property should not be deducted from the taxable income in income tax, as then the latter would be a special tax on earned incomes and the reverse of the modern demand to treat unearned income more severely. In certain Federal constitutions there is only one income tax which is levied by the Federal Government and shared with the Units. In the new Indian Constitution the proceeds of the taxation of personal incomes of the Units, as we have seen, will be shared to the extent of not more than 50 per cent by the Federal Government while the proceeds of company taxation and super tax together with personal incomes in Federal areas will be wholly Federal. There is in addition the principle of surcharges as in France, where the Central Government collects its own revenues (income taxes), but it also collects additional taxes (*centimes additionnels*) on these for departments and communes. This still continues, and is worthy of notice. In India the Federal Government has also the power which the Units have not of surcharges in times of exceptional strain.

END OF VOL. I

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