Public Talks

Who needs an Incomes Policy?

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When deciding, as private persons, how much we can afford to spend all of us have to take into account our expected income and any savings from income received already.

Government operates the other way round. It is now the accepted practice for government first to decide how much they intend to spend and then to fix taxation at a level expected to provide, more or less, sufficient revenue.

It was not always thus. In dim ages past English Kings were expected to provide for the expenses of State from their ordinary revenue and not to trouble their subjects. In the history of the English it is not until the late Anglo-Saxon times that we come across payments from subjects to the Crown that might be described as taxation. From the outset these tax payments were considered to be in the nature of a gift to the Crown to meet extraordinary expenditure and even today a clause to this effect is inserted in the Preamble to every annual Finance Act.

When is a tax not a tax? When it is a gift which can be collected as if it were a debt. So holds our constitutional fiction.

But fiction or not, being considered as a gift, taxation in this country of necessity requires consent – the consent of Parliament. This is a source of parliamentary power – no ruler can meet state expenses for long without calling a Parliament. In turn Parliament has used this power to gain control over the expenses that give rise to the need for its consent to additional revenue.

Thus, in 1340 Parliament demanded the production of Royal Accounts. In l406 the Commons were allowed to choose Auditors. By the time of William and Mary it had become normal practice to insert a clause in Money Bills forbidding the Lords of the Treasury

to use the moneys for any other purpose than that for which it was appropriated. This century the House of Commons has succeeded in reserving to itself the power to spend public revenue and the power to determine and consent to taxation.

The story of how the present practice of public finance came to be is a story closely intertwined with the securing of our liberties: a cause in which over the centuries many bloody battles have been fought, and a cause in which many have died, suffered deprivation, torture and execution.

But nonetheless, in the long struggle to secure our liberties, the present practice of public finance has emerged not so much as an integral part of the Constitution essential to the continuance of our parliamentary democracy and our personal liberties but rather as a weapon – a weapon which ensures political power is concentrated in the hands of these who control that weapon. This political power struggle may be considered as a constitutional example of, as it were, Darwinian evolution – the survival of the fittest. The fittest has proved to be the First Lord of the Treasury who for the past two centuries has been acknowledged as the Prime Minister – although such a position was not recognised constitutionally until 1905.

With the continuing development of the Constitution we have drifted into circumstances where under the leadership of the Prime Minister the majority party for the time being in the House of Commons exercises far greater power over public spending and taxing today than did any absolute monarch of old.

The constitutional requirement to hold a General Election within every five years appears to be even less of a force for restraining the financial irresponsibility of modern governments than did the fear of insurrection in times past.

We have moved now beyond the time when the taxpayer could expect at least some temporary relief from the regular Election Budget. The fact that Sir Geoffrey Howe during his period of Office as Chancellor of the Exchequer managed to extract from the

taxpayer an additional £7 billion in a time of slump, and did not produce an Election Budget, was claimed as a mark of political integrity.

Constitutional issues apart, in this final quarter of the twentieth century it is the very magnitude of public spending and taxing that raises a vital question for macroeconomics: To what extent is the appropriation by general government of nearly half the nation's income a cause of present social evils? A practical question demanding a practical answer.

If we then peruse the literature of contemporary established economics for an answer to this question we will end up rather disappointed. Professor Prest for example devotes a whole chapter of his book *Public Finance in Theory and Practice* to the issue of allocating resources as between government and the rest of the economy. He concludes: "But the very bareness of the economic principles set forth will make it clear that we are now on the borderland where economic and political considerations meet and mingle inextricably with one another. Recent years have in fact seen the publication of various ideas by economists on the appropriate principles of voting, on the grounds that one simply has to seek a political solution to these issues."[1]

Go back two hundred years to *The Wealth of Nations*, and the question remains unanswered. Although Adam Smith denounced profligate government with all the Scottish fervour known only to a Balliol man, nonetheless he concluded that when the needs of the State exceed the revenue from proper subjects of taxation then government must have recourse to improper ones.

Yet, whilst there may be little to glean from writers in English, during the forty years prior to the outbreak of the Great War there was a lively debate amongst Austrian, French, German, Italian and Swedish writers on public finance on both the ideal means of taxation and the optimum distribution of resources as between government and the rest of the economy.

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1 Towards the end of Chapter 3, *The Allocation of Existing Resources*, p. 65.

To give you the flavour I will quote from just one of this number, a Frenchman, Paul Leroy-Beaulieu. He admitted: “the major part of the sums raised by taxation have been put to uses which are commendable neither from the economic nor the social point of view” but he also rejected the then popular view which considered all taxation as an evil.

In a passage that could be read with advantage by all those who today would advocate indiscriminate privatisation, Leroy-Beaulieu supported his view that some taxation is necessary, with a then topical example.

He wrote: “A new branch railway exerts a beneficial influence over a very wide sphere; it increases the receipts of neighbouring lines which it feeds, and augments the income not only of those who use the new line for the transport of their products, but also of those who do not send their products any distance away but simply bring them to the nearest market which is now less glutted. Thus the effect of the branch line is widespread, diverse and manifold; but the entrepreneurs cannot make all the beneficiaries contribute to the cost, since many of them derive no direct benefit from the new line nor even manifestly use it at all, simply stepping into the place of those who do use it. This is why many public works cannot be carried out for private account; they would ruin private entrepreneurs, while being highly remunerative for society as a whole.” [2]

I select Leroy-Beaulieu for particular mention as he formulated precisely the contemporary practical question.

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2 A similar example of a public good is the construction of a lighthouse on rocks dangerous to shipping. No bargain can be struck between the ship’s captain, who may or may not observe the beam, and the lighthouse keeper; nor is the availability of its benefit to other captains diminished if he does observe it. Not least among its benefits is the saving of the lives of sailors, who would otherwise be at risk of drowning; whilst those merchants who do not venture overseas also benefit from the construction of a new lighthouse because of reduced competition in their home markets. It becomes apparent, therefore, that an equitable method is required by which the cost of building, operating and maintaining the lighthouse can be met.

“Is there a formula”, he asked, “which could serve as a rule for the establishment of the proportion of people’s income which can be exacted without damage for society as a whole?”

He attempted a practical answer and wrote: “We believe that it is possible to fix an empirical lower and upper limit to taxation. The limits are not inflexible; they are only approximate. We consider that taxation is very moderate when the sum of national, provincial and municipal taxes does not exceed five or six percent of private incomes. Such a proportion should be the normal rule in countries where the public debt is small and whose politics are not dominated by the spirit of conquest. Taxation is still bearable, though heavy, up to ten or twelve percent of the citizens’ income. Beyond twelve or thirteen percent the rate of taxation is exorbitant. The country may be able to bear such a rate, but it is beyond doubt that it slows down the growth of public Wealth, threatens the liberty of industry and even of citizens, and hems them in by the vexation and inquisition necessarily entailed by the complexity and the height of the taxes.”

This continental debate was largely ignored by English speaking economists. One possible reason was that not until the advent of Lloyd George as Chancellor of the Exchequer in 1908 did the tax take in this country regularly exceed a ten percent slice of the national cake. Until then, the attitude of the establishment was determined by the *golden maxim* of J. B. Say: “The best of all plans of public finance is to spend little, and the best of all taxes is that which is least in amount.”

Even during the 1930s the dominant view had changed very little. The ‘Treasury view’, as it was then lampooned by Maynard Keynes, ensured that during that depression a Labour Government and its National Government successor both reacted to falling tax revenues by retrenchment. Through to the 1940s governments at Westminster were parsimonious rather than profligate.

During the course of the Second World War a change of attitude was forced upon those in authority, and at the same time

economics became dominated by a new breed of so-called Keynesians. In addition to the plans for social security prepared by the then Sir William Beveridge, The Times published between November 1942 and April 1943 a series of ten articles under the general heading of ‘Full Employment’.

The Economic Journal of April 1943 published a ‘Post-war full employment Budget’ prepared by the then Nicholas Kaldor.

Thus, successive post-war governments found themselves committed to whatever volume of spending might be required to sustain a near zero rate of unemployment in a welfare state. The golden maxim and the worship of a balanced Budget were cast out to join the dodo. In pursuit of these all-party objectives, public spending was increased to record peace-time levels and, in accordance with accepted practice, taxation was raised to record peacetime levels also and topped up by persistent borrowing.

With this fundamental change in the establishment’s attitude to public spending and taxing there sounded at least one English speaking senior academic voice echoing from time to time views similar to those expressed by Leroy-Beaulieu and other participants in the earlier continental debate.

In an article published in the Economic Journal of December 1945 Colin Clark concluded from pre-war evidence gathered from many countries that when general government spending necessitated a tax revenue persistently in excess of 25 percent of net national product at market prices then economic forces were set in motion leading to rising costs and prices with some restriction of output. From this evidence Clark concluded Kaldor’s full employment Budget to be unfeasible, as it implied a tax take exceeding 30 percent of the net national product at market prices. Maynard Keynes agreed with Colin Clark.

Since 1945 Colin Clark has many times restated his case on the basis of the post-war evidence, but with little effect on established views, be they contemporary Keynesian or monetarist. In 1977 he returned to London from semi-retirement in Australia to publicly

state his case yet again. At that conference his paper was criticised and rejected by an economist MP who is now a member of Mrs. Thatcher's administration, Mr. Nigel Lawson.[3]

Today there are indeed many economists, in this country and others, who argue for one reason or another in favour of significant cuts in general government spending and taxing. The British and United States governments have attempted to follow this kind of advice but without success – both countries have suffered a more intense slump than most and in both countries the general government share of the national cake has increased as a result.

Ranged against this view there is today also a large body of economists who assert that the road to recovery requires an increase in general government spending. The French government have attempted this road without success.

Unfortunately this contemporary academic divide has not given rise to an academic debate in which the case of each disputant is well founded in theory and all are seeking to eradicate error.

Rather, it has given rise to something resembling a war game, with each faction trying to obliterate the other whilst remaining ensconced in their particular ideological bunker. This economic war game is proving to be more destructive of livelihoods than anything as yet unleashed by the military men. To the best of my knowledge there has been, for example, no sustained scientific research at our universities designed to discover whether Colin Clark's conclusion from his empirical studies is a matter of statistical accident or whether it is to be predicted from theory.

To find a dominant school of thought with a truly scientific approach to public finance founded on a coherent theory one has to go back to eighteenth century France – to the Physiocratic school.

The Physiocrats were scientific in the sense of having a confident belief that all phenomena will yield to investigation and

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3 Mr. Nigel Lawson became Chancellor of the Exchequer shortly afterwards, replacing Sir Geoffrey Howe after the General Election of 9th June 1983. On 7th July 1983 he announced some £500 million of public expenditure cuts.

will turn out to fit into a scheme of natural law. They are widely accepted as being the founders of modern economics as a distinct discipline and certainly the crude origins of many contemporary concepts may be traced to this group.

For example, they recognised that included within the material output of any undertaking there is a material input which must be deducted when aggregating the net contributions. This notion is, after all, the basis of modern value-added analysis, and it is also the basis of Colin Clark's aggregate – the net national product at market prices.

In the 1980s we need not bother overmuch with the details of the Physiocratic system, for we now live in a very different kind of society, and economics too has made some significant advances over the past two hundred years. It will be sufficient for us to note the scientific method by which the Physiocrats reached their conclusions in respect of public finance.

The Physiocrats adopted a macroeconomic approach. Their 'natural order' was divided into three classes: an agricultural class, a proprietary class, and an industrial or merchant class which included the rest. The industrial class were considered to be sterile in the sense that as a whole they made no net addition to the wealth of the economy – the material output of this class was reckoned to be no greater than their material input.

Only the agricultural class were considered to be productive in the sense that their material output was reckoned to be greater than their material input. The excess produced by the agricultural class – termed the net product – became the income of the proprietary class.

From this position the Physiocrats argued it to be wrong to tax the industrial class, for there was no net addition – there was nothing to tax. Any attempt to impose a tax on this class would take away what they needed to sustain themselves and their production and so lead to poverty.

Equally they reasoned it to be wrong to tax the agricultural

class, for after passing the net product to the proprietary class, the agricultural class too were left with no more than was needed to maintain themselves and to sustain future production. Any tax on the agricultural class must of necessity restrict future production and so impoverish society as a whole.

It followed that the proprietary class must bear the full burden of taxation, for their income – the net product – was the only available source of taxation which could be used without damage to society. The Physiocrats concluded the natural and proper rate for taxation to be 30 percent of the net product.

To those who argued 30 percent of this net product to be insufficient to cover the expenses of government, Dupont – the same man who later went to America and founded the firm which today is the multinational bearing his name – Dupont replied: "If unfortunately it be true that three-tenths of the annual net product is not sufficient to cover ordinary expenditure, there is only one natural and reasonable conclusion to be drawn from this, namely, curtail the expenditure."

Note well. For the Physiocrats, no woolly waffling about the need to cut or increase public spending by some unspecified amount. No moralising about the need for workers to restrain their demands, to work harder for less, in order to sustain a profligate government. No question of government enjoying a privileged position and having the right to adjust tax revenue to whatever amount they might decide, in their wisdom, to spend.

To each class there accrued an income, and each class was required to live within that income. The agricultural and industrial classes received an income sufficient to maintain themselves and to sustain production. The surplus, the 'net product', was divided proportionately between the proprietary class and government.

One might say that the idea of an incomes policy also originated with the Physiocrats but their incomes policy included government with everybody else. Their argument admits of no exceptions; in their approach to public finance there is, as Dupont put it, "only

one natural and reasonable conclusion."

Today we live, as I have said, in a very different kind of society to that of the Physiocrats. Whether the Physiocratic system would have been workable in 18th-century France is a matter for historians; it is not applicable directly to 20th-century Britain.

Yet, we can learn from their method – from their scientific approach to the matter of public finance. Conditions have changed, but the questions related to public finance which macroeconomics is required to answer today are not fundamentally different from the questions the Physiocrats attempted to answer over two hundred years ago.

The Economic Study Association (ESA) has spent twenty years researching into issues related to public finance, and the scientific approach pioneered by the Physiocrats has proved useful.

However, in the second half of the 20th century we did not start with the basic concepts and definitions of the Physiocrats but with something more appropriate to contemporary conditions – with the *General Theory of Employment*, as formulated by Keynes in l936.

We have developed the supply-side of Keynes's theory in a way that incorporates Milton Friedman's restated *Quantity Theory of Money* – which is essentially a generalisation of Keynes's theory of liquidity preference – as well as later developments in monetary theory, and also in a way that provides theoretical backing for Colin Clark's empirical work on what he calls the "economic upper limit to taxation".

As a matter of theory we can argue now that once a lower tax threshold is breached then all taxation motivates a tax shifting process. If government increases employees' social security taxes by, say, a penny a week then nothing much may happen, but if they make the increase £1 a week, on average, then employees will retaliate. The tax-induced cut in take-home pay will be taken into the reckoning at the next pay round. As a result employers' average labour cost will be higher than it would have been had the tax increase not been imposed.

Faced with higher labour costs employers will, in turn, depending on market conditions, either raise prices or cut back on employment, or some combination of these two.

In terms of the theory, the tax shifting process causes the aggregate demand function and the aggregate supply function to increase simultaneously by more or less the same amount so that the point of intersection rises vertically.

In practical terms, the tax shifting process causes a rising general price level which effectively disperses the tax effects throughout the economy until they are so thinly spread that they cease to motivate further retaliation.

In other words, the tax shifting process may be considered as a mechanism by which an economy absorbs a level of taxation, or additional taxation, by a movement from one stable general price level to another higher general price level. The converse holds for a tax cut.

This line of reasoning leads to the conclusion that in any economy it is possible for the amount of taxation to be such as to cause the tax shifting process to continue indefinitely. When this happens that economy will then be subject to what may be called persistent tax inflation.

Thus, as a matter of theory, it is to be predicted that for any economy in given conditions there is an "economic upper limit to taxation" – as Colin Clark concluded from his empirical studies.

When government spending necessitates the economic upper limit to taxation being persistently exceeded, then, the theory predicts, monetary policy will determine the trade-off between the rate of inflation and the restriction of output and employment. With a lax monetary policy there will be more inflation and less unemployment. With a tight monetary policy there will be less inflation and more unemployment.

This prediction from theory changes fundamentally the significance of the work pioneered by Colin Clark. The economic upper limit to taxation ceases to be a mere statistical inference

from empirical studies, which may or may not hold at some other place or at some other time. The statistical investigations become tests of a prediction from theory – attempts to answer the question as to whether the conclusion from a generalisation is borne out in practice.

The scientific method begins and ends with observation. Let us look at the evidence. Until recently both the United States and this country pursued discretionary monetary policies – that is to say, "lax" policies – and in these circumstances the theory predicts a significant positive relationship between the annual rate of inflation and the proportion of the net national product at market prices (NNP) appropriated as general government tax revenue.

First the United States:

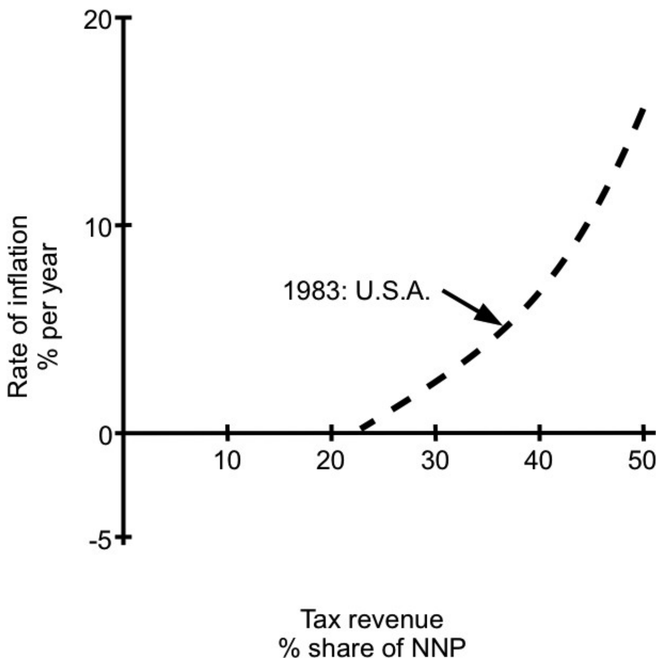

Figure 1: Tax revenue and inflation rate, U.S.A.

Now the United Kingdom:

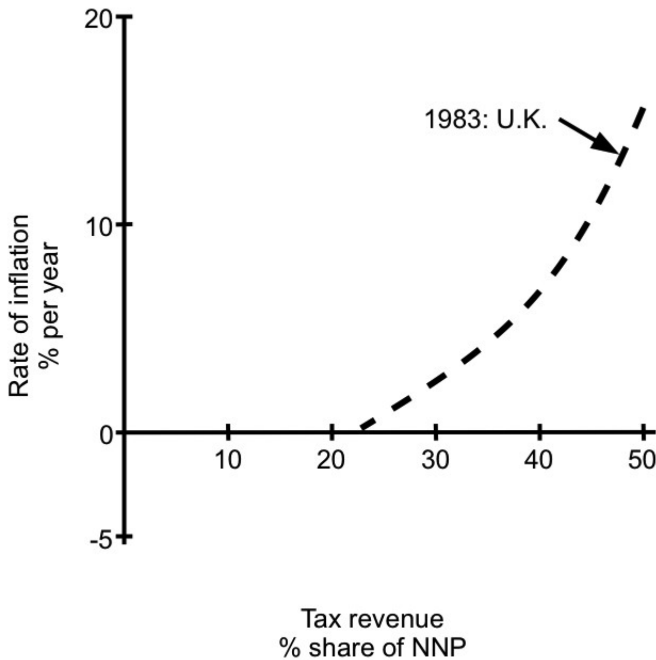

Figure 2: Tax revenue and inflation rate, U.K.

As may be seen from the charts the evidence is consistent with the theoretical prediction. In the United States the rate of inflation has moved up and down with the tax percentage of NNP at market prices. In the United Kingdom, where a borrowing requirement has been a persistent post-war characteristic, the rate of inflation has moved up and down with the total of tax revenue and borrowing requirement as a percentage of the NNP at market prices. With the further use of calculus it can be shown that in both countries the relationship is positive and significant.

Now the importance of these statistical investigations is that they show predictions from the theory to be consistent with the facts of experience. One can also carry out a number of statistical

tests to show that the chances of these statistical results being a matter of accident are negligible. Thus, we have confidence in the theory, and may proceed to draw particular policy implications.

The implication for United States economic policy is that if the Federal Reserve Board pursues a monetary policy consistent with a zero rate of inflation, then, to avoid a slump, the United States government must pursue a fiscal policy requiring a tax take of no more than 23 percent of the net national product at market prices. Put the other way, if the United States government persist with their present fiscal policy then it is impossible for an economic recovery to be sustained without an upsurge in the rate of inflation.

For the United Kingdom our theory predicts that if government persist in combining present fiscal policy with the medium term financial strategy then inflation may be squeezed out of the system over time but only at the cost of keeping the economy permanently depressed.

Ministers of the Crown who stump the country claiming that inflation is now under control and that they foresee a sustained economic recovery without inflation either have fooled themselves or are attempting to fool the rest of us.

To what extent is the appropriation by general government of nearly 50 percent of the nation’s income a cause of present social evils? A practical question to which now we can give a practical answer.

Theory predicts and the facts of experience confirm that the primal cause of the present social evil of inflation is a tax take persistently in excess of the economic upper limit to taxation. For just so long as government continue by the force of law to appropriate nearly half of the nation’s income then, just so long as we continue to enjoy the freedom of choice, our choice will be limited to either hyper-inflation or mass unemployment.

The alternative to having a choice is to give up our liberties for the regimentation of a centrally controlled siege economy. There is always this alternative.

However, do not rush to the easy conclusion that both macro-economic theory and the facts of experience demand the indiscriminate slashing of general government spending. Some government spending could be cut with advantage to all for it is unnecessary and wasteful. It is as true today as when Leroy-Beaulieu was writing at the turn of the century: "The major part of the sums raised by taxation have been put to uses that are commendable neither from the economic nor the social point of view."

But the social evil of inflation is the result of successive governments persistently exceeding the economic upper limit to taxation and this limit is a ratio. Whether or not the limit is being exceeded is determined as much by the size of the nation's income as by the amount of taxation. Both theory and evidence support the conclusion that whilst the primal cause of the present social evils of inflation and unemployment is in part an excessive amount of taxation, a not insignificant part is the method of raising tax revenues – methods which constrain the nation's income. But this question of method is beyond the scope of this talk – perhaps we may consider it another time.

The title of this talk poses the question 'Who Needs an Incomes Policy?' The answer must be the government, not the rest of the economy. The non-government sector of the economy has shown such restraint during the post-war decades that its share of the nation's income is now smaller than ever before in our history. We are on average better off than pre-war for the simple reason that we have multiplied our output – in other words, 70 percent of ten oranges was not as many oranges as 50 percent of twenty is now.

Nonetheless it is our post-war governments that have lacked restraint; it is post-war governments who have made excessive income demands, and an unbridled government is inconsistent with general prosperity and social justice.