The Chance to Change

By Ronald Burgess

ESA Paper No. 6

September 1977

© Economic Study Association, 2024

All rights reserved.

ECONOMIC STUDY ASSOCIATION LIMITED

The Economic Study Association was incorporated as a Company limited by guarantee on the 22nd February 1966, and is registered with the Charity Commission under the Charities Act, 1960.

The main object of the Association is to pursue economic research upon independent lines of enquiry, and its members come from all walks of life and have political allegiances which cover all three main parliamentary parties.

Council of Management

H. R. NEIL
R. G. J. BURGESS
J. P. D. MacGEORGE

12 Addison Avenue,
London, W11 4QR

50p.

The Chance to Change…

Towards an economic revival

Contents

Foreword		ii
I	The Chance to Change	1
II	The Price of Sterling	3
III	The Four Prices of Labour	6
IV	The Burden of Taxation	13
V	Tax-created Unemployment	23
VI	The Change-over to Prosperity	26
VII	Proposals Summarised	33
Sources and references		34

Foreword

As out balance of payments moves into a current surplus, much of the economic news is good although at home, output remains sluggish and unemployment continues to rise. With this mixture of good and bad news the Government are coming under increasing pressure to introduce a measure of reflation backed by detailed controls.

Unfortunately recent experience and the monetarists have both demonstrated that inflation creates more difficulties than it solves. We know also, as a matter of experience, that detailed government intervention creates discord and hardship. Central controls, to be effective, must be enforced and, as Professor Wiles stated in the *Economic Journal* of June 1973, enforcement "involves a head on clash with trades unions."

This paper is concerned with immediate issues and outlines proposals which, if put into effect this Autumn, would lay the foundations for economic revival without recourse to inflation or industrial discord.

I would like to take this opportunity of thanking the members of the joint ESA/ESSRA research team: Peter R. Hudson, Geoffrey Lee, German Lema, Ray Linley, Ralph Mackie, Brian Newble, Gwyneth Owen and Victor Saldji.

Ronald Burgess
Economic Study Association

September 1977

The Chance to Change

September 1977

I THE CHANCE TO CHANGE

There now exists a time of great opportunity for the British people – the opportunity to make a lasting break from an economic disaster spiral, and to lead the world out of economic depression.

To achieve these objectives public economic policy must now be directed towards creating conditions in which earned incomes may rise without an acceleration in the rate of price increases or an erosion of our competitiveness in international markets. As a pre-condition, the constant repetition of past mistakes must cease.

Oppressive measures as used by the 19th-century industrial masters are no basis for 20th-century economic policy. Prices and incomes policies cannot for long be imposed on a free people with a sense of justice. The efficacy of these policies depends upon restricting freedom and depressing both prices and incomes, and this inevitably leads to more injustice.

As Adam Smith pointed out, men will not work for less than they are prepared to accept – a fundamental observation applying to the whole community.

When the purchasing power of take-home pay falls below what is considered to be a reasonable minimum then employees will strike; and when profits fall below the necessary minimum then employers cannot provide employment, and firms will simply stop producing.

The British people have suffered more than most from excessive public expense, incurred with the best of intentions but without due regard to the inevitable consequences.

At first, moderate inflation seemed an acceptable price for the prevention of mass unemployment and the mitigation of the worst effects of poverty.

In 1958 the newly-formed Council on Prices, Productivity and Incomes[1] expressed its concern about the rate of inflation. At that time prices were increasing at about 3 per cent a year, yet it could report: "The post-War years have been good years for the United Kingdom" (1).

However, it is now apparent that unemployment has been on a rising trend since 1955, and this year the numbers registering as wholly unemployed will approximate to the 1937 totals. Our social services have begun to fail; the standard of living is falling, whilst for the past three years output has stagnated; and persistently rising prices have become a major cause of our economic tribulations, including unemployment and relative poverty.

As the present economic depression steadily deepened the fear of accelerating the rate of price increases has rendered government incapable of effective remedial action, and so the British economy has slid into a condition described by Professor Milton Friedman as 'slumpflation' (2, p.31).

The depression of the thirties was intensified by 19th-century conventions, which for decades had restricted public finance and justified restrictive policies. The Keynesian revolution swept away these old conventions, but since then the subsequent decades of public prodigality have imposed new constrictions which are even more limiting than the old.

Now we have the opportunity to effect a second revolution in which the art of good government is employed to ensure that 'self-interest prompts what justice demands'.[2]

---

1 The Council on Prices, Productivity and Incomes was set up in August 1957. Its official terms of reference were: "Having regard to the desirability of full employment and increasing standards of life based on expanding production and reasonable stability of prices, to keep under review changes in prices, productivity and the level of incomes (including wages, salaries and profits) and to report thereon from time to time". It published its reports in February 1958, August 1958, July 1959, and July 1961, and was formally wound up in January 1962.

2 Quoted from *Christianity and Social Order*, W. Temple, published in 1942.

II THE PRICE OF STERLING

The world economic depression of the 1970s was precipitated by the oil-producing and exporting countries combining to enforce a sharp increase in the price of oil. Their declared intention was to provide oil exporters with some measure of protection against the then rapidly accelerating depreciation in the purchasing power of the national currencies of oil-importing countries, but it resulted in wrecking the balance of world trade.

Although the impact of OPEC's action on the British economy was severe, it is now, paradoxically, instrumental in providing an opportunity to escape from the full consequences of past mistakes.

High oil prices stimulated exploration, and the new North Sea discoveries have added a much needed 20th-century dimension to our previously known generous endowment of national energy resources. Already, more than half of the United Kingdom's oil requirements are being supplied from newly discovered national oil reserves.

Next year the supplies from these reserves will be sufficient to ensure a substantial surplus on our current balance of payments.

Continued profitable production will make significant additions to the annual revenues of government.

Oil – boon or bane?

However, all extractive resources are finite and North Sea oil is more limited than most. Whether a period of self-sufficiency in energy supplies is to be the boon or the bane of lasting economic prosperity depends on action taken now. The new discoveries offer the time and opportunity for effecting lasting solutions to our troubles. They do not, of themselves, provide the lasting solution.

Throughout the next few years oil-generated surpluses will transform the United Kingdom's balance of payments, and this could be crucial both for industrial harmony and the attainment of a relatively stable general price level.

An important factor contributing to the breakdown of the social contract was the failure of government policy to reduce the rate of retail price increases to single figures within the agreed time. To a large extent the government were prevented from honouring their promises in respect of prices by the persistent weakness of sterling on the foreign exchange markets, and in turn this weakness was near inevitable given the continuing massive deficits on current balance of payments.

The last year in which our international transactions showed a current surplus was 1972, and since then sterling has depreciated by an average of some 40 per cent against other major currencies.

This means that even if the price of our imports had not risen in terms of foreign currencies, which it has, the average increase in their sterling price would still have exceeded 60 per cent, and each 4 per cent rise in the sterling price of our imports is estimated to produce about a 1 per cent rise in the level of domestic prices.

Let the market decide

In 1978 oil-generated surpluses will be causing a measurable upward pressure on the sterling exchange rate both by directly increasing the demand for sterling, and through the associated confidence effects. This pressure is being anticipated already by the market. Provided the government does not intervene sterling will appreciate, thus tending to stabilise the level of prices on the home market by lowering the sterling price of imports.

In the case of imported consumer products the effect on prices will be direct; in other cases it will be indirect and take time before being reflected in retail prices.

An initial deceleration in the rate of price increases would be magnified if it were met with moderation in money wage claims leading to a slower rise in all domestic costs, and consequently to smaller price increases for home-produced goods and services.

To take full advantage of the opportunity presented by North Sea oil in the struggle against ever rising prices market forces must

be allowed to operate freely, for, in the medium term at least, they will be tending to reduce prices.

The government needs to concentrate instead on policies which complement market forces, and in particular, those policies which will regain and enjoy the full co-operation of both employees and employers.

Intervention unnecessary

However, when formulating policy, oil-generated balance of payment surpluses must not be confused with an export-led boom. Oil surpluses are not job-creative, and do not result from increased activity throughout the economy.

Further, an appreciation of the exchange rate which lowers the sterling price of imports automatically erodes the price advantage of British labour costs relative to those of foreign producers. Such a reduction in relative labour costs, argue those who favour more government intervention, can be achieved by a further extension of statutory controls.

Thus the interventionist argument concludes that to safeguard, let alone expand, home production and employment, there must be continued intervention by government to hold down the exchange rate, or even induce a mild depreciation, together with protection against imported manufactures and effective controls over prices and incomes.

On the other hand, the supposed danger of lasting damage being inflicted on UK industry and employment prospects by allowing market forces to determine the exchange rate exists only on the basis of unchanging government fiscal policies.

Tax effects unobserved

At root the argument for and against government intervention is an argument about the effective incidence and burden of taxation. Admittedly, if sterling does appreciate then, other things being

equal, labour costs of employers in Britain will tend to rise relative to those in other countries, and the competitiveness of British products will be eroded in both home and overseas markets.

Note, however, that the condition of other things being equal is of vital importance, for it includes tax effects, and taxation is not only significant in determining the level of labour costs, it is also wholly determined by government policy.

What may be described as the interventionist argument cannot take the effects of government tax policy fully into account since its advocates do not distinguish clearly between employers' labour cost, wages and salaries, take-home pay, and the purchasing power of take-home pay. This simple confusion is one of the reasons for the persistent failure, in practice, of economic policies based on interventionist and similar arguments.

There was a time when the basic concepts of economic theory reflected practice, as for all intents and purposes labour costs, wages and salaries, and take-home pay, were so indistinguishable that they could be safely lumped together under the term money wages, in contrast to real wages or the purchasing power of the money sum actually received by employees. Such a time has long since passed, and today the old concepts of economic theory no longer reflect current practice – indeed, they have become thoroughly misleading when directly applied to the formulation of economic policy. The level and methods of taxation have created a new situation where British labour costs can be cut immediately by right fiscal policy, whilst at the same time take-home pay may rise both in money terms and in terms of purchasing power.

III THE FOUR PRICES OF LABOUR

In accordance with its 18th century origins, current economic theory considers real wages to be *the* price of labour (3, p.15). This one and the same price, or real wage, is a factor income from the standpoint of an employee and a factor cost from the standpoint of

an employer. But conditions have changed – even forty years ago Keynes's statement that "factor cost is, of course, the same thing, looked at from the point of view of the entrepreneur, as what the factors of production regard as their income" (4, p.23) was no more than an approximation of the truth and today it is wholly invalid.

Factor cost and factor income have ceased to be the same thing from a different view of point. The cost of labour to an employer is not the same sum of money as that which represents real wages to an employee. The tax system now operating in the UK and in most western nations has created more than one price of labour.

The employees' view

The price of labour that matters to employees is the purchasing power of take-home pay over the assortment of goods and services they wish to buy – that is, over the assortment which both Pigou and Keynes described as wage goods. This price is an indicator of the standard of living represented by take-home pay.

An approximation of this price may be obtained by inflating aggregate money take-home pay with a suitable consumer price index to show a standard of living index. An index calculated in this way for the UK is given in column (i) of Table 1.

To provide the equivalent to real wages as used in economic theory, or factor income, the standard of living index must be further adjusted for economic growth, as has been done in column (ii) of Table 1. Thus, in a modern mixed economy the index may be considered as relating to the average real supply price of labour.

The employers' view

To an employer, money take-home pay is no more than one of the components of labour cost.

Other components include income tax on wages and salaries, the social security contributions of both employees and employers, and any other taxes which, from time to time, may be directly

Table 1: The four prices of labour

1948 = 100

Year	(i) Standard of living index %	(ii) Average real supply price %	(iii) Ave. effective demand price %	(iv) Ave. effective supply price %
1948	100.0	100.0	100.0	100.0
1949	103.6	99.9	101.6	100.4
1950	106.4	99.4	103.4	102.3
1951	107.5	97.4	103.9	102.5
1952	109.2	99.3	103.3	102.6
1953	114.1	100.3	102.6	102.5
1954	119.9	101.8	103.3	103.3
1955	126.5	103.6	105.8	105.2
1956	131.4	106.2	107.3	106.3
1957	133.7	106.3	107.7	105.9
1958	132.7	105.6	107.7	104.0
1959	138.0	105.7	107.0	103.5
1960	146.9	106.5	107.2	103.5
1961	153.1	108.2	109.2	104.2
1962	153.7	107.3	110.1	103.9
1963	158.3	106.6	109.1	103.4
1964	166.3	105.7	108.8	102.5
1965	167.6	103.7	109.1	100.7
1966	169.8	103.0	110.7	99.9
1967	171.1	101.7	110.4	97.7
1968	171.2	97.8	109.2	94.7
1969	171.7	96.2	110.1	93.9
1970	178.4	98.0	110.1	94.7
1971	182.0	98.2	108.9	93.6
1972	192.1	101.3	110.4	95.0
1973	201.0	100.0	111.6	94.6
1974	203.2	101.9	118.1	97.2
1975	205.2	104.6	122.4	96.4
1976	199.9	99.8	120.5	93.2

assessed on employment, as well as contributions to employees' pension funds and the like.

The money sum paid out as labour cost in relation to the total money sum received as a result of incurring that labour cost determines the price of labour that matters to an employer. The total money sum received includes, not only the proceeds from the sale of value-added produced, but also items such as subsidies and indirect taxes collected on behalf of the tax authorities.

This ratio of labour cost to the total money sum received may accurately be described as the effective demand price of labour, as it is a significant factor in determining an employer's demand for labour (see Section V) and directly affects unit selling prices of the goods and services produced.

An average effective demand price of labour can be calculated by expressing aggregate employers' labour cost as a percentage of the net domestic product at market prices plus subsidies, and an index for the United Kingdom based on such a calculation is given in column (iii) of Table 1.

Finally, in column (iv) of Table 1 is given an index of the average effective supply price of labour corresponding to the demand price that is shown in column (iii). The average effective supply price is calculated by expressing aggregate take-home pay as a percentage of the net domestic product at market prices plus subsidies.

It is apparent from Table 1 that in a modern developed economy at least four prices of labour can be isolated, and each of them has some validity for limited purposes. The column (i) index shows the purchasing power of aggregate take-home pay more than doubling during the post-war years, and yet, during the same period, the average real supply price, column (ii), exhibits no definite trend.

These two indices are calculated from the employees' viewpoint and suggest a rising standard of living is closely associated with increased production, but the so-called inflationary wage claims have done no more, after allowing for economic growth, than keep

money take-home pay in step with rising prices. In respect of pay, it seems that the trade unions are defensive, rather than offensive.

Funnelling taxes

Of the two indices calculated from the viewpoint of employers, the average effective supply price of labour, column (iv), is similar in trend to the real supply price index. Both appear to have a long-run stability, and the differences which do arise between these two supply price indices may be explained in terms of shifts in the price level of wage goods relative to non-wage goods.

However, the index of average effective demand price shows a persistent rising trend, and the divergence between the effective demand and the effective supply price indices implies that the factors making for higher labour costs must be other than pressure from employees seeking a larger slice of the cake.

The evidence is consistent with the hypothesis that employees offset, but no more than offset, the effects of increased direct and indirect taxes by demanding and getting more money wages which in turn tends to raise the average effective demand price of labour.

This is to say that employees act as a kind of tax conduit pipe, funnelling the taxes levied upon them through to their employers.

Adam Smith fully appreciated that taxes levied upon employees are shifted on to their immediate employers, and he argued that a direct tax on wages, or an indirect tax on goods purchased out of wages, would raise gross wages by a greater proportion than the tax applied. A twenty per cent additional tax on wages would, he maintained, lead to a 25 per cent increase in gross money wages.

It was left to the post-war Keynesians to fondly imagine that by the use of the regulator, or by changes in income tax, they could directly affect real take-home pay.

Statistical investigations using the ample evidence published by the Central Statistical Office over the past thirty years now fully confirm the conclusions reached by Adam Smith, writing some two hundred years before the practice of demand management.

The effect on labour

Table 2 gives figures for each year from 1946 for the average effective demand price of labour and for its component parts, expressed as a percentage share of the product and as a percentage of the demand price. In the last thirty years the share of the product represented by direct taxes on employment has multiplied nearly three times, and these taxes are now about equivalent to a 50 per cent rate of VAT on aggregate take-home pay.

On the basis of annual first differences, the changes in the tax component in column (iii) of Table 2 are not significantly related to changes in the take-home pay component in column (ii) but they are significantly and positively related to changes in the average effective demand price of labour in column (i).

These results imply that an increase in direct taxes levied on employment will increase the employers’ labour cost rather than depress take-home pay, and that conversely, a reduction in direct taxes on employment will reduce employers’ labour cost rather than increase take-home pay.

Again, on the same basis, changes in the tax component and in the take-home pay component are each significantly and positively related to changes in the average effective demand price of labour. This result suggests that to the extent that an incomes policy is successful in depressing take-home pay it will tend also to reduce employers labour cost, but whether this tendency is actualised will depend on tax policy.

The indices given in Table 1 are consistent with the hypothesis that changes in indirect taxation, such as VAT, assessed on goods and services purchased out of take-home pay, are fully reflected by changes in money take-home pay.

The percentages given in Table 2 are also consistent with the hypothesis that any changes in direct taxes on employment, and changes in take-home pay, are fully reflected by changes in the average effective demand price of labour.

Both these hypotheses accord with Adam Smith’s observations

Table 2: Components of the demand price of labour

Year	(i) Ave. effective demand price % of product	(ii) Take home pay % of (i)	(iii) Direct taxation % of (i)	(iv) Employers' other costs % of (i)
1946	59.6	86.0	11.4	2.6
1947	60.1	86.5	10.7	2.8
1948	59.5	85.6	11.5	2.9
1949	60.0	84.5	12.3	3.2
1950	61.1	84.7	11.9	3.4
1951	61.8	84.5	12.1	3.4
1952	61.7	85.0	11.5	3.5
1953	61.5	85.6	10.9	3.5
1954	61.7	85.7	10.7	3.6
1955	62.6	85.3	11.2	3.5
1956	63.9	85.0	11.4	3.6
1957	64.2	84.3	11.8	3.9
1958	64.3	82.7	13.3	4.0
1959	63.6	82.7	13.2	4.1
1960	63.0	82.6	13.3	4.1
1961	64.3	81.7	14.2	4.1
1962	64.7	80.8	15.1	4.1
1963	64.1	81.1	14.6	4.3
1964	64.0	80.7	15.1	4.2
1965	63.9	79.0	16.8	4.2
1966	65.1	77.3	18.3	4.4
1967	64.9	75.9	19.6	4.5
1968	64.1	74.3	21.0	4.7
1969	64.3	73.1	22.3	4.6
1970	65.8	72.0	23.5	4.5
1971	65.2	72.5	22.8	4.7
1972	64.7	73.6	21.5	4.9
1973	64.9	73.5	21.4	5.1
1974	68.5	71.8	23.1	5.1
1975	71.5	68.4	26.4	5.2
1976	70.1	66.3	27.6	6.1

as to tax effects made some two hundred years ago, and lead to the conclusion that government tax policy is the important factor in determining changes in employers' labour cost.

IV THE BURDEN OF TAXATION

Taxes which inflate labour costs are only part of the total tax burden, although in the United Kingdom they are a significant and rapidly expanding part.

In 1938 direct taxes on employment accounted for 13 per cent of total tax revenue. By 1950 this had risen to 20 per cent; by 1960 to 28 per cent; by 1970 to 38 per cent; and it is now near the 50 per cent mark. A multiplication of four times in the proportion of this one part of total tax revenue must be seen in the context of a persistently expanding whole.

The share of the product appropriated by total tax revenue has doubled in comparison with the inter-war years.

Are we over-taxed?

Some of our politicians today, supported by a few economists of interventionist convictions, argue that Britain is not over-taxed in relation to our main trading competitors, and quote approvingly the tax league tables published annually in *Economic Trends*.

The latest published figures prepared by the Central Statistical Office relate to the year 1974. They show that UK tax revenue as a percentage of GNP (Gross National Product at factor cost) is, by international standards, relatively low. In 1970 we were the fifth highest out of thirteen countries, but by 1974 we had dropped to tenth place amongst the same thirteen; only Italy, the United States and Japan returning lower percentages.

Unfortunately these percentages do not carry the meaning that is often ascribed to them. They do not provide a measure of the relative tax burden as between one nation and another (5), for no western developed economy fulfils the necessary conditions in

which total tax revenue expressed as a percentage of the Gross National Product at factor cost might provide a useful measure of national tax burden.

Twenty-five years ago in *The American Economic Review*, Alan Sweezy showed that to express a government's income, or public spending, as a percentage of the standard concepts used in national income accounting would normally produce results of uncertain meaning, if not absolute nonsense (6). He also concluded that such percentages would have some limited validity only in an economy where there are no indirect taxes and no transfer incomes.

Who finally pays?

Measuring the tax burden is a matter of first determining the effective incidence of taxation, and since economic theory as now established is uncertain as to effective incidence, it follows that it is uncertain also as to the burden a given tax revenue imposes on any particular economy.

For practical purposes the majority of writers on public finance assume the effective incidence to fall upon the person immediately assessed for the tax. That is to say, employees are assumed to pay employees' social security contributions and employers to pay the employers' contributions.

On the other hand, indirect taxes are assumed to be passed on to the consumer through higher prices. For example, an indirect tax on beer is assumed to be paid by the person who eventually buys the beer for consumption and not by the brewer, or the landlord, or some other intermediary, although they may in fact pay the money to the tax collector.

However, a few exceptions to these general rules have been admitted. Dalton[3] believed that in periods of full employment, taxes imposed on employees might be shifted on to prices (7, p.58) and, in a recent article in *The Economic Journal*, some evidence

3 Chancellor of the Exchequer in the first Attlee administration of July 1945.

was presented suggesting that in Canada additional direct taxes on wages were being shifted on to employers (8).

Adam Smith observed, as noted above, that employees shifted both direct taxes on wages and indirect taxes on wage goods on to their immediate employers. In the final analysis, however, his real conclusions as to the effective incidence remain uncertain.

Smith concluded, for example, that the effective incidence of taxation rested in part on the rent of land, thus reducing the income of landlords, and in part upon consumers.

The conclusion that the effective incidence of taxation would, in part, rest upon consumers followed on directly from an important prior assumption – that manufacturers pass on to consumers any taxes levied directly upon them, or shifted on to them, by raising the prices of their products.

However, to follow Smith's argument through, if the consumers are employees and the price rises affect wage goods then the tax will be shifted yet again back on to the manufacturer who, as an employer, will have to pay out increased money wages. In turn the increase in money wages will lead to even higher prices, and so on *ad infinitum*.

In this respect the discussion of tax incidence in the *Wealth of Nations* may be considered as anticipating the concept of a self-generating cycle now popularly known as the wage/price spiral.

But this is to avoid the issue – taxes cannot be passed on for ever. Eventually some person, from some source, must pay the tax and suffer a reduction in income.

The appropriation of property income

If it is accepted that taxation tends to leave post-tax labour incomes unaffected, which is to accept Smith's conclusions, as confirmed by recent statistical investigations, then it necessarily follows that the effective incidence of total taxation must be on net property incomes; that is, rent and profits after allowing for stock appreciation and capital consumption.

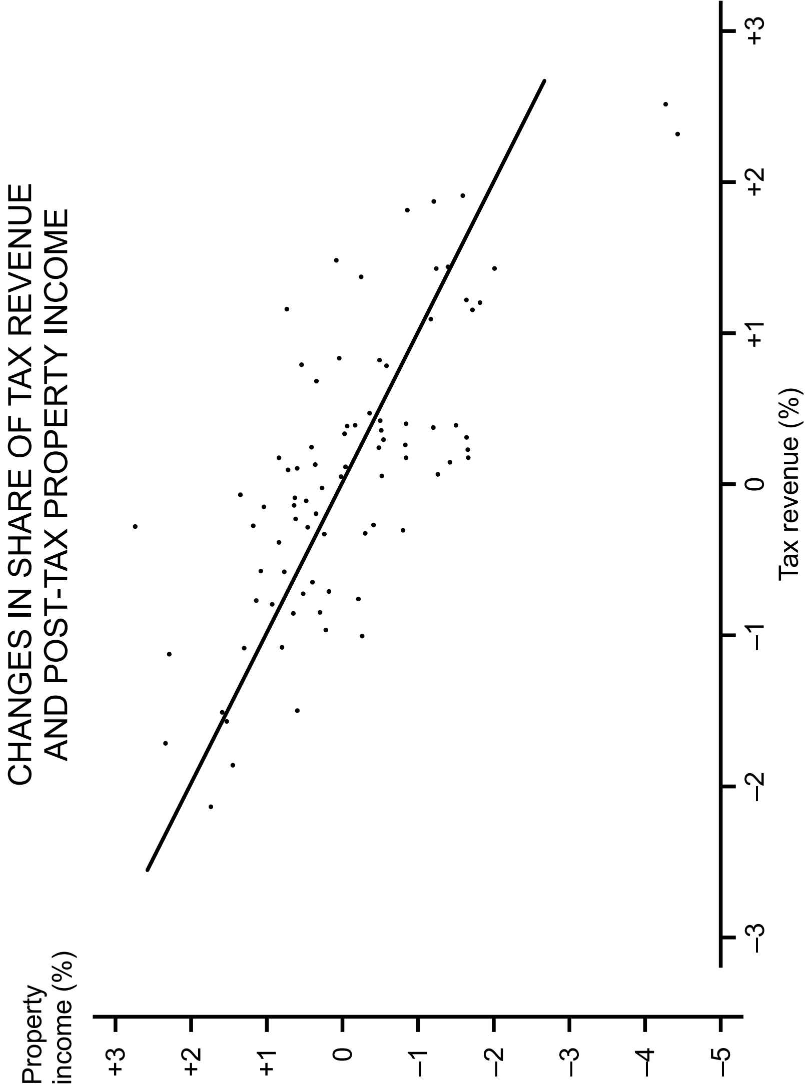


Chart A

Taxes must be paid by someone from some source. If post-tax labour incomes are excluded then the only remaining source is net property incomes. As an additional tax assessed on the rent of land reduces the income of landlords, so also any additional tax must reduce aggregate post-tax net property incomes.

The increases in prices and in gross money wages and salaries which are associated with the imposition of taxes other than those on the rent of land are simply the mechanics of tax shifting which inevitably come into play when the formal incidence, or impact, of a tax is other than where the effective incidence must rest.

The hypothesis that is implied by concluding that the effective incidence of total taxation is wholly upon net property incomes, is that an expansion, or contraction, in the share of the product appropriated by total tax revenue will be matched by a contraction, or expansion, in the share of the product represented by post-tax net property incomes.

This hypothesis is capable of being tested by statistical methods and the results are illustrated on the scatter diagram, Chart A. As official estimates do not provide a basis for isolating the post-tax labour income component of self-employed incomes, these are included as part of property income.

In the United Kingdom for the last 100 years since 1876, the relationship between total tax revenue, expressed as a percentage of the net domestic product at market prices, and post-tax net property income similarly expressed, yields, on the basis of annual first differences, a regression coefficient of -0.999 ($t = 9.660$).

This means that within the United Kingdom economy in the long run, every percentage point increase in the share of the product appropriated by total tax revenue since 1876 has been matched, almost exactly, by a percentage point decrease in the share of the product accruing as post-tax net property income.

A similar calculation relating changes in the take-home pay of employees to changes in total tax revenue, indicates that these two variables have no significant statistical relationship.

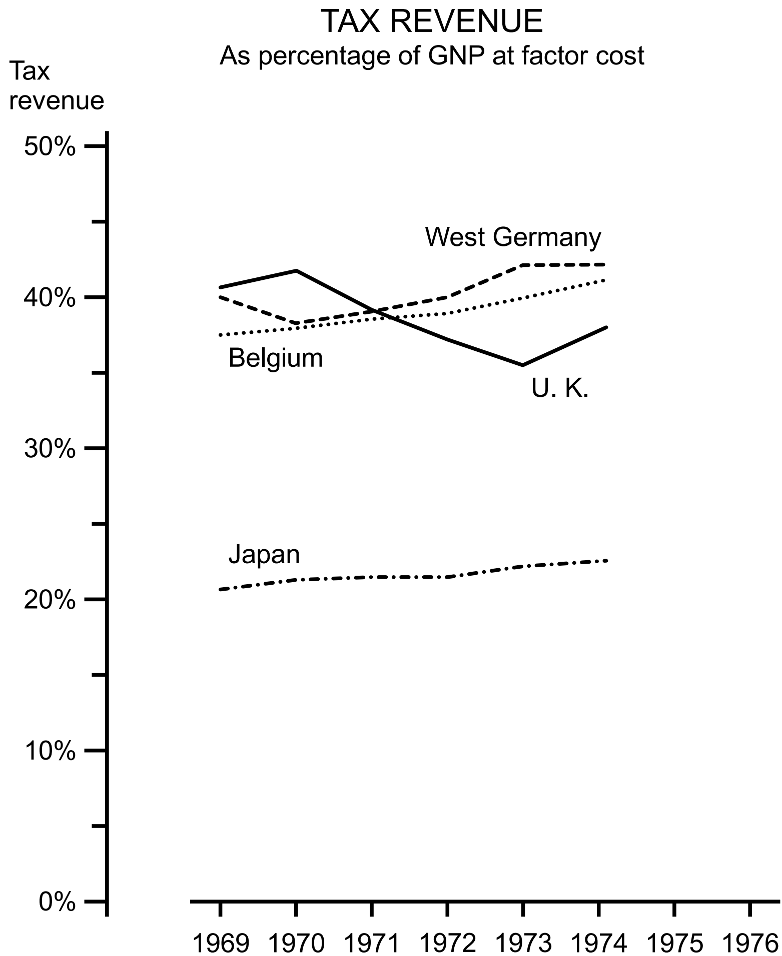


Chart B

Measuring the burden

Statistical evidence amply confirms that the effective incidence of taxation is wholly upon net property income, and it is to be deduced from this that the total tax revenue plus home-produced post-tax net property income in any given period is effectively the domestic taxable capacity of an economy.

A measure of the domestic tax burden which will be meaningful, both nationally and for the purposes of international comparison, may be obtained by expressing total tax revenue as a percentage of domestic taxable capacity.

Another advantage of this measure is that it avoids the fallacy of Say's *golden maxim*, for it does not imply that 'The very best of all plans of public finance is to spend little, and the best of all taxes is that which is least in amount'.

The real tax burden will be reduced if any additional public authority spending which necessitates an additional tax, expands taxable capacity by an amount more than the additional taxation.

In other words, an increase in taxation will result in a reduction of the tax burden, provided that the additional public authority spending covered by the extra tax leads to an increase in pre-tax rent and profits that is greater than the tax increase.

Conversely, a cut in taxation will increase the tax burden if the associated cut in public authority spending results in taxable capacity being reduced by more than the cut in taxation.

Unfortunately only a few countries publish national accounts in sufficient detail to provide a basis for an international comparison of their domestic tax burden. On available evidence, it appears that in the UK we have persistently borne a much heavier tax burden than our main trading competitors, although the United States after 1969, being among other things, heavily committed in a South East Asian war, provides a possible exception.

The marked difference between the tax league tables derived from the Central Statistical Office's estimates of tax revenue as a percentage of the GNP at factor cost, and comparative tax burden,

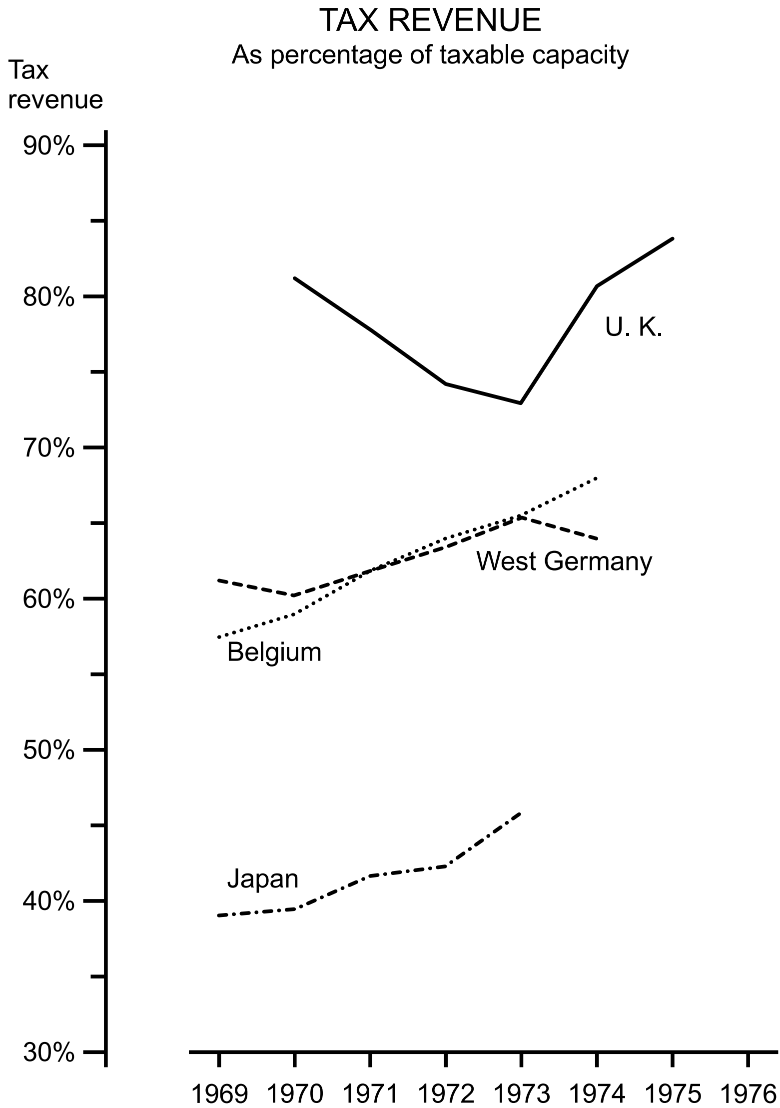


Chart C

is illustrated on Charts B and C. On any basis it is readily apparent that the highly competitive Japanese economy is lightly taxed.

On the other hand, while on Chart B the official calculation of tax percentages places both Western Germany and Belgium above the UK, Chart C shows that, on a comparative basis, after 1971 the domestic tax burden of the UK remains substantially heavier than either of these two countries.

As has been argued, total tax revenue expressed as a percentage of taxable capacity provides a comparative measure of domestic tax burden which is directly related to a country's economic performance. However, where governments rely to a significant extent on deficit financing, the borrowing requirement will also have an effect on the economy and must be taken into account when making comparisons.

Thus, a comprehensive comparative measure of what may be described as the public authority spending burden can be obtained by expressing total tax revenue plus borrowing requirement as a percentage of taxable capacity. An excessive spending burden, like an excessive tax burden, will erode the competitive ability of home producers by pushing up prices, limiting investment, restricting output and destroying jobs.

In this country it is an excessive public authority spending burden which has made it near impossible for manufacturers to compete with foreign products in the home and overseas markets, even with the assistance of a depressed sterling exchange rate.

The domestic tax burden and public authority spending burden for the United Kingdom from 1957 are shown on Chart D. The inter-dependence of tax revenue and the borrowing requirement is very apparent between the years 1970 and 1971. The spending burden increased while the tax burden was reduced by the simple method of a sharp expansion of the borrowing requirement.

By 1975 the UK spending burden actually exceeded domestic taxable capacity, which means that public authorities were eating into overseas earnings and piling up foreign debts.

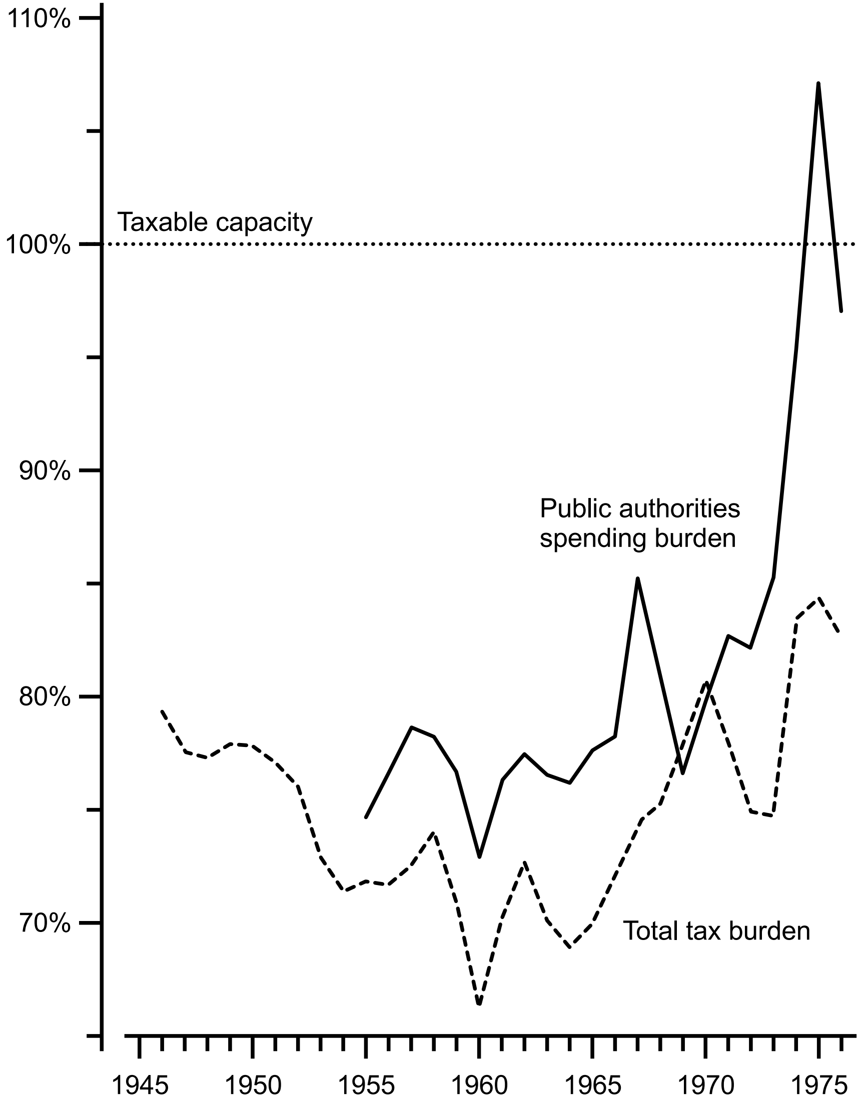


Chart D

The correct level

An overburdened ship is in danger of becoming a total loss. On the other hand, a ship which is persistently lightly burdened will not provide its crew and owners with a decent living.

Similarly, with an economy, where the public authorities are too parsimonious, the economy is likely to be depressed with massive unemployment and all the associated injustices. Equally, where the public authorities are profligate, this too will result in a depressed economy with all the associated injustices.

It follows that between these two extremes there must be a right level of public authority spending burden which, when properly apportioned, will lead to prosperity and facilitate justice.

In this country the domestic tax burden is excessive in relation to our main trading competitors, and a cut in taxation is urgently required. There must also be a cut in the level of public authority spending since, at present levels, it exceeds our capacity to pay, and is steadily impoverishing the nation.

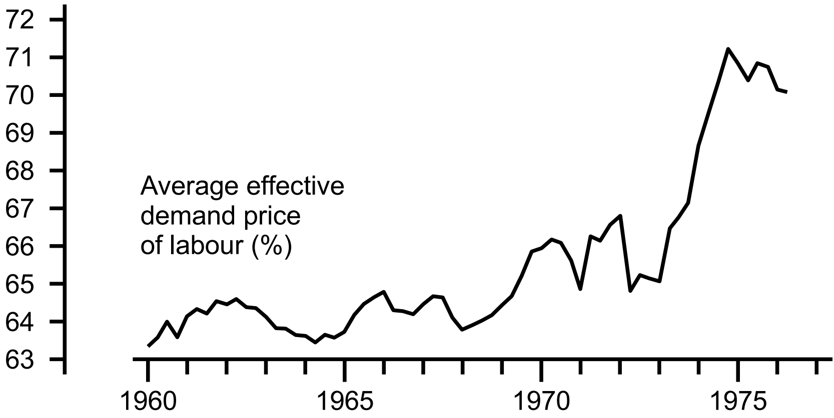
V TAX-CREATED UNEMPLOYMENT

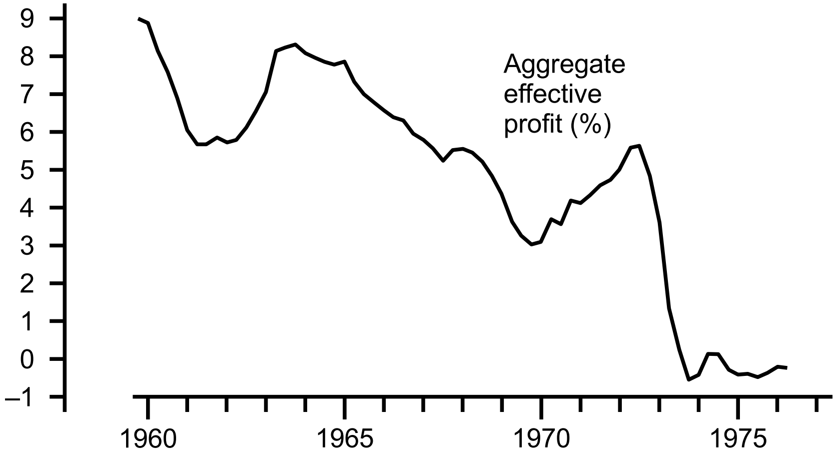
Direct taxes on employment raise labour costs; an excessive tax burden depresses profits.

When these are combined unemployment is inevitable. Except in the very short run, tax-created unemployment cannot be reduced by additional public authority spending. More spending must lead to more taxation and thus to even more people being unemployed.

In the UK unemployment has been on a rising trend since 1955. Most of this is the result of an excessive tax burden necessitated by excessive public authority spending, and to improve employment prospects in the UK, public authority spending must be curtailed and the tax burden reduced.

The relationship between the average effective demand price of labour, aggregate effective profit, and the UK unemployment rate lagged by five quarters, is shown on Chart E.





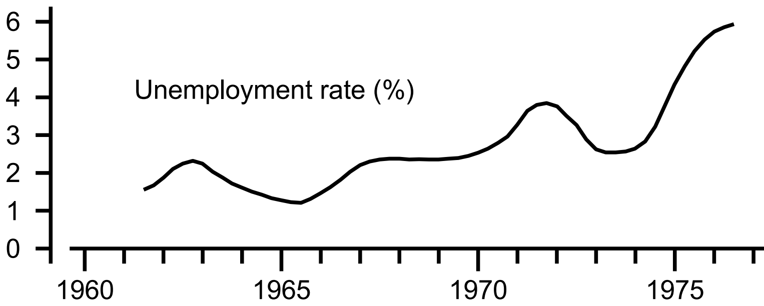


Chart E

The demand price of labour rose sharply from the beginning of 1974 to reach an all-time high in the 3rd quarter of 1975. Since then, two years of voluntary pay policy, coupled with some cuts in income tax, have effected a small decline.

This movement in the price of labour was positively reflected in the unemployment rate, which rose sharply from the end of 1974 until the last quarter of 1976, and then began to moderate.

Since the average supply price of labour in 1975 was lower than for any post-war year prior to 1967, the all-time high for the average effective demand price recorded in the 3rd quarter of 1975 must result from long-run increases in direct taxes on employment.

This confirms the analysis given in Section III above.

Zero profits

As is readily apparent from Chart E, changes in aggregate effective profit are significantly and negatively associated with changes in the effective demand price of labour. As the price an employer must pay rises, so profit declines.

This negative relationship is consistent with Adam Smith’s observation that taxes imposed on employees are shifted on to their employers. However, whilst effective profits are directly affected by changes in taxes on employment, they are also affected by other forms of taxation.

The persistent declining trend in profits reflects a rising trend in the domestic tax burden. Since mid-1974 an excessive burden of taxation at a time of economic depression has reduced aggregate effective profits to around zero, that is to say, the real losses incurred by many companies have been sufficient to cancel out the true profits earned by other companies.

So long as this situation continues, unemployment will rise, for employers can offer employment only when they can afford to do so, and aggregate effective profit is a measure of what they can afford. Although two years of voluntary wage restraint did produce a very slight fall in the demand price of labour, this has not been

followed by a reduction in unemployment. Any price of labour is too high when profits are being squeezed to zero by an excessive burden of taxation.

The domestic policies needed to expand employment coincide with those needed to maintain and improve our international competitiveness. Public authority spending, the tax burden, and direct taxes on employment, must all be reduced so that output and employment can expand on the firm foundation of competitive ability. Any re-inflation of the economy will make matters worse. No purpose is served by taking the ‘flation’ out of ‘slumpflation’ and then re-introducing it as a policy for mitigating the slump.

VI THE CHANGE-OVER TO PROSPERITY

For economic revival, our inherited wealth from North Sea Oil needs to be used to advantage. At present it is being wasted.

The authorities are merely dissipating the surpluses which this newly discovered wealth is now providing by the purchase of foreign currencies, in an effort to hold down the price of sterling.

An artificially low price for sterling may give some immediate boost to exports but, in the longer run, this is more than offset by the artificially high sterling price of imports.

The British people cannot afford to waste resources in attempts to control the currency market. By allowing the sterling rate of exchange to be determined by market forces, government would be freed to concentrate fully on the domestic issues that will eventually determine the continued well-being of the British economy. For Great Britain, the key to lasting economic prosperity is the level of labour costs, as measured by the average effective demand price of labour – as shown in Table 1, column (iii).

When the price an employer must pay for labour is high and persistently rising, then all other costs and prices will be high and persistently rising. High prices contract demand, restrict output, and increase unemployment.

If the prices of British goods tend to be higher than those of foreign producers then imports increase their share of the home market and British exporters are priced out of overseas markets. Thus, output and employment in Britain are restricted still further.

This process pressures the government into devaluing sterling; it also creates pressures for protection and controls. But protection and controls are, by their very nature, restrictive – and sterling devaluation leads to an even faster rate of price increase on the home market. Employees, faced with rising prices and restricted employment opportunities, quickly discover that the purchasing power of their take-home pay is being eroded – Table 1, column (i) – and, in recompense, demand more money wages.

Since more money wages, unrelated to increased output, raises the level of labour costs, the process becomes self-generating.

The wage/price spiral

Successive post-war governments have attempted to break this self-generating economic disaster spiral by a variety of prices and incomes policies relying upon a combination of exhortation and statutory powers.

Without exception all these attempts have enjoyed some initial success only to meet with final failure, the last state being worse than the first. Such policies must inevitably fail eventually, for they attempt to achieve a stable level of prices and costs by depressing the purchasing power of take-home pay and profits below the level that employees and employers are prepared to accept. This is impossible to sustain in a free society.

The only way the spiral can be broken, other than by recourse to a fully controlled totalitarian state, is by cutting labour costs – without depressing either the earnings of employees, or the profits received by their employers, below what they consider to be an acceptable minimum, or what they know to be the going market rate. Historical evidence suggests that employees and employers never knowingly price themselves out of the market, although

there is much evidence which suggests they are frequently forced out of the market by government interference and taxation.

Industrial warfare unnecessary

Current economic theory confuses policy makers by implying that there is only one price for labour but, as has been argued, there are in practice many prices, and the price received by employees is not the same price as that paid by an employer.

By allowing the sterling prices of imports to fall, cutting taxes, and reducing the annual public authority borrowing requirement, government can create the necessary conditions for an expanding economy in which the purchasing power of take-home pay may rise and pay anomalies may be resolved by negotiations between the parties directly concerned.

Given the right conditions, these direct negotiations between the parties concerned will not result in industrial warfare, nor impair the competitive ability of British industry.

Whilst they will lead to improvements in the purchasing power of take-home pay, they will not lead to an explosion in the average real supply price of labour shown in Table 1 column (ii), which is the price of labour most closely corresponding to the *real wages* of economic theory.

If the average real supply price of labour remains relatively steady, then it follows, from the analysis presented in this paper, the average effective supply price of labour, as shown in Table 1 column (iii), will remain relatively steady also. Thus, any cuts in the direct taxes on employment incomes will tend to reduce the average effective demand price of labour in column (iv), which to an employer is the cost of labour that matters.

This latter price of labour matters equally to employees, for it is a significant factor determining the demand for labour which, in turn, governs an employee’s ability to maintain the current level of earnings.

The first positive step

The positive action that government must take, in order to make possible a first step along the road to sustained economic recovery, is a cut in direct taxes on employment.

To ensure the intended result the tax cut must have the greatest immediate effect on labour costs with the minimum of net loss to government revenue.

If the net loss of revenue is too large, success is pre-empted by the inevitable sharp increase in the borrowing requirement.

Immediacy is equally vital; for, during a time lag between the tax cut and its effect on labour costs, the competitive advantage of British producers may continue to be eroded, thus dissipating the intended benefits before they arise.

The most effective method open now for government to achieve a significant and immediate reduction in labour cost would be the abolition of employers' contributions to social security, including the recently introduced surcharge, with a pro-rata reduction in the self-employed rates.

Such action would have an immediate effect since, within one month, the actual paid-out costs of all UK employers would be significantly less. To marginal firms, the immediate effect could mean the difference between making true profits, or real losses.

This direct and effective result could not be achieved by cuts in other forms of taxation. For the most part, other reductions would make little or no immediate contribution to economic recovery.

For example: with a cut in income tax it takes some months for the tax tables to be adjusted and, assuming the twelve-months rule is adhered to, it will then take up to another year before the tax cut is reflected in the average demand price of labour, with yet a further time lag before unemployment is noticeably reduced.

The immediate priority is to get the economy moving again, after which income tax and other direct employment taxes could be cut with advantage to sustain the momentum.

A tax cut

In a full year, estimates of the gross loss of revenue arising from the abolition of employers' contributions might be around £6,000 million. The precise figure would depend upon the assumptions, but it is the actual net loss of central government revenue which is of importance to public finance, and this would be far less.

Firstly, public authorities are large employers of labour and in their case employers' contributions amount to no more than a self-cancelling book transaction.

Secondly, a reduction in employment taxes would reduce the need for employment subsidies, and most of these could be phased out with advantage to overall employment prospects.

Thirdly, the proposed tax cut is the equivalent of a reduction of 4 to 5 percentage points in the average effective demand price of labour and, by stemming the tax drain, would improve the liquidity of employers.

From past experience, the combined effect may be expected to reduce the number of unemployed by some 400,000 people within fifteen months. A reduction in unemployment will automatically cut public spending through savings in social security payments for unemployment.

Yet again, the expansion of output and employment improves the buoyancy of the yield from other taxes, thus reducing the net loss of revenue still further.

A tax increase

In the 1840s Sir Robert Peel turned a large budget deficit into a surplus by cutting the tax rates. In the present circumstances the power of government to cut taxation is constrained by the size of the current borrowing requirement. Thus, notwithstanding Peel's example, they now have little choice but to cover a substantial proportion of the net loss of revenue from the proposed cut by an increase in other tax rates.

Since a reduction in social security benefits is not part of the proposed measure, it seems likely that government may feel bound to claw back in other taxes some £2,000 million of the original tax reduction. This new revenue needs to be raised immediately with the minimum of administrative costs, which necessarily excludes the consideration of any new method of raising revenue.

Again, the additional revenue must be raised in a way that will not significantly depress the purchasing power of take-home pay, or raise labour costs, or impair the competitive ability of British producers relative to foreign producers. The least harmful method within the framework of the present tax structure by which these requirements could be met is by raising the standard rate of VAT from 8 per cent to 12½ per cent. This one measure would provide sufficient revenue and could be implemented immediately with the minimum of administrative expense.

How they balance out

The common argument against an increase in the rate of VAT is that it tends to raise directly the price of most consumer goods, and thereby tends to reduce the purchasing power of take-home pay.

When considering tax effects in isolation this argument is valid, but within the total immediate policy package being proposed in this paper, the VAT effects on the general consumer price level will be more than offset.

Appreciation of the sterling exchange rate will reduce directly the sterling prices of all imported consumer goods (for example, tea and coffee prices about which the Government are expressing much concern), and will also reduce indirectly the price of other consumer goods to the extent that their manufacture depends upon imported raw materials.

The reduction of labour costs by the abolition of employers' contributions will tend to reduce the prices of all consumer goods, particularly where labour cost is significant, whilst the increased VAT rate will apply only to a limited range of consumer goods and

services. Some items may rise in price as a result of the VAT effect not being fully offset, but many essentials, such as food, will be significantly reduced, for they are not currently subject to VAT.

In general, the consumer price index may be expected to fall, with the greatest benefit accruing to those on low incomes and to families with children, since those two sections of the community spend a larger proportion of their incomes on essential items that are excluded from VAT.

Effects at home and abroad

The advantage of raising additional revenue from VAT is that it is less harmful to the competitive ability of British producers than direct taxes on employment. Direct taxes on employment do not affect firms based overseas but they directly affect British costs and prices.

Changes in the employers' contributions to social security affect British labour costs immediately. Changes in income tax, or in employees' social security contributions, affect labour costs after a time lag through changes in money wages and salaries.

However, goods and services liable to VAT are charged at the same rate of VAT when sold on the home market, whether they be produced in this country or imported, whilst VAT is not charged on exports. Thus an increase in the rate of VAT will not discriminate between home or overseas production, but a cut in direct taxes on employment will provide British producers with a much needed opportunity to improve their competitive edge in all markets.

Editors' note:

VAT was introduced from 1st April 1973 as a condition of Britain's entry into the Common Market. It was initially applied at a flat rate of 10% for most items. In July 1974 this was split into a lower standard rate of 8%, and a higher rate of 12.5% for petrol and some luxuries. The higher rate was increased to 25% from November 1974, and reverted back to 12.5% in April 1976. Then, in June 1979, the higher rate was abolished, and the standard rate increased from 8% to 15%. The standard rate for most items was further increased to 17.5% in March 1991.

VII PROPOSALS SUMMARISED

1. Non-intervention in the foreign exchange market.
2. Abolition of employers' social security contribution, including the present surcharge.
3. Phasing-out of all employment subsidies other than payments in respect of re-training.
4. Continued restraint in public authorities' spending, and the full acceptance of monetary disciplines.
5. Excessive net loss of government tax revenue to be covered by raising the basic rate of VAT.
6. Government revenues from oil to be used in the following order of priorities:-

   a) Phased abolition of employees' social security contribution.

   b) Reduction of income tax.

   c) Reduction of public debt.
7. Investigation of methods for the future reform of the system of public finance. This investigation to include:

   a) The eventual abolition of all taxes on employment.

   b) The re-financing of the system of social security.

   c) Reform of local government finances along the lines suggested in ESA Paper No. 2.[4]

---

4 *Local Government Finance*, published by the ESA in January 1970. The recommendations included the determination of rateable values on the basis of situation rent (location value) only, accompanied by a centrally regulated equalisation fund to which all local authorities would contribute.

Sources

1. Chart A: Changes in share of tax revenue and post-tax property income.

   Prior to 1946: (i) C. H. Feinstein, *National Income, Expenditure and Output of the United Kingdom, 1855-1965*; (ii) Mitchell and Deane, *Abstract of British Historical Statistics*; (iii) *Annual Abstract of Statistics*, HMSO.

   From 1946 through to 1975: *National Income Blue Books*, HMSO.

2. Chart B: Tax revenue as percentage of GNP at factor cost.

   Economic Trends, HMSO.

3. Chart C: Tax revenue as percentage of taxable capacity.

   Economic Trends, HMSO; and Department of Employment.

4. Chart D: Tax and borrowing as percentage of taxable capacity.

   National Income Blue Books, HMSO.

5. Chart E: Labour costs, profits and unemployment.

   Economic Trends, HMSO; and Department of Employment.

References

1. *Council on Prices, Productivity & Incomes. First repor*t. HMSO, London, 1958.
2. M. Friedman, *Inflation and Unemployment*. Occasional Paper 51, Institute of Economic Affairs, London, 1977.
3. M. Friedman, *Unemployment versus Inflation*. Occasional Paper 44, Institute of Economic Affairs, London, 1975.
4. J. M. Keynes, *The General Theory of Employment, Interest and Money*. Macmillan & Co., London, 1936.
5. Ronald Burgess, *Fanfare to Action*. Paper No. 3, Economic Study Association, 1973.
6. Alan Sweezy, *Comparisons of Government Expenditures with National Income*. The American Economic Review, Vol. XLII, December 1952, No. 5, pp.887-890.
7. Hugh Dalton, *Principles of Public Finance*. Routledge Keegan & Paul, 4th edition, 1954.
8. C. J. Bruce, *The Wage–Tax Spiral: Canada 1953–1970*. Economic Journal, Vol. 85, No. 338, June 1975, pp.372-376.
9. C. H. Feinstein, *National Income, Expenditure and Output of the United Kingdom, 1855-1965*. Cambridge University Press, 1972.
10. Mitchell and Deane, *Abstract of British Historical Statistics.* Cambridge University Press, 1962.

ECONOMIC STUDY ASSOCIATION PAPERS

No. 1	Enquiry into Prices and Incomes	£ 0. 25
No. 2	Local Government Finance	£ 0. 75
No. 3	Fanfare to Action	£ 0. 75
No. 4	Social Justice or Unbridled Government	£ 1. 00