Enquiry into Prices and Incomes

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Enquiry into Prices and Incomes

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Foreword

This paper was initially the joint work of a group of members, but in its final stages it owes much to the direction and advice given by Colin Clark (Director of the Agricultural Economics Research Institute at Oxford) and his colleague, G. H. Peters.

The Association also wishes to acknowledge its debt to Antony Fisher, Managing Trustee of the Institute of Economic Affairs, and to Edward Holloway, Hon. Secretary of the Economic Research Council, without whose help and encouragement this first paper could not have been published.

March 1968.

I

Introduction

The first wage freeze was enacted by Parliament over 600 years ago, shortly after the Black Death.

The first of the great plagues swept through England in 1349, and within a few months the centuries-old social system was fundamentally changed and the full rigour of feudal serfdom disappeared. Wages doubled or trebled overnight, but with the population reduced by one-third by the end of the century there was no corresponding rise in the price of food or other necessaries.

First by Royal Proclamation,[1] then by Statute,[2] the government reacted swiftly in a determined bid to end the peasants' bonanza. It was decreed that wages would be fixed at pre-plague levels, and that any previous agreements for increased wages would be void.

Successive Parliaments re-enacted the Statute of Labourers with ever-increasing penalties for disobedience, and a whole system of Justices and Quarter Sessions was established in order to fix and enforce wage rates, but all to little or no avail. The Prices and Incomes Board of today is heir to a long tradition.

Government reaction to economic forces has remained fairly consistent over the centuries, taking strength from an occasional apparent short-term success.

The government White Paper on *Prices and Incomes Policy after 30th June 1967* issued a year ago illustrates the King Canute attitude that is apparently endemic at the Palace of Westminster; in the context of the phenomenon of persistent price inflation, it was decreed that the wage increase "norm" would be nil. [3]

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1 The *Ordinance of Labourers* (23 Edw. 3 cc1-8), 18th June 1349.

2 The *Statute of Labourers* (25 Edw. 3 Stat. 2 c1), enacted in 1351.

3 Cmnd. 3235, *Prices and Incomes Policy after 30th June 1967*. HMSO, London, March 1967. See also: *Prices and Incomes Act, 1966*.

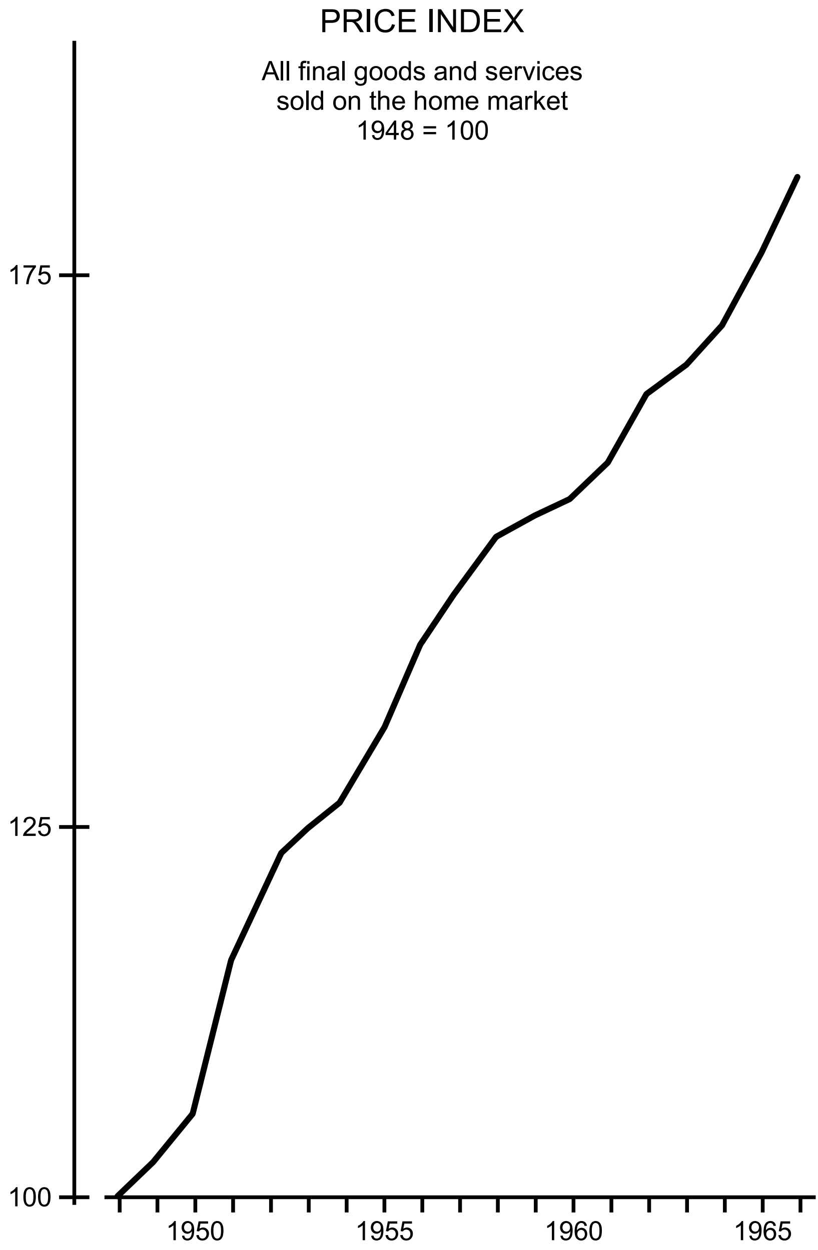
PRICE INDEX
All final goods and services
sold on the home market
1948 = 100
175
125
100
1950
1955
1960
1965

Chart 1

Recent history shows that prices in the United Kingdom have risen every year since 1934. Up to 1939 the rise is regarded as a recovery from previous falls, and by the outbreak of the Second World War prices had returned to roughly the same level as in the late 'twenties; special wartime factors are taken as accounting for the rise in prices during hostilities, and by the end of the war prices were about the same as they had been during the boom period that immediately followed the 1914–1918 War.

It is the continuous rise in the general price level since the Second World War, as illustrated in Chart 1, which is described as persistent or creeping inflation, and to which most of our current economic ills are attributed.

The risk of a rise in prices resulting from the pursuance of a policy for full employment was foreseen by Keynes thirty years ago; but under the conditions then prevailing it was clearly of secondary importance compared with the harsh reality of persistent large-scale unemployment. [4]

In 1950 Alexander Loveday, Warden of Nuffield College and a former Director of the Economic and Financial Department of the League of Nations, formulated the danger with greater urgency and suggested that one of the risks attendant upon inflation was "that of raising imports and reducing exports", [5] and that such pressures would drive governments towards a controlled economy where "all classes of society are prevented from earning the income they might otherwise obtain by government fixation of prices, of wages, of profits and of interest rates." [6]

The British Government has been so driven.

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4 J. M. Keynes, *The General Theory of Employment, Interest, and Money*, Macmillan and Co., London, 1936. Bk. V, Ch. 21, p.303.

5 Alexander Loveday, *The Only Way – A Study of Democracy in Danger*, William Hodge and Company Ltd., London, 1950. p.151.

6 *Ibid.* p.163.

II

Persistent Inflation

The phenomenon of persistent inflation may be viewed in two ways; first, as a persistent tendency for the general level of prices to rise; and second, as a decline in the internal purchasing power of money.

This rising price level is illustrated in Chart 1, and the decline in the internal purchasing power is its reflection; both aspects have some importance in relation to the recurrent balance of payments crises in the United Kingdom. [7]

From 1949 to 1967 the external purchasing power of sterling was fixed between US $2.78 to $2.82. The price index on Chart 1 shows, however, an internal price rise of 86% from 1948 to 1966, the last complete years before the devaluations of 1949 and 1967. That is to say, the internal purchasing power of the pound declined by about 46%. Yet, during the same period, the internal purchasing power of the US dollar declined by just over 30%.

This disparity tends to create a situation where exports are less attractive to UK producers and imports are more attractive to UK purchasers, thus adding to the strain on our gold and foreign reserves, already sadly depleted by the Second World War. Clearly, if exporters raise their prices in step with the general level of prices at home, there is a great danger of becoming uncompetitive; and to the extent that export prices lag behind, those engaged in exporting will receive less in terms of internal purchasing power. In fact, between 1948 and 1966 the price index for UK exports of goods and services rose by only 55%.

Conversely, unless import prices rise as fast as the general level of domestic prices, then imports will appear relatively cheap and

7 R. G. D. Allen, *On the Decline in the Value of Money*, The Athlone Press, University College London, 1957. p.5.

increasingly attractive to UK purchasers, and during this same period the price index for imports of goods and services rose by only 51%. This persistent decline in the internal purchasing power of money has repercussions on the balance of payments. The link is of importance since the government must react to such obvious pressures, while still able to prevaricate in respect of the insidious nature of the disease itself. [8]

The devaluation of sterling to US $2.38 to $2.42 in November 1967 may well have removed the disparity that had arisen between the internal and external purchasing power of sterling, but taken in isolation it is merely tampering with a result of persistent inflation, and at best can only mitigate the worst effects for a period. Indeed, by increasing the demand for exports and the return from them in terms of internal purchasing power, and by raising the prices of imports, devaluation will give an additional impetus to persistent inflation, and other measures are imperative if the last state is not to be worse than the first. As Sir Roy Harrod said before the event: "There is no more potent cause of inflation than a downward movement of the exchange rate." [9]

Although the post-war sequence of events was not entirely unforeseen, economists remain divided in opinion as to the main forces making for inflation, and hence cannot agree on effective policies for dealing with the situation. There are still some who support, with Michael Farrell, a policy for "a stable rate for price inflation"; [10] while among those responsible for national economic policy, acceptable opinions appear to fall broadly into two main groups, namely "cost-push" and "demand-pull", with government actions resting on whichever line of argument may be temporarily convenient.

8 Colin Clark, *Growthmanship – A Study in the Mythology of Investment*, Hobart Paper 10, I.E.A., London, 1961, and 2nd edition 1962; reprinted in *Ancient or Modern*, 1964. p.114.

9 Sir Roy Harrod, *Towards a New Economic Policy*, Manchester University Press, 1967. p.62.

10 M. J. Farrell, *Fuller employment?* Hobart Paper 34, I.E.A., London, 1965.

III

Cost Inflation

The cost-push inflation argument lays great stress on the persistent effects of trade union pressures and the national wage negotiating mechanisms which, it is held, cause wages and other employment incomes to be pushed up beyond the limits of growth in average productivity, irrespective of the demand for labour. As a result of this, labour costs per unit of output are increased and passed on in higher prices. The process tends to become regenerative, it is said, as higher domestic prices give rise to further wage increases, often automatically, as when the wage agreement has a 'cost of living' clause incorporated within it.

Pure cost-driven inflation has been defined as resulting from such autonomous increases in costs, particularly in wages, whether generated internally or externally, although most exponents of the cost inflation hypothesis would not be prepared to support such a restricted definition. [11]

The majority of cost inflationists in fact pay particular attention to increases in wage costs per unit of output, resulting from what may broadly be described as "trade union pressure". [12]

This explanation of the forces making for inflation has received wide popular acclaim under many guises, such as the 'wage-price spiral'. It is largely responsible for the wage freeze, and is a parent of the productivity formula for determining wage increases, whose direct descendant is the so-called "norm".

In 1944 the government's White Paper on *Employment Policy* (Cmnd. 6527) stated that "increases in the general level of wage

11 R. J. Ball, *Inflation and the Theory of Money*, George Allen & Unwin Ltd., London, 1964. p.264.

12 L. A. Dicks-Mireaux, *Cost or Demand Inflation*, Third Economic Lecture, Woolwich Polytechnic, 4th May 1965.

rates must be related to increased productivity due to increased efficiency and effort”. This sentiment has since been restated in various ways by successive governments.

Indeed, the ill-fated *National Plan* issued twenty-one years later in 1965 (Cmnd. 2764) included the phrase: “Experience has shown that the growth of money incomes can outstrip the rise in real output, whatever the rate of growth of productivity.” Similarly, the report issued by the TUC General Council on *Productivity, Prices and Incomes* begins by accepting the opinion that “in conditions of full employment it is possible for incomes to get out of tune with output, with the result that costs and prices go up.”

Chart 2 illustrates the growth of aggregate money wages and the production of goods and services between the years 1948 and 1966. Such information forms the basis of much popular advocacy for policies derived from the cost inflation theory. Because wages are outstripping production, it is said, money wage costs per unit of output have multiplied.

In Chart 3 the same figures for production are related to the various factor incomes as classified by the CSO (Central Statistical Office), where wages form part of *Income from Employment*. Such illustrations must be treated with caution since, for example, no allowance is made for any trend in respect of the numbers of self-employed. Further, the year taken as the base will radically affect the apparent rate of increase of different classes of income.

In the ten years between 1938 and 1948, for example, rents fell by about 3%, while other classes of income rose by more than 100%. Thus, if 1938 is taken as the base year, rents would be shown as having increased by four times, and a little more than self-employment incomes; profits shown as increasing by seven-and-a-half times; and employment incomes by only slightly less.

If the base year is taken as 1958 the picture is again changed, with rents up 84%, employment incomes up 67%, profits up 65% and self-employment incomes up 39%, while production rose by only about 30%.

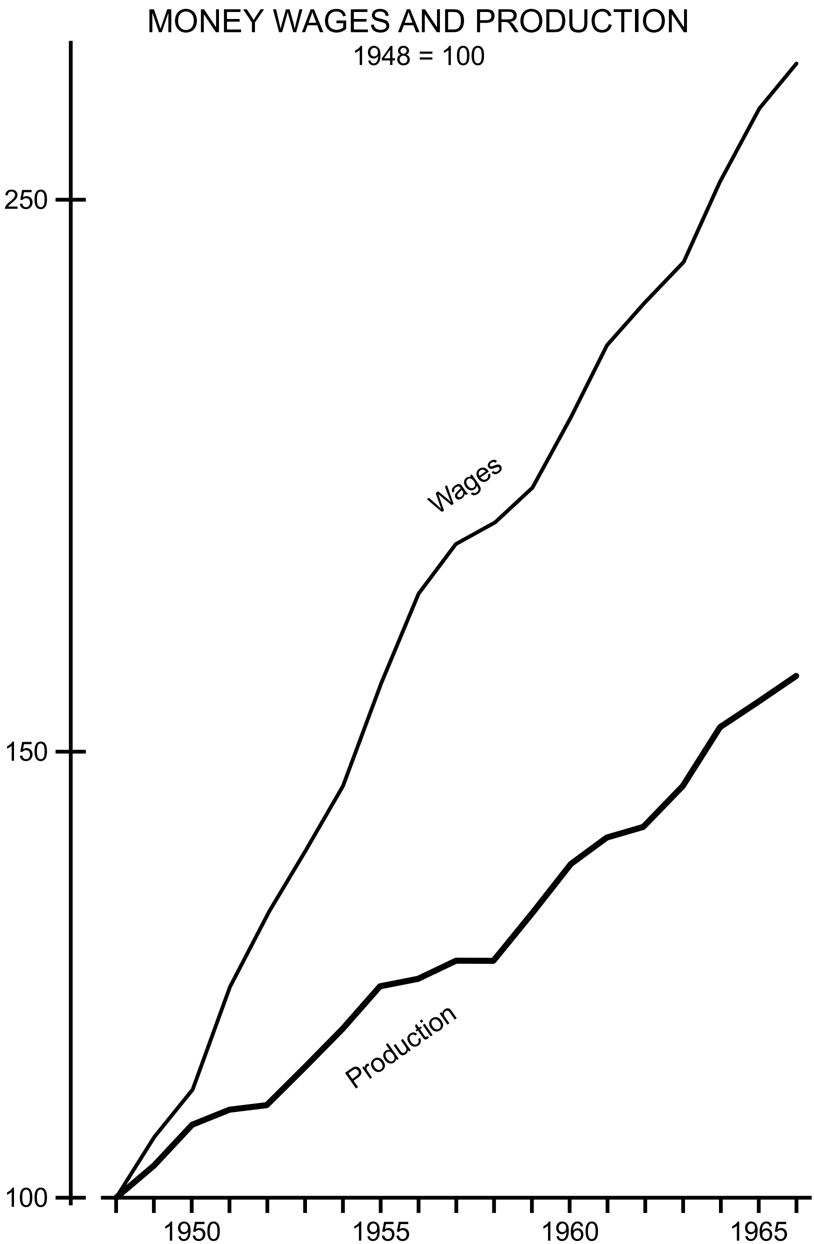
MONEY WAGES AND PRODUCTION
1948 = 100
250
150
100
Wages
Production
1950
1955
1960
1965

Chart 2

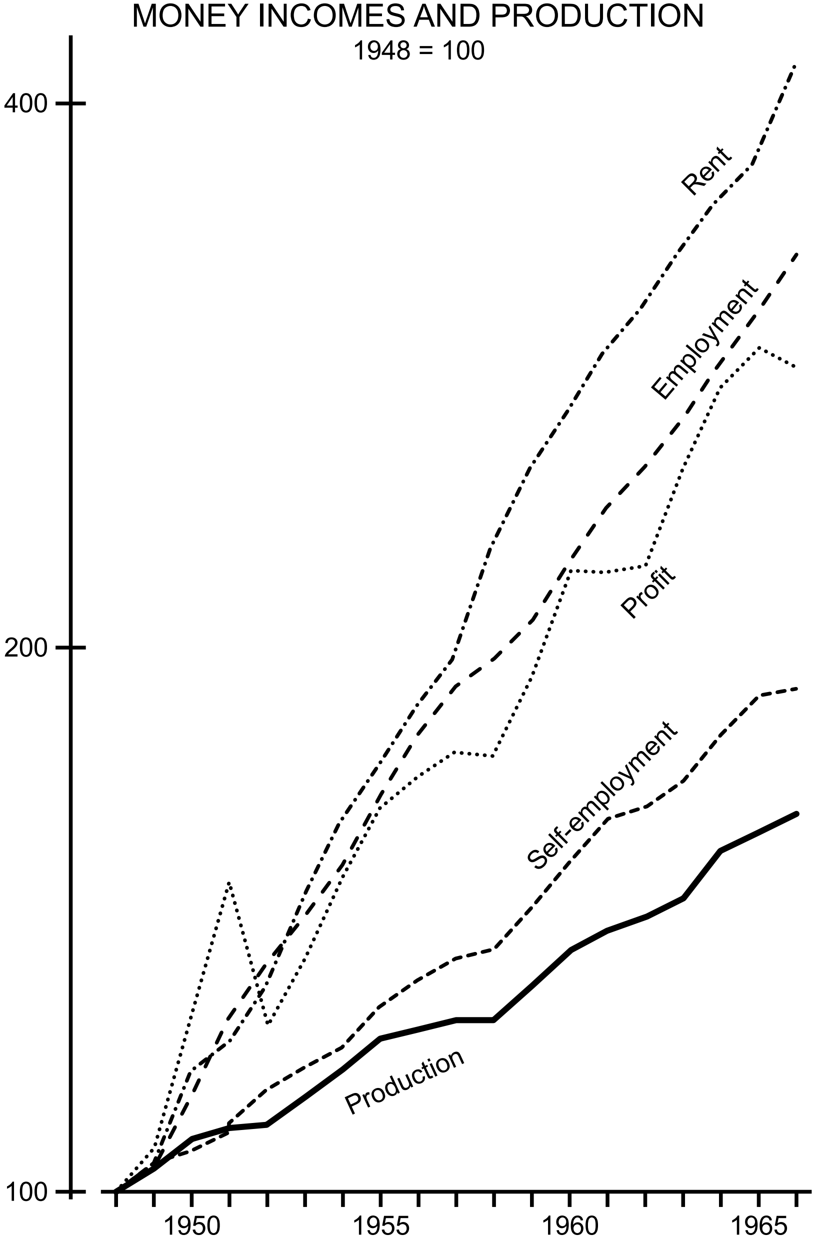
MONEY INCOMES AND PRODUCTION
1948 = 100
400
200
100
Rent
Employment
Profit
Self-employment
Production
1950
1955
1960
1965

Chart 3

Nonetheless, Chart 3 illustrates that all money incomes arising from economic activity have risen much faster than the volume of goods and services produced and that, contrary to what might be concluded from the many statements of the cost inflation theory, employment incomes did not have any prerogative in this. Chart 3 also illustrates the reason government policy has been extended from a ‘wage pause’ to an ‘incomes freeze’.

The fact that all money incomes are now rising faster than production does not, however, necessarily support the conclusion that it is money incomes which are causing prices to rise, since if the internal purchasing power of money is falling for any reason, money incomes will indeed be rising in relation to real production.

The statement in the *National Plan* that “the growth of money incomes can outstrip the rise in real output, whatever the rate of growth of productivity” is a truism within the conditions illustrated in Chart 1. Indeed, within such conditions, the higher the rate of growth of productivity, the more is the growth of money incomes likely to exceed the rise in real output.

All this raises the question of whether the classifications and concepts generally used, and mostly borrowed from the *National Income and Expenditure* calculations, are suitable for investigating the monetary phenomena of creeping inflation.

The first *National Income ‘Blue Book’* included the following definition in its introduction: “The National Income is a measure of the value of goods and services becoming available to the nation for consumption or adding to wealth. It may be considered either as a sum of incomes or as a sum of expenditures. From the first point of view, the national income is the total of incomes of all the United Kingdom residents (including institutions such as British Companies and the British Government) so far as they are derived from current economic activity, i.e. derived from a contribution to ‘production’ in its widest sense”. [13]

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13 *National Income and Expenditure 1946-1951*, HMSO, London. Published in August 1952.

Briefly, then, the factor incomes plotted on Chart 3, when added together and after allowing for stock appreciation, give the Gross Domestic Product (GDP) at factor cost. The GDP plus net property incomes from abroad gives the Gross National Product (GNP) at factor cost.

The *Blue Book* introduction continues: “The National Income may also be regarded as being ‘generated’ by certain expenditures, chiefly expenditures on goods and services; this approach is fundamentally consistent with the first.”

These expenditures when added together total either the GDP or the GNP at market prices, and the adjustment to factor cost is achieved by deducting taxes on expenditure and adding subsidies.

The two methods of calculating the GNP at factor cost usually show some discrepancy, but after allowing for this and deducting capital consumption the National Income figure is obtained.

This system of national accounting resolves the very complex methodological problems in a satisfactory manner for the purpose of providing “a measure of the value of goods and services” useful for comparison of either one year with another, or internationally. But persistent inflation is a monetary phenomenon; a prices and incomes policy is a monetary policy; their investigation requires rather different concepts from those apt for calculating the national income.

The factor cost concept is unsuitable since, among other things, it excludes net taxes; that is, it includes subsidies, which are part of government expenditure, but excludes taxes on expenditure, which form part of government income. The market price concept is also unsuitable as it includes net taxes; that is, it includes taxes on expenditure but excludes subsidies. For the purpose in hand, taxes on expenditure and subsidies must both be taken into account, as they are mostly designed to have a direct effect on prices and on the balance between classes of income. For example, an increase in the rate of purchase tax may be designed to raise prices and so reduce the internal purchasing power of the pound.

Further, such an increase may also increase the government's tax income which, in turn, may be used to cover an increase in government expenditure, so changing the whole picture.

The concepts of both GDP and GNP are unsuitable because, when calculated by the expenditure method, only the value of the physical increase in stocks and work in progress is added in, while by the income method a deduction is made in respect of stock appreciation. However, when considering monetary phenomena or a monetary policy, the book value is of importance, as in normal everyday transactions.

To obtain a satisfactory estimate of total money claims for our purpose, aggregate incomes will not add up to GDP, GNP, or the national income, but to what may be described as total claims to the national product. Total claims may be calculated by either the expenditure or income method; and after allowing for the residual error between the two, the balancing item will be the difference between the categories, *Exports and property income from abroad*, and *Imports and property income paid abroad.* [14]

Most discussions of the cost inflation theory, and of policies derived from it, lay great emphasis upon wages. Wages, in fact, account for less than 40% of the total incomes of persons, and the division between wage earners and salaried employees has little social significance today.

As a percentage of the total occupied population, wage earners have been declining for many generations; during the past fifteen years their estimated number employed in manufacturing industry has fluctuated only narrowly, while the estimated number of salary earners in the same industry has increased by 50%.[15]

Keynes used the term 'wages' to include salaries, but today it is probably much clearer to use different terminology to cover both

14 See also: Sir John Hicks, *After the Boom…* Occasional Paper No. 11, I.E.A., London, 1966. Table 1, p.9.

15 E. H. Phelps Brown and P. E. Hart, *The Share of Wages in National Income*, The Economic Journal, June 1952.

wage and salary earners, for to limit the discussion to wages only in this technological age is unrealistic. [16]

For this purpose the CSO *Blue Book* classification of *Incomes from employment* readily suggests itself, but on closer inspection is not sufficiently exclusive. It includes, for example, the employer's National Health and Insurance contributions, so that any increase in these contributions duly appears as an increase in incomes from employment, but in reality, the employee's income is unchanged, whereas government's income has been increased at the expense of the employer. Indeed, it is difficult to follow the logic of including such an item at all in the calculation of the GDP at factor cost, especially as it has also been decided to include the SET (Selective Employment Tax) in the category of taxes on expenditure. [17]

The item is not insignificant. Of the increase at current prices of GDP at factor cost during the 1960s, about 5% may be accounted for by the increases in these employers' contributions.

Both PAYE and employees' contributions to National Health and Insurance are also included as income from employment, but as they are deducted at source, they are more properly considered as government income.

The CSO term *Incomes from employment* covers all incomes that arise as a consequence of the relationship between employer and employee (excepting now the Selective Employment Tax); that is to say, it is an estimate based on employers' expenditure. This is the fallacy in many statistical time series covering wage rates and earnings, that while purporting to show incomes, they are in fact based on employers' expenditure.

Today, however, an ever-widening gap has opened up between employers' expenditure and employees' disposable income, shown on Chart 4 overleaf, and there is ample evidence to suggest that the difference is taken into account whenever the pay bargain is struck between employer and employee.

16 J. M. Keynes, *op. cit.* Bk. II, Ch. 4, p.41.

17 *Economic Trends*, HMSO, London, January 1967. p.XI.

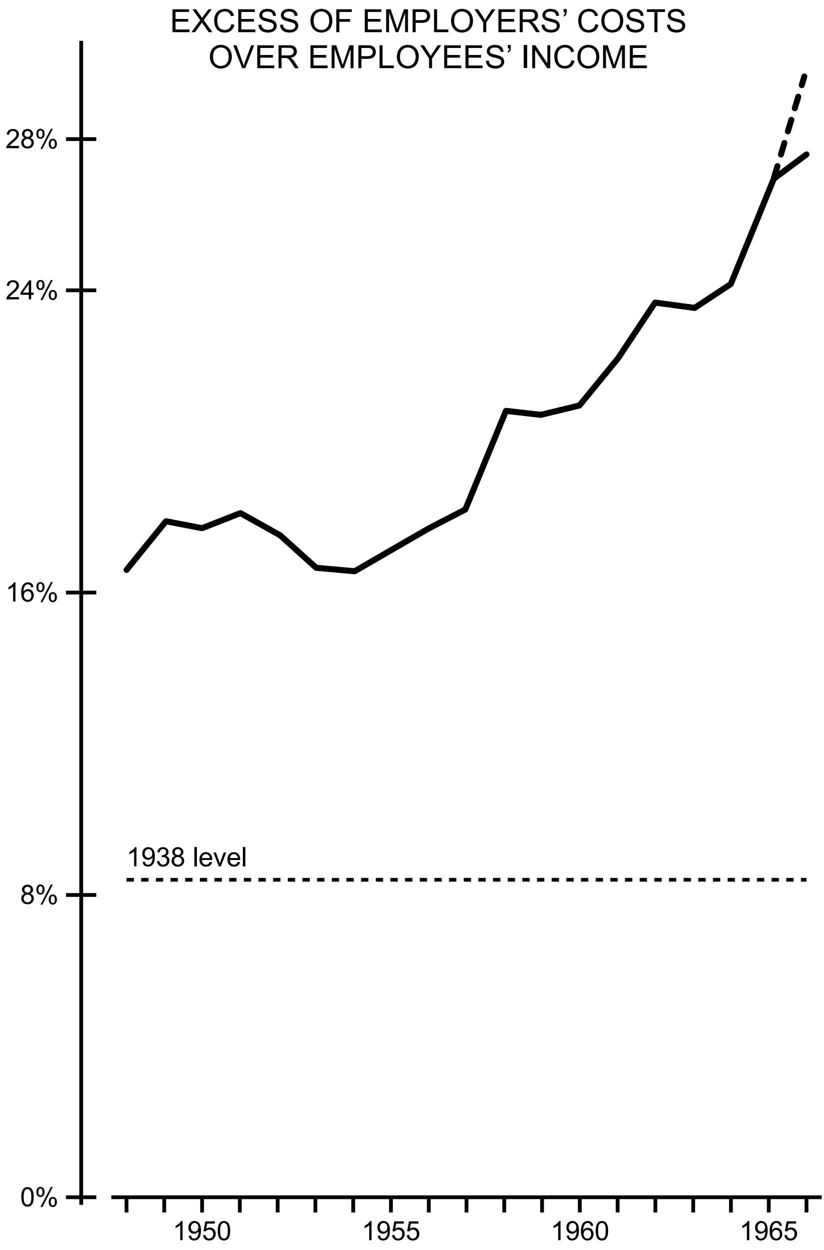
EXCESS OF EMPLOYERS' COSTS
OVER EMPLOYEES' INCOME
28%
24%
16%
8%
0%
1938 level
1950
1955
1960
1965

Chart 4

In testing the cost inflation theory Keynes' alternative definition of factor cost–that it is "the same thing looked at from the point of view of the entrepreneur, as what the factors of production regard as their income"–has a precision lacking in modern usage, for it is disposable income that is of importance, especially if the theory is to be used as a basis for government policy. [18]

The results of taking all of the above objections into account are shown on Charts 5 and 6 overleaf, where:

Civilian Employees' Income is 'Income from employment' [19] less taxes on income, National Health and Insurance contributions, and the pay of H. M. Forces. It is the same quantity as 'Income from civilian employment', forming part of Item 35, Table 9 in the 1966 *Blue Book*.

Other Income arising from economic activity includes all other factor incomes, [20] less taxes on incomes and National Health and Insurance contributions.

Tax Revenue is the total of taxes on expenditure, taxes on income, and National Health and Insurance contributions. It does not show total public authorities' income, since trading surpluses and the like, which accrue to public authorities by reason of their economic activity, are included within *Other income*. What it does show is the claim to the national product which public authorities are able to exercise by reason of a legal power to levy taxation. [21]

Total claims to the national product represents the aggregate of the above three items.

The first point illustrated by these two Charts is that, while in monetary totals civilian employees' income has risen every year since 1948 (Chart 5), no trend is evident as a proportion (Chart 6).

18 J. M. Keynes, *op. cit.* Bk. II, Ch. 4, p.23.
19 *National Income and Expenditure*, HMSO, London, 1966. Reference 13.
20 *Ibid*. References 13, 14, 15, 16, 17, 18, 19 and 23.
21 *Ibid*. References 8.9, 33 and 49.

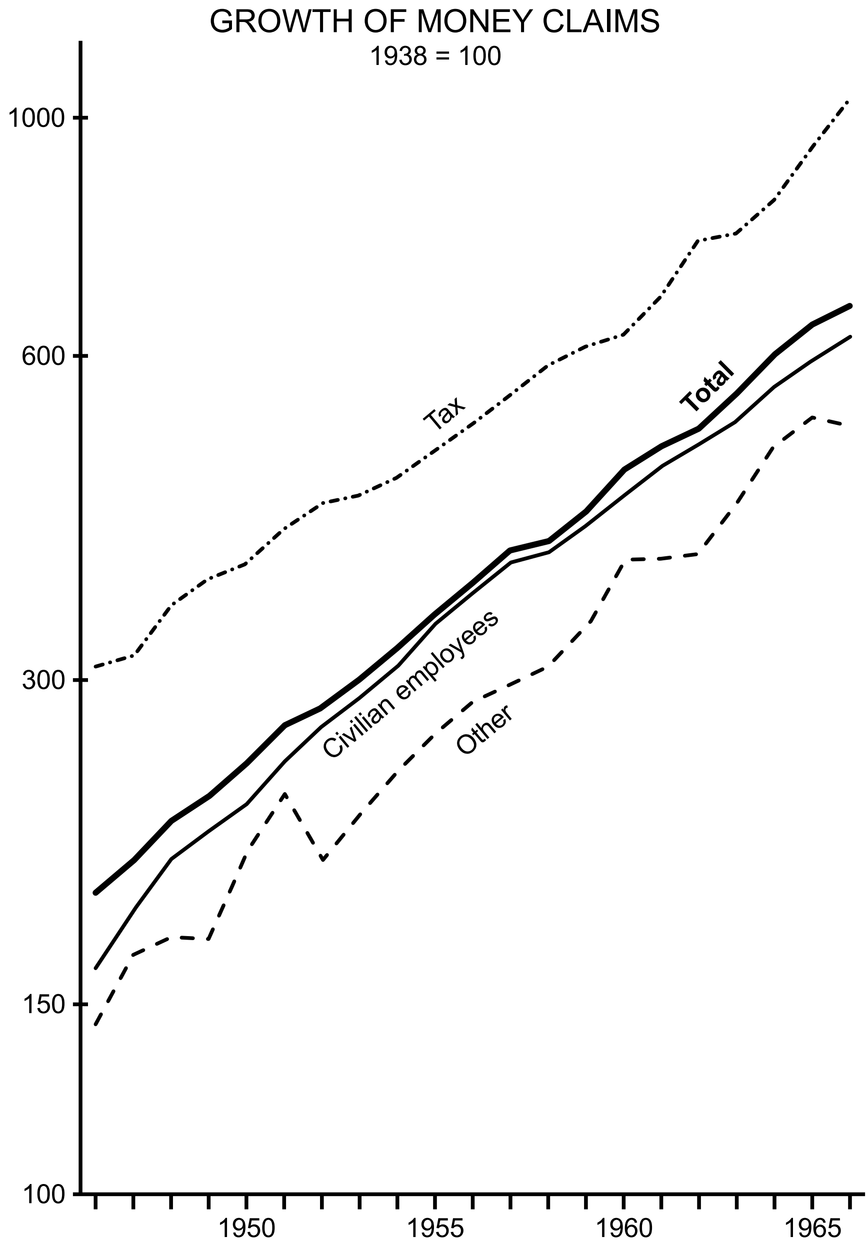
GROWTH OF MONEY CLAIMS
1938 = 100
1000
600
300
150
100
Tax
Total
Civilian employees
Other
1950
1955
1960
1965

Chart 5

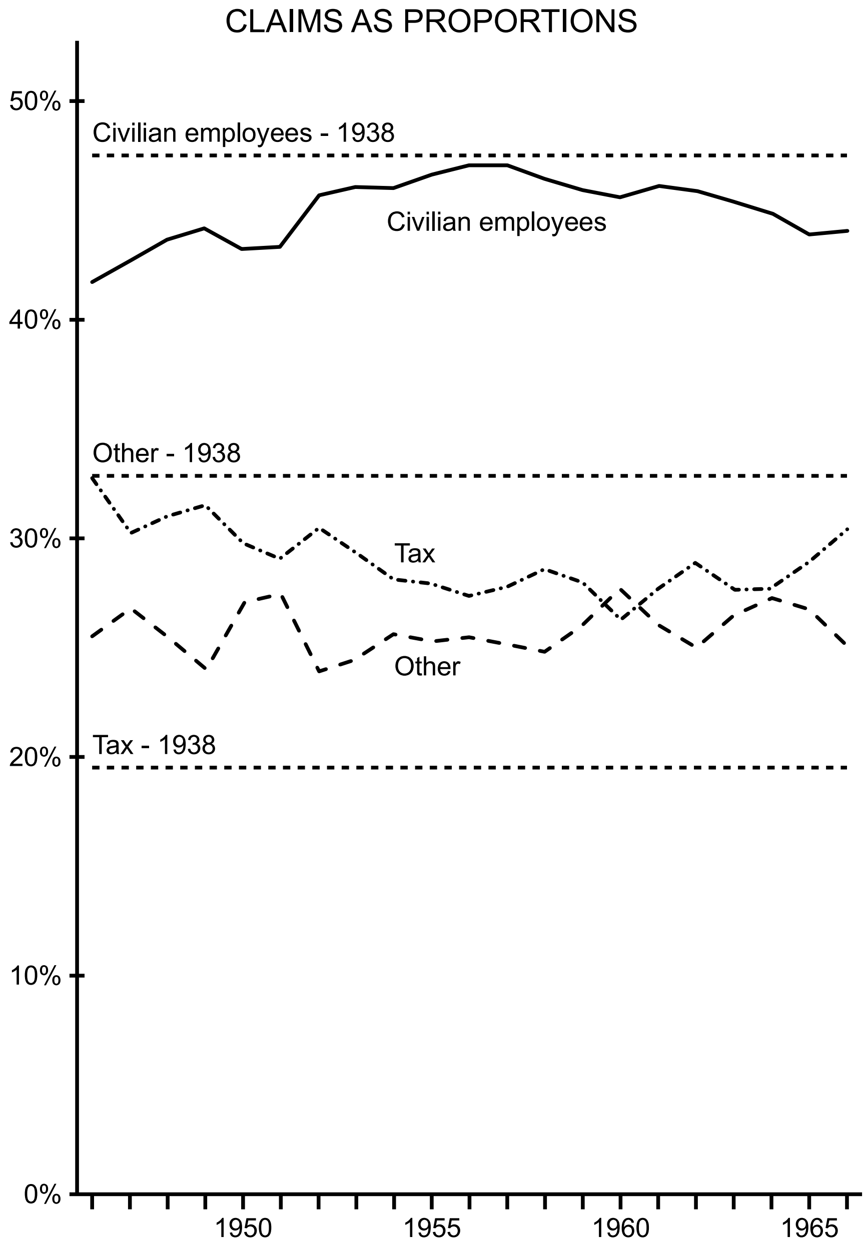
CLAIMS AS PROPORTIONS
50%
40%
30%
20%
10%
0%
Civilian employees - 1938
Civilian employees
Other - 1938
Tax
Other
Tax - 1938
1950
1955
1960
1965

Chart 6

This point is in line with Professor Phelps-Brown's established findings that, since 1870, wages have fluctuated narrowly around about 40% of what he describes as the 'Home Produced National Income'. The results on Chart 6 show civilian employees' income fluctuating around a mean of about 45% of total claims. [22]

The second point is that while tax revenue in monetary terms has also increased year by year (Chart 5), it also shows a marked increase, as a proportion, of about 50% when compared with 1938 (Chart 6). As civilian employees' income appears relatively stable as a proportion, it follows that this upward shift in tax revenue has been at the expense of other incomes. It is interesting to note, in relation to the balance of payments, that the period 1956 to 1958, during which a surplus was achieved, coincided with the post-war peak of tax revenue as a proportion of civilian employees' income, and immediately followed a four-year period, 1952 to 1956, during which tax revenue fell as a proportion of total claims.

Thirdly, since, as shown on Chart 5, the rate of growth from 1938 of both total claims and civilian employees' income has only varied fractionally, with the two lines lying very close together, it follows that the rate of increase in production and the growth of civilian employees' income have also kept in step, bearing in mind the prevailing conditions of declining internal purchasing power of money (Chart 1). That this is so, rather than the popular belief that employees' income is outstripping production, is reinforced by the results shown on Chart 6. For, if employees' income is outstripping production, then the chart would show an increase as a proportion, whereas it shows that between 1948 and 1966 employees' income has never reached so high a proportion as in the year 1938, and has been declining as a proportion every year since 1961.

These results also suggest that wage and salary negotiations are less subject to 'money illusion' than is commonly assumed, and that a more important determinant is disposable real income.

22 E. H. Phelps Brown and P. E. Hart, *The Share of Wages in National Income*, The Economic Journal, June 1952. Table 1.

Certainly, Charts 5 and 6 do not lend immediate support to the conclusion that labour costs may be an active force in the national malaise of steady inflation. Despite this evidence, many advocates of policies derived from the cost inflation argument rest their case upon costs per unit of output.

On Chart 7 are plotted on a logarithmic scale indexes of money costs per unit of output. Here, *Employers' costs* is the same as the CSO classification 'Income from civilian employment'. From this item all payments made by the employer direct to the government, such as National Health and Insurance contributions, employers' PAYE, etc. are shown as the *Tax charge,* while *Employees' income* is the same item as *Civilian employees' income* on Charts 5 and 6.

Employers' costs are shown to have increased every year from 1948, and by 1966 have risen by 98%, or just over 100% including the Selective Employment Tax (SET). Employees' income is also shown to have risen every year, although more slowly since 1954, so that by 1966 it has increased by only 80% over 1948. The tax charge, whilst more erratic, is shown as rising sharply, and by 1966 is up by 208% compared to 1948, or by 232% if SET is included.

Under conditions where the purchasing power of money is falling, evidence that the money costs per unit of output of any particular factor are rising is not proof that the particular factor is creating or adding to inflationary pressures. Real costs must also be considered. If the real costs per unit of output of any particular factor are rising under such conditions, then its money costs must be rising, and it is conclusive that the particular factor is at least adding to general inflationary pressures. However, if under such conditions, real costs per unit of output are falling irrespective of its money costs, then that particular factor is absorbing, rather than adding to or creating inflationary pressures.

Chart 8 shows indexes of real costs per unit of output for the same classifications as on Chart 7. *Employers' costs* shows a rising trend from 1953–1954, to the extent that by 1966 it was 6% up on 1948, or 7½% including SET.

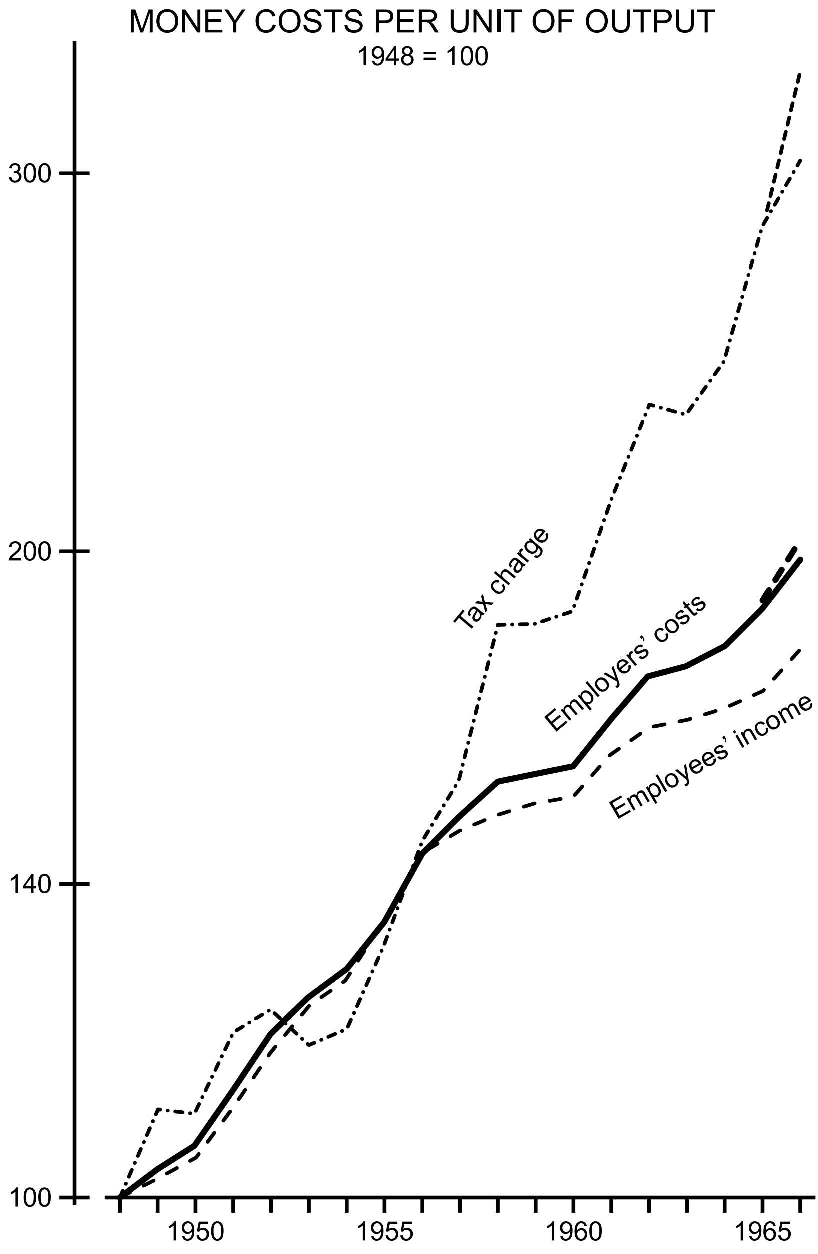
MONEY COSTS PER UNIT OF OUTPUT
1948 = 100
300
200
140
100
1950
1955
1960
1965
Tax charge
Employers' costs
Employees' income

Chart 7

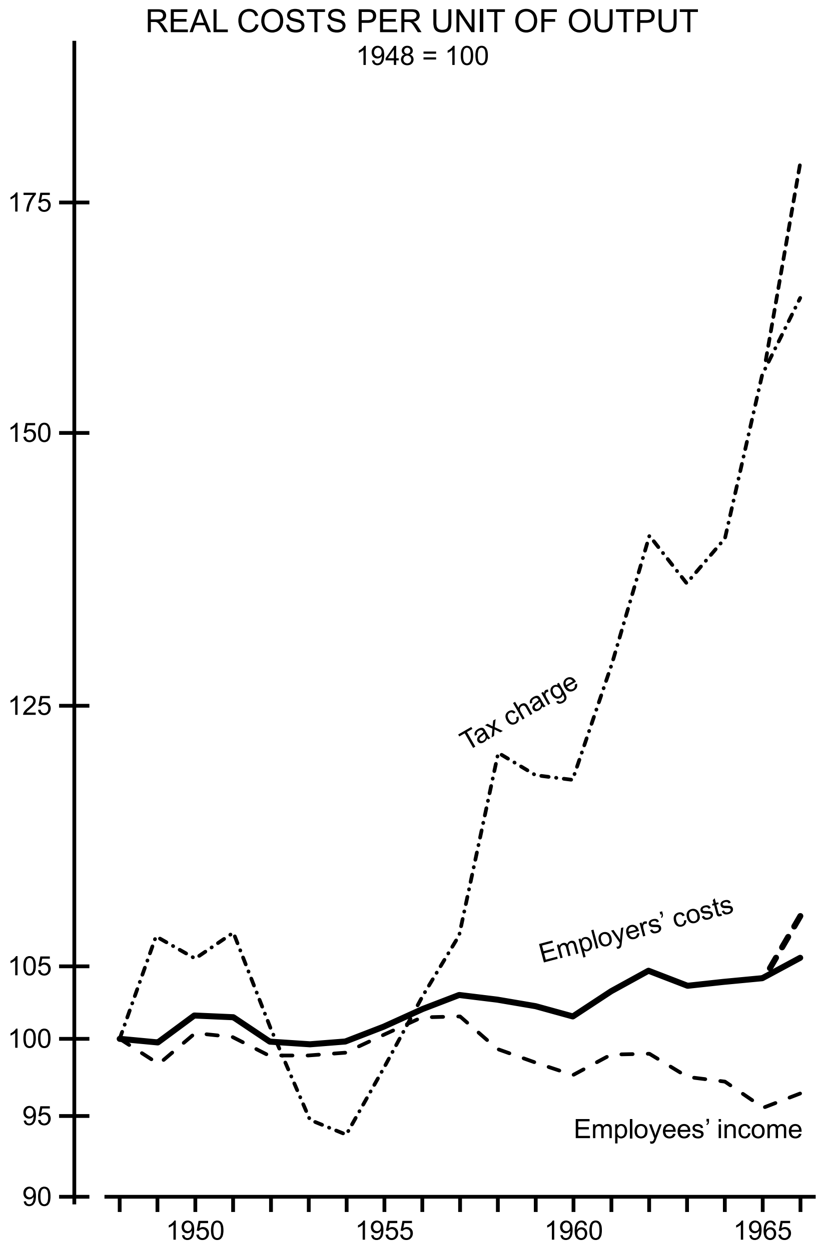
REAL COSTS PER UNIT OF OUTPUT
1948 = 100
175
150
125
105
100
95
90
Tax charge
Employers' costs
Employees' income
1950
1955
1960
1965

Chart 8

This rising trend of employers' costs per unit of output appears to result from the sharp increases in the tax charge that have taken effect since 1954, as between 1954 and 1966 the tax charge index rose by 90%; relative to 1948, the tax charge was up 78% by 1966.

The index of employees' income shows over the past ten years a tendency to fall, and in 1966 was a little over 3% down on 1948.

Certainly, the result of the analysis lends no support to the cost inflation argument in so far as it rests on either general increases or a rate of change of employees' income. Fluctuations apart, in these post-war years, employees' money income has barely kept in step with rising production and rising prices.

Over the past decade employees' income has tended to fall in terms of real costs per unit of output, and to that extent it has absorbed rather than created inflationary pressure; but the effects of this have been masked from employers by the sharp rises in the tax charge. Employees' income, by reason of its stability, may be held to be a good conductor of inflationary forces, but it is not valid to suggest that it has been, at least for some years, an active force adding to the persistent post-war inflationary pressures.

If the cost inflation theory is to be offered as an explanation for persistent inflation, it must be on the basis that the active force inflating costs in the United Kingdom is taxation. Not only did the burden on employers and employees double in terms of real costs per unit of output during the war years, but it has doubled yet again in the post-war era.

Further, total tax claim as a proportion of the national product has been maintained at a level about 50% above that prevailing before the Second World War. In monetary terms, in 1966 (the last full year before devaluation), tax revenue was three times that of 1948 (the last full year before the first post-war devaluation), and over ten times what it was in 1938. [23]

Many advocates of the demand inflation explanation, however, maintain that this high level of taxation is necessary.

23 See Chart 5.

IV

Demand Inflation

The demand inflation argument holds that the main force making for persistent inflation arises from aggregate demand being greater than the economy can satisfy. In *How to Pay for the War*, Keynes applied a straightforward demand-led inflation analysis to the then urgent problem of the wartime economy. [24]

The kernel of his argument was simple: money incomes being generated by the war effort were not being balanced by goods and services coming forward on to the market, and rapid price inflation was inherent in such a situation. His proposals were practical for the time: defer part of the money incomes until after the war, and not only would the danger of wartime inflation be minimised, but also the danger of a post-war depression.

In part, Keynes' proposals were accepted, and post-war credits and a variety of national savings schemes instituted. Unfortunately, in the ensuing quarter of a century, those formulating economic policy have forgotten that Keynes called his book 'How to pay for the war', and not 'How to pay for the peace'.

More recently, Professor Tom Wilson has set out a definition of inflation that is generally acceptable to most advocates of the demand inflation theory, stating: "Inflation occurs because the total claims to a nation's resources exceed what is available to meet them; it is therefore a symptom of inconsistency, of a failure to constrain competing monetary demands within the limits set by real resources." [25]

There are also many popular guises shielding this point of view: 'demand-pull' inflation; too much money chasing too few goods; attempting to live beyond our income; and so on.

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24 J. M. Keynes, *How to Pay for the War*, Macmillan and Co., London, 1940.

25 T. Wilson, *Inflation*, Basil Blackwell & Sons, Oxford, 1961. p.1.

It is held that the present high level of taxation is justified and necessary since taxation, by reducing personal incomes, reduces demand. "Mopping up excess demand" is the catch-phrase. It is popular with Ministers, being used to shift the responsibility for increases in taxation on to the taxpayer, on the grounds that the general public refuse to save a large enough proportion of their income, so they must be forced to save by means of penal taxation.

Echoing his predecessors, the Chancellor of the Exchequer in his 1966 Budget speech said: "The message is clear: more savings, less tax." And for 1968 we were promised a "tough budget".

Keynes, in his *General Theory* said: "The relationship between the community's income and what it can be expected to spend on consumption… will depend on the psychological characteristic of the community, which we shall call its *propensity to consume*." [26]

The first report of the new Council on Prices, Productivity and Incomes stated in its conclusions that "The country has pursued during the post-war period a number of objectives arising naturally from the circumstances of the time, and in themselves desirable, but making in aggregate a greater demand on the industry and thrift of its citizens than they have had the power or the will to satisfy. This has shown itself in an abnormal pressure of monetary demand for both consumer and capital goods and services, which has been the main cause of the rising trend of prices and money incomes." [27]

In this conclusion, the Council appears to have come down firmly in support of the demand inflation explanation, which rests on the existence of excess aggregate demand.

When translated into practical politics, however, there appears to be a considerable confusion between the concept of aggregate demand, and the Keynesian psychological characteristic.

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26 J. M. Keynes, *The General Theory of Employment, Interest and Money*, Macmillan and Co., London, 1936. Bk. I, Ch. 3, p.28.

27 Council on Prices, Productivity and Incomes, *First Report,* HMSO, London, 1968. p.51.

Aggregate demand includes consumption, investment, and all government spending. More personal savings necessarily implies less consumption and a reduction in the propensity to consume, but not necessarily a reduction in aggregate demand if investment and government spending take up more than the slack.

Furthermore, a reduction in the private sector's propensity to consume will not warrant a cut in taxation, which is dependent on lower government spending, unless of course it is intended to run a budgetary deficit and increase the National Debt.

Keynes' analysis leads to the conclusion that if the proportion of current income being spent on the consumption of goods and services is greater for the public authorities than for the rest of the community, then the community's propensity to consume will be increased by an increase of taxation. In other words, a situation of 'less tax, more savings' will exist. [28]

A policy of high taxation may however reduce the amount spent on consumption by persons and may even reduce, in terms of their disposable income, their individual propensity to consume (though this is unlikely at the current high rates of taxation), but it will not reduce aggregate demand if the proceeds are used to finance government spending.

Indeed, if the public authorities' marginal propensity to spend is greater than that of the rest of the community in respect of both consumption and investment spending, then higher taxation will increase aggregate demand, and a situation of 'less taxation, less aggregate demand' will exist.

The relationships between income and expenditure for various sectors of the economy are shown on Charts 9, 10, 11, 12 and 13.

A division is made between the private sector plus the public corporations (Chart 10), and the public authorities (Chart 11).

The reason for this division rather than the more common usage of private sector and public sector is, firstly to isolate the public authorities as such; and secondly because, although all the public

28 More accurately, the community's marginal propensity to consume.

corporations fall within government control, they are, at least in terms of Acts of Parliament, under commercial pressures similar to those exerted on companies, and the purpose of their investment is likewise to improve production, efficiency and profitability.

On these five charts the horizontal axis represents incomes and the vertical axis represents spending; along the diagonal, income equals spending. The charts are on a log-log scale, so the trend of the income-spending relationship is apparent on visual inspection.

If the proportion of income being spent at any level of income is constant, then the trend line is parallel with the diagonal; if the trend is less than 45°, then the higher the level of income the lower the proportion likely to be spent. Conversely, if the trend line is greater than 45°, the higher the income the greater the proportion that will be spent.

The income and expenditure figures are all deflated by the CSO price index for final goods and services sold in the home market, as shown on Chart 1.

On Chart 9, *Income* is taken as personal disposable income; that is, the income of persons, net of income and social security taxes.

Expenditure is consumer expenditure, plus gross domestic fixed capital formation and the total increase in book value of stocks and work in progress. The period plotted is 1948 to 1966 inclusive.

The chart shows that not since 1955 has any excess demand in the economy originated in this sector. There is clearly a trend for expenditure to decrease as a proportion as income rises; that is, for the marginal propensity to spend to be somewhat lower than the average propensity to spend.

In 1966 the average propensity to spend has a value of just less than 0.97. The plots for the last four years, 1963 to 1966 inclusive, all fall either on or very close to the trend line, and for these years the marginal propensity to spend has a lower value of 0.88.

This means that, at constant prices, for every additional £1 of disposable income, the personal sector may be expected to spend about 17/8d. (88p per £1) and to save 2/4d. (12p per £1).

INCOME – EXPENDITURE RELATIONSHIPS

Persons

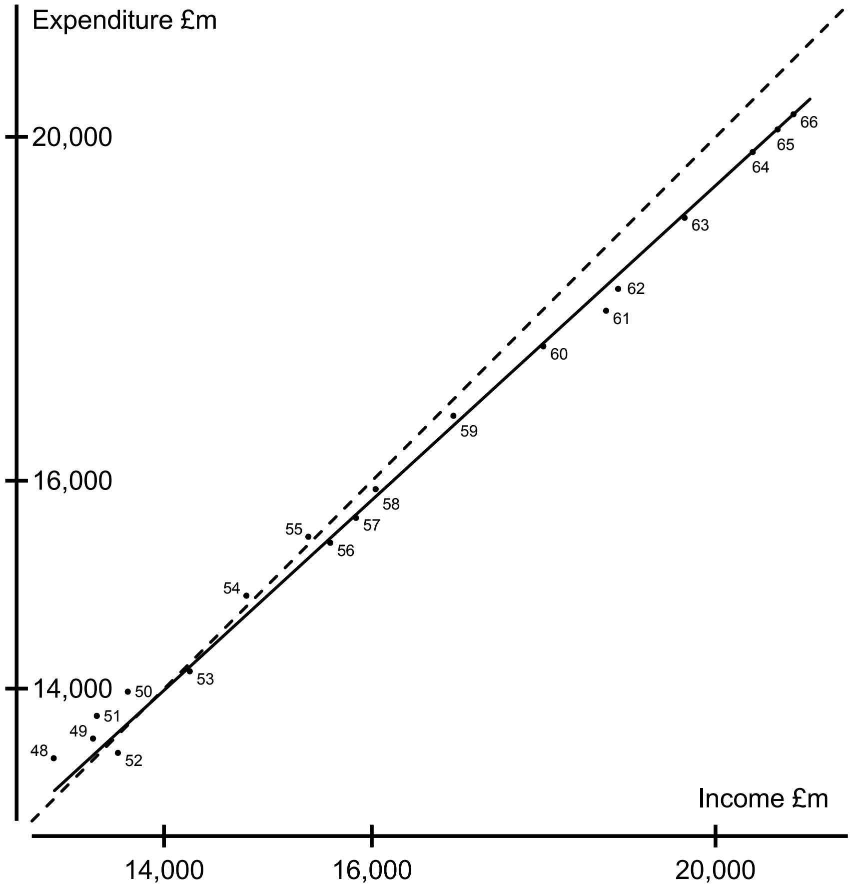

Chart 9

INCOME – EXPENDITURE RELATIONSHIPS

Private Sector and Public Corporations

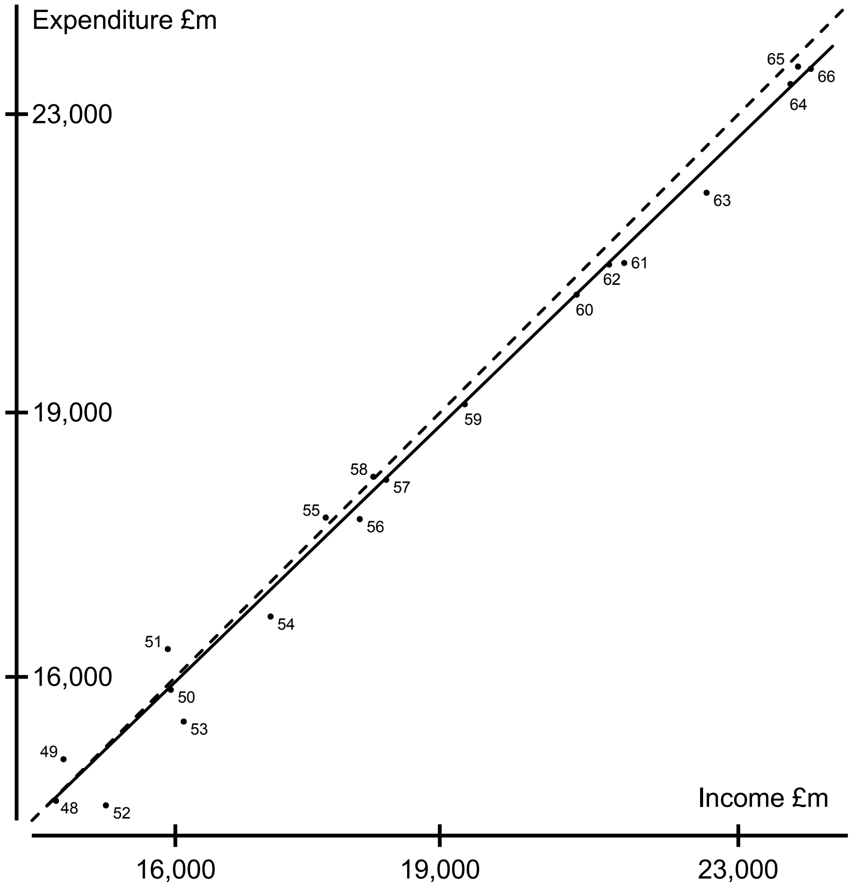

Chart 10

INCOME – EXPENDITURE RELATIONSHIPS

Public Authorities

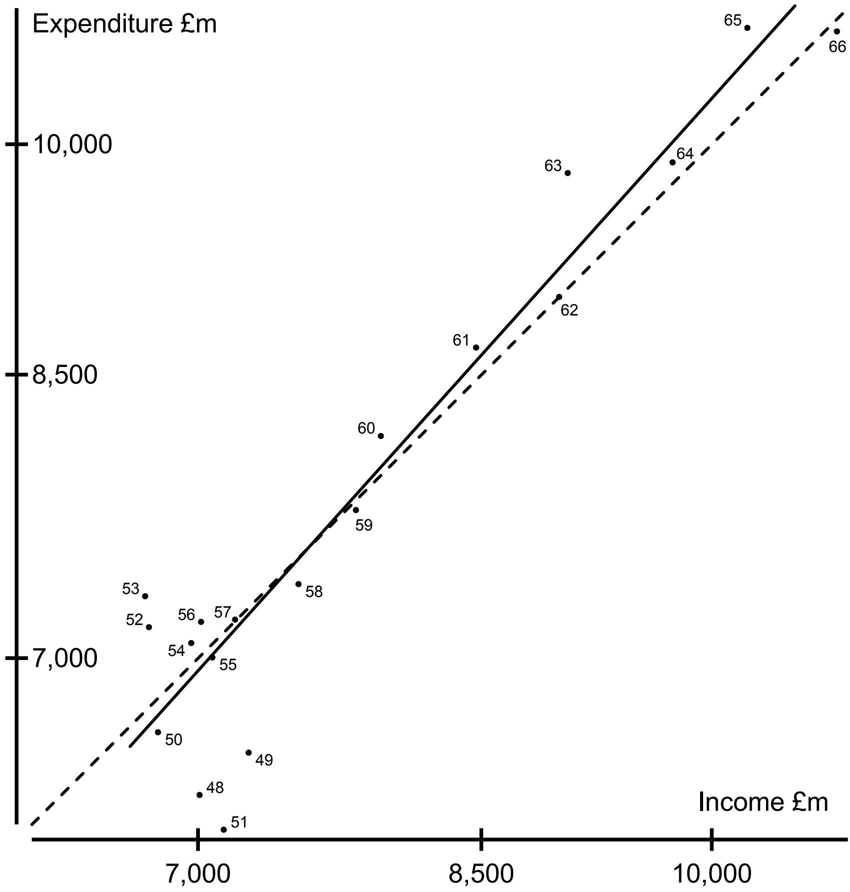

Chart 11

Chart 10 covers income-spending relationships for the private sector and public corporations for the period from 1948 to 1966 inclusive. Income is taken as personal disposable income (as for Chart 9) plus undistributed corporate income after tax. Spending is consumer expenditure plus private sector and public corporations' gross domestic fixed capital formation and increase in book value of stocks and work in progress. As can be seen, the effect of now including corporate income and spending is to increase the average propensity to spend as compared with Chart 9.

This is to be expected, since personal savings are an important source of finance for corporate investment; further, there is a large body of opinion holding that the public corporations should also be forced to rely upon personal savings to a greater extent, or even entirely. The chart also illustrates the effect of the fall-off in profits in 1966 with the average propensity to spend moving from 0.98 in 1965 to 0.99 in 1966. Overall, however, the picture is similar to that for persons, in that a trend remains for spending to decrease as a proportion as income rises, with a plot indicating excess demand for 1955. Over the last few years the trend line shows a marginal propensity to spend of 0.93.

Chart 11 shows the income-expenditure relationships for public authorities for the years 1948 to 1966 inclusive. [29]

The plots are more widely scattered than those on Charts 9 and 10. For the first eight years no particular linear trend is apparent, but from 1956 there is a marked tendency for spending to outrun income. In ten of the nineteen years plotted the average propensity to spend is greater than unity, and in the 1960s, only the year 1966 falls below the diagonal with an average propensity to spend of 0.995. The 1966 result was achieved by increasing income relative to spending; income was raised by £1,318 million, whilst spending increased by £524 million at current prices.

29 The income of public authorities is almost entirely tax revenue, but it also includes the following items: rental income, trading income other than that of public corporations, interest and dividends, etc.

The relationship between 1965 and 1966 is very similar to that between 1963 and 1964, when at current prices income was raised by £1,063 million whilst spending went up by £382 million. On this showing there is little ground for assuming that the trend of spending outrunning income so apparent over the past decade has been radically changed, or that a relationship similar to that of 1964 and 1965 (when, at current prices, thirty shillings was spent for every additional pound raised in income) will not re-appear. The chart indicates that at constant prices one may expect public authorities to spend 22/6d. for every additional 20/0d. received.

Charts 12 and 13 show the breakdown of Chart 11 between the central government and local authorities. It must be borne in mind that some items, such as government grants to local authorities, appear on one chart as expenditure and on the other as income. In Chart 11 such items are excluded.

On Chart 12 income and expenditure relationships are plotted for what is classified by the CSO as the local authorities' current account. All of the plots lie very close to the trend line which is parallel to the diagonal and apart from the first four years are fairly equally spaced: a model of financial rectitude. Of greater interest, however, is the total income and expenditure relationship.

It is immediately obvious that in every year total local authority spending exceeds income by a substantial proportion. This may be divided into three quite distinct periods. Between 1948 and 1951, no particular trend is apparent. From 1952 to 1958, the trend is for income to increase faster than spending, while during the 1960s total spending has increased faster than total income. [30]

In considering this, however, it is well to remember that the two main items making for local authorities' excess of spending over income are housing and education, and in both they are subject to considerable pressure to spend from the central government and from their own electors.

30 See also: Sir John Hicks, *After the Boom…* Occasional Paper 11, I.E.A., London, 1966. Ch. IV.

INCOME – EXPENDITURE RELATIONSHIPS

Local Authorities

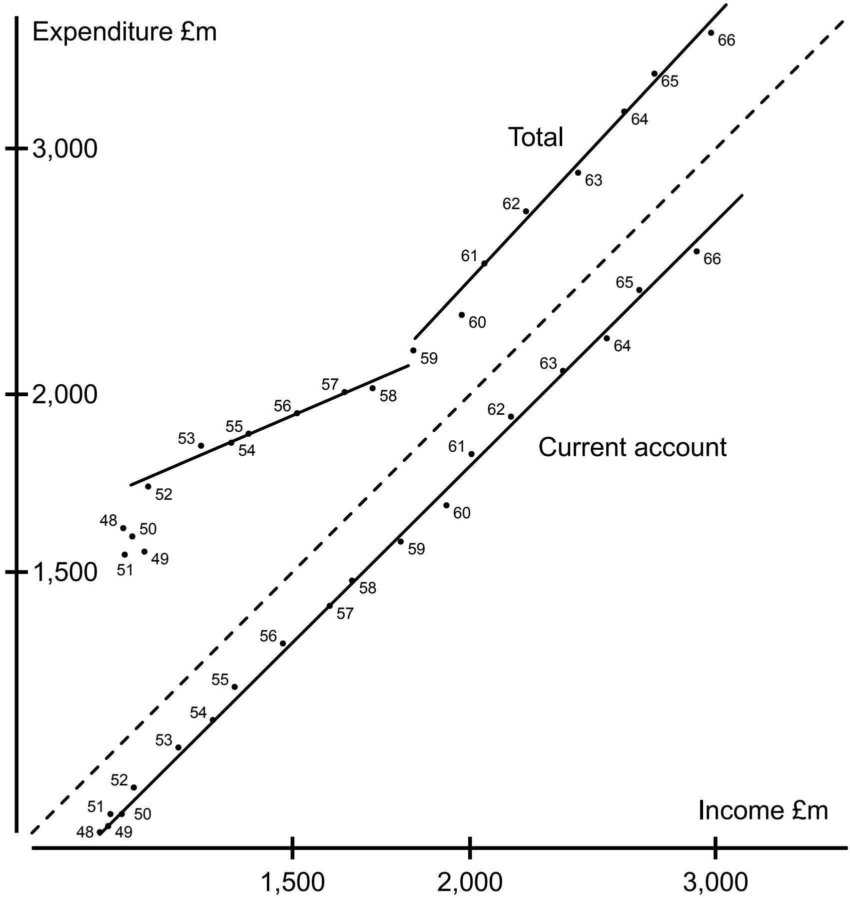

Chart 12

INCOME – EXPENDITURE RELATIONSHIPS

Central Government

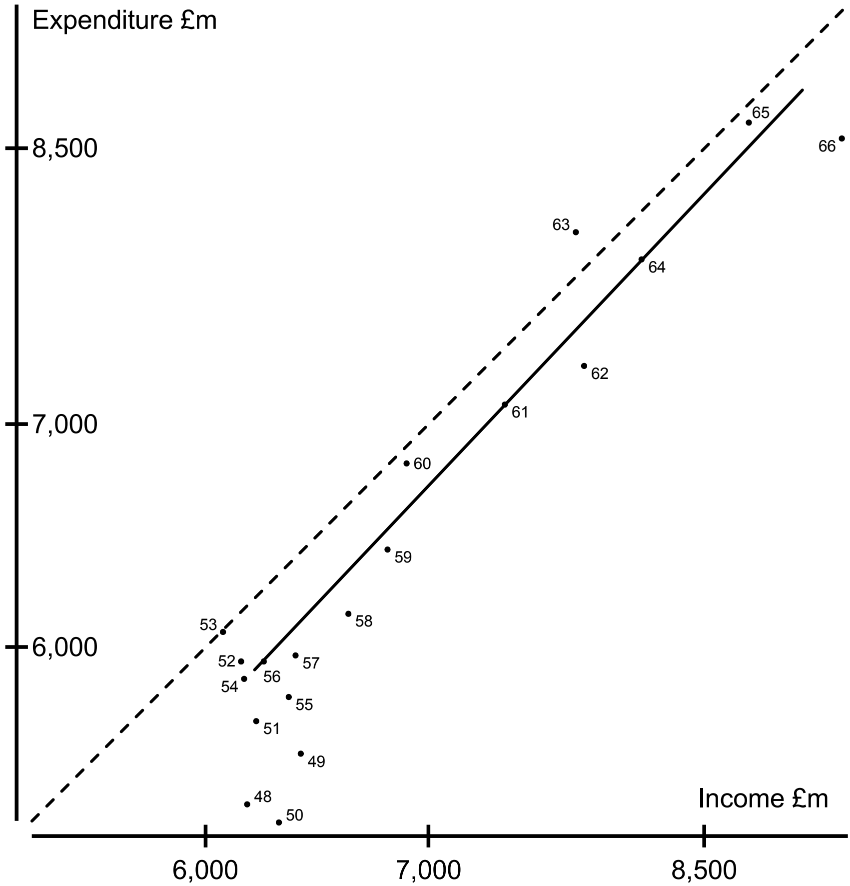

Chart 13

Further, it is not correct to conclude from Chart 12 that local authorities are directly contributing to an excess of demand in the community, as their deficiency is mostly covered by borrowing from the central government or the private sector. [31] Between 1956 and 1964 the central government was not an important net source of local authority funds.

The income-spending relationships of the central government, as shown on Chart 13, may be divided into two periods. During the first eight years, from 1948 to 1955, no particular trend emerges. At constant prices spending and income were relatively stable; in 1956 income was still below the 1949 level, and spending below the 1953 level. Since 1956 both income and spending have risen rapidly, and although only in 1963 did spending exceed income, there is a recent tendency for spending to outpace income.

As in Chart 11, there is a similarity in relationship between the plots for 1963–1964 and 1965–1966. It is noticeable, however, that the cut in spending is greater, and the increase in income is less, between 1963–1964 than between 1965–1966.

These changes only appear as variations on a general trend that has become apparent over the last decade; it is grandiose to speak of them as 'regulating the economy', or to expect as a result of such variations the correction of a 'fundamental disequilibrium'.

For the demand inflation explanation of the declining internal purchasing power of sterling to hold good, there must be excess aggregate demand, and a comparison of the five charts leads to the conclusion that if there is such excess aggregate demand, then the pressure must be coming from public authorities, in all probability largely (albeit indirectly) from the local authority sector.

A further comparison of the results shown by these five charts indicates that a point has now been reached where not only is the average propensity to spend and the marginal propensity to spend of public authorities higher than it is for the rest of the community,

31 Lord Aberdare and others, *A Programme for National Recovery*, July 1967. Signatories to the Programme included Colin Clark and Edward Holloway.

but also a state has been reached where their marginal propensity to spend is, in its long-term trend, greater than unity.

The only possible conclusion to be drawn from this is that we have reached a situation where, over a period of years, increases in taxation will tend to increase rather than reduce aggregate demand. As has been shown, we now have a pattern of public expenditure (including loan expenditure) apparently of necessity increasing faster than revenue.

Another danger inherent in such a situation of continuing excess demand in the public authority sector, coupled with a consumption demand not reducible beyond certain limits, is that private sector investment will be reduced, particularly in those industries most likely to succeed in export markets. Sir John Hicks has suggested that just such a lack of private investment was in part responsible for the most recent balance of payment difficulties, and certainly the foregoing analysis shows that conditions were conducive. [32]

Without entering into discussion of whether the UK is suffering from cost inflation or demand inflation, from the point of view of economic policy, both arguments lead to the same conclusion. The high level of taxation (or, particularly in the past decade, the high level of public authorities' expenditure, which makes a high level of taxation a necessity) is the long-term active force making for persistent inflation. It therefore follows that any long-term solution must provide for an absolute reduction in public authorities' expenditure so that the level of taxation may be permanently reduced. In the short term, of course, each post-war crisis has been caused by an assortment of factors differing from time to time; and equally, in the short term a number of policies may be effective. For example, the present government's action in devaluing, and the prices and incomes policy, may give a breathing space, but if one heats a gas, it will expand; and although it may be restrained for a time by strengthening the containers, unless the heat is turned off such action is only creating the conditions for a later explosion.

32 Sir John Hicks, *op. cit.* Ch. 2.

V

Public Authorities' Expenditure

The very size of total public authorities' expenditure ensures that, whenever the cutting of expenditure is suggested, the proposal is put to cut out waste. This is a very safe approach for the politician since, in an expenditure of £13,457 million, as there was in 1966, there must be a deal of wastage. A saving of 5% equals the annual income from purchase tax, while a saving of only 2% would enable duties on wines and spirits to be abolished. Such notions have popular appeal; words such as 'efficiency' and 'productivity' are very fashionable, and it appears that the taxpayer will be the beneficiary.

Difficulties arise, however, as to precisely how the economies are to be effected without reducing the services, and in keeping the cost of the checks upon expenditure within the bounds of the expected savings. Further, for backbench or Opposition MPs, the "cut out waste" slogan is doubly attractive, since not only is the charge a safe one but, should the government of the day make a detailed examination of the parts, there is a great opportunity for scoring political points by making out near-irrefutable cases for increases in expenditure.

By concentrating on public wastage and lack of efficiency in government, the fundamental economic issue is avoided. As has been shown, a consistent feature in the UK economy over the past twenty years has been the maintenance of taxation claims some 50% greater as a proportion than those prevailing in 1938. [33]

It has also been shown that successive governments have been forced to pursue this policy of high taxation to meet the ever increasing expenditure of public authorities. [34]

33 See Chart 6.

34 See Chart 11.

Between 1955 and 1966, while consumer expenditure at current market prices rose by 84%, total expenditure of public authorities rose by 116%. For a person or a company, the restraining factor in expenditure is income. Either expenditure must be kept within the bounds of actual income, or it must be carefully spent in a manner calculated to increase income sufficiently to cover it.

It is this restraining force operating through a limited income which encourages, indeed demands, efficiency and economy of expenditure in the private sector; it is this very discipline that is totally lacking in our public affairs.

If local authorities were limited to rates as a source of income, the psychological barrier against high poundage would provide a restraint on expenditure by limiting income. As assessed, however, rates suffer from a serious defect if used for such a purpose. The rateable value of any property depends fundamentally on use; that is, the extent to which it is developed; and is only influenced to a minor extent by local authority expenditure. As matters stand, rate income considerations provide little or no restraint on expenditure.

True, ratepayers are highly sensitive to increases in poundage, but the same people as taxpayers appear ready to provide ever larger grants from the central government. Additionally, the local authorities have become accustomed to borrowing annual sums of a similar magnitude to their rate income to meet what is described as capital expenditure.

Traditionally, the restraint upon central government expenditure is supplied by the members of the House of Commons, but this no longer operates. Since the war, apart from a few pressure groups concerned with particular expenditures, the pressure in the House has been for government to spend more, and members have only raised token opposition to the successive increases in taxation that have necessarily followed.

That such a situation could arise stems in part from the fiction solemnly enacted every year. The preamble to the annual Finance Act states: “We, Your Majesty’s most dutiful and loyal subjects, the Commons of the United Kingdom in Parliament assembled, towards raising the necessary supplies to defray Your Majesty's public expenses and making an addition to the public revenue, *have freely and voluntarily resolved to give* and grant unto Your Majesty the several duties hereinafter mentioned."

The sting is delivered in the tail, as it is also enacted that these 'free and voluntary gifts' may be collected as if they were a debt. There was a period in our history when the sentiments expressed in the preamble to the Finance Act served a useful purpose, but the situation has changed. Today the wording is clearly a fiction, but it is also dangerous, conducive to maintaining an economic climate in which it is almost impossible to restrain public expenditure.

In the thirteenth century, St. Thomas Aquinas reasoned that: "The fellowship of society being thus natural and necessary to man, it follows with equal necessity that there must be some principle of government within the society." [35]

In the twentieth century, few would now disagree, but economic science must go further. It surely follows with equal necessity that there must be some natural basis for taxation, for providing the government with an adequate income. It is a grave condemnation of economic science that public finance should be founded on a fiction. Until the fiction is discarded there can be no final solution to those difficulties stemming from excessive public expenditure; at best one may hope to mitigate the worst excesses.

Within the sphere of mitigation fall most of the proposals aimed solely at cutting public expenditure. The two popular targets for such proposals are defence expenditure, and the paraphernalia of the welfare state.

The defence of the realm is a right and proper matter for government concern, and therefore defence expenditure is a right and proper expenditure. While economic considerations should provide limits for defence expenditure, within those limits foreign policy, rather than economic policy, is the main determinant.

35 *Aquinas – Selected Political Writings*. Basil Blackwell, Oxford, 1959. p.5.

The carrot of expenditure cuts is dangled, often quite falsely, in support of a reduction in our overseas commitments. A reduction in defence expenditure overseas would help to ease the strain on our foreign currency, but so far as defence expenditure in total is concerned it may well be, for example, more expensive to station armed forces in the United Kingdom than east of Suez. [36]

Current expenditure on military defence, although a large item (and, judging from the Ferranti and Bristol Siddeley disclosures, subject to a great measure of waste), is not increasing as fast as many other items as a proportion of current central government expenditure, and has fallen in the past ten years. At constant prices defence expenditure has been increasing slowly over recent years, but in 1966 it was still much less than in 1956. Further, the pay and allowances of the Armed Forces account for more than a quarter of our current expenditure on defence, and therefore any substantial saving would require substantial disarmament. Such matters call for political decisions, and an economist can offer little help.

There is no general agreement that the high cost of running the welfare state is a right and proper public expenditure. [37]

Even so, over the past decade such expenditure has multiplied, and it now accounts for approximately half of public authorities' total expenditure. Most proposals for a reduction in the costs of providing state welfare, or restricting its scope, come from sources other than those responsible for public expenditure. Even during the prices and incomes freeze the present government pressed on with the majority of its welfare schemes. Professional politicians seem to be of the opinion that votes are more likely to be won and held by an extension of state welfare than by lowering taxation.

Until this climate changes, cutting back public expenditure by reductions in this sphere is not a practical proposition. The opinion polls conducted by the Institute of Economic Affairs do indicate, however, a growing body of the electorate preferring lower taxes

36 Sir John Hicks, *op. cit.* pp.14,15.

37 Colin Clark, *Taxmanship*, Hobart Paper 26, I.E.A., London, 1964. pp.15,16.

to more welfare, and economists can assist this climate change by destroying the illusion of ‘free’ services and by offering practical alternative schemes.

One item of central government expenditure rarely singled out for reduction is grants to local authorities. Yet it is one of the most rapidly increasing items in the expenditure of central government; in 1966 it totalled £1,561 million, in 1956 only £566 million, and in 1938 it was only £169 million. Most politicians speak in favour of further increases, and much of the debate between the Labour and Conservative parties at the last General Election was over which party would increase grants the most. The general public look on the idea favourably, accepting the political argument that it will reduce their rates, and most economists follow this general drift. The effect of this is to make local authorities increasingly dependent upon and subservient to Whitehall, since these grants, by reducing direct local accountability, are conducive to wasteful expenditure at the local level, and encourage irresponsibility and apathy at local elections. In the final account, taxpayers pay very dearly in a variety of different ways as a result of their subsidising themselves as ratepayers.

The problem of local finance flows largely from the lack of an adequate, sound and expanding basis for local income. The size and consequence of the lack, snowballing over years, is dramatic.

In 1966 the local authorities’ total expenditure reached £4,518 million, while their income from rates was only £1,353 million. The deficit was made up by grants from the central government of £1,561 million, plus miscellaneous income of £650 million, and by borrowing of £954 million. As shown on Chart 12, this was not an exceptional year.

The total debt of the local authorities, excluding overdrafts and temporary loans, is now in the £12,000 million range, larger than the entire pre-war National Debt. Under conditions of dear money, the burden of this increasing debt is of necessity aggravated by rapidly-mounting interest charges.

An approximate doubling of total debt has meant a trebling of the interest charge. In 1965 interest charged to local authorities' current account totalled £600 million, or 44% of their rate income. In 1956 the figure was £193 million or 35%, and in 1946 it was £61 million or 23% of the income from rates. Local authorities are facing no fiction of public finance, but the reality of bankruptcy. In context this would mean complete central government control and an end to the system of government which only half a century ago was a source of pride, admired by the world. [38]

Oddly, in the face of this situation, local finance is one of the few spheres where it is politically feasible to take remedial action. Many countries have for a long time based local taxation on some form of land tax with apparent success. Site value rating has been the subject of political debate, parliamentary enquiry, private bills and Royal Commissions for nearly a century, but with little result.

The most recent Committee of Enquiry, appointed by the Attlee administration, gave its report in 1952. The majority report of the Committee did not favour the introduction of site value rating at that time, mainly because of the financial system that had been set up by the Town and Country Planning Act of 1947. The system of development charges introduced by the 1947 Act failed to work, and was abolished by the Town and Country Planning Act 1953.

The report of the Committee of Enquiry included this statement: "Any assessment of the product of a site value rate, or of the redistribution in rate liability which might occur, can be made only in the light of a comprehensive test valuation, and we emphasise our conviction that it would be essential to carry out such a test before any decision to introduce a site value rate were made." After the manner of government, no official action was taken.

In 1963, a professional body conducted a pilot survey at Whitstable financed from private resources. The results answered most of the Committee's objections. It was shown that site values were of the same order of magnitude as orthodox rateable values,

38 Sir John Hicks, *op. cit.* p.17.

that the work involved in valuing sites only was much less than by the orthodox method, and that it could be accomplished speedily.

What is of importance to this enquiry, however, is the extent of the redistribution of the rate charge likely to be effected by site value rating. The pilot survey shows that in the case of Whitstable Urban District, and assuming no large-scale exemptions, rates on houses, bungalows, flats and maisonettes would all be reduced by 50% under site value rating compared with the present method. [39]

The main political argument against reducing the size of central government grants to local authorities is, that the increase in rates which would necessarily follow would place an intolerable charge upon householders. On the best evidence available, it appears that the introduction of site values as the basis for the local rate would enable local authorities to double their rate income without any increase in the aggregate rate charge falling upon householders.

In such circumstances the central government grants could be ended. Although such a shift would have little direct impact upon local government finances, undoubtedly there would be much careful pruning of expenditure under the close scrutiny of the local ratepayers who would have to pay the whole of the bill. Costs of providing local services such as housing, schools and sewage farms, would certainly be reduced. A major problem in local affairs is the purchase of suitable land; the rating of site values would increase the quantity of land on the market and deflate its price.

In the matter of housing, if some of the suggestions put forward by Mr. MacRae and Mr. Carmichael were also put into operation, local finance would be relieved of one of its heaviest burdens. [40] [41]

Industry and productivity would also benefit, since housing is widely recognised as a major bottleneck. Lord Robens has recently stated that the coal industry is poised to exploit its potential, but

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39 H. M. Wilks, *Rating of Site Values: Report on a Pilot Survey at Whitstable,* Rating and Valuation Association, London, 20th February 1964.

40 Norman MacRae, *To Let?* Hobart Paper 2, I.E.A., London, 1964.

41 John Carmichael, *Vacant possession*, Hobart Paper 28, I.E.A., London, 1964.

the success of the scheme depends on a redeployment of labour, which requires the building of 25,000 houses. [42]

The Chairman of the City of Oxford Motor Services made the same point when he said: "Unfortunately housing is not available in Oxford or its environs for all who want to work in the city; as a result, many of our employees, although they like Oxford and their job, understandably become disheartened by the unsuccessful search for somewhere to live and return to their families and perhaps unemployment. If redeployment of labour is to mean anything, then surely it must go hand in hand with the provision of housing." [43]

Results obtained from one small town in the south-east of England are not sufficient to form the basis for a policy to cover the whole United Kingdom. But the pilot survey does suggest that the introduction of site value rating as the basis of local taxation would enable the full responsibility for meeting local expenditure to be placed on local authorities and those who directly elect them.

It follows inevitably that local expenditures would be pruned and wastage reduced, while the operation of the rate itself would bring about a reduction in the costs of providing many services.

Further, since site values themselves are dependent in part upon the quality and quantity of public services in the immediate area, local authority expenditure would directly affect their income base.

With a statutory limitation on the poundage to be levied, the possibility then arises of subjecting all local authorities to the same discipline, demanding efficiency and restraint in expenditure, as currently applies in the private sector of the economy.

By itself, however, the reform of local government finances is unlikely to have significant effect in reducing the impact of public authorities' expenditure on the national product.

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42 Lord Robens, *Size and Potential in British Coal*, National Provincial Bank Review, August 1966.

43 W. M. Dravess, Chairman, City of Oxford Motor Services Ltd. Remarks at the 61st Annual General Meeting, 29th March 1967.

Indeed, if site value rating were introduced merely as a means of providing some additional taxation, it would do little or nothing towards solving the fundamental imbalance within the whole of the economy. It is vitally important therefore that any saving made by the Chancellor of the Exchequer from stopping grants to local authorities should be disbursed in such a manner as to reverse the post-war trend of ever-increasing taxation to meet ever-increasing expenditure.

On the basis of the 1966 figures, the reform of local finances would appear as a saving of up to £1,561 million for the central government, thus presenting the Chancellor of the Exchequer with a number of opportunities for tax reductions and reform.

For example, National Health and Insurance contributions totalled £1,797 million in 1966, and although the scheme may have originally been envisaged as insurance, these contributions today form a part of aggregate taxation as much as any other particular item. Employers' contributions are a non-selective (apart from age and sex) employment tax, and it would be more honest and efficient to amalgamate them with SET. In practice, both are paid and collected together, and there would be real advantages in keeping them together in the accounts.

Employees, self-employed, and non-employed contributions are poll taxes. Much is made politically of the regressive nature, as at present levied, of local rates, but these so-called contributions are much more so. For an employee earning £14 a week after PAYE the rate is 5%, for one earning £28 a week it falls to 2½%, and so on. They should, in justice, be abolished. At the 1966 rates this would be a reduction of income to the Exchequer of £895 million, but after adjustment of income tax, the net loss would be less.

Coupled with such a step could also be the abolition of family allowances, making a gross saving of £156 million, plus a further £5 million a year in administration expenses. At least 60% of families currently pay out more in National Health and Insurance contributions than they receive by way of family allowances, and would be better off on balance. Not more than about 15% would definitely incur a loss on balance, and these and any other cases of need could be compensated by increasing the child allowance forming part of unemployment pay, pensions, national assistance grants and tax allowances.

So a start becomes possible, without creating small pockets of hardship, in dismantling the expensive Robin Hood arrangement mistakenly labelled welfare. Saving on administration expenses is important, since these have been growing rapidly. For example, so far as family allowances are concerned, in ten years the total paid out as allowances has grown by 30%, but administrative expenses are up by 80%.

On the basis of the 1966 figures the Chancellor would have had a further £800 million to be used to adjust the employment tax and other company and self-employed taxes. Adjustments and reliefs would be advisable, since the sites used by shops, hotels, public houses, banks, cinemas and offices would become highly rated.

One of the arguments put forward by the Chancellor in support of the SET was that service industries did not in general carry a reasonable share of taxation. A site value rate would remedy this with much finer selectivity. For example, a Cornish hotel would not pay the same weight of tax as one in Piccadilly.

It is incredible that in the face of so many mounting difficulties successive governments have been allowed to remain apathetic to the reform of local finances, since this appears to be a key to the solution. It is now fifteen years since the report of the Committee of Enquiry on the Rating of Site Values was published; fourteen years since development charges were abolished; and four years since the Whitstable Report showed that site value rating might be a practical proposition.

It is perhaps understandable that a Labour government wedded to socialist theory should not wish to promote such measures. Reforming local finances on the lines suggested would strengthen the position of local authorities; while inherent in socialism is the idea of centralised power and control. In this respect the Land Commission Act of 1967 has put the clock back twenty years, for included in the Act through the "betterment levy" is an attempt to appropriate to central government a possible base for an adequate local tax. Many authorities doubt the practicality of the new Act, and the Conservative Party has promised to repeal it upon return to power. [44]

It is difficult to understand why the whole subject remains untouchable as far as Conservative governments are concerned, unless it is that emotions roused at the turn of the century still run strong. Such matters are raised from time to time in the Liberal Party, but their parliamentary members prefer to talk now of the structure of local government, rather than its financial base and its implications for the national economy.

44 D. R. Denman, *Land in the Market*, Hobart Paper 30, I.E.A., London, 1964.

VI

Conclusions

Sir Roy Harrod has recently suggested that, before reaching the final verdict that our tottering economic progress has been due to the inadequacies of the administrative system, we should first ask whether the real fault does not lie in the inadequacies of economic science itself. [45]

While undoubtedly the administrative system has many faults, and there have been many serious political mistakes and missed opportunities, Sir Roy's question is apposite.

As a body, economists have tended to misdirect and confuse the public on important post-war economic questions. Only one or two have consistently drawn attention to the inevitable results of high taxation, at levels such as have been maintained in the United Kingdom during the past quarter of a century.

Economic science is at present inadequate in the realm of public finance, and most economists have nurtured the popular belief that governments have bottomless purses from which they are able to provide security and material welfare.

Politicians and administrators are sensitive to the climate of public opinion; that this climate is conducive to profligate public expenditure is largely the fault of today's economists; changing this climate is the main task confronting economics.

In this paper we have not concerned ourselves with the direct causes of any particular economic crisis, but with the long-term phenomenon of the persistent decline in the internal purchasing power of sterling, which seems to underlie most of our post-war economic difficulties. A study of the two theories apparently most acceptable to those responsible for economic policy has led to the

45 Sir Roy Harrod, *Treasury under the Tories*, Review, The Economic Journal, September 1965.

conclusion that the direct cause is to be found in the size of public expenditure, particularly local expenditure, and the high level of taxation that is necessary to support such expenditure. In this, our conclusions support those of Sir John Hicks, whose enquiry was directed to the causes of the 1966 crisis. [46]

The national income figures published by the Central Statistical Office are subject to margins of error, and as a consequence conclusions drawn from short period analysis must be subject to some reservations. It is not felt, however, that these margins of error can be so great and so consistent as to alter the conclusions to be drawn from the marked tendencies illustrated on the charts.

The suggestions made here are not put forward as an immediate panacea. We have tried to point the direction of the first few steps along the road on which full rehabilitation of the economy will become a practical possibility.

The immediate need, however, is for more research and more detailed evidence. These are prerequisites for the reorganisation of public finance. Public funds would be better spent in this direction than on investigating the structure of local government.

In 1954, Mr. T. L. Poynton, then President of the Institute of Municipal Treasurers and Accountants, said: “The strength of local government, as the strength of all government, lies in financial independence.” [47]

Mr. Gladstone put it even more bluntly. Speaking at Hastings in 1891, he said: “The finance of the country is ultimately associated with the liberties of the country.” [48]

46 Sir John Hicks, *op. cit.*

47 T. L. Poynton, *Local Authorities Dilemma*, in the National Provincial Bank Review, November 1954.

48 W. E. Gladstone, from a speech at Hastings on March 17, 1891.

Postscript

The most recent measures outlined by the Government "to make devaluation work" indicate no fundamental change in policy from that followed over the past decade and more. The so-called cuts announced to date do not represent a reduction in total public authority expenditure, but merely a slowing down over the next two years in the rate of growth of that expenditure, and as shown on Charts 11 and 13 this has been tried before.

Local authority expenditure estimated at constant prices is still expected to increase at nearly twice the rate of increase in GNP [49] which the Chancellor of the Exchequer has described as reasonable for 1968 and 1969. [50]

The proposed increases in taxation, whether or not they reduce home demand, will certainly increase costs (when taken together with increases following automatically from devaluation) and will give another added push to the persistent decline in the internal purchasing power of sterling. [51]

49 Maurice F. Stonefrost, Secretary of the Institute of Municipal Treasurers and Accountants, *Getting a Firm Grip on Town Hall Planning*. The Times, 6th February 1968.

50 In a speech to the Overseas Bankers Club, 5th February 1968.

51 For example, the internal price index for basic materials increased rapidly by 3.9% during December 1967.

Historical note

1. In the 1930s, unemployment in the UK reached a peak of 3 million, or about 20% of the working population, with considerable variation by region. It was the dominant economic issue addressed by Keynes in the *General Theory* which he completed in December 1935. In his chapter on the Theory of Prices, Keynes anticipated "… a condition which might be appropriately designated as one of true inflation."
2. After 1945 Britain's balance of payments recovered quickly, moving into surplus for a period of six years from 1950 to 1956. Exports had increased by about 75%, and imports, subject to controls, by 25%.
3. The pound sterling had been devalued in 1949 from \$4.03 to \$2.80 not primarily because of the overall international trade position, but due to a growing deficit on trade with the United States in particular, and rapidly declining reserves. The use of sterling as an international reserve currency created further difficulties.
4. A balance of payments crisis occurred in 1955, followed by a second in 1957 when the Bank Rate was increased rapidly from 5% to 7%.
5. After 1959, there was a steady decline in the balance of payments, and a third balance of payments crisis occurred in 1964, followed by higher interest rates and rising inflation.
6. The National Board for Prices and Incomes was established by the Prices and Incomes Act 1966. On the basis of its recommendations, the government issued a series of Prices and Incomes Orders from 1966 onwards in an attempt to regulate wages in specific industries.
7. A second devaluation of sterling against the dollar, strongly opposed by R. Harrod, J. Hicks, and other prominent economists, took place in 1967. The rate of exchange was reduced from \$2.80 to \$2.40.
8. The government White Paper of March 1967 on *Prices and incomes policy after 30th June 1967* proposed the implementation of further provisions of the 1966 Act with the aim of controlling inflation.
9. The annual rate of inflation rose from 2.4% in 1967 to 5.9% in 1968.

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