Public Talks

Methods of Taxation

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If the proposition 'all taxes are bad' were put to a vote of taxpayers, there can be little doubt that it would be passed by an overwhelming majority. Their motives may be varied, but the certain result is consistent with the conclusions to be drawn from an economic analysis. All taxes are bad; they are bad in that by their formal incidence, that is on impact, they distort relative prices and so distort the economy as a whole.

More than that, all taxes are bad in that sooner or later they all motivate a tax shifting process, and eventually this tax shifting process causes a rising general price level with some cutback of output, the social evil which is described in the jargon of today as 'slumpflation'. In this country we are suffering from what may be accurately described as statutory slumpflation – statutory, for it is largely the result of decisions taken in Cabinet and confirmed by Parliament.

The direct cause of our statutory slumpflation is an excessive tax burden, that is an excessive amount of taxation relative to the Net National Product (NNP) at current market prices, and we will be rid of the disease only when the cause is removed.

Do not be fooled into believing that this government's policies are removing the cause, even of inflation. The evidence is quite to the contrary. What is happening is that the social evil of mass unemployment is being pitted against the social evil of persistent tax inflation. As a result, the unemployment of both people and resources, and in particular the fear of unemployment – all this is slowing down the tax shifting process, and in turn, this is being manifested as a slowing down in the rate of inflation. The primal cause remains, and it has a greater power today than it had in 1979.

I dealt with this issue of an excessive tax burden in my talk last April (Who Needs an Incomes Policy? – 14th April 1983), and so tonight, what I wish to consider is the methods of taxation which have been pursued by successive British governments, and as I will hope to show you, methods guaranteed to ensure that any amount of taxation will prove to be an excessive burden.

That they are taxing too much may be so – but even if they weren't taxing enough the way they are doing it would make it excessive, because the fact is that whilst all taxes are bad, some taxes are worse than others, and some taxes are worse than others in that they have a greater power than other taxes to restrict the economy, and to create the social evils of mass unemployment and persistent inflation. Successive post war British governments have consistently relied more and more on revenue from those same very bad taxes, and less and less on the revenue from not-quite-so-bad taxes. By their fiscal policies, they have not only perpetrated sins of injustice, they have compounded them.

However, let us begin by looking at the evidence – the official estimates made and published by government departments. On the chart in Figure 1, it has been broken down into three broad classes: pay bargain taxes, other direct taxes, and other indirect taxes.

Pay bargain taxes are those taxes which drive a wedge between what employees receive as take-home pay for their labour, and the cost of that labour to their employers. At present, these pay bargain taxes consist of income taxes on wages and salaries, employees' and employers' social security contributions, and the National Insurance surcharge.

Other direct taxes include all income taxes other than taxes on wages and salaries – that is, including such things as corporation tax, petroleum revenue tax, and so on and so forth. Included also in this class are all taxes on capital – those are mainly death duties, and Capital Gains Tax.

Lastly, the other indirect taxes include all of the so-called taxes on expenditure (other than the National Insurance surcharge which is included as a pay bargain tax), so that other indirect taxes, as I have described them, include such things as the local rates, Value Added Tax (VAT), and all other classes of customs and excise revenues, stamp duties, motor vehicle duties – you name it, and they are included in it. That is other indirect taxes.

So, in Figure 1, there are pay bargain taxes – that is taxes which drive a wedge between what an employee receives and what it costs an employer; other direct taxes – that is all other kinds of income tax and capital taxes not already included; and the other indirect taxes – which includes all taxes on expenditure (only one of which is included in pay bargain taxes, the National Insurance surcharge). A little earlier, around the seventies, there was also the Selective Employment Tax (SET).

Now, in order to produce comparable statistics over some 37 inflationary years for the revenue from each of these taxes, or from each of these broad classes, I have expressed them as a percentage of the Net National Product (NNP) at current market prices for that year. By expressing it as a percentage, one can eliminate any inflationary elements – in other words, what it represents is a slice of the cake, when those taxes are taken, or as I would describe it, they are a burden.

Let us then start at the bottom, with other indirect taxes. As you can see, the proportion has remained fairly steady throughout the post-war years from 1946 through to 1981. (I apologise that it’s so far out of date but the government are rather slow to produce the necessary information, and one can’t get details for later than 1981 – the details are not yet published.) As you can see, it starts high just after the war, stops a little, and then climbs up towards the end here. That’s the sharp increase in the VAT rate introduced by Sir Geoffrey Howe, and of course he was also rather keen on putting up excise and other duties – you had to pay more for your beer and wine and so on, since his tenure of office – and this shows itself in the sharp jump from 1979, but even so, the percentage has only just about returned to what it was in the late forties.

In any event, throughout the whole of those 37 years, the other indirect taxes have only gone up and down by about 3 percentage points – the range is very small.

Move up to the other direct taxes, and of course this shows a very steady and persistent decline over the years, and indeed, were it not for the North Sea and the new petroleum tax, as a share of the national product this would have already gone to join the dodo. The sharp turn up is entirely due to the petroleum revenue tax – North Sea taxes, which now account for over 30% of all other direct taxes. In fact, if we ignore the North Sea element in this, then these other direct taxes have fallen quite sharply over the past couple of years. They would be down at the bottom, and off this graph, but the fact is that there is North Sea oil, and we have got a petroleum revenue tax, which is included.

Taking these other direct taxes as a whole, that particular class is only about half as burdensome today as in the late 1940s, when they were a little over 14% percent. Today they are between 6% and 7%, so they are about half as burdensome as they were. Now one main reason for that decline is the squeezing of profits. If you squeeze profits, that will reduce dividends. This has happened as a result of increasing pay bargain taxes. Very simply, if you squeeze the base of a tax, then obviously the yield of it is going to fall. As I say it's quite a serious decline, but it does to an extent measure the decline in the profitability, or net profitability and competitiveness, of British producers.

Moving now to the top of Figure 1, there are the pay bargain taxes, and this has simply leapt; the burden of this class of tax has trebled during the post war decades. In 1947, pay bargain taxes took about a 6½ percent slice of the Net National Product; today they take a 20 percent slice.

From being a class of tax which yielded the smallest revenue – and before the Second War it was an insignificant revenue – from being, just post-war, the class of tax with the smallest revenue, it now yields the most revenue.

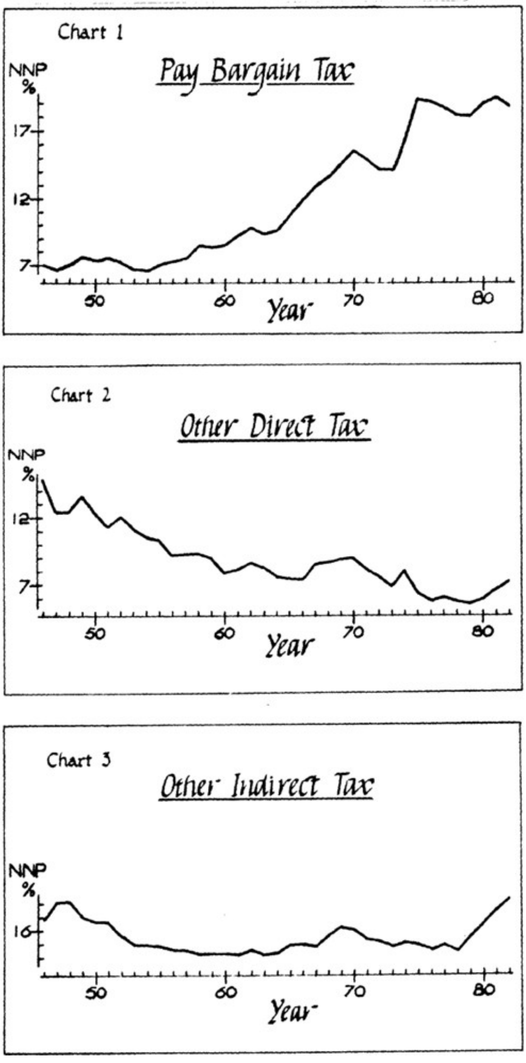

Figure 1: Classes of taxation, 1946 to 1981

Since 1959 the yield of pay bargain taxes has risen above other indirect taxes, and since 1973, it has risen ahead of the other direct taxes, from being the smallest class to become the largest class.

Since 1960 the burden of general government taxation has increased by about fifty percent; almost the whole of that increased burden has been imposed through increased pay bargain taxes.

We hear a great deal today about the burden of Non-Domestic Rates[1] – it's one of the 'in things' for the CBI (the Confederation of British Industry) to complain about – how they are knocking out otherwise thriving businesses. But that's no more than the last straw, and it's always the last straw that gets noticed. The burden of pay bargain taxes, happily being paid by business, is some eight times that of Non-Domestic Rates.

Today the Trades Unions march and protest about the increase in the standard rate of VAT to 15%. They claim it has caused a lot of their members to lose their jobs; well, if that is so, then what of pay bargain taxes – a direct tax on jobs with a burden three times that of VAT, even at its new rate of 15%?[2] If only people would look and consider, before they go out and cause civil commotions, and incidentally put up our domestic rates in so doing, that the last straw produces a noticeable effect only because a burden of many tons has been imposed previously.

This chart, Figure 1, shows how according to official estimates, the method of raising general government tax revenue has changed over the post-war years, and it is a very significant shift.

Gladstone talked about these two taxes – they didn't have that sort of tax in his day – as being the two sisters, the twin sisters that he courted, and that remained valid until the Second World War.

There were pay bargain taxes before the Second World War, but they were quite insignificant. They were very difficult to measure statistically because they were in the margin of error of aggregate national account figures.

But this new method of taxation has grown from being nearly non-existent to being the largest source of general government revenue, tax revenue, whilst what was previously used to provide

1 Now known as Uniform Business Rates; the same complaint is still raised.

2 The standard rate of VAT was increased from 8% to 15% in June 1979.

some 50% of general government tax revenue has now become the smallest of taxes.

This is a very significant change to have happened over a decade, but it's happened, so let us consider this significant shift, and disengage from our obsessions over the last straw that happens to hurt us, and consider the effects of this massive increase in pay bargain taxation – from next to nothing to close on 20% of the Net National Product (NNP).

Now in their formal incidence pay bargain taxes come in two varieties: those which have an impact effect on the take-home pay of employees – that is income tax on wages and salaries and the employee's social security contribution – and then there are those taxes having an impact effect on the employer's labour cost, that is the employer's social security contribution – the former Selective Employment Tax and the present National Insurance surcharge.

Now to take the first variety first, when taxes on the wages and salaries of employees are increased, what the Americans call rather descriptively, withholding taxes, when these withholding taxes are increased, then immediately and directly take-home pay is cut.

For example, when the employee's social security contribution was increased last April, then in the same month, the amount of money received as take-home pay was cut by precisely the same amount as the tax increase, because these are withholding taxes – you just don't get the amount that is withheld.

What you do get of course is an immediate distortion of relative prices. What happened was that for each of us as an employee, each of us who works for a living, the price each of us received in return for our own labour fell relative to all the other prices that we each had to pay out, or happened to receive. Similarly, when taxes imposed on an employer are increased, then of course labour costs are increased by the full amount of the tax. Again it's an immediate distortion of relative prices. The price an employer must pay for a given quantity and quality of labour increases, relative to all other prices that the employer pays out or receives.

Now, taking these two impact effects together, what happens is that a wedge is driven between the price paid out for labour by an employer and the price received in return for that labour by an employee – this is the pay bargain tax wedge. It has, inevitably, a disincentive effect on both the employee and employer, for as the taxman takes more, and the employee receives less, the employee becomes less and less willing to work, and that is matched by the employer becoming less willing to offer work, as the taxman takes more and labour costs more.

Further, the progressive nature of most of the pay bargain taxes intensifies the disincentive effect. The pay bargain tax wedge is, on average, the equivalent to a 40% payroll tax on take-home pay. In other words, if you take home £1, it costs your employer £1.40.

That's on average, and of course the average always tends to obscure what actually happens, and in particular, what tends to happen in the marginal cases; and in marginal cases, this difference comes close to being 100%. In marginal cases it means that if for some additional job an employee asks say £10, then the cost to the employer may be as high as £20. If the employer cannot afford £20 and the employee will not accept less than £10 pounds, then the job doesn't get done. But note, not only do the employer and the employee lose out, but we are all the poorer by a job not done.

Now of course, human nature is what it is, and fortunately for us on many occasions there is a will to find a way, and the only way is to evade the tax. Thus there is brought into being the black economy, so-called. Whoever wants some additional job done, and whoever is prepared to do that job, agree to a deal off the record, and split the tax saving. The person doing the job receives more, the person having the job done pays less; both gain, and only the government loses in tax revenue; but again more important, the job does get done, and to that extent we are all better off as a result of a job that has been done.

From time to time there is an exercise that civil servants in the Inland Revenue and the Treasury economists engage in – it's a nice little exercise, because they can occasionally get paid for it, and from time to time they can appear on radio as well as on television – from time to time, great claims are made as to the revenue to be gained from effective action against the black economy.

Just don’t be misled – in most cases, if not all cases, there will be no gain in tax revenue, for if the tax wedge were enforced the job would not get done, and to the extent that jobs that are now being done in the black economy were not done, we should all be the poorer and the government no richer. Whatever the size of the black economy, what does it matter? They are earning a living, they are not on the dole, not drawing social security – well if they are that’s up to the other people. As I say jobs are getting done but whatever may be the size of the black economy, if we wish to be rid of the black economy without all becoming poorer, then there is only one certain way – remove the cause, and abolish this pay bargain tax wedge.

It's very easy – if you don’t like the result, don’t do it. But note well, all that we have mentioned so far flows from just the formal incidence of pay bargain taxes – their impact effect, the way they hit – and serious though this effect may be, it really is as nothing when you start comparing it with the longer-run effect.

Two hundred years ago the granddaddy of all economists Adam Smith argued that any tax imposed upon the income of employees is shifted by them onto their immediate employers. Impose a tax of 20 percent on gross wages, and gross wages, he asserted, will rise by 25 percent.

By statistical investigation we can now confirm Adam Smith’s conclusion from his tax analysis. The OECD (Organisation for Economic Co-operation and Development) admits that net of tax wage bargaining is common to all the industrialised countries. It is recognised as being so.

Thus, as predicted by classical theory and confirmed by modern statistical techniques, by tripling the burden of pay bargain taxes over the past 37 years, our successive British governments have caused British labour costs to be that much higher than they would have been otherwise and that much higher is now 20% of the Net National Product at market prices – 20 pence in every pound.

The British worker (and that probably includes most of us) has not priced himself out of the market – he's been taxed out of the market. We live, whether we like it or not – whether we accept it, or whether we are in the van of the reformers – we live in a society dominated by the employee and employer relationship, and the employers are, for the most part, firms and corporations who can offer employment only to the extent that it is profitable for them to do so, at the current cost of labour. When it is profitable for them to offer employment, they must do so in order to gain the profit. When it is not profitable for them to offer that employment, they cannot do so, and any of them that are foolish enough to attempt the impossible are eliminated. They go to the wall. They appear in the bankruptcy statistics.

Firms and corporations have no option; when it is profitable for them to offer employment they have got to do so, they've got to make the profit, and when it is not profitable for them to do so they can't, because if they attempt it they are finished, that is as it is.

It may not be a pleasant condition, but it is the contemporary condition, and from the existence of this condition it follows of necessity that as the current cost of labour is inflated by the imposition and shifting of pay bargain taxes, employers have no option but to either raise the prices of their products or to cut back on output or some combination of the two. Thus, we can predict that an ever increasing pay bargain tax wedge will lead, sooner or later, to a rising general price level and to rising unemployment.

Monetary policy will play an important part in determining the precise combination of these social evils. An easy monetary policy will allow for less unemployment but will cause more inflation. A restrictive monetary policy will allow less inflation but cause more unemployment. There is no amount of choice – you'll get both, it just turns on what the emphasis is going to be. But this isn't the only long run effect; the shifting of pay bargain taxes raises the current cost of labour relative to all other prices that an employer has to pay and of course in doing that, it encourages labour saving investment. First you get the distortion of relative prices, then research is distorted, then investment spending is distorted, and in the end many jobs are destroyed for all time.

It was no accident that the upsurge in self-service shops coincided with the imposition of Selective Employment Tax during the period when Mr Callaghan was Chancellor of the Exchequer;[3] that is just about there where this takes off. Irrespective of whether the customer desired the service or the shopkeeper wished to offer the service, neither could afford the service at the new tax inflated cost of labour. Once firms have incurred investment expenditure in a certain direction, its effects continue for a very long time and little can be done to induce any immediate change.

For example, the present heavy youth unemployment has not brought about a return of the delivery boy. Not only is he being taxed out of the market, but the pattern of recent investment in the distributive trades means that there is no place in that trade today for a return of that service. Until all the latest investment spending gets worn out and firms begin to consider replacing it, that's going to continue. Cutting youth unemployment benefits is not going to provide any solution; that only compounds the sins of injustice perpetrated by successive governments at Westminster.

Our recurring balance of payments difficulties, difficulties with the sterling exchange rate, our so called high propensity to import, have been made much worse by this post-war shift in the method of raising tax revenue. When the cost of British labour is inflated by taxation, the prices of all British products are inflated, be they intended for sale in the home market or the export market; but pay bargain taxes imposed in this country do not of course inflate the manufacturing costs of our overseas competitors. The result is that

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3 Selective Employment Tax was introduced in August 1966, and withdrawn upon the introduction of VAT shortly after Britain joined the EEC in 1973.

our manufacturing base is eroded. Many markets are lost forever, and when markets are lost forever, output and employment is lost forever; each link in the chain, from cause to effect, is important when formulating public economic policy. Bright ideas and good intentions are not sufficient.

A public talk is not a place to go into the details of statistical investigations, and so I won't proceed to baffle many of you on regression calculus, but nonetheless, whilst the details of these investigations are best left to Economic Study Association (E.S.A.) seminars, the results of the complex investigations are informative.

On the basis of official estimates published by governments over the past 30 years, we can now explain more than 80% of the increase in the rate of unemployment by the increase in those pay bargain taxes. When the pay bargain tax burden is increased, then twelve to eighteen months later there follows an increase in the rate of unemployment, and on those rare occasions when the pay bargain tax burden was cut, which happened two or three times, then twelve to eighteen months later the rate of unemployment fell. This is quite predictable in accordance with a stable mathematical function.

A similar significant relationship exists between the size of the pay bargain tax wedge and the rate of growth of output, measured as Net National Product at constant market prices, but in this case the relationship between the rate of growth and the tax is a little shorter. Either a slowing down in the rate of growth follows six to nine months after the increase in pay bargain taxes, or an increase in the rate of growth follows six to nine months after those odd few occasions when they did actually cut the burden – about half the time that it took to show up in unemployment.

Again, our statistical investigation shows that a significant relationship exists between the size of the pay bargain tax wedge and the rate of inflation, but in this case the time lag is very short indeed – not more than a few months at the most. Of course this is to be expected, because producers are better able to calculate their costs and know whether or not they have to increase their prices, than they are able to predict demand, and further, in the absence of statutory controls, price changes can be quickly put into effect.

The result of that price change, however, in terms of output and employment, takes longer and comes later, so one would expect that difference in the time lag. First you get a change in this tax wedge that affects prices, then secondly, later on, it affects output, and then lastly, it affects employment; and all this in accordance with a stable mathematical function.

Taking it further, test statistics indicate that these relationships are not the result of any chance correlation, nor are they a matter of accident, and of course the time lags leave little room for reasonable doubt as to the direction of causation.

Thus, the combination of these two social evils of mass unemployment and persistent inflation, the two combined, is a post war phenomenon – and its cause is another post-war phenomenon, a significant pay bargain tax wedge. To eradicate slumpflation, governments must stop causing slumpflation; to stop causing slumpflation it is necessary for them to abolish pay bargain taxes. This is the inescapable policy implication to be drawn from the results of investigating the evidence produced by government.

Of course, from outside government it is very easy to propose the abolition of pay bargain taxes, and even more so when the available evidence fully supports the proposal, but for government there is an additional matter for consideration. Does the proposal amount to a feasible policy?

All the evidence may support the policy, the proposal may be both relevant and desirable, but the question for government is whether its implementation would be the act of a responsible government in the given conditions? Would it not be irresponsible for government to begin the process of abolishing a whole class of taxation, a class that yields 45% of total tax revenue, when every year government is forced to borrow large sums in order to cover their current spending?

It is an important question which government has to answer, so let us try answering it by again considering the available evidence. The first matter one has to consider, is that government today directly and indirectly is the largest single employer of labour in the country. It follows that a significant part of the revenue from pay bargain taxes is in effect paid by the government; what they receive in with one hand, they have to pay out with the other.

Now when you net out that rather large item, the net loss of revenue from abolishing pay bargain taxes is not 45% of current revenue but around 33%, or one third. If government spending is to be sustained at close to current levels and pay bargain taxes are to be abolished then the revenue from the two remaining classes of taxation must be increased by 50%. The last Chancellor did of course nearly double the rate of VAT, and his government was still re-elected, but even so we may doubt whether this government, the new government that was re-elected, or any other government could repeat that process without dire results. Fortunately, the evidence suggests that action along these lines, or along the lines of savage cuts in government spending, is not really necessary.

But again turning to official estimates, calculations show that current output measured as the Net National Product at constant market prices is less than two thirds of our potential, and, given the abolition of this class of tax – pay bargain taxes – then it is to be predicted, and predicted with some confidence, that output would expand by 50%. With the Net National Product expanded, then so would the revenue from these two remaining classes of taxation be expanded, without any need to raise the rates of tax.

Thus, over a period, the yield from these two classes of tax may be expected to grow to be equal to the current yield from all three classes, and so from that it is to be concluded, that the abolition of pay bargain taxes does not imply slashing government spending, nor does it imply the necessity of an upward shift in the rates of most other taxes, nor even does it imply a permanent increase in the annual borrowing requirement.

Whilst it may not imply all those things, there is still the present borrowing requirement, about which there has been much debate over recent years, and which Nigel Lawson is worried about. But, when one looks at the government accounts in relation to that, what does one find? Government accounts show that the present borrowing requirement is in the same order of magnitude as their present level of spending on unemployment benefit, social security supplementary allowances, and a whole variety of other grants and subsidies, that constitute necessary government expenditure only given the continuance of restricted output, mass unemployment and persistent inflation.

As output and employment expanded, as British firms became more competitive and profitable, then all this kind of government expenditure would in due course become unnecessary expenditure. The borrowing requirement as it stands at the moment would be allowed to fade away like an old soldier in his own good time, and would not be an excuse for cuts in public spending on what are truly necessary public goods and services.

All taxes are bad, and pay bargain taxes are worse than other taxes, but to abolish all pay bargain taxes is no more than a first step on the road to recovery. The proposal is not only relevant to our present predicament, but it also amounts to a feasible policy in present conditions. It was about one hundred years ago that a certain American economist wrote: "taking men in the aggregate, their condition is as they make it."[4] This comment is as valid in the 1980s as it was in the 1880s.

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4 Henry George, *Progress and Poverty*, Part X: The Law of Human Progress. See Chapter 5, The Central Truth, Section 15: The Cross of a New Crusade. "... when we see that social development is governed neither by a Special Providence nor by a merciless fate, but by law, at once unchangeable and beneficent; when we see that human will is the great factor, and that taking men in the aggregate, their condition is as they make it; when we see that economic law and moral law are essentially one, and that the truth which the intellect grasps after toilsome effort is but that which the moral sense reaches by a quick intuition, a flood of light breaks in upon the problem of individual life."

With all the advantages of a freely elected parliament we have allowed successive governments to pursue fiscal and monetary policies that could have no other result than a combination of the social evils we now suffer. We cannot expect to escape overnight from the consequences of past mistakes. It has taken many decades for us to plumb our present depths, and the cutting of the first shackle – the abolition of pay bargain taxes – will take some years.

But why not make a start? To reach any objective we have always to start from wherever we happen to be. That requirement has in fact a great advantage because it means we can always start now, from where we are now, for the simple reason we can't do anything else. Why then do governments persist in continuing with the mistakes of the past? The evidence is as readily available to government as to those outside. Why then do the freely elected opposition parties allow government to persist with such actions? Indeed, why do these oppositions expect to become government on the promise of continuing these mistakes?

A possible explanation – I won't go further than that – was given by Colin Clark some 20 years ago when he was Director of the Research Institute at Oxford, and this was at a time when we were all worried, because both rising unemployment and rising inflation were moving into the two or three percent region.

Colin Clark wrote: "Some moralists it is true would say that these actions are not blameworthy, because the politicians who perpetrate them are in such a state of profound and invincible ignorance about the consequences of their own actions and the standard of justice required of them, that no reasonable man can hope for them to act otherwise". He added: "Few politicians however would like to be excused on the grounds of such ignorance, even if the alternative were an accusation of injustice".

It is now no matter whether the politicians are to be accused of ignorance or injustice, for the consequences of their actions are now a fact of current everyday experience. In any event it is not the job of an economist to excuse or accuse; the job of the economist is to link causes with economic effects in a logical order.

The mass of evidence that is available today demands of an economist that he use advanced statistical techniques, and modern computer technology, and one result of that is that their economic arguments are mostly incomprehensible to both politicians and their electorate. This is a common characteristic of contemporary scientific advance, and a member of the general public who tries to understand a technical paper on say nuclear physics, indeed even a specialist in the subject, expects to find the reading of a technical paper hard going, but an economist in addition to exchanges with other economists is required to inform those politicians and the electorate. It is rather like an advocate at a Court of Law – he is required not only to be able to dispute the finer points of his case with other professionals but also to present a case in a way that can be understood by a jury, unlearned in the jargon and in the finer points.

A politician has to implement public economic policy and in a parliamentary democracy the electorate is from time to time called upon to accept or reject public economic policy. Now they can do this job only on the basis of information received, but there is another side to it. The electorate is required to make an effort, and act on the information received; for it is the electorate who have the power to cast out ignorant or unjust politicians and their professional advisors.

Well, I trust tonight it has been informative. The power to insist on right action by government lies in your hands – our condition is as we make it. Thank you.