PART II

CHAPTER I

OUR FINANCIAL EMERGENCY

§ 1. HAVING formulated the main principles of sound taxation for the normal life of the modern state, with the chief reforms in our present tax system which the application of these principles involve, we are confronted with the questions, " How far are these principles and reforms adequate to the financial emergency in which Great Britain stands after the war ? " " Is it possible or necessary to supplement normal methods of sound finance by some special levy designed to relieve the stress of the emergency and to expedite a return to more normal conditions of finance ? " In order to furnish an answer to these questions, it is necessary first to present an approximate estimate of the financial situation when the extraordinary expenditure involved in war has been concluded. For this purpose, it will be convenient to endeavour to forecast the situation presented at the close of the year 1919–20 when our national finance may be considered to have settled down on a more normal basis.

In round figures (it would be idle to aim at precision among so many incalculables) the situation at the close of the present financial year (1919–20) is likely to be this: The gross sum of the national debt will have risen from 650 millions, the pre-war figure, to at least 8000 millions. For the debt at the close of last financial year reached 7557 millions, and 275 millions is an exceedingly low estimate of the new borrowing needed to make both ends meet this year, when the estimated expenditure amounts to 1435 millions. For, making ample allowances for a large contribution from the sale of Government properties of various sorts, and for the maintenance of the excess-profits tax, or some equivalent, a large gap between revenue and expenditure admittedly exists, requiring increased borrowing.

Now, on the assumption that our Dominions make provision for the sums loaned to them, and deducting the pre-war interest on the pre-war debt, we are faced with the necessity of finding a war debt of 7000 millions. The interest on 7000 millions will be some 350 millions, to which must be added 35 millions for a low sinking fund at ½ per cent. Next year's pensions fund will admittedly exceed the 72 millions for this year, and may be placed at 80. This gives 465 millions as a direct war legacy. How large an addition must be made for the normal costs of military and civil government it is impossible to prognosticate, for these sums depend upon national policy. But, even if a peace be got so satisfactory and so well guaranteed as to secure the early withdrawal of all expeditionary forces and armies of occupation, it is impossible to expect that military, naval, and aerial expenditure can be reduced for some years to come to anything approaching the pre-war figures. The most sanguine of financiers could not hope to see the united expenditure upon these services down to a lower sum than 150 millions. It is equally certain that the civil expenditure must greatly exceed the pre-war level. Even were we to get rid entirely of the heavy subsidies for bread and railways, the higher level of prices, salaries, and wages for all materials and services, together with the new expenditure incurred on housing, education, land improvements, etc., must certainly involve an increase of purely civil expenditure from 95 millions in 1913–14 to at least double that sum. Indeed, a round estimate of 190 millions will be recognized by anyone who considers the circumstances an exceedingly conservative one.

But if we add to these sums, respectively 150 millions and 190 millions, to our estimates for debt and war pensions, viz. 465, we reach the total of·805, or, for convenience, say 800 millions. And even this makes no provision for many important tasks, such as improved transport, electrical development, etc., which will almost certainly demand large initial expenditure from the State.

§ 2. The early and considerable reduction of the war-debt therefore presents itself as a financial problem of immediate urgency. To its solution several proposals have been made in the nature of a levy upon the body of existing wealth or capital. If no such emergency step is possible, we are confronted by a situation which will oblige us to raise the income-tax and death-duties to a far higher level after the war than the highest point of war-taxation. For even if the lowered excess-profits duty, essentially a war tax, is retained, its yield must be very largely reduced, and the aggregate yield of tax-revenue from all present sources will show a very considerable deficit, even if a most conservative policy is pursued by the Government in regard to all new committals.

Now, is there any reasonable ground for anticipating that ordinary taxes will be more productive in 1920 than in the last year of war, when the total revenue from all sources amounted to 889 millions, towards which the excess profits-tax contributed 285 millions?

Possibly customs and excise may furnish a few more millions. If the excess-profits tax were then entirely dropped, such elements of rising income as would have been brought under this tax would then become liable to income-tax and super-tax. Allow 20 millions for the former and 80 millions for the latter rise in ordinary tax-revenue, there will still remain a deficit of more than 100 millions.

Thus we shall be forced to face the alternative courses of raising the income-tax and death duties above the high level of war-time or reducing the size of the war debt by a special levy upon property. Another alternative, that of cutting down to a large extent civil and military expenditure, must be ruled out as impracticable. Though more careful administration of finance can make considerable reductions in the staffs and other costs of civil dependents, it cannot wholly stay that growth of expenditure demanded by increased efficiency of Government in every modern state. Nor is there any remarkable expectation that for some years to come the state of the world will be such as to bring about in this country a reduction of expenditure on armaments below the pre-war level.

Indeed, to place the deficit for 1920 at 100 millions is really an exceedingly conservative estimate. For it assumes that the artificially-swollen prices and money increases of war-time will be retained in peace-time, or will be compensated by enhanced productivity of industry and commerce on a not much reduced price basis. Now, though it is pretty certain that high incomes, so far as they are the natural expression of high prices, will remain, it is likely that there will be great difficulties in maintaining the full employment and the high productivity of war-time, for reasons in part financial and industrial, in part political. In assuming, therefore, that income-tax, and super-tax with the other minor contributions from customs and excise and other 'business' success, will remain at as high an aggregate as in the last year of war, I am taking a perhaps unduly favourable view of the revenue. But even so, there remains this deficit of 100 millions. If it had to be met by income-tax and death duties, contributing proportionately as now, some 95 millions more must be got from income and super-taxes. Since the yield of these taxes for 1918–19 was 290 millions, an increase of at least one-third would be required. In other words, the normal 6s. on unearned incomes would be raised to 8s.

Professor A. C. Pigou writing in the *Economic Journal* of June 1918, makes a more unfavourable computation of the post-war situation.

He holds that the needed revenue after the war will amount to 800 millions (with no allowance for increased expenditure on the new social-economic policy), and, taking the 1917–18 basis of revenue from income- and super-tax estimates that "except so far as other duties are imposed—and broadly speaking other duties hamper and interfere with production more than the income-tax does—it would seem inevitable that income-tax and super-tax, which yielded £239 millions in 1917–18 will have to be raised permanently to double the rates which then ruled." The significance of this judgment is given in the following table which I may here adopt as approximating fairly closely to the situation expressed in my own computation based on the higher tax and revenue yield of the year 1918–19. If the 1917–18 rate of income-tax were doubled, so as to meet the requirements of the revenue,

Incomes of	£500	will pay	3/9	in the £	=	£93	leaving	£407
,,	£1,000	,,	5/–	,,	=	£250	,,	£750
,,	£2,000	,,	7/4	,,	=	£733	,,	£1,267
,,	£5,500	,,	8/8	,,	=	£1,083	,,	£1,417
,,	£3,000	,,	10/–	,,	=	£1,500	,,	£1,500
,,	£5,000	,,	11/3	,,	=	£2,895	,,	£2,125
,,	£10,000	,,	13/1	,,	=	£6,541	,,	£3,459
,,	£30,000	,,	15/8	,,	=	£23,500	,,	£6,500
,,	£75,000	,,	16/2	,,	=	£60,624	,,	£12,366
,,	£100,000	,,	16/7	,,	=	£82,916	,,	£17,084

Now those who, examining this table, concentrate their attention upon the relatively large incomes remaining to the rich after the State has taken its increasing slice, may be disposed to approve this method of raising the required revenue, on general grounds of equality and utility. The £10,000 man can, they will say, easily afford the sacrifice of £6541, for the remainder will still enable him to live not merely in comfort but in luxury. Why should not the £100,000'er, whose swollen income is evidently the fruit of monopoly, give up nearly £83,000? The remaining £17,000 will satisfy all but his most extravagant tastes. At any rate, there is a double gain in attaching these high incomes. The revenue is benefited and productive power is diverted from luxury trades to useful employment by this reduced expenditure on superfluities.

But, while agreeing that the necessary revenue must be got out of the well-to-do with large ability to pay, we must ask ourselves whether this is the best and safest way of trying to get it. For, if the attempt to get it were met by a refusal or an inability to produce it, it would be best to try another way. Now, there are reasons to believe that some motives or incentives needed to bring these high incomes within the reach of this taxation would be seriously impaired by so sudden and large an increase of the graduated income-tax. A raising of the income-tax normal rate from the 6s. level of 1918 to our 8s. level, or Professor Pigou's 10s. level, would leave such a small proportion of the gain from the higher increments of income to the recipients as to make it probable that many of them would withhold the trouble of earning them. Professor Pigou puts it thus: "The extra effort which raises an income from £2500 to £3000 would be mulcted of no less than 16s. 8d. in the £; that which raises one from £9000 to £10,000 of 16s. 2d.; from £16,000 to £20,000 of 16s. 11d.; from £30,000 to £40,000 of 17s.; from £75,000 to £100,000 of 17s. It seems impossible to doubt that these tremendous rates—tremendous even on additions to relatively low incomes—must clearly check enterprise. The gain left as a reward for success in risky undertakings would be so small that many, who would otherwise have ventured out of the beaten track, will no longer think it worth while to do so." Even if our reformed graduation were applied so as to reduce the taxable rate for the lower as compared with the higher incomes, the main difficulty would remain. Indeed a new difficulty would be added. For a graduated curve which should sensibly relieve the lower at the expense of the higher incomes would probably reach 20s. in the £

before the highest income level was tapped. Even my own proposed rate of 8s. would in a scientific graduation approach the same result in the highest incomes.

We need not overstress the difficulty. Some critics will deride the suggestion that any really productive effort is required from the recipients of these high surplus incomes. A landowner will take the highest ground rent his economic opportunties permit, even if 19s. in the £ of the rent were taken from him in taxation. So with the big proprietor or shareholder in businesses whose monopoly or quasi-monopoly enables them to earn great surplus profits. The 'effort' involved in earning the highest increments of this profit will be incurred not by the recipients of the surplus, but by the management and labour whose remuneration will be calculated to sustain this 'effort' and will not be 'mulcted' by the high taxation. Provided that the directorate and managerial staff have some real interest in making the business as profitable as possible, a very small share of surplus profits is required to furnish sufficient motives to the saving public to subscribe all the capital that is needed. To some considerable extent these considerations reduce the danger which Professor Pigou fears. Large incomes which are entirely unearned, in the sense that no productive effort, directorial, managerial, initiatory, or other, is put forth by the recipient in making them, cannot resist the highest demands of taxation. But, on the other hand, where even a moderate amount of exertion or sacrifice, or risk-taking, is involved in the earning of the higher increment of income, it is manifest that some reasonable proportion of that income must be secured as net personal gains to those called upon to exercise the effort, undergo the sacrifice, or incur the risk. It is not a question of ideal justice, or of the relative importance of the money to the private owner and the State. A great deal of the economic force which extorts very high payments from the consuming public from the goods or services it supplies is at the disposal of clear-headed business or professional men, who plan and direct it into productive and socially useful channels. They can demand extraordinarily high remuneration for this skilled initiative, organization, and direction, which does involve the expenditure of time, effort, and sometimes mental drudgery. Though this rate of remuneration is often grossly in excess of what they would be willing to take, unless they received what they would regard as a sufficient reward they would not give their best care and judgment to the business. In a word, for such high increments of income there must be a limit of taxability.

The same consideration is applicable to the 'sacrifice' of saving among those grades of savers where the act of 'saving' is a conscious calculation between present and future advantages. An income-tax of 8s. or 10s. in the £, rising to come 17s. in its highest reaches, would undoubtedly reduce the proportion of saving and investment to spending. Though the portion of an income that was spent would have to pay the same rate of taxation as that which was saved, spending would be stimulated and saving repressed. For, while the full present enjoyment would be got from the fixed portion that was spent, the future enjoyment from the taxed income that was saved, would be reduced by the further continuous taxation of the interest it earned. This consideration would have less force in restraint of savings on the higher incomes, in spite of the higher rate of taxation, than on the moderate incomes. For a very large proportion of the savings of the very rich is, as we have already recognized, an almost automatic accumulation of surplus income after a high habitual standard of personal expenditure has been provided. But for moderate incomes, subjected to higher taxation than has been customary, and with a smaller proportionate margin of surplus, the enhanced taxation will certainly diminish saving. The net effect, therefore, of a greatly raised income-tax upon certain important kinds of directorial and other mental productivity, and upon the proportion of saving to expenditure of private incomes, will be injurious. If this be so, the injurious effects will be exhibited in a reduced national productivity during subsequent years, or what amounts to the same thing, a reduced pace of industrial progress, with a damaging reaction upon the taxable body of wealth and the public revenue.

§ 3. The amount of such damage, however, is not gauged by these immediate reactions on the productive effort of our people. A raising of our income-tax to 8s. or 10s. would have other bad reactions upon our financial and commercial position in the world. The London money-market has hitherto been the place where most great enterprises all over the world have had their financial origin. That has been due to the fact that the quantity of capital there available for investment and for other financial operations has been so large as to attract to itself great resources from other rich countries for convenient and profitable handling in a common centre. The 'Bill on London,' the free market for gold, and the certainty of being able to raise large sums of money more cheaply and easily in London than elsewhere, laid a solid basis of financial confidence which has been exceedingly profitable not merely to our finance but to our foreign commerce and national industries. For a very large proportion of the loans and investments financed in London has gone out in the shape of export goods to foreign countries. Now any considerable rise in the taxation of interest upon capital raised in this country would strike a dangerous blow at this profitable business. For in order to induce foreign investors to subscribe to companies floated in London for railway development in Argentina or China, or for mining operations in Russia, it would be necessary to promise rates of interest far exceeding the highest pre-war limits, so as to secure to them even a moderate taxed return for their capital. Can it be doubted that under such circumstances the bulk of our financial business of this order would pass to New York where capital was available on easier terms, and that the stream of profitable commerce would follow the shift of financial supremacy ? For America will be under no necessity to raise her income taxation to our level. Already she has opened effective competition for financial and commercial hegemony in South America and the Pacific, while her growing population and rapid manufacturing development force her to substitute to an ever-increasing extent manufactured goods for food and raw materials in her export trade. The high interest charges in this country, required to secure a minimum necessary return upon fresh invested capital, would so raise the cost of production and the level of prices for our manufactured goods in the markets of the world, as to make it exceedingly difficult, in competition with America, to pay for the imports necessary to feed our population, and furnish materials for our factories.

§ 4. To start our post-war industrial life with this crippling burden of nearly 400 millions taxation for interest and sinking fund upon the war debt would be calamitous. Any sober business man, confronted with such a situation in his own affairs, would feel impelled to make the earliest and fullest effort to reduce the burden of his obligations and to restore his credit, even if he had to sacrifice some of his sound holdings in order to do so. A joint stock company or corporation, plunged into heavy indebtedness by some unforeseen emergency, would endeavour to induce its shareholders to make an early effort to get on to a sound financial basis again. Is a State, regarded as an economic entity, relieved from the obligation to follow this prudent course, because the bulk of its debt is held by its own citizens and involves a transaction by which annual payments are collected from the body of its taxpayers to be handed over to a more select number of these taxpayers who are creditors? I claim to have presented a *prima facie* case to the contrary by indicating the dangers and difficulties of collecting so great an annual sum through the chief channel of our revenue, the income-tax.

But it must not be forgotten that no inconsiderable part of our debt is held by foreigners. Though no exact figures are available, financial experts set the aggregate of our foreign borrowing, inclusive of sales of foreign securities entrusted to our Government, at something like 1500 millions. This does not include the very large sums, withdrawn early in the war from financing foreign trade operations in various parts of the world and applied to finance the needs of our Government. Nor does it include the large sales of foreign securities effected by private owners in this country for conversion into money for subscriptions to war loans. The net effect of these financial operations will probably be to reduce our aggregate foreign holdings by something like 2000 millions and to create a positive indebtedness of another 1000 millions. Now this would signify a disturbance to our balance of foreign trade amounting to at least 150 millions per annum. In other words, if we are to maintain our necessary supplies of imported goods, we shall, by reason of our diminished interest on foreign investments and our new interest obligations on our foreign borrowings, be compelled to increase our export trade by at least 150 millions. And this we must do at a time when the world prices of the goods we import, foods and materials, will, by the circumstances of a world shortage, stand for years to come at a higher price level than the manufactures which we export. It is true that, as we have shown, the selling price of our manufactured goods must, for internal trade at any rate, be raised by reason of this high rate of interest, and, we may add, the high money wages of labour. But for export trade, we shall have to sell at prices determined by the competition of countries less hampered than ourselves by these increases in cost. This necessity of 'dumping' our goods in foreign markets in order to pay for our necessary imports will be fraught with new risks to our people. For it will oblige all our exporting trades to organize themselves as strongly as possible so as to maintain the prices in the home market at a level high enough to support the dumping policy abroad. In order to do this, there would be a specious case for keeping out foreign manufactures from our markets. In other words, the establishment of tariff-protected and subsidized trusts, cartels and combines, would be an almost inevitable result of the financial and commercial pressures generated by the burden of war indebtedness.

§ 6. There is only one way of avoiding these perils, viz., by an early and drastic reduction of our national debt. The policy of debt redemption is admitted, and all State financiers propose some sinking fund for the purpose. But if this sinking fund is operative in slow process over forty or fifty years, the financial situation in the early years of unsettlement following this war will be fraught with all the perils I have described. The only means of safety is the enlargement of this sinking fund to such a size as to furnish immediate or early relief. To establish a sinking fund which would at once reduce the total indebtedness by one-half, leaving the rest of the debt to the slower process of redemption, would greatly ease the situation. If, by a levy upon the capital wealth of our people, we could reduce the debt now, or at an early date, from 7000 millions to 3000 millions, the present rate of taxation might enable the Government to meet its necessary expenses, instead of being confronted with an annual deficit of over 100 millions. For the reduction of interest and sinking fund thus achieved would amount to nearly 200 millions. This would seem to wipe out the deficit, leaving some 100 millions surplus in hand. The actual position, however, would not be so favourable. For if this reduction of the debt was achieved by a capital levy, the interest upon the capital thus taken would no longer figure in the annual income subject to taxation, while the values passing each year as death duties would also be reduced. Thus both sources of annual revenue would suffer a reduction which must be taken into account in considering the net economy of the levy. The exact amount of the reduction cannot be estimated. For the latest official returns do not enable us to know what proportion of the yield of the income-tax is from rents and dividends and interest. Earlier Reports, however, give the yield for such unearned income at approximately three-fifths of the whole. Allowing for the heightened discrimination against unearned income in war-budgets, this proportion may reasonably be raised to two-thirds. Thus, according to the yield from unearned income, two-thirds of the net yield from income- and super-tax for 1918-19 (amounting to 290 millions), we should get a figure just below 194 millions. Next, taking the aggregate capital-values in this country susceptible to taxation at 16,500 millions (a figure from which we shall find a large amount of support), we perceive that a levy of 3,500,000,000 amounts to between one-fourth and one-fifth of the aggregate wealth. On this basis, the loss in yield of income-tax, on account of the capital levy, would be between 49 millions and 39 millions. Put it at 45 millions and add a proportionate amount of 4 or 5 millions for the reduced yield for death duties, and the figure reached, say, 50 millions, would still leave a small surplus in hand upon the basis of a retention of the present rate of income-tax. A levy of some 3500 millions would, in a word, save us from the dangerous alternative of raising in peace time the rate of the war income-tax.