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**FIRST PRINCIPLES  
OF PUBLIC FINANCE**

FIRST PRINCIPLES  
*of*  
PUBLIC FINANCE  
*by*  
ANTONIO DE VITI DE MARCO



*Translated from the Italian by*  
EDITH PAVLO MARGET

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THIRTY BEDFORD SQUARE  
LONDON

FIRST PUBLISHED 1936

REPRINTED 1950

REPRINTED 1952

X7

G6

41503

PRINTED IN GREAT BRITAIN BY BUTLER & TANNER LTD.

FROME AND LONDON

BOUND BY A. W. BAIN & CO. LTD.

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## TRANSLATOR'S NOTE

No apology is needed for introducing this book to English readers. In the review to which Professor De Viti de Marco refers in his preface to this translation, Dr. Frederic Benham stated the book's claim to attention from an English audience better than I could hope to state it:

"This is probably the best treatise on the theory of Public Finance ever written. In its more restricted sphere, it is comparable to the *Principles* of Marshall. Like the *Principles*, it is the product of many years' thought; like the *Principles*, it can be read again and again, and brings fresh illumination each time; but, unlike the *Principles*, it has not had the influence it deserves, except in Italy, where its effect has been profound, and possibly in Sweden . . . The lack of an English translation is a great misfortune and loss to all students of Public Finance in English-speaking countries."<sup>1</sup>

This translation is based on the definitive edition of the *Principii*, published at Turin in 1934. Books I, II, and V are presented in their entirety, with a few very minor changes, most of them suggested by the author, and all of them approved by him. At his suggestion, also, or with his approval, several sections have been omitted from Books III and IV, since their discussion of the details of the Italian tax-system was deemed of minor interest to non-Italian readers.

My sole aim in this translation has been to render the author's meaning with the maximum of fidelity. I have made no attempt to soften or modify the peculiarities of the author's style; if I had attempted, for example, to provide a substitute for the abrupt transitions or the short, brusque paragraphs, I should have conveyed an impression entirely different from that conveyed by the Italian original.

The author has seen and revised the whole of the translation. I have attempted to incorporate his suggestions even in cases in which I myself should have preferred what seemed to me a more elegant rendering; but I trust that I have admitted no barbarisms. In order to minimize the danger of misunderstanding wherever questions of

<sup>1</sup> *Economica* for August, 1934, pp. 364, 367.

### TRANSLATOR'S NOTE

nomenclature are involved, I have added a series of footnotes in which the translated phrase is given in the Italian original.

I must acknowledge my debt to my husband, Professor Arthur W. Marget, under whose supervision the translation was made.

EDITH PAVLO MARGET

Minneapolis

*January, 1936*

## PREFACE TO THE ENGLISH EDITION

To the Reader:

I HAD intended to write a preface to this English edition which would take account of such reviews of my book as have appeared — especially those which appeared in German publications — and would answer some of the criticisms that were made in those reviews.

But when I began to write the preface, I realized that the major criticisms do not derive logically from the premises on which my treatment is based, but arise from a different conception of the theory of Public Finance. They derive, that is to say, from the common notion that the phenomena of Public Finance give rise to problems, not of theory, but of practical statecraft. For the solution of these practical problems each writer then has recourse to his personal ideals of social justice, on the basis of which he offers gratuitous advice to the politician, often without noticing that the latter accepts the advice and follows it only in so far as the precepts that were developed within the scientific or supposedly scientific field happen to coincide with the interests that the politician is defending in the political field.

It is for this reason that, on the fundamental issue, my critics and I proceed along parallel lines which never meet.

In fact, I treat Public Finance as a theoretical science, assigning to it the task of *explaining* the phenomena of Public Finance as they appear in their historical setting. Hence it is necessary, on the one hand, to go back to the causes of these phenomena, and, on the other hand, to trace their effects.

From my point of view, therefore, the phenomena of Public Finance are variable. Thus, the Public Finance of the Middle Ages is not the Public Finance of modern times; the Public Finance of States based upon slavery and absolutism differs from that of free and parliamentary States. The resulting treatment is a complex one, which passes from the abstract to the concrete; the method involved is not an easy one, since it borders upon different disciplines; but at any rate it is a treatment which is objective, impersonal, and

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theoretical, in contrast with an approach founded on *a priori* canons of absolute justice, which does not exist.

It is also logical that the basic premises of the theoretical reasoning should be deduced from the historical milieu to which the phenomena belong, since Public Finance cannot stop with the abstract, but must proceed to the concrete problem.

Now, we hold that in modern society all income is produced as the result of the free activity or free choice of the citizens, and that these incomes are, as a matter of fact, qualitatively equal — that is, that they are homogeneous economic quantities — since they represent the maximum that each individual is able to produce under given conditions. From this is derived the juridical premise of equal fiscal treatment of all incomes; and from this it follows also that, as we pass from the abstract to the concrete, every deviation from this principle — whatever the cause of the deviation — is an acknowledgment of the presence of a political factor, the nature of which must be ascertained and the relative influence of which must be evaluated.

And here I stop, because I do not wish to repeat myself *ad infinitum*.

While holding firmly to my premises, I am prepared to regard as useful and even welcome, for purposes of discussion, all the criticisms directed against my particular theories; but I prefer, for the present, to leave these criticisms to the judgment of the reader.

I have greatly desired this translation, particularly because I hope to find among English economists, who maintain faithfully the tradition of theoretical treatment of economic problems, an easier understanding of the method that I have tried to apply, *mutatis mutandis*, to the problem of Public Finance.

And now that the translation is appearing, I am anxious to express my gratitude to those who have helped to bring it into being: to Professor Arthur W. Marget, who charged himself with the responsibility of finding a translator and publisher; to Professor Lionel Robbins, who graciously offered to include the volume in the series in which it appears; to Dr. Frederic Benham, who was kind enough, in a review of this book in its Italian and German dress, to call for an English translation, and thereby, I suspect, encouraged the publisher to assume the risk involved (which I hope will turn out



#### PREFACE TO THE ENGLISH EDITION

to have been not too great); and, above all, to my translator, Mrs. Marget, who, with the generosity of true friendship, so readily consented to undertake a difficult and trying task. To all these I can only express my heartfelt thanks.

A. DE VITI DE MARCO

Rome

. December 24th, 1935

## INTRODUCTION

THIS book, now presented in a definitive edition, is one of the representative works of contemporary Italian economics. The international reputation of its author, Antonio de Viti de Marco, does not yet correspond to the estimate of him as *facile princeps* which is held by the scholars of his own country; just as, indeed, it often happens that men whose reputation at home is no more than average enjoy a great reputation beyond the borders of their own country. It is therefore to be hoped that this translation of his book will make known outside of Italy one of the most independent and original spirits that grace Italian economic science.

For more than forty years Antonio de Viti de Marco was a renowned professor of Public Finance at Rome. Yet he has always been very much more than a mere professor. He is a true nobleman, a statesman, a thinker. He is also one of the group of men who, between 1885 and 1900, published in the pages of the *Giornale degli Economisti* contributions to the pure theory of economics so important that they made the period which was known as that of the Lausanne School, but which should really be called that of the Italian School, comparable with the most brilliant epochs in the history of our science. Of the men who made up this group, Pareto is perhaps the best known; but the others — Pantaleoni, Barone, and De Viti — have equal, if not greater, claims to distinction.

One is perhaps less quickly attracted to De Viti than one was to the others. The fine face, with its distinguished features, the inviting yet slightly ironic smile, the slow speech, hesitating sometimes as it gropes for and finally hits upon the precise expression it wishes, the easy manners of a *grand seigneur* — all these reveal at once his aristocratic origin. Born of a noble family of landed proprietors in the south of Italy, he belongs to the tiny group of men who have consecrated their lives to public service because, being economically independent, they feel it their duty to serve their country without preoccupation for themselves or for interests they might represent. It was to them that, in countries under parliamentary government, the power belonged up to the middle of the nineteenth century. They were always few, however, in Italy, where, for the most part,

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the chambers were crowded with professional politicians or representatives of economic interests. It was almost as rare in Italy that a member of the aristocracy who was still attached to his ancestral estates should devote himself to scholarship.

It is impossible to speak of the share which De Viti has had in advancing the subject of Public Finance without associating it with his general intellectual position and his activity in public life. His position was that of a liberal of the classical period. When, in 1899, he opposed the bill for control of the press which the government introduced after the riots in Milan, he took the position that the press is no concern of the State, and that the State has no right to prescribe its tenor nor to discipline it; that, on the contrary, every citizen has the right to say and to write in the newspapers what he thinks, with the understanding that he is subject to the consequences which his action may have in accordance with the general law of the land. He wanted to see adopted in Italy that definition of freedom of speech which had been established by English authorities on constitutional law: 'the right to say and to write what will not be found improper by a jury of twelve citizens'. To be sure, one does not in this way obtain a 'legal' definition of what one may and what one may not write. Yet he regards as worthy of pity a society which believes that it must defend itself against its members by legal definitions and prosecutions. Free expression of opinion and sharp criticism show where existing evils lie, and facilitate their abolition. If one believes that the twelve members of a jury will acquit the authors of political pamphlets and political offenders, then there is no other way to salvation than to change public opinion and the ideas which are widely diffused and regarded as sound in the society in which the twelve members of the jury live. The free exchange of opinions and not violence is the method by which we must proceed in order to transform society.

In his capacity as one of the editors, beginning with July 1st, 1890, of the *Giornale degli Economisti*, and as deputy to Parliament during the war, De Viti fought notable battles against all forms of privilege and on behalf of freedom: against privilege-demanding protectionism, in favour of a reorganization of the banking system, in favour of the equalization of the tax-burden as between different groups and different regions, in favour of the independence of constituted authorities, against the privileges of public enterprise, the

## INTRODUCTION

co-operatives; and the socialistic organizations. After the war, the excesses of the class-organizations and the disintegration of the social structure led to the tenants' taking the place of the landlords, the seizure of land by those who were not capable of cultivating it, the occupation of factories by workers who had no capital and were not trained to manage them, and to the plundering of shops on the pretext of forcing a lowering of prices. At that time he belonged to those who attacked the inaction of the government. He attacked the dictatorship of the bureaucracy, which had existed before the war, but had grown to enormous proportions during the war — a bureaucracy which, exploiting its supposed familiarity with the technicalities of administration and the unfamiliarity of the ministers with those technicalities, imposed itself upon the successive governments and upon parliament, and regarded the State as its own property, the tax-payers being regarded as subjects who have to pay taxes for their benefit. Though his criticism, up to the very last (1922), was designed to arouse the conscience of the country against all interference with the right of the individual to freedom and against interference with the parliamentary system, his chief aim was always the strengthening of the liberal, democratic state.

The rise of Fascism, with whose action against the dissolution of the state De Viti and his group had at first been in accord, prevented further public activity on his part. It is clear that Fascism was irreconcilable with a political confession of faith that wished, to be sure, a strengthening of the State, but wished also that the State should be democratic and liberal. It wished, that is to say, a state that is so organized that it completes the individual and makes him freer. Thus, in 1922, De Viti and his group had to step aside, and their voice was stilled.

The thinker, however, remained; and he took advantage of the political retirement into which he had voluntarily withdrawn to prepare the book which is now presented to the public.

Perhaps it is due to his retiring character — not haughty, yet not found encouraging by most young people — that De Viti has not formed what is usually called a 'school' of students of Public Finance. Nevertheless all of us who have studied the problems of finance during the last thirty years regard him as 'the' master. He has attained this position naturally, as the result of a spontaneous and universal recognition. It does not always occur to scholars to study

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the books of others when troubled by a problem in the theory of Public Finance; but almost always it seems natural to them to ask themselves: what does De Viti think about it?

The premises of the *Principles* are to be found in an essay published in 1888 under the title *The Theoretical Character of Public Finance* (*Il carattere teorico dell'economia finanziaria*). Those were fruitful years for the science of Public Finance in Italy. While the four men mentioned at the beginning of this introduction advanced general economic science, it was two of them in particular — Maffeo Pantaleoni and Antonio de Viti de Marco — who from that time on exercised their talent on the special problems of Public Finance. To their names, in this particular field, must be added that of Ugo Mazzola. All three felt a sense of dissatisfaction as they surveyed that sorry mixture of practical precepts, rambling discussions of philosophic and political themes, comments on legal texts, and loose applications of definitions and economic laws which made up, and to a great extent still make up, the literature of Public Finance. When one recalls the pages in which were presented a mixture of abstract reasoning and concrete discussion, theoretical schemes and historical examples, deductive reasoning and empirical illustration of legal instances from this or that country, one sees again the master's ironic smile. 'This is not science,' De Viti would announce as he put the book down quietly. 'The fellow's an ass!' Pantaleoni would cry, in brutal condemnation. 'He knows no economics and he never will learn any!' What Mazzola would have said, I do not know, for I did not know him personally. His was a fine talent, equal to that of his friends. But he was cut off prematurely from a scientific career, and his contribution to its progress was less than it might have been.

Mazzola's book entitled *The Scientific Data of Public Finance* (*I dati scientifici della finanza pubblica*, Rome, 1890), published shortly after that of De Viti, gives evidence of the strong feeling these men had, to the effect that Public Finance must be given a predominantly theoretical character. Mazzola's mind had been stirred by the appearance, about that time (1882), of Sax's great work, *Grundlegung der theoretischen Staatswirtschaft*, popularized with amazing success in Italy by Giuseppe Ricca Salerno. But Sax's habit of drawing a sharp contrast between individualism and collectivism, and his habit of postulating certain collective aims, which could in fact be distin-

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guished from individualistic aims only with difficulty, and then not clearly, was not a method which suited the clear minds of our theorists. Mazzola built his logical structure more directly. There exist, in the first place, the aims of the individual. To attain these, however, it is necessary to accomplish other aims, which represent the *necessary condition* for the accomplishment of the final aim, and which cannot be obtained otherwise than by *collective co-operation*. Man does not set as his ultimate or direct aim such things as national defence or general security. He wants to accomplish his material aims of life, or his spiritual aims in the field of moral or intellectual improvement. He cannot arrive at these ends, however, unless he is able to live in such a way that he feels secure against his foreign and internal enemies and is prepared to co-operate with other men for the achievement of aims denied to men who live in a state of isolation. Therefore the 'public' aims are distinguished as being 'conditional' to the attainment of the ultimate aims of man and as being attainable only through political co-operation. The voluntary association of private individuals would not serve the purpose; what is needed is rather a political co-operation which is really a form of compulsion. Having defined public aims, Mazzola, following the same general line, defines public 'goods' as those that serve to satisfy the public 'need', so-called because it arises from the necessity or the wish to attain public 'ends'. In this way, Mazzola showed that the science of Public Finance is an autonomous science, different from the science of economics, because it has a subject matter — public ends, public needs, and public goods — which is different and is clearly to be characterized as different from the subject matter of general economics. It must be remembered that the science of Public Finance had up to that time been regarded as merely a chapter of economics, studied apart from the mother science merely for the practical reason of division of scientific labour that was made necessary by the fact that professional economists found it impossible to include along with general economic phenomena the very numerous and important phenomena which are associated with the life of the State. Only then will one fully appreciate the theoretical importance of the attempt of that courageous band of young Italian economists to give the science of Public Finance its own peculiar content, different from that of general economics. It is from this period that we date the beginning of a type of analysis and

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description of financial phenomena which regards the latter as autonomous and distinct from economic phenomena.

Having written a classic study in economic theory on the subject of *The Theory of Tax-Shifting* (*Teoria della traslazione dei tributi*, Rome, 1882), Maffeo Pantaleoni turned his attention to another problem in Public Finance, contributing to the *Rassegna italiana* of 1883 his *Contribution to the Theory of the Distribution of Public Expenditures* (*Contributo alla teoria del riparto delle spese pubbliche*, re-published in Pantaleoni's *Scritti varii di economia*, Palermo, 1904). He there applied to the distribution of public expenditures those criteria that Jevons and Walras had found useful in clarifying, from the point of view of the individual, the laws of the distribution of a given quantity of money between various kinds of goods, present and future. 'In approving any item of expenditure, parliament cannot help feeling that if the total quantity of available resources remains unchanged, many other expenditures, which had been equally possible before the expenditures actually current were approved, were eliminated by the very act of approval. For this reason expenditures must be judged in advance of the act of approval from two points of view: first, from the standpoint of the inherent utility of the expenditure, on the basis of which it is placed on a list of *possible expenditures*; and second, from the standpoint of the utility of the expenditure under consideration as compared with the utility of other expenditures that are equally possible, on the basis of which it comes to be a *preferred expenditure*.' In 1887, Pantaleoni published another study in economic theory on the subject of the *Theory of the Tax Burden* (*Teoria della pressione tributaria*, Rome; later re-published in the *Scritti* cited above), in which he investigated the effects of taxation on earned income and on income from capital. Thus was planted the fruitful seed from which was to develop a whole literature on the consideration of and the choice between the various forms of public expenditures and taxes.

Most of the writers who followed held that Pantaleoni, Mazzola, and De Viti erred in positing as the foundation of the theory of Public Finance a conscious judgment reached upon the basis of a calculation of advantage of the sort associated with the concept of a *homo economicus*.] As a matter of fact — so these objectors argued — decisions are made by governments and parliaments, organs of classes and groups that legislate in their own interest — often not only against the judgment, but also to the detriment of a majority

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of the country's citizens. They insisted, therefore, that a decision taken in the field of Public Finance differs from a decision taken in a strictly economic field not because it is an economic decision applied to collective ends, but because it is a political decision.

If this criticism were true, it would force the science of Public Finance back into the chaos from which those Italian writers of 1880-90 had tried to rescue it. For to call a decision 'political' amounts to calling it a 'synthetic' one, based on a vast number of conflicting interests as between individual classes and parties, on passions, sentiments, and prejudices, which vary from place to place and moment to moment. If some order is to be brought out of chaos, it is necessary first to classify, to catalogue, to rank these bases for the making of decisions; secondly, by means of successive approximations, to deduce, by a process of abstraction, truths of a very general kind; and then, step by step, to deduce truths that are more concrete and nearer to reality. It was this that Pantaleoni had done in the fundamental essay cited above, with his eyes turned realistically on the Italy of his time, applying Jevons's rules concretely to the budgets presented by contemporary Italian Ministers of Finance.

De Viti's own contribution in that period, so creative in the field of the pure theory of Public Finance, was the construction of two limiting schemes or hypotheses for the interpretation of facts. [Who feels the burden of the costs of government and who obtains satisfaction from public goods? Who decides on the levying of a given group of taxes and their distribution among the various branches of public expenditure? The State.] But in what sense may the State be thought of as a sentient being? To which of the known types of economic individuals can we compare it? Here De Viti offers his hypotheses — not as representations of a concrete reality fully attained at a given time and in a given place, but as interpretative tools designed to throw light on the confused mass of facts in the field of Public Finance. In this the statesman joined hands with the thinker. The student who thinks of the science of Public Finance solely in terms of politics no longer has a guide when he comes to philosophize about his subject. For he expects inspiration from politicians; and he explains the facts, which he must classify and systematize, by the various changeable, vague, and contradictory reasons which inspire the actions of politicians from time to time — these reasons, in turn, being the result of a direct and synthetic



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intuition, on the part of the politicians, with respect to the sentiments and wishes of the ruling classes and the governed masses. De Viti, however, saw in all these things — the tangle of facts, the special interests of groups, orders, and classes, the variety of tax systems created in various times and places — certain vital points of orientation. The political history of the nineteenth century seemed to him a transition from a type of government in which a privileged group held the power to a type of government in which the power was in the hands of all. The history of Public Finance was the reflection, in the field of taxes, fees, revenues from public domains, and of public debts, of this transformation. Yet theory is not identical with history. Although it is more concrete, or nearer to reality, than is pure economic theory, the theory of Public Finance must abstract from the 'many' concrete facts 'some' fundamental types, and must ask what public finance would be like if we start from the hypothesis that a given 'type' exists in reality. Hence his conception of the two fundamental types of state — the monopolistic and the co-operative — and his study of their financial procedures.

It is idle to object to this sort of analysis on the ground that the two types do not correspond exactly to reality, which is of course more varied and rich. It was not De Viti's intention to construct a science of complete reality. No one has ever known or perhaps will ever succeed in constructing such a science. So long as one's reasoning is straightforward, one's logical construction remains valid. So long as De Viti's two 'types' abstract from reality some features of that reality which are true — so long as they represent, as they unquestionably do, two genuine aspects of historic reality, his construction, in addition to being perfectly logical, is not a futile one; on the contrary, it is full of suggestions for further work in the field. Anyone who wishes to conceive another type of state may build another theoretical structure, which will likewise be perfectly logical and anything but futile. What De Viti has done has been to construct the theory of Public Finance for the monopolistic state — the state of the one or the few — and for the co-operative state — the state of the whole body of citizens. Someone else may construct a different theory for a different type of state. Up to now, however, this has not been done; for what other ideal can seem better in the eyes of the student of Public Finance than that of a state dedicated to the service of the general interest, in the present and in the

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future, of the whole nation? The statesman who, when he reads, looks, not for minute rules of daily life, but for a guide which, like a beacon, will direct him in the choice of the road which he seeks, and which he will later traverse in very different ways according to the changing phases of history, will always be grateful to De Viti for having offered two guiding lights. One of these he will certainly wish to avoid; for no one wishes to govern peoples for one's own sake or for that of the group to which one belongs. The other beacon flashes a hope of arrival in a port which will represent a gain for all, the attainment of that goal which is best suited to the whole nation.

Every science is the more fruitful as a science in proportion as it is not dominated by insistence upon immediate practical applications. It was not De Viti's primary intention to give advice to those who govern. What he did was to study, in a logical manner, what would be the actions — and the consequences of the actions — of those who govern, according as the latter are assumed to be bent upon benefiting themselves, on the one hand, or the whole nation, on the other. It is precisely because De Viti wished to remain in the abstract field of science that his book is a precious guide to the practical man.

What then are the two hypotheses, the two instruments for the interpretation of historic reality, that he offers to students of Public Finance?

We have, at one extreme of historic reality, a monopolistic state, characterized by the fact that the decisions with respect to taxes and public expenditures are in the hands of a victorious class, of a caste, of the 'estates' that have the power and use it for their own benefit. Speaking broadly, we have, as examples of this type, the feudal states and the absolute or oligarchic states. Under this hypothesis, the producers of public services are distinct from the consumers of these services. The former, represented by those who govern, are exempt from contributions toward the support of public burdens, since it is impossible to imagine a producer's paying himself for the wares that he himself produces. Since the dominating producing group can sell its wares at a price fixed arbitrarily by itself, and since it can force consumers to buy goods to an amount which, like their price, is determined by it — these are the universal technical characteristics, in every era and every type of state, of the distribution of public expenditures — it will act toward these consumers,

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from whom it is quite distinct, as a perfect monopolist would act. The price of public services will be a monopoly price in which, in addition to the cost of production, will be included a maximum profit for the producer. In fixing prices, the monopolistic state will not run up against the limitations which hamper the private monopolist, who must take account of the competition of substitutes, of the potential competition of other producers who may not yet be in existence, and of the possible restriction of consumption. In the case of the State, the only restraining forces are rebellion, emigration, or the complete exhaustion of the sources of the nation's private wealth.

At the other limit of historic experience, there is the co-operative state — a modern and uncertain conquest which has been completed only after centuries of struggle. [In this type of state, all the citizens participate in the administration of public affairs. All the producers of public services are also consumers, and vice versa; and there is no longer any antagonism between the ruling and the subject classes. In this type of state, also, taxes are levied by compulsion; nor can the individual citizen refuse to consume the amount of public service upon which the legislature has decided. The compulsion to pay and the amount which is to be paid are technical characteristics which cannot be separated from the idea of a tax. Nevertheless, even though the fact of compulsion remains, one can no longer speak of a monopoly price and of the maximum profits which the subject class must pay to the ruling class. The whole nation is at one and the same time producer and consumer, and such a nation cannot pay itself profits. It follows from this that, in contemporary societies, the people, taken as a collective economic unit, pay a 'net cost of production' for their public services. This collective unit decides for itself the extent of public services and the amount of the national tax-burden, and settles for itself the method by which this burden is to be distributed among the individual economic units who make up the larger collective unit. The personnel which administers public affairs, however, has, predominantly, the character of an agent entrusted with executive powers; and the system of compulsion which it may use does not presume, as was the case with the monopolist, to impose on the nation the extent of public service and the burden or cost of production which corresponds to this amount of public service. It undertakes only to apply compulsion to individuals who are recal-

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citant in the observance of the social compact, within the limits of the mandate which has been given it, and up to the point which represents a proper share in the carrying of the national burden.]

Using this tool of research and building logically on the basis of the concepts of the monopolistic state and the co-operative state, De Viti de Marco has constructed a theoretical system of Public Finance which is quite his own. It was first made available to students and scholars in the form of mimeographed lecture-notes — the first draft of which appeared in 1886-87 when De Viti was at Pavia — and later, in 1923, in the form of printed lectures, carried over in 1928 into the volume entitled *First Principles of Public Finance* (*I primi principii dell'economia finanziaria*), to which was added in 1932 an appendix on 'Extraordinary Public Finance' (*Finanza straordinaria*). Step by step the theory became enriched and perfected; so that it would have been interesting to study the successive variations from one draft to another, if it were not impossible by this time to find the mimeographed versions. Yet if one compares even the first printed edition of 1923 with that of 1928, one finds several new things, the most striking one being perhaps the importance given, in the theory of the shifting of taxation, to the idea that one must not consider a given tax as a net loss for the producer affected, as it is considered in the doctrine which is widely accepted, but must study it as a means for realizing an advantage for the taxpayers. This is perhaps a concept that is not entirely new. Traces of it — neither small nor perhaps even the earliest — can be found in the writings of the physiocrats; and the present writer, drawing his inspiration from the Pantaleonian type of analysis, had occasion in 1919 to illustrate this idea from other points of view. Yet it was De Viti who, by applying the idea to the subject of the shifting of taxation, demonstrated how fresh and far-reaching in its stimulating quality the notion really was.

To-day the *Principles* of De Viti are given to scholars in a new dress. The author has revised the text on almost every page and is pleased to consider the present edition as definitive. We want him to live so much longer that there will be time enough for him to go over his pages again with a fresh mind, and to make his readers share in his meditations through other new editions. By this time, in any case, De Viti's system is entirely clear to his readers; because it is

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the theoretical system begun in 1888 which is presented in a completed form in this edition of the *Principles*. That part of reality which is included in his system is significant, illuminating, and perfect in its logical construction. This, after all, is a boast which can be made only on behalf of books which, through their power to arouse both assent and dissent, point out to the scholar a new road for him to follow.

LUIGI EINAUDI

Turin

*March, 1934*

**BOOK I**

**INCOME FROM STATE PROPERTY  
AND FEES**

## CHAPTER I

# THEORY OF THE PRODUCTION OF PUBLIC GOODS

**Summary:** The problem of Public Finance — The logical method of investigation — Collective needs and their classification — The active subject — The absolute State and the popular State — Public services — Division of labour between public and private enterprise — The necessary economic connection between the two

### § I

#### *The Problem of Public Finance*

THE phenomena of public finance or taxation present concrete problems which are very complex, since their solution requires the aid of several disciplines, each of which studies a single phase of the subject.

These phenomena represent, first of all, a factor of the very greatest importance in the history of peoples. It may be possible to write dramatic histories which will describe wars and revolutions without understanding or taking into account the phenomena of Public Finance; but it is not possible to explain those wars and revolutions unless we do take these phenomena into account. Without an understanding of taxation, for example, one could not explain the economic and financial aspects, long in preparation, of the French Revolution; one could not explain the tenacious and century-long struggles waged on behalf of representative government against the English Crown by the people — represented, in different periods, by different social groups; one could not explain the struggle between lay authority and the Vatican for temporal power, the latter consisting, in large part, of taxing privileges; nor could one explain the War of Independence of the United States, which was fought under the slogan 'No taxation without representation'. And so on.

\*With the attainment of representative government, moreover, taxation has come to be covered by positive provisions in the constitutions of modern states, with the result that the ties between

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to an end with the periodic production of these goods in the quantity desired.

Just as individual wants represent the factual presuppositions underlying the general economic problem, so collective wants represent the factual presuppositions underlying the problems of Public Finance.<sup>1</sup>

In the pure theory of Public Finance, one assumes, first of all, that man is impelled to act, in the production of public goods, by the same motives that induce him to function in the production of private goods. It is upon this assumption that we attempt to discuss the laws which regulate the economic activity of the social group.]

This is the hedonistic premise. The citizen, in participating in the financial activity of the State, acts toward the other members of society just as he acts toward his neighbour in his own economic affairs. It is, to be sure, not impossible that the egoism of the individual may be moderated to a greater extent within the social group than it is within the field of private economic activity. Indeed, when we take account of the fact that to the egoism of the individual one must add that of the species, and of the further circumstance that here everyone acts in harmony with others, and therefore with a greater degree of assurance that a sacrifice by many will attain an object for which a sacrifice by an individual would have been in vain, we are led to believe that there is, in Public Finance, a broader field for the development of altruistic motives on the part of individuals. Whenever this happens, however, and in the degree to which it happens, it requires a concrete demonstration in every case; for it cannot be anything but a deviation from the general principle.<sup>2</sup>

On the basis of what has been said, it would be better to lay down two corollaries which may be taken as premises for our investigation. We assume:

(a) that the members of society agree in desiring that public goods shall be produced according to the law of least cost — because the lower the cost, the smaller will be their tax burden;

<sup>1</sup> That is to say: one does not discuss what collective wants *should be*, or what they *should not be*. This does not mean, however, that these wants should not be analysed for what they are.

<sup>2</sup> This observation is addressed especially to those who compare political society to the family and assert *a priori* that the member of the former behaves toward his associates as the member of the latter behaves to those who make up his family.



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(b) that every citizen tends to maximize his consumption of public goods, at the same time attempting to pay the least possible amount as compared with his neighbours.]

The science of Public Finance, then, transfers the principles of the theory of value from Private Economics into the field of Public Economics. It investigates the conditions to which the productive activity of the State must be subjected in order that the *choice of the public services which are to be produced, the determination of their respective amounts, the distribution of the cost among the consumers, etc.*, may take place according to the principles of the theory of value — that is, with the least possible waste of private wealth, in order to attain the greatest satisfaction of collective needs.]

Our conclusion, then, is that the phenomena of Public Finance enter into the framework of a 'theory of the production and consumption of public goods', just as economic phenomena enter into the framework of a 'theory of the production and the consumption of private goods'. For the individual, the active subject in the latter case, we substitute the State, and in place of the wants of individuals we put collective wants.

Starting from the analogies which exist between every phenomenon of Public Finance and the particular economic phenomenon which corresponds thereto in the economic activities of individuals, we proceed to study the differences.

### § 3

#### *The Methodological Nature of Public Finance*

The difference with which it is perhaps best to start has to do with the character and method of the two fields of theoretical investigation.

Public Finance is a *concrete science* — that is, it must be brought down finally to real phenomena.] Economics, on the other hand, is an abstract science, in that it states its problems by isolating the particular principle whose laws it seeks — that is, by *abstracting* from other circumstances that complicate it in historical and political reality.<sup>1</sup>

<sup>1</sup> I call attention here once and for all to the fact that I use the words 'abstract' and 'concrete' in the technical meaning which is given them by Spencer in his *Classification of the Sciences*, and by Cairnes in his *Character and Logical Method of Political Economy*, and which was already adopted and illustrated by me in my *Theoretical Character of Public Finance (Carattere teorico dell'economia finanziaria; Rome, 1888)*.

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Science, as such, does not concern itself with giving rules of action; it seeks rather to establish the reasons why, or the conditions under which, people act in a given way. Its aim is simply to understand, *to know*. Hence it studies certain facts objectively, and seeks to explain them by discovering the relationships that connect these facts with other phenomena by which they seem to be determined, or with other phenomena to which they seem to give rise, or with still others with which they seem to be correlated. The science of economics, for example, has nothing to say against or in favour of *free competition, monopoly, protectionism, etc.*; it simply ascertains the *causes* that bring about the one or the other system and the effects to which they give rise, as well as the relationships that connect them with other phenomena.

Similarly, Public Finance studies objectively the phenomena of State finance, without *a priori* preferences and without wishing to provide rules for political action. The statement that Public Finance seeks, in its investigations, to approach as near as possible to reality; and therefore makes an effort to study real phenomena, taking into account all the factual elements of which the latter are composed, is to be taken simply as meaning that it is a concrete science, as opposed to other sciences that are more abstract. From this conclusion we derive an important methodological corollary: viz., that Public Finance cannot use logical abstraction to the same extent as does general economics.

### § 4

#### *Collective Wants*

The second difference is that which exists between individual wants, on the one hand, and collective wants, on the other.

First of all, collective wants presuppose the existence of a community; that is, they arise from the fact that people live together in society. So long as man lives in isolation, one can conceive of the existence only of individual wants; when man passes from a state of isolation to life in society, there then arise and are added to the individual wants already existing a series of requirements that did not exist before. For example, the individual will feel the need that his person and his goods should be defended against the attacks of other members of his social group; in addition, he will feel the need

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of resolving in some way the disputes that arise between him and other individuals to whom he is bound by economic, ethical, or political ties; and finally — as one passes from the communal life of the various social groups within a political aggregate to the communal life of the various political aggregates which make up the larger international community — he will feel the need for national defence and for the systematization of the relationships which connect him with other nations. Wants, or needs, of this type, which are born in a group from the very fact of social life, we shall call *collective wants*. But in the last analysis, these collective wants, also, are *felt* by the individual. We must not allow the word *collective* to deceive us into believing that we are discussing needs that are felt by the group taken as a whole, as if this group were a sentient organism, capable of feeling pleasure or pain.

Only the individual can feel pain or pleasure; in this respect, the wants of the group as a whole do not differ from individual wants, since both have their origin in the individual. An individual may fear, for example, that his neighbour covets his property; but the neighbour may also feel the same fear with respect to him. And both may have the same feeling toward others, who repay them with the same coin. (Thus a series of individual needs is transformed into a collective need for the defence of an individual's property against a possible attack by thieves.)

Individual needs, on the other hand, are those which arise and remain within the life of a man who is isolated or who believes himself to be isolated. He has no need to defend his property against robbers, who do not exist so far as he is concerned; he does feel, however, the pangs of hunger and thirst, and he does require bread and water.

[The second characteristic of collective wants is that they arise from a certain 'conflict' of interests between the groups that make up the national and international social structure; hence it has always been said that 'the State intervenes in order to regulate and make possible the co-existence of the antagonistic activities' of such groups.]

If one bears in mind these two fundamental characteristics, it is easy to avoid confusion of *collective wants* with *general wants*. The latter are *homogeneous* for all the individuals who make up the social group; that is, they are the arithmetic sum of individual wants. The need for bread, for example, is a very general one, and is measured

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by the arithmetical sum of the need for bread felt individually by each of the consumers.

Collective wants, on the other hand, precisely because they arise from a conflict of interests, are not homogeneous for all. Therefore they are represented, not by the arithmetic sum of individual needs, but by an *algebraic sum* of positive and negative quantities — that is, of the positive needs which some feel for the production of a certain service, and of the negative needs that others feel for the prevention of the performance of that service, or for its performance in a degree different from that which others would prefer, because those who demand this service differ in their estimates of its utility.

It is imperative that these conflicts be either eliminated or reconciled, if we are to arrive at a determination of the collective need for the satisfaction of which we wish to provide.

Hence arises the following difference between what we have called Private Economics, on the one hand, and Public Finance, on the other: viz., that, in the former, every individual want is satisfied in proportion to the demand of every individual, and the total demand is the arithmetic sum of individual demands; whereas in Public Finance the collective demand is the resultant of the conflicting evaluations of various groups and individuals. Thus the latter produces exactly as many hats as there are individuals requiring them; but he does not take into account those who do not wear hats. The State, however, if it furnishes headgear to its soldiers, must produce as many hats as there are soldiers, including those who do not ask for them.<sup>1</sup>

<sup>1</sup> I should like to warn the reader that the concept of collective wants which is presented here does not coincide with certain current definitions, nor with that adopted by Professor Pantaleoni (*Erotemi di Economia*, vol. II, pp. 1-44; Bari, 1925). The latter takes as the basis of distinction the choice of 'a means by which one may realize the hedonistic postulate, so that those wants may be regarded as *individual* which will be satisfied with the least sacrifice or with the greatest satisfaction if *every individual* acts by himself and for himself, and those wants are to be regarded as collective, if the same condition is brought about by concerted effort.'

I consider erroneous the *fundamentum divisionis*, which has reference to the most economical means of producing the goods, without attempting to analyse the nature of the consumer's want preceding production. The nature of the need does not change as the result of entrusting production to individual enterprise, on the one hand, or concerted enterprise, on the other.

Let me add that concerted effort may also be carried on by a private enterprise. One would not say, surely, that the need for bread represents an individual want if the most economical means of production is the housewife, baking at home, and that it becomes a collective want if for the single housewife is substituted a co-operative society of all the housewives of the country!

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### § 5

#### *Classification of Collective Wants*

The oldest collective wants, the satisfaction of which represents a function that has long been necessary in all states, (ancient and modern, are the need for defence of the people and their goods against internal enemies, and the need for defence of national territory against foreign enemies. This is the first group of collective wants. These wants become part of the life of every state; but their sphere to-day is generally more ample and tends to extend more and more, precisely because, with the increasing complexity of social life, the causes of friction increase, and the conflict of interests among the members of society becomes more and more easy and frequent. The activity of the State, therefore, is no longer limited to the defence of the people and their goods, but can enter wherever there are conflicting interests which it is necessary to conciliate in order that they may exist side by side.

In fact, to this first group of wants there has been added a second category of collective wants, which were originally individual wants, but which have been modified by the fact that people live together in society. Thus, personal and domestic hygiene are individual needs that even isolated man feels; but in social life they acquire an additional collective character because of their effect on society when there is danger of contagion. The State intervenes to defend the community by preventing infected persons and things from becoming a source of epidemics; and it does so either by imposing rules of hygiene on private individuals, or by itself providing hygienic services.]

[A third group of collective needs is made up of those that were originally individual and remain such in social life, but acquire a collective element because of the growing division of labour, as a result of which the producing group sometimes finds itself in a quasi-monopolistic position, while the consuming groups are at its mercy.] Water, unquestionably, satisfies an individual need; but if, in a large city, there emerges a group which distributes water to all the houses, and if the latter no longer have reservoirs of rain water and are therefore powerless to provide any form of competition, the producer becomes a *de facto* monopolist, for a longer or shorter period.

This relationship of dependence as between the producer and the

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consumers gives rise to a conflict of interests which may provoke the intervention of the State; in such a case, the State intervenes, not as a producer and distributor of water,<sup>2</sup> but as an organ for the defence of exploited groups against an exploiting group.

[To conclude: in the classification of collective wants, it is possible to construct a scale of such wants according to their degree of urgency for man in society, beginning with the defence of territory, without which no autonomous social aggregate can exist, and ending with the hygienic defence of the community against the dangers of contagion, as well as economic defence against private monopoly.]

### § 6

#### *The Active Subject*

The State, as the active subject in Public Finance, is not a physical person, as is the *homo economicus* of general economics. It is a juridical person; it is the political organ that sometimes summarizes in itself, sometimes represents, and in every case works in the interest of, the whole community.

The motives and the wants that induce the State to produce public goods are a resultant of the motives and the needs of individuals and groups who have *actually* contributed toward the formation of the State's calculation of financial advantage and disadvantage.<sup>3</sup> For this reason, theoretical inquiry must, as far as possible, break down the State's calculation into the economic calculations of the individuals or the groups which represent the constituent elements of the State's calculation.

This is a fundamental principle.<sup>4</sup> In order to do this, however, it

<sup>1</sup> It cannot be said, however, that this principle is currently accepted by those who like to define the needs and ends of the State as being something unconnected with individuals.

Now, it is impossible to conceive of evaluations which are not a result of individual evaluations.

This does not mean, as some seem to believe, that the utilitarian evaluations which regulate the economic conduct of individuals cannot undergo modifications when these same individuals act as members of a political group.

It is well known, on the contrary, that the economic evaluations of every individual change, or are modified, according to the environment in which the same individual finds himself. And the environment of the Economics of the State is not identical with that of Private Economics.

In any case, it is easy enough, for the purposes of theory, to recognize that the State's calculation of financial advantage and disadvantage is a resultant of the individual evaluations of the members or a part of the members that make up the political group, and not of moral precepts or dicta, on the one hand, and the imposition of external force, on the other.

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is necessary, first of all, to take account of the political constitution that is in force in a given country at a given time, in order to know which wants and which individual and group interests help to form the State's calculation of advantage and disadvantage, and which wants may happen to be excluded from this calculation.

In history, we know two opposing tendencies, which lead to two different types of political constitutions: viz., that of the absolute state — either personal or oligarchic — and that of the popular state.

In the first, the sovereign or the dominant caste has exclusive power and uses it under conditions of monopoly, by law or in fact. This gives it the power, in producing public goods, to choose those that redound to its exclusive or chief advantage, and to put the burden of the cost exclusively or chiefly on the subject classes.

In other words, *mutatis mutandis*, there is reproduced, in Public Finance, the case of private monopoly. In various forms — which will be analyzed and defined — the governing class obtains, and the governed classes pay, monopoly prices.<sup>1</sup>

### § 7

Over against the absolute or monopolistic State may be set the popular State, with respect to which, instead of assuming that one class has by law or in fact a monopoly of government, we establish the premise that, through the free competition of social groups and parties, every class can attain power, and, having attained it, must remain under the continuing control of the community.

Thus are realized, at least in *pure theory*, the typical conditions of free competition. Indeed, the characteristic element of free competition consists of this — viz., that at any given moment one may substitute for a producing group another group which comes from the mass of consumers. The easier the substitution, the more easily is the condition of free competition realized. Now, in the democratic state, in which every social group, in the form of a party, is supposed to be able to achieve power, we find repeated an almost similar

<sup>1</sup> What we have called monopoly prices are the so-called 'political prices' of those economists who continue to follow the outmoded practice of considering the problems of Public Finance as being theoretically dissociated from the phenomena of Private Economics.

Such economists would be more logical if they were to deny that a monopoly price itself is an economic price, reserving the latter designation only for competitive and cost-prices!

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phenomenon of alternation and of reciprocal substitution, which brings to power the group that is judged by the community, at a given moment, to be better fitted for the production of public services.

Now from this concept of substitution we may pass easily to the concept of the 'co-operative society'. Indeed, we have merely to imagine that the alternation of the groups in control of the government takes place with sufficient rapidity, and we finally come to consider as practically identical the groups that are in turn governing and governed. This brings out exactly the concept of the co-operative society, the essential characteristic of which lies in the *personal identity of producers and consumers*. Hence, we may regard the democratic State as that which resembles the economic pattern of the co-operative. In the democratic State, in fact, we do assume that there is personal identity between producers and consumers, since the citizens who pay taxes are also the citizens who consume the public services.

This theoretical concept has its historical basis in the principle adopted by all modern constitutions, according to which 'the taxpayers vote the taxes'.

Under both hypotheses, it necessarily follows that the popular, or co-operative, state furnishes public services at cost price.

### § 8

These two forms of political constitution are extreme types that we take as two abstract hypotheses, or two limiting cases, between which would be included all the possible combinations that can be found in the concrete reality of history. In pure theory, the phenomena of Public Finance can be studied either on the hypothesis of the *absolute* political constitution, or on that of the *popular* constitution. In the application of theory to concrete instances, however, if we are to explain the phenomena of Public Finance, it is usually necessary to have recourse to a combination of the two premises; since in reality there does not exist an absolute government in which the will of the sovereign does not experience some modifying influence from the environment, nor a democratic constitution in which the class that governs does not have a position of relative monopoly.



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Nevertheless, one may note that, as a matter of historic evolution, the monopolistic state does not represent a point of rest, of quiet, of equilibrium. The dominant class has always ended by exploiting its position of political monopoly in order to maximize its own public consumption at the expense of the community. From this it follows that the monopolistic position of the dominant group tends to provoke a reaction on the part of the subject social groups and to give rise to a struggle which, sooner or later, and by more or less violent means, according to the temperament of the particular people involved, leads to the fall of the monopolistic enterprise. Peoples move, therefore, toward a popular organization, toward the co-operative state, which constitutes in Public Finance a point of arrival and of political equilibrium.

Accepting this datum as a matter of fact, we shall study the phenomena of Public Finance first of all upon the hypothesis that we are dealing with the co-operative type of state, and shall treat the factor of monopoly as a disturbing force.

It must be noted, however, that this last premise is not a necessary condition for the construction of a theory of Public Finance; since whenever we are dealing with an investigation of historical reality, we must always relate the phenomena of Public Finance to that combination of the two operating causes which actually exists at any given time and place.

### §9

#### Public Services (Public)

To the goods that the State produces in order to satisfy the needs of the community, let us give the name of *public services*. By this designation we mean to refer to the fact that these goods are produced by a public agency — not that they serve the public.

The concept of a *public* good or service corresponds to the concept of *collective wants*. The one is felt by the community, the other is produced by the State.<sup>1</sup>

(Every act of intervention on the part of the State which tends to

<sup>1</sup> Sometimes people speak of a 'public want'; but the expression is not correct, unless it be used in an elliptical sense to mean that what is involved is a 'collective want which the public agency undertakes to satisfy'.

## PRODUCTION OF PUBLIC GOODS

satisfy a collective want gives rise to the production of a public service or public good. It is not necessary, that is to say, that the State should displace private enterprise entirely; it is enough if the State intervenes to regulate in some way the functioning of private enterprise. Thus, for example, if railroad companies fail to make provision at grade crossings for the safety of people and animals, if they mishandle their rate-schedules in such a way as to favour some branches of traffic and damage others, the State may intervene to eliminate these specific abuses. It is not necessary, in order that the abuses may be eliminated, to nationalize the railroads. In every case, then, of either partial intervention or complete nationalization, we shall say that the State produces a public service or a public good or a public satisfaction.

This is only a definition of the terms employed. It does not follow logically from what has been said that the State is or must be the exclusive producer of the goods destined to satisfy all collective wants, nor that private enterprise is or should be the exclusive producer of the goods destined to satisfy all individual wants. No such clear-cut division of labour exists in reality, since at times the State produces goods destined to satisfy individual wants, and at times private enterprise produces goods destined to satisfy collective wants. Indeed, it may be pointed out that there scarcely exists a public service the germ of which one does not find in private enterprise, ready to develop, if only as a complementary agency, whenever the State proves itself insufficient. The old companies of adventurers, modern companies providing night watchmen, the institution of the private detective, arbitrators, constables—all are notable examples, precisely because they belong to that group of public services representing elementary functions which have by this time been assumed by every modern state.

Even more numerous, however, are the examples that can be drawn from the second group of public services, which are on the way to assuming a permanent place in the business of the State—such as road construction and maintenance, postal communications, public instruction; and still more numerous are those that are found in the group of public services which are at the margin and which, at the present stage in history, are sometimes produced by the State and sometimes by private enterprise: telephones, telegraphs, railroads, steamship lines, etc.

## INCOME FROM STATE PROPERTY AND FEES

Now, if we wish to discover the laws controlling the division of productive labour as between public and private enterprise, it is necessary to determine the conditions under which the production of a good has actually passed, or tends to pass, from private to public enterprise, and vice versa.

### § 10

#### *The Division of Labour between Public and Private Enterprise*

Let us first use as our hypothesis a State that is essentially popular, in which there do not exist conflicts of interest between the governing class and the governed; or let us assume that the governing class is concerned only with the interest of the governed class — that is, let us suppose the absence of disturbing political factors. It follows that only the economic principle of maximum profit can determine the division of productive functions as between public and private enterprise. It is this principle that governs the division of labour in general, with the following difference: viz., that whereas in a private exchange economy, the limit to the division of labour is set by the maximum *comparative* profit, in a public economy, the limit is set by the maximum *absolute* profit. For here we are dealing with a collective consumers' enterprise, which can allocate to itself the production of all goods in which it can realize an absolute advantage as compared with private enterprise.

Having established this general principle, we can now describe precisely how it works concretely with respect to the three groups of collective services.

1. For wants of the first category, the principle of least cost arises from the nature of the conflicts that divide the members of society, to whom the State presents itself as the organ which, standing outside of and above the contending groups, is more apt to reconcile their interests. The same could not be said of general wants. Therefore it comes about that the handling of national defence, the administration of justice, and the handling of internal public safety have always been considered public services which by this time have become a part of the business of every modern state.)

These are limiting cases, the cost of which is discussed not with a

## PRODUCTION OF PUBLIC GOODS

view to entrusting or not entrusting the production of the relevant service to a private concern that might spend less, but only in order to keep the expenditure made by the State at the level of that which a private enterprise might make.

2. For the second and third categories of collective wants, however, the expenditure that the State makes, as compared with that made by private enterprises, becomes a positive and decisive element of the problem. When one has weighed the quality of the service and its cost as between public and private enterprise, the result decides whether it is better that production should be carried on by private enterprise, or assumed by the State.

3. An important element in this calculation is a judgment as to whether the private enterprise, if left to itself, would succeed in establishing a monopolistic position; for if we admit that the State sells at cost price, the latter will destroy the monopolistic price of the private enterprise, to the benefit of the community. This is true even in the case in which the private monopolist is a better producer than the State — on the condition, however, that the greater cost of the State enterprise does not exceed the surplus profit of the private monopoly. So long as there exists a difference between the price of the private monopolist and cost-price of the public enterprise, this difference diminishes the price for the service in question, to the advantage of the community.<sup>1</sup>

If the State then charges the consuming citizens the same price as the private monopolist, this difference will benefit the public treasury, and therefore, indirectly, the community itself.

<sup>1</sup> There are those who, taking society as a whole, attempt to show that the substitution of the more costly state enterprise for the more economical private enterprise implies an absolute destruction of wealth. This is obvious; but this consideration, used to defend private monopoly against public enterprise, distorts the problem, because, in taking account of production, it forgets distribution, which is an integral and decisive part of the concrete problem.

Let us suppose that the private monopolist obtains a net product of 100 with the expenditure of 60, while the State spends 70 for the same product. It is obvious that the State has destroyed wealth by 10; but it cannot be denied that, in the first case, the gain of 40 goes to the exclusive advantage of the monopolist alone, whereas in the second, the gain of 30 is divided among all the members of the community.

It is therefore useless to discuss whether it is preferable that national wealth should increase by 40 to the advantage of a few, or increase by 30 to the advantage of all; since one can foresee that the first solution will prevail if the State is dominated by a monopolist, and the second if it is dominated by the mass of consumers.

For the rest, there is no difference in the case presented by a co-operative society, which can be, and usually is, more costly than private enterprise, but nevertheless succeeds in being advantageous to the members, provided that it sells below the price of the private monopolistic enterprise.

## INCOME FROM STATE PROPERTY AND FEES

When these three conditions coincide, the current of public opinion becomes irresistible for the transfer of the production of goods from private enterprises to the State.

### § 11

Vice versa, we may consider as a corollary of the preceding principle the fact that when the conditions just outlined are for some reason lacking, the opposing current asserts itself, being founded on the economic advantage of returning to private production from production by the State.

Similarly, we must consider as a corollary of the same principle the second aspect of the problem, viz., the case in which the State produces goods destined to satisfy individual needs. Other conditions being equal, the production of these goods tends to pass from public to private enterprise. The most important instance of this type of case is to be found in the sale of the government property of modern states, of which a more complete theory will be given in the following chapter.

U We may now conclude that, in the absence of disturbing political factors, public enterprise tends to specialize in the production of goods destined to satisfy collective wants, on the condition that, and in so far as, it produces more economically than private enterprise.

This delimitation is not marked by a line that fixes permanently and *a priori* the productive functions of the State. If we consider especially the development of collective wants of the second and third groups, we see that there exists at the margin a continuing interflow between the two types of enterprises and the boundary line is continually being shifted according to the principle of least cost, which regulates the division of labour among all enterprises in such a way as to render most economical the entire organism for the production of goods, whether public or private.

The State is one of these businesses specializing in the production of a given category of goods.<sup>1</sup>

<sup>1</sup> I. I wish to warn the reader against the critical observations directed against me by Professor Pantaleoni (see *Evotemi di Economia*, vol. II, p. 3 n. and ff.), who accuses me of: (a) wanting to confine activity in the field of Public Finance to the satisfaction of *all* collective wants and *only* collective wants, to the exclusion of private enterprise; (b) of having wished to determine *a priori* or to give to the State *a norm* with respect to the productive functions which should be regarded as belonging to it.

If these criticisms had any foundation, they would put me in a strange contradiction

## PRODUCTION OF PUBLIC GOODS

### § 12

#### ✓ *The Political Factor*

We have till now reasoned on the hypothesis that the principle of maximum economic profit is not disturbed by the intervention of political factors. As a matter of fact, however, a political element, more or less influential, almost always plays a part in the concrete phenomena of Public Finance, and therefore account must be taken of it.

/ In the states of the old regime, the financial management of government property presents a typical example of the disturbance that political factors exercise with respect to the action of economic factors. For the government-property of a state — as will be seen further on — is often kept intact in the political interest of the dominant class, even when the economic interest of the community would urge its sale to private owners./

/ In modern states also one finds an analogous case, although an attenuated one, in the struggle that is being fought more or less everywhere in favour of, or against, the nationalization of property.

with my own doctrine, expounded in 1888 in the volume *The Theoretical Character of Public Finance (Carattere teorico dell' economia finanziaria)*, the fundamental principle of which is exactly this: *that collective wants represent a factual presupposition underlying the economic activity of the State.* Let me quote several decisive sentences: 'Just as it is not necessary for the economist to discuss which wants man should satisfy and which he should not, so it is unnecessary for the theory of Public Finance to discuss the wants of the State — that is, its functions and the expenditures that it should or should not make. The expenditures are taken as data; since, in actual fact, activity in the field of Public Finance arises in order to meet any expenditure whatever, — that is, for the achievement of any goal whatever.' . . . 'The diversity of public functions as between different epochs and different countries is a fact and it is likewise a fact that the financial activity in every case is carried on by the State' (p. 59).

I am unable, therefore, to explain how the misunderstanding arose, — unless it be that it is one thing to recognize that the sphere of public goods is a factual datum of financial activity, whereas it is another thing to analyse and explain the same fact, in order to seek the law of its existence and its evolution.

From the concept that collective needs are a *factual* premise of activity in Public Finance, other writers have believed that one could deduce the conclusion that all the goods which the State *in fact* produces are *public goods*. Now, since the State, in fact, produces grain on its estates in competition with private growers, and produces cheese in the dairies connected with schools of cheese-making, shall we perhaps have public grain and private grain, public cheese and private cheese, just as we may have a public and a private postal system?

It is unnecessary to labour the point in order to show the error into which one falls when one wishes to avoid consideration of the nature of the want — collective or individual — for which one wishes to provide.

We must start from the concept that there exists a necessary relationship between the productive activity of the State and a given category of collective wants, and,

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According to the principle of maximum profit, nationalization ought to come about whenever it can be shown that public enterprise is more economical. Instead, the proposal is opposed, *a priori*, by representatives of capital in their own particular interest, and is defended, *a priori*, by representatives of labour in their own interest. For this reason it may happen either that the act of nationalization is not carried out when it would be advantageous to the community, or that it is carried out when it would not be advantageous to do so, according as the action of the State is dominated by the political power of capital, or by the political power of labour.

In both cases, it is the general community that will have to bear the greater cost of production, paying, in the first case, a higher price to private enterprise and, in the second, greater taxes to public enterprise.

The same is true in the case of public expenditures made as a result of pressure by group-interests (a military caste, those desiring public works, a bureaucracy, etc.). These are usually called unproductive expenditures, merely to indicate that they are relatively less productive than they would have been had the money been spent to satisfy other collective or individual wants.

reciprocally, between the productive activity of private enterprise and another given category of individual wants. In a second approximation, to be sure, it is to be granted that the line of demarcation varies, as we stated in the text.

II. Now it appears that Pantaleoni wished, by means of this criticism, to emphasize his well-known view to the effect that *the essential characteristic of Public Finance lies in the fact of authoritarian control over human activities by a political superior, — that is, by the State.*

I have never been able to agree with this notion, since there is always an element of compulsion in every legal association of individuals, at least within the limits of its governing statute and for the duration of the contract. It exists in business organizations, in which the individual member of the organization must be subject to the will of the majority; it exists, all the more clearly, and tends to become greater, in trade unions, in partnerships, in the church, in the community, and in the State, where it reaches maximum dimensions with respect to the power with which, and the period for which, the compulsion is exercised; but this difference of degree is not sufficient to justify characterizing the problems of Public Finance as being different from others, so far as their theoretical content is concerned.

It may be further noted that there are public goods in the production and consumption of which we do not find a degree of compulsion differing from that involved in the case of a private monopolist. Here I have in mind the entire group of so-called special public services. Where is the element of compulsion in the service provided by the postal system?

On the other hand, I note with satisfaction that Pantaleoni, after having distinguished three possibilities, — viz., that the political authorities may govern either in their own exclusive interest, or in the interest of the governed, or as the delegated agent of the latter — recognizes that in the last case the State may be regarded, in the field of economic activity, as a *co-operative regime*. We had disagreed on this point for forty years!

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The deviations from the principle of maximum economic advantage which are due to political factors increase the price that the tax-payers are called upon to pay for the production of public services: but they do not alter the fact that the State tends to specialize in the production of a given category of goods, just as private enterprise does.

It is precisely this fact that shows the error of treating the phenomena of Public Finance as if they were dissociated from Private Economics. In fact, of course, they form an integral part of the general organism of production, exchange, and consumption of goods.

First of all, the State takes part in exchange by buying and selling private goods. It has already been observed that the State will buy iron, grain, construction materials, services of labourers and engineers, as do private businesses, and thereby helps to determine prices and general economic equilibrium. This, however, is still not the problem of Public Finance, so far as we are concerned; for the latter problem arises from a second step, viz., when the State transforms the iron and personal services into public goods. This transformation is, in itself, an economic exchange. The citizens contribute private goods which the State transforms into public goods; and for this reason the relationship which connects the State as producer with the citizens as consumers is one of exchange; for it cannot be anything else.<sup>1</sup> This exchange will find a point of equilibrium; but the equilibrium point will depend on all the exchanges which are included in the budget of every taxpayer, since he distributes his total income *over all* his items of consumption, whether they are public or private goods.

There is, finally, a third step whereby public goods — after they have been produced — come to influence production, exchange, and the consumption of private goods, and thus form part, by this route also, of general economic equilibrium. The fact to be noted here is that the equilibrium of production and of exchange as between private individuals is different according as one has a good or bad set of roads, an efficient or an inefficient system for the defence of property, a protectionist or a liberal economic policy, and so on.

<sup>1</sup> It will be necessary to return to this idea, which, in spite of all evidence, is denied by those who do not like to treat the obligation to pay taxes as a necessary result of the right to receive public services. This recalls, in attenuated form, the days in which taxes represented the *tribute* that the conquered paid to the conqueror.



## INCOME FROM STATE PROPERTY AND FEES

With reference to this third step, it should be pointed out that there are cases in which one may, for methodological reasons, separate the private economic problem from the public one, if one proceeds by way of abstraction. Thus, one may abstract from the service of providing public security if one assumes, and if the assumption corresponds to the facts, that the amount of security provided is equal for all private productive enterprises that exchange their products. Thus it is as if one were to cancel a common term in the two terms of an equation.

But if the problem involves a comparison between two states or between two regions of a state in which the amount of safety provided is not uniform, or between enterprises that utilize public services in different degree, one would be reasoning badly in abstracting from the quantity involved.<sup>1</sup>

To sum up: the phenomena of Public Finance represent an integral part of general economic phenomena.

<sup>1</sup> The error of the opposed view is due to so-called classical economics, which considered taxes as a subtraction from, and a definitive destruction of, wealth by the State. Taxes were regarded as a sort of hail that destroys part of the crop. Therefore the use to which the tax was put, after its payment, was not studied at all. The consequence was that taxes were regarded, without further ado, as being accompanied by a contraction in the supply of available goods, with all the mistaken consequences of this mistaken premise.

The hail does diminish the supply; a tax transforms it into other goods. We shall return to this matter at a later point. See Book II, Chapter IV, on the *Economic Distribution of the Tax Burden* (II, *The Theory of Shifting*).

## THEORY OF PATRIMONIAL REVENUES

Summary: The financial capital of the State — Ordinary and extraordinary revenues and expenditures; subordination of expenditure to revenue — Classification of revenues — Transformation of patrimonial goods into domain goods — The economic and legal characteristics of domain goods — The patrimonial finance of the old regime — The disappearance of patrimonial revenues and the predominance of contributory finance in modern states — The increase of public expenditure

## § 1

For the production of public goods the State needs a huge quantity of private goods, which form or are transformed into the fixed and circulating capital<sup>1</sup> of the State.

The State constructs streets, railroads, ports, fortresses, schools, courthouses, museums, libraries, warships; it sets up postal, telegraph, and telephone systems. These are examples of fixed or investment-capital. In addition, the State needs circulating capital for the payment of salaries and wages, interest, amortization charges against fixed capital, for ordinary repairs, treasury expense, heat, light, publications, and so on.

The State obtains its capital just as any other enterprise does. It

<sup>1</sup> We do not wish to enter here upon discussions concerning the 'capital' concept. It is sufficient for our present purpose to give the word the sense in which it has come to be used currently in any private enterprise. There are those who regard as capital the first payment of direct goods (*money*) which is made by the subscribers to a company's 'capital'. On the other hand, there are those who regard as capital the factory, the machine equipment, the human effort, and the raw materials which serve technically the productive purpose of the company, and into which the subscribed goods have been transformed.

Similarly for the State: one may regard as 'capital' the total amount of private goods which the citizens pay as taxes, or the iron, the buildings, the work of employees, etc., into which the State transforms these private goods.

The definition of 'capital' is, of all definitions, the most elastic, and allows the greatest freedom of choice. Therefore it is important, above all, to fix the meaning in which the word is used and not to modify it even inadvertently in the course of the argument. In order to avoid misunderstandings, it is better to refer directly to certain fundamental concepts, such as, for example, the notion of instrumental and direct goods, rather than to the words themselves.

## INCOME FROM STATE PROPERTY AND FEES

may, first of all, have an original patrimony, from which it will draw an annual income. In the second place, it may have recourse to borrowing; it may have recourse to an extraordinary levy of a percentage of the citizens' property, or to an annual levy of a percentage of their income. Thus, in offering for the consumption of citizens the public goods produced annually, the State exacts a corresponding payment, with which it reconstitutes its working capital and begins a new productive cycle.

The resources which the State annually procures for itself and annually spends are recorded in its budget as 'revenues' and as 'expenditures'. The year is the unit of time for which private budgets and State budgets are made up.

### § 2

From an accounting point of view, revenues and expenditures are further distinguished as *ordinary* or *extraordinary*.

According to one type of accounting usage, ordinary revenues and expenditures are those which arise from permanent causes or come about from the normal course of administration; all others are extraordinary.<sup>1</sup> The distinction is a vague one; it depends more on the opinion of whoever draws up the budget than upon anything else. One might, therefore, adopt the following formula: '*On the supposition of a continuance of the conditions prevailing at the time the budget-estimate is made, we may call ordinary the revenues and expenditures destined to be repeated in future fiscal periods; extraordinary, those destined to cease.*'

Whether a given item in the budget is to be classified as 'ordinary' or 'extraordinary' sometimes depends on the origin and the nature of the revenue without reference to the expenditure, or, vice versa, on the nature of the expenditure without reference to the revenue. At other times, however, when it is a question of *quantity*, one cannot ignore the reciprocal relation between revenue and expenditure.

Thus, the patrimonial revenue of the State is, in its very nature, an *ordinary* revenue and remains such even if it is used for an extraordinary expenditure. The sale of the State patrimony, on the other hand, gives rise to a revenue which is, in its very nature, extra-

<sup>1</sup> See, for example, article 37 of the Italian 'General Regulations for Governmental Accounting'.

## THEORY OF PATRIMONIAL REVENUES

ordinary, because it can be realized only once, and it remains an extraordinary revenue even if it is used for an ordinary expenditure.

The expenditure for the administration of justice, for the army, for the maintenance of roads, etc., is ordinary, but must be kept within certain quantitative limits which depend on the amount of the State's revenue. Under conditions of equilibrium, the corresponding revenue is also ordinary. On the other hand, a levy on the property of citizens which is adopted to provide for the cost of war is an example of a revenue that is extraordinary not only because of its nature as a levy, but also because it serves to cover an extraordinary expenditure. In this case, it might seem that the amount of the revenue depends on the amount of the expenditure and not vice versa. We are here dealing with an extreme case, in which people are prepared to make extreme sacrifices in order to wage and win the war; yet, even so, the possibility of waging and winning the war depends, in the ultimate analysis, on the means at the disposal of the State.

For this reason one may lay down the following general principle: *the extent of expenditure is conditioned by that of revenue, not vice versa.*

This truth, which is obvious in dealing with the budgets of private individuals, seems to meet with an exception in the case of a State budget, for which the prevailing principle seems to be that first the expenditures are voted, and then the revenue is provided. This latter principle is, however, merely formal, and is based only upon the facts of parliamentary procedure. In reality, the budget of the State, in modern countries with representative government, is derived from the private budgets of the citizens, and is tied up with them. When, therefore, the citizen demands or assents to a public expenditure, the question of the revenue corresponding to the expenditure is already resolved within his private budget. Let us suppose that a citizen himself produces the goods A, B, C and D, and that he then decides to pass on to the State the production of D. It is clear that later he will also have to give the State the already existing means for the production of this service. In short: we assume that the citizen who demands a public service already has the means necessary to pay for it.

The principle according to which the determination of expenditures precedes the determination of revenues has been liable to exaggeration and distortion in those countries in which the governing

## INCOME FROM STATE PROPERTY AND FEES

group has had an interest in preventing or weakening control by the tax-payers, who tend to reduce expenditures.<sup>1</sup>

### § 3

#### *Patrimonial Finance*

Ordinary revenues may be either 'patrimonial' revenues (called also *original* revenues), or 'levied' revenues (called also *derived* revenues).

The predominance of the first type of revenue gave birth to the 'patrimonial finance' of the mediaeval States; the subsequent predominance of the second type of revenue produced what may be called the 'contributory finance' of modern States.

Patrimonial revenues consist of the income that the State derives<sup>2</sup> annually from its 'patrimony'. It is income that is produced by the State in its character of a business enterprise.

Levied revenues consist of the percentage of the income of the citizens which the State deducts annually by means of levies.

*Levies*, in their turn, may be either *fees*<sup>3</sup> or *taxes*.<sup>4</sup>

To sum up: patrimonial revenues, fees, and taxes are the three great and clearly distinguished branches of ordinary revenue.

The 'patrimony' of the State consists of the land and industrial property which the State possesses and administrates, and from which it derives an income, just as would any private proprietor or industrialist; for the State 'patrimony' is subject to general juridical law,

<sup>1</sup> A typical example of this difference in point of view has been provided recently by the difference in the method followed in England and that followed in Italy for the reduction of bureaucratic expenditures, which increased extraordinarily during the war.

In the post-war period there arose everywhere the problem of reducing these bureaucratic expenditures in order to get them into equilibrium with revenue, which the war had drastically reduced, in comparison with the pre-war period.

In England the Chancellor of the Exchequer, in presenting the budget for 1921-1922, said: 'The revenues must not be above £910,000,000; therefore we must bring the expenditures of civil and military services within these limits.' And a commission was named with the precise instructions to propose the reduction of expenditures by a total amount of £175,000,000. Thus it was recognized that it was necessary to subordinate expenditure to income.

In Italy, the commission named for the purpose was charged with studying the possibility of making economies. Since, however, no government knew how to overcome the resistance of interested parties, the expenditures remained, and taxes were raised, thereby subordinating income to expenditure.

<sup>2</sup> [Italian: *tasse* - Translator's note]

<sup>3</sup> [Italian: *imposte* - Translator's note]

## THEORY OF PATRIMONIAL REVENUES

which regulates the rights of property for all citizens, and to general economic law, which controls the formation of the price of private goods.

It is not necessary, despite what is often alleged, that this economic law be that which prevails under conditions of free competition. Even if the State carries on an industry under conditions of monopoly, the industry will be a patrimonial good and the revenue will be a patrimonial revenue, in so far as in its motives, methods, and results, the State is comparable to a private monopolist.

The moment that a patrimonial revenue is turned over to the Treasury, it loses its patrimonial character and becomes a *public revenue*, just as is the case with the percentage of private income which every citizen pays in the form of a State levy. As soon as the private income of citizens and that of the State enters into the public treasury, the productive activity of the State begins.

With respect, then, to original revenues, the modern State accomplishes two distinct functions:

(a) one is a private economic function, which proceeds from the management of State properties or the running of State industries to the realization of the corresponding income from landed property or from the ownership of industry;

(b) the other is a public economic function, and consists of the subsequent transformation of private income into public services.

The co-existence, or the fusion, of these two productive functions in the person of the State is the foundation of the theory of 'patrimonial finance'.

### § 4

This makes it possible to clarify, from an economic point of view, the distinction between domain goods and patrimonial goods.<sup>1</sup>

<sup>1</sup> In its merely legal aspects, the distinction may be seen in the following articles of the Italian civil code:

Art. 426. The goods of the State are divided into public domain and patrimonial goods.

Art. 427: National roads, the coast, harbours, bays, beaches, rivers and torrents, gates, walls, ditches, and bastions of fortifications and fortresses are part of the public domain.

Art. 428: Every other type of good belonging to the State is part of its patrimony.

Art. 430: The goods of the public domain are in their nature inalienable; those of the State's patrimony can be alienated only in conformity with the laws that apply to them.

## INCOME FROM STATE PROPERTY AND FEES

The distinction derives directly from the function performed by the State in transforming private goods into public goods.<sup>1</sup> If the State produces grain on its own lands, sells the grain annually, and then uses the proceeds to construct a road, the road may rightly be called a domain good. We may say that the State has transformed the grain, which is destined to satisfy individual needs, into a road which is destined to satisfy a collective need.

For this reason, domain goods may be said to be merely a group within, or a part of, the general category of public goods.

It is on the basis of this fact that the fundamental economic characteristics of the State domain and the State patrimony may be distinguished.

Domain goods are the result of the productive activity of the State — that is, they are intended for the direct satisfaction of collective needs. And just as in Economics we classify as goods of the first order those which contribute to the direct satisfaction of an individual want, so in Public Finance we may consider domain goods as goods of the first order, as direct or quasi-direct goods.

Patrimonial goods, on the other hand, which may be direct goods in so far as they satisfy individual needs, are always instrumental goods from the point of view of Public Finance in so far as the State must transform them into public goods.

Vice versa, when domain goods come to be used by private individuals, they acquire the character of instrumental goods, because the means of communication, the agencies for the maintenance of order, and so on, are forms of capital destined to assist in the production of private wealth. Thus, also, the patrimonial goods of the State, such as grain, oil, etc., which from the standpoint of the State are instrumental goods, are, from the standpoint of private individuals, direct goods.

To sum up: domain goods are goods which are, respectively, goods of the first order from the standpoint of the State, and instrumental goods from the standpoint of the individual.

In this classification, we are dealing with *utilities* and not with *things*. The latter would be the basis of a *legal* classification. In fact, however, it is not always possible to assign some things to the

<sup>1</sup> A fuller treatment of this matter was given by me for the first time in the *Giornale degli Economisti*, vol. 9 (1894). The paper was republished in my *Essays on Economics and Finance (Saggi di economia e finanza, Rome, 1898)*.

## THEORY OF PATRIMONIAL REVENUES

category of public goods, and others to the category of private goods. One must investigate, in every case, to see whether the utility which is obtained from a given good is a public or a private one.

Hence we may distinguish three categories of goods. One category includes goods from which is obtained a utility which is of significance to private individuals — such as grain. Another includes goods from which is obtained a utility which is of significance to the community — such as fortifications. A third includes goods from which is obtained a utility which is partly the one and partly the other. Goods of this third type would therefore be at one and the same time domain goods and patrimonial goods. Examples of such are forests, model farms, a factory of artistic ceramics, etc.

This, in broad outline, is the economic theory of the matter.

### § 5

This does not coincide with the theory current among jurists. The economic theory may, however, help to clear up some elements of the legal theory, including the distinction made by the jurists to the effect that patrimonial goods are productive, whereas domain goods are supposed to be unproductive.

Taking as a point of reference the community, or the State in so far as it represents the community, all goods — whether patrimonial or domain — are productive of utility: the former of indirect utility, the latter of direct. And if the transformation of the one into the other was economic, the marginal utility of the domain goods — for example, roads — is greater than the marginal utility of the patrimonial good — for example, grain — that was transformed into the roads.

The further fact that one cannot value domain goods in money, whereas one can so value patrimonial goods, is a matter of secondary importance.

With respect to the second characteristic emphasized by the jurists, according to which patrimonial goods are declared to be alienable, whereas domain goods are held to be inalienable, we may say that the statement is true if it is confined within the limits of the theory stated above.

In fact, if one admits that domain goods are goods of the first order and therefore already devoted to the satisfaction of a collective



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need, it follows that they are not alienable, inasmuch as the public administration is not empowered to withdraw them from their destined use. But inalienability is a common characteristic of every direct good even if it is a private good, once the latter has entered into the consumer's budget, since then it cannot be withdrawn from its destined use.

Let us imagine, for example, a proprietor who decides that a part of the wine he has produced shall be sold — that is, transformed into other goods — and that a part shall be kept for consumption by himself and his family. This second part is inalienable, so far as its economic destination is concerned. If, now, we assume that the proprietor has an administrator, we may suppose that he will authorize the latter to sell the first part on certain conditions and will forbid him to sell the second part. In this way arises the concept of a mandate.

This mandatory relationship, which is present in every private enterprise and which contains both an economic and a legal element, gives us, when it is carried over into state enterprise and is adequately developed, the complete explanation of the inalienability of domain goods. So long as a fortress serves for the defence of national territory, it cannot be withdrawn from its destined use and the public authority does not have the right to sell it. But if it ceases to be a direct good from the standpoint of Public Finance, it becomes a patrimonial good and therefore alienable. Alienation is merely one of the ways of producing goods.

### § 6

#### *The Sale of Patrimonial Goods*

If one examines the budgets of modern states over a series of years, one observes that the revenues from patrimonial goods tend to disappear, in contrast with the situation under the old regime, in which patrimonial goods represented the almost exclusive source of public revenues.

The disappearance of patrimonial revenues is the result of a long historic process. The economic and political forces operating in this process will give the most convincing explanation of the fact itself.

## THEORY OF PATRIMONIAL REVENUES

One must go back to the Middle Ages, and, above all, to the feudal period, to find the typical structure of patrimonial finance.

Its point of departure is the right of overlordship, or of eminent domain, which the sovereign claims and which little by little he succeeds in establishing — more or less thoroughly, depending upon the particular country involved — over all the territory and over all the people of his State. Eminent domain has not been a right exercised in fact or with equal efficacy by the sovereign in all countries. Everywhere, nevertheless, it has served as a theoretical principle upon which jurists have built the theory of patrimonial finance.

With the establishment of the barbarian monarchy began the transformation of the Roman land-tax, or public *census*, which was paid by proprietors to the State, into the feudal *census*, paid to the overlord as a private, or quasi-private, transaction — that is, as a consideration for a concession of lands.

With the establishment of feudalism, the original distinction between the two institutions disappeared, in fact if not in theory. The typical process by which the merging of the public *census* with the private *census* was effected was as follows. The proprietors of freehold land, or *allodium*, on which they owed the tax or public *census*, when the security of their occupation was threatened by the barons, by the great proprietors, and even by the functionaries of the king, had recourse to the expedient of selling the free lands to these various trouble-makers in order to buy back their protection, with the understanding that the former proprietors would get the lands back as feudal concessions. Thus the public *census* was in fact transformed into, or became merged with, the private *census*.

This process became more and more perfected, in proportion as the convents, the bishops, the dukes, the counts, and the barons succeeded in taking the place of the king in the collection of crown levies, and in merging the latter with the feudal contributions of a patrimonial character due them within the fief.

The result was that the proprietors of free lands became considered as 'cessionnaires' or 'use owners'.

The transformation of the levy on landed property into a patrimonial revenue was extended logically — in the further development of the theory — to the other fiscal rights which were attached to the exploitation of mines, to hunting, fishing, the use of forests and pastures, of navigable rivers, and of roads; and still more easily, it

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was extended to the operation of mills, bakeries, fisheries, and industries in general, all of which were monopolies of the feudal lords.

Little by little the same patrimonial conception came to include the people and every form of personal activity. The right to carry on a business, an industry, or a trade was considered a prerogative of the overlord, as forming part of his eminent domain. So much so that every man who wished to carry on his personal activities had to obtain a 'concession', or 'license', which did not differ from a grant of land, and he had to pay for it. In this way, the levy put upon the income of industries and professions also came to be considered by the jurists as being on a par with the type of revenue represented by the *census* on land and came to be regarded as the consideration paid for a patrimonial concession.

### § 7

At this stage of development, the theory of Public Finance is complete. Every *census*, or levy, or contribution, or dues paid to the overlord is the consideration paid for a patrimonial concession and is no longer the payment made for the rendering of public services. At any rate, this latter type of financial relationship is hidden behind the patrimonial relationship.

From this followed two consequences which were in a sense similar, and were yet opposite to one another. The first was that the debtor had no right to demand a counter-offering in the form of public services. The second was that the *census* could not be increased merely on the ground that public expenditures had increased.<sup>1</sup>

For the public exchange of a service for a tax was substituted a private exchange of a concession of land for an annual rental payment, with all its legal and political consequences.

A theoretical conception of this kind fitted in with the political conception of feudal despotism and absolute monarchy, for two obvious reasons. The first was that the sovereign used the revenues as he saw fit, merging in fact, if not always with the sanction of law, his personal budget with that of the State. The second was that the

<sup>1</sup> The amount of the *censi*, according to generally accepted doctrine, was fixed, or at least was established in conformity with tradition, whence the *censi* took the name *coutumes* in France; and whenever, as in Italy and elsewhere, it was found possible to increase them despite tradition, by sheer political pressure, they took such names as *maldanaro*, *maltolti*, *abusus*, etc.

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patrimonial revenues put the dominant class in a position of absolute economic and political independence of the subject classes; while, at the same time, they protected these subject classes against the danger of increasing levies.

The lands granted in fief were *inalienable*, precisely and solely in order to assure the perpetuity of the political regime, in the interest of the dominant class. Inalienability is a limitation of domain character; but far from modifying the patrimonial character of Public Finance, it aimed instead to perpetuate it for political reasons.

The ensuing struggle between feudalism and monarchy did not change the principles underlying patrimonial finance; for the monarchy only partially succeeded in its ambition of reclaiming from the barons the right of which it had let itself be despoiled.

The only real difference was that the monarchy softened the rigors of the feudal regime, in so far as the despotism of the central and distant power of the king was less of a burden than the local and near-by despotism of the baron.

### § 8

On the other hand, a new circumstance which changed the terms of the problem arose the moment that the patrimonial revenues were no longer sufficient to cover the public and private wants of the sovereign.

On the one hand, the expenditures of the State increased; and on the other, the patrimonial revenues, instead of increasing, diminished, because of the prodigality of the sovereigns in satisfying the greed of their favourites, because of the absenteeism and rapacity of the overlords, and because of the resultant lack of interest on the part of the tenants in increasing production.

The budget of the monarchy fell into a state of chronic deficit, and it was necessary to have recourse to *grants* or *subsidies* which were demanded from the subjects in order to make up for the growing inadequacy of the patrimonial revenues.

The history of these subsidies is the history of taxation.

Subsidies were an ancient device; but they used to be paid only at intervals on certain definite occasions, such as the departure of the prince on a crusade, the reception of the emperor, the construction of fortresses, etc.

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The characteristics of the subsidy were two: (a) it had to have a public expenditure to which it could be said to correspond; (b) it had to be demanded by the prince and to be assented to by the nobles, prelates, and the common people, who met whenever necessary in assemblies which were called *estates, parliaments, or 'cortes'*, and which were the precursors of the modern parliamentary regime.

The subsidies were the origin of taxation and the means by which the subjects became citizens. In fact, whereas the patrimonial revenue avoided contact and frictions between the sovereign and his subjects, assured the economic and political independence of the former and exposed the latter to systematic levies and extortions, the subsidies, on the other hand, forced the sovereign to have an increasing amount of contact on financial matters with his subjects, and the latter took advantage of these contacts to reconquer or to ask and obtain, at every request for subsidies, old rights and new liberties.

Little by little, taxation reversed the old relationship of political dependence, initiated the transformation of the old absolute monarchy into modern representative states, and substituted for patrimonial revenues derived revenues.

It is not necessary to review this history. The vicissitudes of the long contest were various. In England the struggle ended before it did on the continent, by a series of compromises from which was born representative government.<sup>1</sup> On the continent, as a result of a combination of circumstances, the monarchy was able to resist with

<sup>1</sup> The fact is a general one, but one finds it outlined with greatest clarity in English constitutional history.

The landed patrimony of the Crown had begun to diminish under Henry VIII, Charles I, Charles II, James II, and William III, thanks to mortgages and generous grants. Parliament, called to determine the civil list of Queen Anne, intervened to save what it still could save of the Crown patrimony, since it was necessary to make up the growing deficiency of the patrimonial revenues out of taxes. Erskine May (*Constitutional History of England*, vol. I, chap. IV) comments on the fact as follows: 'While this waste of the crown property had been injurious to the public revenues, it favoured the development of the liberties of the people. Kings with vast hereditary revenues, - husbanded and improved, - would have been comparatively independent of Parliament. But their improvidence gradually constrained them to rely upon the liberality of their subjects; and their own necessities, and the increasing expenditures of the State, at length placed them entirely under the control of Parliament.'

'No constitutional change has been more important in securing popular control over the executive government, than the voting of supplies by the House of Commons: nor has any expedient been better calculated to restrain the undue influence of the Crown, than a strict settlement of its revenues by Parliament. In the reign of Charles II, the principle of appropriating supplies to specific services by statute, - which had not been without previous recognition, - was formally established as one of the conditions under which Parliament granted money for the service of the state.'

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greater success and for a longer time, but it was finally overturned by revolutions. Thus the feudal order and patrimonial finance fell everywhere. The goods of the crown and of the fief became once more the property of the State.

### § 9

With the elimination of the political reasons which had led to the conservation of the patrimonial revenues, economic reasons become dominant in deciding whether it is advantageous for the community to conserve the patrimonial revenues, or to substitute tributary revenues for them.

Now, as has been pointed out, the tendency to sell the patrimonial goods is a persistent and general fact in modern states.

Often the sale has been made necessary by exceptional pressure on the budget, to provide for war costs and war indemnities, or to carry out vast schemes of public works, or to pay debts. In every case, however, the State had and has a choice of selling the patrimony, with a corresponding loss of revenue, or of borrowing, with a corresponding interest-burden.

Given the possibility of choice and the absence of disturbing political causes, the phenomenon is explained as the natural result of a calculation of economic profit.

Suppose, for example, that the State, in order to provide for an extraordinary expenditure, decides to sell patrimonial goods to the value of 100,000,000 instead of contracting a loan of the same amount. In so doing, it will lose the income from the former, but will save the interest on the latter, and the transaction will be profitable, *ceteris paribus*, if it can be shown that the income lost is, in fact, less than the expenditure that has been saved.

In order that this may happen, the management by the State of its patrimony must be less productive than private management, and must be so within such limits that the bargain between the two may be profitable.

If, for example, a given piece of landed property yields the State 100 in net income and can yield 120 in the hands of a private purchaser, it will be worth 2000 of capital as a public enterprise, and 2400 as a private enterprise. If the State can obtain credit at 5 per cent, and if the private purchaser is disposed to give credit at

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5 per cent, the bargain will be possible at any price between 2000 and 2400.

If, however, the State were in a position to obtain the loan at 4 per cent, it would have to pay only 80 a year in interest, and for this reason it could sell only at 2500.

On the other hand, if the private purchaser plans on investing his capital at 6 per cent, he would have to realize a return of 150 before he would be disposed to pay 2500, and even at this price it would be a matter of indifference to him whether he bought the property or not.

To sum up: the State capitalizes the net income which it actually receives from the piece of land in question at a rate of interest that it would pay in the alternative case of a loan; and the private person capitalizes the return which he knows he will receive from the land at the rate of interest at which he could make a loan or otherwise invest his savings.

If, between the two capitalized sums, there exists a difference in favour of the private individual, this may be divided between the two bargainers and thus make possible a sale which will be profitable for both.

### § 10

But this calculation is not always so easy as it seems; because the State, which represents the community, cannot quite reason as does the private individual, who is not interested in the repercussions which the sale may have on the general economic system.

There are those who urge that the State should sell its patrimonial goods even at a loss, on the ground that the community will gain in any case from the greater production that will be obtained from the goods thus sold.

As a matter of fact, the community of consumers always gains from the greater production of grain which the private individual may obtain from the land in question, even if the State, instead of selling it, gives it away.

But then the public treasury will have to make up for the loss by increasing the taxes on the 'community' of taxpayers, with the result that the gift made to the group of buyers will be paid for by the body of taxpayers.

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As one sees, the problem of the maximum total profit — for the treasury and for the community — is complicated by a problem of distribution, since the circle of buyers does not coincide with that of the taxpayers.

It is not possible, *a priori*, to determine with precision the limits which should be set for the sale of patrimonial goods; but perhaps it is not wrong to affirm that the price corresponding to the capitalization of the effective income which the State actually obtains from its patrimonial goods represents a price limit below which it would not be possible to go without damaging the position of the taxpayers to the advantage of the group of buyers.

On the other hand, there is another and better-founded element in the calculation which differentiates the position of the public treasury, when considered as a proprietor, from that of the private proprietor, and that is this. When the sale permits the forecast of an increase of income in the hands of the private buyers, the public treasury may count upon the increase of taxes that the latter will pay. In other words, the State automatically assures for itself, by means of taxes, a continuing participation in the greater future production of the patrimony which it sells.

This does not happen in the case of the private seller. We are dealing here with a difference which provides a real element in fiscal calculations; but even this difference must be appraised with caution.

For, as a matter of fact, the two circumstances mentioned — the indirect economic participation of the community and the participation of the State, through taxes, in the greater production — have often been exaggerated, in order to induce modern States to sell their patrimonial goods too hastily, thus providing an advantage for the buyers without insuring a maximum advantage for the community.

### § 11

The theory just expounded makes clear also the error of the contrary opinion, according to which it would be to the advantage even of the modern State to preserve its private patrimony as a war chest or reserve to be used in moments of unforeseen or pressing need.



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For it is evident that, at any given moment, the sale price of the State's property will depend on the one hand upon the amount of savings available in the country, which may be regarded as representing the demand, and upon the extent of the supply on the other hand. For this reason, if, the demand remaining constant, an appreciable quantity of goods is suddenly thrown on the market, their price will be lowered, and the State will absorb a smaller quantity of available savings than it could absorb directly by means of taxes and loans.

To the modern State, with its financial system based upon taxation, it is more expedient to count upon the growth of its citizens' wealth than on the growth of its patrimony, since it is from the former that it can always, and more economically, satisfy all its ordinary and extraordinary requirements. For this reason, the opinion we have been discussing is to be regarded as a survival from the era of patrimonial finance.

Summing up, we may say that there is an inductive basis for the formulation of the following guiding principle. Modern States, assuming that they do not have prejudices which induce them either to preserve their private patrimony at a loss in order to favour a political class, or to sell it at a loss in favour of a class of capitalists, regulate their conduct according to the principle of maximum profit, actual and prospective.

From the economic explanation of the historic fact, it does not follow, as a 'rule' of financial policy, that modern States must sell their patrimonial goods in the light of the general principle that their productive functions tend more and more to become separate from the productive functions of private individuals. What does follow is merely that the sale has come about as the consequence of the fact that State enterprise has been less productive; and the sale goes on to the extent that this lesser capacity is demonstrated. Thus, the division of labour between public and private enterprise is itself a result and not a cause of the sale.<sup>1</sup>

<sup>1</sup> The difference between the 'law' which explains the dynamic historical fact and the 'norm' which the administrator obeys in regulating his conduct at times seems to be reducible to zero. And, in fact, it is reduced to zero when present conditions are identical with past conditions. Even in such a case, however, the administrator must *make certain* that the conditions are identical.

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### § 12

#### *The Increase of Public Expenditures*

With the substitution of a system of finance based upon taxation for patrimonial finance, there came a rapid increase of public expenditures.

To explain this fact, it is necessary to recall that the struggle between the monarchy and the people came to an end with the definitive recognition of parliamentary sovereignty in the question of taxation and public expenditures. Once there had been removed the political cause that induced parliaments to haggle with the crown and executive power over the granting of subsidies, above all when the latter were on the way to becoming annual taxes, public expenditures increased rapidly.

This means that the amount of these levies, instead of merely being equal to the amount of the patrimonial revenues, greatly exceeded the latter.

The fact is a general one; it was established immediately after the cessation of the struggle between parliament and the crown, of which it was a logical consequence. The patrimonial goods of the crown and the fief came under the administration of parliament, which used them in the production of public services for the exclusive benefit of the community. Similarly, taxes have come to be voted by the delegates of the community of taxpayers and are directed toward the production of goods which redound to the benefit of this same community of taxpayers. It is assumed that no part of the public income shall be spent for the benefit of the sovereign, of his favourites, or of the privileged class which he represents. The community contributes private goods and gets them back completely transformed into public goods. No longer despoiled by the political intermediary, the community tends, on the one hand, through parliamentary supervision, to lower the cost of producing public services, and, on the other, no longer has a reason for not obtaining for itself all those services which are economically useful to it. Therefore only the consideration of economic profit will decide the proportion in which the national and individual income will be divided between the production and the consumption of public goods, on the one hand, and

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the production and consumption of private goods, on the other

To this cause of an economic character there may be added another of a political character. This is the fact that, under a representative parliamentary regime, power tends to pass from the class possessing wealth to the democracy of the many; and the latter uses the power to increase expenditures for their own advantage and taxes at the expense of the rich.

<sup>1</sup> This statement of the matter may seem excessively optimistic, but the fact is historically established. 'When the Commons had neither information as to the necessities of the state, nor securities for the proper application of their grants, - they had often failed to respond to the solicitation of the king for subsidies, - or their liberality had fallen short of his demands. But not once since the Revolution have the demands of the Crown for the public service been refused. Whatever sums ministers have stated to be necessary, for all the essential services of the state, the Commons have freely granted . . . So far from opposing the demands of the Crown, they have rather laid themselves open to the charge of too facile an acquiescence in a constant increasing expenditure. Since they have assumed a control of the finances, the expenditure has increased about fifty-fold; and a stupendous national debt has been created' (Erskine May, *Constitutional History of England*, Vol. I, chap. vii).

## CHAPTER III

### FORESTS AND RAILROADS

**Summary:** Forests and railroads — The forest as a patrimonial good — Shelter forests as domain goods — Private railroads — The intervention of the State in defence of the community transforms them into a public service, and makes them similar to the postal and telegraph systems

#### § I

SOME writers maintain that modern states tend to re-establish the ancient patrimony in the form of forests, railways, and postal and telegraphic systems, the income from which would take the place of the original revenues of an earlier age.

We are dealing here with a huge patrimony consisting of lands, factories and industrial plants, which exist also in the field of private enterprise and which seem to be an exception to the general tendency toward the sale of patrimonial goods. State forests tend to remain part of the patrimony of the State; both they and the other enterprises mentioned yield the State an income not unlike that which private individuals draw or would draw from ownership of them.

The distinction between patrimonial and domain goods, however, puts us immediately on guard against traps which may inhere in such an analogy. For if the State preserves the forests and owns and manages the railroads or the mails in order to satisfy directly a collective want, these goods have, for this very reason, the character of a domain good rather than of a patrimony.

Yet the point deserves further consideration. It will be well to limit our examination to the forests and the railroads, which are two typical forms of goods, each one of which may be taken as representing a group of other goods, to which it is logically easy to extend the conclusions that we shall reach.

As for the forests, one may lay down the preliminary consideration that the State, other conditions being equal, is not so bad a producer in this field as it has shown itself to be in other forms of landed

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and industrial property, when compared with private producers. This is due to several reasons:

(a) while the planting of a forest calls for a large initial capital, its cultivation does not demand the special oversight and care of the producer, whereas this is required in other types of cultivation;

(b) the most economical application of forestry demands rather vast areas;

(c) the State, as a perpetual legal entity, finds itself more able to wait for the period in which the timber will have perfectly matured. Other conditions being equal, it is during this period that the growing forest attains its highest value; and the period of growth usually exceeds the average life of a generation.

For these reasons, which are of what may be called a private-economic character, if the State should preserve the forest as a patrimonial good, that fact would not represent an exception to the theoretical principle expounded. The State forests would be a part of the State patrimony.

But the preservation of the forest as part of the State's property is due principally to the circumstance that forests may, under certain definite conditions, satisfy directly needs of the community which have nothing to do with timber or pasturage.

### § 2

#### *Shelter Forests*<sup>1</sup>

From forests, in fact, two distinct utilities may be obtained. The one, of a private-economic character, derives from the exploitation for profit of the timber and pasture-land. The other, of what may be called a collective-economic character, derives from the fact that forests assure the slow infiltration of rain-water in the mountains and therefore the regularization of the watercourses in the valleys, prevent the erosion of river-banks, and, according to some, may exert a beneficent influence on the climatic and hygienic conditions of the surrounding region. These utilities, which are to the advantage not of the owners, but of the community, confer on the forest the character of a domain good, and justify the intervention of the State in the ownership and exploitation of forests.

<sup>1</sup> [Italian: *boschi di difesa* - Translator's note]

## FORESTS AND RAILROADS

As long as the owner finds the cultivation of forests profitable, he will preserve the forests; and in so doing he offers a free utility to the community. At the moment, however, in which (whether because of the high price of timber or because there is profit in changing to another form of cultivation, or because of difficulties in his private affairs) he finds it convenient to cut down the forest, there is evidenced a contrast between the private interest of the proprietor and the interest of the community.

The contrast can be described precisely as follows. The cost of maintaining the forest is borne exclusively by the proprietor, who sets against this cost only the private utility to be derived from the timber and the pasturage, and does not take account of the public utility of the forest as such. For this reason, the moment that it is to his interest to cut down the forest, and it is to the interest of society to preserve the forest, society must assume that part of the cost to which the public utility corresponds. Only then is the economic calculation complete.

The State, then, intervenes in order to defend the community against the damages which may follow from the cutting down of a given category of forest. It does so in two ways: (*a*) by keeping and not selling the forests in its own possession, and, if need be, declaring them inalienable; or (*b*) by subjecting shelter forests to forest restrictions, whereby proprietors must manage their forests rationally, with periodical cuttings, and must not destroy them.

In the first case, the conflict of interest between the system of private ownership of forests and collective wants disappears automatically. The community bears the whole cost, and enjoys all the utility. And if, as has been said, the State is not a bad forester, it will have no losses. But even if it should obtain a smaller return than a private owner would obtain, this loss would be regarded as part of the cost of producing the public utility obtained from the forest.

In the second case, the forestry law, in imposing restrictions, recognizes, or should recognize, the proprietor's right to compensation. The compensation is merely that part of the cost which the State assumes in order to preserve the public utility of the private forest.

In conclusion: in the shelter forests we must distinguish the exploitation of timber and pasturage, which has utility from a private-economic point of view, from the maintenance of the forest area and

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the body of limitations of a domain character which are placed on forestry.

We may express this controlling criterion as follows: the income from shelter forests corresponds economically to their private utility, not to their public utility, and is therefore patrimonial.

The cost of the public utility is met out of taxes. And if we assume that the State imposes a levy on all those residing on the banks of rivers and in the cities on the plains which are traversed by these rivers, their contribution would correspond to the public good which they enjoy and would have the character of a special assessment.<sup>1</sup>

### § 3

#### *Railroads*

The considerations advanced with respect to forests and similar goods do not entirely apply to railroads.

In contrast to the case of shelter forests — in which it is possible to separate the public utility arising out of the area subject to restrictions from the private utility arising out of the production of timber — in railroads the road-bed is not separable from the transportation industry, though some jurists have attempted to effect such a separation. From the economic point of view, the railroad is an organism formed by the co-ordination of a series of goods bound to each other in a complementary and interdependent relationship, such that each good has value if it remains within the organism, but loses it when it leaves.

The road-bed cannot be separated from the tracks; the latter cannot be separated from the rolling stock and especially from the locomotive; and these, in their turn, cannot be separated from the transportation of freight and passengers. Nor is there an exception to this organic unity by reason of the fact that at times the identity of the proprietor is distinct from that of the manager; for in such a case we are dealing with a mere division of functions which is due to causes of a provisional nature, and which, moreover, is corrected by a contract regulating the relationship between the proprietor and the operator so as to assure unity of service, and usually ends by consolidating ownership and operation in the same person.

<sup>1</sup> Book II, chap. I.

## FORESTS AND RAILROADS

In every case, the unity of the service is never broken from the standpoint of the public, which demands only railroad transportation.

In the case of forests, on the other hand, there are two distinct categories of consumers, each of which demands one of the two utilities produced.

Yet the problem of railroads is simplified for this very reason, because it thus becomes merely a question of deciding whether the State shall treat railroad transportation as a public or as a private enterprise.

### § 4

Since we have excluded the possibility of determining *a priori* whether railroads ought to be left to private industry or be turned over to the State, for us it is a matter of explaining why, as a matter of fact, the railroads in many countries have become, or are tending to become, a State enterprise.

Established originally as a private industry, their absorption on the part of the State has come about step by step, by means of a growing series of acts of intervention which, regulating and limiting the right of private ownership more and more, have ended by substituting a public corporation for the private one.

Now, in all this slow historic process, the undisputed point is that the initial and progressive intervention of the State has not come about for motives of a private-economic character — that is, in order to procure a patrimonial income for the public treasury — but in order to defend the interests of the community, which were in conflict with the interests of the private enterprise.

First of all, the private railroad companies limited themselves to the construction of the more profitable lines, since they were interested solely in obtaining the maximum profit, and did not support railway development throughout the territory of the State in such a way as to satisfy the more comprehensive collective wants which go beyond the mere transportation of freight. In fact, the railroads are becoming more and more a good which is complementary to the public administration, both civil and military, and to intellectual and social communications — that is, they are becoming goods which are complementary to other public services. Hence the intervention of the State in order to regulate private railroad service in



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such a way as to make certain that this service will satisfy collective wants also. In this respect, it is a case analogous to that of the forests.

In the second place, private enterprises do not always have sufficient regard for the personal safety of the passengers and the passers-by. To public protests on such matters the State answered here also by intervening in order to defend the safety of persons and of property.

In the third place, free competition between railway enterprises often ended, and tends as a rule to end, either by a combination of the competing companies, or by the collapse of the weakest. In both cases, there is a waste of wealth, and the result is a monopolistic position more rigorous than ever.

The harm that railroad monopoly may inflict and has often inflicted on the community does not lie merely in the height of the railroad rates. It lies also in the fact that the railroads establish rates, even though they are monopoly rates, which are not equal for all users of the railroads, in such a way as to favour certain definite businesses. Indeed, it has happened, and may happen, that the railroad companies or their officials may become interested in other enterprises the products of which are destined for the consumption of distant markets, and whose earnings depend on great rapidity and safety of transportation. Thus there have been cases in which the railroads have established favourable rates and special terms with respect to shipping, speed of transportation, and use of terminals, for businesses in which they themselves were interested, and higher rates, together with delays in arrival and transshipment, for competing industries, to the disadvantage of the latter.

It is understandable that this danger should have increased, in the degree that, with the development of long-distance hauling, all the trade of the country threatens to fall under the control of the railroads.

Hence the State has intervened once more in order to reconcile these contrasting interests of the producer group and consumer group, by imposing rates, time-tables, terminal conditions, etc., which are equal for all in time and space. It has imposed, that is to say, rates which are fixed and general.

As one sees, we are dealing with systematic acts of intervention which have continued to increase and which, little by little, have

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ended by the total absorption — that is, by the nationalization — of the private enterprise.

Now, since each successive step of State intervention was motivated by the necessity for defending an interest of the community against the monopoly of a group, we must conclude that nationalization itself has come about to the extent that railroad transportation came finally to be considered a public service, and not because of an intention to create a source of patrimonial revenue.

If this conclusion is not universally accepted, it is because of the fact that there is still in progress an active debate between those who want nationalization and those who want the railroads entrusted to private industry.

Leaving aside the good and the bad arguments with which the two theses are defended or attacked, the circumstance which deserves emphasis is that the State does not need to go so far as nationalization — that is, the total absorption of private industry — in order to subordinate the latter to the interest of the community. It has already been noted that every partial intervention of the State is, in itself, a public service.

If now it is admitted, on the basis of experience, that the State is not a better manager than private individuals would be, the most advantageous solution, economically, is obtained (*a*) when State intervention — that is, the system of interventions and of progressive restrictions — remains within the limits rigorously demanded by the needs of the community; and (*b*) when, at the same time, use is made of the superior capacity of the private enterprise in the matter of technique and management, without absorbing the private enterprise itself.

The very difference of opinion prevailing shows that the railroads are on the boundary between public and private enterprise.

The fact remains, however, that nationalization represents a victory for those who consider railroad transportation a public service; and for this reason the railroads, whenever they are nationalized, tend more and more to be assimilated to the group composed of the postal, telegraph, and telephone systems, which are public services, and the cost of which is covered by a 'fee'.

The railroads are the bridge by which we may pass from patrimonial revenues, which we have discussed, to the phenomenon of the fee, which we shall now proceed to examine.

## CHAPTER IV

### THEORY OF THE FEE

Summary: Derived revenues — The concept of a special public service and the conditions for its performance — Law of determination of the fee — Manifold prices in Public Finance — The two cases of manifold prices — The fee provides protection against the danger of uneconomic production

#### § 1

#### *The Special Public Service*

FROM patrimonial revenues we pass to *derived* or *levied* revenues, so-called because they are derived from levies upon the private income of citizens.

To the degree that patrimonial revenues disappear from modern budgets, levied revenues increase and become a predominating part of these budgets.

*Levies* are divided into two large categories: *fees* and *taxes*. To this division corresponds the differentiation of public services as special or general.

From our study of railroads, then, we pass, almost without interruption of the analysis, to the study of public services — that is, of those goods whose production is regarded by the community, at a given moment, as a function of the State.

Public services may be divided into two groups: *special public services* and *general public services*. Included in the first group are the postal and telegraphic systems; included in the second are the defence of State territory, the administration of justice, and the maintenance of roads.

The first category is made up of those services for which it is possible to establish an exchange-relationship of an individual, *special* character between the State as producer and each citizen as consumer. These services are capable of sale at retail — that is, of being offered from time to time to the citizen who demands them, at the moment and in the quantity in which he demands them. In a

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word, the person of the consumer and the quantity of his consumption are given individual attention. Thus arises, in the exchange between the State as producer and the citizen as consumer, the economic phenomenon that we call a price. This price is called a fee. The postal system is pre-eminent among the special public services, and may, for purposes of theoretical treatment, be taken as typical of them.

It is obvious, by now, that such an exchange relationship could not be realized in the case of the service which is represented by the defence of national territory. That is to say, it does not lie within the power of the State to assign to a public service which it produces, at its discretion, the character of a *general* or a *special* service.

In order that a special service may be performed, two conditions must be present:

1. *The supply of the service must be technically divisible into saleable units.*

Obviously, it would not be possible to sell at retail a service that was not materially divisible into saleable units.

The postal system is a special public service, because the supply can be divided into many units (letters, postcards, newspapers, etc.), each one of which satisfies a given want of individual consumers. The same may be said of the telegraphic, telephonic, and railway systems. It could not be said of the defence of national territory.

Of course, the divisibility of the service must not be understood exclusively in the sense of the technical possibilities involved. On the contrary, it must sometimes be considered also from the point of view of economic expediency, in that it may be felt that even though the service may be divisible technically, it is not worth dividing.

Thus, for example, the use of ordinary roads might be technically divisible into saleable units, to which a price or fee or *toll* might correspond. But such a system, which was applicable in the Middle Ages to the few roads then in existence and which may still be applied to a bridge, would be economically inapplicable to the whole system of roads, considering the great development that roads have had in modern times, and the consequent enormous expenditure on supervision and collection that the system would require.

2. *The service must be constantly demanded by individuals.*

That is, it is necessary that the 'state of want', or the need of the individual, which the public service satisfies, be periodically

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reproduced, so that the inducement to renew the demand may again be present.

Now, in Public Finance, there are cases in which the demand of the individual is made dormant as a result of the performance of the public service itself.

Consider, for example, the service of public safety. The better this service is organized, the more it provides against and removes the danger that persons and property may be injured. Hence the citizen finds himself less and less in a position to demand the restitution of his violated rights. But if, for some reason, the smooth functioning of the service of public safety is impaired, the demand of the citizen is re-born with the re-birth of the danger. It is in this sense that it may happen that, through the perfecting of a public service which has a preventive function, the stimulus of individual demand may be made dormant.

When the two above-mentioned conditions are not present, one cannot speak of a special public service. The good produced by the State would then of necessity belong to the category of general public services.

(The ultimate difference between special and general public services depends, therefore, upon whether or not it is desirable and technically possible to divide the total supply of and total demand for these services among individuals.) It does not depend upon a supposed qualitative difference between the two types of service; or, at any rate, such qualitative difference as may be held to exist depends upon the criteria just mentioned.

To the group of general public services belong the administration of justice, the defence of persons and goods against internal and external enemies, the maintenance of ordinary roads, protection against infectious diseases of men, animals, and plants, etc. So far as these services are concerned, the phenomenon of the fee disappears either wholly or in part and there appears the phenomenon of the *tax*. The latter consists of an amount which the State deducts from the income of citizens in exchange for the use of general public services. We shall formulate the theory of the tax in its proper place; let us here complete the theory of the fee and establish the law by which it is determined.

## THEORY OF THE FEE

### § 2

#### *The Fee*

It has already been suggested that the fee is a case of *price*. It may be called, as some suggest, a *public price*, provided that this serves to indicate only that the fee is collected by the State—i.e., that it is the price of a public service.

In Private Economics, two cases of price are usually studied: price under *free competition* and price under *monopoly*.

There is, however, a third type of price, insufficiently developed in Private Economics, and therefore insufficiently emphasized by economists: namely, the *co-operative* price—that is, the price which is formed within a co-operative society, and which may partake of the nature both of cost-price and of monopoly-price. In fact, a co-operative society which finds itself, let us assume, in a monopolistic position (for example, through the exclusive ownership of a factor of production), will sell to its members at cost-price; but it may exploit its monopoly position in dealing with third parties, and also, *within certain limits*, in dealing with some of its members. This is the germ of that phenomenon which arises, to be sure, in Private Economics, but which is developed and completed in Public Finance, and from which is derived the law by which the type of price which we call the *fee* is determined.

We have already said that the modern state reproduces the characteristics of a co-operative society, in so far as, in both cases, there is personal identity between producers and consumers. Indeed, the State carries the concept of such personal identity to its completion, because *all* citizens are at the same time producers and consumers, and one cannot conceive of consumption of public goods outside of the State. One can make a reservation with respect to foreigners, who may be considered *third parties* and may be subjected to monopoly prices, as we shall see when we come to consider the (complementary tax.) It follows that the fee must present the same characteristics as the private co-operative price.

Now, just as the price which a private co-operative sets in its exchange-relations with its members can only be a cost-price, so also in the modern type of democratic state, in which there is no

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profit-making monopolistic group, (the fee will be a cost-price.) Indeed, one may add that, in pure theory, it will be a price equal to (minimum cost) because when citizens are moved to demand the transfer of the production of a given good from private to public enterprise, they aim to obtain thereby a price equal to the private price which would prevail under conditions of free competition.<sup>1</sup>

By way of driving home this concept, it may be pointed out that a state which is of the co-operative type is nothing but a 'collective use-economy', in which the goods produced are destined not for external exchange with other groups, but for consumption among the members who compose it.

If this position is accepted, then it follows that if the State aims to maximize the consumption of a special public service within the social group, it must reduce the cost to a minimum and ask a price that merely covers cost.

The price of least cost becomes the point of reference for an appraisal, criticism, or approval of the productive capacity of the State, quite apart from the fact that the State may come to occupy a monopolistic position.<sup>2</sup>

This establishes the first condition of the law of the determination of the fee: 'The public price must be equal to or must gravitate toward cost of production.'

But the State — even if it produces at a lower cost than the private enterprise, so that it does not have to fear competition — strengthens this position by the establishment of a legal monopoly, forbidding and penalizing private competition.

This establishes the second condition of the theory: 'The fee is also a potential monopoly price.'

<sup>1</sup> We shall see presently how, with the nationalization of the enterprise, and with the realization of a first state of equilibrium through the elimination of private monopolistic enterprise, there is a renewal of the struggle within the state enterprise between the various groups of citizens who consume public services.

<sup>2</sup> In fact, it is only in an exchange-economy that there arises the difference between competitive- and monopoly-price. A private enterprise aims, in every case, to maximize its consumption of the goods which it buys, giving in exchange as little as possible of the goods that it produces. When it operates under conditions of free competition, it buys and sells at cost-price; so that as a result of the exchange the consumption of the contracting parties is maximized. On the other hand, it is only the monopolist who succeeds in selling above cost and in buying at cost, thus maximizing his consumption of the goods which he buys and minimizing the consumption, by the other contracting party, of the goods which he sells. But in a use-economy — whether it is individual or collective — there is only minimum cost and maximum consumption, from the standpoint of the one who is at the same time producer and consumer.

## THEORY OF THE FEE

### § 3

The two conditions seem contradictory. In fact, however, they function co-ordinately in this way:

(a) The fee must be equal, *in the aggregate*, to the cost of production of the service. That is, the aggregate amount of the fees which the State collects from individual consumers must equal the aggregate expenses of production.

(b) But in the distribution of the aggregate cost among the various categories of consumers, the public price may become a monopoly price. In fact, for the same unit of service the State, as a monopolist, may demand different prices from the various categories of consumers, or it may demand the same price for units that have different costs. For example, it may charge the same price for sending a letter over various distances, even though distance is an element of cost.

Now, it is only because of its monopolistic position that the public enterprise may establish prices not every one of which corresponds to the cost of the relevant unit of service consumed. Under conditions of free competition, the State would be constrained to apply a single cost-price for every unit consumed.

To sum up: the law of the determination of the fee must be considered as a third case, intermediate between the law of the determination of competitive price and that of monopoly price. In the aggregate, so far as the body of taxpayers is concerned, the fee is a cost-price; in the distribution of the total cost of production among the various groups of consumers, it is a monopoly price. In a word, the State practices the policy of *manifold prices*.<sup>1</sup>

### § 4

Having established this conclusion, let us add that the double price-policy which the State applies is not like that which the private monopolist practises.

<sup>1</sup> These are more often called *multiple prices*; but the word *multiple* has in mathematics a meaning which is not identical with its meaning in economics. For this reason, it is better to speak of manifold prices. We speak also, using a phrase that is perhaps more elegant, of a *double price policy*, in which case it must be understood that the prices may also be more than two.



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We know that the latter, when he succeeds in getting around the impersonal nature of exchange in dealing with the public and in uncovering the differing subjective evaluations of the various consumers, imposes for the same unit of service, not the one price that would be determined by competition, but as many prices as there are subjective valuations of the various buyers.

The typical example that is usually given is that of the theatre. In the theatre, units of goods, whether orchestra seats or boxes, which are of equal or almost equal cost, are sold at different prices.

The difference between double price-policy in Private Economics and in Public Finance lies, above all, in this: the private monopolist exploits the diversity of subjective valuations solely in order to realize the maximum possible profit from exchange, and therefore tends, on the whole, to an average price which is raised as much as possible above the level of cost. In Public Finance, on the other hand, the public enterprise, if it demands from some buyers prices which are above cost, must charge to others prices which are below cost, and vice versa, because the total receipts must be equal to cost.

In spite of this general limitation, it remains a fact that the State, even though it undertakes to produce at cost, practices an internal policy of double price in favour of one group and to the disadvantage of another. The question arises whether or not this is a case of class politics.

Let us recall that from the moment when the intervention of the State is called for, all are in accord in demanding that a public cost-price be substituted for a private monopoly-price; hence the former is considered the immediate point of equilibrium. But afterward, when State ownership has been brought about, the groups that dominate politically are led to exploit the new position of public monopoly, by practising the policy of manifold prices to their own advantage and to the disadvantage of others.

### § 5

Nevertheless, the adoption of manifold prices does not always represent class politics.

First of all, there is the case of the single rate-schedule -- for example, the single schedule of postal rates -- which automatically carries with it the practice of manifold prices. This does not con-

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stitute class politics if the establishment of the single schedule was made for (technical reasons) in the interest of all the consumers, as we shall see.<sup>1</sup>

In the second place, class politics are not involved in the case in which, if the authorities were to establish a single cost-price per unit, the total cost would not be covered because of the small number of consumers.

This, as is well known, happens when the supply of services cannot, from the very beginning of their production, be exactly equal to the initial demand and to the successive gradual fluctuations in this demand, but must, to some extent, exceed and anticipate movements in demand. Thus, it may happen that production must be begun with an expenditure on plant which, even if the expenditure be kept down to the minimum, has a productive capacity superior to the consumers' capacity of absorption at cost price.

A typical example is found in the case of the railroads. Even though the initial investment be reduced to the minimum possible proportions and even though running expenses be cut down, it not infrequently happens that the carrying capacity of the railroad is greater than the demand for its services at cost-price. Let us suppose that 1000 represents the cost of production and that this is divided into 100 sale-units. It is necessary to find at least 100 persons disposed to buy the 100 units at the single price of 10. But these cannot be found; instead, 50 can be found willing to pay the price of 10, 25 disposed to pay 13, and then another 25 willing to pay 7. In this way the cost could be covered.

In such a case, the policy of manifold prices does not provoke a class struggle; for (it has become a necessary condition for the very production of the service,) so that the various classes of consumers face this dilemma: either to give up the service, or to accept the three prices which correspond to their respective evaluations. If, on such a hypothesis, the various groups of citizens decide on the production of this given service, each one undertakes implicitly to pay his own price, without comparing it with the price that the others will pay. Indeed, it may be supposed that the policy of having three prices, in the example suggested, is (the result of an agreement by the three groups, and marks, for this reason, a point of equilibrium)

The group that pays the price that is below cost is not a

<sup>1</sup> See also Book I, Chap. v, § 7.

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parasitical group living at the expense of the group that pays the price above cost; it helps to cover the costs, and lessens the deficit of the enterprise, to the benefit of the other groups.

In proportion, however, as, with the growth of business, the use of the railroad, or any other special service, is extended, there comes a time when a mere cost-price is enough to cover expenses; and then, with the disappearance of the economic reason for manifold prices, the struggle between the various groups arises again and class politics begin.

The point of the new equilibrium is reached with the return to the single cost-price. How this point is reached will be told in the discussion of the theory of rate-schedules, which completes the theory of the fee.<sup>1</sup>

### § 6

This theory of the fee as a price seems, in concrete cases, to meet with an exception that deserves to be noted. Not infrequently the fee exceeds cost and gives a surplus which cannot be explained by the theory as we have expounded it.

Now, the State does not produce only one special service; it produces several, among which may be found a group of services which may be treated as a group of homogeneous quantities. Such a group would be represented, for example, by the postal, telegraphic, and railroad systems.

The State may exploit its monopoly position with respect to the group by imposing, for example, prices above cost on consumers of telegraphic services, in order to compensate for the prices below cost which it may grant to the consumers of postal services, and vice versa. The policy of different prices may take the whole group as its basis. And in such a case one may apply the theory of manifold prices to the various special services which form the groups, and speak of compensation.

But when the revenue derived from the fees exceeds the total cost of the entire group of services, the excess evidently serves to cover the cost of general public services, and therefore assumes the character of a tax. In other words, (the monopoly of the special service is exploited further in order to draw a profit therefrom.

<sup>1</sup> See Book I, chap. v, § 3.

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It is known that the postal system was in the past a monopoly for the purpose of obtaining revenue. Under the old regime it was a 'royal prerogative' and for this reason yielded a patrimonial revenue.

Nowadays, in modern systems of Public Finance, we have some fiscal monopolies which the State maintains in order to draw from them a revenue which is essentially (an indirect tax on consumption.) This revenue could be regarded as similar to that part of the price which the State would propose to obtain from a monopoly of special public services, over and above their cost of production.

On the other hand, it is to be noted that when the entire cost is covered by fees alone, account is not being taken of the indirect benefit which the special service sometimes brings to classes that are not direct consumers of the service. Thus, railroad transportation is as useful to the producers and the consumers of transported goods as it is to the tradesmen who pay the cost of transportation.

Hence arises the current opinion that railroad rates ought to be lower than the cost of transportation and that the difference should be covered by taxes at the expense of producers and consumers.

(The premise is correct; the conclusion is erroneous.) For the middleman includes the cost of transportation in his selling-price, and distributes it among those who, indirectly but none the less actually, participate in the consumption of railroad services, whereas the tax would strike also those who get no advantage from the railroads, either directly or indirectly.

### § 7

#### *The Productivity of the Fee*

A corollary of the general theory of the fee is that when the State covers the cost of production by its system of fees, it does not run the risk of producing anti-economically, in the long run; since it puts itself in the position of any private producer, who regulates supply in such a way that the consumers will absorb it completely at a given price per unit, whether this price is a cost-price or a monopoly-price. In this lies the proof that the production is economical, even if it cannot be said that it has attained the maximum of economy. If, for example, the consumers who make free use of the postal service cover the total cost through the postal fees, this

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means ~~that~~ they regard the production as economical. If, instead, the revenues do not cover expenditures, it means that the supply is greater than the demand, and that the State can and must restrict the former.

To sum up: under a system of fees, the citizens enter as a force tending toward the *ex post facto* control of the productivity of special public services, just as they would in the case of any private producer. The same is not true, as we shall see, of taxes.<sup>1</sup>

<sup>1</sup> See Book II, chap. II.

## CHAPTER V

### THE THEORY OF RATE-SCHEDULES<sup>1</sup>

**Summary:** Determination of units of sale — Process of diversification of rate-schedules — Process of simplification and unification — Railroad rates — Postal rates — Transition from the fee to the tax

#### § I

##### *Diversification of Rate-Schedules*

THE theory of fees is completed by the theory of rates. The rate is a translation into actuality of the general concept of the fee. The expression rate-schedule is, in fact, intended to refer to a synoptic picture in which the units into which the service has been divided are assigned corresponding prices per unit.

The construction of a rate-schedule is not an arbitrary matter. The division of public services into units follows certain general criteria:

(a) Every unit must represent a unit of consumption which is as small as possible, but is complete, account being taken of the conditions and habits of each country.

If any other procedure is followed, a waste of wealth results. Thus, in the case of the telegraph, when the unit was a group of twenty words, it was found that this unit was too large, because usually the number of words sent in telegrams at any one time was less than twenty. Hence the adoption of this unit led to a waste of wealth, because the user felt obliged to use all the twenty words which he was allowed, even though a smaller number of words would have sufficed.

If, on the other hand, we adopt a unit that is too small, we go to the other extreme. That is, the number of words allowed is too small, in ordinary cases, to express a thought, make an announcement, etc., and thus obliges the sender to use two units, thereby forcing him to incur waste, just as in the preceding case.

In practice, the proper unit is obtained by proceeding experimentally, by successive trials.

(b) In the second place, the division into units aims to facilitate

<sup>1</sup> [Italian: *tariffa* — Translator's note]

## INCOME FROM STATE PROPERTY AND FEES

the extension of consumption; and therefore, in practice, tends to divide the public service into a relatively large number of units.) For the larger this number is, the easier it is to satisfy all possible combinations, forms, and dimensions of individual demands, to attract a larger number of consumers, and to facilitate the disposal of the whole supply of the service produced.

Thus it is that the postal service is divided into a large number of consumption-units: letters, postal wrappers, ordinary postcards, picture postcards, newspapers, packages, insured articles, registered articles, and so on.

In railways, also, the diversification is relatively great. The basic units are the ton-mile and the passenger-mile. But there are, further, different classes for passengers and merchandise, and, again, numerous sub-categories for the shipping of merchandise: fast freight, slow freight, delivery to the addressee, etc.

### § 2

Every one of these units has its price. Now, the classification is made by taking into account not only (all differences of cost, but also all possible differences of subjective evaluation.) Thus, the transportation of a letter for which one pays three cents costs somewhat more than the transportation of a postcard, for which one pays one cent; but the ratio of the costs is not three to one.

Passing to the case of the railroads, we note that the various classes of travellers represent different costs for the producer, but that the difference between the respective passenger-rates does not correspond to the difference in costs. The same may be said of the classification of merchandise, which takes account of the value of the merchandise by putting the most expensive goods into the first class, at a higher rate, and the cheapest goods into the lowest class.

To sum up: the State, in order to extend the consumption and cover the cost of production of a given service, is forced to divide the supply into a large number of units of sale, and then to practise the policy of manifold prices. This explains the general fact which characterizes the first period of the evolution of rate-schedules: namely, that they become more and more diversified. This process begins at the moment when the production of the public service is begun; and continues and develops thereafter. It comes to an end

## THE THEORY OF RATE-SCHEDULES

when an opposite process of simplification and unification begins

The latter process consists of the gradual reduction of the number of units and the substitution of one or a few average prices for the whole series of prices which prevailed previously.

### § 3

#### *Process of Unification*

That a process of simplification follows the initial process of diversification is a normal and recurring fact, and may be considered as a contingent historical law.

It is necessary to make clear when and why one process succeeds the other.

The first condition which must be present in order that the process of unification may begin is that the increase in the consumption of the special public service must increase the income therefrom to such an extent as to make it possible to cover the costs of production by means of a single cost-price. In other words, in order that the problem of the unification of rates may present itself, it is necessary, first of all, that the cause that had made the policy of manifold prices necessary and useful for all concerned should disappear.<sup>1</sup>

When this happens, the preceding equilibrium is disturbed, since the classes that had been willing to pay prices above cost will now demand that the rate be brought down to the level of cost, while the classes that paid prices below cost will demand that there be a proportional reduction in all the rates which had been previously diversified.

The dispute will end, in fact, as soon as other conditions are fulfilled.

The first of these conditions is (that every consumer, large or small, must utilize, directly and indirectly, all the units into which the supply of the public service is divided'.) Let us suppose, for example, that every citizen ships goods over all distances — the rich in large quantities and the poor in small. It is obvious that it is a matter of indifference for both whether they pay a different price each time, or pay the same average price each time.

This condition may be expressed by saying that 'the average of the different rates which the consumer includes in his budget must be equal to the average which the producer includes in his budget'.

<sup>1</sup> See Book I, chap. IV, § 5.



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Whether or not this condition is fulfilled in any given case may be established, experimentally, by studying actual indices which may be taken as symptomatic of the growth in the consumption of the public service and its entry into the budget of all classes of the population.

The second condition which must also be present is an absolute reduction in the cost of production of the public service. )

The mere fact of the simplification of rate-schedules, which always represents a benefit to the consumer, resolves itself into an effective reduction of the expenses of production; but this is not the most important factor.

The important thing is that the expansion in the consumption of the public service usually leads to a reduction in the cost of production by virtue of the fact that it transforms the small State enterprise into a large one, and the large one into a still larger one. This makes possible the reduction of rates which were formerly differentiated. Nor is this all.

The same result is obtained through the co-operation of all other external causes — of which the most important is industrial progress— which at a given moment combine to reduce the cost of production. They accelerate the process of unification, because they permit the adoption of an average rate which is not far removed from the lowest rates of the differentiated system which had prevailed previously.

If, and in the measure to which, the old below-cost rate becomes the single cost-rate, it is extended to the consumers who used to pay rates above cost.

In this way we remove the possibility of opposition from the classes that used to pay the lowest rates in the diversified schedule.

### § 4

Here we see in action, for the first time, one of the fundamental controlling principles of Public Finance: (the principle of compensation and of averages.)

The phenomena of Public Finance are phenomena of averages. The process of averaging, however, demands special attention.

First of all, the average which the producer includes in his budget differs in economic significance from the average which the consumer includes in his budget.

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The first average is an average of prices per mile which are paid by various persons and are received by the same person; the second is the average of prices per mile paid by the same person.

Now, the first type of average has accounting significance to the extent that it shows the total cash receipts of the producer per mile; and it has a real economic value for him, since he can then appraise his enterprise correctly on the basis of average receipts, average expenditure, average income. Similarly, one may speak of the average income of individuals, of average revenue-yield per acre or per inhabitant, when we take the point of view of the State which produces the services and collects taxes.

If, however, we pass from the problems of production to those of the consumer and the payer of these levies, then it appears that this type of average per mile becomes an unreal value, because it could not be substituted for the series of prices per mile from which it is derived — that is, for the series of terms that make it up. And if one did make this substitution, the cost of the public service would be distributed according to the principle that *'some people are paying for others'* and would provoke a reaction.

This does not happen in the case of the second type of average, mentioned above, which arises from a series of acts of consumption performed by the same person, to whom the average is a real value which can be substituted for the series of differing prices which go to make up the average. In this case, the distribution of the total cost comes about according to the principle that *'every one pays according to his own consumption'*.

When the two averages coincide, the unification of rates does not, *broadly speaking*, disturb the preceding equilibrium.

### § 5

#### *Proportional, Differential, and Uniform Rate-Schedules*

The general theory of fees and of rate-schedules expounded above finds an application in a special case involved in the study of railroad and postal rate-schedules, which usually attracts the attention of students of the subject.

In this case attention is confined to the consideration of *distance*, which is an element in the cost of transportation, and with respect to

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which the railroad rate-schedule is still diversified, whereas the postal rate-schedule has become undifferentiated.

With respect to distance, three types of rate-schedules may be distinguished:

(a) the proportional rate-schedule, which exists when the price per unit—that is, the price per ton-mile—remains constant for the whole distance traversed, and the total price of transportation is obtained by multiplying the price per unit by the number of miles traversed;

(b) the differential rate-schedule which exists when the price per unit decreases with the distance and the total price of transportation is obtained by adding the successive prices of the miles traversed;<sup>1</sup>

(c) the uniform rate-schedule, which exists when the price per unit remains the same regardless of the mileage involved, and the total price is independent of distance.

It is customary to add to these three types the graduated, or zoned, rate-schedule, which is a *composite* of two rate-schedules—for example, of the undifferentiated rate-schedule, which applies within a given zone, and the proportional or differential rate-schedule, which applies as between zones. For this reason the graduated rate is not an autonomous type, in that it does not, in itself, give rise to a theoretical problem. It is of significance only in so far as it represents a step toward the unification of rates.

Usually, in current literature, the proportional rate-schedule has come to be considered as the typical rate-schedule, of which the others are derivatives.

This is erroneous, and the error arises from two causes. The first of these is that the problem is usually stated and discussed from the point of view of the producer, in whose budget expenditures and revenues are global figures, having reference to mileage. The second is that the proportional rate corresponds to the single price of Private Economics; and this price is considered a natural form of price from which manifold prices are, as it were, a deviation.

According to the theory which we have expounded, however, the type of rate-schedule from which one must start is that which corresponds to the first period of production and of consumption of the public service: namely, the differential rate-schedule; for this type of schedule takes account of all differences in cost- and utility-calcula-

<sup>1</sup> It should be noted that the adjective *differential* includes other cases; virtually all cases, in fact, involving differential treatment.

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tions for each individual mile or group of miles, and in it each individual act of exchange establishes its own price. In fact, railroad transportation is produced — within broad limits — under decreasing costs. The first mile costs relatively more than the second, the second more than the third, the third more than the fourth, and so on:

It is not difficult to explain how this comes about. It has been estimated that, under normal conditions and with scarcely noticeable variations, about 75 per cent of railroad expenditures are fixed — that is, independent of distance — and 25 per cent are variable — that is, they decrease with distance. The first group of expenditures, therefore, varies in inverse proportion to distance; the second is proportional. That is to say, in order to find the cost per mile, the first type of expenditure must be divided by the number of miles traversed, while the second must be multiplied by that number.

On these assumptions, let us — solely in order to make the concept clear — establish precisely, in the following table, what would be the theoretical share of total costs to be assigned to each successive mile. For the first mile or group of miles,

the cost is represented by	$75 + 25 = 100.00$
for the second	$\frac{75}{2} + 25 = 62.50$
for the third	$\frac{75}{3} + 25 = 50.00$
for the fourth	$\frac{75}{4} + 25 = 43.75$
for the tenth	$\frac{75}{10} + 25 = 32.50$
for the twentieth	$\frac{75}{20} + 25 = 28.75$
for the fiftieth	$\frac{75}{50} + 25 = 26.50$
for the hundredth	$\frac{75}{100} + 25 = 25.75$
for the two-hundredth	$\frac{75}{200} + 25 = 25.38$
for the five-hundredth	$\frac{75}{500} + 25 = 25.15$

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It will be seen that the part of the cost which is variable, since it decreases with the distance, becomes less and less until it becomes a very small quantity, even though it never drops out completely. In practice, however, once an adequate number of miles has been traversed, it becomes a negligible quantity and is in fact neglected, with the result that the differential rate-schedule ends by being transformed into a proportional rate-schedule.

If we pass from the producer to the consumer, we note that goods near the consumers' market enjoy a rent of situation, when compared with those that are distant from the market. For this reason it is held that the former can bear relatively higher rates, which gradually eliminate the rent of situation, in proportion as the distance from the market increases.

Finally, it is customary to take account of the value of the goods transported by establishing *ad valorem* rate-schedules. The rates in such schedules are higher for expensive goods and decrease as we pass to cheaper goods.

These are the bases upon which a system of differential rates rests. And, as we have already pointed out, this type of rate-schedule corresponds better to the first period, in which, in order to maximize the revenue from a given public service, there is a tendency toward a maximum subdivision of the units of sale and toward a corresponding maximum diversification of rates.

### § 6

The proportional rate-schedule, in contrast to the differential schedule, is based upon a price which is the average of the cost for short distances, on the one hand, and the cost for long distances, on the other. It would be a price below cost for the users of short distance, and a price above cost for users of long distance. Hence arises the danger that the type of use which does not cover expenses may be expanded and that the type which does cover expenses may be contracted.

Many facts are available to confirm this general principle. In Italy, before 1905, the system of proportional rate-schedules was prevalent. Travellers going distances less than 25 kilometres represented 70.44 per cent of the total; those between 150 and 200

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kilometres, barely 1·26 per cent; and the percentage of those travelling more than 400 kilometres was less than 1 per cent. The situation with respect to freight was similar. In 1889, the amount of freight transported less than 100 kilometres was almost 3 million tons; between 100 and 200 kilometres, it decreased to  $1\frac{1}{2}$  million tons; between 200 and 300 kilometres, it became a negligible quantity. Once differential rate-schedules were put into effect after 1905, these conditions improved, and long-distance traffic increased.

These facts prove and do not refute our theory, since they show that the application of proportional rate-schedules in Italy during the first period was a mistake.

Differential rate-schedules, on the other hand, automatically became proportional rate-schedules, as soon as the two conditions already examined were realized. The first of these conditions was that every consumer must utilize, directly or indirectly, both short and long distances. Now, a particular circumstance which hastens this process of compensation in the case of railroads is that railroads are a means of facilitating exchange at a distance, and fulfil this function by means of a two-way journey. The result is that the user of the railroads must pay, directly or indirectly, two inverse differential rates — that is, an amount equal to the rate which would have to be paid if the proportional rate-schedule were in force.

The second condition was that the absolute cost of transportation must diminish. This comes about in railways — independently of technological progress — from the very fact that, and in proportion as, within the limits of the carrying-capacity of the railroads, the distances travelled become longer and the number of units transported becomes larger. For in such a case the fixed costs — that is, 75 per cent of the total expenditures, according to our assumption — are spread over a larger and larger number of ton-miles and passenger-miles, and therefore become less and less of a burden on the rate per mile.

Thus there is a tendency to pass from differential rate-schedules to proportional schedules.<sup>1</sup>

<sup>1</sup> The process of unification of railroad rates practically stops at the attainment of proportional rate-schedules, although there have been attempts at further progress toward unification in the application of undifferentiated rate-schedules within zones. The immediate reasons for this fact are to be found (a) in the rise of costs in proportion to distance, which could not easily be overcome by the use of an average; (b) in the facility with which the consumer is able to calculate and apply the single rate to the distance traversed; (c) in the circumstance that railway travel is in itself a pleasure,

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If this tendential process is slow in its operation, this results above all from the fact that the two conditions mentioned are realized slowly, and from other combinations of circumstances which have no interest for general theory.

### §7

#### *Postal Rate-schedules*

From the proportional, and sometimes directly from the differential rate-schedules, there is a tendency to pass to the uniform rate-schedule. Already in the case of the railroads there is an indication of this in the attempts to establish zoned rate-schedules. In the case of tramways, on the other hand, the unification of rates is almost an accomplished fact.

But the special public service which provides the typical example of the uniform rate-schedule is the post office.

To be sure, even in the transportation of letters several different rates are still maintained. In most cases, for example, there is one rate for letters within the country, and another for letters abroad. Nevertheless, to-day we may speak of a single postal rate, by way of emphasizing the fact that the tendency toward the unification of rates in this case has virtually reached the possible maximum.

Distance is no longer a cause for the diversification of postal rates; the price of each unit of service is fixed independently of the length of the journey. Yet distance is an element of cost and is not always a negligible element. Historically we started with a system of postal rates which were differentiated according to distance. In the second half of the eighteenth century the process of unification began in Europe and it was completed with impressive rapidity.

The rapid introduction of the single postal rate has been favoured by a combination of special circumstances that will be examined in the light of the general theory developed above.

In order to make this matter clearer, it is necessary to divide the

and therefore an undifferentiated rate-schedule would probably bring about an increase in long-distance travel—that is, trips which would represent a loss to the producer.

But these circumstances, if carefully considered, are consistent with the general conclusion that it cannot yet be asserted that each user of the railroad travels over all distances.

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postal system into two distinct transportation agreements: (a) that which is made by the State as the administrator of the postal service with the managers of the means of transportation — for example, the railroad; and (b) that which is made by the State with the users of the service.

In the historical period which preceded, it was the State, or an agency to which the State granted a concession, that had to take care of everything — the collection of the mail, the means of transporting it, and its distribution. To-day there is a more nearly complete division of labour, and the means of transportation are not merged with the postal service. The State or its concessionaire is the agent entrusted with the carrying of the mail; and it carries out this obligation by means of a contract which is nowadays made with the railroads.

The price which the State pays the railroads immediately becomes part of the theory of railway rate-schedules, which are to-day, as we have said, differential or proportional schedules. Hence the State will pay the rate which applies to a ton-mile of letters and of other types of mail.

If, subsequently, the differential or proportional rate per mile is transformed into a single rate, or even into a price *à forfait*, this is due to the circumstance that the State carries the mail in all directions, over all possible distances within the State. And this is a fresh proof of the theoretical concept previously discussed: once the average rate which the railroad includes in its budget is equal to the average rate which the State includes in its budget, it becomes a matter of indifference to the State whether it pays all the various rates one after the other, or pays the same average rate each time.

### § 8

Passing now to the relation between the State and the private individuals who write letters, we may say that the conditions which must be present if the unification of rates is to begin are, as we have repeatedly pointed out:

(a) that use of the service must be so generalized as to permit the conclusion that a process of compensation as between short and long distances occurs in the budget of each individual user;

(b) that the single rate prevailing must be lower than the average



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of the rates per mile previously existing, in order to guarantee against disturbance of the economic equilibrium which had already been attained in the budgets of the less important users of the service.

Now, these two conditions have rapidly been more than realized in the postal service.

Postal correspondence has developed enormously in all civilized and progressive countries. Its expansion has been such as to give adequate basis for the presumption that everybody is, directly or indirectly, a user of postal service over all distances. In fact, one who does not use the postal service directly — that is, by writing or receiving letters — uses it indirectly by using all the services with respect to which the mails are a complementary or instrumental good. The mails are, in fact, necessary for administrative and political communication; they greatly facilitate all commercial relations. Hence every citizen must be regarded as an indirect user of the postal system. Population movements, moreover, are nowadays becoming more and more considerable and frequent in all social classes. Such movements help to facilitate compensation and the establishment of an average of the various rates within the budget of each citizen.

These circumstances have permitted the State to charge the individual users of the service the single price that it pays the carrier, according to the same criterion — that is, a fixed amount for every unit.

### § 9

The cause which has had a preponderant influence, however, has to do with the second condition — namely, the absolute reduction in cost and in price, which has made it possible to carry the new single postal-rate to the level, and even below the level, of the lowest differential rate previously existing.

To understand this fact, it is necessary to remember, above all, that the postal service represented in the past a 'fiscal monopoly'; that is, it was a means of levying taxes, and therefore the rates were monopoly prices. It was toward the middle of the eighteenth century that this policy was changed. In fact, through the development of political, economic, cultural and personal communications between the various regions of a country, the carrying of the mail began to be regarded no longer as a fiscal prerogative, but as a public service,

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the expansion of which must not be hindered by monopoly prices. It was thought that the maximum development of communication by letter would be more useful to the community than the corresponding revenues for the treasury. Thus it came about that, with the abolition of the monopoly, cost-rates were substituted for monopoly-rates.

This cost-price was further lowered by the continuous improvement of the means of transportation. Consider, for example, the progress which has been registered by the successive stages represented by messengers on foot, post-riders, the diligence, and the railroad. A ton may represent more than 60,000 letters. There is no doubt that the enormous diminution in the cost of transportation has been the decisive cause of the rapid unification of postal rate-schedules.

From this circumstance some writers have concluded that the cost of mere transportation has become a negligible quantity, and they therefore explain the single rate as one resulting solely from the total expenditures on collection and distribution which are then divided into a fixed amount for every letter.

But this theory, apparently more simple and plausible, does not explain the phenomenon in all its complexity, because it regards as an exclusive cause that which has, in fact, been only a chief cause. In fact, it does not explain the evolution that the transportation contract between the State and the railroad has undergone, though this represents an integral part of the problem. Nor does it take account of other differential elements in cost, such as the transportation of packages. The cost of transportation over mountainous regions is greater than the cost of transportation over plains; the cost of transportation by railroad is different from that of transportation by diligence or messenger, to which resort must be had in mountain regions subject to snows; the cost of transportation from the motherland to the colonies and vice versa differs from the cost of transportation within the country. These are differences which are not of negligible magnitude; yet they are included in the average that is represented by the single rate.

To sum up: the single postal rate, instead of being an exception, takes its place within the framework of the general theory which explains the common tendency of all rate-schedules toward simplification and unification, account being taken of factual circumstances which speed or retard the tendency in each individual case.

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### § 10

#### *The Price of Season Tickets<sup>1</sup>*

Neither the general theory itself nor the actual process of unification ends with the undifferentiated rate-schedule. From the latter we may pass to a further simplification — namely, the price of a season ticket, which adds to the average of which we have already spoken, an average of consumption over a given period of time. It is a phenomenon similar to the price *à forfait* which the State pays railroads for carrying the mail.

In the case of the postal system, it would be impossible to have a season-ticket price to cover the relations between the State and private individuals, because technical reasons (the use of stamps and the impersonality of the exchange relationship) exclude it. There is a partial example of it, however, in the subscription arrangement made by newspaper companies; and thus the law of general tendency is confirmed. On the other hand, season tickets are used both on railroads, with respect to which it has not yet been possible to establish a uniform rate-schedule, and on tramways, which have a single rate. By buying a season ticket, the holder has the right to traverse the whole system or a part of it, without limitation as to the number of trips, but with a limitation as to time.

Now, it is worth making clear how from the season ticket one may pass logically to the tax. The jump is a very small one and may be made theoretically. In fact, the railway season ticket is almost always purchased by business men for use within the zones in which their business is carried on; the use of the railroad varies with the amount of their business. The price of a season ticket is part of the cost of production for the business which uses it, and in the budget of this business this element of cost is spread over the units of merchandise sold and business transacted.

Under these conditions, it is possible to imagine substituting for the season-ticket arrangement between the business using the season ticket and the railroad an agreement by virtue of which the former grants to the latter a share of its annual profits in exchange for the unlimited use of the railroad during the year. The sharing of the

<sup>1</sup> [*Prix d'abonnement* — Translator's note]

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profits amounts simply to granting a percentage of net income. This is precisely what a tax is.

This comparison permits us, by following the principle of compensations and averages, to pass logically, without interrupting the thread of the analysis, from the theory of the fee to the theory of the tax.

The price of a season ticket is the cradle of the tax.

**BOOK II**

**DIRECT TAXATION**

CHAPTER I  
THEORY OF THE SPECIAL  
ASSESSMENT<sup>1</sup>

**Summary:** Concept of the special assessment and payment for improvements — Difference between it and the fee and the tax — Some controversial cases — The system of special assessments is a vestigial historical phenomenon.

§ 1

FROM the levying of fees and the form which it ultimately takes — namely, the season ticket — we do not pass directly to taxation properly so-called, but must first deal with a connecting link between the fee and the tax — namely, the 'special assessment'.

The reader is warned at the outset that we do not use the word 'special' in the sense assigned to it by many writers, who use it to indicate any particular reason or external circumstance whereby a special tax is distinguished from a more important form of tax, even when the theoretical elements involved in the two types of tax are identical.

A typical case of the special assessment is found when the State undertakes to produce a service which benefits a particular social group chiefly or exclusively, and then causes the levy which is necessary to cover the corresponding cost to fall chiefly or exclusively upon this group.

In this way there is created a special exchange-relationship — a rendering of a service and a payment for that service — as between the producer-State and the consuming group.

A typical example of the special assessment is the so-called 'payment for improvements',<sup>2</sup> which is to be found when the producing agency — the State or the city — completes a work that is of general usefulness, and therefore warrants the imposition of a tax on everyone, but is also of such a nature as to justify the demanding of an additional and greater contribution from any group of citizens who

<sup>1</sup> [Italian: *imposta speciale* — Translator's note]

<sup>2</sup> [Italian: *contributo di miglioria* — Translator's note]

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State, representing the whole community, and the special consumer of the service must be a group which is a part of the same community.

In other words, the group that pays the special assessment must not itself constitute a self-ruling organization, separate from the State; it must, on the contrary, be a part of the community which is subject to the tax-levying power of the State.

For this reason, a tax paid to the city by all the citizens constituting the municipal community is not a special assessment, because the city is a self-ruling organization.

Similarly, we must not consider as special assessments, in the technical sense of the term, all those payments which groups of citizens organized as chambers of commerce, labourers' societies, professional organizations, trade unions, and the like contribute to their own organization. For these levies are paid by all those who make up the small community in exchange for the services rendered by the latter to all of them in equal measure.

### § 3

Once these basic concepts have been established, it becomes easy to solve certain controversial cases.

There is no doubt that municipal and county taxes are not special assessments, because by general consent the city and the community are recognized as having sovereignty in the levying of taxes, within the limits of the law.

The military tax is never a special assessment; nor, in general, are those taxes which, although paid by certain special groups, are merely substitutes for other equivalent taxes which are paid on the same legal basis—though in a different form—by all the other citizens.

Still less in the nature of special assessments are the taxes on land, on buildings, or on wages, since each of these taxes is levied on a given part of the citizen's general income.

The so-called 'special-purpose taxes',<sup>1</sup> also, are often spoken of as if they were special assessments.

[Special-purpose taxes are those set apart exclusively for the production of a given public service.] Such would be the tax for poor- and unemployment-relief, for public lighting, for drainage, for disabled ex-servicemen, etc.

<sup>1</sup> [Italian: *imposte di scopo* - Translator's note]

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The fact that the proceeds of these taxes are assigned to special uses is not enough to justify the characterization of the special-purpose tax as a special assessment. If all the taxpayers pay to the State or to the agencies which have been created by the State and serve as organs of State administration a given share of their income for the relief of the poor or the unemployed, and so on, the levy which is derived from the income of all and is set apart for a given type of expenditure is not a special assessment, because it does not correspond to a special benefit received by the individual or the group paying the taxes. The special-purpose tax does require, to be sure, separate accounting—that is, a *special budget*. This, however, is an entirely different thing; and it is from this fact that the misunderstanding has arisen.

### § 4

The system of special assessments is a vestigial historical fact even though, if it were to be consistently applied, it would make possible a more rigorous control of the utilization of public services with respect to special groups and regions.

The use of special assessments, however, has been and is being abandoned in proportion as the consumption of a 'service to a group' is extended directly or indirectly to other groups; or whenever, within the whole mass of public services, there are compensations with respect to consumption as between the various groups of citizens, in the sense that one group pays a special assessment for service A, and another group pays a special assessment for service B.

As we proceed in this direction, there comes a time when the taxpayer, in making up his own budget, no longer compares every special assessment with the consumption of the corresponding service, but compares the whole of his taxes with the whole of the services he consumes. The differences end by becoming a negligible quantity.

We then pass from the system of special assessments to one of taxes, pure and simple.



## CHAPTER II

# THEORY OF THE TAX

**Summary:** The tax and the presumption that the consumption of general public services is proportional to income — This presumption can be regarded as approximating the truth, but contains an arbitrary element — The productivity of the tax in comparison with that of the fee — Expenditure for general public services always has an element of unproductiveness — Mercantilist theory of the productivity of taxes — Problems of the distribution of the tax-burden — Exchange between taxes and general public services.

### § I

**THE** tax is a share of the income of citizens which the State appropriates in order to procure for itself the means necessary for the production of general public services.

The first formal difference between the fee and the tax follows from this fact. The fee presupposes the production of public services and is merely a method for recovering expenditures already made. Hence it cannot represent the sole source of public revenues, but must exist side by side with other sources of revenue — ordinary and extraordinary. The tax, on the other hand, supplies the State in advance with the means necessary for the production of public goods and may therefore represent a system of public revenues complete in itself.

Both, however, have in common the broader function of covering and distributing among the citizen-consumers the cost of production of public goods.

Now, this is precisely the function of price in economics. Hence fees and taxes enter into the general framework of the theory of the value of goods.

For this reason it is necessary to re-examine here the question whether there exists an exchange relationship in the production and consumption of general public goods of the kind that exists in the production and consumption of special public goods.

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If we consider the State as a collective use-economy, the transformation of private goods into public goods is an exchange of whose economic advantage the State itself is the judge.

If, however, we prefer to suppose that there is a personal separation between the producing State and the consuming citizens, the exchange of which we have been speaking may also take on the ordinary external appearance of an exchange of two goods by two persons. This is precisely the hypothesis that we adopted in speaking of special public services.

For those who have followed the theory developed in the pages which have preceded, there can be no doubt that, if it is recognized that an exchange-relationship exists between the consumer and the State producing the special public service, an exchange-relationship also exists between the State as the producer of general public services and the community of tax-payers.

In fact, we have made clear that special public services differ from general public services for reasons of a merely technical character, depending on whether these services are or are not divisible into units of sale. It follows that the same public service may assume, according to circumstances, the character of either a special or a general service. This is true with respect to the maintenance of highways: this has been, and may be, a special public service if, in order to cover the cost, a toll is imposed; but it becomes a general public service if it is found more convenient to impose a tax. Now, the transformation of the toll into an equivalent share of income cannot change the original nature of the economic relationship which exists between the producing State and the consuming citizen. And this relationship is one of exchange.

A further example may be seen in the administration of justice. Its cost is covered in part by fees and in part by taxes; but it might also be covered by a tax alone or by a fee alone.

The same may be said of public instruction. Recourse is had to students' fees to cover the cost of that part which is divisible and is actually divided into units of individual consumption; the tax is adopted in order to cover the cost of that part which is not divisible or which it is not felt desirable to divide.

Now, if it is held that exchange is involved in the first instance, it must be held that exchange is involved in the second also.

Finally, it should be noted that the law of taxation in modern

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States is based on the assumption of an exchange-relationship: that is, the exchange of a payment to the State for the provision of public services by the State. In the older States, the tax could be paid and collected by virtue of the personal domination of the subject by the sovereign, or of the conquered by the conqueror; or by virtue of a patrimonial concession, which, as we have seen, is an attenuated form of servitude. In the constitutional law of modern States, however, to the duty or obligation of citizens to pay taxes there corresponds the duty or obligation of the State to provide public services.

To sum up, the tax is the price which each citizen pays the State to cover his share of the cost of the general public services which he will consume. Once this has been pointed out, it becomes obvious that the law of determination of the price-tax differs from the law of determination of the price-fee, just as the latter differs from the law of determination of competitive price, as well as from that of monopoly price.

It is precisely the search for this law which is the task of Public Finance.

### § 2

The fundamental difference between the fee and the tax lies in the difference in the technical processes whereby they distribute the burden of public levies among the members of the community.

We have seen that, by means of the fee, the cost of special public services is distributed according to each person's actual consumption of public goods. Individual consumption or demand is the basis for the distribution.

The same system cannot be followed in distributing the cost of general public services; for, so far as these services are concerned, individual consumption is an unknown quantity. The problem consists of solving for this unknown. We proceed, in this case, on the basis of certain presumptions.

We begin by assuming that all the members of the community — not merely some of them, as may happen in the case of special public services — are consumers of general public services.

This is a first presumption which corresponds, or comes very close, to reality, since it cannot be admitted that there are people who lay no store by the independence of their fatherland, or the

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defence of their property, or the safety of their persons. Those who might disclaim such interests may be regarded as negligible in number, or as a pathological group against which society must defend itself. On the other hand, we must, for the time being, regard as an open question the degree of esteem in which each person holds the various general public services and the measure in which he demands their production.

In the second place, ever since Public Finance has existed, the income of each citizen has been taken as an index for measuring his demand for general public services; and it is on the basis of this presumption that taxes have been fixed as a percentage of income.

This is a second presumption, which must be added to the preceding one. It is necessary to see how close it is to reality.

### § 3

There is no doubt that our income is the index by which we measure the total of our consumption, present and prospective, individual and collective. It is axiomatic that we consume *in proportion* to income. But this proportion, true for the whole, may not be true for the part. It may happen that individuals having equal incomes distribute them differently, or are disposed to distribute them differently between the satisfaction of individual wants and the satisfaction of collective wants.

This is the crux of the problem. In fact, even on the less favourable hypothesis of two individuals having equal incomes — in which case it would be generally admitted that they owe the same amount in taxes — it may happen that one demands and consumes relatively more public goods and the other relatively more private goods. All the more reason for questioning the presumption that Brown demands and consumes twice the amount of public services as compared with Smith merely because he has an income twice that of Smith.

Nevertheless the presumption is closer to reality than it seems.

It is necessary, first of all, to substitute for individual demand, which in the levying of fees makes itself felt on each separate occasion, at least consumption as spread over a series of years, during which it may happen that Brown may consume, at a given moment,

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public services which he did not consume before, and vice versa. The demand for public services presupposes, as a rule, those changes in external circumstances to which every individual may find himself exposed in the course of his life. And since our society is founded on the principle of progressive change (*il principio di divenire*), it is very probable that everyone will experience changes in circumstances and therefore compensations over a period of time. In short, it is possible to maintain that every taxpayer pays taxes to-day, not only in consideration of his present wants, but also in anticipation of future wants. Similarly, individual taxpayers must be faced, not with the consumption of one particular public service — with respect to which the differences between individual citizens may be very great — but with the total of public services, since it is probable that Brown consumes, in proportion to his income, more of service A and less of service B, and Smith, with an equal income, more of service B and less of service A. If we have reference to the sum of these two services, instead of to one of them alone, the difference between Brown and Smith diminishes or disappears.

To sum up: for the series of acts of consumption and of consumers, different in time and in space, we may substitute, within reasonable time-limits — for example, the life of a generation — an average consumption for the individual or even for the family group.

The process of compensation and of averages is here neither arbitrary nor unreal, but corresponds to a condition found in concrete reality; for it merely transforms, for each individual and for a given time, a series of different prices into a single average 'subscription' price. And in this way the presumption that the consumption of public goods is proportional to income takes a first step toward reality.

But this first step is not sufficient; nor is it the most important step.

The circumstance which, more than anything else, provides a better basis for this presumption, is that almost all general public services take on the character of goods which are instrumental in the production and necessary for the consumption of the goods produced by private persons. To this should be added the fact that, if a number of the general public services directly benefit some groups more than others, indirectly they are useful to all. This is true of the

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maintenance of highways, which are used directly by those who transport merchandise, and are also used indirectly by those who consume the merchandise. The same may be said of the administration of justice, the maintenance of public security, etc.

From this characterization of general public services is derived the fact that their utilization on the part of citizens varies with the amount of income. The larger the amount of private wealth, the production of which is aided and the enjoyment of which is assured by general public services, the greater will be the consumption of these general public services.

Hence, if account is taken of the average consumption, over time and space, of the various general public services, and if account is taken, above all, of their instrumental character, we may accept with sufficient confidence the proposition *that the consumption of general public services is proportional to the income of each citizen.*

This becomes, so far as we are concerned, the premise necessary for the construction of the pure theory of the tax.

Despite this conclusion, it still remains true that income does not give an exact and certain measure of the individual demand for and consumption of public goods. And it is precisely for this reason that the theory of Public Finance seeks to correct the index of income by means of the concurrent use of other subsidiary coefficients, such as the number of children, or the age of the tax-payers, or the absolute amount of minimum taxable income, etc. The truth at which we finally arrive is this: that a part, though it be a very small part, of the basis on which the structure of taxation is erected is necessarily arbitrary. This truth must be a constant warning to the builders of systems of taxation, in order that they may avoid the danger of adding, to the two presumptions indicated, which represent the necessary minimum for the construction of a sound tax-system, other unnecessary presumptions which in the aggregate tend to carry us farther and farther away from reality.

From this danger arises, inevitably, a two-fold tendency in theory and in legislation.

One is the tendency of those who build their system on the arbitrary element and enlarge it step by step, until they arrive at the affirmation that the tax is an act of the sovereign will of the State, independent of the economic substance of the exchange of tax-payments for public services. It is the theory of the old jurists of

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absolutism, which is coming back through the work of some modern jurists who are anxious to increase the power of the State over the individual.

The other tendency is that of those who, starting from the exchange-relationship between taxes and public services, build on the natural play of economic forces, reducing as much as possible the margin of what is arbitrary, in order to achieve a more stable political equilibrium.

### § 4

#### *The Productivity of Taxes*

From what has gone before, there follows another difference between the tax and the fee; namely, that of the productivity of the expenditure on general public services, as compared with that on special public services.

The fact is that so far as the fee is concerned, a sure proof of the productivity of expenditure is given by the fact that citizens buy, at the price set, all the units produced. In the case of the tax, however, this datum of control is lacking.

Since the demand for general public services is a mere presumption on the basis of income, it may happen that the State will continue for a long time in anti-economic production. The representative organs of the community may, voluntarily or involuntarily, make a presumptive calculation with respect to the demand for general public goods which does not correspond to the effective estimate of wants by the citizens.

[From this it follows that under a system of taxes it is possible to carry out class policies which are anti-economic from the standpoint of the community, for a longer time and to a greater extent than would be followed under a system of fees. The classes which are politically inferior or weak pay for public services which they would not demand of their own accord.

The unproductiveness of public expenditures produces crises of economic exhaustion and of political reaction, which in the long run re-establish equilibrium.

Now, such a danger can be avoided or attenuated whenever and to the extent that, for the posthumous control exercised by the

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consumer under the system of private economic prices or of public fees, is substituted the preventive intervention of tax-payers, which is possible when taxes are used.

Only if the tax-payers participate in the initial calculation of wants, in which each person judges the economic advisability of paying a given tax in order to obtain in exchange a given public service, and only if this calculation is subjected to annual revision and is open to criticism and continuous public discussion by the Press, the political parties, and parliament, is it possible to have a guarantee that what is involved is a productive public expenditure — that is, one which is regarded as such by those who bear the cost.<sup>1</sup>

The procedure just described is tied up with the political constitution of the State; since only a constitution which gives to the largest possible number of citizens the right and the means of participating in the calculation of value to the community and the periodic revision of this calculation can also give the greatest possible guarantee against the danger of unproductive expenditures.<sup>2</sup>

<sup>1</sup> Students should be warned against the common error to the effect that 'individual valuations of the utility of general public services are impossible because the share of utility which each individual citizen derives from the military defence of national territory, or the administration of justice, or public security, or the maintenance of highways, is unknown and unknowable'.

This — it is said — has no counterpart in private economics! As a matter of fact, however, in order to demolish the series of economic errors contained in these propositions, it is well to take a concrete example precisely from 'private economics'. When Jones buys a ticket for a theatrical performance, could it be said that the share of utility which he derives from the performance is known or knowable? Yet no one can doubt that there does exist an economic exchange-relationship between the price of the ticket and the enjoyment that the buyer hopes to derive from its use.

The example of the theatrical performance is a case of value or exchange which, when carried over from private economics into the economics of Public Finance, becomes, in the latter, the typical case of value in the production and consumption of general public services.

To sum up: the misunderstanding resides in the belief that it is necessary to set against the tax which is paid, the share of public service consumed by each individual citizen; whereas it is enough to set the individual evaluation of the tax paid, or to be paid, against the individual evaluation of the general public service demanded.

The only necessary condition is that the evaluation must be made by the same person, as taxpayer and as user of the public goods. (Cf. the following note.)

<sup>2</sup> Many deny that every citizen has the capacity to judge the advisability of public expenditures, and they therefore maintain that the direction of politics must remain in the hands of the intellectual *élite*.

Against this, which is the theory of absolute government, we may set the following alternative proposition: the judgment with respect to the advisability of a given policy is left to one class; this class will end by deciding in its own particular interest and not in that of the community. This latter proposition is, indeed, confirmed by history.

As for the capacity to evaluate the utility of a public expenditure, there is no doubt that it demands culture and historical experience and knowledge and aptitudes with



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Now this theory of the tax, which has a political orientation, has a counterpart in Private Economics. Consider the case in which the consumers, instead of buying a given good after it has been produced — thus leaving to the producer the adjustment of supply to demand — give their orders in advance for the quantity which each person requires per day. For example, a baker produces 1000 loaves of bread daily because he has arrived experimentally at this quantity as being equal to the demand of his customers. If, on the other hand, it is supposed that each customer orders in advance the quantity of bread which he requires per day, the result is no different in practice. The advance orders for bread will be 1000 loaves.

We are dealing, therefore, with two different procedures which lead in practice to the same equilibrium position, with the negligible difference that the oscillations about the point of equilibrium pass from the budget of the producer to those of the individual consumers.

The example of the baker who produces at his own risk 1000 loaves of bread daily is, in essence, the case by which we may pass from Private Economics to the part of Public Finance which is concerned with the fee.

On the other hand, the example of the consumers who, at their own risk, order from the baker the quantity of bread which they

which only superior individuals are endowed; and therefore we may grant that only this superior *élite* can and should make the financial calculation in the interest of the others who are held to be incapable of doing so.

Granting this much by way of premise, certain facts must be emphasized.

(a) First of all, the citizen rarely finds himself confronted with the problem of whether or not it is advantageous to spend two or three billions at one time, in order to provide for a given institution — for example, the army. Few people, when confronted by such a problem for the first time, would be in a position to answer.

In reality, the problem of expenditures usually presents itself as an increase or decrease of expenditures which have been made previously, and which had been taking form only gradually. 'Is it advantageous to increase or decrease expenditure for the army, or for roads, or for public works, or for public safety, or for public instruction?' It is a question of deciding the *marginal* expenditure for each public service and the relative *marginal* increase or decrease of a tax. Many are in a position to form an opinion with reference to such a problem.

(b) In the second place, the modern citizen is not isolated; on the contrary, he is a member of some political organization or party which has its traditional position with respect to the more important problems involving public expenditures and taxes. These are discussed in the press, in propagandist meetings, political organizations, and in parliament.

The preparatory public discussion is directed by the *élites* of all parties. The individual citizen need only make his final choice.

In the final analysis, therefore, what is being discussed is not so much the question of individual capacities, but is rather the old problem of whether the judgment with respect to the advisability of a given course of action is or must be the result of a conflict of the ideas of the various *élites*, or of the unilateral will of only one of these.

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need each day is, in essence, the typical case by which we may pass from Private Economics to that part of Public Finance which is concerned with the tax, assuming that the tax-payers have the right to approve and that in fact they do approve the levying of taxes.

### § 5

This is not an abstract economic construction; on the contrary, it is derived from history and explains a fundamental provision which can be found in the constitutions of all countries with representative government — namely, that no tax may be determined upon or collected unless it is approved by the representatives of the nation.

The right of the taxpayers to consent to taxes is very old; it comes down from the epoch of subsidies, grants, donations, and benevolences,<sup>1</sup> which the sovereign demanded and the subjects granted, when patrimonial revenues were insufficient.<sup>2</sup>

This right was more or less lost on the continent under the domination of absolute monarchy, and was regained by means of revolution. It was never lost in England, however, where Parliament and the people defended it by means of a tenacious and continuous struggle which had its first victorious affirmation in the Magna Charta of 1215 and ended in 1688 with the recognition of the sovereignty of Parliament in the matter of levying taxes.

The struggle had three phases.

The first revolved about the right of the tax-payers to grant or refuse the subsidies or 'donations' which the sovereign had to request and could not impose.

The second revolved about the right to distribute the proceeds of taxes among the various public expenditures. The sovereign, as representative of the executive power, affirmed his exclusive right to spend at his discretion the proceeds of the taxes to which Parliament had given its consent; and the latter, as representative of the tax-payers, claimed that this right belonged to the body that had granted the taxes. This second struggle also ended with the victory of Parliament, which, through the budget estimate, accomplishes

<sup>1</sup> See Book I, chap. II, § 8.

<sup>2</sup> Patrimonial revenues were at that time considered *ordinary*; the grants represented *extraordinary* revenues.

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just this aim of distributing revenues among the various governmental departments and the various public services.

Thereafter, in order to protect itself against the danger that the executive power, in administering the budget, might divert funds from the expenditures to which they had been assigned, Parliament also reserved for itself the right to superintend the execution of the budget, which it does by means of the comptroller-general in England, the *Corte dei conti* in Italy, and through other officials or agencies elsewhere.<sup>1</sup>

Once this step has been taken, the condition necessary for a solution of the problem does not rest in the fact that the rights of the taxpayer are written into constitutional documents, but in the degree of strength with which these rights are felt by the people and in the consequent efficacy with which they are exercised by parlia-

<sup>1</sup> Note should be taken of the relationship between these three phases and what happens in every private economy in which the individual first produces the income, then distributes it among his various needs and finally consumes it.

'In my opinion,' writes Thorold Rogers, 'the consent of the taxpayer to extraordinary grants had to be obtained at all times, and the framers of the Great Charter were not putting new limitations on the power of the Crown when they drew up the memorable clauses in that ancient instrument, but were simply affirming what was customary or notorious.' (*The Economic Interpretation of History* [London, 1909] p. 120.)

G. Park Fisher: 'The *Magna Charta* (1215) secured two great principles: first, that the King could take the money of his subjects only when it was voted to him for a public object; and secondly, that he could not punish or imprison them at his will, but could only punish them after conviction, according to the law, by their countrymen.

'The Great Charter is based on the Charter of Henry I (1100-1135). It precisely defines and secures old customs.' (*Outlines of Universal History* [New York, 1885], Vol. I, p. 296.)

Edward I (1272-1307), against his inclination, swore to the 'Confirmation of the Charters', by which he engaged not to impose taxes without the consent of Parliament. (*Id.*, p. 316.)

Since the Crown often failed to keep the pledges assumed and the struggle continued, it was constrained periodically to renew them: a fact which suggests to Lord Macaulay the comment that the rights of the English citizen, instead of merely being written in old and venerable documents, have been rooted for more than four hundred years in the heart of every Englishman, without distinction of party.

This right was imported into the United States from England, was preserved as an old British tradition, and was then consecrated by the War of Independence and written into law.

The first effective resistance which assumed a character of general importance came when Great Britain attempted to impose internal taxes in America. The levies proposed did not represent a great burden in themselves; but they were justly considered by the American people as a forerunner of eventual acts of interference by the Parliament of the mother country in matters on which the colonies were even more sensitive than they were on questions of money. Such, for example, was the threat, already voiced, that England might wish to impose the episcopal hierarchy on the colonies.

When, however, the English Parliament, confronted by popular opposition, repealed the Stamp Act, it wished nevertheless to reaffirm its absolute right to legislate for the colonies on questions of all kinds, and this claim took a concrete form in the

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ments. It is not enough that there be a legal norm; there must be an operating force. To the extent that this force actually functions, it eliminates in pure theory and attenuates in applied theory — where it must overcome the inevitable forces of friction — the difference between the fee and the tax in the matter of the productivity of public expenditures.

To the extent that these conditions are not present, the tax is a reflection of the interests of the dominant class, which may coincide or may not coincide with the interests of the community.

To sum up, the right of the tax-payers to approve taxes and to distribute them among the individual branches of expenditure is the most important economic element in modern constitutional law and is a necessary and integral element in the modern theory of taxation.

attempt to levy a tax on the tea imported into America. The American people, however, promptly met this with immediate and general resistance, considering it an invasion of the elementary rights belonging to every Englishman, and therefore to every citizen of the colonies, who, in transferring his residence to America, had remained an English citizen.

The obstinacy of Parliament and the tenacity of the American people led to the Revolutionary War as it was then called, or the War of Independence, as it was later called.

I should like to cite the thought of Washington, which I consider representative of the popular sentiment.

In 1774, a year before he was nominated Commander of the Continental Forces, he wrote to a friend (Bryan Fairfax):—'As to your political sentiments, I would heartily join in them, so far as relates to a humble and dutiful petition to the throne, provided there was the most distant hope of success. But have we not tried this already? . . .

'I observe, or think I observe, that government is pursuing a regular plan at the expense of law and justice, to overthrow our constitutional rights and liberties; how can I expect any redress from a measure which has been ineffectually tried already? For, Sir, what is it we are contending against? Is it against paying the duty of three-pence per pound on tea because burthensome? No, it is the right only, we have all along disputed, and to this end we have already petitioned his Majesty in as humble and dutiful a manner as subjects could do. Nay, more, we applied to the House of Lords and House of Commons in their different legislative capacities, setting forth, that as Englishmen, we could not be deprived of this essential and valuable part of a constitution. . . .

'What hope then from petitioning, when they tell us, that now or never is the time to fix the matter? Shall we, after this, whine and cry for relief, when we have already tried it in vain? Or shall we supinely sit and see one province after another fall a prey to despotism? If I was in any doubt, as to the right which the Parliament of Great Britain had to tax us without our consent, I should most heartily coincide with you in opinion, that to petition, and petition only, is the proper method to apply for relief; because we should then be asking a favour, and not claiming a right, which by the law of nature and our constitution, we are, in my opinion, indubitably entitled to. I should even think it criminal to go further than this under such an idea; but none such have I. I think the Parliament of Great Britain hath no more right to put their hands into my pockets, without my consent, than I have to put mine into yours for money. . . .

'I wish, I own, that the dispute had been left to posterity to determine, but the crisis is arrived when we must assert our rights, or submit to every imposition that

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### § 6

In discussing the productivity of public expenditures, it is necessary to emphasize another difference, of a permanent character, between the fee and the tax. It resides in the fact that, even on the abstract hypothesis of a state in which all taxpayers would participate in the preparation of the budget, the expenditures on general public services always contain an element of partial unproductiveness, as compared with the expenditures of private individuals, on the one hand, and those of the State for special public services, on the other. For, as a rule, the private producer adapts the supply only to the arithmetical sum of the individual demands of actual consumers; nor does the State act differently under a system of fees.

can be heaped upon us, till custom and use shall make us as tame and abject slaves, as the blacks we rule over with such arbitrary sway . . . If you disavow the right of Parliament to tax us (unrepresented as we are), we only differ in respect to the mode of opposition.' (Lucretia Perry Osborn, *Washington Speaks for Himself* [Charles Scribner's Sons, 1927], pp. 61f.)

In France the right to assent to taxes, after having gone by default for centuries, was won by the Great Revolution; it was written into the Declaration of Rights, was put into practice, and slowly makes its way into the people's consciousness, without one's being able to say that it has as yet struck deep root.

But in other continental countries, into which this right was imported from France and granted by sovereigns to their peoples, it was an unearned blessing, a right seldom used by parliaments, hardly understood by the people. A suggestive example is to be found in Italy, where absolute monarchy lasted without being subject to control until the very eve of the establishment of the new kingdom.

Massimo D'Azeglio writes as follows (*La politica e il diritto cristiano*, p. 33, Florence, 1860): "There is a treatise on the duties of subjects towards their monarch, compiled officially for the primary schools of the Lombard-Venetian kingdom; this treatise has been memorized in all the schools of upper Italy for forty years; one may get an idea of it from the following passage:

"Q.—Why must the subjects regard the sovereign as their master?

"A.—The subjects must regard the sovereign as their master because he has full rights over their goods and their persons."

And the treatise goes on to draw all possible corollaries from this fundamental principle.

It is worth comparing this treatise with the *Philosophical Catechism for the Use of Primary Schools* (*Catechismo filosofico per uso delle scuole inferiori*), published at Pesaro by the Tipografia Nobili in 1832; at Modena in 1833; and at Naples by the royal press in 1837, where it had the good fortune to have two further editions in 1850.

I reproduce the only part that has to do with taxes:

'Student.—When the prince overburdens the subjects with enormous taxes and squanders the money of the State, would rebellion and insurrection of the people be justified?

'Teacher.—It would not be justified, because the people have no right to judge the needs and expenditures of their princes. And the Holy Spirit, through the mouth of St. Paul, has said to the people: Pay your taxes; it has not said: Audit the King's accounts. Moreover, if it is true that a prince dissipates a part of the money of the State, it is also true that revolution completely upsets both public and private finance, and injures all the property of the subjects of the State.'

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On the other hand, when what are involved are general public services, which are indivisible, the State is, to be sure, guided in its choice of a given type of production by the anticipated demand of the majority; but it subsequently adapts the supply to the total consumption of the majority and the minority.<sup>1</sup>

If, therefore, we are to judge the economic utility of public expenditures, it would be necessary to deduct from the degree of productiveness felt by the majority the degree of unproductiveness felt by the minority.

On the other hand, it would be erroneous to measure the harm done to the recalcitrant minority by the whole amount of tax which this minority is obliged to pay; for the minority becomes a *de facto* consumer of the service produced and therefore it is probable that the minority, or some part of it, would have consented to the production of the public service if a smaller tax had been suggested. The damage suffered by the minority is measured, therefore, by the difference between the tax which it pays and that lesser tax which it would have been willing to pay.

From this conclusion results a difference between Private Economics and Public Finance which has noteworthy consequences: namely, that *demand* and *consumption* coincide in Private Economics, whereas they do not coincide in Public Finance. Public goods are consumed by those who did not demand them, as well as by those who did.<sup>2</sup>

### § 7

On the question of the productivity of the tax, it may be useful to call attention to a common error of mercantilist origin.

It is alleged that high taxes do not harm the community, because the wealth which the State takes in taxes remains in the country and returns to the taxpayers in the form of wages.

To this argument, it could be objected that the proceeds of a tax never return to the very same people who have paid it; but even if we grant that the same people receive these proceeds in the form

<sup>1</sup> This happens also in those private enterprises which operate according to decisions voted by a majority. But this case, which in private economics is of a secondary or temporary nature, represents the germ of what, in Public Finance, develops to the point of becoming the typical case.

<sup>2</sup> *Il Carattere teorico dell'economia finanziaria*, Book I, chap. III, § 5.

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of wages for labour, or in the form of a price for goods sold to the State, it would still be true that we are dealing here with an ancient economic fallacy.

As a matter of fact, the citizen who subsequently gives his labour to the State undergoes a second sacrifice for which he expects a second compensation. The State, therefore, pays him a wage or a price which closes this second round of give and take. The first sacrifice, however, remains unrewarded, inasmuch as the payment represented by the tax is still to be compensated for; and it can obtain such compensation through a counter-offering of public services.

The error in this theory resides, therefore, in the fact that wages, which represent the form in which the proceeds of the tax return to the community, cannot be the single counterpart of two distinct credits which the citizens hold against the State.

### § 8

#### *Value to the Individual*

Having clarified the notion of 'value to the community', which is represented by the relationship between the total utility of public goods and the total amount of taxes, we have now to deal with the problem of distributing the burden of taxation among the consuming citizens — that is, the problem of 'value to the individual'.

Before discussing this matter, it would be well to point out the connection between the problem of the productivity of the tax and the problem of its distribution.

On the abstract hypothesis that *all* taxpayers are called upon to give their judgment in advance concerning the advisability of a public expenditure, each one of them will, in his individual budget, make a comparison between the marginal utility of the general public service and the marginal utility of the tax. Let us now suppose that all the taxpayers decide upon and give their assent to the building of a given railroad line or a given system of fortifications, each contributing 10 per cent of his own income.

From the standpoint of this theoretical set-up, it follows logically that the problem of value to the individual — that is, the problem of

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the distribution of the tax-burden — is settled at the very moment that a decision is made with respect to the problem of 'value to the community' — that is, the problem of the productivity of the public expenditure.

Yet even though we remain within the limits set by this theoretical hypothesis, the truth which we have just stated is always modified in the concrete case, as soon as we pass from the process of making the decision to that of carrying it out — the latter process involving the determination of the amount of each person's income, an agreed percentage of which is to go in taxes. For this second task will start a conflict among the very same taxpayers who have decided upon the expenditure — a struggle in which each person will attempt to pay the smallest possible tax.

It is in this way that the problem of distributing the tax-burden becomes independent of the problem of the productivity of public expenditure.

Still more obviously does it become an independent problem when account is taken of the facts (1) that not all taxpayers participate in the calculation with respect to the value to the community of a given expenditure, (2) that not all exercise the same relative influence in the making of this calculation, (3) that not all give their assent, (4) and that over a period of time, during which the first decision is subjected to periodic revision, the same individuals are not involved.

This struggle usually leads to an actual distribution of the tax which does not coincide with our theoretical hypothesis, according to which every contributor is bound to pay an actual 10 per cent of his income. Even if the total expenditure is equal to 10 per cent of the national income, it is highly probable that some will pay more, and others less, than 10 per cent of their own individual incomes. It is the task of a positive system of taxation and of the improvements made in such a system to make the two results coincide.

### § 9

With this purpose in mind, it is possible, in distributing the tax-burden among the individual taxpayers, first of all to exact a percentage of the *total* income of each taxpayer; or it is possible to strike separately the various elements that make up the total income — such



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as, for example, the income from land, buildings, or professional or business activity. In the first case, a single tax is employed; in the second, a system of many taxes.

Similarly, it is possible to strike only the income of each taxpayer, or to strike the whole series of acts that make up private consumption, or to strike both income and consumption. This gives rise to the problem of direct and indirect taxation, and of the reciprocal relationships between the two.

These two problems and others of less importance constitute the theory of the *technical* distribution of the tax-burden, because they have to do with the structure of concrete systems of taxation. These systems are established by law, but it is presumed that their structure is dictated by criteria of an essentially technical nature.

In addition, a tax may vary, not only according to the nature of incomes, but also according to their size. It is possible to decree that the larger incomes shall pay a larger percentage than do the lower incomes; or, vice versa, that smaller incomes shall pay relatively more than large ones; or, finally, that large and small incomes shall pay the same percentage.

This gives rise to the problem of progressive, regressive, degressive, and proportional taxation, to the problem of the exemption of minimum or small incomes, to the problem of discrimination, etc. These are problems which enter into the theory of what we shall call the *juridical* distribution of the tax-burden, by way of indicating that the legislator follows a scheme of his own for the distribution of the burden of taxation among the various categories of taxpayers and believes that it is possible to realize this scheme *ope legis*, without regard to the natural play of economic forces, and even in opposition to them.

It then becomes necessary, however, to take account of the action of these forces, in so far as they may neutralize, reinforce, or modify the effects which are sought by means of the juridical distribution. The legislator may have established a distribution which weighs more heavily on some categories of incomes than it does on others; he may have exempted certain incomes altogether. But after this has been done, it is a question of knowing whether the play of economic forces will neutralize these differences in fiscal treatment, in such a way as to cause a return, in another form, of the economic equilibrium which existed previously.

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To sum up: the problem of distribution may be subdivided into three chapters: a first chapter which studies technical distribution; a second, which studies juridical distribution; and a third, which studies economic distribution.

It is difficult to give a satisfactory logical order to this threefold investigation, because each of the three problems is connected with the other two, and the study of one presupposes, at several points, a knowledge of the others.

Nevertheless, it seems most convenient to begin with the question of direct and indirect taxes, which are the two largest branches of taxation and to which it will often be necessary to refer in treating of economic and juridical distribution.

## CHAPTER III

### DIRECT AND INDIRECT TAXES

**Summary:** The problem of the technical distribution of taxes — The administrative difference between direct and indirect taxes and the criticism thereof — The economic basis of the distinction — Indirect taxes complement direct taxes — Direct taxes complement indirect taxes — Indirect taxes reduce to the minimum the frictional forces involved in collection — The elementary condition for the appearance and development of indirect taxation — A note on method

#### § I

THE problem of the 'technical distribution of taxes' resolves itself into a discussion of actual tax systems, which distribute the total tax-burden among the various categories of incomes and taxpayers.

We take it for granted that in every tax three elements are involved: the definition of taxable income; the ascertainment of the amount of this income; the collection of the tax.

Collection is simply a matter of money-payment; and the determination of the tax-rate results from the arithmetic relationship between the financial requirements of the State and the total of taxable income. These problems are of no great interest to theory.

Once taxable income has been defined, its appraisal remains the most important elementary fact in all questions pertaining to taxation. For it is the methods of appraisal adopted which decide whether the estimate is correct and complete, and whether it is equal and uniform as between the various taxpayers.

The tax-system is above all a more or less sensitive mechanism designed to ascertain the incomes or, more generally, the wealth of the citizens. It approaches perfection according to the degree in which it succeeds in appraising incomes with increasing precision, absolutely and relatively.

If we could know the amount of each citizen's fortune, the problem of the distribution of taxes would cease to exist or would have little importance.

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Tax-systems, as they actually exist, are divided into the two branches of direct and indirect taxes.

The direct taxes are the taxes on income from land, and the tax on buildings; the tax on intangibles or 'movable property',<sup>1</sup> which falls on income from investments, as well as on that arising from business and professional activity; and, finally, the tax on total individual income. These taxes strike the citizen's income at the moment of its *production*. Indirect taxes are those which strike the private consumption of citizens and also transfers of property. They strike the income at the moment when the citizen spends it to acquire other goods.

The criterion for distinguishing between the two types of tax which is usually employed in practical administration has reference to the method of *collection*. According to this criterion, those taxes are considered direct which are collected on the basis of lists containing the names of the taxpayers, and which recur at fixed intervals; those taxes are considered indirect which are collected on the occasion of certain definite acts, which do not come at fixed intervals and are not susceptible to a method of collection involving lists of names.

Against this distinction it has been objected that taxes which undoubtedly have the same economic character become direct or indirect according to the method of collection chosen for them. One need only be reminded that the taxes on carriages, on dogs, and on motor vehicles, which are usually collected on the basis of lists of names, are nevertheless taxes on consumption. The administrative distinction must therefore be modified so as to read: 'taxes collected directly', and 'taxes collected indirectly'. In this form the distinction may be retained, in as much as it corresponds to the exigencies of financial administration, which is precisely the agency of collection. This formal criterion becomes inadequate, however, when a basis for differentiation is sought which shall emphasize the distinct economic function ascribed to each of the two categories.

Thus it has come about that some writers have sought the scientific character of the distinction in the phenomenon of shifting. We shall see presently, however, that all taxes may or may not be shifted. Other writers, modifying this concept, have gone back to the *intention* of the legislator, so that direct taxes would be those

<sup>1</sup> [Italian: *imposta di Ricchezza Mobile* - Translator's note]

## DIRECT AND INDIRECT TAXES

which are intended not to be shifted and indirect taxes are those which are intended to be shifted. Again, however, it should be noted that in every case shifting is a phenomenon which takes place after the intention of the legislator has been formulated, and is independent of such intention./

Still other writers, confronted with the uncertainty of such criteria, have ended by giving up the idea of making any sort of economic distinction which would differ from the administrative one.

### § 2

On the other hand, a useful basis for distinction other than the administrative one may be obtained if, instead of viewing the problem as it presents itself at the moment when the taxes are being collected, we go back to the moment when taxable income is being appraised.

Let us recall that, in passing from the fee to the tax, it was pointed out that the unknown in the problem is the 'individual demand' for general public services and that 'income' is taken as the equivalent of, or as an index measuring, individual demand. Hence it is through the ascertainment of income that the value of the unknown is determined.

Now, this ascertainment may be made by the direct method of appraisal; and in that case we shall call the tax that follows from such appraisal a 'direct' tax. Direct appraisal of taxable income is not, however, always possible or exact. Whatever may be the method of valuation, one is persuaded that some incomes evade ascertainment in whole or in part, and that such ascertainment cannot be equally rigorous for all. Thus, it is possible that the banker and the professional man may succeed in concealing a greater part of their income than the proprietor of lands and houses does of his.

In such cases the errors and the deficiencies involved in the direct ascertainment of income may be discovered and in some measure corrected by an indirect appraisal thereof, as when the private consumption of each citizen is used as the equivalent of, or as an index measuring, his income.

In other words: income which escapes, in whole or in part, direct valuation at the moment of its production is watched for and seized in the successive moments in which its possessor spends it. The Treasury waits for him to acquire private goods — whether they are

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consumers' goods or producers' goods—in order that it may deduce from the value of these goods the total income spent or invested.

To sum up: if we wish to give a greater degree of unity to the theory of the classification of public levies, it is necessary to take as a point of departure the *individual demand* for public services, which is the unknown quantity in the problem. From the standpoint of this demand, only the fee is a direct levy. The tax, on the other hand, is an indirect levy in its very origin, because it is commensurate not with the demand for public goods, but with the citizens' income, which is taken as an index of this demand. In its turn the indirect tax is commensurate with neither the demand for public services nor with income, but with consumption and the acquisition of property, in so far as their value is taken as an index of income. Hence, bearing in mind that we are considering these levies in their relation to public goods, we may say that direct taxes are commensurate with an equivalent of individual demand for such goods, and indirect taxes are commensurate with an equivalent of this equivalent. For this reason, if the fee is regarded as the only true direct levy, (direct taxes would be indirect levies of the first order, and indirect taxes would be indirect levies of the second order.)

### § 3

#### *Direct and Indirect Taxes as Mutual Complements*

As can be seen, it is the same income that is at one time estimated directly, and at another, indirectly. This has given rise to the old criticism that indirect taxes are a duplication of direct taxes. In reality, however, the two types of tax divide between them the taxpayer's fiscal obligation, which is a single aggregate determined in the light of the taxpayer's income and the needs of the State. Hence it is a question merely of deciding whether it is preferable to pay the whole of this obligation by means of direct taxes alone, or by indirect taxes alone, or partly by direct and partly by indirect taxes. It is easy to show the technical superiority of a fiscal system in which direct and indirect taxes exist side by side and function in such a way that each complements the other.

If we assume, as our first hypothesis, that it is desired to distribute the total tax burden equally—i.e., proportionally—over all incomes, it would be well to describe precisely the way in which

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indirect taxes correct or attenuate the inequalities of direct taxation.

The direct appraisal of income usually results in a figure which is less than the true income; but if it were less than the true figure by the same amount in the case of all incomes, the problem would be resolved by raising the tax-rate sufficiently to cover the need, and it would be unnecessary to have recourse to indirect taxation. In fact, however, the errors of under-estimation are not equal for all taxpayers of the same category, and still less equal for taxpayers of different categories.

Let us imagine a landowner and a professional man, each of whom has a net income of 20,000; and let us suppose that the former has his annual income estimated at 18,000, and the latter at 9000.

If the tax is 20 per cent, the former would pay 3600, and the latter, 1800; in all, 5400, which we shall suppose to be equal to the financial need of the State. This amount, however, ought to be divided equally between the two; instead, the landowner pays 900 more than he should, in comparison with the professional man.

Let us now suppose that the tax-rate of 20 per cent is divided into 10 per cent direct taxes and 10 per cent indirect taxes. The landowner will pay a land-tax of 1800, and the professional man will pay a tax of 900 on his income.

So far as indirect taxes are concerned, however, the former will pay 10 per cent on his net income of 20,000 minus the tax of 1800, that is, on 18,200; the latter will pay on 20,000 minus 900, that is, on 19,100. In this way, one will pay 1820, and the other 1910. The landowner will pay, altogether, in the way of direct and indirect taxes, 1800 plus 1820, that is, 3620; the professional man, 900 plus 1910, that is, 2810; the original inequality is notably decreased, since the landowner now pays only 405 more than he ought to as compared with the professional man.

But the State now collects 6430 — that is, 1030 more than it needs — because the productivity of the tax has also increased. By reducing the tax-rate proportionally from 10 per cent to about 8.3 per cent, the inequality between the two is further decreased, because the landowner will now pay only about 365 more than he should as compared with the professional man.

In this way it is possible to minimize the inequality between the two taxpayers, which was greatest when only direct taxation was in force.

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### § 4

A second case in which the two types of taxes complement each other arises from the following two circumstances: (a) incomes cannot be re-appraised as rapidly as they vary in fact; and (b) these re-appraisals are not made at the same intervals for all taxes. Thus, the tax on land tends to be set for a very long period because it is based upon a survey of land-values; on buildings the re-appraisal is made, or should be made, at intervals shorter than those used in revising land-values, but longer than those adopted for appraising income from movable property. Now, in the interval between one re-appraisal and another, incomes change, but the changes are not taken account of by direct taxation; they are taken account of, instead, by indirect taxes, which follow closely all oscillations in income.

### § 5

Conversely, direct taxes have the function of complementing indirect taxes. First of all, the latter do not succeed in striking goods which are consumed by the producers themselves, or do not hit them to the extent desired. This circumstance has more weight in those cases in which economic activity is less specialized, and exchanges are less developed. For example, agriculture is usually less specialized than are other industries.

Moreover, indirect taxes may be expected to strike all incomes equally only if we suppose:

(a) that the value of the goods consumed or transferred is ascertained with equal precision in all cases; in fact, however, this is a task which is at least as difficult as ascertaining income from land or from professional activity; and

(b) that all goods and services — with no exceptions — are affected by the tax; in fact, however, this condition cannot be realized.<sup>1</sup>

Thus indirect taxes also present gaps and inequalities, which may be partly adjusted or attenuated by a simultaneous appraisal, at the source, of income produced. The two methods of ascertaining income

<sup>1</sup> See Book IV, chap. 1, § 3.



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act as mutually controlling data. To sum up: if we continue to assume that it is desirable to appraise and to tax as equally as possible all categories and all parts of the national income, we may say that the division into two parts — namely, direct and indirect taxes — of the single fiscal obligation of each citizen makes it possible to diminish those inequalities which would be maximized if only one of the two systems existed, or if only one of them were well-developed. From the use of both types of taxation is obtained a more nearly perfect, or less imperfect, system of taxes than could be obtained through the use of only one of them, and such a system, by exerting equal pressure over the whole area subject to taxation, assures, not only a greater degree of equality in taxation, but also the highest possible revenue-yield. /

### § 6

By way of completing this fundamental theoretical point, we may mention other cases of collaboration of direct with indirect taxes, which involve a new hypothesis — namely, that it is desired to subject individual incomes to differential treatment.

1) An example is provided by progressive taxation, which cannot be fully realized either through indirect taxes or through a system of manifold direct taxes, but requires as its rational basis a single direct tax on total income. The effect of such a tax may be supplemented, however, or neutralized, by the use of indirect taxes.<sup>1</sup>

2) Another case is that of the preferential treatment granted by much modern legislation to the smallest incomes, especially to the lowest labour-incomes, which are by law, or, sometimes, by administrative practice, exempted in whole or in part from direct taxes, but are subject to indirect taxation on articles of consumption.

Various possibilities present themselves.

1) It may happen that the exemption is accorded merely because of the difficulty of collecting the direct tax from the hands of the wage-earner; but then the latter is more heavily burdened by the indirect taxes on articles of popular consumption.

2) It may happen, on the other hand, that a country which is relatively poor, but is subject to a heavy tax-burden, cannot renounce a system of indirect taxation on articles of necessary and

<sup>1</sup> See Book IV, chap. I, § 1 ff.

## DIRECT TAXATION

general consumption, with the result that the incomes of the poorer classes are burdened disproportionately, as compared with higher incomes; and in such a case, it is only through direct taxes that it is possible to grant compensatory exemptions which are limited to the poorer classes.

Finally, it may happen that fiscal policy, especially that of rich modern countries, aims to treat small incomes more favourably, in which case it will tend to exempt such incomes from both direct and indirect taxes.

These considerations show how the co-ordinated action of direct and indirect taxes makes possible a more *elastic* tax system, capable of bringing about a more delicate and precise distribution of taxes, even on the hypothesis that it is desired to treat individual incomes differentially.

### § 7

#### *The Forces of Friction*

In addition to its function as a complement to direct taxation, the system of indirect taxes has another function: namely, that of reducing to the minimum the action of the frictional forces which operate in the ascertainment of incomes and in the collection of direct taxes. In fact, direct taxes, being a proportion of ascertained income, represent for the taxpayer a visible part of his private needs, the satisfaction of which he must renounce as a result of the payment of the tax. The periodic ascertainment of income and the periodic payment of the tax, moreover, renew and make more acute the contrast between the present pressure of the private needs which must be renounced, and the remote weaker pressure of collective needs, which it is thought the State will have to look after in any case. Hence the greater the final degree of urgency of the private want that is renounced, the greater will be the resistance to the payment of the tax.

On this account, an attempt has been made, in levying direct taxes, to have the time at which the taxes are paid coincide with that at which income is received; also, when it is the State that pays the income to the taxpayer, to substitute, wherever possible, collection by means of retention of a portion of wages, in place of the payment,

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of the tax in periodical instalments; and at times it has been necessary to renounce completely collection of the tax directly from the taxpayer (for example, from labourers) in order to collect it, by law or in practice, from the employer.

On the other hand, it is only in indirect taxation that the forces of friction disappear, or are reduced to the minimum. First of all, the time at which the tax is paid always coincides with that at which a part of income is spent. Furthermore, the payment is divided into very small instalments on each penny of income that is spent, and is effected in such a way as to coincide, rather than conflict, with the satisfaction of the individual want. The stimulus to satisfy the desire for tobacco, salt, or clothes also provides an impulse toward the payment of the tax. If, in direct taxation, it is necessary to establish sanctions in the form of fines for failure to pay, in indirect taxation the sanction consists in the taxpayer's being forced to renounce the satisfaction of a want.

Similarly, in indirect taxation it is not necessary to ascertain the amount of income, since the tax is assimilated to and merged with the price of the commodity; and in this way there also disappears the preliminary friction which, in direct taxation, arises as between the taxpayer and the Treasury at the time when income is being appraised.

Consequently, the more the pressure of taxation is increased in a given country, the more, other conditions being equal, indirect taxation increases. This explains why indirect taxation, in spite of the lively attacks on it by democratic parties, represents a necessary and often preponderant part of the income of modern States.

### § 8

The theory expounded above, which is based on considerations of a preponderantly technical character, would also be sufficient to solve the problem of the quantitative relationship between direct and indirect taxes — a relationship which varies from place to place, at any given time, according to the financial need or the wealth of the country, according to the degree of perfection reached in the methods used for the direct ascertainment of incomes, or according as indirect taxation includes or excludes goods of popular consumption, and so forth.

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But if these conditions are assumed to be equal, and if we abstract from the expenses of collection, which are calculated separately for each case, and from every disturbing cause of a political nature, the quantitative relationship between direct and indirect taxes is found, as a matter of experience, in that combination which is capable of assuring the greatest returns to the Treasury.

To be sure, disturbing causes of a political nature do intervene as a rule and may be summed up in this: that the richer classes press for a relative increase of indirect taxes on articles of consumption, and the poorer classes go in the opposite direction.

These oscillations about the point of maximum fiscal return may be restrained, in modern states having representative government, by the spirit of mutual combativeness which the interested groups evidence in their own defence.

### §9

#### *Conditions for the Development of Indirect Taxes*

The elementary condition for the appearance and development of a system of indirect taxes is the existence of an exchange-economy. If we imagine, for a moment, that each individual consumes everything that he produces and can produce everything that serves for his consumption, no part of his income goes out of his budget to acquire goods produced by others, and there would be no possibility of measuring his income by means of his purchases.

On such a hypothesis, the ascertainment of the income produced by the taxpayer would coincide with the ascertainment of the value of the goods consumed by him. From this is derived one first corollary: namely, that, in the absence of indirect taxes, the taxpayer must meet his fiscal obligation through an adequate increase in direct taxation.

There follows also a second corollary: namely, that since the law has assumed it to be the rule that goods which are produced are also exchanged, if some groups of goods are an exception to this rule, they must be subjected to substitute taxes equivalent in amount to those which they would have paid if they had been exchanged.

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### § 10

A methodological observation will close this chapter. Direct taxes are commensurate with the income of the producer; indirect taxes are commensurate with the value of the things which the consumer buys. In both cases, it is the value of the grain, the oil, or the wine which measures, at one and the same time, the income of the agricultural producer and of the consumer.

To be sure, the same datum is treated differently in the two budgets. In the consumer's budget the current price of those commodities, as it stands, measures the consumer's income; whereas in the producer's budget that price is still a crude datum, from which it is necessary to subtract the costs of production in order to find the producer's income.

It should be noted, however, that the cost of each unit of grain, or of wine, or of oil is not the same for all units, but varies according as the commodity is produced at increasing or decreasing costs; according as it is a large or a small enterprise that is involved; according as the enterprise — as is the rule in agriculture and other industries that utilize by-products — produces one good or several goods; and according as the enterprises involved are competitive or are monopolistic — in which case, even if we suppose that production takes place at constant costs per unit, each unit has a different price, since it varies with the total quantity produced, and the monopolist may vary this quantity at will.

From this it follows that the percentage of tax on the net income of the producer does not correspond either to a fixed amount per unit nor to a uniform percentage on the value of each unit that goes to make up his income.

In fact, if we suppose that a grain-grower produces 10,000 bushels of grain and sells them at one dollar per bushel, his total or gross income is \$10,000; his net income is, by hypothesis, \$6000; the tax of 10 per cent on the net income is \$600. If we translate the tax on income into a tax on bushels of grain, we may say that the grain-grower pays six cents for every bushel. But this tax-burden represents an average value, because we know that the 10,000 bushels are produced at increasing cost; hence the six cents should be distributed in such a way as to put a tax of more than six cents on the first

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bushels, and less than six on the last. This substitution of the average for the items from which the average is derived is permissible so long as we are sure that we are dealing with the budget of a single producer and that this budget is considered to be in a static condition.

Let us now assume that the grain-grower increases his production under conditions of increasing costs per unit; it is obvious that six cents per unit would not be applied to future bushels of grain.

Let us make the further hypothesis that there are several grain-growers, each one of whom produces at different costs per unit; it is obvious that it would not be possible to apply to each of them the same percentage of the price of grain per unit, because this uniform percentage or specific tax of six cents per bushel would not represent the same percentage of tax on the net income of every grain-grower.

Still more obviously does this consideration hold in the case of the monopolist.

Hence we may conclude that the translation — often made by economists — of the tax on income into a tax on the units of goods that make up the income presents dangers and requires great caution.

This danger is not present in the case of indirect taxes, in which it is the price of the good that measures the net income of the taxpayer.

## CHAPTER IV

# ECONOMIC DISTRIBUTION OF TAXES

### I

#### GENERAL NOTIONS

Summary: Shifting — Incidence — Diffusion — Evasion — Consolidation of taxes — Effect of a growing national income

#### § 1

THE most outstanding problem in the economic distribution of taxes, or at any rate the problem which up to now has interested students the most, is that of the shifting or the transfer of taxes. This phenomenon occurs when the tax which the law imposes on a taxpayer, who is called the taxpayer *de jure*, is unloaded by the latter, in whole or in part, upon other citizens, who are called the taxpayers *de facto*.

It is easy to understand how this may happen. (Income is merely the conversion into money of the goods which each individual produces; and in the ultimate analysis it consists of these goods.) Grain, oil, and wine form the income of the landowner. Now, if the latter is subject to an income tax and succeeds in selling the grain, wine, and oil at a price higher than the one previously prevailing, he is in fact released, wholly or in part, from paying the tax in so far as he shifts it to the buyers of the goods that he sells. It goes without saying that he still remains formally a debtor to the State and that he continues to pay the tax.

When this happens, it is said that the tax has been transferred, shifted, or has been thrown back from the taxpayer *de jure* to the taxpayer *de facto*. The problem consists of investigating whether, at what point, and to what extent an increase in prices is brought about by the tax *per se*; since it is necessary to abstract from the possible effect of other circumstances which may increase prices.

∨ In any case, the shifting, when it takes place, cannot continue

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*ad infinitum*. The taxpayer *de jure* may shift all or part of the tax to a first purchaser of the goods that he produces, and the purchaser, in his turn, may shift the burden to a buyer of goods that he produces, and so on. The chain thus formed will end at the moment that an enterprise is found which does not succeed in transferring the tax, either in whole or in part, and thus bears the entire burden itself.

It is then said that the property of the final taxpayer is definitely cut into (*inciso*), or reduced in value; and the phenomenon involved is called 'the incidence of taxation'.

### § 2

Shifting ends in incidence; but this does not mean that the tax has no further effects.

In fact, the individual upon whom the incidence falls suffers a diminution of income, and therefore, other conditions remaining the same, must restrict his consumption; but the restriction of consumption causes a diminution of the income of those who cater to this consumption; and these, in their turn, contract their consumption and diminish the income of those who cater to their consumption, and so on. The tax comes to be *diffused* among all the taxpayers, bringing about a general restriction of the consumption of each individual.

This second process involved in the economic distribution of taxes between the enterprise on which the incidence falls and those who happen to have exchange relationships with this enterprise is called the 'diffusion' of the tax.

The two processes, however, may be interconnected, inasmuch as diffusion reduces income, and a new series of shifts may grow out of this reduction in income.

In any case, the difference between shifting and diffusion is this: the former transfers the tax and makes it unnecessary for the *de jure* taxpayer to reduce his private consumption; the latter imposes a contraction of consumption upon the one on whom the incidence falls, and extends this contraction to all the enterprises from which the latter buys, unless he succeeds in starting a new process of shifting on his own account.

Diffusion, unlike shifting, is a phenomenon which is necessarily



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involved in every tax, since every tax must somehow bring about a contraction in the consumption of private goods.

It is, however, not a process which is necessarily general, or which strikes equally in all directions.<sup>1</sup> On the contrary, since there are some goods the demand for which is elastic and others the demand for which is inelastic, it is probable that the one on whom the incidence falls will reduce his consumption of the first of class goods and not of the second, or will reduce his consumption of the first more than he will of the second.

Similarly, it is not necessary to hold that diffusion goes on *ad infinitum*, in such a way as to strike the whole line of successive consumers, since certain frictional forces intervene to attenuate and, in the end, destroy the effectiveness of the process of diffusion.

### § 3

Not to be confused with shifting and diffusion is the phenomenon called 'tax-evasion', which occurs when the taxpayer conceals taxable material from the Treasury and as a consequence does not pay the tax.

A typical example of tax-evasion is the exceptional case of smuggling; another example is the common case in which the taxpayer succeeds in concealing the whole or part of his taxable income from those responsible for its assessment. Moreover, one must also consider as a partial evasion the case in which the taxpayer decreases the production or consumption of a certain good in order to pay less taxes. Strictly speaking, when this happens it cannot be said that the taxpayer does not bear the loss resulting from the decreased production or consumption; he is, however, compensated for this loss, at least in part, by the advantage of not having to pay the tax. This may happen if the tax is very high.

According to some writers, a case of evasion, to which is usually given the name of 'tax-removal', is found in the case in which the taxpayer, in order to pay the tax without contracting his private consumption, increases his income, and in so doing removes the tax-burden by transferring it from the old income to the new. Strictly

<sup>1</sup> The erroneous opinion to the contrary has been held by some of the greatest economists, who insist that a tax, however imposed, ends by being divided among the *de facto* taxpayers in proportion to their respective consumption.

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speaking, however, this is not a case of evasion, because the new income involves a new cost of production for the taxpayer/

The question to be asked is rather whether or not a tax can be in itself an incentive to increase production. Let us suppose that, before the tax was levied, an individual had found his point of equilibrium in the completion of a fifth hour of work. The State takes from him, in the form of a tax, the fruit of this fifth hour of work. The question is whether this individual is disposed to endure the sacrifice of a sixth hour of work, in order to procure for himself a satisfaction equal to that which he had obtained by means of the income from the fifth hour of work/

If we abstract from all considerations with respect to the utility of the goods that the State will produce in exchange for the tax, we may conclude that such a thing may happen, but only within narrow limits. In fact, if the tax deprives the consumer of an article of consumption to which he had become *habituated*, and which had been *consolidated* in his budget, the incentive to continue such consumption — that is, to satisfy again an *habitual* want — is greater than the incentive that first led him to begin this consumption. For this reason the incentive to increase his income by working beyond the fifth hour has also become greater/

It goes without saying that the increased sacrifice which is involved in going beyond the five hours tends to neutralize the increased incentive to work longer. It cannot be said with certainty, therefore, that the individual in question will work the whole sixth hour; but there is no doubt that the point of equilibrium tends to be pushed somewhere beyond the fifth hour of work.<sup>1</sup> The whole debate is, however, of merely theoretical interest, without great practical importance, since we are dealing here with negligible magnitudes. In the concrete case, we cannot count on a tax's having a stimulating effect on production, without arriving immediately at the obviously absurd conclusion that a tax neutralizes the sacrifice involved in paying it/

<sup>1</sup> If we draw a curve of decreasing wants arranged according to their degree of urgency, the latter having reference to the moment at which the successive satisfaction of these wants begins, the whole curve would have to be shifted upward as soon as the degree of urgency is made to have reference to a situation in which the wants have become habitual and are threatened with contraction as a result of the tax.

Professor Maffeo Pantaleoni has criticized this opinion of mine in a note to page 43 of his *Teoria della pressione tributaria*. The reader will find there the diagram to which I refer.

## ECONOMIC DISTRIBUTION OF TAXES

### § 4

Another phenomenon to be mentioned is that of the 'consolidation' or 'elision' of the tax. A typical case of it is to be found in a sale-transaction in which the buyer discounts the purchase-price which he would otherwise have obtained by an amount proportionate to that of the tax imposed on the property he buys, since in all sale-transactions the price is determined by capitalizing the net income — that is, income after deduction of all charges, including taxes. A piece of property, for example, which pays 1000 and is charged with taxes of 100 gives a net income of 900; on a 5 per cent basis, therefore, the buyer will pay 18,000 for the property. Another piece of property which also pays 1000, but is taxed 200, gives a net income of 800; the buyer, therefore, will pay 16,000 for the property.

The tax is consolidated in the purchase price, to the disadvantage of the seller and to the advantage of the buyer who has retained a capital sum proportionate to the amount of the tax.

From this follows the principle that the inequality in taxation that existed *by law* between the two sellers of property is *in fact* eliminated once the property passes into the hands of the two buyers. This is undeniable so long as the phenomenon is considered from the standpoint of the relative position of the two buyers.

On the other hand, erroneous conclusions have been drawn from this simple truth. Of these, the most important is that the buyer, having discounted the tax in his purchase-price, will, in fact, no longer pay the tax that the seller used to pay.

In order to test the truth of this affirmation, one has to take into account the relative positions of the seller and the buyer. The error lies in not having called attention to the fact that, as between the buyer and seller, the consolidation is bilateral. Each of the contracting parties deducts the tax imposed on the good that he buys — that is to say, receives in exchange for the good he sells.

Let us take, as a typical example, an exchange between land and industrial bonds. The buyer of the land escapes the real estate tax, but the buyer of industrial bonds also escapes the tax on intangibles. In a word: it is always net incomes that are exchanged, or bought, or sold.

From this it follows that after the exchange each of the contracting parties will, *as a matter of law*, pay the tax that is assessed on the

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good he has bought; but *in fact* he continues to pay the tax which is levied on the good sold. That is, each party carries along with him, *in fact*, the tax that he used to pay. For example, if land the income from which is 1100 and the tax on which is 100 is exchanged for a house the income from which is 1200 and the tax on which is 200, the values of the two pieces of property — before taking account of the tax — would have been 22,000 and 24,000, respectively; but after taking account of the tax, the exchange takes place on equal terms on the basis of the equality of the two net incomes. That is, the landed proprietor obtains 20,000, leaving in the hands of the house-owner 2000 corresponding to the capital value of the tax of 100, and the house-owner obtains 20,000, leaving in the hands of the landowner 4000, equal to the capital value of the tax of 200. After the exchange, therefore, the landowner will, to be sure, pay 200 in taxes on the house he has bought, but he has also held back 2000 more from the purchase price; therefore it is as if he continued to pay only the 100 that he used to pay. Similarly, the seller of the house will pay on the property purchased 100 instead of 200, but it is also true that he has had to give up 2000 of capital in determining the values of the exchanged properties.

If we pass from the case of exchange to that of a sale-transaction in which the land is exchanged for money, it might seem that since no tax is levied on money as such, the consolidation turns out to be unilateral. This, however, is merely an illusion; since the seller of the land discounts in his selling price the tax which he will pay on whatever investment he has in mind for the proceeds of the sale.

To sum up: (a) the possible juridical inequality in taxation which may exist between the sellers is *in fact* equalized once the property passes into the hands of the buyers; (b) each contracting party, after the sale-transaction, continues *in fact* to pay the tax that he paid before; (c) hence, the larger tax which may have fallen on the first sellers remains definitively consolidated, to their disadvantage; (d) the Treasury continues to collect, both in law and in fact, the same amount of taxes as before.

If it is supposed that the original distribution of the tax-burden, which struck some incomes more heavily than others, was desired by the legislator, it should be pointed out that this policy succeeds only once in harming the first taxpayers who were heavily burdened

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by the law; it is annulled in fact as soon as the property passes to the hands of new buyers.

The phenomenon is not limited to the case of a sale-transaction, but applies to all transactions in which it is necessary to make values equal from the standpoint of several interested parties — as, for example, in the case of the division of an estate through inheritance, and sometimes in the case of gifts.

To the extent that the saleability of goods and the liberty of contract become highly developed, the principle of consolidation becomes a modifying force which is always more effective than the juridical distribution of taxes.

### § 5

From the preceding argument we derive the following general principle: the combined action of the economic forces of shifting, diffusion, evasion, and consolidation work in the direction of a return to an equilibrium dominated by the action of economic forces, if this equilibrium was disturbed or modified by a juridical distribution which contradicted these economic forces.

At this point it is advisable to stress the fact that, in reality, these results are often obscured, and even rendered invisible, by the circumstance that the national income may be continuously increasing. We have up to now abstracted from this possibility; now it is necessary to consider it because it is a normal element in the concrete problem. The increase of the national income is used, *ceteris paribus*, for the satisfaction of new needs, and, *a fortiori*, for the renewed satisfaction of previous needs, if the latter have undergone a contraction because of the tax.

Now it may and does happen that the new and larger tax is paid by the new income; so that the old equilibrium remains undisturbed and the impression prevails that economic forces have not come into play. In fact, however, they have been neutralized by the action of a new element in the concrete phenomenon.

For this reason it is necessary that the solution of the problems of economic distribution be handled by the deductive method, with the understanding, of course, that we must control our results and state them in quantitative terms if and in so far as the statistical material permits.

# DIRECT TAXATION

## II

### THE THEORY OF SHIFTING

**Summary:** The problem of the shifting of direct taxes — Shifting in the case of free competition — In the case of rent — In the case of monopoly — The shifting of indirect taxes — The forces of friction in Public Finance

#### §6

#### *The Shifting of Direct Taxes*

Having established these general notions with respect to the economic distribution of taxes, it is desirable to dwell at some length on the problem of shifting, the current theory of which is vitiated by fundamental errors.

Since we must limit ourselves to the general outlines of the problem, it is necessary to concentrate upon two principal hypotheses. The first is that of a tax commensurate with the net income of each citizen, and has to do with the shifting of direct taxes. The second is that of a tax commensurate with the value of goods, and has to do with the shifting of indirect taxes.

Let us begin with the first. We must suppose that before the tax is levied, there will have been attained a position of equilibrium, — that is, a system of prices at which the demands for and supplies of all goods will have been brought into balance.

The problem of shifting consists of investigating whether the tax, in itself — that is, abstracting from the action of other forces — modifies the equilibrium position, in such a way as to bring about an increase of some prices and a decrease of others. For in such a case there will always and necessarily be phenomena of shifting.

The price may be modified either because the supply of goods varies or because the demand curves vary; hence the first point to be examined is whether the tax affects, and how it affects, supply and demand.

The current theory rests on two traditional errors of classical economics.

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The first of these, already pointed out, is the practice of considering the problems of Public Finance as if they were completely independent of the phenomena of Private Economics. As a result, no attempt is made to see what happens to the tax once it has left the budget of the taxpayer; on the contrary, there is a general disposition to suppose that the tax represents a loss of wealth for the taxpayer and for society.

The other error consists of treating all economic phenomena, and therefore also taxes, from the point of view of the producer, who is directly subject to the tax and translates it into an increase in cost or a diminution in profits; whence it is supposed that the immediate effect of the tax is to increase prices, through a reduction or a threatened reduction in supply.

The combination of these two erroneous propositions leads to the assertion that the tax disturbs the preceding equilibrium to the extent that it influences supply and induces the producer to react immediately.

One of the most accurate expositions of the current theory is as follows: 'The tax must evidently at first be regarded as an increase in the cost of production. For the time being, and until the old stock is exhausted, those who produced before the next tax was imposed are benefited to the extent of the ultimate rise in price. But as soon as this interval has elapsed, all producers are on the same footing. Since the tax is an addition to the cost of producing the article, they will seek to recompense themselves by raising the price. Unless they succeed in this, their profits will be curtailed and the production of the article will diminish. For one of two results must ensue: either producers will gradually transfer their capital to untaxed industries, or, even if the transfer of capital is impossible because it is firmly fixed in the industry, production will be curtailed by the crowding out of those who were previously on the very margin of profitable production, while the tax will prevent the influx of any new capital. In either case, then, in the long run, the supply will decrease; and this diminution, provided the commodity continue to be produced at all, will involve an increase of price. The consumer will, therefore, bear the burden of the tax.'<sup>1</sup>

<sup>1</sup> So Professor Seligman: *The Shifting and Incidence of Taxation*, p. 220. But all the current theories follow the same line of argument. Ricardo regards the tax as an increase in cost of production, or as a diminution of the profit of an enterprise, and argues that if the tax strikes one branch of industry only, it will be shifted, but that if it

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### § 7

This theory, or argument, assumes as an axiomatic truth that the tax, in itself, and in its entirety, and independently of any counter-offer of public services, always means an increase in the cost of production of private goods. This opinion is a corollary of the erroneous conception of classical economists, according to which the tax is regarded as a net loss for the producer, who then proceeds to deduct it from the value of his product. ✓

Now we have admitted — in general — that public goods are instrumental in the production and the enjoyment of private goods; whence it follows that the price paid by every enterprise for the production or acquisition of public goods — that is, the tax — may be taken, at any moment — that is, under static conditions — as a measure of the cost of production of public services. But whether or not the increase of taxes always means an increase in cost of production depends upon the efficiency of the relevant public services, which may be increased, decreased, or kept stationary. It may happen that the instrumental utility of these public services will have increased by 15 per cent while the tax will have increased by only 10 per cent. It could not be said, in such a case, that cost of production has increased. ✓

To make the issue clear, it is sufficient to abandon the error of

<sup>1</sup> We may accept the accounting practice of deducting taxes from total or gross product, for the purpose of separating that part of the value of the product which is directed to the acquisition of public goods, from that part which remains available for the acquisition of private goods and is thus distributed among the private agents of production.

<sup>2</sup> This error is an old and persistent one. It derives from the same sort of confused reasoning as that which would identify cost — represented, for example, by labour — with wages, which are a payment for cost — that is, for labour; or would identify abstinence, which is the cost of saving, with interest, which is the payment for such a cost, etc.

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strikes all industries, it will not be shifted. All writers on the subject follow him. J. B. Say writes that 'if supply does not change, prices cannot change'. And Esquiroll de Parieu writes: 'Taxes fall on the original taxpayer if the commodity on which they are levied is not susceptible to restriction.'

Rau also regards supply as the sole cause of price-changes. Nor do the more recent writers hold a different opinion.

Not one of them takes the trouble to follow the tax into the hands of the State which transforms it into a demand for private goods, in order to produce public goods. *A fortiori*, not one of them takes pains to consider the effect which public services have on the budget of the private producer.



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supposing that a tax represents a destruction of wealth as soon as it leaves the budget of the taxpayer, and to take account of the use that the State will make of the proceeds of the tax.

Let us take as an example an association of proprietors who at their own expense maintain a private road for the transportation of their merchandise. The transportation is a part of the cost of production.

Let us now suppose that these proprietors agree to pay the State, in the form of a tax, as much as or less than they used to spend for their private road, and that the State builds and maintains a better road, on which transportation is more convenient and faster.

It could not be said, in such a case, that the tax increased the previous cost of transportation. It must be said to have decreased it.

From this special example we may pass to the general case — namely, that the introduction of public services and their growth and improvement have reduced the cost of all the productive activities of the country. Hence it is necessary to discuss the problem on the most general hypothesis that the substitution of public enterprise for private enterprise results in advantages for the taxpayers. But even if the contrary hypothesis is adopted, it will always have to be admitted that it is not the tax paid by the producer that decides, but the nature of the public services produced and the degree to which each individual enterprise can in fact make use of these services.

To sum up: the previous cost of production may have been increased, left as it was, or diminished by an increase in taxes. In pure theory it must be said to have decreased.

If, on the other hand, the tax is regarded, in itself and without reference to the type of public services that it produces, as an expense of production, the theory of shifting is reduced to the following argument: the tax is a part of the cost of production; increased taxation increases the cost of production; the price must cover the cost of production and will rise; therefore the consumer will always have to pay the higher taxes.

This is not a theory, but a mere playing with words which settles nothing.

## DIRECT TAXATION

### § 8

Once we abandon the premise on which the current theory of shifting is based, we must abandon the theory itself. Nevertheless it is well to call attention to some propositions in which the theory is embodied.

It is customary to take first the case of a partial tax on some incomes and then the case of a general and equal — that is, proportional — tax on all incomes. And then, looking at the problem from the point of view of the producer, an attempt is made to ascertain how the producer would conduct himself according to whether he operates under conditions of free competition or of monopoly.

On the hypothesis of free competition, it is said that a partial tax, which increases the cost or lessens the profit of one or a few industries, induces the entrepreneur to pass from the industry affected by the tax to one of the industries that are not affected; and in this way the supply of the goods produced by the first industry is restricted, their price rises, and the tax is transferred to the consumers. On the other hand, if the tax on all incomes is general and equal (proportional), the producer is unable to move, because in all industries he will find an equal reduction in the rates of profit, interest, and wages, and he will immediately bear the burden of the tax.

On the hypothesis of monopoly, if we take the case of a tax which strikes monopoly profit, in such a way as not to impair ordinary profit, the monopolist has no inducement to move to other industries; he will not be able to modify supply and will bear the burden of the tax.

If, subsequently, the tax impairs ordinary profit, we return to the preceding hypothesis.

These are the three controlling principles in the current theory, which will now be re-examined.

### § 9

First of all, it should be borne clearly in mind that in no case is the immediate effect of the tax such as to modify the existing supply of goods. If, before the tax was levied, the agriculturist normally produced and sold 100 bushels of grain, the florist 100 bunches of

## ECONOMIC DISTRIBUTION OF TAXES

flowers, and the hat-maker 500 hats, the tax of 10 per cent on the income of each one of these does not bring about on the market a modification of the previously prevailing supply of grain, flowers, or hats. The difference is merely this: that each producer will sell for the benefit of the Treasury the 10 per cent of his product which he previously sold for his own benefit; or he will assign to the Treasury 10 per cent of his product and the Treasury will sell it directly. In any case, 100 bushels of grain, 500 hats and 100 bunches of flowers will go on the market as before.

The supply remains, for the moment, as it was.

The same cannot be said of demand. If we adopt the less favourable hypothesis of a general and proportional tax on all incomes, and if we admit that the latter are reduced in the same proportion, it does not follow that the consumption of all goods is restricted in the same proportion. In fact, we know that the contrary is true.

Before the tax was levied, the grain-grower used to divide his income of 100 bushels of grain among all his items of consumption, according to the principle of the equalization of marginal utilities. After the tax, he will have only 90 bushels of grain to divide among his various private items of consumption. (Therefore the demand curves previously prevailing vary, so far as the taxpayers are concerned, after the imposition, and as a result of the imposition, of an equal and general tax on all incomes.)

Nor is this all. We must also follow the course pursued by the tax which has given the State 10 bushels of grain. The State will now present itself on the market in place of the taxpayers, and will demand private goods in order to transform them into public goods; but it will not demand the same goods that the taxpayers demanded before the tax was imposed. Whereas the taxpayers may have used the 10 per cent of their incomes to acquire clothing and food and manual labour, the State may use them, for example, to acquire iron, arms, munitions, and intellectual labour.

Nor can it be assumed that the demand remains the same,—that is, that the State, in replacing the private consumers, uses the tax to acquire the same goods that the consumers used to demand; because such a hypothesis would be in conflict with the very reason for the State's intervention, — that is, the reason for the production of public goods and for the tax. It is a matter of indifference whether

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the State spends the tax wisely or unwisely ; it is, however, necessary and sufficient that it should spend it in a manner different from that in which the consumers would have spent it.<sup>1</sup> The *immediate* and *necessary* effect of the tax, then, is that it changes the previously prevailing demand curves for private goods on the part of the taxpayers and the State. And for this reason the new direction of the demand of the taxpayers and the State is the only fact which necessarily disturbs the preceding equilibrium.) This implies variations, upward and downward, in the previously prevailing system of prices; and therefore in all cases there will be phenomena of shifting, whether the tax affects all citizens equally or only a part of them, or whether the producers operate under conditions of monopoly or of free competition.<sup>2</sup>

The producers of goods the demand for and price of which have increased, shift the tax; the others feel its incidence,

But these phenomena are not definitive.

<sup>1</sup> The student must be warned against the other error, which consists of assuming, as a hypothesis, that demand remains the same. In making such an assumption, instead of avoiding the impasse we merely add to the errors of the current theory an error of economic logic; since it is not permissible to carry the method of abstraction to the point of abstracting from the conditions that constitute the problem. And the problem, according to our argument, arises from the fact that the tax necessarily modifies demand and leaves supply unchanged.

Moreover, this hypothesis cannot be justified by the consideration that to the increased demand of private individuals it is necessary to add the increased demand of the State, so that the total amount is the same.

It is not a question here of the total amount, which consists of and remains 100 bushels of grain; it is a question rather of the different distribution that is made of this sum as between the private goods demanded before the imposition of the tax and the public goods that are added later.

<sup>2</sup> As a sort of curiosity mention may be made here, incidentally, of the distinction that has sometimes been made between a personal tax on total income and a real tax that strikes a part of the income at the source. Thus, for example, there may be a single tax which strikes the entire income of 100,000 that the taxpayer derives from the sale of the grain he produces, the hats he manufactures, the lessons he gives, and the houses he rents; or there may be four distinct taxes — one of which strikes the income from land, another industrial income, a third professional income, and a fourth from buildings.

Now it is alleged that, in the first case, the tax will not be shifted, because the taxpayer is taxed on the whole of his income and does not know whether he must increase the price of the grain, or of the hats, or of the lessons, or of the houses; whereas it is shifted in the second case.

There is a difference between the two cases if one starts from the erroneous idea that the first person to react to the tax is the producer. But if, in conformity with our theory, the first to move is the consumer, the producer will not be slow to learn in which direction the new demand is going — toward the grain or the hats or the lessons or the house; and thus the supposed difference disappears entirely.

It may also be observed that the hypothetical example of a personal tax on total income is realized in actual life in the case of the tax on land, which in fact strikes an income consisting of various commodities: grain, cattle, oil, wine, etc.

## ECONOMIC DISTRIBUTION OF TAXES

### § 10

This first stage is immediately followed by the new distribution of productive services which is effected in order to adapt the supply to the new demand curves.

It is in this second stage that we come to deal with the action of the producers who, by increasing the supply of goods the demand for which has increased, and diminishing the supply of goods the demand for which has decreased, reach the new equilibrium, the criterion of which is the equalization of profits.

This movement toward the new equilibrium, or toward the return to the old equilibrium, will be examined, first of all, in the light of the two fundamental cases of value: the case of free competition and that of monopoly.

On the abstract hypothesis of free competition the following results will be realized: first, the producers who, as a result of increased demand, have shifted the tax will tend to increase production; second, the producers who, as a result of decreased demand, have borne the incidence of the tax will tend to decrease their own production, transferring their activities to industries of the first group; third, new savings and new labour-power, as they become available, will strengthen the two-fold movement of the first and the second groups.

To be sure, this process of readjustment of supply to demand requires more or less time, and meets obstacles of various sorts and resistant forces of more or less strength. There are a number of frictional forces the examination of which would require very detailed analysis; much depends, for example, upon whether in the enterprise which feels the incidence of the tax there is more fixed capital, which is difficult to disinvest, or circulating capital, which may be disinvested rapidly; whether the enterprise operates under increasing or decreasing costs; whether the goods involved are subject to an elastic or an inelastic demand; whether the incomes involved are fixed or variable, and so forth.

Nevertheless, the general framework of the theory permits us to say that in the case of free competition there will be a return to an equilibrium in which the phenomena of temporary shifting and of temporary incidence will be elided in the future, leaving intact, however, the gain that will have been made in the meantime by one group and the loss that will have been suffered by another.

## DIRECT TAXATION

### § II

The case of monopoly, to which we now pass, may, for purposes of discussion, be treated jointly with the case of land rent, which, moreover, is nowadays considered as a general case applicable to a great number of analogous phenomena.

In both cases — but for different reasons — there is a difference between the varying cost per unit of the goods produced and their single sale price. This difference gives a rent to the non-marginal producers and an extra profit to the monopolist.

Now the current theory holds that a tax, when it does not exceed this difference, falls on the taxpayer, since the latter does not find it profitable to move to industries operating under free competition, the ordinary profits of which are also affected by the same tax.

But this conclusion, which is reached when the phenomenon is considered from the point of view of the producer and the tax is regarded as representing a net decrease in profits, is modified if the problem is studied from the point of view of the consumer.

In fact, if we examine first the case of land rent, we may assume that, after the tax is imposed, and because of it, the State and private individuals intensify their demand for grain, thereby raising its price. The producers of grain shift the tax-burden, in whole or in part. But then, at a second stage of the process, the increase in rent will act as an inducement to cultivate less fertile marginal lands, or to cultivate grain more intensively at increasing cost. There will be an increase in production and a consequent decrease in the new price of grain. Within certain limits, therefore, the first shift tends to be neutralized. It will not, however, be completely neutralized; because the new grain is produced at higher costs and the price of grain will not be able to fall below these higher costs, and will not be able wholly to eliminate the increase in rent which was the result of the increase in price. Instead, therefore, of holding that there is no shifting in the case of rent, it must be said that the shift which is brought about as a result of the tax, because of the increased demand for grain, tends in some measure to be stabilized.

## ECONOMIC DISTRIBUTION OF TAXES

### § 12

For the same reasons it has been denied that a monopolist can shift a tax, when the latter merely impairs monopoly profit, and leaves the ordinary profit untouched.

(According to our theory, on the other hand, shifting may take place in favour of the monopolist if the State or private individuals, as a result of the tax, increase their demand for the goods that he produces.)

Let us see more in detail how this comes about. It is a commonplace that the monopolist decides the extent of supply, that the price increases in proportion as he decreases supply, and that he will bring to the market that quantity of merchandise which, multiplied by the corresponding price, assures him the maximum profit. If we suppose that he can carry on production within the range represented by a maximum of 10 units and a minimum of 1, that he produces at a constant cost per unit of 2, that the price per unit ranges from a minimum of 3 to a maximum of 12, and finally that the State imposes a tax of 10 per cent on net income, we may compile the following familiar table, which will serve as a basis for our discussion.

<i>Units for sale</i>	<i>Total cost</i>	<i>Price per unit</i>	<i>Gross receipts</i>	<i>Net receipts</i>	<i>Net receipts after deduction of tax of 10 per cent</i>
10	20	3	30	10	9
9	18	4	36	18	16·20
8	16	5	40	24	21·60
7	14	6	42	28	25·20
6	12	7	42	30	27
5½	11	7·50	41·25	30·25	27·225
5	10	8	40	30	27
4	8	9	36	28	25·20
3	6	10	30	24	21·60
2	4	11	22	18	16·20
1	2	12	12	10	9

From this table it will be seen that the monopolist, by selling 5½ units at the price of 7½, realizes a net profit of 30·25 before the deduction of the tax, and a net gain of 27·225 after the deduction of the tax. The two profits are the maximum obtainable either before or after the imposition of the tax.

## DIRECT TAXATION

It is usually concluded, on this account, that the monopolist bears the burden of the tax.

We know, however, that this would be true only on the hypothesis that the tax does not modify the demand curves of private individuals and of the State. But such an hypothesis, even if it may conform to reality in some exceptional cases, cannot be accepted as a general one; hence it is necessary to take account of the two other possible cases: namely, the case in which the price per unit rises from 3 to 4, and that in which it falls to 2.

If the price rises from 3 to 4, the table given above is modified as follows:

<i>Units for sale</i>	<i>Total cost</i>	<i>Price per unit</i>	<i>Gross receipts</i>	<i>Net receipts</i>	<i>Net receipts after deduction of tax of 10 per cent</i>
10	20	4	40	20	18
9	18	5	45	27	24'30
8	16	6	48	32	28'80
7	14	7	49	35	31'50
6	12	8	48	36	32'40
5½	11	8'50	46'75	35'75	32'175
5	10	9	45	35	31'50
4	8	10	40	32	28'80
3	6	11	33	27	24'30
2	4	12	24	20	18
1	2	13	13	11	9'90

The new table shows that the monopolist has an interest in increasing the quantity sold from 5½ to 6, because he realizes a net return of 36 instead of 35'75, and therefore shifts the tax. To sum up: confronted by the increased demand of the market, which is a consequence of the tax, the monopolist has an interest in satisfying this increased demand by increasing production, because in this way he shifts the tax wholly or in part.

On the hypothesis that the price comes down to 2, the first table will be modified as follows:

<i>Units for sale</i>	<i>Total cost</i>	<i>Price per unit</i>	<i>Gross receipts</i>	<i>Net receipts</i>	<i>Net receipts after deduction of tax of 10 per cent</i>
10	20	2	20	0	0
9	18	3	27	9	8'10
8	16	4	32	16	14'40
7	14	5	35	21	18'90
6	12	6	36	24	21'60



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Units for sale	Total cost	Price per unit	Gross receipts	Net receipts	Net receipts after deduction of tax of 10 per cent
5½	11	6.50	35.75	24.75	22.275
5	10	7	35	25	22.50
4	8	8	32	24	21.60
3	6	9	27	21	18.90
2	4	10	20	16	14.40
1	2	11	21	9	8.11

It will be seen that even in this second case the monopolist has an interest in moving from his previous equilibrium position, because by passing from 5½ units to 5, he in part makes up for the tax. Therefore, even when there is a decrease in the price of the goods subjected to the decreased demand, the monopolist meets the decreased demand by reducing supply and increasing the price, and thus shifts part of the tax.)

The matter of tax shifting is not at all exhausted by this analysis; many other questions remain to be examined. We have discussed the problem of shifting on the assumption that the monopolist produces at constant costs; there is also the case of the monopolist who produces at increasing or decreasing costs. There is the case of a tax that strikes gross income rather than net income, or that is levied according to the number of units of goods sold rather than according to their value. But these are questions for detailed analysis giving rise to a series of corollaries the study of which carries us into the field of economic theory.

Our primary purpose has been to demonstrate the general truth that the introduction of a tax always gives rise to phenomena of shifting.

### § 13

#### *The Shifting of Indirect Taxes*

We have been concerned up to this point with the type of tax that is commensurate with the income of the producer, and have thus outlined the theory of the shifting of direct taxes.

We may now pass to the second case—namely, that of the type of tax that is commensurate with the value of the goods that the consumer buys—that is, the case of indirect taxes.

## DIRECT TAXATION

Let us assume, then, that a tax on wine, coffee, tobacco, sugar, etc., is imposed for the purpose of affecting the income of the consumer, who is subject to the tax.

Now it often happens that, in fact, the tax is paid or anticipated by the importer or manufacturer, who automatically includes it in the price of the goods affected and makes up for it at the expense of the buyer.

This reimbursement is considered by current theory as the case that constitutes the problem of the shifting of indirect taxes; but this is an error the nature of which is almost self-evident.

The manufacturer of sugar, for example, pays the direct tax on his industrial income, which may be related, as has already been pointed out, to the quantity of sugar he produces; he is then called on to pay a manufacturer's tax<sup>1</sup> on this same quantity of sugar that he produces; but this second tax is not added to or identified with the first. The sugar manufacturer pays, on his own account, only the direct tax with respect to which he is the *de jure* taxpayer, and he advances the manufacturer's tax to the Treasury on behalf of the consumer who is the *de jure* taxpayer with respect to this tax.<sup>2</sup>

Hence, one may speak of the relationship between manufacturer and consumer as involving 'shifting' only in a book-keeping sense; it does not involve any economic phenomena of shifting.

The latter can begin only with the consumer, after he has bought the merchandise and has paid or reimbursed the seller for the tax/

### § 14

If, then, we start from the proposition that a tax on the consumption of grain and coffee is nothing but a tax on the income of the consumer of grain and coffee, the tax will be paid in its entirety if, or in so far as, the taxpayer devotes a larger part of his income to buying the *same* quantity of grain and coffee as he bought before. This excess price, which is erroneously regarded as a phenomenon of shifting from the producer to the consumer is, instead, the tax which is owed by the latter.

<sup>1</sup> [Italian: *imposta di fabbricazione* - Translator's note]

<sup>2</sup> A confirmation of this - if indeed such confirmation is required - may be found in the legislative improvements which tend more and more to relieve the manufacturer of the burden and risk of advancing the taxes by making the moment of collection coincide with the moment at which the consumer makes his purchase.

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Now, the indirect tax is absorbed into the current price of the commodity affected and raises that price by the amount of the tax. In the light of this increase in price, consumption may decrease. To the extent to which the taxpayer reduces his consumption, the incidence of the tax falls on him; but at the same time, as far as the Treasury is concerned, he escapes the tax. No phenomenon of shifting has thus far been involved.

It should be remembered that the indirect tax is a debt charged against the income produced by the consumer, not against consumption; it is a debt that is collected at the moment and in the act of consumption.<sup>1</sup> Hence, if the taxpayer restricts his consumption, he fails to pay the whole of his debt.

The tax is a compulsory payment; hence it carries with it the logical consequence that consumption also must be, to some extent, compulsory. A characteristic illustration, in this connection, is provided by the old *octroi* on salt, which was supplemented by the obligation of every family to buy a given quantity of salt annually.

We no longer have recourse to this anti-economic form of compulsion;<sup>2</sup> nevertheless we must prevent the taxpayer from avoiding the payment of the tax. The method for accomplishing this purpose would be to levy on all goods and services, without exception, the same tax on consumption — for example, a tax of 10 per cent of the value of all goods and services; since the taxpayer would then be unable to evade the tax and at the same time remains free to distribute his disposable income according to the principle of the equalization of marginal satisfactions.

It is only by proceeding on this hypothesis that we can discuss the phenomenon of shifting from the theoretical point of view, thus abstracting, at least for the present, from the disturbing element of evasion.

### § 15

If we hold fast to this assumption, it will be clearly seen that a direct tax of 10 per cent on net income is equal to an indirect tax of 10 per cent on the value of all consumption goods. In both cases,

<sup>1</sup> Cf. Book II, chap. III, § 2, § 8 and *passim*.

<sup>2</sup> It is anti-economic because it prevents the taxpayer from distributing his income according to the principle of the equalization of his marginal satisfactions.

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at the moment the tax is levied, the supply remains what it was. The taxpayer owes the State, in each case, 10 per cent of his income. Under direct taxation he pays the State 10 per cent of his income — that is, he turns over to the State a tenth of the goods he produces; under indirect taxation he pays the State 10 per cent of his income as he spends it — that is, in the ultimate analysis, he turns over to the State a tenth part of the coffee, grain, and wine that he buys.

He has left, in each case, 90 per cent of his former income, which he must distribute anew, and in a different way, among the goods entering into his private consumption. But to distribute \$90 among goods the price of which has not increased because of indirect taxes is the same thing as to distribute \$100 among goods whose price has increased by 10 per cent as a result of indirect taxes. In either case, he will make this new distribution freely; but this means that he will have to change his previous demand curve.

There is in addition, however, the new demand for private goods which the State will exert in using the proceeds from the tax.

From this it follows that the old equilibrium is disturbed by the new direction given to the demand of private individuals and of the State; this, in turn, gives rise to changes, upward and downward, in the system of prices previously prevailing and therefore, of necessity, to phenomena of shifting, which will be followed by the reaction of the producers in their attempt to reach the new equilibrium.

To sum up: the theory of shifting which we have studied for direct taxation is also valid, *mutatis mutandis*, for indirect taxation.

### § 16

We now pass to the more complex concrete phenomenon, and introduce the element of evasion, from which we had abstracted. It is here that a theoretical difference arises, depending upon whether we are dealing with direct or indirect taxation.

The hypothesis of levying consumption taxes on all goods and private services, without exception, cannot be realized in practice, as we shall see later.<sup>1</sup> Taxes on consumption must be limited to a group of goods. If we reason on the basis of this new hypothesis, it follows that, under direct taxation, the taxpayer who does not succeed in shifting the tax distributes the rest of his available income among

<sup>1</sup> Cf. Book IV, chap. I, § 3.

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the various items included in his private consumption solely according to the principle of the equalization of his marginal satisfactions, and thus obtains maximum satisfaction.) On the other hand, the indirect tax on consumption, which is limited to a group of goods, creates *per se* an inducement to reduce preferably the consumption of the goods affected by the tax, because such a reduction permits the consumer to avoid the tax. That is, it compensates him, to some extent, for the sacrifice of the anti-economic contraction of consumption, and leaves him a margin within which evasion is possible.

The possibility of evasion, therefore, artificially disturbs — other conditions being equal — the taxpayer's equilibrium of marginal satisfactions and diminishes the Treasury's revenue.

### § 17

#### *The Forces of Friction*

What has been said about the economic distribution of taxes allows us to bring out the following truth: the action of those economic forces which are set in motion by the juridical distribution of taxes tends toward an equilibrium which does not differ from that which would be brought about by the natural play of the operating forces in the field of Private Economics.

From this follow two corollaries:

1. The action of economic forces, if they are to break down a juridical distribution which has not taken account of them, must, as a rule, overcome a series of obstacles — that is, a mass of *forces of friction*. Hence the phenomena of shifting, of diffusion, of evasion, and of elision or consolidation of the tax require more or less time to be realized completely. Equilibrium is established only after the lapse of a certain period of time, during which the juridical distribution may fully attain its incidental ends.

If, for example, the law exempts wages and burdens profits by the same amount, the wage-earner will enjoy exemption from taxation until the new equilibrium between profits and wages is re-established. So, also, all confiscatory taxes which are levied only once are not subject to control by rectifying economic forces. Suppose, for example, that the legislator proposes a partial expro-

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priation of large fortunes by means of a sharply progressive tax. He will accomplish his purpose completely, except that there will be a return to the old equilibrium so far as concerns new saving, new production, new purchasers and proprietors, and new generations..

The forces of friction, then, operate in favour of a juridical distribution which is carried out in opposition to the natural play of economic forces; and they are on that account a factor of great theoretical and practical importance, from which we cannot abstract in the study of problems in taxation.

2. An analogous, though opposite, case is found when the legislator does not propose to obtain a juridical distribution that is different from the economic distribution, but actually relies upon the play of economic forces to obtain the distribution he desires.

There are several examples of this. There is the case of the single tax, by which the legislator hopes to obtain the financial requirements of the State from one or from only a few categories of income, leaving to shifting and to diffusion the task of distributing the tax-burden among all incomes not directly affected by the tax. Another example is to be found in the practice of regarding as superfluous the periodical appraisals of taxable income in order to equalize the tax periodically, on the ground that the natural play of economic forces in fact constantly operates to bring about equalization.

Such reasoning is wrong, however, because it does not take account of the forces of friction, which cause the processes of shifting, diffusion, and evasion of taxes to be long-continued, difficult, unequal, and partial, and therefore keep alive inequalities which the legislator does not desire.

Nevertheless, there are two cases of inevitable inequality to which attention should be called, in connection with the ideas just discussed. One is that of inequality as between visible wealth, which is always fully taxed, and invisible wealth, which avoids taxation. Lands and houses comprise the first; the professions in general comprise the second. Equalization of taxes as between these two categories of taxpayers is impossible *ope legis*; economic forces come to the rescue in so far as savings and human effort pass from agricultural to professional occupations, until such time as, through a discounting of the tax, on the one hand, and of the freedom from taxation, on the other, the compensations of the two types of occupation will be equalized.

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The other case consists of duplications in taxation which result in a greater tax-burden in those instances in which duplication cannot be avoided. The distribution of savings among all possible investments takes account of the tax and — given sufficient time — re-establishes equilibrium.

From what has been said we may obtain the following guiding principle in tax-policy: the distribution of taxes must be made, from the first moment, in such a way as not to disturb or to disturb as little as possible the existing economic equilibrium. Only after having exhausted all means of avoiding inequalities can one entrust to the natural play of economic forces the task of ironing out those remaining inequalities which the law has not been able to remove.

## CHAPTER V

### JURIDICAL DISTRIBUTION OF TAXES

Summary: The principle of the equality of all citizens before the law in matters of taxation — Proportional and progressive taxation — Distinctive characteristics

#### § I

FROM the theory of shifting it follows that if other conditions remain the same, economic equilibrium is disturbed less by an equal and general tax on all incomes than it is by a higher tax levied on only a part of income.

This is the economic basis of the juridical and political principle that 'all citizens are equal before the law in matters of taxation.'

This principle, which corresponds to the general sentiment of contemporary society, also underlies the political constitutions of modern States; but, as is usually the case with declarations of abstract and absolute rights, it does not have a concrete and positive content. It has, rather, the value of a critical and negative position in protest against certain historical forms of tax-exemption.

It was, in fact, this principle that gave direction to the political struggle against the fiscal exemptions enjoyed by the nobility under the old regime. After the ancient fiscal privileges were abolished by the French Revolution, the struggle continued to be waged against the possibility of the emergence of new privileges.

The principle finds expression in the following two canons: the *universality* and the *uniformity* of taxation.

The first means that no citizen who has an income may escape taxation; the second, that all those who enjoy a given income must be subjected to the same fiscal treatment.

This may be illustrated by the provisions of Italian positive law. For example, Article 25 of the Italian constitution states, 'All inhabitants of the realm, without distinction, must share the burdens of the State in proportion to their wealth.'

Again, Article 10 of the law of 1864 with respect to the taxation



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of land states: 'All privileges and every special exemption from taxes on real property are abolished.' Similarly, the law with respect to the taxation of movable property states that 'every individual or juristic person, whether citizen or alien, must pay taxes on movable property owned within the State.'

The exception made by these laws in favour of lands and buildings which are of domain character is not a privilege, because domain goods do not yield a private economic income. The patrimonial goods of the State, on the other hand, are correctly subject to taxation.

A true form of privilege is that which preserves, as historical survivals, certain forms of personal exemption — the civil list of the Crown and appanages, diplomatic representatives, etc. Another case of privilege which has been created and which has been developing under recent legislation is provided by the exemption allowed *in view of particular conditions*, objectively stated.

There are several types of exemption in Italian law, some of them recent, others representing a survival from an earlier period. Thus, soldiers in active service below the rank of commissioned officers are exempt from taxation; so are mutual aid societies; still another example is that of the exemptions enjoyed by public officials and government enterprises. Finally, there is the case of temporary exemptions granted to infant industries.

An attempt is made to justify such exemptions on the pretext that they are granted, not on behalf of certain individuals, but in view of certain definite conditions, in which, it would seem, all citizens may find themselves, or into which they may voluntarily put themselves, and that therefore the juridical principle of equality is not violated.

It remains a fact, nevertheless, that not all citizens find themselves in, or can put themselves into, these conditions; and that if they could or did do so, the fiscal advantage of the exemptions would be annulled.

If we were to take account of the present state of legislation, the principle of equality would have to be represented by the following formula: 'Two individuals who are alike with respect to the amount of their incomes and with respect to the *other conditions specified* by the law owe the same tax.' But this formula contains within itself a negation of the principle, since the law can always introduce conditions which, though providing an appearance of generality, are

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applicable to only a few and thus conceal the element of privilege.

The correct formula, therefore, is the rigid one that limits itself to declaring that two individuals with equal incomes owe the same tax. It goes without saying, as has already been observed, that this principle becomes politically operative in the form of scientific criticism and political opposition, whenever the body of taxpayers resent the injustice involved in the lightening of the tax-burden of some group — since this resolves itself into an increase in taxation for all the others — and resist; they cease their resistance when they have realized in practice the principle of equality in the rigid sense laid down above, or an approximation to the principle in the rigid sense. Thereafter, the exceptions that remain and are accepted without protest are usually cases of collective altruism.

### § 2

Having established the principle of equality in taxation, we come to a discussion of its application in the system of proportional and progressive taxation.

Proportional taxation exists when the percentage or rate of taxation is the same for every unit or group of units — or for every group of \$100 — into which individual income is divided. Progressive taxation, on the other hand, exists when, income being divided into groups of \$100, the rate or percentage of taxation increases with the increase in income.]

It is not necessary, however, that the progression be geometric or arithmetic, or that it follow any other law of increase. It is enough that the tax should, in some way and in some degree, suggest uniformity of treatment and yet turn out to be more than proportional to the income received.]

This generic concept of progressive taxation disposes of several superfluous criticisms that encumber the ground. Thus, it is not worth while bothering with the objection according to which progressive taxation, if carried to extremes, absorbs practically the whole of income; since it is not necessary that progressive taxation should be carried to the point of absorbing the whole of income, if this is not the purpose of the legislator. On the other hand, even if progression stops half-way, it gives rise to the problem with which we are concerned. The criticism in question is a *reductio ad absurdum*

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which does not destroy the principle of progressive taxation, but merely makes it necessary to apply the principle correctly in concrete cases.

The most common concrete form of progressive taxation is that which is called *degressive*. Under this type of taxation the highest percentage is set for that given type of income on which it is intended to exert the most pressure; from this point on, the rate is applied proportionally on higher incomes and decreasingly on lower incomes, falling to zero on the lowest incomes as we shall see below.

Included in the concept of progressive taxation is the *inversely progressive* tax, which exists whenever the tax strikes the smaller incomes relatively more heavily than the higher ones. An example is to be found in the system of taxation that preceded the French Revolution, in so far as that system, taken as a whole, was consciously intended to put the burden on the less well-to-do classes.

It is clear, in the light of what has been said, that an example of progressive taxation does not exist when progression is adopted in order to compensate the smaller incomes for the inversely proportional burden which they bear in the form of indirect taxes on consumption. One may not speak, in such a case, of progressive taxation, since the intention is to bring about, in the end, a proportional distribution of taxation.

Having defined the general concepts represented by the two systems of taxation, we may examine some of their specific characteristics. The proportional tax is a *real* tax; the progressive is a *personal* tax. These words are to be understood in the sense that the proportional tax is levied directly on things, on goods, without taking account of the person who owns them; the Treasury directs its attention to the wealth affected and considers the proprietor, or his representative, merely as the intermediary through whom the payment is made.

The percentage of the total income of the community which is needed to cover the needs of the State is applied to the income of each individual and to the various components of individual income.

This is not the case with respect to progressive taxation. The latter levies upon different incomes tax-rates that differ according to the size of the incomes, — that is, according to the income-group in which the person receiving the income falls. The State does not strike the whole income, or each part of income, with objective

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equality; on the contrary, it takes account of the position of the income-recipient as an individual, summing up, for this purpose, all the forms of income that accrue to him at a given moment. The same piece of property pays a different tax according as it belongs to a rich, a less rich, or a poor man.)

Which of the two systems realizes the principle of equality of all citizens before the law in matters of taxation?

This is the rather vague way in which the problem of proportional and progressive taxation has been posed.

Of the attempts which have thus far been made to solve this problem, the ones that are of some scientific value are those that seek to relate the two systems to the theory of value. Thus, some believe that they have demonstrated the validity of the proportional system by treating it as a corollary of the theory of objective value — that is, of *economic equivalence*. Others think they have demonstrated the validity of the progressive system by treating it as a corollary of the theory of subjective value — that is, of the *equality of sacrifice*.

As can be seen, in both cases what is involved is a question of equality.

## CHAPTER VI

# ECONOMIC THEORY OF PROPORTIONAL AND PROGRESSIVE TAXATION

**Summary:** Economic theory of proportional taxation and the criticism thereof — Economic theory of progressive taxation — Criticism of the principle of equality of sacrifice — Is it true that the importance attached to successive increments of income by the recipient thereof decreases with each increment? — The question of inheritance and of productive factors obtained without cost — Conclusion

### § 1

LET us begin with proportional taxation. If we start from the two premises already expounded — namely, (a) that the consumption of general public services varies directly with individual income, and (b) that all citizens are equal before the law in matters of taxation — it would seem possible to deduce immediately the principle of proportional taxation.

In other words, if it is assumed that Brown, with an income of 10,000, consumes 100 units of public goods, and that Smith, with an income ten times larger, consumes ten times as much, it seems obvious that he must also pay ten times as much in taxes as Brown.

The reasoning thus used with respect to the two taxpayers is the same as that used within the field of Private Economics with respect to two consumers, one of whom buys two pounds of bread and the other one pound, the first being called upon to pay twice as much as the second.

But the analogy does not hold. It contains an error in economic logic, in so far as it takes for granted what really would have to be demonstrated — namely, the assumption that the State, like a private enterprise, operates under the principle of the 'single price.' When it is stated that Smith must pay ten times as much as Brown, because he consumes ten times as much public services as Brown, it is taken for granted that the two must pay the same price for every unit of public goods demanded and consumed.

Now, the single price is not a necessary feature of the financial

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policy of the State, which is monopolistic, as it is a necessary feature of private enterprise when conditions of free competition prevail.

The single price is a necessary result of the forces which operate when sellers and buyers compete. The action of these forces eliminates different subjective appraisals, from which, also, different prices may arise, if the competitive regime is transformed into a monopolistic one.

In the financial policy of the State, however, which is at once monopolistic and authoritarian, the forces that lead to the establishment of a single price are not necessarily operative. The State, in greater measure than any private monopolistic enterprise, is in a position to practise the policy of manifold prices.

For this reason, if we retain the assumption that each citizen consumes general public services in *proportion* to his income, it does not follow that proportional taxation is what is called for. There is missing the intermediate link which is represented by the assumption of a single price.

Hence the principle of objective value or of economic equivalence does not explain proportional taxation.

### § 2

The possibility of paying different prices for the same units of public goods is the first general condition for progressive taxation.

Indeed, the latter exists when — granting that the consumption of public goods is proportional to income — it is assumed that the possessors of larger incomes are willing and are therefore called on to pay, for each unit of consumption, a higher price per unit.

This summary statement of the problem contains several assumptions that will now be discussed.

First of all, let us admit that when the system of proportional taxation — that is, the system of the single price — prevails, consumers' rents are established in favour of some taxpayers. From this first presumption may legitimately be derived another — namely, that these taxpayers are willing to pay different and higher prices per unit than are the taxpayers who do not enjoy a consumer's rent.

Let us also concede that the State, through a shrewd policy of

This theory or criticism of proportional taxation may be found completely formulated in the mimeographed notes of my lectures from 1887 on.

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manifold prices, may well appropriate the consumers' rents of these taxpayers for the benefit of the community.

Yet, if these are the preliminary conditions which make it possible to speak of progressive taxation, they do not constitute the problem of progressive taxation. The latter supposes that the 'rent' enjoyed by a consumer depends only on the size of his income; that the readiness of the taxpayer to pay different prices increases uniformly with the increase of his income; and furthermore, that it increases equally for all taxpayers.

The validity of these assumptions must be demonstrated. And the demonstration consists in measuring the greater or lesser willingness of the taxpayers to pay increasing prices per unit for public goods, according to the urgency of the private wants that they satisfy with their different incomes: the possessor of a high income satisfies wants which are less urgent than those which are satisfied by one who has a modest income.

It was once common to speak of a division of wants into necessary, useful, and superfluous wants; now we speak of a scale of wants decreasing in urgency. In any case, however, it is held that the degree of urgency decreases *uniformly* with the increase in income. Thus, from the postulate of the decreasing intensity of wants is derived the corollary that a *proportional* levy on incomes imposes on the possessor of the larger income a sacrifice which is less than proportional to that imposed on the possessor of the lower income.

Given two individuals, Brown and Smith, with incomes, respectively, of 10,000 and 100,000, a proportional tax of 10 per 100 would take away 1000 from Brown and 10,000 from Smith, leaving the former with an income of 9000, and the latter with one of 90,000. Brown will then have to renounce the satisfaction of private wants which are relatively more urgent than those which Smith will have to renounce. From this follows the conclusion: the tax must be more than proportional — that is, progressive in relation to income — if it is desired that the tax be proportional to the sacrifice of each individual.

Thus far the theory. In order to discuss it, let us continue with the reasoning and see what further consequences may be drawn from it.

Keeping Brown's tax at 10 per cent, let Smith's be raised to 20, then to 30, and then to 50 per cent; his residual incomes of 80,000, 70,000, and 50,000, respectively, will still permit him to satisfy wants which are relatively less urgent than those satisfied by Brown.

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Proceeding on the same logical basis, we come to the conclusion that only if a tax of 10 per cent is levied on the income of Brown, and one of 91 per cent on that of Smith, will it be possible to say that the consumption of the two individuals has been equalized.)

(Hence, if this were the way in which the principle of subjective equality ought to be understood, it would logically lead to the objective equality of incomes.)

But not all those who support the principle of progressive taxation commit this error, or intend to obtain this result.)

### § 3

Equality of sacrifice is not the same thing as equality of fortunes. The error in logic that is made by most writers lies precisely in jumping from the theory of equality of sacrifice — which is derived from the theory of subjective value — to the theory of the equality in the distribution of wealth, which is derived from the theory of objective value.)

Now, for purposes of theory, what is important, above all, is that the two principles should not be confused. They are two absolutely different concepts, also corresponding to two distinct goals, which progressive taxation may set for itself.)

Progressive taxation may, indeed, be considered as a means for correcting the natural inequality in the distribution of private wealth, by preventing the accumulation of such wealth beyond a given maximum and encouraging accumulation up to a given minimum.)

Or, far from proposing an equal distribution of wealth, it may recognize all the economic stimuli which in one way or another impel men to increase their wealth, and all the *de facto* conditions which, in different ways, assist them in obtaining wealth. Hence it may accept the fact that wealth is unequally distributed; but, holding that the sacrifice involved in the payment of taxes is inversely proportional to the pain or sacrifice experienced by the taxpayers. 'The rich man is willing to pay prices that increase uniformly with the increase in his income.'<sup>1</sup> This is the fundamental concept underlying the doctrine; and it is clear that, if the taxpayer is willing to pay the higher price, the incentive to increase production, savings, and wealth, is not restrained.)

<sup>1</sup> This is a different thing from saying and recognizing that in certain definite cases involving a benefit to certain definite people the rich man is willing to pay for these persons. (See Chapter VII immediately following.)



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In the light of this analysis, a formal and concrete difference may be said to exist between the two theories. The one — involving a tendency toward the levelling of fortunes — is not afraid to push progression to the point of absorbing the larger estates entirely. The other — that of equality of sacrifice — tends, to be sure, to distribute the load of taxation progressively, but wishes to do this in such a way as not to prevent the indefinite increase of private fortunes. From this it is an empirical but logical step to transform a progressive system of taxation into a system that is proportional beyond a given limit which is fixed at the discretion of the legislator.

The fundamental difference between the two aims does not make it impossible that, at given historical moments, the sponsors of a programme of equalizing the distribution of wealth and the sponsors of the principle of equality of sacrifice may work together, at least for part of the way. In politics the two aims may be joined, but in theory they correspond to two distinct principles.

### § 4

We shall examine later the theory of progressive taxation, which proposes the levelling of fortunes or in any case a modification of the natural distribution of wealth, and which has a social or political character. It is more important, at this point, to clarify the economic principle of equality of sacrifice, when this principle is correctly understood.

Since we wish to pass step by step from the major arguments to the minor ones, let us first make all necessary concessions with respect to the decreasing scale of wants and the consequent readiness of the taxpayer to pay taxes representing uniformly increasing percentages of his income. Even on this hypothesis, we do not overcome the fundamental difficulty — namely, that the principle of subjective value does not allow comparisons of sensibility — whether to pain or pleasure, sacrifice or enjoyment — as between different individuals.

The elementary principle on which this structure is built is that for each individual, decreasing importance is attached to successive increments of income. But this principle, assuming that it is true, is true on condition that one confines oneself to the budget of each separate individual; only then could it be concluded that one is willing to pay lower rates on the first increments of his income and

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higher ones on the following increments. And that, in itself, would be something.

Nevertheless, in order to pass from this conclusion to progressive taxation, we must get out of the closed economy of an individual and make comparisons between different individuals.

In fact, let us suppose that Brown, with an income of 10,000, is willing to pay the following tax-rates:

on the	first	2000,	5 per cent,	i.e. altogether	100
„ „	following	„	6	„ „	120
„ „	„	„	7	„ „	140
„ „	„	„	8	„ „	160
„ „	„	„	9	„ „	180
Total income 10,000					Total tax 700

Brown will pay 700 on an income of 10,000, distributed progressively by percentages from 5 to 9, which is equal to a proportional tax of 7 per cent.

Let us now consider the cases of two other taxpayers: Jones, with an income of 6000, and Smith, whose income is 16,000. Dividing the incomes into groups of 2000, we may construct two tables analogous to the preceding one.

on the	first	2000,	5 per cent,	i.e. altogether	100
„ „	following	„	6	„ „	120
„ „	„	„	7	„ „	140
Total income 6000					Total tax 360

This would constitute a tax of 6 per cent on the total income.

Smith would pay:

on the	first	2000,	5 per cent,	i.e. altogether	100
„ „	following	„	6	„ „	120
„ „	„	„	7	„ „	140
„ „	„	„	8	„ „	160
„ „	„	„	9	„ „	180
„ „	„	„	10	„ „	200
„ „	„	„	11	„ „	220
„ „	„	„	12	„ „	240
Total income 16,000					Total tax 1,360

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This will be a tax of 8.5 per cent on the total income.

Thus, a tax of 6 per cent will be paid on an income of 6000, a tax of 7 per cent on 10,000, a tax of 8.5 per cent on 16,000. The progression seems to be the automatic result of the decreasing importance that each taxpayer attaches to the successive portions of income within his budget, without comparison with other individuals. But this is not so; since in the example it is supposed that the decreasing scale of sacrifice is equal for all three taxpayers, whereas the theory of subjective value does not permit us to adopt such an hypothesis. On the contrary, it is more probable that the scales are different for each of the three. The example amounts to comparing the sacrifice of different individuals and measuring these sacrifices by the different levels of income.

[Even for the advocates of progressive taxation it is true that two individuals receiving the same income owe the same amount in taxes. This is obvious on the basis of the theory of objective value; but it is false on the basis of the theory of subjective value; since, even if incomes are equal, the pain or sacrifice of the two taxpayers may be and usually is different. Nevertheless, it is this proposition that underlies the structure of progressive taxation.]

[At this point it is already permissible to conclude that the principle of equality of sacrifice, correctly interpreted, does not demonstrate the validity of progressive taxation.] And, strictly speaking, we might content ourselves with this negative conclusion, just as we did in the case of the theory of objective economic equivalence.

### § 5

Nevertheless, it is well to push the analysis somewhat further; since the negative conclusion just stated says only that the marginal importance attached to each new increment of income does not decrease *uniformly* for all; it does not deny that it decreases for everyone in some measure. In other words [the progressive principle would still have been demonstrated within the autonomous sphere of each individual economy, and its practical application would be impossible only because of the theoretical impossibility of comparing the autonomous progressive scales of the different taxpayers, and because

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of the technical impossibility of establishing different progressive taxes for each individual.)

This uncertainty and this logical gap in the analysis follow from the acceptance as an axiom of the principle that less subjective importance is attached to successive increments of income as income increases.)

This principle, however, must be re-examined. It is usually formulated as follows: Given an income of a certain size, its possessor values each successive increment of it less than the preceding increment, because the degree of urgency of his wants is decreasing.

It should be noted, first of all, that the income is treated as a *given* quantity and not as a quantity that is *produced*, or that is *inherited* by its present possessor; and therefore, while it is put into relation with the decreasing scale of wants, it is not compared with the cost of producing it by an expenditure of effort or of acquiring it without effort. The two cases must be kept separate.

Let us suppose, first, that the *given* income has been produced by its owner. In this case, every increment of income produced includes an increment of cost; and, in dealing with values, it is not possible to avoid a comparison between the utilitarian appraisal of each successive increment of income and the corresponding sacrifice which is represented by each successive increment of cost.

Whatever the type of labour — whether it be manual or intellectual — each new unit of labour, or of risk, or of time, or of responsibility, or, in general, of effort directed to the production of a new unit of income, represents for the producer an increasing subjective sacrifice, while each successive unit of consumption represents to him a decreasing satisfaction. Every labour effort is, therefore, subject to the law of progressive exhaustion. And since the factor of labour is part of all activity directed toward the production of goods and is the element of cost which far outweighs the other elements, it may be seen from this what part of the increase of wealth is controlled by the principle of increasing sacrifice. Hence, for the greater part of the incomes which are the fruit of the work of the present generation, if the scale of human wants follows the law of diminishing satisfaction, the production of the income itself follows the law of increasing sacrifice. We know that everyone finds for himself the point which he regards as equilibrium and at which he decides to stop. Within

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these limits it is not clear why the wealthier person, who has produced and produces with increasing sacrifice, would be willing to pay in taxes rates or percentages which increase with the successive increments of income.<sup>1</sup> The proposition is not demonstrated.

(The relationship between the decreasing satisfactions and the corresponding increasing costs points to the idea of proportional taxation, and not of progressive taxation — to the concrete system of single price and not of manifold prices.)

### § 6

Now, not all incomes are a fruit of the actual labour of the recipients of the incomes. The typical, if not the only, case of this sort is that of inheritance.

In this instance, wealth which was produced and saved at increasing costs by the past generation becomes more or less costless as far as the heir is concerned. Jurists presume that the heir carries on the personality of the deceased; but this presumption, which is valid in explaining formal relationships in law, and also economic relationships of another sort,<sup>2</sup> is not valid with respect to the relationship between the heir and the deceased in the matter of satisfactions and sacrifices; since, at the death of the testator, there ceases to be physical continuity between the one who has borne the cost of production of the inheritance and the one who uses it only for the satisfaction of his wants. Hence, in the case of inherited wealth, as far as the heir is concerned, the law of decreasing marginal valuation is applicable; since, there being no cost of production as the other term

<sup>1</sup> There are those who, while accepting the principle of increasing marginal sacrifices for labour, deny it not only in some special cases, as, for example, the very special case of the inventor, which we may ignore, but also in the general case of saving. The man who saves begins to save at increasing costs, but then, having assured himself of the maintenance of his present and prospective standard of living, which his *habits* prevent him from abandoning, he continues to save and to accumulate automatically at constant or even decreasing cost, so that he justifies the popular saying that 'saving produces saving'.

Even if we grant this point, we may note that the greater the amount of saving, the greater is the demand for labour, and hence, other things being equal, the more accentuated is the scale of increasing marginal sacrifice on the part of workers. Furthermore, there is a decrease in the remuneration of the saver, and in this way, the decreasing sacrifice which ultimately comes about is discounted.

<sup>2</sup> See 'Inheritance Taxes', Book IV, chap. v, § 7 ff. It goes without saying that the consideration stated in the text is only one of the elements involved in the complex phenomenon of inheritance.

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of comparison, the evaluation of the successive doses of the patrimony is measured only by the scale of intensity of wants, which is a decreasing one.

In any case, however, this circumstance must be limited to inheritance; it would be a mistake to extend the progressive principle from incomes that have been inherited to those that are in the process of formation; and for this reason the special consideration of inherited incomes could not, in and of itself, provide an adequate basis for the adoption of the general system of progressive taxation.

### § 7

Nor is this all. The second circumstance to which it is necessary to direct our attention is the relation between the subjective marginal valuation of income and the subjective marginal valuation of public services. For if it is maintained that the taxpayer sets a decreasing valuation upon successive increments of wealth or of income, it is also necessary to maintain that he will set a decreasing valuation upon successive increments of public services; the latter, as we have pointed out, being goods which are instrumental in, and a necessary condition for, the production and the enjoyment of private income. In other words, if Brown values his second piece of property relatively less than the first, his third less than his second, and so on, he will also value the second policeman who insures his possession of the second piece of property relatively less than the first, the third less than the second, and so on.

It should be noted that the comparison of subjective value as between the tax and public services applies both to incomes in formation and to inherited incomes. This fact, of course, leads to a modification of the conclusion stated above.

To sum up: after having examined the theory in all its aspects, we may confirm the negative conclusion, that the principle of equality of sacrifice, or of subjective economic equivalence, does not demonstrate the validity of progressive taxation, just as the principle of objective economic equivalence does not demonstrate the validity of proportional taxation.

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### § 8

Before we conclude this chapter, it may be worth while to mention an old theory which has been readopted by writers who hold that all large incomes, when they pass a given minimum or average level, are necessarily the product of costless factors. These writers consider it legitimate that the Treasury should respect that part of income which covers cost of production, but should consider everything above this as belonging to the community and should absorb it through taxation.

This statement of the problem deserves to be cleared up, inasmuch as it is not based on differences in subjective evaluations and consumer rents, but on the difference between objective costs and producers' rents. The basis is sounder. But above all, it must not be limited to the income from lands and buildings, as was the case with the earlier writers; it must be broadened to include all incomes in whose production some costless factor plays a part, a phenomenon of rent thus being created.

For this reason, if we take as the basis of comparison the current rate of remuneration — profit, interest, or wages — all income above this level represents a case of rent and ought to be absorbed by taxation.

What we must decide, therefore, is whether the owner of a more fertile piece of land must contribute to the State all or part of the greater income that, expenses of production being equal, he obtains as compared with the marginal farmer. We must decide whether or not the more capable entrepreneur must contribute all of the larger profit that he makes in comparison with the marginal enterprise. We must decide whether the more intelligent, the more skilled, or the stronger worker must contribute the higher wages that he earns as compared with the marginal worker. We must decide, in a word, whether or not the more *fortunate* producers must pay for the less fortunate, and thus produce public goods that satisfy collective wants felt equally by both groups.

This method of distributing taxes is not new; its counterpart is to be found in the institution of the family, in which 'each member produces according to his capacity and consumes according to his needs'.

This is the germ of the phenomenon which may logically be

## DIRECT TAXATION

carried over from the private economy into the collective economy and may provide the theoretical basis for a distribution of taxes whereby 'the more fortunate pay for the less fortunate'.

To what extent can the sentiment of solidarity among the members of a family be transferred and transformed into the feeling of social solidarity? And to what extent will this transfer and transformation — if they are possible — be useful to society? This is a problem which it is not our task to solve, because, so far as the purpose of our theory is concerned, it merely states the conditions under which a given financial principle may be applied.<sup>1</sup>

It is important, on the other hand, to emphasize the fact that the principle of distribution followed by the family does not lead to progressive taxation, which progresses *uniformly* with the increase of income and avoids a detailed examination of the wants for which the less fortunate are not in a position to provide; it implies only that, when faced by the *ascertained* need of a social group with respect to which it has been established that its members are totally or partially unable to take care of themselves, and when the social desira-

<sup>1</sup> If one wished to discuss at some length the possibility and the desirability of the State's adopting the principles which regulate the economic life of the family, it would be necessary to extend greatly the limits of the problem of Public Finance. But if we wish to remain within the present limits of the latter, we can only call attention to a few general concepts.

The functions of the family are nowadays distinct from those of the State, since the family has lost the character of an embryonic political society and the State has absorbed the corresponding functions of the family, at the same time absorbing nuclei of several families.

Because of this increasingly sharp division of labour, the family restricts itself to members joined by natural bonds of blood and affection, and its economic function consists of educating the offspring and preparing them for the struggles of life by developing in them all the latent aptitudes that make victory easier when they will have entered society, where the struggle takes place. This is why, in this preparatory activity, the head of the family and the stronger members produce according to their capacity and spend according to the wants of the younger and weaker members.

But as soon as the latter, having become ready for the struggle, enter and become active members of society, they are compensated according to their merit, not according to their wants. This is the selective principle that assures to the community the survival of the fittest. In this principle Herbert Spencer sees the first and most general reason for the historical fact of the division of functions between the State and the family. But the principle has the value only of a first approximation; for the modern State produces services and makes expenditures that benefit the weak, the less able, without causing thereby any adverse selection, since it intends, by these expenditures, to reinforce the function of the family — that is, to select the more capable and to separate them from the mass of those who are and remain without adequate means and for whom modern society provides through the system of charity.

We must, therefore, proceed case by case. The selective principle sets the limits, in the sense that the contribution of the rich to the less fortunate social groups must stop when there is a danger that an exaggeration of this policy may lead to the survival of the less fit.



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bility of caring for them is recognized, the richer come forward to help. And this is the policy that is practised, as we shall see, in modern States.

It must also be pointed out that the principle according to which the richer or more productive member of society turns over a part of his income to the less productive or more needy member tends to make equal, *ope legis*, individuals who consider themselves different but whose incomes and needs it is desired to make more or less equal *in fact*, and that this has nothing to do with the theory of subjective value. It expresses, rather, the second aim that progressive taxation may set itself — namely, that of attempting to equalize the distribution of wealth — and thus opens the way for a treatment of the problem as a political one.

## CHAPTER VII

# POLITICAL THEORY OF PROPORTIONAL AND PROGRESSIVE TAXATION

**Summary:** The political character of proportional taxation — The political character of progressive taxation — The struggle between the rich and the poor — The policy of exempting the smallest incomes from taxation leads to progressive taxation — Effects of progressive taxation on the production and distribution of wealth and on the budget of the State — The theory examined in the light of actual conditions — The 'removal' of the tax from the smaller incomes to the larger is impeded by progressive taxation, but is not impeded by proportional taxation

HAVING arrived at the negative conclusion stated in the preceding chapter, which prevents our considering either the proportional or the progressive system of taxation as a corollary of the theory of value, we have only to treat the two systems as two *primary facts* deriving from political tendencies, each system corresponding to the interest of the classes that happen to be dominating.

In history, there are examples of taxation inversely proportional to wealth, as well as of proportional and progressive taxation.

Before the French Revolution there was in force an inversely proportional system which exempted the dominant classes and put the burden of taxation on the mass of the peasantry and the industrial bourgeoisie. The tax-exemptions were a part of the whole system of political privileges enjoyed by the secular and ecclesiastical nobility.

With the triumph of the French Revolution, the *third estate* found in proportional taxation the tax system which harmonized with the general political tendency that it championed.

Finally, with the growing influence of the masses, the tax system turned in the direction of progressive forms of taxation, which tend to modify the distribution of wealth in favour of the less fortunate classes.

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When the phenomenon of taxation is thus put on political ground, it cannot be treated as an abstract problem, isolated from the general political tendencies of a given historical period. It is a necessary part of a whole; it is connected with the other parts that form the whole and is determined by the causes that decide the general political tendency. Once this fact is established, the *theoretical* investigation consists of: (a) ascertaining in what relationship taxation stands to the general policy of the State; and (b) describing precisely what are the economic and fiscal effects of the system adopted; in order that in the struggle of opposing interests, each class may consciously choose its own method of realizing in practice the aims that it pursues.

The French Revolution affirmed in its legislation the system of *proportional taxation*. The latter, despite the fact that it was opposed by the extremists, who championed the progressive system as a means for equalizing the distribution of wealth, was the natural result of the political and economic thought prevalent at that time.

For proportional taxation strikes wealth objectively. That is, it strikes the 'thing', without regard to the person of the proprietor. It was this objective, non-personal character of the proportional system that led to its being carried into effect by the men of the Revolution, who wished, above all else, to protect themselves against the danger of a return to these privileges. They conceived the equality of all citizens before civil and tax law in a rigidly *objective* sense; hence their choice of proportional taxation, the application of which logically excludes all possibility of allowing favouritism on behalf of persons and classes.

This was the political merit of proportional taxation; but it also has an even more important economic merit, since it harmonized with the economic legislation of the time, which was guided by the principle of the maximum production and the indefinite accumulation of wealth.

Feudal civilization, with its privileges of the dominant landed class, with its relationship of *status* and not of *contract*, which subjected the vassal to the whim and the personal exploitation of the feudal lord, with its systems of emphyteusis, tithes, and quit-rents, which made intensive cultivation unprofitable for the vassal, had sterilized agricultural production and therefore undermined at its roots the political existence of the dominant class.

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Hence the necessity, with the increase of the population and the wants that arose therefrom, of breaking the chains that were an obstacle to the increase of production.

The scientific criticism which preceded and prepared the ground for the French Revolution had shown, above all, how the mass of restrictions placed upon the free circulation and division of landed property (entail, primogeniture, feudal property, mortmain, right of usufruct, etc.) made it impossible for such property to pass, by means of free contract, purchase, or the division of inheritances, into the hands of the persons most able to realize their maximum value.

In the second place, it had pointed out how the increase of production was hampered by the contractual forms then in force (emphyteusis, quit-rents, tithes, etc.). These contracts, while they forced the worker of the land to bear the risk involved in every new investment of capital and labour, continued to obligate him to pay the same share of the total product. This arrangement, which usually resolved itself into an increasing annual levy on net income, discouraged the vassal from any new investment for the purpose of introducing intensive cultivation.

Finally, the organization of the various crafts into guilds diminished the efficiency of human labour; this was the economic cause of the abolition of the guilds and of the consequent substitution of free for unfree labour. Other laws made it possible to transfer freely the property that had been tied up by mortmain, entail, etc., and transformed payments in kind into fixed and redeemable ground-rents expressed in terms of money.

In harmony with these reforms, proportional taxation is the fiscal system which respects to the utmost the production of wealth and capital accumulation. In fact: (a) it does not exercise, *per se*, any influence on the production of wealth, because it imposes the same burden — i.e., the same tax-rate — on each new unit of wealth produced, after deduction of expenditures of production; (b) it does not exercise any influence on the distribution of wealth, since it levies a uniform tax-rate on all incomes, and thus does not of itself create relatively more favourable terms of exchange either for those possessing small incomes or those possessing large ones; (c) in regard to the State budget, the proportional tax involves a single tax-rate, so that the ratio of total taxes to total national income is the same as the

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ratio of the taxes paid by each individual to his income, the tax having the exclusively fiscal aim of covering the financial needs of the State.

To sum up: proportional taxation respects the natural play of the economic forces involved and remains neutral as between them. For this reason it is the type of tax which was proper to an historical epoch that was dominated, on the political side, by the fear of a return to class and personal privileges, and, on the economic side, by the desire to avoid hindering the indefinite accumulation of wealth.

In other words, the problems of *production* prevailed over those of *distribution*, and found their natural expression in the system of proportional taxation.

### § 2

It is different with progressive taxation.

After the great advances that have in fact been accomplished with respect to the production and the accumulation of wealth, relatively greater importance has again begun to be attached to the problem of the distribution of wealth.

Just as, before the French Revolution, scientific criticism had initiated the movement against the obstacles that stood in the way of the increase of production, so, subsequently, it began the campaign against the social dangers involved in the formation and the concentration of large fortunes.

Hence the tendency to legislate against capitalistic combines, against inheritance and in favour of the breaking up of large estates, and then the whole growing structure of social legislation: laws with respect to woman and child labour, compulsory accident and unemployment insurance, workers' pensions, maximum working hours, minimum wage laws, free public schooling, free medical service to the poor, public baths, hospitalization, maternity care, and so forth.

This system of legislation, which we shall call *the policy of special benefits for the masses*, involves an increase of public outlays at the expense of all the taxpayers. Moreover, in order to prevent its coming about that the necessary taxes would be paid by the very classes which benefit from these expenditures, the system is logically supplemented and assured by tax exemptions — articles of popular consumption being exempted from indirect taxes, and small incomes exempted from direct taxes.

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All these measures, taken together, culminate in progressive taxation, which becomes the tax system corresponding to the new general orientation of economic policy, in which the problems of distribution predominate over those of production.

### § 3

Through progressive taxation, two somewhat distinct ends may be sought. In the economic field, progressive taxation is the means, according to the formula of Helvetius, 'of decreasing the wealth of the few and increasing the wealth of the many': that is, it aims at equalizing the distribution of wealth. In the fiscal field, it is the means of distributing the cost of public services according to the principle that 'some pay for the others'.

In both cases, it does not hide behind the screen of the theory of subjective value, but affirms its wish to realize a greater objective equality among the citizens and their property, by calling on the more fortunate to pay, in greater or less degree, for the less fortunate.

The aspiration toward the equality of men is an irresistible force that has overcome all the political and religious barriers which had been created for the benefit of the dominant class, and has been checked only by the insurmountable natural barriers which are set up by the inequality of individual abilities. Hence arose and arises again — along with other problems — the problem of progressive taxation.

Other conditions being equal, it may be said that in the countries in which the numerical strength of the masses has achieved a preponderant political influence, progressive taxation becomes the banner of the struggle between the rich and the poor. The latter advance by attacking with progressive taxation; the former defend themselves by advocating proportional taxation.

This is the present position of the political problem.

### § 4

It may be useful to point out, incidentally, that in the more civilized and progressive countries, the contemporary struggle has lost some of the primitive violence of former times. The old formulae, which proclaimed that property was theft and demanded its expropriation without indemnification, the insurrections of the labouring

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classes, and the violent occupation of landed estates and factories, have given way to the demand for nationalization, the winning of higher wages and the right to strike, social legislation, and exemptions from taxation.

More attenuated forms of struggle succeed more violent forms.

Various reasons combine to explain this fact.

The organization of modern society is founded on the *principle of advancement* (*principio del divenire*) — that is, on the right of every citizen to pass from an inferior to a superior class — and not on *status*, which restricted everyone to the conditions in which he was born.

The struggle between the rich and the poor no longer takes place between two well-defined classes, in a closed field. To-day there exists a scale made up of increasingly numerous groups which, shading closely into one another, represent all gradations of wealth. Thus each group finds itself between the group immediately beneath it, from which it arose and to which it may return, and that immediately above it, to which it aspires; in this way it serves as a natural cushion in the struggle between the two. The series of groups forms a system of cushions which lessens the shock of conflicting interests.

Passing now to the economic causes, we may point out that the unprecedented leap which production took in the nineteenth century has shown leaders of the proletariat that the increasing share of wealth in process of formation which is obtained by the worker is a more important quantitative factor affecting his welfare than would be a splitting up of lands or a general redistribution of existing divisible property.

Similarly, the large industrial organizations have made these leaders see the importance of the directing and intellectual factors in production. The worker fights the capitalist, the entrepreneur, and the inventor, in order to modify the distribution of the product in his own favour; but he knows that without the capital of the first, the ability of the second, and the inventiveness of the third, large-scale industry could not, by means of labour alone, produce increasingly numerous and cheaper products.

From this it follows logically that the labouring classes do not or ought not to have an interest in obstructing the increase of production and the formation of large enterprises and large fortunes.

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As far as the employing classes are concerned, moreover, the complaisance with which they have accepted the growing policy of special benefits proceeds *pari passu* with the increase of production.

While they have accepted the policy of special benefits, however, they have resisted and resist the adoption of progressive taxation.

### § 5

It is true that the policy of special benefits is, in its general effects, the first blow to the economic system of industrial liberty and the fiscal system of proportional taxation, but it is still not the same thing as progressive taxation. On the contrary, from public expenditures made for the special benefit of the classes considered poor and from the fiscal exemptions made in favour of the latter, one cannot pass logically to progressive taxation.

The proletariat, in fact, attempts to enlarge the sphere of its class benefits by urging the increase of the taxes from which it is exempt, but it has no interest in whether the tax-burden which is involved is distributed proportionally or progressively among the propertied classes.

To be sure, to the extent that the system of special benefits is enlarged, there must also be an increase in the levy imposed on all the taxpayers. Given the system of proportional taxation, a point will be reached at which the economic condition of the upper proletarian groups will be superior to the condition of the lowest brackets of the smaller taxpayers, who will react-against such a situation.

It may then happen either that the smaller taxpayers will ally themselves with the larger taxpayers in order to resist the increase of proletarian privileges, or that they will make common cause with the proletariat against the larger taxpayers. The proletariat is anxious to break up the taxpayers' bloc by detaching from it its most aggressive group; the lower middle class is anxious to ally itself with the stronger party. In this way, the second alternative represents the line of least resistance, and prevails.

As a result, the lowest bracket of smaller incomes obtains compensatory tax-relief: that is to say, it obtains a reduction in the rate of proportional taxation. For, in proportion as the distance between the proletariat and the lowest bracket of taxpayers decreases, the



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distance between the latter and the next bracket of taxpayers increases; the latter, in its turn, will demand reductions in the tax-rate, even if only to prevent the possibility that, after having paid the whole tax, this second class of taxpayers will have an income equal to, or only slightly higher than, the income of those in the class beneath it, which has obtained the tax-relief.

At the same time, the Treasury, *ceteris paribus*, must find within the higher income-brackets some compensation for the graduated reductions granted to those in the lower income-brackets.

From this readjustment of tax-rates, kept at the start within modest limits of a technical and fiscal character, is born progressive taxation in an attenuated form, which is logically connected with the policy of special benefits, and becomes an integral part of the programme both of the proletariat and of the lower middle class, which likes to call itself the intellectual proletariat.

This is the first stage in the life of progressive taxation. It is born of the *internal pressure* which the groups of smaller taxpayers exercise on the groups of larger taxpayers; but it is set in motion by the *external pressure* that the policy of special benefits exercises on the smaller taxpayers.

### § 6

As soon as the principle of progression attains this initial success, it has before it a free road for all further development. For, by reason of its formal structure, it does not know the checks and limits to which the policy of special benefits is subject. In the case of the latter, every expenditure is discussed as a separate case in relation to a definite purpose and a definite group of persons, and with the expectation that the sacrifice of the rich taxpayers will eliminate an inconvenience or an evil or a social plague which represents a need also of those classes which pay. Once the discussion is put on this basis, it usually leads to a compromise—that is, to a legislative provision that guarantees relative stability for the future.

Progressive taxation, on the contrary, is a general method of distributing the total amount of public expenditures—whether old or new—according to a formula that causes the tax-burden to increase automatically with increases of income. In order to put the whole tax-burden on the rich, all that is necessary is to increase at a

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given moment the progressive ratio. In modern countries, at the same time that the proletariat and the lower middle class exercise their increased political influence in order to demand continually new expenditures, they find at hand the instrument best adapted for shifting to the wealthier classes the burden of increasing taxes.

Thus arises and is accentuated the danger — involving a fundamental economic and constitutional contradiction — that an increase in expenditures will be demanded by those who do not pay taxes, while the taxes will be paid by those who do not demand an increase in expenditures.

This is a reproduction, with the rôles reversed, of the situation that existed before the French Revolution.

Once the first dam has been breached, therefore, progressive taxation tends to break out of the modest limits set to it at the beginning and to become transformed into a weapon in a remorseless struggle against the propertied classes. The latter oppose such taxation not so much for what it was in its beginning or for what it may be at a given moment, but for what it may become: it threatens the gradual confiscation of large and growing fortunes. For this reason, it cannot provide a point of political equilibrium.

### §7

What the outcome of this class struggle will turn out to be in the long run may be foreseen if we take as a norm the historical experience of the past. But our task is to make clear the more immediate economic and financial effects of the system of progressive taxation. This constitutes the second part of our theoretical investigation.

We must take as our premise the assumption that the progressive tax which we are now about to discuss must have attained, in the course of its legislative development, a height capable of exercising a noteworthy effect on the distribution of wealth. For, if it retains a mild form, in which the tax-rate rises by a few dollars, or a fraction of a dollar, for every \$1000 of higher income, it is very probable that there will be no tangible effect; but then the problem itself would not exist.<sup>1</sup>

<sup>1</sup> Such 'mild' forms are in use in *complementary* taxes on income, which represent a secondary and sometimes negligible part of the tax system, the latter continuing to remain on a proportional basis. It should be remembered that we take as our hypothesis a progression that runs through the whole tax system.

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Assuming sharply progressive taxation, however, we may say that a progressive tax reacts on production as a cause of decreasing yield.<sup>1</sup> From this we have the following consequences: (a) progressive taxation is an obstacle to the increase of production and saving;<sup>2</sup> (b) it modifies the previously prevailing terms on which goods were exchanged, because the tax-burden per unit changes according as production is large or small, and according as every unit produced is part of a larger or smaller whole. Thus, a large business that produces 1000 units as compared with one that produces 100 will, *ceteris paribus*, have, after the payment of the tax, an income less than ten times larger than that of the smaller enterprise. And since in exchange incomes are capitalized on a net basis after deduction of the tax, the capital value of instrumental goods (governmental bonds and industrial shares, professional clientele, houses and lands) differs according as the sale is made by the less rich to the richer, or vice versa.

Let us take as an example an owner of ten farms, who pays a progressive tax that ranges from 1 per cent on the first farm to 10 per cent on the tenth. If he sells a farm to someone who has twenty farms and already pays 20 per cent and would therefore have to pay 21 per cent on the new acquisition, the transaction is made difficult, since the two parties will have to divide a margin of loss and not of gain. But if he sells the same farm to the owner of two farms, who will pay 3 per cent on the new acquisition, the exchange will be facilitated by the fact that the two parties will share a margin of profit as a result of the smaller tax.

The same may be said of the distribution of the shares of business corporations; since it would be advantageous to avoid their concentration in a few hands, in order to give them up to small shareholders, whenever the tax strikes the dividend as received by the individual stockholder and not the corporation as such.

Progressive taxation, then, works in the direction of a breaking-up of large estates and large enterprises.

And even if this retrograde process will not be rapid because of

<sup>1</sup> Cf. my *Carattere teorico, etc.*, Chap. III, § 7, p. 162.

<sup>2</sup> The *tithe* on land was a proportional tax on the total product of the soil, but it became progressive on the net product, and was an obstacle in the way of increased production, whence its commutation into a fixed payment in kind or in money, and its subsequent abolition.

## DIRECT TAXATION

the action of frictional forces, it is certain that new savings and new labour will by preference turn — *ceteris paribus* — to the formation of smaller forms of property and enterprise.

### § 8

Against this conclusion it may be objected that the process of breaking up large fortunes cannot come about, since the seller will pay, on the price obtained, the tax that he used to pay on the property that he sold, and that the buyer will continue to pay, on the property he has bought, the tax that he used to pay on the price of the property he has sold. But such an objection does not take into account the fact that the forms of wealth range from the ownership of land, which represents the maximum of immobility, to circulating capital, which represents the maximum of mobility; hence the latter offers possibilities for evasion that the other lacks, and succeeds more easily in evading proper appraisal by the Treasury.

Moreover, if it is true that it becomes more and more difficult to escape the methods of appraisal which the fiscal authorities are perfecting every day, it is also true that it is becoming increasingly easy to invest one's savings abroad.

Nowadays, it may be stated with certainty that the country in which the return on free capital is highest functions as an equilibrating market.

Hence it will come about that free capital will tend, first, to pass into the hands of those who own large fortunes in the form of movable property, and then to emigrate abroad, to the extent that it will not succeed in evading the rigours of appraisal.

The foregoing analysis leads logically to the conclusion that progressive taxation is a force that tends (*a*) to check the formation of large fortunes, and (*b*) to encourage the breaking up of the existing large fortunes consisting of tangible property. In a word, taken by itself and on the assumption that other conditions are equal, it works in the direction of the levelling of fortunes, which is precisely the aim assigned to it by the political theory of the subject.

### § 9

These economic effects on the production and distribution of wealth react, however, on the State budget, in as much as, if they

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bring about tax-evasion, and to the extent that they bring about such evasion, they must cause a decrease in the public revenues.

The investigation of the fiscal effects of progressive taxation constitutes the decisive point of the theory. Let us start from the premise that the tax serves, above all, to cover the financial needs of the State; and that only eventually and in a subordinate way can it serve as a means for modifying the distribution of wealth. For if it had to serve principally as a means of combating the accumulation of large fortunes and favouring small fortunes, other and more efficacious legislative methods would take its place.

Let us now suppose that it is desired to pass from a proportional system, in which a rate of 10 per cent covered the financial needs of the State, to a progressive system by which the same needs must be covered.

If all other conditions remain equal, it will be necessary to impose a tax of less than 10 per cent — let us say 6 per cent — in the lower income-brackets, a tax of 10 per cent in the medium income-brackets, and 14 per cent on the higher incomes. Let us suppose that, at the start, the three progressive percentages of 6, 10, and 14 are calculated arithmetically in such a way as to cover the financial needs of the State, instead of a single rate of 10 per cent being used.

Now, as soon as it is established that the economic effect of the breaking up of the existing large fortunes has come about, these fortunes tend to enter into the category of medium-sized fortunes and will pay 10 per cent instead of 14 per cent. In this way, the total yield of the tax will decline. The financial needs of the State are not covered, and it is therefore necessary to raise the scale of progressive rates. This will accentuate the process of breaking up the large fortunes and will tend to extend it also to the medium-sized fortunes, which will enter into the category of small fortunes. The process will continue until, with the tendency toward an equalizing of fortunes, we shall in fact have returned to the equalizing of rates — that is, to proportional taxation. In this way, progressive taxation tends to destroy itself.

Now that we have arrived at this result, it may seem that the sum of the small and medium fortunes resulting from the breaking up of the large and very large fortunes will not have decreased the total of national wealth; so that when the rate of 10 per cent is again

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established, the Treasury will have realized its social aim of equalizing the distribution of income, without any sacrifice of public revenues.

Nevertheless, the fact would still remain that the further increase of saving would have been hindered by the increasing rates of progression, which would again begin to function. The amount of the national wealth would tend to become stationary. From this fact follow two consequences: (a) the Treasury could not count on a future increase of public revenues; and (b) the small fortunes would have to renounce the prospect of future reductions in taxation which the progressive system had promised them.

Hence the policy which aims at an equalization of the distribution of wealth is in conflict with that which aims to shift the tax-burden from the poorer classes to the rich. The one eliminates the other. If, therefore; modern states aim to lighten the tax-burden of the poorer classes, the policy is necessarily confined to limits which are the narrower in proportion as progressive taxation succeeds in equalizing the distribution of wealth. *Converse*, this policy of lightening the tax-burden of the poor is capable of an increasing development to the extent that, other conditions being equal, the larger fortunes increase in number and importance.

The point of highest returns for this policy is obtained (a) by applying a proportional rate on the medium and larger incomes, so as not to interfere with the incentive to save, and (b) by lightening gradually the burden on smaller incomes, in proportion as the accumulation of wealth automatically assures increasing revenues to the State.

Then it is said that taxation assumes a *degressive* form.

### § 10.

The theory that we have sketched in broad outline on the basis of the tendencies brought about by the play of economic forces gains in precision when it is examined in the light of actual conditions.

• How national income is distributed among the various classes of income-receivers in the civilized countries of our time is well known.

In order to describe this distribution, recourse has been had to the figure of a peg-top, or a spindle of yarn. Without entering into subtle discussions about the variants among the proposed curves of income-distribution, we may say that for purposes of discussing

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the problem that concerns us here, it is important to know what part of the total income of the country belongs to each category of incomes and income-receivers.<sup>1</sup>

Financial statistics give us fairly complete data for the incomes that are above the line which corresponds to the maximum diameter of the peg-top or the spindle.

The sum of the larger individual incomes which occupy the top section of the upper part of the spindle represents a percentage of the total national income which is less than the percentage represented by the sum of the lower individual incomes which occupy the second section as we pass from the upper point toward the centre of the spindle.

In general, in proportion as the size of the individual incomes decreases, this percentage increases until it arrives at the maximum, which is found at the centre of the spindle, where we find those incomes which are regarded as the medium-sized ones for any given country.

But as we pass down from the centre toward the lowest point of the spindle, the sum of the small incomes also tends to represent a decreasing percentage of the total national income.

Below the line of the greatest diameter, sufficient and reliable data are not always available to show what the curve really is, since financial statisticians usually group in a single bracket the mass of lower and smallest incomes, which are exempt from taxation. There are, however, enough inferential data to warrant the statement that the law of distribution for the lower, tax-exempt incomes follows, inversely, the law of distribution for the higher incomes.

In the absence of these data, the distribution takes the shape of a pyramid, in which the relatively largest part of the national income would be composed of the incomes that tend to become concentrated toward the base — that is, the mass of small incomes.

For purposes of illustration, some statistics may be adduced which are not in all cases recent, but are nevertheless important for purposes of theory.

<sup>1</sup> It is well not to confuse the number of taxpayers, which becomes small as one passes from the smaller to the larger incomes, with the relative importance that each group of incomes has as compared with the total wealth of the nation. If the number of the owners of large fortunes, for example, were very small, and the total of their fortunes were very large, this last datum would be the one that we should need in order to study progressive taxation.

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Wagner gives the following table for Saxony:

Income-bracket		Number of recipients	Total amount in marks
Below	800 marks	830,000	381,000,000
from	800 „ to 3,300	227,000	330,000,000
„	3,300 „ „ 9,600	24,000	134,000,000
„	9,600 „ „ 26,000	4,000	62,000,000
„	26,000 „ „ 100,000	900	39,000,000
„	100,000 „ „ 300,000	85	16,000,000

Here the distribution of incomes and that of their recipients suggests the pyramid rather than the peg-top or the spindle. But if we could follow the distribution of incomes below 800 marks, the figure of the peg-top would probably appear.

The data of Giffen for England are well known.

Professor Mazzola takes from Boiteau the following statistics with respect to the distribution of landed property in France:

Smallest class, up to	2 hectares	5,200,000 hectares
Small „ from	2— 6 „	7,750,000 „
Medium „ „	6— 50 „	19,000,000 „
Large „ „	50— 200 „	9,300,000 „
Largest* „	more than 200 „	8,000,000 „

But recent Prussian statistics<sup>1</sup> bridge the gap, since they show the conformation of the curve of incomes below 900 marks, which are exempt from taxation, and represent exactly the figure of the spindle.

It is worth reproducing these figures, or at least the totals referring to the various classes of tax-payers.

Groups or classes of taxpayers	Total income of each group (in millions of marks)	Percentage of total national income	Percentage of total number of tax-payers
I. The richest class with more than a million in individual (personal) income	224	1	0.3
II. The next class, from 100,000 to 1,000,000 marks	1,027	4.59	

<sup>1</sup> *Zeitschrift des Preussischen Statistischen Landesamts*, 58 Jahrgang, 1918, p. 69.



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<i>Groups or classes of taxpayers</i>	<i>Total income of each group (in millions of marks)</i>	<i>Percentage of total national income</i>	<i>Percentage of total number of taxpayers</i>
III. The next class, from 40,000 to 100,000 marks	1,237	5.53	0.9
IV. The next class, from 10,500 to 30,500	1,799	8.04	
V. The next class, from 3,300 to 9,500	3,130	14.00	4.0
VI. The next class from 1,050 to 3,000	9,942	44.43	42.4
VII. The class of 900 and less	5,014	22.41	48.8

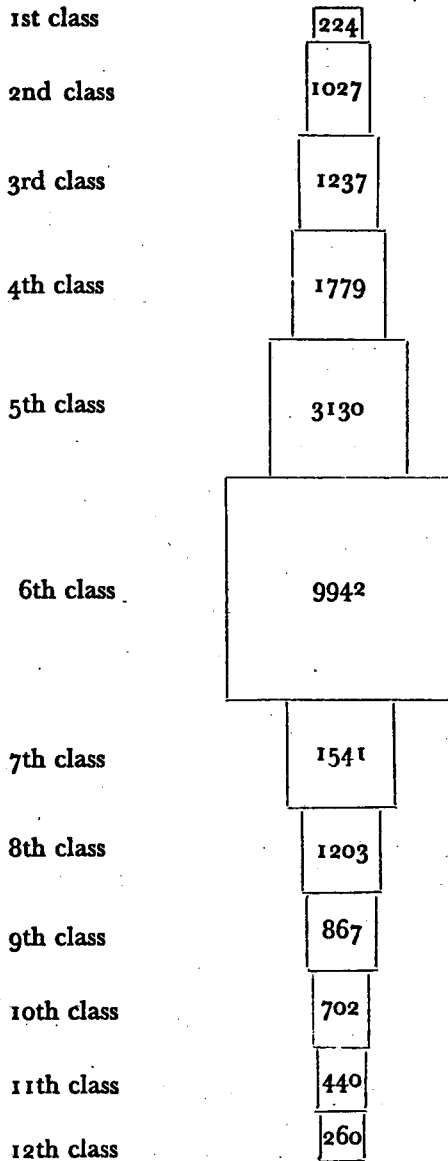
But this group of more than 5 billion exempt from taxation breaks up into the following decreasing series of small incomes:

(a)	Incomes of 900 marks	1541	6.9
(b)	„ 800 „	1203	5.3
(c)	„ 700 „	867	3.8
(d)	„ 600 „	702	3.1
(e)	„ 500 „	440	2.0
(f)	„ 400 „	260	1.0

The first column of this table may be represented by the following diagram, in which the area of each square measures the amount of income of each individual class, exclusive of the seventh, the place of which is taken by the six classes of income less than 900 marks:<sup>1</sup>

<sup>1</sup> The squares were constructed by taking the square root of the figure representing the total income for each class, so that the area of each square is equal to the total income of each class. The figure closely resembles that of a spindle. It was constructed by a student of mine during the academic year 1925-1926.

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The data and the diagram confirm the general statement that nowadays the total amount of the medium-sized incomes occupies the central and largest section of the spindle, while the large and very large incomes tend toward the upper point, and the small and very small incomes tend toward the lower point of the spindle.

What the typical amount of the medium-sized incomes will be depends on the wealth in each country; but what it is important to establish is the fact that in every country there is such a typical income, which represents the relatively largest part of the national income, and which in fact makes the largest contribution to the financial needs of the State.

A progressive tax which proposes to modify the distribution of income must begin by respecting the 'typical size', whatever it may be, of the medium incomes: since, if there were to be applied to such incomes a percentage smaller than the proportional rate existing previously, or a higher percentage which would work in the direction of breaking up the holdings of property into smaller units, this would reduce the public revenues, ultimately if not immediately.

If, in the case of England,<sup>1</sup> respect should not be paid to the two nuclei of incomes which are located between £200 and £1000, and between £1000 and £10,000, respectively, the English budget would, in the end, lose the largest source of its income. The same would happen in Prussia if the proportional rate which had previously prevailed on fortunes from 1500 to 3000 and from 3000 to 9000 marks were lowered.

From this it follows that the supposed social influence of progressive taxation, when it is subordinated to, or allied with, its financial function, cannot modify, to an appreciable extent, the status actually prevailing in any given country.

### § 11

There remains, as the only possibility for the use of progressive taxation as an instrument of social policy, the lightening of the burden on small incomes, the revenues thus sacrificed being made up by heavier levies on the large incomes. A lightening of the burden on the former and a compensating increase in the burden on the

<sup>1</sup> I have reference here to Giffen's data.

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latter are the two mutually complementing factors in the more modest problem as it presents itself in reality.

In order to practise this policy of tax-relief in such a measure as to be noticed by the recipients of smaller incomes, it is necessary to put a very much greater burden on the large incomes. Given the quantitative relationship that exists between the total amount represented by the large incomes and that represented by the small incomes, a slight amount of relief for the latter brings a notable increase in the burden on the former.

According to the data on the distribution of income in Prussia, the large incomes — if we regard incomes of 10,500 marks as 'large' — amount to 4,287,000,000, and the small incomes, of 900 marks and less, amount to 5,014,000,000.

If, for example, under the proportional system, all paid 10 per cent, it would be necessary, in order to provide exemption for the incomes of 900 marks and less, to raise the tax to 22 per cent on the larger incomes. And if, as is probable, the group of large incomes is made up of incomes of 100,000 and higher, the compensating percentage would have to be raised from 22 per cent to 50 per cent.<sup>1</sup>

The higher the progressive percentage on large incomes, the more the spirit of thrift is discouraged in the recipients of medium-sized incomes, since they no longer find the same incentive as before to pass into the upper income-brackets. Thus, in the end, there is a weakening and destruction of those sources of taxation which were expected to provide the necessary compensation, and the policy of exemptions is found to be feasible within increasingly narrow limits.

On the other hand, the development of this policy depends on the accumulation of wealth. And for this reason the formula that assures the maximum development of this policy is that of a degressive tax that would become a proportional one for the medium-sized and large fortunes. If the financial needs of the State remain constant, tax-relief can be gradually extended from the lowest incomes to the *lower* incomes and from these to the lowest brackets among the medium-sized incomes, in proportion as the total amount represented by the large incomes increases.

This, however, is nothing but the practice of 'exemption of the

<sup>1</sup> In Prussia it has been possible to exempt a total of 5 billions of small incomes because it has been possible to work with small tax-rates, since what was involved was a complementary tax, which was expected to take care of only a small part of the total financial needs of the State.

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minimum incomes' that is embodied in the legislation of all progressive countries and which is capable of continuous development.<sup>1</sup>

The logic is conclusive, and experience confirms it.

The country which has been able to push to the maximum the policy of exemptions and relief in favour of the smaller incomes has been England, where the accumulation of wealth, favoured by a liberal economic policy and by proportional taxation, has been greater, and where the minimum exemption had reached, in the pre-war period, the limit of £160, while the full rate of income tax — that is, income tax and surtax — begins only with incomes of £2000.

To sum up: the interest of the Treasury in assuring itself the largest possible permanent and increasing yield from taxation, and the interest of the less well-to-do classes in obtaining the largest possible permanent and increasing exemptions are the two automatic checks that prevent or should prevent progressive taxation from becoming a weapon to be used against the accumulation of wealth.

The leaders of the masses often forget that the indefinite accumulation of savings has reduced the cost of living, increased the reward to labour, and assured a steadily increasing yield in taxation and therefore has made possible a policy of increasing exemptions from taxation for the benefit of the small incomes; they give way to the common illusion that they will be able to preserve the benefits of greater production and at the same time to win, to their advantage, the benefits of a better distribution of wealth. But to wish a better distribution of wealth and to impede the growth of that which is to be distributed, to want tax-relief and to hinder the increase of taxable income are fundamental and indestructible contradictions.

<sup>1</sup> See Book III, chap. VI.

## CHAPTER VIII

# THE SINGLE TAX AND THE ORGANIC STRUCTURE OF A SYSTEM OF MANIFOLD TAXES

**Summary:** The problem of the single tax and of manifold taxes — The single tax on total income — The system of manifold taxes develops into a 'fiscal organism' — The single complementary tax

### § 1

UP to this point we have discussed the problems of the distribution of taxation upon the hypothesis of a single tax — that is, a single tax-rate on the total income of the taxpayer.

Historical reality, however, does not correspond to this hypothesis, since both ancient and modern States have lived under a system of manifold taxes. The total income of the taxpayer is, first of all, divided into various categories — income from personal property, income from buildings, income from professional activity, etc. — according to its nature and origin, and each category of income is subject to its own tax. Income is also classified according to whether it is being produced, or distributed, or consumed, or invested, and on each of these occasions a direct or indirect tax is levied.

So far as the historical antecedents are concerned, it is sufficient to state that we have inherited from former ages a mass of taxes which arose as mere expedients, assembled not according to any criterion of organic co-ordination, but rather as the result of a mechanical process of juxtaposition and superimposition which followed the line of least resistance — that is, of greatest political weakness of those taxed. All the taxes were independent of one another; an increase in one did not involve an increase in another. On the one hand, some incomes were exempted from taxation; and on the other, some incomes were burdened with double, triple, and multiple taxation. These are the characteristics of a system which is at once the effect and the cause of the most unrestrained sort of class politics.

## SINGLE TAX AND MANIFOLD TAXES

Because of this situation the oppressed classes started and gradually strengthened a political reaction, to which has been joined a scientific criticism, directed toward the simplification of the tax system and leading extremist doctrinaires to the uncompromising demand for a single tax.

The French Revolution destroyed the old system of manifold taxes and introduced a new system of such taxes, which, since the new taxes were reduced in number and simplified, and were based on the principle of the equality of all citizens before the law in matters of taxation, tended to avoid duplication and to fill the gaps.

Then the system developed anew along the old lines, the number of taxes being increased and the previously existing inequalities reproduced, though perhaps in a more attenuated form.

To many writers both before and after the French Revolution, the single tax has seemed the most direct and radical means of correcting these inequalities.

Now, it is obvious that the income which in the end bears all the taxes is a single income; it is also obvious that the single tax would give the taxpayer a clear understanding of exactly how much public services cost; it is obvious that such a tax would make it easier for the taxpayers to draw comparisons between their several tax-bills, in order to arrive at a fairer distribution of the tax-burden; it is obvious that the single tax would reduce to a minimum the expenses of collection.

All of these would be clear advantages of the single tax, each of them corresponding to a disadvantage which was pointed out by the criticisms levelled against the system of manifold taxes. But all this abstract discussion presupposes that the total income of every citizen is already known in concrete terms. On the contrary, it is in the possibility of ascertaining this income that the real crux of the problem lies.

### § 2

The first projects cherished the idea of a single tax that would fall, not on the sum of individual branches of income, but on only one of these branches. A classic example was the single tax of the physiocrats 'on the net product of the soil'; and this was followed by proposals for a single tax on 'expenditure', a single tax on 'capital',

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a single tax on 'houses', a single tax on 'visible incomes', and so forth.

In every one of these projects, what is involved is a single *partial* tax: i.e., a single tax which is intended to strike only a *part* of total income. In order to provide their projects with a reasonable basis, the authors usually supplement their theory of the single partial tax with a theory of the shifting and diffusion of taxation. Accordingly, the whole of the tax-burden would be by law concentrated on only one category of income, and it would be left to shifting to diffuse it and distribute it equally among all the citizens.

It is not necessary to enter into a specific criticism of each individual proposal, since we have already seen that the phenomena of shifting cannot be counted upon to rectify all initial tax inequalities; on this account, the necessary presupposition of the theory of the single partial tax falls.

The only single tax that may still be discussed nowadays is that which aims to strike the total income of each individual.

But even on this concept a first limitation must be placed: namely, that it is not possible to speak of a single tax that shall take the place of direct and indirect taxes. For, as we have already seen, it is necessary for technical reasons that the two types of tax should exist side by side. Hence the absolute principle of a single tax becomes changed into another, and more modest, proposal: namely, that of a 'single direct' tax, as compared with the system of manifold direct taxes.

The presupposition of the proposal for a single tax is that it is possible to ascertain total income directly. If a synthetic method were available for the ascertainment of the total income of every citizen with uniform results, the single tax would solve the problem of simplification. But the concrete problem resides precisely in making the hypothesis a reality. We do not possess such a method, unless we are prepared to accept as true and unimpeachable the declaration of the taxpayer, despite the fact that he has the greatest interest in evading the high single tax that threatens him.

The declaration must always be examined critically. But the control can be made only by means of an analytical procedure which goes back on the declaration of total income to the source of each individual part of the income, ascertaining it at the moment of its production, or acquisition, or investment, catching it in the act of circulation or consumption, and discovering it by means of



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controlling data derived from bequests, contracts of sale, lease, insurance, or loan, and so on. This analytical procedure of control is precisely the basis of the system of manifold taxes.

For if, in order to control the declaration of the taxpayer, it is necessary to go back to the source of the various parts that make up the total income, this fact provides the natural basis of the system of manifold taxes. To go back again from this to the single tax would be a mere arithmetical operation that would complicate, rather than simplify, the system.

This is one of the causes that explain why the tax system has taken its present form.<sup>1</sup>

### § 3

The sponsors of the idea of a single tax desire essentially to insure to all taxpayers a greater equality of treatment; but from what has already been said it follows that the defects of a system of manifold taxes are not eliminated by the substitution of a single tax that strikes the whole, in place of the system of several taxes that strike separately the individual parts of the whole. The solution of the problem — at least for the present — lies in the continuous perfection of methods of appraisal. This comes about according as all incomes tend to be appraised with equal rigour. But in order to come close to such a result, it is necessary to follow different methods for the various categories of incomes.

The same thing holds for the tax-rates. It would seem that a single tax-rate gives a greater assurance of equal treatment. This would be true if all incomes were ascertained with the same degree of exactness; but since this condition is never completely realized, only different tax-rates can neutralize the inevitable inequality in the appraisals, assuming that the legislator really wishes to remove such inequality. For example, if the salaries of public functionaries, or even the incomes of landowners, were subjected to the same tax-rate as that to which the incomes of professional men are subject, this would not be equal treatment.

<sup>1</sup> I do not wish to exclude *a priori* the possibility that where greater credence is given to the declaration sworn to by the taxpayer, and the Treasury contents itself with controlling it by coefficients of correction established on the basis of the style of living evidenced by the taxpayer, the reason for the analytical control discussed above would disappear. With the premises changed, the conclusions would change. All this varies according to the period and the country involved.

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To the extent that the conditions stated above are realized, the system of manifold taxes becomes transformed, or tends more and more to be transformed into a co-ordinated system, — that is, into a 'fiscal organism' in which the various taxes rigorously condition one another, and co-operate to produce the following three-fold result:

(a) no income or part of an income escapes appraisal, and therefore escapes taxation;

(b) no income is taxed more than once nor pays more than one tax;

(c) all incomes are affected equally.

The present tendency is for the system of manifold taxes to be perfected as a fiscal organism, in order to accomplish the end which theorists assign to the single tax on total income.

### § 4

There remains to be considered an intermediate system, which consists of the transformation of the various taxes into just as many sub-categories of a single tax, the respective incomes being subjected to the same tax-rate.

The type of system here suggested is that of the English income-tax and also the Italian tax on income from movable property.<sup>1</sup> This system differentiates several categories of income — as, for example, income from land, from capital, from industry, and from the professions — but the rate is the same on all.

In this way, it is said, when the law raises or lowers the tax-rate, the increase or diminution is reflected automatically in all categories of income.

It has already been noted, however, that each category demands, at best, a treatment that is formally different, if the various types of income are to be treated equally in fact. In view of this consideration — and for other reasons that will be discussed further on\* — recourse has been had to the expedient of allowing different quantitative deductions for each category of income, so that although apparently a single tax-rate prevails, each category is treated as if it were subject to a different rate.

<sup>1</sup> [Italian: *imposta sui Redditi Mobiliari* — Translator's note]

\* See Book III, chap. v.

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In this way, the single tax-rate becomes a method of protection which is more apparent than real, since, at the moment it is raised or lowered, a change may be made in the deductions that were formerly allowed in the various categories — and indeed, this has actually happened in Italy and in England — in order to increase or to lighten the tax-burden on some categories of income as compared with that borne by others.

From this we may conclude that science lays down the principle that must be followed if it is desired to assure equal treatment to all taxpayers; but that the attainment and preservation of such a result depends on historical experience — on the political combativeness of the interested groups, and on the sense of equity displayed by the dominant class.

### § 5

Though we have excluded the possibility that the single tax may serve to simplify or to correct the system of manifold taxes, such a tax might be regarded as an element of the tax system that is necessary in order to introduce progressive taxation, which presupposes a knowledge of the total income of each individual. On this assumption, the purpose may be accomplished in two ways: (a) a single tax may be *substituted* for the various direct taxes in force; (b) or the existing system may be left intact, while another tax, progressive in form and of a complementary nature, may be *super-imposed* on the existing system.

In modern states, there is an increasing tendency to establish a single *complementary* tax on income, which accomplishes most economically the purpose of progressive taxation, inasmuch as it does not disturb the historical structure of the existing direct taxes. Indeed, such a tax may, as we shall see, serve to perfect the existing system.<sup>1</sup>

<sup>1</sup> The treatment of the complementary tax on total income must be left for our discussion of the positive structure of direct taxation (see Book IV, chap. 1).

## CHAPTER IX

### THE BASIS OF DIRECT TAXATION

**Summary:** The basis of taxation is the *value* of the goods taxed — Definition of the concepts of *wealth, capital, property, product, and income* — Does taxation fall on the value of capital, the value of the product, or on income? — From the tax on the product we pass to the tax on income — The classification of taxes is derived from the concept of income

#### § 1

UP to this point we have been discussing the tax on *income*, which was a logical deduction from the principle that income is taken as an index for measuring the demand for and the individual consumption of general public services.

Moreover, it is a fact that all our direct taxes fall on income. To be sure, the law always speaks of 'net income'; but before coming to net income, a long historical road had to be traversed.

The tax on land was based, in relatively ancient times, and in some new countries is still based, on the area of the land taxed. In the same way, the tax on persons and on intangible property took the form of a capitation or poll-tax, and the tax on houses was fixed on the basis of the number of doors and windows in the house and the length of its façade.

It may be admitted as an obvious truth that the fiscal relationship is a value-relationship, and that the area of the land, or the number of ploughs, the length of the front of a house, and the number of its doors and windows are taken as indices measuring value. What is involved, more than anything else, is a method of inferential and rough valuation, of the kind that sufficed under primitive economic conditions, in which there was less differentiation and more uniformity as between one piece of land and another, one house and another, and one type of personal activity and another.

As economic progress comes about, however, the process of differentiation of values becomes accentuated, and these indices become insufficient. In place of the area of the land and the number

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of ploughs are put other methods of appraisal which take account of the differences in productivity between one piece of land and another; in place of the frontage of a house is put a valuation which takes account of the cubic content of the house, the size and number of its rooms, and the street on which it is located — elements which give a different value for each building. The poll-tax becomes transformed into a tax according to 'classes' and then into a tax on individual income.

If we accept the proposition that taxation involves a value-relationship, the question then arises whether the basis of taxation must be the value of instrumental goods, or the value of direct goods. If the former is called capital, and the latter is called product or income, the question is whether a tax should fall on the value of capital or on the value of the product.

Since we shall have to discuss taxes on property and taxes on product and income, it would be well to clear up in advance the meaning of these elementary concepts.

We have already called attention to the fact that the quantity with which economics deals is not the *thing* of the jurists, but *utility* in whatever form, time, or place it shows itself, just as physics deals with heat and electricity. Economic utility is, in general, the capacity attributed to things, persons, and services for satisfying human wants directly or indirectly. An 'economic good' is every thing, every act, every service that an individual considers useful and wishes to acquire, in a given quantity, at a given time and place, in order to satisfy a given need.

For this reason, the sphere of *economic goods* cannot be rigidly delimited *a priori* by being made to include only material goods and not immaterial goods; only exchangeable goods, and not those that are not found in trade; or merely goods which are obtainable only at some cost, and not goods that are regarded as costless. There is general agreement with respect to the 'economic' character of the more restricted types of goods, and this is all that matters; the possible broadening of the central nucleus must be left to the particular criterion set up by the investigator, and to the nature of the concrete problem under discussion.

By 'wealth', then, we mean the *sum* of all the economic goods available at a given time and place.

If it is desired to call attention to the ownership relation which

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associates goods with an individual, it is convenient to designate by the word 'property' the wealth that belongs to a person.

'Capital' is that part of wealth or of property that at a given time is employed in the production of future goods; it consists of goods which are also called instrumental, and which may be either things or personal services. What characterizes them is their productive function; hence the concept of capital does not coincide with that of property.

With respect to the concept of a 'product', we may say that the latter can be only the good or service for the production of which a given enterprise was in fact established. Grain is the product of the enterprise organized for wheat-raising, but grain becomes capital in the hands of the miller, who regards flour as the product of his business, and so on.

### § 2

Now, there are taxes on product and taxes on income. What is the difference?

The product consists of goods in kind, considered in relation to the enterprise from which they come and before they are distributed among those who take part in their production. In a primitive economy, the tax is a percentage of the product; this was the case for example, with the tithe, which was deducted in kind on the threshing-floor, and fell on the enterprise itself. In the concept of income, on the other hand, there is a personal element that is lacking in the case of the 'product'. Whereas the latter has reference to the enterprise as such, the former has reference to the person to whom the product belongs. In ordinary speech, we make no distinction between the statement that a piece of land produces 1000 gallons of wine and the statement that it yields \$1000, although this second formulation already suggests the idea of a proprietor. But the difference becomes evident if we have regard to the moment at which the product is divided among those who have taken part in its production; because then one does not speak of 'the product of the proprietor' and 'the product of the labourer', but rather of 'the income of the proprietor' and 'the income of the labourer'. Usually one speaks, correctly, of the 'product of industry' and the 'income of a person'.

The second condition that is necessary if the product is to become

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'income' is that the former must be sold and expressed in money. The expression in terms of money would be a secondary circumstance, if it did not carry with it the consequence that the tax-rate is no longer fixed as a percentage of product, but as a percentage of income. The result is that whereas the tithe took 10 per cent of the goods in kind and all fluctuations in price were borne — to its advantage or to its disadvantage — by the State, the tax on incomes places the burden of price-fluctuation on the taxpayer. The taxpayers must sell annually such a quantity of the goods produced as is necessary to pay the fixed sum owed to the Treasury.

It may be seen from this that the tax on income contains an element of insurance in favour of the State.

Now that our terms have been defined, let us take up again the question whether the tax ought to be commensurate with the value of capital, or with the value of the product — that is, income.

The phrase has a double meaning, since it may involve either a question of merit or merely a question of form.

In the first case, by a tax on income is meant that which the taxpayer will normally be able to pay by reducing his private consumption and seeing to it that the income affected by the tax continues to be received permanently.

On the other hand, a tax on capital would be that which the taxpayer cannot continue to pay by merely reducing his income and his standard of living, but which he pays by being forced to trench on his capital.

If it is supposed that every individual distributes his income freely between expenditure on private and expenditure on public goods, the case just described cannot occur. On the other hand, it may occur if we adopt the hypothesis of the monopolistic state, whenever, with the increase of taxes destined to be wasted in unproductive public expenditure, capital is destroyed or its accumulation is impeded.

These are concepts that do not lend themselves to a rigorous definition. At this point, however, it is sufficient to repeat the axiomatic truth that a tax the continuing payment of which in fact consumes part of an individual's capital is absurd; because, even if we assume that it may exist, it would impoverish and ultimately exhaust the source of public revenues and would lead to the gradual disappearance of the State that levies such a tax.

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Not to be confused with the tax on capital in the sense just described is the 'extraordinary' tax on property, which is regarded — erroneously, as we shall see — as a levy on capital, but which, because of the size of the levy, could not be continuous and must therefore be treated in the chapter on public loans.

Whenever, therefore, one speaks of a tax on capital or on income, it is intended to do so in a formal sense; hence it is a matter of indifference whether, for example, the tax is formally commensurate with income on the basis of a rate of 20 per cent, or with the corresponding capital value on the basis of a rate of 1 per cent.

Once the question is put in these terms, the answer is easy. It is known that the value of instrumental goods depends on that of the corresponding direct goods. The market gives us the price of the latter and the current rate of return on capital. The value of a piece of land is found by dividing the income from it, which is supposed to be perpetual, by the rate of return, and multiplying the quotient by 100. For temporary incomes the process is different, but the principle is the same.

Since the primary datum that must be emphasized is that of the product and its value, it is not necessary to go back from this to the capital value of the piece of land, or the house, or the industry, or all the instrumental goods, and therefore also the capital value of a man, the estimation of which would also run up against obstacles of a moral nature. The tax, then, arises naturally as a tax on product or on income.

### § 3

In this way we come to the other question: whether the tax should strike the 'product' of industry while it is in the hands of the head of the enterprise and before it is divided among the various persons engaged in its production, or whether it should strike each part of the product when it is in the hands of these persons, and has become 'income' for each one of them.

The inductive basis of our reasoning is the historic process. Historically we have passed from the tax on product, of which the *tithe* is typical, to the tax on income. We shall reason on the basis of this example.

The landowner, who was usually also an entrepreneur and



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capitalist and sometimes a labourer, paid a tenth part of all the grain produced, on his own account and on behalf of his labourers, as well as for the smith who made his ploughs and the carpenter who built his carts. The tenth part of the total product of the soil was the single tax that the proprietor paid for all those who had contributed to the production of the grain.

In proportion as the division of labour and industrial occupations became more clearly marked, there was also evidenced a tendency to split the single tax on the product into as many separate taxes on income as there were individuals having a right to share in the product.

From an embryonic or less developed economy, in which the various functions are merged or are of slight importance and are entrusted to the head of the business, we pass to a more developed economy, in which each function is specialized in the persons of the proprietor, the entrepreneur, the capitalist, the labourer, the insurer, and the State, respectively. Each one of these acquires his own economic personality and his own financial personality, and all of them deal and bargain among themselves on the basis of complete juridical equality.

None of the recipients of these incomes could any longer — given the principle of the universality of taxation — avoid payment of his own tax on the ground that the landowner would pay the tithe on all the grain produced. But on the other hand, if they are struck directly by the tax, the system of the tithe automatically ceases to exist; for its survival would involve an obvious duplication.

The old tax on product, or the tithe, must, therefore, be divided into as many parts as there are individuals having a right to share in the product.

In this way the tax on income is born and developed.

Now, among those having a right to share in the product are some enterprises outside the agricultural unit, with which the latter has exchange-relationships for the furnishing of raw materials, machines, manure, etc.; within each enterprise, moreover, are the entrepreneur, the capitalist, and the labourer, in so far as they are in fact, or tend to become, different persons.

We shall call the first 'external agents' of production and the second 'internal agents'. For the production of each individual direct good there exists a co-ordination between the two groups. The

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grain will be divided, first of all, between the external agents — such as the manufacturer of ploughs and machines, and the furnisher of manure — and the grain-grower himself; but then, within the budget of each specialized enterprise, there takes place a division among the internal agents, who are the same in all businesses. Thus, in the last analysis, all the grain produced ends by being divided among the entrepreneurs, capitalists, and employees of each enterprise.

The same process is repeated for other goods.

From the concept of the tax on income is derived the current classification which is based on the economic theory of the distribution of the product, in so far as one tax tends to strike 'rent' in the hands of the proprietor; another, 'profit' in the hands of the entrepreneur; another, 'interest' in the hands of the capitalist; another, 'wages' in the hands of the labourer.

On the other hand, from the original concept of the tax on product arose a classification based on historical juxtaposition, in which the tax was expected to strike the total product of every new enterprise or profession. Thus, the tithe on lands was followed by the tithe on forests, and later by the tithe on mines; and it will be easily understood to what complications and duplications such a system would have led, if it had been able to survive in the face of the continuous increase of specialized new industries.

The modern classification, with its simple structure, has the character of organic stability, because it embraces all possible present and future industries.

To be sure, it must be remembered that we are dealing with a law of historical tendencies, which follows the actual development of the division of labour. Where the latter is lacking, therefore, the several parts of the total product are taxed while in the hands of the same person, if in fact they belong to him.

These are cases, however, which the development of the division of labour is making increasingly rare, and which positive legislation is attempting to eliminate.

## CHAPTER X

# THEORY OF NET INCOME

**Summary:** The tax on *net income* — The quantity of direct goods produced and consumed annually within the country is the basis of the tax — The distribution of direct goods between the external and internal agents of production leads to the concept of net income — Some controlling principles based on the theory of the derivation of net income from gross income — Positive and negative taxpayers' rents — Each part of income, no matter how small, bears a tax-liability from the moment of its origin — The deduction of interest owed — The case of the domestic servant — The problem of saving — John Stuart Mill's error in accounting — Discrimination and the political factor

### § I

FROM the concept of a tax on income we pass to that of a tax on 'net' income.

The word 'net' implies the existence of a gross income — that is, an income from which expenses of production have not yet been deducted. This is correct, at least from the point of view of accounting; but it implies also that the parts of gross income which are deducted as expenses of production are not subject to taxation; and this is incorrect.

The notion of net income is fundamental for Public Finance; but with respect to its definition, the usual uncertainties prevail among economists. It is necessary to clarify the concept; and in order to do this, it would be well to examine, in broad outline, the phenomenon of production.

Let us picture, first of all, an imaginary society of 100 individuals, each of whom is an isolated economic unit accomplishing by himself the whole series of productive acts, from the cultivation of the land to the production of bread. Each one will plough his own ground, will sow and cultivate his grain, will build the road for the transportation of the product, will provide for the defence of the sown field and the gathered grain, will make his own ploughs, will build his own mill, and will have his own bakery.

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At the end of the crop-year, each is assured of a supply of 100 loaves of bread, to the production of which he has directed all the successive steps in his activity and the consumption of which represents his sole compensation for the successive series of costs incurred.

If now we pass to the hypothesis of an economy founded on the division of labour, the only difference will be this: that, previously, each of the 100 individuals performed a series of productive acts, whereas now every individual act of the series is performed by a group of individuals.

One group will plough all the ground and will produce the grain; another will build and repair everyone's ploughs; another will build the roads and will see to the prevention and repression of theft; another will transform the grain into flour; and a final group will transform the flour into bread. There are five specialized groups, each with 20 members.

At the end of the crop-year, thanks to the new and perfected organization, the bread produced will mount from 10,000 to 12,000 loaves; but in all other respects the phenomenon will remain the same. All 100 members of our society contribute, as before, to the production of bread, and all expect only from the distribution of the 12,000 loaves the sole compensation for their labour.

Among the five specialized groups there is, by hypothesis, one that assumes the function of defending all the others against possible theft, of passing judgment on controversies between members of the community, and also of building and maintaining roads. If we call this group the State, the share of the 12,000 loaves of bread that belongs to it we shall call the tax.

We have not yet arrived at the concept of net product. On the other hand, there emerges another elementary truth: namely, that only the 12,000 loaves of bread constitute the income or product of the community; the ploughs, the land, the grain, the roads, the bakery, and public safety are instrumental goods necessary for the achievement of that end.<sup>1</sup>

This permits the following generalization: *The product or income of society consists of the quantity of goods of the first order annually produced and consumed.*

From this it also follows that the tax and the rewards due to the

<sup>1</sup> For this reason they are not yet *income*; they will become income if and to the extent to which they will be transformed into future bread.

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various agents of production are paid out of the 12,000 loaves of bread,—that is, out of the quantity of direct goods in the annual production of which all, including the State, take part.

The members of the community, collectively and severally, must wait until the bread is produced. Each group, including the State, will have a right to 2400 loaves. If the bakery deducts the 2400 loaves belonging to the State and then shares the remaining 9600 with the other external agents of production, we have a tax on the product. The State then asks nothing of the group that manufactures ploughs, nor of the others.

### § 2

We may now pass to the tax on income. The State, which by virtue of its function has direct and simultaneous relationships with all the groups, waits until the four groups will have divided the 12,000 loaves into shares of 3000 for each group, and then demands from each one 20 per cent of the 3000—that is, 600 loaves. The result is the same as before; hence the problem of the tax on income consists of seeing how the division of the 12,000 future loaves among the four groups that take part in their production comes about technically.

The first difficulty is that of waiting. For in practice we do not have to deal merely with the isolated case of bread; what happens in that case happens in others; the number of producing groups increases *ad infinitum*; along with the group organized for the production of bread, others are organized for the production of meat, clothes, houses, shoes, jewellery, domestic utensils, automobiles, theatrical performances, professional services, and so on.

Moreover, these groups do not live in isolation from one another; on the contrary, they are tied together by reciprocal relationships, so that each one has contacts with all the others, and all the others have contacts with it.

Given this complex series of relationships, the division in kind of all future goods of the first order is impossible. Here money comes to the rescue; by its use, each process of give-and-take is concluded *legally*, in each case, at the moment in which the exchange takes place. Thus, the manufacturer of ploughs receives the price for them at the moment in which he sells ploughs to the grain-grower.

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But this price — which is correctly called his income — is only a claim-check on future bread; it is his credit-voucher, which gives him the right to take part in the final division of the bread, which will conclude the process of give-and-take *economically* as well as legally; and his income finds its fruition in the fact of consumption. The same process is repeated in the case of the grain-grower and the miller.

The State follows the same procedure, and turns into cash its fiscal claim against all the specialized enterprises by levying 20 per cent of the price that each enterprise obtains at the moment it sells its product. But even for the State the tax, collected in this way, is a claim-check on future bread and on all future direct goods.

### § 3

The second difficulty lies in the possibility of double taxation; but if one examines a little more closely the accounting procedure involved, one sees that the danger does not exist.

Let us suppose that the State turns first to the manufacturer of ploughs — which we have considered as the enterprise with which the cycle of bread-production begins — and takes from him 20 per cent of the price of the ploughs sold to the grain-grower. It then turns to the grain-grower, to collect 20 per cent of the grain sold to the miller. The grain-grower, however, objects on the ground that from the value of the grain sold to the miller should be deducted the part that the manufacturer of ploughs has already paid, and the State allows this, because *it has already collected the tax on this part of the product*. And when it turns to the miller, from the flour or the price of the flour is deducted the part that the miller has paid the grain-grower (in which is also included the share of the plough-manufacturer) because the State has already collected the tax on it. And when the State turns to the baker, it deducts the part which the latter has already paid to the miller (in which is included the share belonging to the grain-grower, and a second time that belonging to the manufacturer of ploughs), and on which the State has already collected the tax.

The same reasoning is again involved in the relationships between the internal agents of production, among whom is divided the whole of the share belonging to each individual enterprise. And, for this

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reason, when the Treasury demands 20 per cent of the price of ploughs, the entrepreneur deducts the part that has already been paid to capital and to labour, because the Treasury has already collected or will collect the tax on the interest of the first and the wages of the second.

As a result of the double series of deductions — the one in the external creditor-relationships between enterprise and enterprise, and the other in the internal creditor relationships between entrepreneurs, labourers, and capitalists — it is said that *gross* income has been translated into net income, so far as each agent of production is concerned. In reality, all that has been done is to divide the total income — that is, all the bread in our example — into the shares belonging to each person; thus, the determination of taxable 'individual income' is part of the determination of total taxable 'national income'.

To sum up: the translation of gross income into net income, or what we shall call the 'deputation of incomes',<sup>1</sup> is merely a technical accounting procedure, by means of which the total quantity of direct goods produced annually in a country and the corresponding total tax-burden are divided among those engaged in production and among the taxpayers. No part of so-called gross or total income escapes taxes on income. The deduction of expenses of production, as revealed by the budget of each individual business, prevents any part of income from being taxed more than once.

By perfecting the procedure for reducing gross incomes to net, we perfect the fiscal organism.

### § 4

#### *Taxpayer's rent*

The theory of the deputation of incomes, as expounded above, allows us to establish some general principles:

First of all, the process of deputation can be pushed only so far as the division of industrial and personal labour has *in fact* been accomplished. Hence, if the grain-grower is also a maker of ploughs, the tax strikes all the grain while it is in his hands. Similarly, if the

<sup>1</sup> [Italian: *epurazione dei redditi* — Translator's note]

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entrepreneur is also a capitalist and labourer, the tax strikes the total income composed of profit, interest and wages while the income is in his hands.

In order for the process of deputation to conform strictly to the real facts of the case, it would be necessary to examine the budget of each individual enterprise, since in real life the division of labour is not uniform, at the same time and place, as between one enterprise and the other. In some cases, the entrepreneur is already distinct from the capitalist, in other cases they are one; in some cases, the landowner is distinct from the tenant, in other cases he is not. Usually the labourer is distinct from the entrepreneur; but there are cases in which the labourer is also the owner of the land that he cultivates, just as the owner of a small workshop is simultaneously labourer and entrepreneur.

If the Treasury were to ascertain incomes in each individual case, the deputation would correspond closely to the actual facts, and would exclude all possibility of differential treatment as between one taxpayer and another.

But it is not always technically possible or economically expedient to ascertain income separately, in each individual case. Instead, the law proceeds by making use of typical or average values and by adopting uniform percentages of deduction for all the individual cases, although one of these may differ in some measure from another, and both may differ from the selected type. Thus, for example, the law with respect to the tax on land may deduct from every income from land a percentage for expenses of administration, though not all businesses incur such expenses; the law may deduct expenditures for wages, though not all businesses employ wage-earners.

Out of these discrepancies between the typical value and concrete individual values arise phenomena of 'taxpayer's rent', which may be *positive*, as when the taxpayer benefits from a deduction to which, if his case were treated individually, he would have no right; and *negative*, as when he does not benefit from a deduction to which he would be entitled. In the first case, there is a gap in the tax system; in the second, there is double taxation.

What are involved, in any case, are vestigial phenomena and slight inequalities which the law has not been able to reach, but which tend subsequently to be further attenuated and even to disappear in time in proportion as the taxpayers change their manner



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of running their businesses, in such a way as to get rid of the negative rents or avoid losing the benefit of positive rents; and all tend to approximate a more nearly uniform type. For this to happen, it is necessary that the rents should not be negligible quantities.

### § 5

Another principle deriving from the theory is that each part of income produced, no matter how small, contains its proportionate share of the cost that the State has incurred in providing its productive services; and since the tax corresponds to this cost in the same way that wages correspond to the labour provided by labourers, it follows that each part of income, no matter how small, *comes into existence bearing the corresponding tax-debt.*

If one such part of income does not pay its tax-debt, another must pay more than its share.

From this elementary truth it follows that the deductions allowed by the law for the purpose of reducing gross incomes to net must be subordinated to the concrete condition that the Treasury will find them again, as taxable income, in the budget of other enterprises.

For this reason, anyone who would wish to give a complete demonstration of the fact that a given portion of income is not obligated to pay a given tax ought to prove not only that this part of income is included among the deductions allowed by law, but also that it is not subject to another direct tax.

In those cases in which a legal interpretation to this effect is not possible, the law should be revised.

### § 6

Another corollary is this: that the sum of individual incomes or net incomes must be equal to the national income or gross income; if it is larger, there is double taxation; if it is smaller, there is a gap in the tax system. The perfecting of the process of depuration must bring about this equality by uncovering and avoiding duplications and gaps. This can be only the gradual result of statistical surveys and analytical studies of the account-books of businesses. There are, however, some cases in which it is evident that equality of the kind described does not exist.

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A typical example of double taxation exists whenever the law does not allow the deduction of interest that the taxpayer pays on his debts.

This holds in general for all debts, of whatever nature, regardless of whether they are secured by mortgages, or whether they are contracted for the purpose of consumption or of production. For, in every case, the annual interest paid by the debtor is taken from his income, however the latter may happen to be composed. From the economic point of view, the creditor participates in the division of the debtor's income, and therefore the interest is deducted from the income or taxable income of the debtor, always assuming that the State, as is usually the case, collects the tax on interest in the hands of the creditor.<sup>1</sup>

The case of wages demands some special consideration. That wages owe taxes is for us a corollary from our general principles. The deduction of wages from the value of the industrial product is included under the common expression 'expenses of production'; but then wages do not always figure — either by law or in fact — in a schedule of personal incomes under which they would be obligated to pay the tax. There is a gap in the tax system, due to the practical difficulty that the Treasury encounters in following up so large a number of people with small personal incomes.

If it is desired to overcome this difficulty, which is merely one of collection, there are two other possible solutions: (1) a general exemption may be granted to all wages, the financial needs of the State being covered by correspondingly higher tax-rates assessed against the employers, who would be expected to discount the tax in the lower wage-rate which, other conditions remaining equal, would be the natural economic result of the system; (2) or the tax owed by the labourers may be assessed on the amount paid in wages, the entrepreneur being obliged to pay the tax, while at the same time he has a legal right to recover the amount he has advanced in taxes when he pays the wages.

Each system has its advantages and its disadvantages; the essential

<sup>1</sup> Italian tax law permits the deduction of interest by the entrepreneur only in the case of loans incurred for purposes of production; but it also denies such deductions to the landowner, on the obsolete ground that the tax on land is a 'real' tax. Here, there is a case of double taxation.

Vice versa, it allows to income from land a deduction of interest on the value of the inventories of livestock and material belonging to the proprietor; but then this interest is not subject to the tax on 'movable property' (*imposta mobiliare*). There is a gap here

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thing, however, is just this: that once a method has been adopted, it must be adhered to in positive legislation in such a way that all labourers will receive the same treatment.<sup>1</sup>

Another typical case is that of the wages of domestic servants. The person who uses a part of his income to pay wages to a servant has already paid taxes on his whole income and therefore also on the part that becomes the servant's wages. Must the servant also pay a tax on his wages?

It seems that there is double taxation in such a case, but there is not; for the servant is a producer and seller of services. Between the employer and the servant is an exchange of goods on which two direct taxes are owed by the respective producers of the goods that are exchanged. The employer has paid his tax on the income that he has produced; the domestic, who has not yet paid the tax, owes it at the moment at which he produces and sells his services. In the case of producers of personal services, the moment of production and that of sale coincide.

Similar to the case of the domestic servant are the cases of the physician, the lawyer, the engineer, and all producers of personal services. In the exchange between the bread of the baker and the service of the physician, there is one price, but there are two goods exchanged, and therefore there are two incomes on which the tax is owed. There is no exception to the general principle.

### § 7

#### *Saving*

But the case that calls for special attention is that of saving, with respect to which there has been the most discussion, in order to determine whether it should be subject to or exempted from taxation.

According to a current opinion, nothing is income unless it is consumed. Hence bread, which we regard as income, is not income, or does not become income until the moment of actual consumption. From this the current theory wishes to deduce the consequence that income *produced* and *not consumed* — that is, saving — is not income and cannot be subject to the tax on income.

This is a logical play on words, rather than a demonstration. In

<sup>1</sup> This cannot be said of Italian legislation.

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order to clarify the argument thoroughly, it is necessary to establish precisely what the function of saving is in the phenomenon of production.

We, also, have defined national income as the quantity of goods of the first order *produced and consumed annually*. Now, if society is regarded as a whole, it is obvious that the quantity of goods produced is equal to or ends by becoming equal to the quantity of goods consumed. We produce in order to consume, and nothing else is possible. The individual may produce to-day for to-morrow's consumption; but if he is to distribute his consumption over time, he must transfer the goods he has saved to those who will consume them to-day in order to reproduce them and give them back to him to-morrow.

And what is true of society is true, *a fortiori*, of the single individual.

In both cases, we are dealing with the same goods, considered in two successive moments or from two different points of view.

If we look at the productive process in its entirety — that is, from the arising of a feeling of dissatisfaction to the satisfaction of the want — we find no break between the economic process and, for example, the physiological process through which the direct good, by being actually consumed, really satisfies the want and at the same time rebuilds the energies of the worker so that a new productive cycle may be begun. It is a continuous transformation of goods into other goods, which never stops; it is a circle in which there is no point of departure or point of arrival, and which may be broken only for the purpose of solving certain concrete problems.<sup>1</sup>

Thus, in passing from an isolated economy to an economy in which there is division of labour, it is possible to separate the goods that an individual produces from those that the same individual consumes, and to speak of an income produced and an income consumed. The baker produces bread; the bread represents his produced income. The tailor produces clothing; the clothing represents his produced income. At a later time, they exchange bread for clothing, and then we say that the clothing is the income consumed by the baker and the bread is the income consumed by the tailor. But since

<sup>1</sup> Thus, in order to separate physiological or hygienic or moral activity from economic activity, most writers hold that economic activity begins with the want, inasmuch as the latter represents an *external impulse*, which in fact induces man to undertake a series of productive acts that end with the possession, or material control, of the thing that he considers adapted to satisfy the want.

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exchange is nothing but a form of production, we may say equally well that the clothing bought is income produced by the baker and the bread bought is income produced by the tailor.

Hence — if we still hold to the hypothesis laid down above, according to which we suppose that society is composed of only these two enterprises — the income of the baker and the tailor, produced and consumed at the same time, is equal to the sum of a certain quantity of bread plus a certain quantity of clothing.

The qualitative and quantitative difference between the two disappears.

On the other hand, the claim of the State is established and increases in proportion as the productive process develops, since the assistance given by public services does not end with the production of the bread and the clothing, but includes also the exchange between bread and clothing, as well as the consumption of bread and of clothes. This claim is a given quantity corresponding to the cost that the State incurs, and can and must be paid out of income; and it is a matter of indifference, or of secondary importance, whether the income be ascertained at the moment it is produced or at the moment it is consumed, the same quantity being involved in either case.

### § 8

It might seem that in adopting the hypothesis of an isolated economy in which production is for use rather than exchange or in considering society as a unified whole we are excluding, by our very hypothesis, the problem with which we are concerned; but this is not so. Saving, in a modern economy characterized by division of labour, arises from the fact that an individual does not consume all the income he produces, but saves a part of it, which he then, by means of a loan-contract, turns over to the worker, who consumes it in increasing the production of future goods. In the light of this fact, there might seem to be no truth to the hypothesis that, so far as the saver is concerned, income produced is equal to income consumed; the truth would seem to lie with the opposite hypothesis, which is what gives rise to the problem under discussion.

It is not difficult to show that the new circumstance does not

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change the economic problem, nor the conclusion previously reached.

The error lies in holding that a loan, which itself arises from the separation of the person of the capitalist from that of the labourer, is the origin of saving, whereas it is only one form of saving.

Saving is, above all, a phenomenon that may arise within the isolated economy in which production is for use rather than exchange.

Let us take up again for a moment our very first elementary example — that of an isolated producer, who himself constructs the ploughs, himself produces the grain, and himself transforms the grain into flour and the flour into bread. It is while he is consuming the bread that he resumes his productive functions — repairing the ploughs, cultivating the land anew, and so forth.

Since we are dealing with an economic man, we may assume that he never stops with the mere reconstitution of his working energies, with the result that he always produces the same quantity of bread; we may assume rather that he gradually tends to increase the quantity. He accomplishes his aim by being economical in his present consumption of bread — that is, by distributing his consumption over a longer period, so as to have the time necessary for the construction of an additional plough and for the cultivation of another acre and for the enlarging of his mill and his bakery.

Now, to distribute more economically in time the consumption of the available quantity of bread means the diminution of his daily consumption.

This is saving.

The example brings out two elementary truths. The first is that saving arises and develops in each isolated economy. The second is that saving is an elementary and original factor of production, indissolubly tied up with labour. Saving and labour condition each other reciprocally from the very beginnings of production. The primitive man who lives on wild fruit must economize in his consumption of it if he wishes to find time to make a bow and arrow; the first stag that he kills is the product of both his labour and his saving; and if he must turn over a part of it to his chief, this levy falls equally on saving and labour.<sup>1</sup>

<sup>1</sup> For this reason I consider it incorrect to pose the problem of saving by supposing at the outset that production has proceeded for some time without the factor of saving, and then, at a given moment, introducing saving as a new factor that acts from that moment on.

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### § 9

Let us now study the phenomenon in an economy in which division of labour exists and let us take up again the example of the four specialized enterprises — the manufacture of ploughs, grain-growing, milling, and baking — which we left producing 12,000 loaves of bread. There are two possible hypotheses.

The first is that all four save bread in equal amounts, and that all increase their labour in equal amount. The 12,000 loaves of bread will become 15,000; the 15,000 will allow greater saving and more labour, and will become 18,000, and the 18,000 will become 20,000.

In every case, the bread is the product of the same factors; in every stage of its increase it is the result of more saving and more labour; it increases without interruption. Moreover, there is no technical possibility of separating the part due to saving from that due to labour. Hence the 20,000 loaves of bread pay the tax for the same reason for which the 18,000 pay it, and the latter for the same reason that the 15,000 pay it; and in this way, by following the process back, one could arrive at the first man who succeeded in making the dough for, and baking, the first piece of bread on a heated stone.

The second hypothesis is that the saver and the labourer have become separate persons and are bound one to the other by a loan-contract.

This may happen when not all four producers are in a position to increase their labour equally and at the same rate, since some may prefer to increase their labour more and others to increase their saving more.

The manufacturer of ploughs, instead of contributing a dose of greater abstinence and a dose of more labour, will prefer to contribute two doses of greater abstinence. But the final product will continue to be what it was before — namely, the result and reward of the same factors of production. The only change that may possibly take place is a change in the distribution of the final product among the various agents of production; but the tax will follow these variations according to the theory of the depuration of income.

Let us take another example, by way of making the issues clear.

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We have supposed that the four producers have increased the production of bread from 12,000 to 15,000 loaves, all contributing equally a dose of greater abstinence and a dose of more labour.

Let us now suppose that they achieve the same result through the use of the following combination: two of them contribute a dose of greater abstinence and a dose of more labour each; the third contributes two doses of more labour; the fourth, two doses of greater abstinence. The 15,000 loaves of bread are the product of the same factors of production and will be divided among the four in the same proportion as before, or in whatever other proportion will result from the contracts that have been made. The part that will now be assigned to the saver for the larger dose of abstinence was previously included in the share assigned to the labourer; and the part that will be assigned to the labourer for the dose of more labour was included in the share assigned to the saver. Otherwise the consequence would be that the worker would have to pay for both himself and the saver!

So far as relations with the Treasury are concerned, the State contributes the same services and bears the same expense that it undertook in the preceding case, and will cover this expense by following the division that the various enterprises involved will in fact make of the 15,000 loaves of bread.

The circumstance, therefore, that the saver has become a person distinct from the labourer does not change any of the qualitative elements that go to make up the problem; whence it follows that the tax will fall on the 15,000 loaves of bread in their entirety, just as it fell on them when the combination assumed in the preceding case was used.

The only difference is that when it falls on them, they will be in different hands. If the new element in the problem is the fact of a changed division of labour, the case will be covered by the theory of the deputation of income and not by that of tax-discrimination.<sup>1</sup>

A policy of tax-exemption in favour of those who have contributed a dose of more saving as against those who have contributed a dose of more labour does not follow from the economic analysis of the phenomenon. On the contrary, since the financial need of the State is a given quantity, such a policy would produce the following unexpected result: after the separation of the person of the saver from

<sup>1</sup> See § 13, below.



## THEORY OF NET INCOME

that of the labourer, the former would pay less than he paid before or nothing at all, and the labourer would pay more than he paid before, because he would be obliged to pay the difference.

### § 10

This conclusion of a general theoretical nature is strengthened by the further examination of some special arguments, by means of which some writers have attempted to defend the exemption of saving, and which we cannot avoid taking into account.

One of these arguments is as follows: Savings are capital, not income, but they give rise to income in the form of interest:—taxes fall on income and not capital; therefore saving must not be taxed, since the income from savings will be taxed in any case.

The syllogism is only a play with words.

To begin with, savings are not capital; they are income the consumption of which is postponed and which may be transformed into capital if and when it is used to acquire machines, raw materials, and human labour, in order to renew or increase production.

Once this is understood, it will be clear in what sense taxation falls on income, and not capital. As soon as the latter is transformed into income, it is sufficient to tax income in order to tax capital by implication. But if, for the reasons of a technical and accounting nature already discussed, or because of other possible considerations of expediency, we tax capital — that is, the ploughs in the example — it is not necessary to tax income.

There are other cases in which the market value of the capital is known, whereas the amount of income is not known, so that it is felt to be better to tax the former than to calculate an assumed income. Such a case is represented, for example, by land in colonies, which is not yet cultivated and does not yet give an income that can be directly ascertained; and another is represented by building areas in a similar condition.

If the theory under discussion were to be understood in a rigidly literal sense, it would lead to the following result: savings should not be taxed, because savings are capital; from capital arises income, which is the only thing that is taxable; but then, if this income is saved again, it becomes capital once more and is exempted from taxation, and so on. Conclusion: a person who saves at compound interest ceases to be a taxpayer.

## DIRECT TAXATION

### § I I

The truth is that the value of instrumental goods and the value of direct goods — that is, capital and interest, respectively — should not both be taxed at one and the same time. And such taxation is avoided by deputation, which separates interest from capital.

Nevertheless, it is thought by many that double taxation exists whenever taxes are levied on both savings and the interest. This supposed danger was emphasized in a careful, though erroneous argument by John Stuart Mill: ‘. . . The proper mode of assessing an income tax would be to tax only the part of income devoted to expenditure, exempting that which is saved. For when saved and invested (and all savings, generally speaking, are invested) it thenceforth pays income tax on the interest or profit which it brings, notwithstanding that it has already been taxed on the principal. Unless, therefore, savings are exempted from income tax, the contributors are twice taxed on what they save, and only once on what they spend. A person who spends all he receives, pays 7d. in the pound, or say 3 per cent, to the tax, and no more; but if he saves part of the year’s income and buys stock, then in addition to the 3 per cent which he has paid on the principal, and which diminishes the interest in the same ratio, he pays 3 per cent annually on the interest itself, which is equivalent to an immediate payment of a second 3 per cent on the principal.’ And he concluded: ‘The principal and the interest cannot both together form part of his resources; they are the same portion twice counted.’<sup>1</sup>

In this reasoning, there is no confusion of economic concepts; but there is a fusing into a single productive cycle of what are really two productive cycles: that in which the saved income was produced, and the following one in which the interest, which is a new income, is produced.

It is generally agreed that all productive operations must be referred to a period of time. During each of these periods there is an economic transformation of instrumental goods into direct goods; in each one of them costs are incurred again, the product is produced anew, and there is a division of the product among those taking part in production; in each period, labour is employed and paid; in each period, public services are utilized and paid for.

<sup>1</sup> *Principles of Political Economy*, Book V, chap. II, § 4.

## THEORY OF NET INCOME

Each productive cycle has its own economic individuality, which is represented by the budget of the business; the budget is annual; the income produced in 1936 is not the income produced in 1935; the grain produced in 1936 is not the grain produced in 1935.

From this it follows that those who save income produced in 1935 and use it to increase production in 1936 will demand more raw materials and human labour and public services, and will pay more in prices, more in wages, and more in taxes.

The position of the State does not differ in kind from that of the worker or any other agent of production. It incurs an expense corresponding to the whole of the year's production, as in the case of the worker who undergoes hard labour corresponding to the whole of the year's product. If the entrepreneur maintains that he does not owe the State taxes corresponding to the part of the product saved, he could just as well maintain that he does not owe the labourers wages corresponding to the part of the product saved.

But this, which would obviously be an absurd claim, if set up against the labourers, appears plausible if set up against the State.

Why?

### § 12

This happens either because economists have not yet come to think of the State as taking part — whether for good or ill — in the production of private goods, and as entitled to receive an annual payment for its services, or because in carrying on the business of the State it is possible to rob Peter to pay Paul.

The explanation of the phenomenon can be found in reasons of a political character.

The classes that propose the exemption of saving — such as, for example, professional people and public functionaries — are the classes that have political power and use it to obtain exemptions from taxation for their own benefit.

In the same way, under the old regime, the propertied classes enjoyed notable tax exemptions at the expense of the industrial and working classes. The position is similar, except that it is reversed.

To sum up [the taxation of savings is not a case of double taxation; on the contrary, the exemption of savings creates a gap in the tax system — that is, it is a case of exemption which forms part of the theory of *discrimination*.]

## DIRECT TAXATION

### § 13

#### *Discrimination*

Discrimination among incomes is a phenomenon entirely different from that of deputation of income. The word means 'differential treatment' of *net* incomes. It consists of some further deductions which the law grants to certain categories of incomes over and above the amounts deducted for the purpose of translating gross incomes into net.

Thus there is the case of some net incomes which do not reach a given minimum limit, regarded as necessary for the satisfaction of the elementary needs of physical life, and which are freed, wholly or in part, from the duty of paying their tax obligation. There is also the case of net incomes arising from labour, which enjoy a special deduction for savings, over and above that granted to net incomes of equal amount arising from invested capital. We shall have occasion to notice other examples.<sup>1</sup>

The deductions allowed under the respective headings of deputation and of discrimination among incomes are usually confused in the classification employed in positive laws; but they are entirely different things.

The fundamental difference is this: whereas the mere process of reducing gross income to net distributes among the taxpayers all taxable material and withdraws no part of the latter from taxation, discrimination deprives the Treasury of taxable material. In this way, other conditions being equal, the yield from taxation decreases, and in consequence there must be an increase in the tax-rate on incomes that do not enjoy deductions as a result of discrimination.

It is for this reason that the phenomenon of discrimination is necessarily bound up with phenomena of shifting. And it is bound up — when the discrimination is in favour of the smaller incomes — with progressive taxation. In fact, the policy of special benefits on behalf of the masses and the labouring classes consists, in large part, of cases of discrimination.

The device of discrimination tends in fact to enlarge its sphere of

<sup>1</sup> See, below, in connection with income from 'movable property', Book III, chaps. v and vi.

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action and to take the place of progression, which is becoming relatively restricted. For the superiority of the first over the second lies precisely in the possibility that it offers of treating separately each individual case of tax-exemption or tax-reduction; whereas progressive taxation, being uniform and mechanical, is not only less consistent with differences found in reality, but also provokes a reaction, on grounds of principle, against uncertain and unforeseeable dangers.

**BOOK III**

**THE SYSTEM OF DIRECT TAXES**

## CHAPTER I

### TAX ON LAND<sup>1</sup>

Summary: Object and subject of the tax — The elements of the income from land — Income from the landlord's share of the produce — The derivation of the net income from land from gross income

#### § I

THE general theory of the tax — as distinct from the fee — must be supplemented by an examination of the organism of individual direct and indirect taxes.

In treating the theory of the fee we did not enter into a study of individual types of fee, but limited ourselves to taking from each type those positive elements that could be utilized for the construction of the general theory.

The reason for this is that the fee is not a part of an organic whole, but stands by itself; it is the price of each individual special service the explanation for which is found in the general theory. In the same way, in Private Economics, we formulate the general theory of price, but we do not supplement it with an examination of the price of grain, of iron, of cotton, and so on, although it is from the course taken by such prices that we derive elements for constructing, confirming, or criticizing the general theory.

It is different in the case of taxation, in which we set over against the total cost of general public services the total yield from taxes,<sup>2</sup> so that each one of the latter does not stand by itself, but is a part of a whole—that is of a *fiscal organism*, the historical and theoretical formation of which is dominated by certain controlling principles.

This leads to the necessity for judging the relationships, of a mutually dependent and complementary character, that exist between the various taxes, in order to see whether or not they form the organism of which we have already spoken.

<sup>1</sup> [Italian: *imposta fondiaria*. — In this, as in the remaining chapters of Book III, a considerable amount of material having to do with the details of the Italian tax system has been deleted. — Translator's note]

## THE SYSTEM OF DIRECT TAXES

Our examination, therefore, will be of a critical rather than a descriptive nature, so that it will be possible to keep within narrow limits as much of the discussion as may be necessary in order to proceed with the analysis on a concrete basis.

Now, it is a fact that all taxes in all modern countries fall on income, and that their technical structure is not profoundly different; so that by starting from the Italian tax system, or rather from those taxes which give that system its general form, it will be easy for us to pass on to a discussion of the problems that are common to all the tax systems of modern states.

In Italy, the national income has been divided into income from land, income from buildings, and income from 'movable property',<sup>1</sup> the latter, in its turn, being subdivided into income from capital, industrial income, professional income, and income from labour.

It is a classification that corresponds fairly well to the present division between the various productive activities and producing groups and provides a satisfactory outline of the system of corresponding taxes now in force.

To this has been added recently a complementary tax on the total income of each citizen.

### § 2

#### *Tax on Land*

The tax on land<sup>2</sup> falls on that part of the total product of the land which remains to the owner after deduction of expenditures and possible losses. This corresponds to the concepts expounded in earlier chapters, inasmuch as the basis of the tax is the income that remains to the proprietor after deducting the expenditures — that is, the shares due to other agents of production, external and internal — from the *total* income. The deductions on account of possible losses will require a special explanation.

The law, then, regards the owner as the head of the enterprise and therefore as the subject of the tax, while his income is regarded as the object of the tax.

<sup>1</sup> [Italian: *ricchezza mobile* — Translator's note]

<sup>2</sup> In Italy, the tax is administered on the basis of the laws of July 14th, 1864, and March 1st, 1886.



## TAX ON LAND

Theoretically, the product of the land may be divided into five parts: rent in the technical sense, or *Ricardian* rent; interest on capital permanently invested; interest on working capital; the profit of the enterprise; and wages.

In 'capital permanently invested', many writers usually include the capital used for the purpose of making improvements designed to make cultivation possible over long periods. But, strictly speaking, the 'capital permanently invested' consists only of expenditures on reclamation, clearing, drainage, etc., which are indispensable for the preliminary preparation of the land for any sort of cultivation.

It is desirable, in any case, to keep 'capital permanently invested' separate from 'capital used for improvements'; for the latter may to some extent be administered in such a way as to avoid the consequences of fluctuations in prices, since the type of cultivation may be changed, or its extent enlarged or restricted, and agricultural operations may be carried on with greater or lesser intensiveness or expense, whereas capital permanently invested is a relatively fixed quantity which, in itself and because of the expenses of maintenance, is tied up with the fate of the land-rent and with it undergoes the consequences of changes in prices.

Our problem then becomes that of establishing which of the five elements of the income from land belong to the owner, and are the object of the tax.

There are two tendencies in doctrine and in legislation. One of them would wish to limit the object of the tax to that part of the total income which is 'rent'. Legislators who have been under the influence of Ricardian doctrines and have tended to think in terms of a classification of taxes based on the economic theory of the distribution of the product intended to assign *a priori* to the tax on land the task of striking rent as the only part theoretically belonging to the landowner, and to the 'tax on movable property', or its equivalent, the task of striking separately profit, interest, and wages — even if these arose from agriculture — as they were received, respectively, by the entrepreneur, the capitalist, and the labourer.

But economic reality has resisted such an abstract theoretical construction, which is valid only for purposes of indicating a general tendency.

First of all, post-Ricardian economics has made clear that the phenomenon of rent is not confined to land, but extends to all

## THE SYSTEM OF DIRECT TAXES

branches of productive activity. Costs being equal, the income from different mines may be different; there is a difference in the usable power of different watercourses; there is a difference in the fertility of different human intellects.

Hence a tax limited to rent would have to extend its action to every industrial and professional income in which there exist elements of rent.

Thus this classification was found wanting with respect to its most important theoretical basis: the idea that rent is limited to land.

Moreover, this classification ran definitely up against the fact that the actual state of the division of labour in agriculture is such that it does not evidence, or has not yet realized, the logical categories of rent, profit, and interest, as clearly as they have come to be realized within manufacturing industries.

For this reason it is necessary, according to the principle expounded above,<sup>1</sup> to examine whether and to what extent there is a correspondence between the abstract division of the product of the land into rent, profit, interest, and wages, and the actual personal distribution of functions among those taking part in production, which necessarily varies from country to country and epoch to epoch.

### § 3

#### *Income from the Landlord's Share of the Produce*<sup>2</sup>

If we go back to the old contracts of emphyteusis, we find that the landowner and the owner of capital permanently invested appear to be distinct persons. But it has not been possible to maintain such a separation in the long run, as is shown by the evolution that has been undergone precisely by emphyteusis contracts, tithes, and similar devices. In the end, first through the commutation and then the redemption of the traditional dues, the user of the land — that is, the concessionaire — has come to acquire the quality of sole owner.

Now, it is customary, as a matter of traditional doctrine, to call the sum of the income from land and of the interest on the capital

<sup>1</sup> Cf. Book II, chap. x, § 4

<sup>2</sup> [Italian: *reddito dominicale* — Translator's note]

## TAX ON LAND

immobilized therein 'the income representing the landlord's share of the produce' (*reddito dominicale*). And economists have accepted the conclusion that the 'income representing the landlord's share of the produce', and no longer 'rent' alone, must form the basis of the tax on land. But the income representing the 'landlord's share of the produce' was, for them, still a logical category — that is, it represented not what *in fact* remained to the landlord, but what in principle *in law* belonged to him as landlord. It was therefore always necessary to deduct interest, profit, and wages from the total product of the land, in order to establish the basis of the tax on land.

But even this more modest abstract concession has had to yield in the face of reality.

Just as, earlier, it was necessary to add to the rent of land the interest on the capital permanently invested, so, later, it was impossible to separate completely the 'income representing the landlord's share of the produce' from profit and the interest on every type of capital invested in the land.

In fact, 'capital used for improvements' experienced rather quickly the fate of 'capital permanently invested'.

A typical example of personal separation of the landowner from the agricultural entrepreneur is to be found in the old crop-sharing arrangements of an emphyteusis character. But, even then, the separation could never be perfect, since the income from *land-rent* depends on the fertility of the land as affected by the *quality* of the cultivation. That is, a piece of land used for the cultivation of grain may yield no rent; used for viniculture, it may yield a very high rent. Hence one who has a right to the rent alone and wishes to preserve this rent cannot be disinterested in the question of cultivation. And this is confirmed by the fact that in the old emphyteusis grants the landowner imposed on the concessionaire the obligation to make certain definite improvements.

It is well known, however, that insuperable conflicts of interest arose, in the execution of the contract, between the granter of the concession and the concessionaire, and that these conflicts were an obstacle to improvements in the method of cultivation and the increase of production, until finally the contractual forms of divided property to which we have referred were abolished, and the user of the property was given the right to redeem the property exclusive of improvements and become the sole owner thereof.

## THE SYSTEM OF DIRECT TAXES

The final consequence of the reform was that 'capital used for improvements' was consolidated with the ownership of the land and the permanently invested capital, and that the interest on such capital also came to be part of the 'income from the landowner's share of the produce' and to be subject to the tax on land.

### §4

There remains the question of agricultural profit, which falls to the person who has the supreme direction of and responsibility for the enterprise, as well as the question of working capital and of labour.

The existence of the share-cropper, and above all of the tenant-farmer, has given rise to the idea that the landowner does not perform the function of an entrepreneur; and this opinion is strengthened by the fact that the landowner does not usually take a direct or personal part in agricultural production. It is possible to imagine, theoretically at least, a true entrepreneur, who would pay the landlord for the use of the land and of the capital permanently invested, and would relieve him of the consequences of what was happening to the product. On such an hypothesis, the entrepreneur would be the responsible head of the enterprise and would have to be the subject of the tax. The landowner would take on the nature of a capitalist who lends his capital in the form of land and absents himself from the enterprise.

But this theoretical construction does not correspond to historical reality, or corresponds to it only in some cases or in some countries in which the system of leasing land in large units prevails. In fact, the owner of average or small holdings cannot be indifferent — even where share-cropping is prevalent — to how the land will be exploited in the productive process. If the capitalist advances \$5000 to the entrepreneur, at the expiration of the agreed time he will receive \$5000. But if the owner advances land, he is sure, indeed, to receive the same number of acres, but the land may have deteriorated in value. In short, the landowner cannot be disinterested in the enterprise and is for this reason always an entrepreneur, even if he shares the enterprise with other people.

The historical evolution of the old contract of emphyteusis has also, and perhaps most of all, been determined by the interest the

## TAX ON LAND

tenant-farmer has in obtaining absolute control over the direction of the enterprise. The concessionaire who redeems his ground-rent aims to acquire the full right to direct the enterprise in his own way, without the owner's intervention, which was not eliminated by the mere commutation into a ground rent of the obligation to pay a share of the produce.

The figure of the present-day landowner, then, resembles more and more that of the entrepreneur-owner, rather than that of the owner-capitalist.

In relation to him, the share-cropper is one who contracts to execute the necessary labour, and works under the supervision of the 'landowner.'<sup>1</sup> Nor is the position of the tenant different, though he enjoys greater liberty of movement than does the share-cropper. The rent-contracts often specify, down to the most minute detail, how the tenant must conduct the farm, how he must carry out the rotation of crops, fertilize, etc.;<sup>2</sup> this shows that the supreme direction remains with the landowner.

Nevertheless, the share-cropper and the tenant are also entrepreneurs within the limits of the organization of the actual performance of the work. In reality, they are smaller enterprises within the larger enterprise; and for this reason, in the amount received by the tenant and the share-cropper, there is the whole of wages, but there are also elements — more or less considerable, according to local usages — of profit.

If we assume that the enterprise is divided between landowner and tenant, in a proportion that varies from place to place, this explains how the working capital is also furnished by the two agencies between whom the enterprise is divided.<sup>3</sup>

The consequence of what has been said is that the 'landlord's income from his share of the produce' as interpreted in most existing law is no longer the economic abstraction by which earlier legislators thought to identify the part belonging to the landowner as a matter of law; it is, rather, the whole of the income which *in fact* goes to him on the basis of the contract, and in which are included rent,

<sup>1</sup> The Italian courts have also gone on record to this effect.

<sup>2</sup> This is especially true in certain regions of Italy.

<sup>3</sup> In Italian agriculture, in fact, the working capital is usually contributed by both the landowner and the share-cropper, or by both the landowner and the tenant. The separate figure of the capitalist is still far from being a typical phenomenon in Italian agriculture.

## THE SYSTEM OF DIRECT TAXES

interest on capital permanently invested, interest or part of the interest on the capital used for improvements, profit or part of the profit, as well as the interest or part of the interest on working capital.

Only wages are excluded; and they are excluded even if the owner cultivates the soil directly. This results from the fact that it is an almost universal rule that the wage-earner is a different person from the landowner. In distinguishing the share-cropper and the tenant from the landowner, one distinguishes by implication the mere labourer from the landowner. If the owner manages the farm personally, he hires the wage-earners. It is a rare case in which the owner is also a mere labourer.

### §5

#### *The Depuration of Income*

In order to ascertain what is in fact the part of income that remains to the landowner, it is necessary to proceed to derive net income from gross; that is, it is necessary to deduct the amounts which in fact belong to the other agents of production and which the Treasury will tax after they have been received by the latter. For this reason, the law usually deducts expenses of production, having regard to the customs and conditions of each place, — that is, to the particular terms of the contracts involved.

Similarly, there are deductions for fees paid for the use of water for irrigation, for permanent construction of a protective nature, for the rehabilitation of the soil, for expenses of administration, etc. What are involved are always parts of the total product that the Treasury will come across again as income, within the budget of other taxpayers.

On the other hand, not included in the process of depuration are the amounts which the law allows individuals to deduct for atmospheric, meteorological, and volcanic disasters, since these concern the ascertainment of the total product, not its distribution among the various individuals who take part in production. It is obvious, that is, that a hail storm decreases the product in the year in which the disaster occurs. If the ascertainment of taxable income

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were annual and direct for every farm, there would be no occasion for this average and fixed deduction.

But when — as in Italy — the ascertainment of income is made through the use of typical values, and includes all farms, and is extended over a long series of years, the law allows the deduction of a percentage based upon the normal occurrence of disasters due to atmospheric conditions, — which may come once in every ten or twenty years. The purpose, then, is to assure an average value or product, which will approach the real value with increasing accuracy. Then there are cases of exceptional *serious disasters not contemplated or foreseen in the making of the estimate*, for which the law grants temporary tax-reductions.

Now, it is to be noted that not one of the deductions referred to involves agricultural profit; and this confirms our conclusion that such profit, in so far as it belongs to the landowner, is in fact included in the income which is subject to the tax on land.

## CHAPTER II

# ASCERTAINMENT OF INCOME FROM LAND

Summary: The various systems — The cadastral method of ascertaining income from land — Functions of the cadaster — The *parcelle* — Geometrico-topographic operations — Operations of appraisal

### § I

HAVING defined the object and the subject of the tax on land, we may now discuss the method of ascertaining taxable incomes.

The first method is that of *declaration*, in which the taxpayer takes the initiative in the process of ascertainment. The declaration is checked over by the agent of the Treasury and is given definitive form either through amicable agreement between the parties, or through litigation, ending with a decision by administrative commissions appointed for the purpose.

It is customary to contrast with the system of declaration that of *official valuation*, in which it is the agent of the Treasury who takes the initiative in the process of ascertainment. The taxpayer may lodge a complaint against the official valuation and inaugurate the same procedure as that described above, ending either by amicable agreement, or by the decision of administrative commissions appointed for the purpose.

The two methods are based on the notion of making use of the opposing interests of the two parties, in the expectation that the result so obtained would be economically more acceptable.

At times, however, it is found more convenient not to make use of, but to avoid, friction, which in certain places and at certain times may assume too bitter a form, either because of an excessive tendency of the taxpayer to conceal his income, or because of a domineering spirit on the part of the Treasury agent.

It is sought, therefore, to substitute for both the official valuation and the taxpayer's declaration an 'automatic' method. Such a method may be said to be used when the appraisal of income is



## ASCERTAINMENT OF INCOME FROM LAND

made on the basis of external indices and factual data which the law prescribes with precision. Thus, a determination of professional incomes may be arrived at by establishing a classification of the professions and setting up for each profession a series of objective criteria, such as the population of the place in which the profession is practised, the office-rent and the number of clerks employed, the number of cases on a lawyer's docket, the number of projects executed by an engineer, etc. To each one of these data is assigned a coefficient of valuation. From this the estimate of professional income results automatically. One example is to be found in the French tax on licenses.

Similarly, for the income from buildings, a classification may first be made of cities according to population, and then, within each city, recourse may be had to circumstantial evidence and external indicia, such as the area occupied, the cubic content of the building, the number of doors and windows, the length of the street façade, and the position of the house with respect to the various centres of the city.

For the tax on land recourse has been had to the cadastral system, which is the typical and oldest form of quasi-automatic ascertainment.

It may be noted that the system of declaration prevails in Anglo-Saxon countries, whereas the automatic methods have prevailed and are still in use in the Latin countries.<sup>1</sup>

### § 2

#### *The Cadaster*

The cadaster, stripped of its historico-political and juridico-civil functions, and reduced to its purely fiscal character as a method of ascertaining income from land, is a set of books and registers containing (a) a list of landowners owing the tax; (b) the corresponding list of lands belonging to them; (c) the value of, or the income from, the lands on which the tax is levied.

The information with respect to the landowners and the incomes

<sup>1</sup> In Italy, the automatic methods have been abandoned in the case of the tax on buildings and the tax on 'movable property'. The cadastral system is still used for the tax on land.

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can be obtained with more or less precision. This gives rise to various types of cadasters—from the *descriptive* cadaster, which is least rigorous of all, to the *geometric* cadaster based on the *parcelle*, which represents the most exact type and which is to be found in its most perfected form in the Italian law of March 1, 1886.<sup>1</sup>

Cadastral operations are divided into two categories: the first includes the 'geometrico-topographic' operations that are designed to establish the extent and configuration of property in land, its location, and also the identity of its owners; the other includes the 'technico-economic' operations, or, more simply, the operations of 'appraisal', which represent the method adopted for the ascertainment of income.

All these operations, however, presuppose a cadastral unit, to which they must be applied.

The cadastral unit is called a *parcelle*,<sup>2</sup> which is composed of a continuous portion of land or of a building situated in the same municipality, belonging to the same owner, of the same quality and class, or having a given use.<sup>3</sup>

Of the elements constituting the *parcelle*, some, such as the element of ownership, have reference to the juridico-fiscal aims of the cadaster; others, such as the quality of cultivation and the class of land involved, are intended merely to aid in appraising the income; others, such as the type of 'use' to which the land is put, have technical aims, the principal one of which is that the whole area of

<sup>1</sup> This law assigns to the cadaster two functions: the one, the juridico-civil function of 'ascertaining the amount of immovable property (*le proprietà immobiliari*) and keeping a record of changes therein'; the other, the fiscal function of 'equalizing the tax on land', by means of the appraisal of income, to be carried out uniformly throughout the State.

But Article 8 leaves for other laws the reforms necessary in order to give to the cadaster juridico-civil effect, so that the law of March 1st, 1886, is concerned only with the fiscal cadaster.

<sup>2</sup> [Italian: *particella*—Translator's note]

<sup>3</sup> The elements of the *parcelle*, therefore, are: (1) the 'continuity' of the piece of land, since it might be interrupted by a road, a canal, etc.; (2) the 'ownership', which might be public or private; (3) the 'quality of cultivation' (vineyard, crop-land, forest, etc.); (4) the 'class' or degree of fertility of the soil for each quality of cultivation; (5) and finally, the element of 'utilization', which may have reference both to areas not directly cultivated, but serving agriculture (farm buildings, roads on the farm, etc.), and to areas which neither are cultivated nor serve agriculture, but which are part of the territory to be subjected to cadastration (public roads, canals, rivers, centres of habitation).

From this definition it follows that the larger the number of the elements that define the *parcelle*, the smaller it becomes, and the more stability it confers on the cadaster in the face of changes in land-utilization.

## ASCERTAINMENT OF INCOME FROM LAND

the land of the State must be subject to cadastration without exception.

Cadastral operations consist in practice of applying to the land the definition of the *parcelle*.

### § 3

It may be of value to focus attention briefly on the significance of the various operations involved.

The first and fundamental one is the *delimitation* of the properties, which consists of the *recognition* of the boundary line between municipalities and adjacent properties, and, where necessary, of the drawing of boundary lines.<sup>1</sup>

The process of delimitation identifies the land on which the tax is to be levied. If for the appraisal of income recourse were to be had to the taxpayer's declaration, or to the rental-contract, the cadastral operations would end here, since the declaration, or the rental, would indicate the total income from the property.

On the other hand, if the law adopts as the method of ascertainment an appraisal by experts, it becomes necessary to have further subdivisions with respect to the quality of cultivation and the 'class' of the delimited area. The expert makes a survey of the territory and of all the *parcelles*, giving the configuration, dimensions, and exact position of each of them: and in this way is obtained the '*parcelle-map*'.

With the making of the map, the geometrico-topographic operations come to an end.

### § 4

After the determination of the *parcelles*, we pass to the 'technico-economic' operations, or operations of appraisal.

The appraisal may be *synthetic* or *analytical*.

<sup>1</sup> In Italy, the delimitation is made after hearing the opposing views of the owners of adjacent properties, who are invited by the commission of experts to be present while the boundaries are being determined; but these hearings have no standing in civil law, either with respect to the person of the owner or to the nature of the property. Italian law expressly prescribes that the commission of experts, in case of disagreement between the owners of adjacent properties, should not suspend operations, but should pursue them *according to the existing facts* with respect to actual possession without prejudice to the legal considerations involved.

## THE SYSTEM OF DIRECT TAXES

The synthetic system exists when the information as to the income from the land is obtained from the rental-contract, and, by way of check, from sale-contracts, divisions of inheritances, mortgages, etc. The method is called synthetic because the rental-charge on which the parties have agreed is a synthesis of the analytical calculation that each party has made on his own account with respect to the productivity of the land and the expenses of cultivation. The rental-charge, properly checked, is the economic market-price, and ought to be preferred to expert valuation. Moreover, it would render superfluous the operations of establishing the 'quality' and the 'class' of the various properties, and would save the expenses involved in those operations.

The rental-contract, however, is not, as a rule, used in all parts of a country. Hence, in order that a uniform method of appraisal may be followed, the analytical system is usually preferred. This system, ignoring the rental-contracts or having recourse to them only as a datum for checking purposes, appraises the income from land by means of direct expert appraisal. This consists of attempting to ascertain the amount of production in kind for a given period of years, and then the corresponding selling-prices per unit of product, in order to determine the annual average income, from which are deducted expenses of production, thereby obtaining the taxable income.

In view of the fact that the number of *parcelles* is very large, it would not be practically possible to appraise each one of them *directly*. For this reason they are usually appraised *indirectly*, by ascertaining, municipality by municipality, the taxable income of some typical *parcelles*, then reducing it to the acre as the unit of measure, and finally extending it, in proportion to their area, to all the other *parcelles* which were not examined directly.

## CHAPTER III

# TAX ON BUILDINGS

**Summary:** Legislative basis of the tax on buildings — Farm-buildings, factories, and residences — Residences are direct goods of repeated utility — The owner is the producer of the residence, and therefore the subject of the tax — The tax on buildings is not an indirect tax on consumption — Depuration of income from buildings — Criticism of a common method — The tax on rental value.

### § 1

#### *Basis of the Tax*

IN many countries, the tax on buildings is combined with the tax on land. In such cases, the building is usually regarded as an adjunct of the land, or, more precisely, as an improvement of the land on which it is built.

This theoretical construction has, however, been made obsolete by the fact that the increase in urban construction and the consequent development of the industry of building houses for rental purposes have made it impossible to regard the value of the building as an adjunct of the soil. Hence, in some countries — as in Italy — the tax on buildings is no longer discussed from the standpoint of its analogies with the tax on land, but is discussed rather from the standpoint of the differences that distinguish the two types of tax; and thus it is possible to examine separately the tax problems involved, in accordance with the true facts of the situation.<sup>1</sup>

According to Italian law, which may be taken as typical of law which regards buildings as a separate object of taxation, the subject of the tax is the owner of the building, or the occupant, or the one having the use of it; the objects of the tax are buildings and all other permanent structures, which are taxed in proportion to their net income.

<sup>1</sup> The law which in Italy has separated buildings from lands and which now regulates the matter is that of January 26th, 1865. Later laws and decrees have not changed the basic principles of this law.

## THE SYSTEM OF DIRECT TAXES

For the definition of taxable income the law takes as its standard of reference a building which is rented, and not one which is inhabited by the owner; so that, in the first case, the income is given by the rental, and in the second, it is estimated, by analogy, from the rental-value of other buildings in a similar condition and location.

This total income is translated into net income by deducting a certain percentage of the rental for repairs, insurance, and all other possible sources of expenses or loss.

This, in broad outline, is the legislative basis of the tax on buildings. Despite its apparent simplicity, it involves many theoretical questions.

### § 2

First of all, it is necessary to define the economic function of the building. The latter may be 'capital' if it serves for the production of an income, as in the case of farm-buildings and factories; on the other hand, it is a direct good when it serves as a habitation, either for the owner or a tenant. Now, farm-buildings and factories co-operate in the production of an income — agricultural or industrial — which is subject to the tax on land or the tax on 'movable property' (or its equivalent), respectively.

Hence arises the tendency of both theory and legislation to exempt farm and industrial buildings from the tax on buildings, in order to confine its basis to residences only.

The Italian laws have recognized that farm-buildings have the character of capital; and for this reason these buildings have not been subject to appraisal, but only to topographical survey, because the income which they help to produce is already struck by the tax on land.

The same treatment ought to have been applied to factories, which help to produce industrial income. But the authors of the first Italian law on the subject stopped short in the face of the practical difficulty of defining a factory in such a way as to distinguish it, in the concrete case, from residences, as well as from other buildings which have the character of capital.

The difficulty is accentuated in centres of population, where a building may easily change its purpose and where the principle ought logically to be extended to warehouses, cafés, and shops, which are instrumental goods for the trade and industry that they serve.

## TAX ON BUILDINGS

The Italian legislation has overcome this obstacle by renouncing any attempt at sub-classification, of buildings according to their economic function and has put all non-rural buildings into a single category, taking as the criterion of classification the rental-contract, which is common to both residences and industrial buildings in general.

The rental-contract shows that the owner of the building is a person distinct from the entrepreneur; hence the total income from industry is divisible and is in fact divided between the two. All danger of double taxation is avoided; the problem is resolved in conformity with the principle of the deputation of incomes and the treatment for all buildings is equal.

It still remains to be decided whether the share due to the owner of the industrial building must be subject to the tax on buildings or the tax on 'movables';<sup>1</sup> but there is no doubt that it must be subject to the latter, because it has helped to produce an industrial income.

If the two taxes treated the two incomes equally, the question would be of secondary importance; since the inevitable errors of classification would not offend against the principle of tax equality. But if income from buildings is taxed more heavily than industrial income, as is the case in Italy and several other countries, this makes it to the interest of the owners of buildings to pass from one tax-classification to the other.

This is the crux of the problem.

The reform tending to exclude factories from the tax on buildings demands, therefore, as a necessary minimum: (a) either that all buildings (factories, shops, stores, hotels, etc.) occupied by businesses that already pay the tax on 'movable property' be excluded from the tax on buildings; (b) or that the two taxes give equal treatment to income from buildings and income from 'movables'.

It goes without saying that the buildings whose character as business buildings is clearly recognized need not be appraised separately, any more than farm-buildings are appraised separately.

In spite of the difficulty presented by the solution of the problem of factories, there is no doubt that the tax on buildings tends to strike only residences.

<sup>1</sup> [Italian: *imposta mobiliare* or *imposta sui redditi di Richezza Mobile* - Translator's note]

## THE SYSTEM OF DIRECT TAXES

### § 3

#### *Residences Are Consumer's Goods*

From this fact arises another theoretical problem that has been raised recently. A residence is a consumer's good; it is not a capital-good; it is therefore a product or an income, and the tax may fall on the value of the house, but not on the income from the house—that is, on the income from an income.<sup>1</sup> This point calls for some clarification.

In the current language of accounting, a residence is treated as capital and its rental is treated as income. If this usage has reference to the fact that there are those who use their savings in the construction or in the purchase of houses in order to draw therefrom an annual return, the residence might, as a matter of formal analogy, be regarded as capital *so far as the house-owner is concerned*, just as it is customary to call the quantity of bread that the baker puts on sale daily in his shop capital so far as the baker is concerned. And in this way the tax on buildings may well be modelled after the tax on land and the tax on 'movable property', the house being regarded as capital and the rental as income; and all three direct taxes may be regarded as constituting an homogeneous group for purposes of accounting. But this analogy does not solve the economic problem, since it is still a fact that the residence is, *per se*, a good intended for direct consumption, as is the bread of the baker, and hence is different from a farm-building, a factory, or machinery, which are instrumental goods giving rise to income.

It is, however, not difficult and it may also prove useful to include the tax on buildings within the group of taxes on income, by retaining the idea that the house is a direct good — that is, the final result of a productive act which has transformed instrumental goods (materials of construction, land, human labour, etc.) into a consumption good — that is, into an income.

If, therefore, we regard the residence as an income-good, it

<sup>1</sup> Out of this theoretical difficulty arose Professor Irving Fisher's long discussion of the concepts of capital and income. After having posed the theoretical problem, he believed that, in order to solve it, it is necessary and sufficient to change the traditional nomenclature, thereby increasing the terminological confusion which existed and still exists with respect to the definition of capital and income.



## TAX ON BUILDINGS

follows that the tax on buildings is not owed on the income from the buildings, but on the value of the buildings itself.

If a landowner produces 100 bushels of grain, he must pay the land-tax on the value of 100 bushels, minus the expenses of production. Similarly, if an individual builds a house, he owes a tax on its total value, minus the expenses of production.

If a house were like bread, which is consumed at one time, this would be all that need be said. The analogy would be complete.

A residence, however, is typically a direct good of repeated utility. A loaf of bread is consumed in perhaps three or four instalments during the day; a pair of shoes is consumed in six months; a suit, in two years; a pianoforte, in thirty years; a house, in a hundred years. Let us retain these figures in order to provide an example which will help toward a better understanding of the train of reasoning involved.

The first characteristic of direct goods of repeated utility shows that it is technically possible, as a matter of accounting, to distribute the cost, the consumption, and the tax over the period during which such goods last, instead of making these items refer to the initial moment of production.

Moreover, what is technically possible becomes economically expedient for various reasons. The first is that the value of the goods of repeated utility changes as they are consumed during succeeding years. The second is that goods of repeated consumption usually require the making of continuous expenditures if their utility is to be preserved or increased during the succeeding years. The third is that the cost of acquiring or constructing a house is almost always too great to be paid for out of the annual income of any individual; hence the savings of several years are usually required for the purchase of a house, whereas the annual acquisition of a hundredth part of the utility of the house is possible within the limits of one's annual income.

Hence the initial expenditure on construction may be considered as the original capital-investment to which it is necessary to add continuing or periodical expenditures on maintenance (ordinary and extraordinary repairs), and possibly on improvements — this second group of expenditures being comparable to expenditures out of working capital. In this way, account is also taken of the annual variations in the utility, the cost, and the tax.

## THE SYSTEM OF DIRECT TAXES

To sum up: the annual tax on a residence falls on its direct utility, divided by the number of years the residence lasts.

Assuming that a house will last a hundred years, the owner may live in it or rent it — that is, each year he may consume a hundredth part of the residence or he may sell that hundredth part to others. The value of this hundredth part of direct utility would be measured by the rental. It is of secondary importance whether or not this is an exact measure.

In conclusion: the annual rental may be taken, in every case, as the raw datum on which the tax on a house may be based.

### §4

If it be admitted that a residence is not capital, which aids in the production of future continuing incomes as land does, it follows that it is a product of the ordinary factors of production; and if a residence itself cannot be divided among these factors as grain, for example, can be divided, its value can be divided among them. In fact, this value may be broken up into the site-rent of the area covered, interest on the capital permanently invested in its construction, profit, and wages.

We have now to decide on which of these elements the tax on houses is to fall — that is, which of them belong to the owner of the house.

The sum obtained by adding the site-rent to the interest on the capital invested in construction represents, in a typical way, what was called, in the case of the land-tax, the 'income from the landlord's share of the produce' (*reddito dominicale*). In this case, also, the older tax systems used to distinguish between the owner of the land and the owner of the building; but what has already been described as having happened to the old contracts of emphyteusis and tithe has happened in the case of houses also; the person holding the concession for the use of the land has redeemed the right to its ownership and has become the sole owner of the land and of the building.

To-day there exist credit institutions which furnish capital in the form of loans at long term and with slow amortization; but they always end in the same way as the old *census* contracts ended — namely, in the unification of the ownership of the land and the structure thereon.

## TAX ON BUILDINGS

There is no doubt that the profit belongs to the entrepreneur, who is usually also the owner, or to the owner who builds the house.

As for wages, they are paid, in every case, during the process of construction.

So far as the owner is concerned, it may be noted that in order to build or buy a residence without having to hire the house of someone else, he must spend a considerable sum, which usually represents an accumulation of savings over several years.

In fact, he considers this sum as capital that he invests in the acquisition or the construction of the house; from this it follows that the rental that he will obtain from now on by letting his house, or that he will save by living in the house, represents for him nothing but interest, and he will generally speak of having invested his capital at 5 per cent or 10 per cent.

Nevertheless, the future fluctuations in the value of the house depend not only on fluctuations in the rate of interest, but also, and above all, on the variations in the rental of buildings, in profits and in wages — that is, on the 'cost of reproduction', as the expression once ran.

This analysis of the elements involved in the value of houses is necessary in order to decide the amount of the tax or its variations over a period of time, especially in countries in which rent, interest, profit, and wages are differently taxed.

### § 5

From this analysis we pass more easily to a decision as to what part of the value of the house must be subject to the tax on buildings.

The problem of deputation presents considerable difficulty, given the complexity of the concrete phenomenon and the multiplicity of the possible combinations.

The theoretical principle is always the same: *it is necessary to avoid duplications and gaps*. In particular, the greatest danger lies in the possibility that some one of the elements that make up the annual value of the house may be taxed several times.

One cause of this danger derives from the fact that the deputation of income may be made, and in part is made, as soon as the house is constructed. Thus the part belonging to the workers as wages and

## THE SYSTEM OF DIRECT TAXES

the part belonging to the enterprise as profit fall at that moment within the scope of the tax on 'movable property', or of some other tax designed to strike personal incomes.

Similarly, all the materials of construction, which have been paid for during the period of construction, have already paid a tax while the materials were in the possession of their respective purveyors.

If we deduct these shares from the total value of the house, or deduct the corresponding taxes already paid from the annual tax on buildings, the basis for the latter would be restricted to the income from the 'owner's share of the product',— or, as we shall call it more briefly, the 'owner's income'.

But even then other distinctions would have to be made. If the owner has borrowed the capital for the construction of the house, the interest that he pays to the creditor would have to be deducted from the 'owner's income'. On the other hand, if the owner is also the builder of the house, the profit would be added to the 'owner's income', if this profit has not already been subjected, or is not about to be subjected, to the tax on industrial income.

The share going to wages would give rise to other distinctions, depending upon the nature of existing legislation with respect to the taxation of wages. If the legislation of the country makes explicit provision either for exemption or for taxation of wages, it would follow, in either case, that the owner would not owe any more taxes. If, however, the law establishes the principle that wages are to be taxed and imposes the burden of paying the tax on the employer of labour, the share going to wages would find its proper place in the tax on incomes from labour; but it might also be joined — for simplicity — to the owner's income from the house.

In the tax on houses, as in the case of the tax on land, the interest owed by the owner on mortgages ought always to be protected against double taxation.

A final question presents itself. Should it be permissible to deduct amortization payments on the capital invested in the construction of the house?

If one takes as the standard of reference a commercial enterprise engaged in the construction of houses, there is no doubt that such an enterprise must recover its capital over the period of years represented by the life of the building; nor is there any doubt that the owner who

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buys a house must pay off the capital either in a lump sum, or, in the event that he has agreed to pay it in fifty or more years, he must add to the interest an amortization-payment.

In any case, the amortization payment, calculated on the basis of the presumed life of the building, is always a very small quantity and may be included among the deductions granted to those house-owners who build their own homes, who will thus, by analogy, be put in a single group with the professional builders.<sup>1</sup>

It goes without saying that no deduction is granted on this account for the value of the land, since when the house ceases to exist the owner retains this value unimpaired.

The deductions mentioned lead — in conformity with our theory of the depuration of income — to the determination of the basis for taxation.

Yet it is precisely of this group of deductions that the laws of many countries make no mention.<sup>2</sup> They take as the basis for taxa-

<sup>1</sup> A question — of more significance for purposes of theoretical refinement than for its practical utility — could be raised, if we were to divide into separate categories the habitual professional builders of houses, on the one hand, and the owners who have bought houses or have had them built as personal residences, on the other. For the latter may be classified (1) as producers of their regular income, on which they pay a direct tax, or (2) as consumers of all the goods that they buy, among these goods being bread, a pianoforte, and a residence.

It would follow from this second case that they ought not to pay a direct tax on the value of the house, any more than they do on the bread and the pianoforte; but they could be called on to pay an indirect tax on consumption, just as they do on the pianoforte.

Here it may be recalled that the tax on residences has such close connections with taxes on consumption that early economists — even some of great competence, such as John Stuart Mill — have not always succeeded in separating sharply the tax on residences from taxes on consumption. Thus, there was often discussion of the inequality involved in putting the *objective value* of the house into relation with the general income of the owner who lived in it. A comparison was made between two equally rich individuals, one of whom lived in a provincial city, where he could rent a large apartment for a low price, while the other lived in a large, densely populated centre where he would have to pay a high price for only a small apartment.

Such criticisms have their place in a discussion of indirect taxes; but they are somewhat out of place in a discussion of direct taxes.

Without entering into further subtleties on this point, it may be recalled that we have already seen that the line dividing the various exchanges between two producers, which may give rise to four types of tax — two direct and two indirect — is an arbitrary one, in the sense that it varies and shifts continually according to the actual division prevailing between productive occupations. Thus it is possible in fact that in one place a man who ordinarily produces grain may have to build by himself the ploughs, the cart, the barn, and the house, whereas in other places such a man may be able to buy them from a specialized enterprise.

Where both cases exist, there is an equal basis in theory for the legislator's taking either of them as the standard type, referring the other to it as a basis of comparison, and treating both individuals as producers of houses, subject to a direct tax.

<sup>2</sup> This is true also of Italian law.

## THE SYSTEM OF DIRECT TAXES

tion the total or annual value of the house, whence arise inevitable duplications, which make the building of houses unprofitable and restrain their development until the increase of rentals will have discounted the increase in cost which is due to the tax duplications.

### § 6

On the other hand, it has come to be generally recognized that from the annual value, or the rental, of the house must be deducted expenses for repairs and maintenance, which are designed to preserve the value of the house and to prolong its life, and therefore to benefit equally the house-owner and the Treasury, both of whom must, for this reason, share in the expense.

Similarly, there are deductions for expenditures for illumination, water, elevator, and janitor-service, etc., according to local customs, when these services are rendered by people other than the owner.

But the deductions that the laws allow for possible losses do not enter into the theory of the deperuation of income, since these deductions depend on the fact that for buildings also — as was pointed out in the case of land — an average is made on the basis of experience over a series of years, and the deductions on account of possible fires, vacancies, inability to pay the rent, etc., serve to bring it about that this average is, as far as possible, a *real* value.

The deduction for repairs ought to be calculated separately for each house, at the time when the taxable value of each house is determined. For reasons of convenience, however, the laws usually establish inclusive and uniform deductions calculated as a percentage of the annual value. Thus Italian law makes an inclusive reduction of a third of the rental for all buildings and for all of Italy. And this third thus includes expenditures for repairs as well as for accidents and losses of all kinds.<sup>1</sup>

<sup>1</sup> The Italian law used to allow the deduction of 25 per cent in the case of residences though it has increased this to 33½ per cent. But this 33½ per cent is allowed on account of repairs, insurance, and all other possible expenses or causes of loss.

English law allows 25 per cent for repairs, this 25 per cent not including losses from vacancies and other causes. Furthermore, it establishes that *if the house is not occupied for any period during the year, it is not subject to the tax during that period*. Similarly, it permits the owner to obtain a reduction of more than 25 per cent whenever he can show, on the basis of actual expenses during the preceding five years, that the allowance of 25 per cent is not enough.

Another circumstance that merits consideration is that the English legislator has sought to attenuate the rigid uniformity of the 25 per cent provision by classifying

## TAX ON BUILDINGS

Quite aside from the fact that a third seems in some cases to be insufficient to cover repairs, maintenance, accidents, and losses from vacancies, the more serious criticism of the system consists of this: that its uniformity takes from it all concrete value, since it transforms the tax on houses into a tax on gross rentals.<sup>1</sup> In fact, to levy a tax of 12 per cent on two-thirds of the rental is the same thing as levying a tax of 8 per cent on the whole rental, the tax on houses being thus transformed into a tax on gross income.

Now, houses give, *ceteris paribus*, net incomes which differ considerably because of the fact that expenses on repairs and maintenance and for amortization and losses through fire and vacancies differ in fact from place to place and from building to building.

The differences depend, above all, on the material used and the habits and density of the population of the district. There already exists, in some countries, a classification of houses according to quality, and this classification is being made more and more precise.<sup>2</sup> Once we have admitted, in some way, that in translating gross income into net income it is convenient to proceed by using typical rather than individual cases, it is not difficult to increase the number of type-cases and to define them better.

From this fundamental error it follows that the structure of a tax system based upon this device of a flat percentage reduction is such as to lead to inequalities.

In the first place, there is no exact division of the total or gross income between the owner and the other enterprises in whose budgets the deductions will figure as net income.

In the second place, the tax bears more heavily on houses of the poorer classes than it does on houses of a luxury character, since the expenses for repairs, maintenance, and amortization are relatively greater for houses of the poor.

<sup>1</sup> This criticism, which is obvious and decisive, has been advanced for a long time in Italy, but without effect; I read it for the first time in one of the earlier editions of Professor Einaudi's treatise on Public Finance.

<sup>2</sup> Thus, in Italy, houses are classified into houses of a luxurious character (*case signorili*), houses of moderate comfort (*case di civile condizione*), and houses of the masses (*case popolari*); and some of the old laws give us an example of such a classification.

houses according to their value, inasmuch as the houses of lesser value demand relatively greater expenditures on repairs, as follows:

Houses having an annual value of not more than £40, 25 per cent.

Houses having an annual value between £50 and £40, £10.

Houses having a greater value than £50, but not more than £100, 20 per cent.

Houses exceeding £100, 20 per cent plus a sixth of the sum exceeding £100.

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Finally, other conditions being equal, the tax-burden is lightened in proportion as, with the growth of the city, the site-rent increases. Let us take as an example a house rented for \$1200. When such rentals are not excessive, it may be assumed that one-third of the rental — that is, \$400 — represents the real total of expenditures; the taxable income is \$800, on which the owner pays 20 per cent, that is, \$160.

Let us now suppose that the house is rented at \$1650, and that the increase is due only to an increase in the site-rent. If a third is deducted, the taxable income becomes \$1100, on which the owner will pay \$220 in taxes. On the other hand, the expenses have remained constant, and therefore the new taxable income should have been \$1650 minus \$400 — that is, \$1250 — and the tax \$250, instead of \$220.

Thus, in the course of time, an inequality is established as between houses in the centre of a city and those on the outskirts in favour of the former, while, at the same time, the Treasury gives up the right to collect a tax on rent and on increases in site-rent.

### § 7

#### *The Rental Value<sup>1</sup>*

There is a fairly widespread opinion that buildings are struck not only by the tax just examined, but also by that on *rental-value*, which in Italy is part of local finance.

The tax on *rental value* is paid by the tenant on the basis of the rental he is charged. And since the tax on buildings is usually commensurate with rentals, it is said that the same income is struck twice; and it is further stated that the tenant shifts the tax to the owner by forcing the latter to grant a corresponding reduction in the rental. To sum up: the tax under discussion would be, directly or indirectly, a duplication of the tax on buildings.

The opinion is sound only in small part. First of all, it is not sound with respect to the object of the tax, since in fact the rental is taken as the single measure of two different incomes. So far as the owner is concerned, the rental measures the value of the house

<sup>1</sup> [Italian: *valore locativo* — Translator's note]



## TAX ON BUILDINGS

which is subject to the tax on buildings; so far as the tenant is concerned, the rental value is taken as an index of his general income, when this tax is intended and is administered as a direct tax. It is in the tradition of tax-legislation to take the value of the house as the index of the general wealth of the individual, though it goes without saying that the index is insufficient and inaccurate. Fresh proof of this is given by the fact that usually the tax on rental-value is progressive in relation to the rental, since it is held that the expenditure on housing is, to some extent, inversely proportional to the wealth — that is, to the income — of the citizens. A person who has a small income spends a relatively larger proportion of it on house-rent than a person with a large income. For this reason, the progressive tax on rentals is intended as a proportional tax on the general income of the tenant. The object of the two taxes is, therefore, different.

There is, on the other hand, some truth in the second affirmation. First of all, the demand for houses is not rigid, since it is possible to contract consumption by restricting oneself to smaller quarters or by sub-dividing very large apartments, or by sub-letting extra rooms. Since this is so, the tax on rental-value causes a general contraction in demand and therefore a lowering of rentals. In this sense it may be said that the proprietor bears in whole or in part the tax on rental value.

To be sure, there is no phenomenon of shifting involved, since the tenant who cuts down his consumption of housing bears the burden of the tax precisely because he does cut down his consumption. But in cutting down his demand for housing he brings about a diminution in rentals, and hence imposes on the owner also a lowering of income and a consequent contraction of his expenditures on consumption. It is a typical case of 'diffusion', which is a general phenomenon common to all taxes.

What happens specifically in the case of rental-value is that the tenants are driven to contract their consumption of housing in preference to cutting down their consumption of other things, in order to *evade* the tax. But this follows from the circumstance that general income is ascertained by the use of rental as an index.

In fact, the same thing does not happen in the case of the 'family tax'<sup>1</sup> which is adopted in many local communities in place of the tax on 'rental-value' and which is also a general tax on income. The

<sup>1</sup> [Italian: *imposta di famiglia* - Translator's note]

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ascertainment of the latter, however, is made by means of a complete declaration by the taxpayer, or is derived from the sum of all the direct taxes that he pays, and is then corrected by all available indices of his standard of living. In this case, also, the taxpayer will have to restrict his private expenditures on consumption; but each person will restrict his consumption of things that he considers relatively less urgent, and he is not forced, in order to evade the tax, to restrict, by preference, his consumption of housing. In this sense and within these limits, it is true that in most cases the tax on rental-value falls on the house-owner — that is, the diffusion of the tax is directed especially against him.

## CHAPTER IV

# THE TAX ON INCOMES FROM 'MOVABLE PROPERTY'<sup>1</sup>

Summary: The characteristics of the tax on 'movables' — The categories of income from 'movables' — *Interest* on lent capital — Industrial income — Professional income and wages — The deputation of income from 'movable property'

### § I

#### *Characteristics of the Tax on 'Movables'*

FROM ancient times, side by side with the tax on land we find other taxes on personal and industrial incomes and on income from capital, which have appeared under the various designations of taxes on licenses, personal taxes, industrial taxes, and taxes on professions and employments.

The taxation of incomes from 'movables', fragmentary at first, developed rapidly during the past century, along with the great growth of industry, commerce, and the professions.

To-day, movable property is greater, in progressive countries, than wealth represented by land, and tends to become greater by an increasingly large margin. The reason for this can be easily understood. Other conditions being equal, the production of wealth in the form of 'movables' has no limitations of area and is not subject to the principle of decreasing returns in the way in which, and to the extent to which, agricultural production is subject to that principle. On the other hand, the incessant increase in man's consumption depends more on the creation and development of manufacturing industries than on the increase or perfecting of agriculture. In short: in the budgets of modern States, the tax on 'movables' yields a preponderant and continually increasing part of direct derived revenues. Consequently, it has assumed, in the theoretical construction of the

<sup>1</sup> The Italian law with regard to the taxation of income from 'movables' or 'movable property' (*redditi mobiliari, redditi di ricchezza mobile*) corresponds to Schedules C, D, and E of the English income tax.

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system of direct taxes as well, the pre-eminent place which in the past was held by the tax on land.

The characteristics of this tax may be illustrated by an examination of the Italian law on the subject.<sup>1</sup>

The basis, or object, of the tax is established in the following terms.<sup>2</sup> After having made a positive list of taxable incomes from 'movables' — namely, incomes from mortgages registered within the country, salaries, pensions, annuities, interest and dividends paid by national, provincial, and municipal governments, or by business corporations; incomes arising from industry, commerce, employment, professions carried on within the country — the law concludes as follows: 'and, in general, every type of income *other than income from land* that is produced within the country'.

It was thought that in this way the boundary between the tax on land and the tax on 'movables' was well marked out. Subsequently, however, it was observed that some incomes which were in the nature of income from land were as a matter of fact escaping the tax on land, and were as a matter of law escaping the tax on 'movables', thus creating a gap in the fiscal organism. Thus it came about that later legislation<sup>3</sup> established that 'incomes in the *nature of income from land* will also be subject to the tax on "movables" whenever in fact they do not pay the tax on land'.

From these legislative provisions it follows that:

(a) The tax on 'movable property' (*ricchezza mobile*) has the character of a general tax, since it falls, as a matter of law, on all incomes, making an exception only of the income struck by the tax on land and that on buildings.<sup>4</sup> The Italian tax, following the English income tax, thus unites under one tax incomes from capital, industry, commerce, the professions, and labour, which under other legislative systems are dealt with and struck by separate taxes;

(b) The tax on 'movable property' has the character of a *tax which supplements* the two taxes on real property (i.e. the tax on land and the tax on buildings) since it is joined with them on the principle

<sup>1</sup> The matter is regulated in Italy by the fundamental law of August 24th, 1877. Other laws followed; and among these laws special mention should be made of the law of July 22nd, 1894, as well as of the decree of October 16th, 1924.

Italian law owes much to the English income tax.

<sup>2</sup> See Article 3 of the law of 1877.

<sup>3</sup> See Article 4 of the law.

<sup>4</sup> In accordance with this concept, the Italian courts have correctly declared to be subject to the tax on 'movables' the income from such land as, by mistake or otherwise, might not have been subjected to the cadaster.

## THE TAX ON INCOMES

that the three direct taxes form a 'fiscal organism', in such a way that no type of income escapes some one of the three, and none is struck by more than one. There are, to be sure, exceptions, some of them already mentioned,<sup>1</sup> and others of minor importance, which the further development of legislation will be called upon either to correct, or to maintain as intentional exceptions for social or political ends or for reasons of law, which are beyond the scope of financial technique;

(c) Finally, the tax on 'movable property', like the tax on land and on buildings, has been conceived by the Italian legislators as a *real tax* — that is, as a tax whose purpose it is to strike income at its source. A logical consequence of this is that of *territoriality*, whereby both Italians and foreigners are subject to the tax, but only so far as concerns that income or that part of their income which they have produced within the country.

### § 2

#### *Basis of the Tax*

The positive but unco-ordinated list of taxable sources of income given in the Italian law<sup>2</sup> includes, in a broad way and as a first approximation, the economic categories of *profit, interest, and wages*. The first elaboration of the law was made by a regulation<sup>3</sup> that puts into one category (Category A) incomes from capital — that is, interest; in another category (Category B), industrial income — that is, profits; in still another category (Category C), income derived exclusively from human labour — that is, wages. Later, however, still other criteria were introduced, with the result that the categories set up by the law as a second approximation do not coincide with the economic categories, and tend to become more numerous than the latter.

This is the first point to be cleared up.

From an economic point of view, profit, interest, and wages

<sup>1</sup> One of the principal examples is the failure to permit deduction of interest on debts encumbering landed property, which thus pays two taxes. Another is the permission to deduct interest on capital invested in live-stock and stocks of materials, which pay no tax.

<sup>2</sup> See Article 3 of the law.

<sup>3</sup> See Article 50 of the Regulation of November 3rd, 1894; cf. Article 54 of the law.

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arise from the distribution of the total product of an enterprise among the entrepreneur, capitalist, and labourers. And from this it would seem that Category A — interest — and Category C — wages — would derive from the distribution of industrial income, which is placed in Category B.

But in fact it is not so. Italian law defines as industrial income that which capital and labour co-operate to produce. At the time the earlier Italian legislation was framed, the dominant concept was that entrepreneurial profit was a *composite* of 'interest' on the capital invested by the entrepreneur in the enterprise and of 'wages' for the labour of direction and superintendence.

Nowadays, in economic theory, a more accurate understanding of the special functions of the agents of production has been attained; and the entrepreneur is assigned a function distinct from that of the capitalist and the labourer. But if account is taken of reality, the concept of the Italian legislators still corresponds to the present state of affairs, since the entrepreneur is also to some extent a capitalist, and the shareholder who contributes capital cannot help being to some extent also an entrepreneur.

It is generally recognized that from industrial income should be deducted, first of all, the expenses of production paid out to external agents of production; and, secondly, interest and wages.

As far as interest is concerned, however, its deduction is possible only when the capitalist is distinct from the entrepreneur, as is the case, for example, when a loan-contract exists between them. If this possibility is lacking, recourse is had to the expedient of collecting from the entrepreneur the whole tax, with the understanding that he may recover a proportionate amount from his creditors by legal processes, if the law allows him to sue for such a purpose, or, otherwise, in a general economic way.

It should be noted that the 'interest' of Category B does not include all instances of income from capital. Besides the interest on capital invested in industry, there is interest on capital lent without reference to the use to which the borrowed capital is to be directed. In short, there is 'the business of lending', in itself. It includes loans made to the owners of land and houses, loans for purposes of private consumption, and public loans. The interest on such loans does not fall under the industrial income which we have discussed. There is capital which is invested directly in industries and

## THE TAX ON INCOMES

shares the risks associated with such industries; there is capital which prefers to be independent, so far as possible, of industrial risk; such capital seeks investments that range from industrial bonds to public loans. The owners of capital of this sort are always persons distinct from the entrepreneur and the enterprise, to which they are bound by a loan-contract bearing a fixed rate of interest.

Hence Italian law has established Category A, which includes interest on capital lent. The existence of a loan-contract is the criterion for inclusion within this group.

The result is that the two categories, A and B, mutually complement each other, in such a way as to strike every income having the character of interest, thus avoiding gaps and duplications.

### § 3

Let us now pass to wages, or, as the Italian law says, the 'income from human labour without the addition of capital'.

Just as interest is deducted from industrial income, in the way described above, so the wages and salaries of employees are deducted from that income. The deduction of wages is the regular rule, since under present conditions the labourer is almost always distinct from the entrepreneur.

In accordance with this rule, the wages deducted from industrial income are moved over to Category C. But these wages do not represent all the cases of income from labour. In fact, they do not include either the salaries of State employees or income from the professions. Hence arises the necessity for bridging the gap by including in Category C every form of income due or believed to be due to labour without the assistance of capital.

The number of categories into which the various types of income have been grouped has varied, at times increasing and at times decreasing, for reasons that we shall discuss presently.

In the meantime, it may be pointed out that it is possible, on the basis of what has preceded, to draw the conclusion that the various categories of income form a framework that includes, as a matter of logic, and is able to include, as a matter of fact, all incomes from 'movable property'; and that these categories border on each other in such a way that no income from 'movables' escapes some one of them and no income is included in more than one category.

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The principle that regulates the external relationships between income from 'movables' and the two taxes on real property (i.e. the tax on land and the tax on buildings) also regulates the internal relationships between the various categories of the tax on 'movables'.

### §4

#### *The Categories*

But though all incomes are taxed, not all are taxed to the same degree, since each category pays a different tax-rate; hence the great importance of the classification of incomes from 'movable property'. This is the second point that must be explained.

The different tax-rates levied on the various categories are applied after the incomes have been translated from the gross into the net and therefore depend on the principle of discrimination.<sup>1</sup> Thus, net income from labour is taxed less than the same net income from capital; while temporary net income is taxed less than the same amount of permanent net income.

As a result of this differential treatment of, or discrimination between, incomes, it has come about in Italy that the few fundamental categories have sometimes been subdivided and at other times merged, according to variable criteria which have moved the legislator to accord more or less favour to some incomes than to others.

According to the first Italian law on the subject there were three categories: A, B, and C. Thereafter, State employees, advancing the argument that their salaries and pensions could not escape the rigorous ascertainment of income, obtained the new Category D. Then the law of 1894, holding that interest on public loans guaranteed by the State offers a greater degree of safety as compared with that on private loans, split Category A into A' and A".

The decree of October, 1924, abolished the division into sub-categories A' and A", and merged them into the old Category A; on

<sup>1</sup> The Italian tax on income from 'movable property' followed very closely the law laid down by the English income tax; but it differed in one important respect namely, that the Italian law adopted from the beginning (i.e., as early as the first law of 1877) the principle of *discrimination*, which did not exist in English law, where it has only recently been introduced.



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the other hand, it subdivided Category C into C', comprising incomes from the professions, and C", comprising the salaries of employees of private business concerns and life annuities.

Thus, over the whole period covered by the legislation, the categories have numbered a minimum of three and a maximum of six, and the tax-rates on the various categories have varied almost every time that the total tax-burden has been increased.

It may be of value to present in a summary table the changes in the categories and the tax-rates:

<b>Tax on 100 Lire of Net Income from 'Movables'</b>				
<i>Category</i>	<i>Status prior to 1894; general tax - rate 13'20%; deductions by eighths</i>	<i>Law of July 22, 1894; general tax - rate 20%; deductions by fortieths</i>	<i>Decree-law of Oct. 16, 1924; tax-rate on net income without deductions</i>	<i>Total increase in the tax-rate expressed as a percentage of income</i>
A'	13'20 }	20-	20- }	6'80
A"	13'20 }	15-	20- }	
B	9'90	10-	14	4'10
C'	8'25 }	9- }	12-	3'75
C"	8'25 }	9- }	10-	1'75
D	6'60	7'50	8-	1'40

This table shows that the diversification of incomes and the number of categories develop in an arbitrary way; they do not correspond to any guiding economic criterion.

Category D, for example, was taxed, under the first legislation, only half as much as income from capital was taxed — that is, it paid a tax-rate of 6·6 per cent instead of 13·2 per cent. This relationship was retained in the reform of 1894; but it was changed by the reform of 1924, according to which salaries were obligated to pay 8 per cent, while the tax-rate on Category A' was raised to 20 per cent.

Thus it may be said of all the relationships among the various categories that they have been modified without any visible or plausible economic reason.

On the other hand, if we compare the first period with the last, it will be seen that the tax-rate increases by 6·80 per cent on the income of Category A, by 4·1 per cent on that of Category B, by 3·75 per cent on that of Category C', by 1·75 per cent on that of Category C", and by 1·4 per cent on that of Category D.

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One might have thought that once the criteria for discrimination have been fixed in some way, the increases in taxation necessary to provide for the growing financial needs of the State ought to be proportional in all categories. What is clear from the last column, however, is that the tax-burden on the wages of employees of the State and of private enterprises has experienced a relative decrease, the difference being unloaded upon incomes in other categories, especially Category A.

The fact that emerges, then, is this: the total tax-burden, or the total quota assigned to the tax on 'movables', has tended to be distributed in such a way as to put a greater burden on incomes from capital and a smaller and smaller burden on incomes from labour.

This tendency is a general one in all countries; it may now be regarded as a principle which — quite apart from the question of its limits and its remote economic effects — underlies the tax policy of the present era. Thus we see a reversal of the positions with regard to relative political power that existed among the various social classes before the French Revolution.

## CHAPTER V

# DISCRIMINATORY TREATMENT OF INCOMES FROM 'MOVABLE PROPERTY'

Summary: Temporary character of incomes — Incomes from labour and incomes from capital — Discrimination and progressive taxation — Interest on private loans and public loans

### § 1

We now pass to an examination of the criteria generally adopted for discrimination between different types of income, taking as the basis of our discussion the provisions of the Italian law on the subject. The deductions permitted by way of discrimination presuppose that gross incomes have already been translated into net incomes.

In fact, after industrial and professional incomes have been subjected to deputation, the Italian law allows further deductions — which were at first set at two-eighths for industrial incomes, three-eighths for professional incomes, and four-eighths in the case of the salaries of public officials. They are deductions which increase according as and to the extent that the incomes are regarded as perpetual or temporary, according as they arise from capital or labour, according as they are more or less certain, and according as they are ascertainable with more or less accuracy.<sup>1</sup>

This last circumstance explains why the incomes of public officials are granted a deduction of more than 30 per cent, since they are ascertained with much greater exactness than are professional incomes. But a deduction made for this reason does not enter, strictly speaking, into the theory of diversification, since it has rather the character of a coefficient of correction, used in order to make the appraisal of income as nearly accurate as possible.

Apart from such considerations, Italian legislation discriminates

<sup>1</sup> The eighths of the original law were transformed into fortieths, and in the last law enacted it was preferred to abandon that system in order to diversify directly the tax-rates applied to the various categories of income. These are matters of form which do not alter the principle of discrimination.

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according to the criterion that incomes derived from labour are temporary, whereas incomes derived from capital are held to be permanent.

The mere fact that some incomes have a temporary character would not explain the increasingly preferential treatment which is accorded as one passes from industrial income to the salaries of public officials, since in fact the former is more temporary than the latter. The second basis of discrimination is the *source* of incomes, which may arise either from labour or from capital. This explains why industrial income, which arises in part from capital, is allowed a smaller deduction than are professional income and wages, which the law regards as arising solely from labour. In the concrete case, moreover, the two circumstances are found to merge, since all incomes from labour are regarded as temporary.

Nevertheless, since we wish to establish precisely what is meant by temporary income or by permanent income, it should be noted that from the point of view of society taken as a whole and from that of the Treasury, all incomes are permanent, since they represent a continuous flow of goods.

Industries are re-established, succeed one another, increase and yield continuously an annual product. To make this product taxable it is sufficient to translate gross product into net by making provision for the amortization of fixed and working capital.

Professions succeed professions, professional men professional men, from generation to generation, from father to son. To make professional income permanent, it is sufficient to amortize the capital that was invested in the father, so that the latter may in turn invest it in his son or successor.

Hence the perpetuation of industrial and professional incomes does not require any preferential treatment in order to put them on a position of equality with income from capital; it is sufficient to make the deductions which are involved in the deputation of incomes.

If, then, it be admitted that the annual production of all incomes is a permanent phenomenon, we may speak of a temporary character of incomes only with respect to the persons who enjoy them; but in that case all incomes are temporary.

We may consider the total national income, which is perpetual, as being turned over to various and changing persons for partial and

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temporary enjoyment. Each one of these persons owes the tax on the part of the income that he enjoys and for the period of time that the enjoyment lasts.

It has already been shown that the total product of an industry carries the obligation to pay taxes from the moment of its origin. If this income is divided among two or more agents of production, the tax also will be divided among two or more taxpayers; similarly, if the income is enjoyed successively by two people, the entire tax will be divided up in time, and will be paid first by the one and then by the other. A typical example of this is inheritance. And inheritance includes not only the case in which a person invests his savings in order to form an estate which he passes on to his heir, but also the case in which he invests his savings in the person of the heir, in order to insure for him the continuity of his professional income.

On the other hand, there is a difference between the two cases in one respect: namely, that a person who inherits an estate in the form of land or capital can obtain a yield by making use of the labour of others; whereas a person who inherits an 'intellectual' estate must, if he is to obtain a yield from it, contribute his personal labour. This difference brings out the second element in discrimination: labour. For this reason a distinction is made between income produced by the present labour of the taxpayer, and income produced by the labour of past generations; this is the basis of the distinction made by other legislation between earned and unearned income. In any case the one is the fruit of the labour of the present generation; the other is the fruit of the saving of past generations. It is alleged that taxation based on this distinction corresponds better to the principle of equality. And it is further alleged that the producer of a labour-income, in order to assure comfort in old age for himself and the continuity of income for his children, must save more than the owner of an income from capital.

From this is derived the theory, passed down without criticism from one writer to the other, that incomes from labour should be permitted to deduct a certain percentage for saving, which shall be exempt from taxation.

We have already shown, in a general way, that savings should be taxed, and we have refuted the error of John Stuart Mill. In this special case, moreover, this error becomes more serious, since it has to do not only with actual savings but with presumed savings, and

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would result in granting exemption even to those who in fact do not save. This is a first contradiction, which makes it clear that the real purpose is to grant preferential treatment to incomes from labour, regardless of whether the latter are destined to be saved or consumed.

By way of confirmation of this conclusion, other considerations, more directly associated with the problem of discrimination, may be added. Let us admit — although the proposition has not been demonstrated — that the recipient of an income from labour amounting to 1000 is obliged to save more than the recipient of an income from capital amounting to 1000. But to admit that the recipient of a temporary income is obliged to save more than the recipient of a permanent income is not equivalent to saying that he ought to pay a relatively smaller tax.

This widely held opinion originates from the error of considering as equal and comparable two quantities which are unequal and dissimilar.

To make the two incomes comparable, it is necessary either to transform the income from capital into a life annuity or to transform the income from labour, no matter how long it lasts, or even a life annuity itself, into a perpetual income. For example, given certain conditions of age and health, a life annuity of 1000 may be transformed into capital giving a perpetual income of 600. Thus it may be seen that tax equality consists in paying either a temporary tax on 1000 or a perpetual tax on 600. For the temporary income, a temporary tax; for the permanent income, the permanent tax.

A differential treatment leads to this consequence, that it would be to the interest of the owner of a perpetual income of 600 to transform it into a life annuity of 1000 in order to evade the tax; and in this way, precisely as the result of a policy supposedly designed to encourage saving, he would be induced to increase his consumption.

On the other hand, if the temporary income of 1000 is permitted to deduct a certain percentage for saving, there is no reason for not allowing such a deduction also to the perpetual income of 600 which is equivalent to it; and, if the perpetual income of 600 is allowed to make greater deductions than is a perpetual income of 1000, there is no reason for not allowing the perpetual income of 1000 to make a greater deduction than one of 2000, or for allowing the latter a greater deduction than an income of 3000, and so on.

But, once this is admitted, the special theory under examination

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falls to the ground. For if a constant percentage for saving is deducted, the result will be a proportional tax with higher rates on all incomes; and this leaves things as they were before. And if the amount allowed for saving decreases in proportion as incomes increase, the result will be a progressive tax, which — despite the different phrasing in which it is presented — leaves the problem of progressive taxation in exactly the same position in which it was discussed previously.

### § 2

A second point deserves to be emphasized. Assuming that the needs of the State are constant, discrimination in favour of labour-incomes in process of formation shifts the tax burden from income which is the fruit of present labour to income which is the fruit of past labour. That is, in order to exempt the actual or assumed saving of to-day, it is necessary to strike the accomplished saving of yesterday.

In order to make clear this relationship, it is necessary to isolate the problem by abstracting from inherited incomes from land and capital, and by supposing that the taxpayers who make up the four groups included in the tax on 'movables' represent the whole community. It then becomes clear that the taxpayers of Categories B, C, and D with their savings must form and maintain Category A.

From this it becomes evident also that the benefit from discrimination is attenuated and may even be annulled; since the exemption of some fraction of income would automatically lead, for the same taxpayers, to a corresponding increase in the tax-rate on their remaining income from which the resources corresponding to the given financial needs of the State will have to be drawn. Furthermore, the exemption granted for possible savings in Categories B, C, and D are annulled, wholly or in part, in Category A, where this saving is subjected to a greater burden of taxation. From this it follows that the greatest advantage is obtained from discrimination when the taxpayer does not save, but consumes his whole income.

This constitutes a fundamental theoretical contradiction, which prevents our explaining the practice of applying differential tax-treatment to the various types of income by a supposed desire to exempt the part of income directed toward saving.

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If we pass now to actual conditions, this contradiction is eliminated for two reasons: (a) because Category A is maintained not only by savings arising from the income of Categories B, C, and D, but principally by inherited savings, on which the Treasury makes up for the preferential treatment granted to incomes from labour; (b) because Category A includes investments — such as long- and short-term government bonds — which do not pay a tax. For these reasons, the industrialist, the professional man, and the employee get the advantage of a smaller tax within their respective categories and, in case they actually save, they evade the higher tax of Category A.

The final result is this: diversification in favour of labour-incomes is a practice which stands by itself, and which finds its immediate and sufficient explanation in the political preponderance of the industrial, professional, and labouring classes, who use it to gain tax exemptions.

### § 3

#### *Discrimination and Progression*

From what has preceded, it is clear that there is a theoretical and political analogy between discrimination and progressive taxation.

Strictly speaking, discrimination aims to shift the burden of taxation from incomes derived from labour to incomes from capital, without regard to the size of income. Progressive taxation, on the other hand, aims to shift the burden of taxation from smaller to larger incomes, without regard to the type of income.

The spheres in which the two concepts apply do not coincide theoretically, but they may find a common basis for political action because of the affinity of class interests associated with them.

In fact, it seems contradictory that small incomes from capital should be treated kindly under the system of progressive taxation, only to be later mistreated by discrimination; and that large industrial and professional incomes — which often also depend on intellectual rents — should be favoured under a system of discrimination, only to be harassed by a system of progressive taxation.

But the two devices, when carried over to the ground of political struggle, may and in fact tend to be co-ordinated, either by having discrimination take account of the size of income, or by attenuating



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the rigours of progression in the case of the larger incomes from labour, as compared with the treatment of the larger incomes from capital.<sup>1</sup>

It is precisely by this process that the political compromise was originally made and has since been strengthened.

Discrimination has the advantage over progression in that it proceeds case by case, appealing to the actual circumstances in order to obtain tax reductions, now for one group and now for another. In this it resembles the policy of special benefits for the masses, and succeeds, just as the latter has succeeded, in gradually penetrating into positive legislation, without provoking the objections on grounds of principle which the richer classes raise against progressive taxation.

But on the whole the target on which are concentrated the co-ordinated forces of discrimination between incomes and progressive taxation is inheritance, the incomes from which are not earned, according to the former, and are susceptible to high progressive taxation, according to the latter.

The two devices are supplemented by the inheritance tax, which will be discussed further on. Discrimination, progressive taxation, and the inheritance tax are integral parts of the general tendency of the taxation policy which is prevalent to-day.

### § 4

A third case of discrimination has to do with the interest on private loans, as against the interest on public loans. The criterion for discrimination is alleged to be the different degrees of safety that they give, respectively, to the creditor.

<sup>1</sup> In Italy, according to the law of 1877, all incomes of Categories B, C, and D pay less than the incomes of Category A and less than incomes from land and houses, even if the former are very high and the latter very small.

In England, the discrimination between incomes from labour or *earned* incomes and incomes from capital or *unearned* incomes is recent (1907), but was limited from the beginning to incomes between £160, which were entirely exempt, and £2000, the deductions adopted being graduated in such a way that the final tax-rates came out approximately as follows:

<i>Incomes from Labour</i>	<i>Tax-rate, in percentage terms</i>
from £160 to £ 400	2'25
up to £ 540	2'62
" £ 600	3'00
" £ 700	3'38
" £2000	3'75
above £2000	5'00'

Five per cent was at that time the rate of income tax.

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The history of discrimination in favour of the interest on private loans deserves brief mention because of the valuable contribution that it makes to the completion of the theory.

The Italian law of 1877 did not discriminate between public and private loans. It was said at that time that interest represented, in its entirety, net income. But the law of 1894 reflected a change of opinion, since it held that the greater degree of safety afforded by investment in a public loan should permit the deduction from the interest on private loans of a given percentage as a risk-premium.

Thus it came about that in 1894 a new sort of discrimination was introduced as between the interest on a loan made to the State or guaranteed by the State, and the interest on private loans. To the former was applied the entire tax-rate, without any deductions; to the latter was granted a deduction of ten-fortieths, so that only thirty-fortieths of the income from capital was taxed.

But the decree of October, 1924, again denied that there exists a different degree of safety as between the two types of loans and applies the whole tax-rate, without deductions, to the interest on both public and private loans.

Is there really a different degree of safety in the two cases?

The market affirms that there is, inasmuch as it contents itself with a lower rate of interest on public loans. Economic reasoning explains why this should be so.

In fact, the person who lends \$5000 to a private enterprise, no matter how much he may try to avoid the industrial hazards involved therein, in fact is dependent on its vicissitudes. The person who lends \$5000 to the State shares the hazards not of one but of all of the country's industries, which become responsible to him as a group, through the intermediary of the State. The State pays interest by means of taxes; but the taxes are levied on the income of all industries and professions; if one industry fails, or a hundred, others take their places.

The interest on public loans depends on an average, whereas that on private loans depends on one term of the average. It is in this that the different degree of safety lies.<sup>1</sup>

If the ascertainment of the amount of interest received were

<sup>1</sup> It is obvious that other circumstances may contribute to this result, — such as the superior saleability of a public security, which makes it possible for the creditor to realize on it at any time.

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made at long intervals and depended on an average, as is the case with income from land, it would be possible to grant on private loans a deduction for possible losses.

In fact, however, the ascertainment is made at very brief intervals, and therefore the only consideration that is valid is that the different degree of safety is already discounted in the different rates of interest which the two types of loan bear. These two rates present themselves as quantities which have been put upon an equal basis economically, and the Treasury has only to apply the same tax-rate on both.

## CHAPTER VI

# EXEMPTION OF MINIMUM AND SMALL INCOMES

**Summary:** The practice of exempting minimum incomes — Theory of the reconstitution of the *capital value of a man* — Theory of the *minimum of subsistence* — Theory of compensation and impossibility of collection — Progressive exemption of lower incomes

### § I

#### *Exemption of Minimum Wages*

BETWEEN discrimination and progression comes the practice of completely exempting the lowest incomes from taxation. This practice is found in all advanced legislation; there are, however, various reasons which cause the technical details of this legislation to be different in different countries, and this fact makes it impossible to give a single theoretical explanation of the phenomenon.

Above all, it is necessary to distinguish two tendencies: one, which reduces exemption to the smallest amount possible; the other, which tends to extend it from the *lowest* incomes to the somewhat higher ones, — that is, to those incomes that we shall call *lower* incomes.

Italian law is an example of the first; English law, of the second. Comparison of the two is necessary for a more exact understanding of the theory.

The original Italian law<sup>1</sup> granted absolute exemption from the tax on 'movables' to taxable incomes — that is, incomes already translated into the net and subjected to the discrimination deductions — no higher than 400 lire a year. After the World War, the income exempted was raised to 2000 lire<sup>2</sup> in order to take account of the paper money depreciation, which brought it about that 2000 lire of the present day are approximately equal to 400 lire

<sup>1</sup> That of August 2nd, 1887.

<sup>2</sup> By the decree-law of October 16th, 1924.

## EXEMPTION OF MINIMUM INCOMES

of the earlier period. In both cases, apart from the quantitative limit set by the law, the following conditions must be fulfilled if incomes are to be eligible for exemption:

(1) The incomes must fall under Categories B, C, and D; that is, they must be incomes which derive wholly or in part from labour; incomes from capital are therefore excluded;<sup>1</sup>

(2) The sum of the income from labour and other possible incomes from tangible or intangible property must not be greater than the minimum.

In other words, it is necessary to have a very small *total income* in order to obtain exemption on that part which is income from labour. The legislator has had in mind the exemption not of minimum incomes, but of minimum *wages*, on condition that the labourer lives only by his labour.

On that account, the Italian practice of exemption appears to be a logical extension of discrimination, which is employed on behalf of incomes that are labour-incomes in whole or in part.

One would not venture, however, to speak of saving and the allowance for saving in the case of incomes that are not high enough to purchase a sufficient supply of bread; and for this reason all authors have attempted to discover a different phraseology, which should have the flavour of economic theory.

### § 2

Thus arose spontaneously a first idea, — namely, that of considering the minimum income from labour as an amount necessary in its entirety for the rebuilding of the energy consumed by the worker during the process of production. Man is regarded as capital, similar to a machine or a horse, which wears out and must recover in the product the value of that part of it which is worn out. When net income, after discriminatory deductions, is not more than 2000 lire, it is supposed to be the allowance necessary for the reconstitution of the capital value of a man.

This case would thus again make part of the general theory of the deperation of income. But this explanation does not stand up under criticism.

<sup>1</sup> Life annuities and pensions are exempt, since they are regarded as a continuation of wages and salaries.

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Let us first consider the case of the horse. There is an owner who breeds and feeds the horse and sells its labour to the farmer. The latter draws an income of 100, from which is deducted 40 belonging to the horse, — that is, the owner of the horse. The farmer pays the tax on 60; the owner of the horse, on 40.

If for the horse is substituted a slave, there is no change in the reasoning. The farmer deducts from his income an amount representing a sum corresponding to the labour of the slave, — that is, the wages on which the slave-owner pays a tax.

If now the slave becomes a free labourer — that is, his own master—he will receive his wages in cash from the farmer and will pay directly the tax that was previously paid by his owner. The object of the tax is still the same.

Thus, the theory of the reconstitution of the capital-value of a man falls to the ground.

It must be noted, furthermore, that if one were to adopt the principle of the reconstitution of energies expended in labour, this principle could not be limited to minimum wages, but would have to be extended to higher wages and subsequently also to professional incomes in general.

### § 3

With the abandonment of the theory of the reconstitution of the capital value of a man, recourse was had to the broader economic concept of the 'minimum of subsistence'.

The minimum of subsistence is not the same as the minimum wage, since old men, women, children, and those unable to work who have a small income from capital or land also have the right to a minimum of subsistence. This concept set up as the theoretical basis for the exemption of the minimum of subsistence the relationship between the demand for and the supply of public services. It is alleged that those who have scarcely enough to satisfy the elementary needs of existence cannot appreciate the marginal utility of public goods. That is, it is held that they do not *demand* these services, even if in fact they consume them.<sup>1</sup>

For us it is enough to recall the principle according to which every income owes taxes from the moment of its origin, as long as

<sup>1</sup> See Book II, chap. 11, § 6.

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public services figure in its cost of production. This means that the demand for public services exists, at least in part, prior to the production of income.

To clarify the argument, let us take as an example a large factory. In order to produce, it has requested State assistance; and for this reason the whole product owes the tax. Now, according to the theory under discussion, if the product is divided into small wage-incomes, these incomes would be freed from the corresponding tax-obligation; if the product is divided into high wage-incomes, the latter would pay the tax. This is absurd, since the cost of public services must be paid in any case.

The demand for and the consumption of public services have come from the enterprise, and the tax-obligation is the obligation of the enterprise; and if the total product is divided among the various agents of production, each one must pay the tax on his part of the product. The worker may be exempted from paying his share of the debt; but this means that another — the entrepreneur, for example — must pay for him.

### § 4

Other explanations have been proposed.

One is that of compensation, which starts from the familiar premise that indirect taxes, which fall on necessities and articles of popular consumption, result in taxation that is inversely proportional to income. Hence, in order to compensate the small incomes for this relatively larger burden of taxation caused by indirect taxes on consumption, these incomes are granted exemption from direct taxation.

This consideration has been adduced in parliamentary discussions and has prevailed in relatively poor countries which cannot renounce the yield from indirect taxes on necessities, which have a very broad base, and must limit themselves to giving a compensation confined to the group represented by the poorest citizens.

It is easy to show, however, that the theory of compensation does not explain the general practice of exemption. It does not explain it in Italy, where exemption is limited entirely to incomes from labour, whereas compensation ought to be given to all possessors of small incomes — whether from land or capital — who have paid consumption taxes inversely proportional to their incomes. And it

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does not explain it in richer countries, in which it comes about that while the minimum income exempt from direct taxation is successively raised and broadened so as to include not only incomes from labour but also small incomes from capital, objects of necessary and popular consumption are exempted from taxation *pari passu*. This double, synchronous, and general tendency shows that the two phenomena, in their evolution, are parallel effects of common causes, and exclude the possibility that they are bound to each other by an interdependent, compensatory relationship.

This brings us, by a process of elimination, to Professor Mazzola's theory, the only one which gives an immediate explanation of the practice when the latter aims to reduce to the minimum, as in Italy, the benefit of the exemption.

This theory calls attention to the difficulty that the Treasury encounters in collecting the tax on wages from millions of workers who have small incomes and are pressed by immediate needs and do not offer any *real* guarantee that they will pay taxes. Hence it is more economical that the tax which is owed by the parts of industrial income that go to pay thousands of individuals their very small wages should be paid in fact by the enterprise — that is, by the entrepreneur — on behalf of the labourers. The entrepreneur will then have economic recourse, which might also be legal recourse, against the workers, retrieving the tax either at the time when the new wage-rates are agreed upon or at the time they are paid.

This theory explains why, in Italy, exemption is not allowed when the small income from labour, combined with a supplementary income from capital on land, exceeds the minimum; since there then exists a real guarantee for the payment of the tax.

This explanation finds characteristic confirmation in the apparently contradictory fact that in Italy it has several times been proposed to extend the exemption to the very small incomes from land, on the ground that the tax on land also is practically uncollectable if the owner of a small piece of land does not pay it, because the State is not able either to sell or to get more income from the small piece of land that it would have to expropriate.

Another fact which confirms the theory is that the Italian Treasury has had in fact to give up the collection of the tax on wages in general, even when they are higher than the exempted minimum.



## EXEMPTION OF MINIMUM INCOMES

### § 5

#### *Exemption of Lower Incomes*

In carrying exemption into effect, it is necessary to avoid the danger that an income not much larger than the exempted minimum, after paying the tax, may be reduced to the level of the minimum. Thus, if an income of 2200 lire had to pay a tax of 12 per cent, it would be reduced to 1936 lire.

In order to obviate this possibility, Italian law establishes that incomes from 2000 to 2100 lire shall be allowed an exemption of 1000 lire, and shall pay a tax only on the remainder; incomes from 2101 to 2200 lire are allowed an exemption of 800 lire; those from 2201 to 2300 are allowed an exemption of 600; those from 2301 to 2400, an exemption of 400 lire; and those from 2401 to 2500, one of 200 lire. From 2501 on, the tax is applied without exemptions.

From 2000 to 2500 lire of income, taxation becomes progressive, and it must not be overlooked that if it had been desired to avoid only the technical difficulty to which attention has been called, it would have been possible to do so by stopping this side of 2500 lire, and it would also have been possible to diminish the percentage deducted in each bracket. Hence the opinion may be expressed that in the graduated treatment of incomes from 2000 to 2500 lire, there is the germ, small to be sure, of progressive taxation. In any case, it is certain that this intermediate scale, introduced for technical reasons, is capable of developing into progressive taxation.

In fact, this has happened in rich countries, as may be seen from the following table for England:

<i>Income</i>	<i>Amount exempt</i>	<i>Tax-rate</i>
Up to £160 (whether from labour or capital)	—	Exempt
From £160 to £400	£160	3 per cent.
From £400 to £500	£190	3·55 per cent.
From £500 to £600	£120	4 per cent.
From £600 to £680	£70	4·50 per cent.
Above £680	0	5·00 per cent. <sup>1</sup>

<sup>1</sup> To this scale has been added the other, reproduced above, of discrimination, which applies only to earned incomes, and which goes up until it stops at the maximum income of £2000, reducing by a fourth the progressive percentages given in this table.

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Thus the English practice of exempting minimum incomes no longer permits the explanation that such exemption is due to the impossibility of collection.

Given the size of the exempted income and the breadth of the zone of larger incomes which enjoy graduated exemptions, it is clear that we have here an application of the progressive system, which has passed from *minimum income* to the *lower incomes*.

The form is degressive and seems to be contained within the limits already indicated as those which allow the gradual shifting of the burden of taxation from the smaller to the larger incomes, without making the scale of progression such as to impede and prevent the formation and growth of these higher incomes.<sup>1</sup>

<sup>1</sup> Given England's wealth, the partial or total exemption of incomes practised in that country would provide a concrete example of this theoretical possibility. To the exemption of incomes of which we have spoken, however, has been added a *supertax* on large incomes, which might give the tax-policy inaugurated by Lloyd George in 1907-1908 an entirely different political and economic meaning. It is hardly necessary to observe that it is not my intention here to defend the English system, or to point to it as an example to be followed.

## CHAPTER VII

# EXEMPTION OF INTEREST ON THE PUBLIC DEBT

**Summary:** The economic reason and the legal reason for taxing interest on the public debt — The State as debtor with respect to interest and creditor with respect to taxes — How, in Italy, the principle of discrimination has transformed the tax on movable property into a special tax — The absence of a maturity-date in public debt-contracts — The alternative solution: exemption — Consolidation of the tax, or of exemption from taxes, at the time of issue — Privilege of the creditor and compensations for the State as debtor — The question of foreigners

### § 1

#### *The Rule with Respect to Liability to Taxation*

It is an old and continually debated question whether interest on the public debt should be subject to taxation, as is interest on any private debt, or whether it should be exempt.

The problem may be discussed on the basis of legal arguments having to do with the nature of public loan contracts, or on the basis of considerations of economic expediency having to do with the credit of the State. But before we come to this type of consideration, it is necessary to provide an economic solution of the problem.

Let us first adopt the hypothesis that in order to provide for extraordinary expenditures the State has recourse to levying an *extraordinary tax*, which not all are able to pay out of their annual income or out of savings held in the form of disposable capital.

Given this hypothesis, it is obvious that all those who lack sufficient liquid capital — professional people without other sources of income and owners of real property are usually in such a situation — will, in order to pay their share of the extraordinary tax, be obliged to contract debts with those who keep their savings in the form of disposable capital and who make a business of lending.

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These private loans will give rise to the payment of annual sums of interest, and no one would question the obligation of the capitalists to pay taxes on such interest received.

Now the State, for reasons of a technical economic character which will be discussed later, transforms the extraordinary tax into a voluntary public loan by substituting itself for the private borrowers and lenders.<sup>1</sup>

What is involved is an operation whereby the State substitutes a single public loan for a series of private loans. On the one hand, it frees all those who do not have disposable capital from the necessity of contracting private loans, and obliges them to pay only in the form of a *tax* those sums which they would have had to pay to the private lender in the form of interest. But on the other hand, the State, having become a direct debtor, turns over to its creditors, as interest, the sum that it has collected from the taxpayers as a tax. In this way, the creditors of the State receive the same interest — except for the question of its amount and other terms that may be involved in the loan-contract — which they used to receive from the private debtors. The object taxed is the same.

From this it follows that interest on the public debt is obligated to pay taxes.

### § 2

The tax is owed by the creditor, whether he be a citizen of the country levying the tax or a foreigner. The basis for this conclusion will become obvious from an examination of Italian practice in the matter.

As has already been pointed out, the Italian tax on movable property has a territorial character, and is owed by Italian citizens and by foreigners on all their income that is produced in Italy. Now, a person making private loans owes the tax on the interest derived from such loans, since this interest is produced in Italy.

The fact that Italian legislation regards the tax on movable property as a 'real' tax — that is, a tax on things, rather than on persons — puts this tax on a par with the taxes on land and on buildings and carries into effect the principle that all are equal before the law in matters of taxation, in so far as all the categories

<sup>1</sup> Compare Book V, chap. 1.

## EXEMPTION OF INTEREST ON PUBLIC DEBT

included under the tax on movable property, as well as under the taxes on land and on houses, are given equal treatment.

Thus, there is no basis for the claims that foreigners who have purchased government bonds do not owe taxes under Category A, on the alleged ground that the relationship between them and the State is an obligatory *personal* relationship, and not a *real* one.

On the contrary, the foreigner pays the tax on land and on buildings if he is the owner of lands and factories; he pays the tax on movable property according to Categories B and C if he invests capital in Italian industries, or if he practices a profession; he pays the tax on movable property on interest received from capital lent to private individuals; logically, therefore, he owes the tax on interest received from loans made to the State.

It is hardly necessary to call attention to the erroneous nature of the common argument to the effect that foreigners do not owe the tax because they do not consume public services. According to our principles, public services have been consumed during the process of producing the income from land, industry, capital, and the professions, on which the tax falls.

Nevertheless there are still some aspects of the question that merit discussion.

### § 3

As a second stage in our inquiry, it is necessary to see whether and to what extent this first and more general principle — namely, that interest on the public debt should be subject to taxation — is modified through the action of other circumstances with which it comes in contact in reality.

It is to be noted, above all, that between the public loan and the series of private loans for which it is a substitute, there are two differences. The first is that the State becomes at one and the same time a debtor with respect to the interest that it owes, and a creditor with respect to taxes that it is entitled to levy. The second is that the public debt is often perpetual, — that is, it has no fixed maturity-date at which the creditor may exercise his claim against the State, the State being the sole judge in choosing the moment at which to pay off its own obligations.

From the first fact arises the danger, of which the creditors of

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the State are constantly aware and to which they are continually exposed, that the State, by raising the tax-rate on the interest on its debt, may progressively balance what it gives out by what it receives, and thus mask its insolvency.

It is not worth while to spend any time on the usual objection that the State acts in a different guise in the two cases, — that is, as a public authority in the act of levying the tax, and as a private person in the act of paying the interest.

These are scholastic differences: the concrete significance of which is not evident; since it may be said, with more justification, that when the State acts as a public authority in the levying of taxes it represents the interest of the creditors, and when it acts as a private person, it represents the interest of the debtors. And since in modern states the class of tax-paying debtors is more numerous, and may also, at a given moment, be politically stronger than the class of capitalistic creditors, there is by no means any elimination of the risk that the State may assume the cloak of sovereign authority in order to increase the taxes on interest due to the capitalists, to the end that the taxes owed by the taxpayers may be diminished.

The danger is so real that the authors of the Italian law on 'The Great Book of the Public Debt', thought it necessary to reassure the creditors by promising them that in no case would the interest on the public debt be decreased by a *special tax*.<sup>1</sup>

### § 4

The legal provisions just referred to must be interpreted as a formal pledge to the effect that interest on the public debt will not be subjected to an *exclusive* tax. But a general tax that strikes equally all categories of income subject to direct taxation must be extended also to the category of interest on the public debt.

The argument derives directly from the formal principle of equality before the law; but it has a politico-economic content that merits discussion.

The dangers to which the creditors of the State are exposed

<sup>1</sup> Law of July 10th, 1861, n. 9, Art. 3: "The income inscribed in the Great Book may never, for any reason, even of public need, be subject to any special tax, and its payment may never, for any reason, even of public necessity, be diminished or delayed."

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arise from the possibility that each group of taxpayers may succeed, when it is a question of increasing public expenditures, in shifting its own tax-burden on to the others. This is more likely to come about under the system of manifold taxes, each one of which is legislatively independent of the others. Thus, it is technically easy to increase only the tax on land, or only the tax on buildings, or only the tax on movable property, or only the tax that falls on the interest on the public debt.

Under the hypothesis of a single tax with a single rate, on the other hand, the increase in taxation automatically strikes or ought to strike all categories of taxpayers; whence it follows that the taxpayers, instead of fighting each other, become united in their determination to control the increase in public expenditures and to check, in the interest of all categories of income, the increase in taxes.

The significance of this conclusion may again be illustrated from Italian experience.

In Italy, the laws regulating the taxation of land and buildings are autonomous; hence it was necessary first of all to detach the owners of land and of houses from the bloc of all taxpayers for their common defence.<sup>1</sup>

There still remained, however, the tax on movable property which until recently included and subjected to a single tax-rate four groups of incomes and taxpayers who already formed by themselves an important bloc for common defence against excessive taxation. According to Article 1 of the law, the tax-rate and possible increases in this rate were intended to strike equally all categories of income from movable property. And this would have been a sufficient guarantee for the owners of government bonds, if the promise of Article 1 had not been evaded by the principle of discrimination, which may transform, and has transformed at the discretion of the legislator, the *general tax on movable property* into four or five *special taxes*, one for every category, each different from the other.<sup>2</sup>

<sup>1</sup> It is well known, on the contrary, that in English legislation incomes from land and from buildings are included under the categories of the Income Tax.

<sup>2</sup> The law of 1877 had made a given discrimination, keeping in Category A the interest on public as well as private loans, and allowing a deduction of 2s. 8d., 3s. 8d., and 5s. 8d., respectively, to categories B, C, and D.

The law of 1894 first of all raised the *single* rate of Article 1 from 13'20 per cent to

## THE SYSTEM OF DIRECT TAXES

At this point, and for the reasons given, the consideration of foreigners again becomes important, inasmuch as they have no direct means of parliamentary defence. And if the public loan is placed abroad, the danger of a coalition of all domestic taxpayers against foreign creditors becomes more probable.

### § 5

The other circumstance which renders precarious the condition of public creditors as compared with that of private ones, as has been pointed out, is that the public debt is often perpetual from the standpoint of the creditors and is payable at the will of the debtor. From this it follows that if the tax on interest is increased in the manner described, the creditor must bear it, not having in his favour either a fixed maturity-date or the right to demand reimbursement.

In private relationships, on the contrary, if the tax decreases the amount of interest stipulated, in such a way as to carry it below the current rate, at the expiration of the contract the creditor withdraws his capital and renews the loan under the new conditions of the market.

Given, then, the possibility that under a system of manifold taxes, and under the principle of discrimination, a general tax may

20 per cent; it then divided Category A into two Categories A' and A'', and modified the scale of discrimination in such a way as to increase slightly the old rate on Categories D, C, and A'', and to shift the new rate of 20 per cent only to Category A'. In this way the *general* tax of Article 1 was transformed without seeming to do so, into a *special* tax on interest on the public debt.

The following comparison shows how in fact the categories of income from movable property are treated by the two laws:

	<i>Law of 1887: uniform rate of 13.20 per cent</i>	<i>Law of 1894: uniform rate of 20 per cent</i>
Category A	13.20 per cent	{ A' 20.00 per cent A'' 15.00
" B	9.90	10.00
" C	8.25	9.00
" D	6.60	7.50

This shows that discrimination is used merely as a device for arriving, in the case of each category, at the result that was desired.

Thus, while industrial profits experienced an increase in the tax-burden of 0.10 per cent, and interest on private loans an increase of 1.80 per cent, interest on the public debt experienced an increase of 6.90 per cent in the tax-burden.

The latest reform abolishes the protection supposedly given by Article 1, which in this respect has now become useless, and establishes directly different rates for each of the four categories. Thus they now constitute four independent taxes.



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be transformed in fact into a special tax; and given the fact that the creditors of the State have no right to demand reimbursement of the capital they have lent, the only alternative solution is that of absolute exemption from taxation.

This is not in itself a bad solution. Its logical basis is to be found in the theory of the consolidation of taxes or of freedom from taxes, which is discounted in the issue-price of the public loan.

The State contracts the loan, offering for public and voluntary subscription, let us suppose, bonds the nominal value of which is \$100, but the real market value of which is usually lower, depending on the net interest that the State will pay. If the State promises \$5 free from taxes, the actual price of the bond will be 100 or near 100. If it promises \$5 liable to a tax of 20 per cent, it is as if it promised \$4 net, and the actual price of the bond will be 80 or near 80.

Thus it is said that taxes or freedom from taxes are discounted and consolidated in the selling price.

Accordingly, at the initial moment of issue—that is, of the sale or subscription of the bonds—it is a matter of indifference for the State and for the investor whether the interest is free from or liable to taxation.

In the one case, the State obtains 100 in capital and nothing in the way of a tax on the creditor; in the other, it obtains 80 in capital, but collects annually one dollar in taxes, which is the interest on the twenty dollars which it failed to realize on the selling price of its securities.

The subscriber, on his part, in one case pays \$100 and receives \$5 net in interest, while in the other he pays \$80 and receives \$4 net in interest.

To be sure, this initial condition of equality is modified in the future, according as general taxes increase or decrease. Assuming that they increase, the owner of a tax-exempt bond will continue to receive \$5 in interest and escapes the increase in taxes which will fall on all other incomes; while the owner of a taxable bond will bear this increase like all the others.

### § 6

Now it cannot be denied that the first creditor acquires a fiscal privilege. In theory, certainly, the contrary may also happen—that is, general taxes may decrease; but this case is in fact generally held to be less probable.

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On the other hand, the privilege is in fact attenuated by some compensations that the State derives. Thus, to the extent that the taxes on all incomes increase, savings will seek investment in tax-exempt State bonds and thereby raise the price of the bonds at the same time that they depress the value of land, houses, and industrial bonds. It follows from this that the price of government bonds, precisely because of the fiscal privilege attached to them, will rise very quickly to par and will go above par, thus hastening the moment at which it becomes profitable to bring about a conversion whereby the State may renew the old debt at a lower rate of interest.

Similarly, freedom from taxes, which makes the creditor independent of the vicissitudes of taxation in the debtor country, influences the capitalization of the interest at the initial moment of issue, since the investor is willing to pay an insurance premium against the risk of new taxes in the future.

Through these compensations the policy of exemption would provide a radical solution of the problem without distinguishing between domestic and foreign creditors; and, in the end, this policy comes to be adopted by countries with a high tax-burden which must have frequent recourse to internal and external borrowing.

Here, also, special consideration for foreigners, which is excluded in pure theory, comes again to prevail in the concrete case. For foreign capital is sought not only by countries that go into debt because they are poor, but also by rich countries which do not wish, through the flotation of loans, to withdraw domestic savings from investment in native industries.

Now, what is an obstacle to, or renders burdensome, a foreign loan is not always the remote danger of special or confiscatory taxation, so much as the danger of double taxation to which interest on the debt may be subjected, — once in the country of the debtor and once in that of the creditor.

This explains why there is nothing unusual in the circumstance that wealthy countries of high credit standing should extend special treatment to foreign subscribers to their loans, by applying only to such foreigners the policy of exemption and by giving them other guarantees, such as that of the payment of interest in gold and possibly the right to demand reimbursement of their capital.

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After this extended treatment of the problem, it seems permissible to conclude that the first method — that of taxing interest on the public debt — is proper for countries that hold their credit high by means of a traditional observance of pledges assumed, and that the second is the alternative left to governments which do not inspire the same degree of confidence.

## CHAPTER VIII

# THE COMPLEMENTARY TAX ON GENERAL INCOME

Summary: Subject of the tax — Foreigners — Object of the tax: net incomes which have been subjected to discrimination — Deduction of debts — Coefficients of correction

### § I

THE complementary tax on income is added to the system of direct taxes and is the crowning feature of the system, if it satisfies certain fundamental principles which we shall now examine.

From the fiscal point of view, the complementary tax represents an increase in the amount of direct taxation; it strikes the sum of the incomes that were separately subjected to direct taxation, even in those cases in which, as the result of some sort of preferential treatment, these separate incomes in fact pay no taxes for a time; and usually, but not necessarily, it has a progressive form.<sup>1</sup>

From this definition it follows that the subject of the complementary tax is the citizen, a physical person, or, at the most, the

<sup>1</sup> If we go back to its historical origin, the most valuable material on which is contained in the inquiries and parliamentary debates of the House of Commons, we find that the income tax was proposed in order to compensate for the bitterly criticized inequalities which were involved in the taxes on consumption. But the protests were satisfied not by the introduction of progression in a symmetrical form, but by the exemption of the lowest incomes derived from labour and capital and by the granting of percentages of abatement to minimum and small incomes.

In the United States, also, the income tax was originally regarded as a device tending to correct the inequalities of the system of taxes, direct as well as indirect, which burdened agriculture almost exclusively, while industrial and professional incomes escaped adequate taxation.

But one must not lose sight of the fact that the two taxes on income — in England and America — are not *complementary* taxes, but are *basic* taxes, more nearly comparable to the Italian tax on movable property (*imposta della ricchezza mobile*) than to the Italian complementary tax.

Since there is a growing tendency, nowadays, to exclude the goods consumed by the masses from indirect taxation, we cannot assign to such a tax as the Italian complementary progressive tax the purpose of counter-balancing the inequalities involved in indirect taxes on consumption. There is no doubt, however, that in judging the distribution of the total tax-burden among the various classes, the complementary progressive tax is an important new factor in the problem, since in fact it represents a notable increase in the tax-burden of the richer classes.

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family dependent on him, since it is only with respect to such a person or to his family that it is possible to sum up all incomes for the purposes of this type of tax. Business corporations, therefore, are not subject to an inclusive tax of this type, since they have only a *single* income — deriving from their special type of productive activity — which is distributed among the different shareholders, in whose private budgets the income thus received may become a part of each person's general income.

It also follows that each individual — whether he is a citizen or an alien — owes the complementary tax on the sum of his various incomes, on each one of which he already pays, or theoretically ought to pay, direct taxes.<sup>1</sup>

From this fundamental concept it follows that (a) the foreigner who draws his income from the country levying the complementary tax and consumes it in his own country owes the complementary tax, because his income is intended to be subject to the direct taxes to which the tax under discussion is complementary; (b) the foreigner who derives his income from his own country and consumes it in the country levying the complementary tax does not owe the complementary tax, because this income is not subject to the various direct taxes of the country in which he lives; (c) the citizen of the country levying the complementary tax who finds himself in the same situation as the foreigner just described does not owe the complementary tax; the fact that the one is a citizen and the other an alien does not modify the economic relationship, which derives from the exchange of taxes for public services.

It may seem, and it may in fact be true, that the foreigner and

<sup>1</sup> In the literature on Public Finance, it is still the practice to treat the complementary tax as a *personal* tax and the various direct taxes as *real*.

It has already been noted that, from our standpoint, the difference between the two is merely *technical* — that is, it does not have the legal significance which is usually assigned to the words 'personal' and 'real'. The relating of the sum of incomes from various sources to their single possessor facilitates technically the solution of certain problems, such as that of the deduction of interest on the personal debts of the taxpayer, and may correct, in part, the error of not having deducted such debts from the separate incomes when they are subjected to the various direct taxes; but the *sum* of these incomes has the same character — real and territorial — as the *terms* that go to make up the sum. This is confirmed by the fact that the same questions that arise concerning the complementary tax have been asked repeatedly in the case of the tax on movable property in Italy, and in the case of the income tax in England and America. Those who have wished to appeal to the personal criterion of the political status or the citizenship of the taxpayer have found themselves faced by insurmountable formal contradictions, since it is not possible to ignore the fact that income is produced and is therefore taxable within the territory of the State!

## THE SYSTEM OF DIRECT TAXES

the citizen who consume in the country levying the complementary tax income produced abroad profit from the public services represented by the provision of safety, roads, illumination, etc., and that they do not pay the price for such services on an equal footing with other residents of the country. This would be a case of economic evasion; let us admit this, and see how existing legislation takes care of the difficulty.

### § 2

Nowadays, the foreigner and the citizen pay direct taxes in the country in which they produce the income, and pay indirect taxes in the country in which they spend it. This is the basis for the solution of the problem. If we suppose that direct taxes are equal in the country of origin and in that of residence and that in both countries the indirect taxes counterbalance the direct, it is no longer true that there is tax evasion on the part of the two taxpayers.

Reasoning now theoretically, and assuming that the Treasury in the country of residence succeeds in striking income produced abroad, the tax is an evident duplication. And if the same policy is practised — either by way of reciprocity or by way of reprisal — by the other State, there will be double duplication. This will induce both taxpayers to return and live in the country in which their income is produced.

Thereby the expectations of the Treasury are disappointed, wholly or in part.

The solution mentioned above has prevailed not only by virtue of this negative reasoning; it rests also on a solid positive basis of an economic and political character.

We have established the principle that indirect taxes are an integral part of the single tax-debt owed by the citizen. For this reason, if the citizen consumes his income abroad, he escapes the payment of a part of his tax-debt; hence arises, without further need for justification, the right of the domestic Treasury to levy upon him either increased direct taxes or substitute taxes or export or emigration duties, or some other form of tax.

On the other hand, the indirect taxes that the State collects from the foreigners who come and stay in its territory correspond to the indirect taxes that it does not collect from its citizens who go abroad.

## TAX ON GENERAL INCOME

Herein lies the compensation.

The presumption of compensation is coming to accord more closely with reality each day in proportion as the exchange of persons between countries develops and becomes intensified. It derives from the ancient right to free movement, which was one of the first conquests of the modern world over feudalism in the field of individual liberty; and it expresses itself, in international relations, in the principle of reciprocity.

Each country may govern its tax-legislation by this principle, without needing to conclude a formal international agreement; the latter serves to insure citizens against the danger that the principle may in fact be violated and that double taxation may result.<sup>1</sup>

The solution which has prevailed up to now seems, because of its simplicity and its sound foundation, to be the most satisfactory.

But if it is still maintained that indirect taxes on consumption and local taxes do not suffice to pay for the services that foreigners receive from the State in which they live and in which they consume the income produced abroad, a substitute tax — such as a visitors' tax — may be adopted without falsifying the character of the complementary tax.

### § 3

#### *Object of the Tax*

The object of the tax is the sum of the incomes, whatever their source, that belong to one person.

It should be noted that we are dealing here with a *complementary tax* — that is, a tax that strikes the sum of many incomes, each one of which has already been struck by another direct tax. From

<sup>1</sup> The principle of reciprocity and compensation goes beyond the confines of the complementary tax, and has a much broader field of application. It aims to eliminate all cases of double taxation, and might be made the first step toward a more uniform international tax system — a goal very remote from contemporary reality.

Many cases which are regarded as duplications can be eliminated by applying the principle of the deputation of incomes when an income passes from one country to the other and pays taxes in both. On the other hand, there are cases of inevitable technical duplication: for example, that of the tax on rental value, which necessarily strikes every tenant, whether citizen or foreigner, and brings it about that since the rental is used as an index of general income, the foreigner and the citizen who derive incomes from abroad pay taxes indirectly on the latter also. It is a typical case of those capillary inequalities which the law is incapable of reaching, and which become adjusted through the action of the tax-payer himself, who will choose his residence in such a way as to pay, in total taxes, an amount which he regards as adequate on the basis of his personal evaluation of the facts involved.

## THE SYSTEM OF DIRECT TAXES

this it follows that it must form, with these, a harmonious whole, so as to avoid the possibility that the provisions of one type of tax may be in conflict with the provisions of the others. It is not necessary to take such precautions when we deal with a *single* tax which strikes the sum of several incomes belonging to one individual, no one of which has been struck before by another direct tax.<sup>1</sup>

If these incomes, to which it is proposed to apply a complementary tax, were all ascertained with the same degree of accuracy, their arithmetic sum would also be the definitive basis of the complementary tax, which, under the conditions indicated, would have solely the function of introducing progression.

But we know that the conditions thus assumed are unreal; hence to take the arithmetic sum of the incomes from various sources as the basis of the complementary tax would only aggravate that inequality that already exists as between the different direct taxes. Yet the arithmetic sum is a first crude datum, which must be subjected to further elaboration.

First of all, we deduct the debts, including the personal debts, of the taxpayer, if account was not taken of them in the deputation of income from land, buildings, etc. Once this deduction is made, it becomes evident that the incomes ascertained for purposes of levying the complementary tax are put on a more equal basis one with the other, since in fact we shall have eliminated one cause of duplication and inequality which existed in the structure of direct taxes.<sup>2</sup>

<sup>1</sup> The criticisms that are directed against the Italian complementary tax -- and on these it is not necessary to pause -- derive precisely from the fact that Italian legislation, in borrowing provisions from foreign laws (those, for example, with respect to the Income Tax), has not taken into account the fact that these laws have reference to the single tax on general income, and has applied them to the complementary tax, thereby creating several contradictions in principle.

[For a detailed account of the criticisms mentioned, see the Italian text. -- Translator's note]

<sup>2</sup> We are, however, still far from having thereby corrected the more important inequality that remains in the relationships between the various direct taxes. In this connection, for example, it should be noted that Italian legislation falls into the contradiction of recognizing the principle of the deduction of debts in the case of the small tax-rate used in the complementary tax, and yet does not recognize it in the case of the various direct taxes, which tax the interest on debt twice, and at considerably higher rates.

It is not necessary to devote much attention to the false argument alleging that the direct taxes are *real*; since if the owner of lands and of houses and of industrial and professional incomes shows that he has a debt due to a third person who pays the tax on the interest, this interest can and must be deducted from some one of the debtor's incomes, or from those that have a relatively greater importance in his budget. The technical legal question could in any case be easily solved.



## TAX ON GENERAL INCOME

Another deduction that the law often allows is the sum of all the taxes that the taxpayer has already paid to the State and to local governmental units. This is contrary to the general principle according to which all taxes strike, contemporaneously or successively, the same net income; but the exception that is made in the case of the complementary tax has a technical reason, in so far as it aims to eliminate the differences in the tax-rates which are paid on equal net incomes under the various direct taxes. Thus, the tax-rate on income from land might be as high as 60 per cent and even higher; on income from buildings as high as 25 per cent, on income from capital 20 per cent, on income from professional activity 16 per cent, etc.

Even if we grant that this differential treatment has a justification, this justification must be understood to be removed as soon as the structure of direct taxation receives a definitive form.

It is therefore only in order not to aggravate the 'inequality of tax-rates' that taxes already paid are deducted. To be sure, the deduction of taxes already paid does not correct the 'inequality of appraisal', in which lies the real problem to be solved. We have already insisted many times on the inequality as between the various direct taxes which is due to the different degree of accuracy with which it is possible to ascertain the incomes subject to these taxes. If we take one taxpayer whose total income is composed mainly of income from land and another whose income is made up principally of industrial and professional income, and then subject the two sums to the complementary tax, the inequality referred to persists if the complementary tax is proportional, and is aggravated if the tax is progressive. In the first case, the complementary tax would be a useless organ added to the tax-organism; in the second, a harmful organ.

Let us, in fact, take two incomes which are really equal, amounting to \$5000 each, but which, according to the appraisals arrived at in the administration of the other direct taxes, amount to \$5000 for one and \$2500 for the other; and let us also suppose that in paying their direct taxes they are subject to the same tax-rate — for example, 20 per cent. The second will then pay half as much as the first. By hypothesis, the two incomes are struck by the proportional complementary tax with an additional tax-rate of 10 per cent. This is equal to an increase of 10 per cent in the two direct taxes previously

## THE SYSTEM OF DIRECT TAXES

paid; but if the complementary tax is progressive, the first income will pay a higher rate than the second; for example, one 10 per cent and the other 5 per cent. The inequality is aggravated in such a way as to defeat the very intention of the legislator.

We may mention, further, the limiting case of incomes derived from public bonds payable to the bearer, which evade the tax on movable property and the complementary tax; also that of private securities payable to the bearer, on the income from which the business corporation pays the tax on movable property for the shareholders, but which, after the company's profit has passed to the owners of the stocks and bonds, completely escape the complementary tax.

If the actual incomes are equal, therefore, a person who succeeds in concealing a larger part of his income will also, besides paying less indirect taxes, pay a smaller progressive rate as compared with a person who did not succeed in concealing his income — that is, the original inequality would be aggravated. This can be partly avoided if the incomes already ascertained for the purposes of direct taxation are reviewed and corrected by means of coefficients based on the standard of living evidenced by the taxpayer, the value of whose residence, automobiles, horses, servants, and country houses are the usual indices.

The process is difficult but necessary; the correction of incomes appraised in the administration of the various direct taxes in force must be considered as an essential element of the complementary tax; since only to the extent to which this tax equalizes the appraisal of incomes already struck by direct taxes does it become a useful organ perfecting the 'tax organism'.<sup>1</sup>

<sup>1</sup> In the light of these considerations, it may be stated that the Italian complementary tax does not serve the purposes of a better structure of direct taxation. It is merely a *progressive super-tax*, which increases the rates on incomes of 6000 lire and over, leaving intact and often aggravating the inequalities existing among the various direct taxes.

**BOOK IV**  
**THE SYSTEM OF INDIRECT TAXATION**

## CHAPTER I

### INDIRECT TAXES ON CONSUMPTION

**Summary:** The two branches of indirect taxation — The basis and the distribution of taxes on consumption — Effects of the distribution : are indirect taxes inversely proportional to income? — Tendency to limit taxes on consumption to one group of goods; character of this group — The exemption of articles of popular consumption and minimum incomes

#### § I.

We have already seen that indirect taxes represent, not a duplication of direct taxes, but a division into two portions of the single tax-debt which every citizen owes the State.

After the taxpayer has paid direct taxes on the incomes he has produced, he owes indirect taxes on the same income, to the extent that he in fact spends it either in the acquisition of direct goods, in order to satisfy present wants, or in the acquisition of instrumental goods, when he saves his income in order to satisfy future wants.

From this arise the two branches of indirect taxation: 'taxes on consumption', and 'taxes on the transfer of property'. The first strike *expenditure*; the second, *saving*; the two together strike the total income of the taxpayer.

Hence, the relationship between the two branches of indirect taxation is a mutually complementary one, of the kind that has already been discussed several times: first in connection with the relationship between direct and indirect taxation, then in connection with the mutual relationships of the various direct taxes to one another, and then again in connection with the relationships of the various categories of income from movable property to one another.

Given this complementary relationship, there ceases to be any basis for the old criticism according to which taxes on consumption involve inequality because they strike, not the whole income of the citizen, but only his *expenditure*, which, moreover, varies from individual to individual.

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In fact, the inequality involved in the indirect taxes on consumption is paralleled by the inequality involved in the indirect taxes on property-transfers: the latter strike, not the whole of income, but only *savings*, which vary, like expenditures on consumption, from individual to individual, but vary inversely to such expenditures. A person who spends much and saves little pays more in taxes on consumption and less in taxes on property-transfers; and a person who spends little and saves much will pay more in taxes on property-transfers and less in the form of taxes on consumption. As a whole, therefore, we may admit, by way of first approximation, that both expenditures and savings are subjected to equal fiscal treatment in the case of each individual taxpayer; or, at any rate, that there is a tendency toward such equality, and that it is at least technically possible to obtain such equality.

This is the fundamental principle regulating the distribution of indirect taxation as between the taxpayers.

But in considering the relations between the taxpayers and the State, we must emphasize the fact that the Treasury loses no part of the consumption-taxes which were owed on income that has been saved. As a matter of fact, the saver reinvests his savings in new production; instead of buying an automobile or going on a pleasure trip, he buys industrial equipment and human labour for the production of new goods.

Between the saver, on the one hand, and the labourer and producer of machines, on the other, an exchange takes place, through which the labourers and the producers of machines pay the consumption-tax on the income saved by the buyer, who in his turn pays the transfer-tax on the instrumental goods which he buys.

Through this exchange the two taxes complement each other, but remain distinct; since 'goods for consumption' and 'goods for production' cannot be treated equally by the two indirect taxes, for the reason that the former affect only present consumption, whereas the latter affect the whole process of production.

The exchange is regarded as taking place at the moment when the saver makes his payment; but this exchange may itself give rise to another tax, also, when it is regarded as involving the provision of a special public service, as we shall see later on.

This is the general outline of the theory.

## INDIRECT TAXES ON CONSUMPTION

### § 2

The immediate object of indirect taxes on consumption is represented by the mass of goods of the first order which the individual intends to devote each year to the satisfaction of his current wants. Since we live under an exchange-economy, we may say that taxes on consumption strike every part of income that every individual spends in the acquisition of goods of the first order.

The ascertainment of this income is made in successive instalments, as the taxpayer spends each instalment of his income. The price of every good that is bought measures exactly the part of the income spent. On this basis, total income would be ascertained exactly by summing up the purchases made in a year.<sup>1</sup> It is obvious, therefore, that in order to strike the income, it is necessary that the tax be commensurate with, or have reference to, the value of the goods bought.

We also know, from our general principles, that the whole income of the citizen is obligated to pay indirect taxes; whence it follows that it must be ascertained in its entirety. This requires that all consumption-goods — none excepted — must be subjected by law to an *ad valorem* tax.

Reasoning, for the moment, on the basis of this hypothesis — which is abstract, but is necessary in order to make precise the guiding principles involved — let us see in what ratio — proportional or progressive or inversely progressive — the total burden of taxes on consumption is distributed among the various categories of taxpayers.

### § 3

It is possible to classify direct goods by beginning with those that satisfy relatively more urgent elementary wants, passing on gradually to other goods that satisfy more refined wants, each of them relatively less urgent than its predecessor in the scale, and ending with so-called articles of luxury.

<sup>1</sup> One should avoid the error, in dealing with indirect taxation, of regarding consumption as an index measuring income in the sense in which, for example, the consumption of housing is, or is taken as, an index of the presumed general income of the inhabitant of the house.

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Now, the indirect tax is necessarily a case of single price — that is, it cannot differ, for the same article, from consumer to consumer. If a rich man buys ten pounds of sugar and a poor man one pound, the first will pay ten times the tax that the latter pays. This means that the tax on sugar is necessarily proportional to that *part of his income* which each of the two spends on the consumption of sugar; it is not proportional to the total income of the two.

If, however, the same *ad valorem* rate is levied on other goods and services, the total tax-burden will be proportional to the total incomes of the various taxpayers.

On the other hand, if the tax-rate increases as we pass from goods that serve the consumption of the poor to goods that serve higher and luxury consumption, the distribution will be progressive.

Similarly, absolute exemption of the goods that make up the irreducible standard of living of the poorer classes corresponds to the exemption of small incomes in direct taxation.

If, instead, luxury articles are exempted and those of prime necessity are heavily taxed, inversely progressive distribution exists.

From this parallelism it is permissible to infer that the principles and the forces that determine the policy of direct taxation also operate in indirect taxation and explain its organic structure and development. Persistent and intended contradictions between the two would be impossible; for example, progressive direct taxation would not be logically compatible with a heavier burdening of articles of popular consumption by indirect taxes. As for the effects of the two, moreover, it may be pointed out that — always assuming the hypothesis stated above — evasions are either impossible or are reduced to negligible quantities; since the contraction in the consumption of a good that is taxed leads to an increase in the consumption of other goods which are also taxed.

This, in broad outline, is the picture presented by pure theory; but it is not one which is capable of complete realization in practice, because the hypothesis of inclusive taxation of all goods and services, without exception, is not realistic.

The attempt to obtain such taxation has, to be sure, been made, and one may admit that it is possible to persist in such attempts; but success has been lacking for various reasons which prevent its achievement in practice. First of all, it is not possible to ascertain all consumption goods, because of the circumstance that it would be

## INDIRECT TAXES ON CONSUMPTION

necessary to include among them those personal services which escape ascertainment and which represent, especially for higher incomes, a notable part of expenditure, and which, moreover, are extremely variable in value — as, for example, the fees of professional men. Hence arise gaps and inevitable inequalities.

In the second place, tax-duplications are numerous, unexpected, and repeated, because it would not be possible to avoid taxing at one and the same time raw materials and direct goods. Indeed, the larger part of direct goods may also be the raw materials for the manufacture of other direct goods, which in their turn may be the raw materials for further transformations. The grape is a direct good, and is also a raw material for the production of wine; wine is a direct good, and is also a raw material for the production of alcohol; alcohol, in its turn, is a direct good and is also a raw material for the manufacture of liqueurs.

To this must be added the detailed labour that would be necessary in order to ascertain the value of every consumption good and to deplete it of the value of the instrumental goods already taxed; and think of the complex bureaucratic organization and the expense that such work would necessitate!

To sum up: the failure of the attempt to tax all goods makes it necessary to solve the problem of the distribution of indirect taxes on consumption *by limiting the number of the goods to be taxed*. This becomes the new premise of the concrete problem.

### § 4

Now, if the taxation is carried out in progressive form, in order to make the burden fall predominantly on rich consumers, a large yield cannot be counted upon, since we already know that the large incomes form a small part of the total national income, as compared with small incomes.<sup>1</sup>

To overcome this difficulty, it is necessary to raise the rates; this will lead the rich to contract their luxury consumption all the more rapidly. Thus, the yield of the tax, as a whole, will grow smaller; to make up for the deficit it will be necessary to raise the consumption-taxes on the classes with small incomes and at the same time it will

<sup>1</sup> Consumption, by income-classes, may be measured by the table and diagram given for the distribution of incomes, in our discussion of direct progressive taxation (Book II, chap. VII, § 10).



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be impossible to allow tax-reductions or exemptions on the consumption of the classes with minimum incomes.

The play of economic forces tends toward an equilibrium in which progressive indirect taxation tends to become proportional to incomes. This explains why the yield from surtaxes on luxury articles is often reduced to a negligible quantity.

The same phenomenon was pointed out in the case of direct progressive taxation, except that in that case the effect was slower in appearing, because one had to wait for the rich to liquidate their estates, reduce their savings, or send them abroad. In the system of indirect taxation, the effect is more prompt.

The result does not appear in the case of taxes on goods subject to an inelastic demand, which are usually consumed also by the classes with modest incomes.

No class escapes such taxes, because no one can contract sufficiently his consumption of bread, meat, or salt. Here, then, is the broadest possible basis for taxation. But it is precisely here that the greatest defect of taxes on consumption appears; for, while they are proportional to that part of income which the rich and the poor respectively spend for the most necessary goods, they are inversely proportional to the total income of the two. The part of income spent for bread and salt and other similar goods represents a relatively large part of the income of the poor, but a relatively small part of the income of the rich. Take, for example, the case of salt: the *per caput* consumption of salt is fixed — that is, it is independent, or almost independent, of the consumer's income. Take the case of bread: the workman spends a relatively larger part of his income on bread than do the wealthier classes. Take the case of dwellings: the same is true, though to a smaller extent. These are three typical examples.

### § 5

#### *The Group of Selected Goods*

Now that the elements of the problem have been given, we can construct a system of indirect taxes on consumption which reduces to the minimum the defects mentioned.

Since it is impossible, for the reasons indicated, to strike all the goods and services on which the income of citizens is spent, it is necessary to work with one group of goods.

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This group cannot consist only of luxury articles, because it would then provide only a limited basis for taxation and because the high rate to which it would be necessary to subject such articles as a result would restrict their consumption, and hence the tax-revenues. It is not possible to take as a basis the group of necessities and articles of mass consumption — although such a group would yield an appreciable revenue even at low rates — because the taxation would be inversely proportional to income. By a process of elimination, the problem is capable of solution if and to the extent that there exists a group of direct goods which satisfies the following three-fold requirement: (a) it must represent articles of consumption which are not necessities; (b) these articles must be consumed on a broad scale; (c) the consumption of these articles must be capable of increasing expansion.

This group exists everywhere, with more or less notable variations from country to country. Coffee, tea, tobacco, wine, alcohol, liqueurs, beer, sugar, and a few other articles satisfy these three requirements. And the requirements are satisfied also by other articles of consumption which reflect more directly the standard of living of the family — such as servants, riding horses, automobiles, bicycles, pianofortes, etc.

Naturally the group varies according to the habits of different peoples; but it varies above all according to the wealth of each country, tending to include fewer commodities in proportion as the standard of living of the population is raised. Articles that are not regarded as necessities in relatively poor countries become necessities in richer countries in proportion as there is an increase in the well-being of the masses. A typical example of this is sugar, which is regarded as a luxury in poor countries, and hence liable to heavy taxation, while in rich countries it has become an article of necessary consumption which the masses try to exempt from indirect taxation.

In proportion as it shrinks, the group under discussion accentuates the characteristic of including goods of practically unlimited consumption, which increase with the continuous increase of wealth and general well-being, even independently of the increase in population, while the taxes on necessities, which are rapidly saturated, increase almost entirely as the result of the increase in population — that is, slowly.

Every tax-reduction, moreover, that is accorded to necessities

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leaves a free margin of income which may be devoted to higher forms of consumption, which can bear a somewhat higher tax; from the standpoint of the Treasury, this resolves itself into a compensation which is partial, but is immediate and destined to increase.

### § 6

This solution of the problem is not immune to criticism. In fact, it rests on the presumption that the consumption of the goods that form the group is an exact index of the general consumption of the citizens, and that therefore the taxes paid on the consumption of the group are proportional to the income of the taxpayers.

Now, since we are dealing with an indirect and inferential determination of income, it is obvious that this presumption is not exact and may be criticized.

We do not have statistical data that permit us either to affirm or to deny; but we can advance some further considerations which have the effect of weakening the criticism mentioned.

First of all, 'consumption' must not be limited to a comparison of two individuals; it must, in addition, take account of the *nuclei* — members of a family, the number of servants, etc. — which are grouped about the individual who pays. If Brown, a labourer, has an income of \$200, and Smith, his employer, has an income of \$4000, it is difficult for Smith, as an individual, to consume 20 times as much coffee, wine, spirits, sugar, and tobacco as Brown. But when account is taken of the fact that Smith pays for the consumption of all the members of his family and of the servants and often of friends and guests, the conclusion stated above undergoes a first modification.

Nor is this all; for every good within the group is susceptible of division into units having different degrees of excellence, to which different market prices are attached, and with respect to which the State, by means of a tax on consumption, applies the policy of manifold prices. If it is difficult, therefore, for Smith to drink twenty times as much wine as his workman, it is not equally difficult for him to drink wine twenty times as expensive, if in place of ordinary wine he puts fine wines for himself and for the group with which he has social relations.

Finally, it must be borne in mind that the comparison is not made

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for each individual good, but for their sum, since some do not enter at all into the consumption of the less fortunate classes.

If these circumstances still seem inadequate, there remains the consideration that the consumption of tobacco, of alcoholic beverages, of coffee, and other similar things is not *necessary*: everyone may renounce such consumption wholly or in part, or may get along with articles of inferior quality and substitutes. In the final analysis, the result is that these two types of action — that of the Treasury which bases the tax on goods that are not necessities, differentiates these goods according to quality, and subjects them to the policy of manifold prices, and that of the consumer who has great freedom in contracting consumption — meet in an equilibrium point, at which the tax finally comes to be distributed proportionally, or almost proportionally, to the income of the citizens.

### § 7

#### *Raw Materials*

Another principle for the determination of the group to be subjected to indirect taxation is that instrumental goods — that is, raw materials — should not be included among them.

We have already said that indirect taxes on consumption are intended to strike the citizen's income. Now, income is measured more exactly by the value of the goods of the first order and less exactly as one passes to goods of increasingly higher orders. Furthermore, the indirect tax on raw materials becomes unequal in its effects upon the various consumers, since from the same raw material are obtained products of different value; hence if a tax is levied on the raw material rather than on finished products, the poorer taxpayer is forced to pay a relatively larger tax.

This second condition which must be satisfied by the group of goods chosen as the basis for indirect taxes on consumption is expressed by saying that these taxes should strike the goods *as near as possible to the consumer*. It goes without saying that what is meant is economic nearness, in the sense that it is necessary (a) to strike the article at the moment that it is finally transformed into a direct good; and (b) to avoid phenomena of repercussions and friction between

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the consumer, on the one hand, and the producer or the middleman, on the other, by avoiding, so far as possible, compelling the latter to pay instead of the former.

To sum up: the tendency to concentrate the burden of indirect taxation on an increasingly restricted group of goods of general consumption which are not necessities represents the law of formation or transformation of indirect taxation in modern countries.

The extent to which this general tendency is in fact realized is limited by the actual position of the public budget in relation to the private wealth in each country. But the general condition for its realization is that private wealth must increase more rapidly than public expenditures, since only then can the citizens employ the new margin of income to increase their private consumption, passing from the more to the less urgent articles of consumption and making possible the shifting of the burden of taxation from the first to the second.

In relatively poor countries with a high tax-burden, it is not possible to exempt entirely goods of general and necessary consumption, since they are the only goods that provide a base broad enough to assure an adequate revenue for the Treasury. Every exemption, no matter how small, that is made for the benefit of the poorer class would resolve itself into a reduction in the tax-burden for all the wealthier classes, without compensation for the State.

We are dealing with a state of fact with respect to economic and financial conditions in which all modern countries have found themselves in the first stage of their economic development. And it is at such a time that the countries concerned adopt, as the only expedient of limited scope and transitory character that is available, the exemption of minimum incomes from direct taxation as a compensation for inversely proportional indirect taxation.<sup>1</sup> But as soon as the country emerges from this first period, and, with the general increase of wealth, initiates a broader policy tending to make the burden of indirect taxes proportional to incomes, and subsequently also to transfer it progressively from the less fortunate classes to the richer classes, the two practices — that of the exemption of minimum incomes from direct taxation and that of the exemption of articles of popular consumption from indirect taxation — are developed along parallel lines, as two corollaries of a single tax-policy.

<sup>1</sup> Book III, chap. vi, § 4.

## CHAPTER II

### ASCERTAINMENT AND COLLECTION

**Summary:** Ascertainment of the objects on which taxes are to be levied: *ad valorem* duties and specific duties — Direct collection from the consumer, indirect collection from the producer — Revenues from State monopolies are different from fees and patrimonial revenues — Critical examination of the difference between revenues from State monopolies and taxes on manufactures — Conditions under which each is likely to prevail — Comparison between taxes on manufactures and sales taxes — The principle that all indirect taxes on consumption are mutually complementary

#### § I

##### *Specific Duties*

HAVING defined the basis of indirect taxes on consumption, or the objects on which such taxes are to be levied, let us pass to the problem of ascertainment of these objects.

If we start from the principle already expounded — namely, that the tax must be proportional to the value of the commodity which it is desired to tax — theoretically the so-called system of '*ad valorem* duties' ought to prevail.

In the concrete case, however, this system gives rise to almost insurmountable difficulties in collection, as soon as an attempt is made to ascertain 'values'. Every commodity is subdivided into sub-species each of which has a different quality, different uses, and a different value. Take, for example, wine, which has a national market and with respect to which the circumstance just mentioned might not seem significant: the wine of each region and often of each municipality has a different alcoholic content, a different composition, a different price; the wine of one region is a raw material, that of another is ready or almost ready for consumption; the one can be kept and transported and allowed to age, while the other cannot.

Moreover, ascertainment of the different values ought to be made

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at the time of collection — that is, when investigations for the purpose of ascertaining market value are most difficult, and when the disputes between the taxpayer and the Treasury agent are most bitter. In order to make collection rapid, certain, and not too expensive, it has been found necessary to fix the duties on the basis of weight or capacity or volume or number, substituting for *ad valorem* duties 'specific duties', as they are called when they are commensurate with weight, number, etc. Thus, ordinary wine is taxed, without further qualifications, at so much per gallon. As a result, the duty comes to involve inequality; but an attempt is made to avoid this evil by subdividing each commodity into several classes and attempting to have each class coincide with a different price, although the evil is thereby merely lessened, rather than eliminated. In any case, it is along this line that an attempt is made to reconcile the economic basis of the *ad valorem* duty with the practical basis of the specific duty.

### § 2

#### *Forms of Collection*

In passing to the problem of actual collection, it should be noted that what is important is the choosing of the most convenient moment for collection. Now, according to the principle already expounded, the most convenient moment is that at which the commodity is nearest the consumer.

(a) Hence the group that best satisfies this criterion is that in which the indirect taxes are collected directly from the consumer: this is the case with respect to taxes on servants, bicycles, horses, dogs, automobiles, pianofortes, and so on.

This method of collection is the most direct and the least expensive; but it can be applied only to goods which are used more than once, and not even to all of these, for it would require inquisitorial investigations into domestic life which would not be tolerated. In order to strike other goods, therefore, it is necessary to ascertain their existence and their value while they are in the hands of the producer and the merchant, who, as we have already pointed out, will pay the tax in advance on behalf of the consumer.

(b) Now, it may happen that the producer of the taxable good is

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the State itself, in which case no agency intervenes between the Treasury and the taxpayer. It is necessary, however, that the State should not be in competition with private producers of similar articles, if tax evasions are to be avoided.

Thus arises the 'prerogative'<sup>1</sup> or fiscal monopoly, which we may regard as the second method for the collection of taxes on consumption. Through such 'prerogatives' the State becomes proprietor, entrepreneur, manager, and merchant under conditions of legal monopoly, and sells the goods produced at a monopoly price. The difference between cost and price is the tax on consumption. The tobacco monopoly is a typical example of the group.

As a result of the fact that the State becomes an entrepreneur, these monopolies have often been put on a par with the postal system, the telegraph system, railways, and even with patrimonial goods.

But it is easy to see the difference.

We know that the fee is a price for public service and that it is a cost-price. The manufacture of cigars, on the other hand, is not a public service and the price of cigars is a monopoly price. We are dealing with two monopolies that are entirely different in scope, content, and price policy. In one case, the State wins at the highest possible gain through monopoly price; in the other, it aims at the maximum expansion of the consumption of public goods through the charging of only a cost-price.

Similarly, the cigar factory is managed by the State for the purpose of, and within the limits necessary for, collecting a tax. If, however, the form of collection were to change, the State would abandon the industry, but would not sell it to others as if it were a patrimonial asset. In other words, it would sell the factory as a building, but would not sell the monopoly for the manufacture of cigars to a private enterprise. Nevertheless, an analogy does exist between a State factory for the manufacture of cigars and patrimonial goods; for in both cases the State is an entrepreneur and behaves — subject to the limits set by the fiscal aim that it wishes to achieve and the time in which it hopes to achieve it — like a private monopolist. For this reason, the same objections that are advanced against fiscal monopolies are advanced against other forms of state enterprise, these objections being summed up in (a) the relatively inferior business capacity of the State, and (b) the greater political independence that revenues

<sup>1</sup> [Italian: *privativa* — Translator's note]



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from fiscal monopolies give to the power of the executive, as against the legislative, branch of the government.

Both of these causes tend to bring about the same result: namely, that they work in the direction of the abolition of fiscal monopolies, unless reasons of economic and financial expediency or of political interest prevail.

### § 3

The alternative to fiscal monopolies is the tax on manufactures, which, though it is intended to be paid ultimately by the consumer, is collected while the goods are still in the hands of the producers.

Between the fiscal monopolies — a typical example of which is the tobacco monopoly — and the tax on manufactures — a typical example of which is the tax on the distilling of spirits — there are relations of a mutual substitutional character, in the sense that one may be used in the place of the other.

Abstracting from possible pressure by special interests, and reasoning only from the standpoint of the fiscal interest of the community, we may say that the development of the system of fiscal monopolies — which excludes private competition — reaches its limit of expediency as soon as the adoption of the tax on manufactures, which strikes all manufacturers, provides relatively greater advantages.

The calculation must be carried out case by case, all the elements of the concrete problem being assigned due weight. But a consideration of a general economic character is this: that in both cases the margin available for taxation is given by the difference between cost and selling price.

The selling price may be assumed to be equal in both cases; for, by use of the tax on manufactures, the State can bring the price up to the level of the price that would be set by a fiscal monopoly; hence the difference between cost and price can be increased only by reducing cost.

All the difficulties that the State meets in organizing and managing a monopolistic industry — difficulties of a technical and political character, those having to do with relative abilities, the prevention of evasions, and so on — result in increased cost. If the State produces at a cost higher than that which private enterprise would

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incur, it condemns the nation's capital and labour to relative unproductiveness and decreases that difference between cost and price which is the margin available for taxation.

The contrary usually happens in the case of a private enterprise.

On the other hand, even if the State does produce at higher cost, thus condemning the nation's capital to relative unproductiveness, it can find some compensation in the following two circumstances.

(a) In actual fact, the State hardly ever succeeds in raising the tax on manufactures up to the theoretical limit of monopoly price that would be charged by a fiscal monopoly, because of frictions and evasions and the expenses of supervision and enforcement, which increase as the tax increases, so that, other conditions being equal, the tax on manufactures cannot, as a rule, attain levels that are so high as to equal the prices which are charged by fiscal monopolies. (b) Under monopoly, on the other hand, it is possible to practise the policy of manifold prices, to which the products of some monopolies — such as the tobacco monopoly — lend themselves.

To sum up: it may be said — and this is also confirmed by experience — that through the use of the tax on manufactures the State utilizes, to the country's economic advantage, the greater productive capacity of private industry, at the cost of some sacrifice of public revenues; and that through the use of fiscal monopolies it obtains larger revenues, at the cost of some sacrifice of the productiveness of the nation's capital and labour.

From this may be derived the following law of general tendency: when the fiscal needs of the Treasury are more pressing, fiscal monopolies take the place of taxes on manufactures, at the same time increasing the amount of taxation; but when fiscal pressure is lessened and the interest of the general economic system again asserts its dominance, taxes on manufactures again replace monopolies, at the same time reducing the amount of taxation.<sup>1</sup>

The tax on manufactures is further removed from the consumer

<sup>1</sup> The Italian taxes that strike consumption goods while they are in the hands of the producer or the middleman are many, and were increased during the World War.

Taxes are collected on the following commodities while they are in the hands of the producer: spirits, sugar, matches, beer, chicory and coffee substitutes, gas, and so forth. Recently there was introduced a tax on wine in the hands of the vine-grower, but this has since been abolished.

Municipal taxes are collected on the sale of the following articles while they are in the hands of the middleman: wine, vinegar, liqueurs, meat, etc., as well as on the sale of luxury articles, and so on.

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than all other indirect taxes; and for this reason recourse ought not to be had to it so long as it is possible to strike the consumer directly either through internal or external duties on consumption, or through taxes on 'sales' or 'turnover', levied on goods while they are in the hands of the middleman who sells directly to the consumer.

To be sure, sales taxes,<sup>1</sup> which in Italy are now levied on both wholesale and retail sales, present other inconveniences, among them that of not striking the producer, or, at any rate, of bringing it about that evasion by the producer and those dependent on him becomes almost inevitable.

Sales taxes are paralleled by duties on consumption and customs duties, which strike merchandise upon its entrance into the municipality and upon its importation into the country, and are paid by the middleman or by the consumer himself.

From this first general outline of the various methods by which indirect taxes on consumption are collected, it may now be seen that every method has its own sphere of application, and must not be examined by itself, apart from the others. Each has its particular deficiencies and its merits, which others either do not have or have in an inverted order; and all together make up the organic structure of indirect taxation, tending, in their total effect, to avoid duplications and tax evasions and to assure the distribution of indirect taxes in a uniform ratio — let us say proportionally — over all incomes, or over the part of all incomes that represents *expenditure*.

Nevertheless, it seems to us useful to study, at somewhat greater length, certain fiscal monopolies and also customs duties, both of which have a long history and present major theoretical interest.

<sup>1</sup> [Italian: '*imposte di spaccio*' and '*imposte di scambio*' — Translator's note ]

## CHAPTER III

# FISCAL MONOPOLIES

Summary: The tobacco fiscal monopoly — Other methods of collection —  
The salt fiscal monopoly and the exemption of minimum incomes —  
The lottery fiscal monopoly: the fiscal theory and the moral theory —  
The compromise between the two solves the concrete problem and  
prepares the way for the abolition of the public lottery

### § 1

#### *Tobacco Monopoly*

WE shall first discuss the tobacco monopoly. Tobacco is taxable material *par excellence*, since it presents all the elements that a commodity subject to indirect taxation should have: it is a direct good and is not the raw material for any other significant product; it is an article very widely consumed, but is not a necessity; its consumption is elastic, and is more likely to vary in the direction of progressive expansion than of contraction.

Indeed, the possible consumption of tobacco may be regarded as being practically without limit, above all in countries, like Italy, in which the average consumption of the inhabitants is still far below the average consumption in richer countries. Furthermore, tobacco lends itself, because of the multiplicity of its products of different degrees of excellence and value, to the satisfaction of the requirements of the various consumers, who differ in taste and financial standing.

In all countries, tobacco is heavily taxed, but it is not taxed in all countries by means of a monopoly. We shall begin, however, with a discussion of the latter method; and we shall use, for the purpose of illustration, the Italian law on the subject.

According to this law, (a) the State limits the cultivation of tobacco to certain specified zones, and grants cultivation concessions to private individuals, who exercise these concessions under the supervision of Treasury agents; (b) tobacco leaf is sold to the State exclusively, at prices corresponding to the quality of the product, the

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price schedules having been made known to the growers in advance; (c) the State carries out directly in its own factories the transformation of the leaf into tobacco products and sells these products in retail shops.

From this it may be seen that the State uses the superior technical capacity of the private farmer, and might also use the superior technical capacity of the private manufacturer, reserving for itself only the supervision and the control of the cultivation of the plant and the supervision of the manufacture of the products.

In order to provide the quantity of tobacco required by domestic consumption, neither large areas of land nor numerous factories are needed; hence it is economically possible to concentrate the manufacture in a few large factories. This circumstance also makes possible a reduction in the costs of supervision and makes it easier to prevent illicit activity at least outside of the zones of cultivation.

The regime of monopoly is completed by forbidding private individuals to import tobacco from abroad, except for small quantities for personal use, on which a high customs duty is levied.

In its price policy, the State behaves like a perfect private monopolist, who aims at the highest possible profit, without invoking considerations of any other sort; for tobacco, if it is not injurious, within certain limits, certainly is not a hygienic object of consumption, so that its use may be diminished without bad effects, if it suits the monopolist's advantage to effect such a reduction in its use. Furthermore, tobacco products lend themselves to a policy of manifold prices.

### § 2

The alternative to the monopoly would be a tax on cultivation and manufacture.

The tax on cultivation would be paid by the grower according to the area of the land cultivated and the number of plants grown on a given unit of area.

Recourse is had to the double criterion of the area of the land and the number of plants in order to prevent easy evasions of the tax.

In fact, if the tax were established only on the basis of area, there would be a tendency to increase the number of plants which can be cultivated economically on each unit of area, with the purpose of

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evading the tax. On the other hand, if the tax were commensurate only with the number of plants, there would be a tendency to prevent the cultivation of plants of the most economical size, since the growers would raise larger plants in order to evade the tax.

To the tax on cultivation must be added a tax on manufacture, which is intended to tax the different articles on the basis of their quality and degree of fineness.

The tax on manufacture yields less than the fiscal monopoly does, probably because, given the freedom to manufacture and the number of manufacturers, the high tax encourages smuggling and obliges the State to undertake supervision which is expensive, and, to a large extent, futile. The system has, nevertheless, advantages from the economic point of view, because private enterprise might either produce at lower cost, or manufacture articles more satisfactory to the variety of consumers' tastes, or have the suppleness and elasticity which are necessary for the maintenance and expansion of the factories, the prompt provision of raw materials, the forecasting and the satisfaction of consumers' demands. These are the respects in which all the shortcomings of State monopoly were evidenced during the World War.

To sum up: the system of taxes on cultivation and manufacture may be preferred when the Treasury does not demand an excessively high tax on the consumption of tobacco. If, however, considerations of a fiscal nature predominate, monopoly has given and will give greater revenues.<sup>1</sup>

### § 3

#### *The Salt Monopoly*

The second ancient monopoly is that of salt. Salt presents characteristics opposite to those of tobacco: it is, to be sure, an article of popular consumption, but it is also an article of consumption which

<sup>1</sup> A third method of collection which had been perfected in England and which has recently been radically modified, is the prohibition of the cultivation of tobacco within the country, in order to force domestic consumers to obtain abroad both the raw materials and the finished products. The Treasury collects high import duties.

But the transformation of the raw material into finished products which is subsequently carried out must be subjected to a new tax, which may take the form either of a tax on manufactures or of a fiscal monopoly.

In the final analysis, therefore, the difference would reduce itself to the prohibition of cultivation within the country. This cannot be economically injurious to a country in which the cultivation of tobacco is not *natural*; but it would be economically harmful to a country like Italy, in which the cultivation of tobacco is naturally remunerative.

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is necessary for the physiological maintenance of the human organism; it is a direct good, but it is also a raw material used by a continually increasing number of industries; it is an article of general and necessary consumption, but the demand for it is not elastic, and does not increase with growth in wealth.

The production of rock salt is concentrated in a few mines, which are easy to supervise; on the other hand, it is expensive to supervise the sea-coast, where it is possible to carry on illicit operations by means of the evaporation of sea-water. The monopoly is therefore based on the prohibition of the use of a good which is free or almost free; it is this fact that has always made the tax on salt unpopular.

For this reason the principal question is not what method of collection is to be preferred, but the very principle of liability to taxation.

Salt was a taxable material *par excellence* in the past, when fiscal policy, through necessity or as a result of the will of the dominant classes, tended to shift the burden of taxation to the dominated masses. There was a time when each family was assessed a minimum annual consumption of salt. Thus the salt tax corresponded, in indirect taxation, to the poll-tax in direct taxation.

For these and other reasons, in modern countries salt is the typical commodity excluded from indirect taxes on consumption.

The solution of the problem depends on the relative importance of one or the other of these two general tendencies in fiscal policy. All the considerations of a technical economic nature which are advanced on behalf of the preservation or the abolition of the salt monopoly have only a secondary importance.

Nevertheless the tax and the monopoly are still defended or attacked by the use of arguments which may be met by other arguments, and thus leave the problem unsolved. Thus, to the criticism that we are dealing with an article of consumption which is physiologically necessary, it is replied that we are dealing also with an article the consumption of which is limited; to the criticism that we are dealing with an article of consumption that is inversely proportional to income, it is replied that sumptuary taxes on the rich re-establish a proportional relationship; to the criticism that salt is a raw material for stock-breeding, and subsequently for the manufacture of manure and several other industrial products, it is said that

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salt as a raw material may be denatured and sold at cost-price or at a price close to cost.

In fact, an attempt has been made to set up several classes of salt — namely, salt as a raw material, salt for cooking, and table salt — each class having a different price. But the spread between the different prices must be kept within very narrow limits if evasion of the tax is to be prevented.

An argument in defence of the tax on salt is that the cost of production is so low that it is able to bear a moderate tax which, though it involves only a small sacrifice on the part of the taxpayer, assures a considerable revenue to the State. But it is replied that the State's cost of manufacture is much higher than the cost would be to private enterprise, and that it is high as compared with the cost of the salt that can be extracted from salt water, which is almost a free good.

The following two facts, which are taken from Italian experience, have more weight than any of the arguments that have been used in an attempt to clarify the question.

(a) The first is that it has been impossible to maintain the monopoly in either Sicily or Sardinia.

(b) The second is that in Italy the average consumption of salt is lower than in richer countries; and that in more than half of Italy — the South — the average consumption is lower than average consumption in the nation as a whole. And when it is remembered that the diet of the Italian population of the South is made up primarily of vegetables, and that the Italian people would therefore be expected to consume more salt than would meat-eating peoples, it must be recognized that the elementary sources of the demand for salt are not saturated and that the tax is an obstacle in the way of such saturation. And it must be noted, further, that since we are dealing with an article the consumption of which should not be allowed to fall below a physiologically indispensable minimum, the reduction of a small part of such consumption causes more than proportionate changes to the health of the poor taxpayers.

To sum up: poor countries with a high tax-burden do not easily give up the ancient tradition of a salt tax. The defences of it aim only to prolong its feeble existence in countries that are not yet in a position to practise with some liberality the policy of a progressive tax-exemption of minimum incomes.



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But as soon as economic progress permits such a policy, salt cannot avoid being affected, in spite of all defences that might be made on technical grounds, by the action of that higher law.

### § 4

#### *The Public Lottery*

In certain countries — as in Italy — the public lottery is also a monopoly of the Treasury. In every game of chance, there is one who accepts the wagers and ‘holds the bank’ and there are those who wager. If the game is open to everybody and competition exists among those that hold the bank, the latter pay out winnings which leave them a profit very near to what ordinary profits would be in other types of business; if, on the other hand, the banker is in a monopoly position in fact and by law, he pays out smaller winnings, so as to assure himself the maximum profit over longer periods.

When the law forbids private lotteries, as it does in Italy, it thereby creates a fiscal monopoly for the State.

The desire to gamble — whether it be regarded as a need or a passion or a vice — is innate in human nature; it is a concrete fact. This fact is susceptible to moderation as a result of the influence of private and public education, of habits of work and thrift, of propaganda and State policy. But at any given moment, in spite of the action of these influences, the passion for gambling survives as an indestructible residuum. It is with respect to this minimum that we raise the theoretical problem: should a consumption tax be levied on gambling?

There seems to be no doubt that the answer is in the affirmative: gambling does not satisfy a necessary want; it is a direct good like the theatre or any other public spectacle. If the theatre- or cinema-goer pays a tax, it is difficult to understand why gamblers should enjoy a fiscal privilege.

It does not matter, moreover, whether the desire to gamble is or is not a general want; for even if it is, the intention is to restrict it; and a monopoly price is suited to this purpose.

Granted that gambling should pay a tax, a monopoly is the most advisable method of collection, from a technical point of view; first, because the business of gambling does not present difficulties of

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organization or management; and second, because monopoly price may be carried to the maximum limit at which the private monopolist would set it, without adverse consequences resulting.

This, broadly speaking, is the strict theory of the matter from the standpoint only of economics and public finance.

### § 5

The problem contains, however, a moral and legal element. It is said: a lottery is a game of chance; it is not a necessity, but a vice; it is a crime punished by the law.<sup>1</sup> Hence the fundamental contradiction: the gambling of some people is punished for the purpose of maintaining public morality, and the gambling of others is legalized for the purpose of obtaining a public revenue.

This contradiction is sharpened by the very form of the monopoly; for the monopoly unites, in the person of the State, the agency which is called on to combat the vice with the one which derives profit from it.

The tax would perhaps arouse fewer objections if it could be levied on private wagers, to which the State would not be a party. But as it is, the State participates in private gambling, becomes a gambler, as well as the exclusive and perpetual holder of the bank; this, more than anything else, offends one's sense of what is called for in morals and law. There is a fiscal stake involved; this predominates, and paralyzes any attempt at repression by the public authorities.

For this reason some people want the State to get out of this false position and to concentrate on opposing more effectively and uniformly all games of chance.

This, in broad outline, is the juridic-moral theory, which is absolutely contradictory to the economic-fiscal theory.

The former starts from the premise that gambling is a vice and a crime condemned by morality and punished by the law; the latter starts from the premise that gambling satisfies a want which is like all

<sup>1</sup> Compare, for example, the following provision of the Italian penal code (Article 484): 'Whoever in a public place or a place open to the public conducts a game of chance . . . is punishable by imprisonment up to one month, which may be extended to two months in the case of repeated offenders . . . and by a fine of not less than one hundred lire.'

Article 487: 'Games of chance are held to be those games in which gains or losses, at the end of a game, depend entirely, or almost entirely, on chance.'

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other wants; and that, within the limits in which this want exists, it should pay like all the others; it does not exclude action by private agencies and the State which is designed to improve morals and punish departures therefrom, but it does not concern itself with such action.

The latter position leads to the logical result of recognizing the right to gamble; the former position leads to a complete denial of such a right.

Both theories are one-sided, running parallel to each other without any common meeting ground in logic.

### § 6

Nevertheless, they constitute the two actual elements of the problem; and the solution is found in a compromise which will be different in different times and places, depending upon which of the two factors predominates.

First of all, from the economic point of view gambling not only provides the satisfaction of a want, but ends by becoming an unproductive occupation which permanently distracts the gambler from any kind of work; and for this reason it is economically advantageous that the tendency to gamble should disappear.

But it is precisely to the attainment of this result that the lottery monopoly may contribute; for if it is true that the State is led by its fiscal interests to oppose private gambling in order to increase its own clientele, it is also true that by establishing monopoly prices it may discourage gamblers, or alienate them from the practice.

Moreover, from the point of view of the theory of morals, it is a mistake to believe, or at any rate much exaggeration is involved in the belief, that gambling depends on the monopoly and that if the monopoly were abolished, gambling would disappear. Similarly, it is a mistake to believe that repression, by itself, has ever succeeded or can succeed in eradicating completely the desire to gamble and in suppressing private and clandestine organizations that satisfy this desire. It can become efficacious only to the extent that the general environmental conditions continue to be improved.

The causes of gambling in lotteries are to be found in the habits bred by idleness and disorder, in the hope for easy gains without

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working for them, in ignorance, and in small reliance upon getting ahead through labour and thrift.

Now, these causes are being gradually, but surely, eliminated by the economic progress of our society. To the extent that their effectiveness becomes attenuated, the tendency to gamble also becomes attenuated; the number of gamblers is reduced; the profits of the monopoly decline to such a point that they no longer make the enterprise sufficiently remunerative. The public lottery may end automatically as a result of the action of the taxpayers themselves.

This is the surest way to abolish it. Moralists can help by acting on the causes and by inducing the gamblers to stop; the State, driven by the force of public opinion, will support the movement by making use of the monopoly itself to raise prices gradually beyond the limits which would be set by the desire for maximum profit — and will do so with the definite intention of discouraging gambling.<sup>1</sup>

But if a hasty policy of ultra-monopolistic prices, instead of alienating gamblers from the public lottery, should throw them into the arms of private gambling interests, thus making more difficult the task of suppression itself, there is no reason for not turning to the advantage of the Treasury — that is, the community — a part of the gamblers' stakes, which otherwise would go to the benefit of the private 'bankers' and would escape taxation.

<sup>1</sup> The fact is that the policy of the Italian Treasury has been in the opposite direction, in that it has incited people to gamble by diffusing gambling-booths throughout communities that did not ask for them and even in communities whose authorities opposed their introduction. The author, in his long experience as a Deputy, has known of cases of the latter type.

## CHAPTER IV

# THE FISCAL THEORY OF CUSTOMS DUTIES

Summary: Basis of the taxation — Free trade and protection in relation to the development of international trade — Effect of protectionism and free trade on the fiscal yield of customs duties — The types of fiscal duty — The disappearance of transit and export duties — Treatment of raw materials — The 'drawback', temporary admission duty-free, and compensatory duties — General tariffs, conventional tariffs, and differential tariffs — Commercial treaties and the most-favoured-nation clause — Maximum tariff, minimum tariff, and autonomous commercial policy — 'Coefficients of increase' — The net fiscal income from protective tariffs

### § 1

#### *The Volume of Foreign Trade*

ANOTHER method for collecting indirect taxes on consumption is by means of *duties*. These duties are levied on commodities in the process of circulation, either while the commodities are in the hands of the middleman, or while they are in the hands of the direct consumer; and the levy is made either at the moment when the commodities cross an administrative boundary — in which case the levies are called *internal duties* or *duties on consumption* — or when the commodities cross the political boundary — in which case they are called *external duties* or *customs duties*, which are collected when the goods are imported, exported, or pass through the country.<sup>1</sup>

<sup>1</sup> In some countries, as in Italy, the internal duties are a part of local finance; the State takes part in their collection either by reserving for itself a group of commodities distinct from the group assigned to the municipalities, or by claiming a fixed share of the municipalities' receipts (the so-called *cànoni di abbonamento*). The actual collection of these internal duties is usually entrusted to the municipalities, apart from certain exceptional cases in which the State undertakes collection on its own behalf and on behalf of the municipality.

In Italy, only customs duties concern the finances of the central government exclusively.

## THE FISCAL THEORY OF CUSTOMS DUTIES

Customs duties presuppose the existence of international trade; for this reason they find a theoretical premise in the principle of comparative costs, and a political premise in the orientation of commercial policy, which may be either mercantilist or protectionist or free trade.

The general basis of the tax — that is, the taxable object — is given by the volume of international trade. The political premises must be examined, first of all, from this point of view.

Now that the world has passed beyond the period of mercantilism and the system of duties characteristic of that period, the sole purpose of which was to create, by means of export bounties and import duties on all manufactured goods, a favourable balance of international payments, and thereby increase the stock of money within the country, the only matter in debate to-day is the choice between a policy of protectionism and a policy of free trade.

The maximum development of international trade comes about when the countries concerned adopt a policy of absolute freedom of trade, which makes it possible to extend to the maximum — i.e., to the extreme limit indicated by the principle of comparative costs — the geographical distribution of the productive activities of the various countries. Under the system of free trade, two or more countries, by trading freely with each other, become virtually a single market, in which the available capital and labour are distributed in such a way as to give the maximum economic return — that is, the maximum of production, exchange, and consumption — and therefore the broadest base on which to build subsequently the system of customs duties.

The statistical material with respect to the volume of international trade provides the first basis for the construction of the system of customs duties according to the principles of indirect taxation which we have already examined. Subsequently, these duties, originally established merely as taxes on consumption, will react on the volume of foreign trade, probably restricting it. But this effect is inevitable whenever a tax restricts the consumption of the articles taxed, whether the consumption involved is that of private individuals, or that of the State, or that of both.<sup>1</sup>

The difference between the effect of a duty established as a tax on consumption and that of a protective duty is this: the protective

<sup>1</sup> See Book II, chap. iv, § 7ff and § 12ff.

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duty restricts the volume of international trade — that is, the basis of the tax — at the very outset and with certainty; the duty on consumption, on the other hand, will ultimately bring about a further contraction, just as every tax does.

In fact, the policy of protectionism attains its goal when it reduces the importation of foreign products which are competing successfully with domestic products; this results, subsequently, in a reduction of exports, and in a reduction of the volume of international trade generally — that is, a reduction of the taxable material.

Even though it is admitted that the volume of foreign trade is reduced under a policy of protection, it is alleged that, in compensation, the volume of internal exchanges increases; but this is an error which is almost self evident. The protective duty serves, as a rule,<sup>1</sup> to cover, and even more than cover, the greater relative cost of domestic products. The effect of increasing the price of these products in the domestic market is that the available capital and labour are withdrawn from the less costly production of goods that were formerly exported, and are attracted to the more costly production of goods that were formerly imported, with the result that the capital and labour involved are condemned to relative unproductiveness. As a result, there is a decrease in the national income; with the decrease in income there is a decrease in consumption; and with the decrease in consumption, the very basis of indirect taxation is diminished.

To be sure, this truth is concealed, in the concrete case, by the fact that protective duties themselves provide an income for the State; for this reason it is often said that protective tariffs are adopted in order to obtain public revenues.

To clear up this point, let us suppose that under a policy of free trade the physical volume of trade is estimated at three billion units; and that after the adoption of a protective policy, it is reduced to two billion. If we assume that these two billion give the Treasury a revenue of 200,000,000 — that is, 10 per cent — this means that in order to obtain an income of 200,000,000 under free trade, it would have been sufficient to tax the three billion at the rate of 6 per cent.

<sup>1</sup> Sometimes a case may be found in which an import duty is levied against articles of which the country levying the duty is a natural exporter; in such cases, the duty is merely a device designed to make dumping possible by preventing goods that have been exported and sold on the foreign market at a loss from returning to the country of origin and being sold there at a profit.

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### § 2

#### *Fiscal Duties*

Having established the general premise of economic policy which would assure the highest revenue to the Treasury, we may go further, and specify the technical characteristics that distinguish fiscal duties from economic or protective duties, it being understood that our task is the construction of merely the fiscal theory of customs duties.

We have already established the general guiding principles of indirect taxation; they are valid also in the special case of customs duties. The only additional point to be borne in mind, in applying these general principles to our special case, is that we must take account of the circumstances that while an internal tax does not distinguish between the product of one factory and the product of another factory and treats all equally, in the case of customs duties it is necessary to discriminate between the product of domestic factories and the product of foreign factories. Hence it is necessary, on technical grounds, to subject these products to different taxes — for example, the one may be subjected to a tax on manufactures, while the other will be subjected to customs duties.

Let us first suppose that we are dealing with commodities which are imported from abroad and at the same time are produced domestically. If a customs duty is levied on the former, and the latter are not subjected to an equivalent tax on manufactures, a case of evasion arises, for the consumer would buy only the domestic product and the State would collect nothing. But this is precisely the result desired by protectionist policy. It attains its goal in proportion as the duty eliminates or decreases imports; whereas if the effect of the customs duty is neutralized by a tax on manufactures, protection is annulled. If the commodities from whose competition it is desired to defend the domestic producers are the same as those from which the Treasury wishes to obtain a revenue, the protective tariff annuls this revenue.

But this does not mean that the domestic consumer does not pay the tax. The customs duty increases the price of the domestic commodity; the consumer pays the higher price, but this goes to



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the profit, or, in any case,<sup>1</sup> into the coffers of the protected industries, and not into those of the State.

We may clarify this point by means of a concrete example, — namely, the Italian duty on grain.

If we consider a series of years in the pre-war period, we find that the amount of grain imported into Italy was about a fourth of that produced within the country. It was calculated that if we should deduct from this the grain used for seeding and for the direct consumption of the Italian *mezzadri*, or share-croppers, for every 100 lire of *higher price* paid by the buyer of grain, 30 lire represented the duty paid to the State and 70 lire the higher price that the consumers paid to the grain-growers as a result of the customs duty.

In short: under the system of protective tariffs, the total sacrifice of 100 lire sustained by the mass of consumers does not accrue to the benefit of the Treasury, but is divided between the State budget and the private budgets of the protected industries.

Now, if it is desired that the whole of the burden borne by domestic consumers as a direct or indirect result of a customs duty should accrue to the financial benefit of the State, the import duty must be matched by an equivalent tax on domestic production. Only in such a case can one say that the duty (*a*) does not provoke anti-economic distortions of the natural line of investment for the nation's capital and labour, because it does not push such investment toward the production of the goods affected by the duty,<sup>2</sup> and (*b*) maximizes the public revenues.

In this case, the duty is said to be a *fiscal* one.

### § 3

A second type of fiscal duty is to be found whenever the commodities taxed are not and cannot be produced within the country. This is true for western countries, for example, in the case of tea or coffee.

In fact, there is no doubt (*a*) that the domestic consumption of

<sup>1</sup> If the duty exactly covers the greater cost of production, it gives no money-profit to the producer, but merely harms the economic structure of the country and the Treasury.

<sup>2</sup> It goes without saying that we must here abstract from the possibility that this may happen as a result of changed circumstances — as, for example, in the case that, after the tax is imposed, the demand for the goods struck by the duty increases.

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such commodities, which is entirely dependent upon imports, turns over to the coffers of the State all that it pays in the way of a higher price, — that is, in the way of a tax; (*b*) that the duty itself does not modify the natural direction of internal investment of capital and of labour, because it does not push them toward the production of tea and coffee within the country. But in order that this may be entirely true — especially in view of the fact that these exotic goods are highly taxed — it is necessary to prevent the consumer from evading the tax by the use of substitutes, such as chicory. It is necessary, therefore, to impose a tax on the manufacture and the importation of the substitutes, also.

A third case is presented when the duty is not high enough to make up for the difference in relative costs, since such a duty is not high enough to change the direction of investment and to substitute internal production for importation. This theoretical principle may be translated into the empirical rule that a small duty, precisely because it is small, is not a protective duty, but a fiscal one. But the case may have a broader field of application, extending to all those duties of a protective character which are not completely exploited by domestic industries, as we shall see presently.

The cases described thus far are cases of fiscal duties on imports. Another case is that of duties on exports. We shall see that the duties on exports tend, for purely fiscal reasons, to disappear; but exceptions to this rule are provided by some goods which, although they are produced within the country under conditions of free competition, constitute a natural monopoly in production for the exporting country taken as a whole. Until recently, for example, it used to be said that Italy enjoyed such a position of natural monopoly in the case of sulphur, which is produced under conditions of free competition within the country and of which Italy used to be the sole producer. The same thing is usually said with respect to Carrara marble. In any case, if we assume the case under discussion as an hypothesis, there is no doubt that if the domestic producers were to unite in a trade combination, they could enjoy a monopolistic position in international trade. The State anticipates the formation of such a hypothetical combination and provides a substitute for it by placing a tax on exportation which transforms the internal competitive price into a monopoly price in the foreign market.

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### § 4

#### *Import, Export, and Transit Trade*

Customs duties may strike commodities upon importation, when they come from abroad and are destined for domestic consumption; or upon exportation, when domestically produced commodities are destined for consumption abroad; or, finally, in transit, when the commodities produced abroad and destined for consumption in another foreign country cross the territory of an intermediate country.

Now, it is a fact of general and constant observation nowadays that transit duties and also export duties are tending to disappear.

The transit duty has the character of a toll — that is, a fee, and not a tax on consumption — which is collected by the country through which the trade route passes. If the country has a geographical monopoly of the route, it can benefit from its monopolistic position. But nowadays the routes of world trade are multiplying on land and on sea, and the means of transportation, especially by sea, are acquiring a continually increasing degree of autonomy; the result is that monopoly of the great trade routes has practically ceased to exist. On the other hand, transit trade is advantageous to the country traversed, for other reasons; so that the competition of the various countries to obtain the transit has led to the abolition of the relevant duties:

The disappearance of the duties on exports is to be attributed to more complex causes.

The policies of mercantilism and protectionism tend, though for different reasons, to favour exports, and hence oppose the use of export duties. The protectionists, to be sure, make an exception in the case of raw materials; their general attitude, however, is one of opposition to duties on the exportation of direct goods, which, after all, is the essential point in the matter of taxes on consumption.

We wish, however, to abstract from the political factor.

The economic premise of the pure fiscal theory of customs duties is that *imports are paid for by exports*. For every value that is exported there is a corresponding value that is imported. If we suppose that the amount that it is desired to derive from customs duties is

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a given quantity, the problem is to decide whether this amount should be levied on exported commodities or on imported commodities, or whether it should be divided between the two.

The question is answered by the principle that the tax should strike the commodity as near as possible to the consumer. Exports are still instrumental goods destined to be transformed, through trade, into goods of the first order or of an order nearer the consumer; and the latter are precisely the goods which are imported.

The value of exports in the market of origin is lower than the price realized by the corresponding imports in the market of arrival, — that is, in the domestic market; hence it is the imports which reveal the exact amount of taxable income and the person of the true debtor.

These considerations usually establish the rule that export duties should be gradually abolished, and that customs duties should be levied on imports only; and they furnish the economic content of the formal juridical principle that 'the State has no right to tax merchandise destined for consumption abroad'.

It is probable that all States would be glad to violate this precept, if they could. And they violate it in fact whenever they are able to impose an export duty on merchandise the production of which is a domestic monopoly. But if we except the case of monopoly, in which the intention of making foreign consumers pay is successfully realized, we may conclude that in all other cases it is an old fallacy to argue that an export duty raises the price of the exported commodity on the foreign market, so that the duty is shifted, in whole or in part, to foreigners. Let us follow for a moment a commodity which is subjected to an export duty of 10 per cent of its value. This means that 10 bushels out of every 100 exported belong to the State; but since it is advantageous to export the commodity, the 10 bushels belonging to the State are also exported. The exporter will offer on the foreign market 100 bushels, as before; other conditions being equal, the price will be as before; the merchant will obtain in exchange the same quantity of goods as before and will transport them and sell them in his home country, and will turn over to the State 10 per cent of the goods imported.

It may also be supposed that an export duty prevents the exporter from covering his total cost of production by means of the 90 bushels that remain at his disposal; but his position is really not

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changed if, instead of paying 10 bushels on the merchandise exported, he pays 10 bushels on an equivalent amount of imported merchandise. In this case, he will have to change the dimensions of his enterprise, lower his cost of production or reduce the supply according to the usual rules.

It seems obvious, therefore, (a) that foreign countries do not pay the tax imposed by exporting countries on domestic consumption, and (b) that it is more advantageous for the State to collect a duty on imported goods than on exported goods, for the same reasons for which the private individual finds it advantageous to export domestic goods and exchange them for foreign goods.

Nevertheless, in the tariff regulations of certain countries, as in Italy, the number of export duties on raw materials is still considerable. Almost all of them, however, have an economic or protective character, and tend to lower the price, in the domestic market, of the raw materials that serve protected home industries. The duty is paid, in the form of a lower sale-price, by the domestic producers of raw materials; and it has the effect of reducing, first of all, the amount of raw materials exported, and, subsequently, the amount of foreign goods imported, and hence has the effect of reducing the amount of taxable material available for the future.

### § 5

#### *Raw Materials*

It is a corollary of the principles already discussed that in the matter of import duties the taxation of raw materials should be avoided, and the burden should be concentrated on direct goods.

Here also the purely fiscal problem is complicated by the factor of commercial policy.

Mercantilism and protectionism favour this position, but they do so for ends and within limits that do not coincide with the purely fiscal reasons.

The fiscal policy abstracts from these considerations and appeals to the principles that regulate the material of indirect taxation. Hence attention may again be called to the fact that raw material is far from the consumer; and that a duty on raw material, from

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which are obtained manufactured goods of different values, distributes the tax in such a way as to make it inversely proportional to incomes. On the other hand, raw material is always transformed into goods of the first order, which may be struck directly by other methods if they are destined for internal consumption.

Finally, raw material may be transformed into goods destined for re-export, in which case a duty on imported raw materials is equivalent to a disguised export duty on manufactured articles; and it would be still further removed from the domestic consumer.

This guiding principle, however, meets with several exceptions in concrete cases.

There are cases in which the raw material comes exclusively, or almost exclusively, from abroad, and supplies many small and scattered industries within the country; hence, if we wish to strike the finished products, it is technically advantageous to tax the raw material at the moment when it is concentrated at the border and is easily appraised. Of two evils, the lesser is chosen.

Moreover, there are many goods which are direct goods for certain types of consumption and are indirect goods for certain industries.

In such cases, the consumers suffer to some extent from the defects of the distribution of taxes which the taxation of raw materials involves. They suffer, that is to say, with respect to those manufactures which are destined for domestic consumption. The producers, however, do not resign themselves to the assumption of a similar burden with respect to those manufactured articles which are destined, in whole or in part, for export; for in this case it is possible — at least theoretically — to eliminate the disadvantage.

### § 6

Three devices have been designed to eliminate the effects of an import duty on raw materials.

One is the 'drawback', — the reimbursement or restitution of the duty paid on the raw material when the corresponding manufactured articles are exported.

The 'drawback', if kept exactly within the limits of the duty that was paid on the corresponding raw material, has an exclusively fiscal character. But it is difficult to establish this equivalence with

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exactness; and thus the 'drawback', which was originally introduced for fiscal reasons, very quickly degenerated into a protectionist expedient; since the State, as part of a generally protectionist policy, tends to set the 'drawback' at a higher level than the duty paid on the raw material, so that it becomes, as a result of the difference between the two, a disguised bounty on exports.

Similarly, once the principle is adopted, it comes to be extended to all internal taxes on consumption; so that the tax on manufactures, for example, is paid back as many times as the commodity taxed is destined for export. Nor is it logically possible to prevent the extensive application of the 'drawback'. The law cannot allow the decision to be made in each individual case at the moment of export, but fixes the amount of reimbursement *a priori* for each commodity; and the repayment is made even though the productive processes may have reduced the quantity or changed the quality of the raw material used. And it may also happen, and has happened, that the raw material used is no longer that which was imported from abroad, and on which a duty was paid, but is a domestic raw material, on which no internal tax on manufactures has been levied. Thus it is that the 'drawback' has developed historically into a protectionist expedient for concealing, under the pretext of fiscal theory, a bounty on exports.

Against the system of the 'drawback' it is also emphasized, and with good reason, that the importer of raw materials must anticipate the duty, though, to be sure, he recovers it when the corresponding manufactured goods are exported; and thus he is obliged to employ a larger working capital and lose interest and valuable time as the result of bureaucratic practices.

Furthermore, the 'drawback' is an inconvenient temporary entry, in private budgets as well as in the public budget; this leads to unnecessary complications in accounting and, so far as the finances of the State are concerned, it makes it impossible to know exactly the amount of the net income from each day's customs collections.

In order to obviate these inconveniences it has been proposed to substitute for the 'drawback' *temporary admission* of raw materials *free of duty*, the importer being obliged to re-export the corresponding manufactured goods within a given time.

This proposal has a restrictive character as compared with the

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'drawback', because it is limited to raw materials really imported and really subject to duty, as well as to the person of the importer, and substitutes for the anticipated payment of the duty a pledge of securities on which there is no loss of interest.

Now the device of 'temporary admission' has also been progressively broadened. This process of broadening began with the desire to substitute for the principle of *identity*, according to which one had to use the same raw material that had been imported, the principle of *equivalence*, according to which it was sufficient that a given quantity of raw material be used, independently of its place of origin; this raw material might even be domestic and untaxed.

Even if we overlook these criticisms of detail, there is still a fundamental defect which is common to the two devices, — namely, that it is not easy to determine the quantitative relationship that really exists between the manufactured good and the raw material; and since the number of the goods admitted under exemption from duty has increased considerably, even this second device has degenerated from the purely fiscal form in which it was originally conceived, and has developed into an expedient for the execution of a protectionist policy.

Finally, mention should be made of the device of so-called 'compensatory duties',<sup>1</sup> which exist when, after foreign raw material has been taxed upon its importation, equivalent duties are levied upon goods manufactured abroad from similar raw material.

For example: let us suppose that raw cotton pays upon importation 3 cents per unit of weight, and a slaughtered pig pays 18. If the thread or the sausage which comes from abroad were to pay a duty equivalent to that levied on the raw material, domestic consumption would turn to imported thread and sausage; and this would give rise — apart from any economic considerations — to evasion of the tax on consumption.

Within the limits set by the assumption of a perfect equivalence between the two duties, the device has an exclusively fiscal basis.

In fact, however, compensatory duties have had the same experience as that we have described in the case of the 'drawback' and the practice of 'temporary admission'. Hence it may be concluded that the three devices, although their original basis was exclusively fiscal, have developed into instruments of protectionist policy.

<sup>1</sup> [Italian: *diritti compensatori* — Translator's note]



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Their degeneration militates against the practice of the exemption of raw materials, since an import duty on these is no longer opposed, as it used to be, by the interested industrial groups, who are able to derive from the 'drawback' greater protectionist compensations than they could from exemption itself.

### § 7

#### *Tariffs*

Customs duties are collected on the basis of a tariff, in which, on the one hand, commodities are enumerated and classified, and, on the other, the duty per unit of weight, capacity, or number is indicated.

A tariff may be general, conventional, or differential. The basis for distinction is the place of origin of the commodity on which the duty is being levied. The general tariff is one which is applied to all commodities regardless of their place of origin, unless some agreement has been made to the contrary. The conventional tariff is applied to commodities coming from countries with which trade 'conventions' or treaties are in force. The differential tariff is applied to commodities coming from countries against which a 'tariff war' is being waged.

Hence the differential tariff is harsher than the general tariff, because its purpose is to hurt imports from the country against which reprisals are being made; and the conventional tariff is lower than the general tariff, because through it the two contracting parties aim to grant reciprocal favours to exports of the other country.

A protective tariff is contrary to the interest of those industries which find their export outlets blocked directly and indirectly, and is favourable to the industries that wish to block the channels of importation.

The orientation of the system of customs duties in the direction of protectionism or free trade is the result of an internal struggle between the groups that desire a monopoly of the domestic market and the groups that wish to conquer the foreign market.

The two groups which thus struggle against each other exist in every country. The struggle may be fought exclusively within

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each country and may lead to the moderation or even the one-sided abolition of a protective tariff, regardless of the commercial policy followed by other States; in this case the result may be the triumph of a free-trade policy *without reciprocity*.

Usually, however, given two protectionist States, each of the groups that fight against each other in one of the two countries joins hands with the corresponding group in the other country; and they succeed in obtaining a moderation of the two general protective tariffs, which then become transformed into conventional tariffs, by means of trade agreements or treaties. In such a case a policy of *reciprocity* is said to prevail.

To speak, in this matter of trade negotiations, of the interests of the respective countries, as such, is nonsense. If, for example, a trade agreement is being negotiated between Germany and Italy, one ought not to speak of 'German' versus 'Italian' interests; one ought, rather, to say that the interest of the German metallurgical and mechanical industries in export coincides with the desire of Italian agriculture to export, and that the interest of the Italian metallurgical and mechanical industries coincides with the interest of German agriculture, in so far as both aim to guarantee for themselves a virtual monopoly of their respective internal markets.

This is the real position that is involved in trade negotiations. If we take any two trading countries at a time, we see that each country permits reductions in the tariff on the products which are exported by the exporting group of the other country; and vice versa. Action designed to change the duties on the commodities agreed upon in the negotiations between the two contracting countries remains restricted until the expiration of the treaty.

Now it may happen that one of the two countries, in a later treaty, will grant a third country larger reductions in the duty on some of the articles with respect to which action was already restricted by the preceding treaty. When this happens, the second country would seem to lose the benefit it had gained, while the benefit it has granted still remains in force.

To avoid this danger, treaties are concluded on the basis of *the most-favoured-nation clause*, by virtue of which every greater tariff reduction which is granted in treaties subsequently concluded with other countries is extended as a matter of law to the nations which had signed previous agreements.

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From this it follows that under a system characterized by the use of this clause, each country has, in the end, only two tariffs: a *maximum autonomous tariff*, which is the general tariff, and a *minimum conventional tariff*.

### § 8

Contrasting with this system is the system of the *maximum tariff* and the *minimum tariff*, both *autonomous*. The first corresponds to the general tariff of most countries; the second corresponds to the minimum *conventional tariff* of such countries. The difference lies in the following: (a) the minimum tariff is approved by Parliament before the trade negotiations are opened, whereas the minimum conventional tariff is approved afterwards, at the time when the proposed treaty is subjected to parliamentary discussions; (b) the minimum tariff restricts the mandate of the negotiators, who are able to offer only the minimum tariff in exchange for the most-favoured-nation clause, whereas the minimum conventional tariff assumes that a broad mandate has been conferred on the negotiators, though the giver of the mandate reserves the right to approve the results of the trade negotiations; and (c) the minimum tariff is autonomous, in the sense that Parliament can, whenever it wishes, even during the life of the treaties, raise the tariff or otherwise change it, it being understood that the contractual pledge assumed is limited to granting the same treatment to all the contracting parties, and that Parliament is free to modify this treatment on an equal basis for all countries concerned.

It is above all on account of this last circumstance that nowadays the commercial policy which is so much desired by the protectionists of all countries is called *autonomous*.

It will be understood that this system makes it difficult, and in many cases impossible, to conclude commercial treaties which reduce tariffs considerably, or to conclude them for a long period, in such a way as to give an adequate basis of stability to international trade and to those parts of the nation's production which are dependent thereon.

Hence the system amounts to nothing but an intensification of the protectionist regime. Even if it is adopted by only one country, it has the indirect effect of making international agreements difficult.

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### §9

The exaggerated protectionist policy which is encouraged by a desperate spirit of nationalism leads to the abolition of the most-favoured-nation clause, so as to make each individual commercial treaty autonomous on both sides.

This is perhaps the most acute moment in the crisis that is being experienced in the trade relations between nations. It is this that makes it impossible to conclude lasting treaties and prevents the exporting industries of each country from attaining a relatively stable position.

But even before this moment was reached, the customs-duties, already high, had been aggravated by means of the so-called 'coefficients of increase',<sup>1</sup> which permit the raising of a given duty by 50 per cent or 80 per cent or 100 per cent or even 250 per cent.<sup>2</sup> The coefficients may be modified by the Executive.

Thus, the tariffs would have a stable base, determined by the legislature, to which could be added a changing element, which the executive power would have considerable freedom to manipulate in order to modify the tariff schedule itself.

Theoretically, such a device might be used to correct one of the defects of specified duties, which do not vary with fluctuations in prices, especially at a time like the present when prices change rapidly and drastically.

After having constructed a very minute progressive classification of the items in the tariff, in such a way as to make them correspond to various market values, the coefficients would, theoretically, bring about a further perfection of the system by keeping the specific duty in closer relationship with the value of the goods taxed.

If this were so — apart from the danger of leaving in the hands of the executive a weapon of this kind, which could so easily disturb

<sup>1</sup> [Italian: *coefficienti di maggiorazione* — Translator's note]

<sup>2</sup> Thus, Article 2 of the Italian decree of June 9th, 1921, says: "To the import duties established in the appended tariff on the commodities specified therein shall be added the increase in duty resulting from the application of the coefficients of increase fixed by the tariff itself in each case and indicating the figure by which the amount of the duty must be multiplied in order to determine the extent of the increase."

<sup>3</sup> The Royal government is authorized, by means of a decree which will be presented to Parliament for translation into law, to modify the coefficients of increase, whenever this may be necessitated by changed conditions of production and international trade.

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private contractual relations — we should have a theoretical explanation of the new device that would at first sight be plausible; because we should then have a purely fiscal reason for its use, inasmuch as indirect taxes should be commensurate with incomes — that is, they should represent a percentage of the value of the goods consumed.

But it is not so.

The advisability of adjusting the tax on consumption to the new values of goods furnished the pretext for getting the device accepted; but the device itself was intended to intensify tariff protection. In fact, if the coefficients of increase were intended for the purpose of adjusting the specific duty provisionally to new prices, they ought to have been applied first of all to the goods which are subject to a fiscal duty, such as coffee, tea, oil, etc. In Italy, however, it is precisely these goods that are excluded from their operation.<sup>1</sup>

On the other hand, it is noteworthy that the higher coefficients have been granted to the industries which already enjoyed high protection and asked for an increase in protection.

In short, the coefficients are fixed in direct proportion to the amount of protection demanded by the industries concerned, and in inverse proportion to the tax-revenue they yield; they depend on the executive power, which can modify them and even perhaps abolish them; it had been announced that they were to be *temporary*, but the law does not say this. In any case, the interests that have obtained them will take care, as they always have in such matters, to make them *perpetual*.

### § 10

Customs receipts that appear in the budget represent a gross income from which must be deducted (a) the 'drawbacks', which have been discussed; (b) the expenses of collection, which increase in proportion to the increase in the number and classification of items in the tariff schedules; (c) the expenses of supervision and the suppression of smuggling, which increase as the duties are raised.

To make the suppression of smuggling at the border more effective, there is established a zone for customs supervision, which extends for some miles from the coast out to sea and from the frontier

<sup>1</sup> The responsible minister said in his Report to the King: 'For the items of this category no coefficients of increase are fixed, since the products involved are those which we must of necessity import.'

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into the interior. Within this zone a special regime is in force, under which every dutiable good that passes through is held to have been smuggled if it cannot be shown that the duty has been paid.

It is also customary to make treaties between neighbouring countries in order to allow the authorities of each country to pursue smugglers beyond their own borders into the tariff zone of the neighbouring country.

In any case, after the necessary depurations, of which we have spoken, have been made, and the net income of the customs administration has been ascertained, we should have to deduct from the resulting figure the economic burden that is placed on the consumer when — as is the case almost everywhere nowadays — the customs regime has a protective character. This second residual will tell how much of every \$100 of the total tax-burden which the country bears really goes to the Treasury, and will give the net income — not only from the accounting, but also from the economic, point of view — from customs-revenues.

## CHAPTER V

### TAXES ON TRANSFERS OF PROPERTY

Summary: Object of the tax; registration and the use of stamps — The various theories — Judiciary fees — Fees levied on contracts and successions are indirect taxes on saving — Relationship to indirect taxes on consumption — Continuous increase of taxes on business — The tax on successions: debt of the deceased and tax on the heir — The two periods that characterize it — Its recent and rapid quantitative development — Its political character — The economic and financial effects — The reaction and the recent abolition of the tax on successions in Italy — The two substitute taxes

#### § I

TAXES on transfers of property represent the second branch of indirect taxation. To it are subject all legal documents — public and private, civil and commercial, extra-judicial and judicial — which establish a right or transfer it, with consideration or without, between living individuals or on the occasion of death.<sup>1</sup>

The tax is collected (*a*) as a 'stamp fee',<sup>2</sup> when the citizen is obligated to use stamped paper or to affix a stamp to ordinary paper; and (*b*) as a 'registration fee', when the citizen is obligated to register all documents and contracts, as well as transfers of property associated with gifts and inheritances.

Italian law, for example, divides taxes on transfers into three groups: those levied on contracts, those levied for judiciary proceedings, and those levied on successions.<sup>3</sup> These taxes are collected through registration and through the use of stamps. Registration and the use of stamps are, however, merely methods of collection; they are not the tax, and they must not be confused with the tax. Moreover, in view of the differential characteristics of the three groups on which the tax is levied, it is difficult — perhaps impossible — to bring these groups together in a unified theory.

<sup>1</sup> See, for example, the Italian law with respect to registration fees, as approved by royal decree, May 20th, 1897, Number 217; also the law with respect to the stamp fee and the substitute fee, as approved by royal decree, July 4th, 1897, Number 414.

<sup>2</sup> [Italian: *tassa di bollo* — Translator's note].

<sup>3</sup> [Italian: *imposta successoria* — Translator's note]

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To this difficulty must be added the fact that indirect taxation on property-transfers has had, in the historical period through which we are now passing, a quantitative development of staggering proportions. This has resulted, not from the natural increase of wealth and business, with the tax-rates remaining the same, but from an increase in these tax-rates; and the latter increase, in its turn, has resulted from the new fiscal functions that have been assigned to this group of taxes.

Thus the quantitative factor becomes a new problem in itself. A tax on successions which, in the case of the father-and-son relationship, ranges from 1 per cent to 30 per cent of the capital value of the inheritance, and in the case of distant relationships rises so high as to absorb the whole of the inheritance, does not present one and the same theoretical problem, as one might be led to believe by the fact that the tax-rate rises gradually from a minimum to a maximum without interruption. On the contrary, the minimum and the maximum represent two distinct problems.

The system of taxes on property-transfers, then, is a complex phenomenon which has taken its present form as the result of a slow historical process; and each part of it requires its own explanation, in which differences due to temporal and quantitative factors also play a rôle.

### § 2

Registration is in itself a service which the State provides for the citizen. It consists of the recording of the documents and the transfers in public registers, whereby (a) the legal existence of the documents is affirmed; (b) the documents are summarized; and (c) a definite date against possible action by third parties is established.<sup>1</sup>

Hence arose the opinion, at the outset, that the charge made at the time of registration has the character of a 'fee'. And, indeed, this charge should be regarded as a fee when it first comes into existence; for at that time, in view of the fact that the charge is so small, it may stand in close relation to the cost of production of the service provided. But very soon the fee character became of secondary importance.

<sup>1</sup> Cf. Article 2 of the Italian law of May 20th, 1897, cited above.



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First of all, the price of the stamp and of registration is commensurate with the amount of value which is the object of the contract, and not with the cost borne by the State. The price increases, whereas the cost remains unchanged. In fact, the cost is very much less than the amounts collected by modern States, which are continually increasing their charges for stamps and registration.

This *excess* is a tax.

In the second place, registration is compulsory; and in this respect it does not have the peculiar characteristic of the special public service — namely, that the consumption of such a service is left to the free demand of the individual. The contracting parties are not allowed to renounce the advantage of having a definite date established against possible action by third parties.

Thus, the facts that registration is compulsory, that the levy is a high one, and that it is proportional to the value covered by the document, point in no uncertain way to the conclusion that the change involved has the characteristics of a tax, and has nothing or very little to do with the fee for mere registration.

It may be said, in summary, that the law imposes on citizens the compulsory consumption of a special public service, because at the moment when the service is provided the State can ascertain the existence of a piece of property on which a tax is due, this tax then being added to the fee. The registration fee represents the original trunk on which the indirect tax on property transfers has been grafted.

This is the fundamental guiding principle.

### § 3

In order to explain the element of taxation, which has become the preponderant element and constitutes our real fiscal problem, recourse has been had to various theories.

There are those who have emphasized the circumstance that a transfer involving a consideration increases the marginal utility of the goods exchanged, to the advantage of the two contracting parties. From this fact the attempt is made to deduce the conclusion that the basis of the tax is precisely the higher value created by the exchange.

We already know that indirect taxes — either on consumption or

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on transfers — strike the whole value of the thing bought or sold; whereas the difference in value or marginal utility between the thing bought and the thing sold constitutes the trader's profit, on which he pays a direct tax.

It should be noted, moreover, that the theory under examination would not cover the case of transfers which do not involve a consideration — for example, a donation. Such transfers have nothing to do with economic exchange; yet they are taxed even more heavily.

On the other hand, it is true that both in the case of exchange for a consideration and in that of transfer without consideration at least one of the contracting parties gains in wealth. Now it is this circumstance that explains why, from time immemorial, the act of transferring property — whether or not a consideration is involved — has been utilized in the construction of tax systems as the most opportune moment for collecting a tax. But the choice of the most favourable moment for paying and collecting a debt is only one element in the theory of taxation; it is not the theory itself, because it does not give the reason why the tax is paid.

Hence other writers have regarded the transfer itself as the basis of and the reason for the tax. The State, it is said, guarantees to all the right to own property as a general service, and incurs a given expenditure for this service. But at the same time the right to own property finds concrete expression in the deeds by which individuals dispose of their property or in the claims they enter in Courts when their rights have been violated. Accordingly, the State is regarded as dividing its total expenditure into three parts, the first of which would be a fund for general and preventive protection, which is provided for out of the proceeds of the total of direct and indirect taxes, and not merely out of the proceeds of the tax on transfers; the second would consist of 'judiciary fees', paid by those who in fact appeal to the Courts; and the third would represent 'fees on contracts', paid by those who in fact exercise the right to dispose of their property.

This theory — which is the prevalent one in the current literature on the subject — covers a large number of cases and has an ancient historical tradition. In fact, it goes back to the epoch of patrimonial finance, when the right of eminent domain was held to involve the consequence that for every transfer of property it was necessary to

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obtain the consent of the sovereign, and to pay for such consent.

This principle is no longer applicable to the modern State. Nowadays, however, the same theory is provided with a new basis by invoking the principle of the fee, on the ground that the protection of property rights is, in part, a special public service, since it is possible for the State to provide such protection in the form and the amount in which individuals demand it.

A similar development has been witnessed in connection, for example, with public education, the cost of which is covered partly by taxes and partly by fees.

Now, it is true that this theory explains the group of charges represented by judiciary fees, which are related on the one hand to the individual demand of the citizen, and, on the other, to the provision of personal and expensive services by the courts — that is, by the State. But it does not seem equally convincing when extended to fees on contracts and inheritances; for in these cases what is involved is a transfer of property between two private individuals, in which the buyer or the heir does not ask for a different or a more expensive public service than the State was already providing the seller or the testator.

In spite of this, many writers insist that so far as *fees on contracts* and also on *successions* are concerned, the State does intervene to guarantee the present validity and the future execution of the will of the contracting parties or of the testator. There is no doubt that in this it is possible to recognize *formally* a special exchange relationship between the State and the individual citizens; but there is doubt whether the fee to which this exchange-relationship gives rise is capable of giving a complete and satisfactory explanation of the 'fees on contracts'.

In fact, if the contract is violated, it is necessary to have recourse to the courts and to pay judiciary fees; if the contract is not violated as a result of fear and anticipation of legal action, there comes into play what we have called preventive justice, the cost of which is covered by the taxes already paid by all the citizens.

For this reason it seems more logical to regard the documents affecting the disposition of property as identical with the right of property itself — not as giving rise to the phenomenon of the *fee*, but rather as pointing to that of the *tax*.

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### § 4

If, therefore, we leave the concept of the fee and go back to that of the tax, the explanation of the phenomenon follows from our general principles.

The levies which are called 'fees on contracts and inheritances' are a category of indirect taxes on savings which have in common with indirect taxes on consumption the further function of supplementing the direct taxes; they differ from indirect taxes on consumption in the fact that the latter fall on income produced and consumed, whereas taxes on contracts and inheritances fall on income produced and saved; but even though the two groups of taxes are different, they mutually supplement each other.

Indirect taxes on property-transfers, like indirect taxes on consumption, strike every legal transaction in which the taxpayer — far from asking the State for a counter-offering in the form of a special service — reveals, and the Treasury ascertains, the existence of a piece of property which has escaped direct taxes or which, in any case, has not liquidated its whole tax debt by the payment of such taxes.

Similarly, indirect taxes on business, like those on consumption, follow closely the normal increase of the national wealth, an index of which is the growing volume of business. Finally, they are collected at the moment when the taxpayer realizes a profit, so that the stimulus to profit also becomes an inducement to pay the tax, just as in the case of indirect taxes on consumption, in which the stimulus to satisfy a want becomes an inducement to pay the tax.

On the other hand, an important difference must be pointed out: namely, that indirect taxes on consumption avoid the taxation of instrumental goods and act directly on consumption, whereas the other types of indirect tax do strike instrumental goods and act directly on production. This latter effect is a consequence of the fact that these taxes fall on savings.

From this whole complex of resemblances and differences arise two problems that are of special interest for the theory of the subject. The first is the problem of the external relationships between the two branches of indirect taxation; and the second is that of the internal distribution of the tax among the various groups that are involved in transfers and legal transactions.

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In pure theory, the principle that solves the two problems is the same in both cases: the taxpayer must be left free to distribute the income he has produced between consumption and saving, and then to distribute the income saved between the various possible investments, in conformity with his judgment as to where his greatest advantage lies. In other words, if the various indirect taxes put no pressure on the taxpayer to change his decisions with respect to spending or saving, and also with respect to the acquisition of mobile or immobile investments, lending to private individuals or to the State, and so on, the distribution of income will be made according to the principle of the maximum economic return for the individual and for the Treasury.

If this principle of equal treatment in matters of taxation is violated by positive legislation, it is re-established by the natural play of economic forces; for, in the administration of his private budget, the taxpayer always finds the point of equilibrium by discounting the possible differences in tax-burden, assuming that the latter is great enough to influence the conduct of the consumer and the saver. This implies that he will avoid the employments which bear a relatively greater tax-burden, thus disappointing the expectations of the Treasury.

### § 5

The taxes on contracts have been increasing as a result of the broadening of their field of application and the continual raising of the rates.

They strike new savings through the negotiations that direct these savings to new production, and they follow the savings through to every new transfer and every occasion on which, from time to time, they manifest themselves. If, after years of slow accumulation, the saver seeks a permanent placement of his funds through the acquisition of an immobile investment, this investment is struck by higher tax-rates; and at his death, his estate, which is the accumulation of his annual savings on which all the taxes of successive transfers have been paid, is still subject to the higher tax on successions.

Throughout the series of transfers there is a series of duplications. It may be granted that every transfer — whether or not a consideration is involved in the transfer — brings to the buyer an increase in

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his patrimony. The tax, however, is not limited to striking only the increase; usually it strikes the whole value, which is the object of the contract, and therefore strikes the original saving again and again.

The point may be made more precise by means of examples. Let us suppose first that out of an income of 15,000 Brown has saved 5000. From our principles it follows that if he has paid a 10 per cent consumption tax on 10,000, he ought to pay a 10 per cent transfer tax at the time that he buys 5000 worth of bonds. Let us suppose that later he sells these bonds for 6000. The buyer will have to pay the 10 per cent tax on the 6000, since this is new saving entering the market. But the seller will also have to pay a tax on the 6000 when he spends the money in the acquisition of other securities. It is here that the duplication appears, since he has already paid on the saving of 5000 and should owe the new tax only on the 1000 by which his patrimony has increased.

Another characteristic case is the following: Brown has bought a house for 100,000 and Smith has bought land for 100,000. Both have paid the corresponding tax. Now they decide to exchange the two properties, the value of which, by hypothesis, has not increased. They should not owe a new tax, but they pay it. The duplication is partial, but it does exist.

To eliminate these duplications is difficult and often impossible. It would be impossible in the daily transfers of securities and of mobile property in general. But this category may be provided for by keeping the tax-rates low, so as to make it possible to argue that the taxes collected on the basis of these tax-rates correspond approximately to the greater value which the exchange for consideration assures the buyer, who is the subject of the tax.

It would be possible to make an analysis which would avoid duplication in the transfer of ownership rights in immobile property; but it is precisely on such transfers that almost all legislation maintains higher schedules.

It is alleged, as a reason for this, that immobile property — such as land and buildings — changes hands infrequently, as compared with mobile property and securities. But this explanation leads one to think that the legislator considers the real property and its owner as object and subject of the tax, respectively, instead of regarding the purchase price as the object and the buyer as the subject.

The purchase price is the saving accumulated by the buyer who

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owes a tax on the amount saved. This amount is not changed by the fact that it is used to acquire a piece of real property or a government bond or an industrial stock. In any case, moreover, the saver does not submit without resistance to such disparity of fiscal treatment; for he will discount the purchase price, to the disadvantage of the seller, to the extent that the tax is excessive — that is, to the extent that it reduces the current rate of interest on capital investments.

### § 6

To sum up: we find ourselves confronted by two theories: that of the fee and that of the tax.

The first would argue that all transfers, as such, should pay a fee as the charge for a special public service.

The second regards saving as the sole basis of and reason for the tax, and utilizes the transfer as merely the occasion for collecting the tax. This theory, when elaborated in such a way as to take account of the criticism stated above, would be sufficient to explain the phenomenon of taxes on business.

But in order to explain the concrete phenomenon, as it results from existing laws, it is necessary to have recourse to the combined action of the two theories.

Hence the charge that is levied at the time of registering a deed of sale would consist, first, of a part that is the fee for the special service of registration; second, of a part that is the fee corresponding to the special service which consists of the pledge assumed by the State to insure the execution of the contract; third, of a part — the largest — that is an indirect tax on saving.

### § 7

#### *Tax on Successions*

The high taxation of transfers of ownership rights in immobile property — which, after all, represents the beginnings of a consolidated nucleus of savings that is incapable of avoiding ascertainment by the Treasury — foreshadows the inheritance tax. The inherited

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estate represents the net savings accumulated by the deceased during his life-time, as well as the savings which he may have inherited.

The value of this estate constitutes the object of the tax on successions and is ascertained at the time of transfer — through bequest or through administration in accordance with the legal provisions covering inheritance — from the deceased to the heirs and legatees.

The subject of the tax is the heir or legatee, because the testator no longer exists, and the heir is called upon to pay. According to the law of most countries, however, the heir accepts the inheritance with the privilege of inventory — that is, he pays a tax on the inheritance only if he finds that the estate which he inherits is large enough to pay the tax, after deduction of all debts. The sacrifice involved in the payment of the tax has therefore already been borne by the deceased, whose estate pays the tax.<sup>1</sup>

If we suppose, for the moment, that the inheritance tax is abolished, and that other conditions remain equal, then the deceased would have had to pay a larger tax on his income every year. For this reason, it is theoretically correct to say that the inheritance tax is an income tax the payment of which has been postponed to the moment when the property passes at death. In other words, the object or basis of the tax is the accumulation of annual incomes saved by the deceased during his life, and the tax is the accumulation of the annual taxes not paid by him during the same period.<sup>2</sup>

Hence the tax represents a tax debt of the deceased to the Treasury which falls on the inherited estate and is paid by the heir. But this payment, which concerns the deceased, is only a part of the tax on successions.

It is this circumstance which has given rise to the old question

<sup>1</sup> If the heir is to be regarded as the subject of the tax, we should be going back to the old concept of eminent domain, by virtue of which the State would have granted a new concession and the heir would have paid for that concession.

<sup>2</sup> This theory may be applied to all indirect taxes, inasmuch as all of them may be considered income taxes, the payment of which is postponed to the moment of consumption or saving. But while recourse is had to these other indirect taxes because of the impossibility of ascertaining income directly and completely, in the case of the tax on successions the sum of the incomes saved is susceptible to direct ascertainment.

On account of this circumstance the tax on successions has been regarded by some writers as a direct tax on the estate (*imposta diretta sul patrimonio*); but this is a question of words, more than anything else. The fact is that the inheritance tax has possibilities of development and of fiscal functions of which taxes levied on the documentary transfer of property would be incapable. (See Book IV, chap. v, § 9.)



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whether the tax on successions, in being commensurate with the capital value of the inherited estate, consumes a part of the capital.

If we admit that the tax on inheritance is the sum of the annual taxes which were not paid by the deceased, it follows that the basis of the tax is the sum of the corresponding annual incomes, which are translated into the capital value of the inherited estate. Now, in order to decide whether the tax consumes part of the capital, it is necessary to break up the tax and distribute it over the number of years lived by the saver. It is a question of fact, depending on the height of the tax-rates; but in a majority of cases it will appear that a tax on capital is not involved.

Even if this criticism of the tax on successions is not always well-founded, it is nevertheless true that the annual savings have been invested in production, with the result that in order to make definitive payment of the accumulated debt, which is due in a single instalment, the heir is usually forced to liquidate some investments quickly. The consequence is a corresponding disturbance of the equilibrium that had been achieved — that is, financial embarrassment of the business.

Hence the mere fact of postponing to the time of death the tax-debt accumulated during the life of the deceased would not explain and make acceptable the tax on successions. For the latter tax is in excess of the mere sum of the taxes which were not collected during the thirty-two years of the average life of the deceased; and it is this excess that constitutes the specific problem of the tax.

This excess is the part that concerns the heir.

Thus the tax on successions consists of two parts: one is the debt accumulated by the deceased; the other is the new tax which falls on the heir. In all cases, however, the sum of the two is assessed on the inherited estate; this means that the excess depends on the subjective valuation of the heir.

### § 8

The inheritance tax is very old; but in the course of history it has undergone several transformations — that is, it has provided the theoretical cover for payments of different kinds. Sometimes it has been regarded as a participation by the State in the inheritance, perhaps as a reminiscence of the State's right of dominion over

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everything and everyone; at other times it has been regarded as a recognition of the position of vassalage occupied by one who inherits a fief; it has also been regarded as the price due from the deceased for the acquisition of the right to project his will beyond the grave, and so forth.

But the very fact of the antiquity and permanence of the tax, despite the multiplicity of theoretical constructions which have grown up about it, makes it possible to emphasize the common element in these constructions: namely, that the moment at which the inheritance passes to the heirs is the most favourable time to insist upon and obtain more easily the payment of a tax from the heir. Assuming that a given sum must be exacted, it is less painful to divide this sum between the decedent and the heir than to place it exclusively on the former, by increasing his annual income tax during his life-time.<sup>1</sup>

This is an elementary truth, which is valid whether the tax is proportional or whether it is progressive, and whether, in striking the heir, it does or does not take account of the degree of relationship between him and the deceased. It is a basic guiding principle which cannot be renounced if it is desired to construct a tax system that will reduce the sacrifice of the taxpayers to a minimum and facilitate the collection of taxes.

If, then, we accept the proposition that the inheritance tax is a useful organ in a perfected fiscal organism, the problem that is really important is that of its amount.

We must separate sharply two periods, which also correspond to the two purposes that the tax on successions — like progressive taxation in general — may envisage. One of these purposes is to transfer the tax-burden from income which is being produced to income which has been saved, and from present saving to saving accumulated by past generations, without destroying the incentive to increasing accumulation. The other purpose works in the direction of equalizing the distribution of wealth, through the complete or partial transfer of inheritances to the State.

In the first case, if it is desired that the amount of the tax should

<sup>1</sup> I should like to point out that this consideration ought not to serve as a pretext for legislators, in countries in which the tax on successions has been abolished, to re-establish a tax of this kind by simply adding it to the taxes that have been introduced or increased in compensation for its abolition. When theory speaks of *distribution*, it always supposes that the quantity to be distributed remains constant.

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leave intact the incentives to save, the tax must be regarded as bearable by the heir — that is, the height of the tax must not exceed the limit which is set by the greater inclination or willingness to pay taxes which is evidenced by the heir. We have admitted that, from a hedonistic standpoint, there is a break of continuity as between the deceased and his heir, inasmuch as the former has had to incur a cost of production, whereas the latter is able to enjoy the accumulated patrimony without incurring such cost. But we must not jump from this circumstance to the conclusion that the heir is disposed to pay the tax, or does not mind paying regardless of how much higher it is.<sup>1</sup> We must not forget that the heir of to-day will be the deceased of to-morrow, and that the tax paid by him to-day cannot help influencing his future conduct as a saver. Thus is re-established, through the perpetual circle whereby each heir becomes a testator, a higher economic continuity.

Economics is not in a position to state the concrete extent of the limit to the tax on successions which is provided by this circumstance; its extent is, however, to be found by the experience which has been obtained through the moderation of the absolute height of the tax, the adoption of proportionality or only slight progression, and the exemption or the very light taxation of children and close relatives.

The legislation that regulates inheritance taxation in the first period of its existence is guided precisely by these criteria, which harmonize with that general orientation of economic policy which tends to avoid impeding the indefinite accumulation of wealth.<sup>2</sup> And it is also in this period that the tax on successions is merely one of the taxes on transfers and constitutes, together with the taxes on contracts, a single problem which may be explained by the same theory.

### § 9

But with the introduction and the development of the principle of progression and that of the discrimination of incomes there begins a second life-period for the tax on successions also. This period is characterized by the following circumstances: (a) children of the

<sup>1</sup> This proposition has been advanced in some recent treatises.

<sup>2</sup> Cf. Book II, chap. VII, § 1.

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testator are taxed and the tax-rates levied on the other relatives are increased; (b) continually increasing progressive taxes are levied on inherited shares; (c) another progressive tax-rate is applied to the total value of the estate before it is divided into inherited shares; (d) an additional tax is levied on those heirs who have a patrimony of their own.<sup>1</sup>

These four points derive from the principle of progression.

In fact, if it is supposed that the latter principle prevailed during the life of the testator, it is clear that his tax-debt has grown in amount as the result of the increasing tax-rates which were not paid on the increasing annual savings during his lifetime, and that this tax-debt must in the end be assessed against the inheritance in a progressive form before the estate is divided among the heirs and legatees.

Similarly, the percentage of tax on each individual inherited share is progressive also with respect to the heir, whose evaluation of utilities decreases as the amount of inherited share increases.

Thus, also, the principle of progression leads to the more severe treatment of distant as compared with close relatives. Such a differential treatment would hardly have been understood when the family was a small state, a political nucleus, which was regarded as being represented by the legally designated heir. But nowadays the family has come to be regarded as an exclusively natural organism based on spontaneous relations of affection, which become attenuated as we pass from children to grandchildren or to brothers, and virtually disappear beyond the first degrees of relationship.

This successive loosening of the bonds of affection can be included within the framework of the general theory of progression, in so far as it is possible to argue that the gap in economic continuity between the deceased and his distant relative is greater than that between the deceased and his son. Hence the subjective valuation by the heir of an estate which he inherits from a distant relative or from a stranger is small as compared with that which he would attach to an estate inherited from a father.

And finally, if the heir has a patrimony of his own, to which the inherited patrimony is to be added, the marginal evaluation

<sup>1</sup> This programme, which outlines the general tendency, has not been adopted in its entirety in all countries. In Italy, for example, a progressive estate-tax - i.e., a tax on the whole patrimony before it is divided into inherited shares - was proposed, but was not adopted.

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placed upon the latter will vary inversely with its size. If, for example, a person inherits \$100,000, his marginal evaluation of the inherited patrimony decreases more rapidly if he already has a patrimony of \$100,000.

This is the framework within which the tax on successions has developed.

Now, if it were a question only of distributing a given amount of tax in accordance with these four criteria, it is not impossible that the final result would be a fairer one.

But the problem changes if, instead, this framework serves as a basis for increasing the absolute burden of the tax in four different yet converging ways.

This is precisely what has happened, chiefly as a result of the principle of discrimination, according to which (a) the person who has a patrimony — even if he has formed it out of his own savings — must pay more than the person who is engaged in the process of forming it; and (b) a person who inherits a patrimony is obligated to pay a still higher tax, on the ground that he thus acquires wealth which he has not earned.

To the political tendencies favouring progressive taxation and discrimination are added popular ideas and doctrinaire preconceptions against inheritance.

The result of the combined action of these operating forces may be seen from an examination of a few conclusive figures illustrating Italian experience.

### § 10

In Italy, taxation of inheritances from father to son began with the levy of a proportional tax-rate of .2 per cent, the so-called 'legitimate portion' allowed by Roman Law being exempt from taxation. But by 1897 the tax-rate had already risen to 1.6 per cent. From 1897 to 1921, — in less than twenty-five years, therefore, — under the influence of Socialism, the tax-rates were raised from the proportional rate of 1.6 per cent to a maximum progressive rate of 36 per cent for direct descendants; from a proportional rate of 4.5 per cent to a maximum progressive rate of 43.2 per cent on bequests between husband and wife; from a proportional rate of 7 per cent to a maximum of 50.4 per cent on bequests between brothers; from

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a proportional rate of 15 per cent to a maximum rate of 90 per cent between relatives more than ten times removed, relatives by marriage, and non-relatives.

Nor is this all: Italian law has ordained a complementary fee, whereby the heirs — with the exception of parents, descendants, or husband and wife — pay 6 per cent, 9 per cent, and 12 per cent of the sum inherited, whenever the latter is more than 80,000 lire, and when they have a patrimony of their own of 200,000 lire, 400,000 lire, or 600,000 lire, respectively.

In this case, the maximum tax-rate may rise as high as 90 per cent, and even 102 per cent, whenever the inherited property consists of immobile property the registered transfer of which is obligatory!

If, now, we take a patrimony of a million lire — which is not unusually high, in view of the depreciation of the lira — and suppose that the transfer is from father to son, we find that in 1866 the latter would have paid 2000 lire; in 1888, he would have paid 12,000 lire; in 1897, 16,000 lire; in 1921, 168,000 lire; and if we suppose that the transfer is from uncle to nephew — who often stand in a family relationship similar to that existing between father and son — we find that in 1897 the nephew would have paid 85,000 lire, and in 1921 he would have paid at least 360,000 lire, on the further supposition that he had no patrimony of his own.

It is illuminating to compare what a son would pay in Italy and what he would pay in other countries on an inherited estate of a million lire:<sup>1</sup>

Belgium	39,000 lire
France	60,000 „
Germany	66,500 „
Italy	168,000 „

At this point, taxes on successions pass out of the framework provided by the general class of taxes on property transfers. They are no longer used to complement or counterbalance indirect taxes

<sup>1</sup> I have not taken account of other secondary conditions, the cumulation of which increases the magnitude of these figures, in some cases notably. Particular mention is merited by the little volume of G. Guasti, which is full of data and cases that came to the author's attention in the course of his profession as notary — cases which seem improbable, but are nevertheless true (*Il regime fiscale delle successioni e donazione*, Milan, *Stampa commerciale*, 1922).

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on consumption; on the contrary, they become distinct from the latter, being intended to fall upon and absorb directly savings accumulated out of income.

This constitutes a new and difficult problem.

We are no longer confronted by a tax, but rather by a device having the form of a tax which, as a result of the pressure of the socialist group, the timid acquiescence of the propertied classes and the indifference of the professional classes — was tending toward the confiscation of inherited wealth.

This is one of the most characteristic modern aspects of the struggle that is being waged on the matter of inheritance between the haves and the have-nots, between those who live on the proceeds of present labour and those who live, wholly or in part, from the labour of past generations. We are now faced by a 'prime fact' of a political nature, which is tied up with the levelling influence of progressive taxation and the device of discrimination. The three devices constitute a fiscal group in themselves.

### § 11

We know, then, that our further theoretical investigation must consist of ascertaining the economic and financial effects of a high inheritance tax on the production and distribution of wealth and on the budget of the Treasury.

First of all, (it works against the incentive to save and accumulate.)

People save to assure themselves a comfortable old age, but above all to assure and improve the future prospects of their children or to insure the continuity of the family. There may be other motives which impel the individual to accumulate, but they are usually motives which are of secondary effectiveness; in any case, they are associated with a desire on the part of the saver to dispose of his savings in his own way, by devoting them to certain definite cultural or charitable or religious purposes — that is, purposes different from those to which the State would devote the proceeds of the tax. In any case, it is not our purpose here to make a list of all the possible motives for saving, but to recognize that the larger or a large part of saving is produced by motives which have reference to the future of the family, or which are tied up with the

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particular purpose to which the saver wishes to devote them, independently of the purposes of the State. If this is granted, it follows that if saving were to be entirely absorbed by the Treasury at the death of the saver, the saver would have recourse, so far as he himself is concerned, to forms of insurance, and would cease to save for his children and descendants, as well as for the particular ends that he wished to achieve.

Now, that which is obvious if we reason on the assumption of the limiting case represented by the total confiscation of saving, seems to be so no longer when the tax is, indeed, increased, but still leaves to the saver and his children a part of the accumulated patrimony. Many writers maintain that man saves by instinct as do ants and bees. But in any case the instinct of saving is subordinated to another instinct, — namely, that of providing for the continuity of the family. If the possibility of satisfying the second instinct is removed, the first instinct becomes weakened. In any case, for the saving of the community to be decreased, it is enough that some men should think through the economic aspects of the case. Thereby the rhythm of the increase of production is checked directly, and that of the increase of revenues is checked indirectly.

Undoubtedly there are effects, which work themselves out only in the long run and are not always visible, because one would have to be able to compare the actual amount of present saving with the saving that might have been undertaken if the obstacle of taxation had not existed.

Nevertheless, even if we admit that the depressive effect of inheritance taxes on saving has not been considerable, this derives from the fact that even nowadays the tax has a more potent and immediate effect on the *distribution* of saving, in so far as it leaves to the saver the possibility of choosing investments that may evade taxation.)

In fact, savings may be invested either in immobile property, which does not escape ascertainment by the Treasury, or in mobile property, which escapes such ascertainment more easily, or in bonds payable to the bearer, which escape completely; hence savings will choose the latter way. And if the Treasury should succeed in discovering and tracing such savings, there is the possibility of sending them abroad; and, in the last analysis, they may always be hoarded.

These possibilities give, above all, an immediate explanation of



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the fact that the expected yield from the tax has not corresponded to the extreme tax-rates. This may be explained by admitting either that saving has decreased or that it has succeeded in evading taxation. Moreover, numerous bits of confirmatory historical evidence are to be found in the past, and they are still visible in the characteristic tendency, in our time, for the political power of the richer classes to rest, not, as formerly, upon the ownership of land, which is national, but upon the possession of capital, which is international. The mobility of capital is uncontrollable in its choice between investment at home and investment abroad.

Inheritance taxes, then, as a result of their height, influence the distribution of wealth by encouraging the formation of patrimonies invested in mobile property, and by deterring saving from forming or increasing patrimonies invested in land. Now, this distribution is anti-economic, because it is determined not by the calculation of maximum productiveness, but by the desire to avoid taxation. Hence, to the extent that the latter influences the distribution of wealth, it reduces, indirectly, the productiveness of saving, and, directly, public revenues.

### § 12

From the fiscal point of view, the inheritance tax is one of the most unequal. For, as has been pointed out, it shows favouritism to mobile property in the form of private and public securities payable to the bearer, and hence concentrates the tax-burden and its increase principally on lands and houses, — that is, on a limited category of taxpayers.

Confronted by tax-rates of 30 per cent and 90 per cent of the capital value, one asks how it has been or is possible to pay them. The answer is that the taxes were paid by those patrimonies in liquid form which escaped ascertainment. In other words, the high tax on successions has induced the testator to accumulate his wealth in the form of mobile capital, with the result that the heir distributes the tax, which falls only on the immobile part of the inherited estate, over the whole patrimony. Thus, if we assume that a son inherits a patrimony of a million, a half of which is in landed property reported to the fiscal authorities and the other half in hoarded cash or in bonds payable to the bearer which are not

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reported to such authorities, it follows that the tax-rate of 30 per cent, which he ought to have paid on the whole patrimony, falls — as a result of the progressive form of the tax — to 10·8 per cent on that part of his patrimony which is in the form of land, and in fact resolves itself into a tax-rate of 5·4 per cent on the whole of the inherited estate.

But the composition of the patrimony — that is, the relation between the mobile and the immobile part — is not the same for all citizens and for all parts of a country; whence arise two new causes of inequality.

It should be noted, further, that the income from these bonds payable to the bearer, as well as — to a smaller extent — professional and industrial incomes, escape in whole or in part the tax on 'movable property' and the complementary tax (or their equivalents), as compared with incomes from land and buildings. The result is that the inheritance tax, instead of helping — as one of the indirect taxes on transfers — to correct or lessen the inequalities of direct taxation, merely increases and aggravates these inequalities.

### § 13

From what has been said we may proceed to conclusions of a more general character, analogous to those reached for progressive taxation.

(a) If it turns out that the tax on successions gives a relatively smaller yield; to the extent that it succeeds in its function as a leveller of fortunes, the policy tending to remove the burden of taxation from income and saving in the process of formation to saving accumulated by past generations militates against the achievement of the aim that it is desired to accomplish.

(b) If it is admitted that saving is useful to the community, then it follows that savers are the technical instruments for the accumulation of capital, which increases the demand for labour and assures the increase of production to the advantage of all the agents of production and the consumers.

Now the saver is inspired by the incentive to provide for his children and to assure the continuity of his family; and for this reason inheritance is a necessary corollary of saving, at least until it is proved that people are impelled to save for the political community as to-day they save for their families.

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There is no modern and progressive country without the institution of inheritance; for only through inheritance can each new generation carry on the work of the preceding one and so give continuous and progressive movement to the economic development of the country.

A tax policy that would force each generation to consume what it produces and to produce what it consumes in the course of its lifetime would create a static society, a sort of 'proletarian republic', surrounded by capitalistic countries and destined to be absorbed by them.

A policy which recognizes the individual and collective usefulness of saving and opposes inheritance faces an insurmountable contradiction and must, sooner or later, provoke a reaction.

### § 14

For an example of such a reaction we may again turn to Italy, which has abolished the tax on successions within the family.<sup>1</sup>

But the reform — precisely because it resulted from a reaction — has overstepped the mark. Its error lies in the fact that it has given up the opportunity to utilize the moment when property is inherited to levy on the heir that moderately increased tax which he is capable of paying and which it is not to his advantage to renounce.

A reform that follows logically from our premises would consist, in broad outline, of the following:

(a) The transformation of the tax on successions — that is, the amount it yields — into an increase of all direct taxes, whereby two of its major inequalities would be eliminated and it would be possible to avoid the danger of having to pay the tax all at once, through the liquidation of savings that have already been or that ought to have been invested to the community's advantage.

(b) Levying on the heir that part of the tax which concerns

<sup>1</sup> The Italian reform includes within the family nucleus (a) parents and children, (b) husband and wife, (c) brothers and sisters, (d) uncles and nephews.

At the time of writing this reform has already undergone a modification in that the exemption is made contingent on the condition that the husband and wife must have had at least two acknowledged children, including such as may have died; and the exemption is limited to such transfers as may have been made by parents to two or more children and their descendants and from a husband to a wife (or vice versa) having two or more children.

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him, and which ought to be a tax that is merely 'complementary' to the direct taxes, in order to utilize the moment when he gains in wealth to bring about a more economic distribution of the tax-burden. But the tax, regardless of whether it is related to the capital on a proportional or slightly progressive basis, ought to be paid out of annual income, and its payment distributed over the income of several years.

(c) The taxation of business corporations and government bonds through some form of taxation which would be a substitute for the inheritance tax, the security holders being exempted from the formal obligation to report their holdings.

(d) The exemption or partial exemption of children, a surviving husband or wife, direct descendants and parents, and the relatively heavier taxation of more distant relatives, account being taken of the fact that natural attachments tend to restrict the so-called family nucleus more and more.

### § 15

#### *The Two Substitute Taxes*

We have established the general principle that indirect taxes rest on the exchange economy and presuppose the rule that all goods are objects of exchange. From this follows the corollary that where exchange is lacking, or cannot be ascertained, the reason for the tax does not disappear; on the contrary, it is necessary to adopt other forms of equivalent taxes in order to strike the goods that are an exception to the rule.

This general principle leads us to the problem of the substitute taxes to which recourse is had in two opposite cases: (a) that of goods that change hands very frequently, and often impersonally, with the result that they evade ascertainment and taxation at each separate transfer, and hence escape registration and stamp taxes; (b) that of goods which change hands either not at all or very seldom, — as in the case of goods belonging to undying juristic persons, and which would therefore escape inheritance taxes.

In the first case the place of the registration and stamp taxes is taken in Italy by the 'negotiation tax'<sup>1</sup> which is paid by insurance

<sup>1</sup> [Italian: '*imposta di negoziazione*' — Translator's note]

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companies, business corporations, and in general by organizations issuing bonds, shares, and negotiable securities, and is commensurate with the value of the bonds issued. The individual security holders are thereby freed from the obligation to pay on each separate transfer.

The value taken as the basis of the tax is the real or market value of the securities and therefore of the capital of the corporation, not the nominal value; this is an obvious corollary of the principle that the tax falls on the savings of the buyer and hence the actual amount that he invests in the purchase.

In the second case, the so-called tax on 'mortmain' takes the place of the inheritance tax and strikes the property of undying juristic persons through an annual tax on income, which is added to the other direct taxes. In Italy, the tax-rate, which used to be 4 per cent annually, has been raised to 7·2 per cent.

It is assumed that the annual tax of 7·2 per cent on the income of the mobile and immobile property which constitutes the patrimony of the organization is equivalent to the tax on successions, which ought to be levied about every thirty-two years, on the average. The usual progressive form of the inheritance tax makes it somewhat difficult to verify the mathematical exactness of this equivalence. What is involved, therefore, is an average calculation of a broadly approximate character, which is not of decisive importance.

On the other hand, the importance of the tax on 'mortmain' from the standpoint of theory is much greater than its importance in practice; for it confirms the principle according to which all goods are obligated to pay direct and indirect taxes, so that the abolition of indirect taxes brings an automatic increase in direct taxes. Thus the tax adumbrates the reform indicated above, consisting of the transformation of the tax on successions into an annual increase in all the direct taxes.

BOOK V  
EXTRAORDINARY PUBLIC FINANCE

<sup>1</sup> [Italian: *finanza straordinaria* – Translator's note]

## CHAPTER I

# THEORY OF PUBLIC LOANS

**Summary:** Concept of the extraordinary budget in the individual business — The same concept in the business of the State: the extraordinary tax on property — The private sale- and loan-transactions that derive from it — The subjective preferences of the groups made up of owners of immobile property, capitalists, and professional people — The series of private loans is transformed into a single State loan — The differences and the economic superiority of the public loan — The question of professional people — The extraordinary levy is not a levy on capital — Interest on the public debt is a matter of debit and credit — The rôle of these debits and credits in automatic amortization — The importance of the expenditure in the economic calculation with respect to the advisability of the loan, from the standpoint of future generations<sup>1</sup>

### § 1

THE fiscal organism examined thus far provides for the ordinary, normal, and continuous expenditures of the State; hence it is not complete unless there are added to it other instrumentalities designed to provide for the 'extraordinary' needs which may possibly arise at great intervals in the life of the State, as they may arise in the life of an individual.

We may abstract, for the moment, from the nature of the expenditure, but not from its amount; for, whatever the cause or the purpose of such expenditure, our problem arises whenever the ordinary taxes on income are held to be insufficient to cover expenditure. What is involved, therefore, is an expenditure which can be made only once and may be provided for out of revenue which is to be raised only once; since, if we take the wealth of the country as given, neither the expenditure nor the revenue — on account of their magnitude — could ever become a regularly recurring item in the annual budget of the State.

<sup>1</sup> The theory of the public loan which is expounded here was first published in the *Giornale degli economisti* (January, 1893), and was reprinted with some additions in my *Saggi di economia e finanza* (1898).

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We start with the customary elementary premise that the budget of modern States develops in harmony with the budgets of the citizens, the two together representing the organic budget of the nation. In fact, we may begin with these private budgets in order to establish more precisely where ordinary finance ends and where extraordinary finance begins.

Let us imagine a person called upon to face an expenditure which, because of its magnitude, he decides he cannot meet out of his annual income, even if, in order to make as many concessions as possible, we should include in his annual income the amount of savings that he was accustomed to make annually, or even the larger amount of savings that he might be disposed to make by reducing, in the course of the year, his ordinary standard of living.

Now, if the sacrifices that he makes during the year are not sufficient, he will have to sell a part of his property, or he will be able to contract a loan which, from the economic point of view, is an attenuated form of alienation.

At this moment, we may say, an extraordinary administration of his affairs begins, since the equilibrium represented by his old budget is definitively ruptured. This means that, *ceteris paribus*, he will have to reduce permanently his future standard of living.

But even if we accept the broad and empirical concept which is involved in regarding his extraordinary administration as beginning with the concrete fact of the sale of his property, the boundary line between 'ordinary' and 'extraordinary' administration will always depend, to some extent, on the capacity and the will to save, which varies from individual to individual.

This subjective element prevents us from discovering a more rigorous and more objective formula which would fix the line of demarcation, within the budget of each individual, between extraordinary and ordinary administration.

### § 2

Let us now carry this concept over to the finances of the modern State, which operates in the name of the community and whose conduct cannot be separated from that of the taxpayers.

First of all, the extraordinary public expenditure — for example,



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a war indemnity — which appears in its budget, must be distributed among the individual taxpayers, and the share assigned to each taxpayer becomes an extraordinary expenditure for which each taxpayer must make provision.

Before coming to the determination of these individual shares, the modern State will also consider the problem of reducing ordinary public expenditures. Nevertheless — and in this respect it differs from the absolute State, in whose budget extraordinary expenditure would be merged with the private expenditures of the sovereign. — it will not be able to go far in this direction, in view of the instrumental character of public services, a reduction of which might react on the production of private goods, thus simultaneously blocking and drying up the very source of both private and public income.

In the second place, the State will seek to increase direct and indirect taxes on income, whereby it will induce each taxpayer to lower, as we have already said, his present standard of living.

When this limit is regarded as having been reached, the State will pass to the sale of its patrimonial goods, if it has any. But we have seen that it will, as a rule, already have sold such goods to members of the community, because it can recover their value from the community, whenever circumstances make such action desirable, by means of a tax.<sup>1</sup>

This tax is the 'extraordinary tax on property'. In pure theory it is supposed that the modern State will have recourse to such a tax at the very moment at which the individual has decided to sell his property in order to pay his share of the extraordinary expenditure.

This share may be, for example, a fifth of his property; but it must be pointed out immediately that 20 per cent of his property is not a fifth part of the value of his property. We already know that modern taxes exclude payments in kind, the sale of which would then have to be undertaken by the State. We have already seen that the tax on the product (the tithe, for example) has been transformed into a tax on income, in order to force the taxpayer to undertake the responsibility and the risk involved in sale. The same is true of the extraordinary tax on property; hence the owner will, in fact, have to sell as large a part of his property as is necessary in order to realize 20 per cent of its value. This value is fixed by appraisal at the moment when the tax is first levied — that is, before the new

<sup>1</sup> Cf. Book I, chap. II, § 10.

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offer of lands and houses and securities, which will be thrown on the market, will have lowered prices.

To sum up: from ordinary taxes on income we pass to the increase of such taxes, and then, merely as a result of this quantitative increase, to the extraordinary tax as a percentage of the value of property.

The extraordinary tax presents itself, therefore, as a logical extension of taxes on income, and must be considered as the first fiscal instrument available for the extraordinary finance of modern States.

### § 3

When, in dealing with the economic problems of the individual, it is said that an individual sells a part of his property in order to meet an extraordinary expenditure, the problem is thereby exhausted—that is, it does not go beyond the budget of the seller, since we do not have to concern ourselves with the buyer of the property.

But when we pass to public finance, which has to do with the economic problems of the community, the buyer cannot be ignored, since it is impossible to conceive of all taxpayers' selling their property without taking account of the other parties who buy it.

As against the State, in this specific problem, the community consists of two persons — a seller and a buyer, or a borrower and a lender.

The extraordinary tax gives rise to a sale- or loan-transaction between two taxpayers who do not have homogeneous interests. If all wished to sell and none wished to buy, or if all wished to borrow and none to lend, an extraordinary levy would not be possible.

It is on the existence of these relationships that the theory of emergency finance is based.

This is not true of ordinary taxes on income, with respect to which all taxpayers form a homogeneous group, since all have an income — from land, or buildings, or capital, or industrial or professional activity — and the tax-relationship exhausts itself in the dealings of the State with each individual taxpayer.

Similarly, if all property had the same composition and each property-owner had at his disposal a certain amount of consumers' goods or of money, the extraordinary tax on property would be paid

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directly by everyone, and would give rise to neither sale- nor loan-transactions; the tax-relationship exhausts itself in the dealings of the State with each individual taxpayer.

But this is not what happens in reality; the sole hypothesis on which we can reason is that the various holdings of private property differ in composition.

As the result of individual preferences, there are those who choose to put their savings into immobile investments in the form of land, houses, or industrial plant. For the sake of simplicity, we shall include all these owners of fixed capital under the single heading of 'landowners'. Over against these, there are others who prefer to accumulate and keep their wealth in liquid form — that is, in short-term investments — so as to be able always to turn them to new uses, in whole or in part. We shall call this group the pure 'capitalists'.

Side by side with these two groups there exists a group made up of professional people and workers, who live on the income from labour. These we shall have to discuss separately.

Thus the extraordinary tax on property falls formally on all property owners; but we know that behind this apparent uniformity it acts differently on the various groups by creating contractual relationships involving sale- or loan-transactions between the first and the second group, and creating a separate problem for professional people and labourers.

### § 4

Up till now we have not differentiated between sales and loans; now we must distinguish between the two possibilities.

In the first case, since we have excluded the possibility that the State may collect the tax on property in kind, the State has no alternative to the extraordinary tax on property, which is theoretically bound up with the sale-transaction to which taxpayers have recourse.

In the second case, on the other hand, there arises the possibility of transforming the series of private loans into a public loan.

Let us first see which of the two hypotheses is closest to the reality of the present day.

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From the point of view of objective value, it is a matter of indifference whether one sells or contracts a loan. That is, it is all the same whether one sells a piece of property in order to realize \$5000 once and loses for ever the annual income of \$250, or contracts a loan of \$5000 and pays an annual interest charge of \$250 in perpetuity.

From the point of view of subjective value, however, observation tells us that the landowner will prefer to contract a loan, in order to preserve his land as a field of future investment for himself or for his heirs, to whom he attributes tastes and preferences like his own. When he uses his future savings to pay the debt, it is as if he were investing them in the purchase of land.

Similarly, the capitalists who have chosen for their savings short-term investments — that is, loans — for the sake of preserving the greatest possible freedom in the disposition of their property, dislike 'immobilization' and will prefer the making of a loan to the purchase of land and houses.

We may therefore start from the premise that the extraordinary tax on property resolves itself, by preference, into a network of private loans bearing interest.

On this network of private loans is founded the theory of public loans. In fact, the State can abolish the instrument of extraordinary taxation if it asks as a direct loan from the group of 'capitalists' the total sum that they were prepared to lend to the owners of immobile property, and if, at the same time, it asks from the owners of immobile property a sum equal to the interest that they were prepared to pay the 'capitalists'.

The State makes itself intermediary between private lenders and borrowers, combines in a single inclusive figure the sums demanded as loans, contracts in its own name a single loan for the total amount it needs, and obligates itself to pay a uniform rate of interest on each hundred dollars subscribed by the lenders.

Even at this point the operation thus concluded by the State in fact transforms the multiplicity of individual obligations into a joint obligation of the debtors — and this is true not only of the debtors who in fact had contracted or would have contracted the loan, but of all the taxpayers, including those who have the money to pay the tax.

It will immediately be observed that this extension of the joint obligation from the actual borrowers to those who, having at their

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disposal a sum sufficient to pay the extraordinary tax, did not have recourse or would not have had recourse to borrowing, does no harm to the latter, since they can now use the same sum to subscribe to the public loan, thus becoming, at one and the same time, creditors with respect to the interest and debtors with respect to the equivalent tax.

At this point it may already be concluded that the transformation of individual obligations into a single joint obligation of all the tax-payers explains why the rate of interest on the public debt is usually lower than the current rate of interest on private debts. In fact, this result is advantageous for both the debtors and the creditors: the former pay a lower rate of interest, and the latter are more certain to collect their interest.

This is the first cause that explains why the public debt is, as compared with the extraordinary tax on property, a more economical fiscal instrument for the community, and therefore for the State.

But it is not the only cause.

### § 5

Private loans necessarily have a fixed maturity-date; public loans often do not have one. The State obligates itself to pay the interest annually; but it usually reserves for itself the right to pay the principal at that moment which it considers the most convenient. This is the prevailing form of public loan in modern States, and we shall take it as the basis of our argument.

It is said that this comes about because the life of the State — or the life of the community, in the name of which the State functions — is perpetual as compared with the life of the sovereign of ancient States, or of the form of government, which is also short-lived in modern States. This is true, but this formal condition still does not give a good reason why the relatively perpetual character of the public debt would be more advantageous to the borrowers.

In order to explain this fully, it is necessary to take account of another circumstance: namely, the fact that the public loan is contracted by means of voluntary subscription to bonds which are negotiable, and which the State seeks to make as negotiable as possible by issuing them to the bearer and for round figures, which range from a minimum to a maximum amount: 100, 500, 1000, 10,000, 20,000, 50,000, 100,000, etc.

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In view of this circumstance, the State could not pay at the date of maturity such large amounts of debt, unless it had recourse to a new loan; it might just as well keep the old loan.

Private loans necessarily have a fixed maturity-date, which provides protection against the risk of failure, death, or disappearance of the individual debtor; this danger is eliminated in the case of the public loan by the anonymous solidarity of all the taxpayers, present and future.

The subscribers to the public loan have a double advantage: they may either hold on to a stable investment, or they may realize on it at any time by selling the securities. Similarly, the State can buy on the open market the securities representing its debt, and thus in effect extinguish it in part. There is, therefore, an advantage to both of the contracting parties.

To be sure, the debtor State seldom has recourse to the buying of its own securities. Instead, it exercises its right to pay the old creditors at that moment which is most favourable from its own standpoint. Now, this represents a unilateral advantage; for, if the accumulation of savings reduces the rate of interest, the State is able to contract a new loan under better conditions and reimburse the old creditors; and, vice versa, it does not have recourse to conversion when the rate of interest rises. In order to equalize these two possibilities, in the interest of the first subscribers, it is customary to include among the conditions of the loan the provision that the State will not retire or convert its securities before a certain number of years have passed.

Naturally, if one were to undertake a minute analytical investigation, and were to take into account personal circumstances, one would find that sometimes the lack of a maturity-date may harm the creditor. But on the whole, it may be concluded that, given the easy negotiability of the securities, the absence of a legal maturity-date has, in fact, resolved itself, in the great majority of cases, into a daily maturity-date, which may be enforced freely by either of the two contracting parties.

### § 6

The circumstance that the securities are negotiable has other consequences of considerable importance. First of all, it brings about a continuous *redistribution* of the public debt among savers, with the

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result that the securities are always placed with people who consider it relatively more advantageous to have their own savings invested in this way.

Because of this process of continuous and easy redistribution, the raising of an extraordinary levy through the flotation of a public loan causes less of a burden than an extraordinary tax on property would cause. The private debts to which the latter would give rise could also be transferred, but not with the ease and safety characteristic of government securities.

Similarly, the public loan broadens the market of subscribers to the extent that it attracts foreign investors. It is obvious here also that foreign capital may participate in the private loan to which an extraordinary tax on property would give rise; but it is also evident that the difference is very great, either because of the publicity that surrounds every issue of a public loan, or because of the greater security, or because of the possibility of realizing the principal at any moment.

To the extent that the circle of initial subscribers is enlarged, the financial needs of the State remaining constant, the burden of the extraordinary levy on the country's economic structure is lightened.

### § 7

Finally, the flotation of public loans solves in a radical way the question of professional people and labourers who declare that they do not own property, and hence do not owe the extraordinary tax on property.

Before we examine the question whether professional people, as such, do or do not own property, it is necessary to decide in principle whether they should contribute to the extraordinary expenditures of the State.

If we take as our point of departure the fact that they already pay taxes on income and that they would pay more of these taxes if it were possible to cover the extraordinary need by an increase in such taxes, it follows that they owe the tax on property whenever the increase of taxes on income is not sufficient to cover the needs of the State.

But, it is said, professional people do not own property, if we

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accept the usual definition of property given by jurists, according to which property consists of material things which are external to man and saleable, and, in any case, excludes man himself, with his intellectual and physical capacities assuring him an income. But if, for a moment, it were supposed that the delinquent debtor may be reduced to slavery, as in former times, this conception would disappear. It would lead to the conclusion that the labourers and professional people of to-day, having acquired the most absolute personal liberty, would also have acquired the right not to pay taxes on an equal basis with all other citizens. By starting from an antiquated juridical conception, we go back to an antiquated fiscal conception, which is precisely that the free man does not pay taxes and that the payment of taxes is a sign of personal subjection and of slavery.

The circumstance which constitutes the difference between the owner of property and the professional man is this: the former provides a real guarantee for the payment of the extraordinary tax, whereas the latter does not provide such a guarantee, with the result that, in fact, he may not pay and may even remain, according to the laws of various countries, free from all punishment for non-payment. But this is a factual difference which exists in the cases of other taxes, including the taxes on income. The professional person who does not pay his tax debt falls, not within the group of those privileged by law, but within the group of bankrupts and delinquents, who are subject to punitive laws where such laws exist.

If, then, we grant that professional people also must pay their share of the extraordinary levy, no difficulty exists from the economic point of view. For the value of property is merely the capitalization, at a given rate, of income; so that every professional person can be appraised in terms of a capital sum on the basis of his income — not for the purpose of transforming him into a thing capable of purchase and sale but only for the purpose of determining his share of the extraordinary tax.

But, it is further said, he will not be able to pay the tax, because it usually exceeds his income. Let us take the case of an attorney who earns, normally or as an average, 100,000 a year, on which he already pays the ordinary tax on income; let us suppose that by capitalizing his professional income at a rate much higher than 5 per cent, the attorney is said to have a capital value of only 400,000; let us now suppose that an extraordinary tax of 20 per cent is levied;



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the professional man in question must pay 100,000 — that is, a sum that absorbs his whole income.

Having assumed, as a hypothesis, that he lives only on the income from his labour, he will not be able to pay the 100,000. But if he contracts a loan of 100,000 at 5 per cent, he will be able to pay 5000 annually to his creditor and his share of the extraordinary tax to the State, as do the owners of immobile property.

To be sure, we are confronted here with a new difficulty — namely, that the professional person, not being able to give any tangible security, either may not be able to obtain credit or may obtain it only on terms that are too burdensome as compared with those available to the landowner.

And it is precisely at this point that the State intervenes by contracting the loan of 100,000 directly, and levying an annual tax of 5000 more on the professional man.

To sum up: professional people are treated like those owners of immobile property who prefer to pay an increased tax on land, rather than sell their property.

From all the considerations thus developed, it becomes clear why the institution of the public loan is a more economical fiscal instrument than the extraordinary tax on property and, in the end, takes the place of the latter.

### § 8

It is commonly said that in employing an extraordinary tax on property the State puts a levy on capital, and that in employing an extraordinary tax on income, it puts a levy on consumers' goods. The statement is not exact, and must be clarified.

Whatever may be the expenditure — large or small — that the State must incur, it has need of the same *quality* of goods — that is, *direct goods*, which must be drawn from the national income.

If the State levies on my property — whether it consists of land, houses, or a business enterprise — an *ad valorem* tax of 20 per cent, it does not really demand an equivalent share, in kind, of the land or the houses or the machinery and factories; what it does is to force me to transform these things into direct goods or money, and to pay the proceeds to the State. The property was built up by saving out of income; the extraordinary levy forces the taxpayer to transform his property back into income.

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It follows that, in the case of an extraordinary tax, the possible limits of the levy are given not by the needs of the State as compared with the *appraised* value of the country's property, but by those needs as compared with the amount of direct goods which, at a given moment, are available on the market. The one who decides what the tax will yield is not the seller who is legally subject to the tax, but the unknown buyer. The unknown quantity in the problem is the demand for immobile property; it is necessary to know the amount of available savings which their owners are willing to devote to this use.

The extraordinary tax does not create direct goods, and a high tax-rate does not increase the quantity of direct goods; it can only raise the price of direct goods and lower that of capital goods.

Undoubtedly, the raising of the price for saving increases the supply of saving; but the saving which is forced in this way finds in the saver a growing resistance which is more than proportional; for he must renounce the satisfaction of increasingly urgent wants. It follows from this that a tax-rate which is not calculated on the basis of available savings runs the risk of inflicting on landowners an amount of damage that is disproportional both to the small benefit that the Treasury derives from it and to the large benefit experienced by owners of money capital.

### § 9

What has been said of the extraordinary tax can be repeated, with some variations, in the case of the public loan. In making use of the latter, the State goes directly in search of available savings, and obtains them through voluntary subscriptions. The latter tend to increase as the amount of interest promised increases; they do not tend to increase proportionally, as we have already pointed out.

The State competes for the available savings against industry and commerce, which also exercise a demand for them. What decides the distribution of savings between the Treasury and industry is the rate of interest paid by the State. Loan policy consists of determining the interest-rate and the other conditions under which the loan is floated. The State finds a safe term of reference in the current rate of interest on the open market.

Three hypotheses may be made with respect to this datum: the

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State may fix a higher rate of interest, or an equal rate, or an appreciably lower rate.

The higher the rate of interest promised by the State, the more available savings it withdraws from industry and commerce, with resulting disadvantages similar to those produced by excessive rates of extraordinary taxation.

If the State does not depart from the rate current on the market or if, taking account of the preference accorded it by a considerable proportion of the savers, it keeps its own rate only a little below the market rate, the result will be that the disposable savings will be distributed between the Treasury and industry according to which use offers the greater advantages to the savers. The result will be — *ceteris paribus* — a new equilibrium that will involve a higher interest rate; this may eliminate from the market the weaker marginal industries; but it will not disorganize the vital nucleus of the industrial activity of the country.

Finally, one may adopt, and some writers have adopted, the hypothesis that the interest-rate is too low to induce savers to subscribe. This means that all the taxpayers prefer to pay a perpetual tax equal to the low interest promised by the State, and that no one finds it advantageous to accept this low interest on a loan. This hypothesis may be excluded, because it is in contradiction with the principle of public loans. The freedom to subscribe or not to subscribe must be understood in a purely formal sense, since the flotation of a public loan *must* give a positive result. There is no legal compulsion, as there is in the case of the extraordinary tax, but an economic compulsion must be exercised through the height of the rate of interest promised and the other conditions of the loan. These must be such as to establish, at the least, a point of indifference as between subscribing voluntarily 100 in capital and paying 5 annually in taxes as a matter of compulsion. After this financial equality has been established, it is, as has been pointed out, the personal preferences of the various groups that decide.

This represents the necessary minimum.

From the preceding analysis it follows that the flotation of a public loan is a problem of financial policy for the solution of which it is necessary

(1) To know approximately what, at a given moment, is the amount of savings available on the market;

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(2) To decide what part of these savings it is desirable to draw into the State budget and withdraw from the consumption of the citizens and the needs of industry and commerce;

(3) To establish the terms of the loan in such a way that they give the Treasury the amount desired.

One consequence of the difficulties involved in carrying out the necessary investigations is that governments are usually accustomed to float the loan through banks or banking consortia — that is, specialists who are in a position to know best the real conditions of the money market and the means of their clientele and can guarantee success or some degree of success.

### § 10

The loan burdens the budget of the State with a new expenditure in the form of interest, to which there corresponds a revenue equal in amount. For the State it is a matter of debit and credit; but this is not true of the economic budget of the community, as has sometimes been alleged. The community is not a homogeneous group, which pays 50 million in taxes and receives 50 million in interest; the State receives 50 million in taxes *from one group of citizens* and pays 50 million in interest *to another group*.

According to the theory expounded thus far, the State would have to collect the 50 million from the taxpayers who are *in fact* or who would have been the debtors to the private capitalists. The State, however, could not maintain this sort of individual accounting, nor could it follow it through the continuous changes which would result from the negotiability of the securities.

The State treats all taxpayers uniformly. Let us suppose, therefore, that it floats a loan of a billion, leaving each citizen free to subscribe or not to subscribe. At the same time it levies on all the taxpayers—on those who subscribe as well as on those who do not subscribe—an ordinary tax on income for the sum of 50 million.

Given these technical requirements, let us see how the interest charges are handled as a matter of accounting. It is a point of great importance, which sheds light on the whole problem.

It remains true that the 50 million which the State levies in taxes and pays in interest always represent, in its own budget, a debit and a credit.

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With this point definitely established, let us see, through an example, how the phenomenon develops as between the various groups into which we have divided the population.

Let these groups be represented by a capitalist, a landowner, and a professional man, each having a taxable income of 60,000. The State demands, as an extraordinary levy, 1,200,000.

If it has recourse to an extraordinary tax on property, each person will owe 400,000. But the landowner and the professional man do not have this sum at their disposal; hence they will borrow it from the capitalist who has precisely 1,200,000 to lend.

The capitalist will give 400,000 directly to the State as his share of the tax and will furnish the remaining 800,000 to the landowner and the professional man, from whom he will receive altogether, as annual interest at 5 per cent, an income of 40,000.

Thus the income of each of the three is in fact reduced from 60,000 to 40,000.

If, instead, the State has recourse to a loan, it will obtain directly from the capitalist 1,200,000 by obligating itself to pay him annually 60,000 in interest. At first sight it appears that the State pays in interest a sum larger than that which the private borrowers paid when the extraordinary tax was used. But this is only a matter of appearance, because the extra 20,000 are the equivalent of 20,000 in taxes that the State also levies on the capitalist. And thus it comes about that in the case of the capitalist, also, the 20,000 that he receives in interest correspond to the 20,000 that he paid in taxes. In effect, he has 40,000 of net income from interest, as in the preceding example of the extraordinary tax on property.

Up to this point, therefore, our conclusions are as follows:

(1) The whole 60,000 represent, in the State budget, a debit and a credit.

(2) The 20,000 represent a debit and a credit in the budget of the capitalist-lender also.

It remains to see what happens to the 40,000 that remain in the budget of the State as the actual burden of the loan.

### § 11

This sum does not disappear from the budget so long as the debt is not repaid; and the repayment can be made only as new

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savings are formed in the country. The formation of savings is gradual; the repayment can be only gradual, whether we are dealing with the case in which 40,000 represents the individual debts of the landowners to the capitalists, or the case in which this sum represents a debt of the State.

Let us suppose, first, that the State does nothing to repay its debt; and let us see the direction that new savings will naturally take.

In our society, 'public debts' offer a large field for normal investments. On the one hand, the capitalists, who were the first lenders, try to sell government securities, and, on the other hand, with the increase of savings there is also an increase in the number of people who seek modest and secure investments. Now, in order that a part of the new savings may flow toward the purchase of bonds representing public debt, it is enough that the State should pursue a policy of scrupulous observance of its initial pledges. That this is what happens in fact is confirmed by daily experience.

If we start from this premise it follows that every acquisition of securities representing the public debt by the landowner or the professional man transforms a part of the 40,000 into a debit and a credit, inasmuch as the debit of taxes is compensated, in their budget also, by the credit of interest.

This process, which follows, in every country, from the absolute increase of savings, regardless of their distribution, is further hastened in countries in which the habit of accumulating small savings and the tendency to invest them in State bonds are diffused among all levels of the population. With the *democratization*, as it is usually called, of the public debt, we arrive logically at the conclusion that the 60,000 in our example which the State pays in interest and collects in taxes tend to be divided into three parts of 20,000 each, which are, or become, debits and credits in the budgets of the capitalist, the proprietor, and the professional man, respectively.

At this moment the public debt may be regarded as extinguished *in fact*.

This proposition, by virtue of its truth as an abstract proposition and its truth as a statement of concrete tendencies, demolishes the current opinion that modern States, because of their enormous expenditures in the form of interest-payments, will not, in the long run, be able to bear their weight.

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On the contrary, the burden of a loan on the economic position of the taxpayers is borne entirely at the moment of subscription, when provision is made, out of the ordinary resources of the budget, for the payment of the corresponding interest. Consequently, as we get further away from the time of flotation, the tax-burden of the loan becomes progressively less.

There remain the alarming figures of the original public debts and the interest thereon; but the interplay of debits and credits tends gradually to make them devoid of any economic content.

This phenomenon may be regarded as an automatic amortization of public loans.

### § 12

The State helps to reduce the actual burden of the public debt in several ways.

First of all, it waits until savings increase to such a point that it becomes possible to contract a new loan for the amortization of the preceding one, but under more favourable conditions, — that is, at a lower rate of interest. The proceeds of the new loan are then used to extinguish the old one. In reality, moreover, only a portion of the old creditors will ask for actual repayment; most of them will not be able to refuse the new lower rate of interest which is current on the market, and will consent to renew the loan by converting, for example, the old 5 per cent bond into a new 4 per cent one. This operation is precisely what is called 'conversion'; it leaves intact the principal of the debt, but diminishes the interest burden.

In the second place, with the increase in the amount of national savings public revenues will, *ceteris paribus*, increase, and the State will have the choice of using its budgetary surplus for lowering taxes, for increasing the amount of public services provided, or acquiring its securities freely on the market in order to cancel them.

It must be presumed that the State will choose that use of its funds which at a given moment represents the greater advantage to the country.

Hence, if this process continues, the public debt would in fact be cancelled, and would also be formally reduced in amount until we reach the minimum at which it would seem advantageous to stop.

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In fact, given the easy negotiability and the comparative stability in price of governmental securities, the flotation of public loans often renders subsidiary services in the facilitation of credit operations between private individuals by offering, in its securities, a safe investment for the property of minors, funds held in escrow, funds belonging to public bodies, surety bonds, and so on. It would not be true to say, in accordance with an old belief, that the public debt is a part of the wealth of the country; but its presence and its continuance in the market produces an additional utility, which must be taken into account.

### § 13

Nevertheless, this leaving of the solution of the problem to the natural play of economic forces is not sufficient in the eyes of those in control of the financial policy of modern States. This policy is dominated by the idea that every debt contracted formally and publicly must be formally and publicly extinguished. So much the better!

Thus it is that recourse has been had to the device of sinking funds,<sup>1</sup> to which are devoted such budgetary surpluses as may arise, and other fiscal revenues deriving from annual savings.

The plans devised for the functioning of these funds are numerous, ingenious, complicated, and often fantastic. Many have failed because of technical errors; but many—perhaps all—have a fundamental error in their origin. And their error comes from the failure to realize that a plan for amortization which is rigidly fixed *a priori* by law, in which the dates of repayment and the sums to be repaid are established in advance, may not and often does not correspond either to the real conditions in which taxpayers and savers happen to find themselves, or to the requirements of the State budget at the moment at which it becomes necessary to make the collections and repayments.

If we should suppose that the State, after having contracted a first loan, would not have further recourse to credit, it is very probable that no one would think of establishing sinking funds as a matter of law.

<sup>1</sup> [Italian: '*casse di ammortamento*' — Translator's note]



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But the concrete phenomenon is more complex. A State that has already had recourse to borrowing may need to have further recourse to it.

Good financial policy, foreseeing this, must keep the credit of the State high; and the credit of the State, like that of an individual, depends not only on the real solidity of its finances, but also on the opinion of its finances which is formed by the market.

Now, only when the State pays its debts does it give visible and tangible evidence that the proceeds of a first loan have not been invested at a loss and that, in any case, the savings of the debtor country which asks for new credit have increased in the interval.

This circumstance is of secondary importance, though from it is derived the reason for amortization *by process of law* and the systems of amortization which are most widely current. The circumstance in question, however, does permit us to draw the following first corollary: namely, that the plan for amortization, which is adopted in order to keep the credit of the State high, must be scrupulously carried out. For the failure to carry it out is more damaging to the credit of a nation than the absence of some plan fixed in advance. It follows, as a second corollary, that the sinking fund must not be saddled with new debts.

### § 14

We have abstracted from the question of the *nature* of the extraordinary expenditure which may be involved in any concrete case. Now this circumstance becomes the other necessary term in the equation, if it is desired to obtain a value judgment with respect to the utility of the public loan.

Many criticisms which have been wrongly directed against borrowing as such could with more justice be raised against the nature of the extraordinary expenditure.

The extraordinary levy can consist only of present goods; this is axiomatic. The useful effects of the expenditure, on the other hand, usually concern future generations.

In the future, the heirs and future generations will receive from their ancestors a budget which, on the liability side, is depreciated by the amount of the extraordinary levy, and, on the asset side, is increased by the utility of the expenditure incurred.

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The State, say, has used a billion to build a railroad system; future generations will inherit a billion less in private goods, but will receive the system of completed railroads.

The State has waged a successful war, which cost many billions; future generations will inherit so many billions less, but will receive a unified country, enlarged in territory, colonies, mines, materials, prestige, and influence in world politics.

The State has waged an unsuccessful war, for which it owes a huge indemnity: future generations will receive many billions less, but will receive a country that has avoided invasion, devastation of territory, and even loss of its liberty and independence.

Now this reasoning can be repeated for all State expenditures, large and small, ordinary and extraordinary. The State constructs a man-of-war for the maintenance of its navy: future generations will receive 100 million less and a battleship more.

In the light of these obvious considerations, there is no basis for the old, but still widespread, opinion that a loan, unlike an extraordinary tax on property, makes it possible to shift a part of public expenditure to future generations. On the contrary, in every case the heirs either receive a patrimony which is lessened by an amount equal to the capital sum involved, or are held responsible for the continuing payment of the corresponding amount of interest; there is, as we have seen, no difference from a financial point of view. The heirs who pay perpetual interest can redeem their obligation by paying a corresponding capital sum. But this operation is voluntary, and does not represent a burden; if it is carried out, this is because it is hoped to derive a gain thereby.

### § 15

Quite different is the true economic and financial problem, which lies at the bottom of this outmoded discussion. This problem arises from the circumstance that in the life of the community future generations are forced to revise the economic calculation of the generation that decided on the extraordinary levy in order to cover an extraordinary expenditure, and to recognize either that the preceding generation invested the sum usefully, or that it erred in its forecast. It is a retrospective criticism, which may help the generation that makes it, by preventing it from also committing errors of

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evaluation to the detriment of future generations; but it cannot modify or destroy the fact, universally accepted, that every economic calculation — whether undertaken by private individuals or by the State — is, in the nature of the case, a responsibility of those who live in the present and not of those who have died or of those who are still to be born!

Now, since what is often involved in these calculations is the making of forecasts on behalf of the future generations whose interests are always borne in mind by the present savers, we might deduce, from this consideration, the rule of a policy of moderation in deciding on extraordinary expenditures, which offer the certainty of present cost and the uncertainty of future utility.

Instead there is diffused throughout the theory of our subject a more radical opinion: namely, that the extraordinary tax is preferable to the loan, precisely because it sets up great frictional forces to those governments which seek large sums in order to follow a policy of waste and war.

The fallacy of such an argument is obvious; it is like counselling the use of a horse-drawn carriage to the person who owns an automobile and is in a hurry to arrive at his destination.

The problem resides in the purpose — that is, in the type of expenditure — not in the means of procuring the necessary sum. Those who would have the political strength to force a government to adopt an extraordinary tax instead of a loan would have the political strength to prevent the expenditure which they consider harmful to the country.

Another sterile discussion is that inaugurated by those who champion the extraordinary tax against the public loan on the ground that the former obliges the present generation to increase its savings, which later accrue to the advantage of future generations, who inherit a larger patrimony.

This opinion has a basis of truth, in so far as — *ceteris paribus* — private loans, which bear a fixed maturity-date and a higher interest-rate, induce the debtor to free himself from them, whereas the public loan allows him more time and greater freedom of movement.

Even if we admit that this is true, it has not been shown that it is useful.

The action of the State that would force the savers to reduce

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their present consumption below the limit which they consider useful for their well-being runs up against the economic principle according to which the individual attains the hedonistic maximum when he is left to distribute his income between the satisfaction of present wants and the satisfaction of future wants, according to his own appraisal.

The public loan follows this principle; the extraordinary tax puts an obstacle in the way of its application. Nor has it been shown that it is useful to the community, considered in its entirety over a period of several generations, that a first generation should be induced to save to the maximum, in order to permit one of the following generations to consume to the maximum. The economic principle referred to above, which is valid for the individual, must be assumed to be true also with respect to the aggregate of individuals who make up a given generation.<sup>1</sup>

<sup>1</sup> I wish to call attention to the fact that these words were written upon the assumption of the existence of a liberal and democratic State and at a time when *all* the individual citizens were universally accorded the right of participating, in some way and in some degree, in the formation of the financial evaluation of public costs in relation to public utilities.

To-day, in several States, this evaluation is left to a *single* individual or a small oligarchy. But in this case, also, the same fundamental economic principles are true, even if they are not applied to the one or the few. There is only this difference: that a political equilibrium cannot be attained unless the appraisal of the *one* coincides with the suppressed evaluation of the *many*. This, however, implies a new problem!

## CHAPTER II

### THE ISSUE OF PAPER MONEY

**Summary:** The issue of irredeemable paper money arises from 'requisition' and leads to 'inflation' — Inconvertible paper money acts as 'money' and is at the same time a 'government' obligation' — Its continued issue brings about a progressive increase in prices and ends by destroying 'money' — Stopping of inflation; beginning of deflation; *stabilization* — The monetary and financial problem is necessarily interconnected with a banking problem — The real burden of *reevaluation* on the State budget

#### § I

As we proceed along the route followed by the State in its emergency financial policy, we come to a point at which the State must appropriate from the national income as large a sum as possible, even if this involves a reduction of the consumption and the savings of the citizens below the limit to which they were willing to go, and a disregard of the competing needs of industry, with the exception of those branches producing goods which the State cannot do without. The economic compulsion which is involved in a loan is not enough; it is necessary to find a more direct and effective form of compulsion.

This must be regarded as a case of *ultra-extraordinary* finance, a case which often has presented itself in time of war, and presented itself in an acute form during the World War.<sup>1</sup>

The independence of the nation is at stake; the State must requisition all the forces which are available within the country. It requisitions able-bodied men for the front, less able-bodied men and women for the manufacture of munitions and clothing; it requisitions the services of physicians, nurses, and engineers; it requisitions the

<sup>1</sup> The matter does not lend itself to a thorough treatment in a treatise on Public Finance, because it is bound up with problems of a general economic and monetary nature more than it is with the problems of government finance. I have done my best to keep the discussion of paper money within the limits of the theory of public loans, and have had recourse to the use of footnotes whenever I have thought it necessary to enter the field of 'monetary theory'.

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factories, ships, grain, metals, wood and timber, cotton, etc., which lie within the country. It imports from abroad the goods which it does not find within the country.

For the imported goods it must pay. It does so with the proceeds of its exports, the drafts covering which it may likewise requisition, thus forcing private citizens to reduce the importation of goods destined for their personal consumption. It pays for its imports also through the exportation of the precious metals, having, as a rule, appropriated for itself all bank reserves; it pays for them through the exportation of foreign securities, which it requisitions from the citizens owning them, and through loans, in so far as it may be successful in obtaining such loans abroad.

But in the case of goods domestically produced, neither an extraordinary tax on property — no matter how high it may be — nor an internal loan — no matter how high a rate of interest is promised — would succeed in overcoming the resistance of the taxpayers, whose elementary living requirements, after they have once been reduced to a given limit, take precedence over all considerations of public interest.

Hence arises the idea of *requisition*: the State requisitions goods and services of which it has need; and it requisitions them *where it finds them*.

This last circumstance has led some economists to hold\* that in such crises of supreme public necessity it is not possible to pay very much attention to the principles of tax distribution! But this is a mistake. The principles of the distribution of taxation are not the abstractions of doctrinaires, but rather living operating forces which the State must overcome, and believes it has overcome when it has *paid* for its requisitions.

In reality, the State pays by giving its IOU's, which at most may be regarded as 'promises to pay' to be honoured later — at the end of the war, for example. This means that the State incurs a debt to every person subjected to requisition and that every such person makes a loan to the State.

At the end of the war, the sum of the promises to pay becomes a debt of the entire nation to the group of *those who have been subjected to requisition*, and at that time the debt is distributed precisely according to the principles that happen to prevail with respect to the distribution of taxation. The only difference between this type of loan

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and a voluntary loan is that in the former case, the group of creditors is made up of *those subjected to requisition*, whereas in the latter case, it is made up of the *capitalists*.

Immediately afterwards, however, as the result of the negotiability of all State obligations, the latter are automatically absorbed by savers.

### § 2

The real problem does not lie here. It arises at the very moment of requisition. For the requisition (*a*) strikes those who own the goods which the State needs and leaves the others untouched; (*b*) exacts a loan from those who probably do not have savings and are not in a position to save; (*c*) pays with promissory notes having a future and often indefinite maturity-date; and these promissory notes, no matter what degree of confidence they may inspire, do not circulate as money and therefore do not allow those who have been subjected to requisition to use them in the purchase of other goods which they need.

Consequently, the people threatened with requisition resist by concealing the commodities demanded by the State, and prefer to sell them, secretly if necessary, to private people who pay in cash.

To overcome this resistance, the State has recourse to the issuance of paper money, which becomes precisely the 'cash' without which the market cannot function.

We are thus confronted by a new form of public loan.<sup>1</sup>

Paper money already exists on the market in the form of fiduciary

<sup>1</sup> Until recently the issuance of irredeemable paper money was universally regarded as a form of State debt. But in the newer economic literature that grew up during the War and the post-war period, this view, also, was questioned.

Some have put the issue of paper money on a par with the collection of a 'fee' or 'indirect tax' on the transfer of property. When it comes to analogies, all are possible, because all are more or less wrong. Fees, special assessments, direct taxes, indirect taxes, extraordinary taxes on property, and loans are all levies on the national income. If we go back as far as the concept of a 'levy', the distinctions disappear.

These writers, then, assume that the State, because it supplies money as a medium of exchange, has a right to compensation, and obtains such compensation by issuing a batch of inconvertible paper money, which could be made equal to a percentage of the total value of the exchanges concluded within a year.

Now, it is perfectly possible to conceive of the State as being entitled to a compensation for the 'service of issuing money' which it provides for the community and for individuals each time they make an exchange. But by virtue of what right does it exact this levy?

The service of issuing money is entrusted to the State because the community believes that the State is in a better position than any other enterprise would be to

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bank-notes convertible into gold at the demand of the holder. The State ought really to issue its own notes quite separately from these. It often prefers, however, to preserve the form of the bank-notes, but at the same time to authorize their issue to its own account in a quantity corresponding to its extraordinary financial needs, over and above the normal needs of trade. Hence it frees the Bank generally from its obligation to redeem, either because the two types of note are not distinct, or because those of the State are not issued through the discount of bills and therefore are not destined to return to the Bank when the bills come due; in that case, the gold reserves would not suffice to pay the difference between the possible

guarantee stability in the value or weight or fineness of money in 'defence of public good faith'.

According to this theory, however, the tax would resolve itself into an alteration of the value of the money, in defiance of public good faith!

Furthermore, if the public service is a permanent one, the tax ought also to be a permanent one. Instead, as a result of the issue of paper money, which is destined to progressive depreciation, the tax would, in the end, destroy itself. A true tax or fee would be involved if, at each exchange in which \$100 were involved, the State were to keep \$5 for itself and leave the rest to the contracting parties.

It is not necessary to insist on this point, in order to refute the sophism involved.

In contrast, it may be of value to call attention to legislative provisions from which it follows in a normal way that the printing of irredeemable paper money is a *temporary* loan which the State proposes to repay some day by making the note convertible once more.

In Italy, which may be taken for purposes of example, the first royal decree that established inconvertibility was dated May 1st, 1866. According to Article 1 of the decree, 'the National Bank will lend to the State Treasury the sum of 250 million lire'. Article 2: 'From May 2nd until further notice the National Bank is released from the obligation to redeem its notes in specie on demand.'

Article 3 declared notes to be legal tender for all internal payments *in spite of any agreements to the contrary* between the contracting parties. Article 6 provided that the National Bank's ordinary circulation – that is, the circulation issued to accommodate trade – must not exceed the amount fixed by the bank's statutes. This is an important formal provision, because it aimed to keep the two circulations separate, so that at the time when the debt contracted by the Treasury was repaid, the note-circulation would automatically have reassumed its character of a convertible fiduciary circulation.

By the law of April 7th, 1881, provision was made for the abolition of irredeemability and emphasis was laid on the separation of the bank's circulation from that of the State. Thus it was declared, in Article 1, that 'beginning with July 1st, 1881, such *consortium* notes' (those issued by the *consortium* of banks of issue to the account of the State, which were formally distinguishable from the notes issued by each of the six banks of issue on their own account) 'as will then be in circulation will constitute a direct debt of the State'. 'These notes will be legal tender, but will be convertible at the request of the bearer and on sight into lawful gold and silver money' (Article 3).

By the law of July 22nd, 1894, number 339, irredeemability was again declared in the following terms: 'The obligation to exchange notes of the State for their corresponding metallic value is *temporarily suspended*.' This implies that it was intended to restore this obligation at a later date.

The loan character of the note issue is more evident than ever when it takes the form – and it usually does take the form – of a subvention guaranteed by the bank of issue to the Treasury, or of a discount of Treasury bills, which represent a debt of the State payable at a fixed maturity-date.



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sight demands of the note-holders and the amount of notes paid into the Bank when discounted bills become due.

Thus all notes — those of the Bank itself and those issued to the State's account — circulate as irredeemable legal tender. The public continues to receive them without distinguishing one type of note from the other, and, for some time, it may also be unaware that two types of circulation, each having a different economic significance, are concealed behind the bank-note. Thus the Bank has the position of sole debtor to all note-holders, but in fact only the part issued to the account of the State constitutes the 'public debt' which gives rise to the phenomenon of inflation as affected by governmental finance.<sup>1</sup>

<sup>1</sup> As usual, there is no agreement on the exact definition of the concept of 'inflation'.

By way of first approximation, we speak of inflation when we *allege* that the quantity of money in existence is in excess of the needs of trade. Money must be likened to a machine which operates at maximum efficiency when a maximum of exchanges is accomplished with a minimum of money. If, now, we assume that within a given country — that is, a national market — a point of equilibrium has been reached as between the amount of circulating medium (this expression being understood to include also the velocity of circulation of the circulating medium) and a given volume of trade, inflation may be said to exist when, with the volume of exchanges remaining constant, the quantity of money or its velocity increases.

When, however, the circulating medium consists of metallic currency — on the assumption that free coinage and free redemption exist — many of the phenomena associated with the type of inflation which we are here discussing are not experienced; because if, for example, the quantity of money increases as a result of the discovery of gold mines, the money tends (*a*) to leave the domestic market to be distributed among all trading nations, and (*b*) to be divided between the monetary and the industrial market.

Into the concept of inflation it is necessary to introduce the element of voluntary acts of policy, which may be those of the State or of the bank. Let us first discuss the bank. In order to reduce to a minimum the stock of metallic money it requires, the bank increases the 'velocity' of that stock by issuing bank-notes in correspondence with the natural expansion and contraction of business.

The fiduciary issue — which is a debt of the Bank — has two counterparts on the asset side of the bank's balance sheet. One of them — and it is the chief one — is the portfolio of discounted bills which must be paid at maturity, at which time the notes, after having accomplished a series of exchanges, return to the bank and are cancelled simultaneously with the cancellation of an equivalent amount of discounted bills.

This normal process cannot be regarded as inflationary; for if the matured bills were not paid or if a part of the notes were presented for exchange before maturity, the bank would pay an equivalent amount out of its metallic *reserve*, which is the second, and subordinate, asset securing the fiduciary paper money which has been issued. And if, finally, not even its metallic reserve should be sufficient, the bank would atone, or ought to atone, for its error by becoming insolvent; in which case all notes which are not covered by assets of the bank lose all value and cease to exercise any monetary function.

In pure theory, therefore — that is, if the bank performs its functions correctly — true inflation, in our sense of the term, cannot come about, or, at any rate, can be of only short duration.

We are thus brought to a consideration of the phenomena of inflation as brought about by action of the State.

Under normal conditions, the State, also, is a customer of the bank, whenever it

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### § 3

In any case, our first task is to study the problem of inflation in so far as it is the result of the action of the State, without reference to the related problem of a possible banking inflation.

Let us suppose, then, that the State issues, directly or through the Bank, a first billion of paper money; the billion is added to the other *revenues* of the State and increases its demand for goods on the open market by an equivalent amount. By this action, the State drives up the prices of the goods that it needs to such a point that it eliminates the competition of private buyers; and in this way it can reduce the consumption of the citizens as much as it reserves for itself the right to request *advances* up to a given amount in exchange for granting to the bank the exclusive right to issue paper money.

These advances, however, have reference to the administration of the budget and are undertaken in anticipation of public revenues which have already been provided for and authorized by Parliament for the fiscal year, but have not yet been collected at the moment when it becomes necessary to make provision for the corresponding expenditure. Hence the advances to the Treasury have their counterpart in the taxes that will be collected during the fiscal year. It is for the Bank to fix the relationship between the amount of these advances, which represent a fixed sum, and the amount of note-circulation destined for trade, which is a variable quantity and which the bank regulates in such a way as to avoid the risks inherent in its activity. Advances to the Treasury of this kind cannot, therefore, give rise to inflation.

Inflation begins, rather, when the State issues paper money - that is, when it incurs debts beyond the credits represented by its budgetary receipts. Hence the necessity for making notes legal tender and irredeemable; this is the condition that leads to inflation.

Accordingly, if the bank issues paper money on behalf of the State, and assumes the debt represented by a corresponding amount of bank-notes, it must be granted the same conditions - i.e., irredeemability and the legal tender provision.

Now, it may happen that the bank, protected by the general irredeemability of all its notes, will issue them to trade in such amounts that the corresponding assets will be only a weakened portfolio and, in general, will represent credits on which the bank may not be able to collect. It is only when this happens that we have true banking inflation, arising from the abnormal functioning of the bank.

To sum up: inflation begins as soon as the debts contracted by the bank exceed the amount of credits, which, at maturity, should provide enough cash to meet the bank's debts.

The law prevents the failure of the note-issuing institution by permitting a sort of moratorium which is called *irredeemability (corso forzoso)*.

There are some writers who regard the issue of Treasury bills as inflation; but this is inexact, since the purchase of Treasury bills *by the public* represents an investment of savings, which does not increase the quantity of paper money in existence.

If, on the other hand, the Treasury bills are discounted by the bank, to which they are turned over as security, for accounting purposes, against the issue of paper money, then this process, and not the Treasury bills *per se*, constitute inflation. The same may be said when the Treasury bills in the possession of the public are paid at maturity not out of budgetary resources, but by means of the issue of new money.

Finally, the excessive issue of Treasury bills may be regarded by speculators as a premonitory indication of future inflation.

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wishes, without the latter having any means of resistance or evasion.<sup>1</sup>

This billion, once it is spent and gets into circulation through successive exchanges, brings about an increase in the general level of prices, as we shall see presently.

When this happens, the issue of the billion ceases to be of any use to the State; on the contrary, it harms the State, because the old ordinary revenues have lost the purchasing power which they had previously. In fact, given the general rise in prices and given the fact that direct taxes are levied on the basis of fixed valuations and that indirect taxes on consumption are usually levied on a specific rather than on an *ad valorem* basis, the owner of land and houses and the professional man and the industrialist pay their tax debt by means of a relatively smaller part of the goods that they produce.

Taxes ought to be raised concomitantly with the increase of prices. The State, however, may prefer, and did in fact prefer during the War, to avoid provoking a reaction on the part of the taxpayers, and finds in this circumstance a further reason for having recourse to a second issue of paper money.

If, moreover, the State continues to have extraordinary needs, another and more general cause tends to lead to further issues. This is the fact that the prices of the goods needed by the State will have increased as a result of the first issue; hence the State will need more than a second billion to buy the same amount of goods that it bought with the first.

Thus it comes about that a second issue follows the first, and a third the second; paper money is printed either in successive waves or continuously, until the period of extraordinary need has passed or the source of this revenue becomes exhausted.

It should be added that the paper money is a debt on which the State does not pay interest, and with respect to which it has assumed only the obligation to restore, in its own good time, the convertibility of the paper into gold.

By means, then, of this *extraordinary* form of loan — half forced and half voluntary — the State overcomes the resistance of the

<sup>1</sup> The only exception is represented by the case of those who consume directly goods which they themselves produce and which are not intended for sale. This was the case with the Italian share-croppers (the *mezzadri*) during the War.

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consumers, counteracts the resistance of the taxpayers, and postpones to the future the definitive disposition of the debt.

To sum up: the issue of temporarily irredeemable paper money presents itself to the State for the moment as a fiscal device which is quicker and less costly than a voluntary loan would be, just as the latter was quicker and less costly in comparison with an extraordinary tax on property. From a purely fiscal point of view, it represents the path of least resistance; and on that account every State sees itself forced to follow it when the other sources of public revenue — both ordinary and extraordinary — are exhausted or are held to be exhausted.

### § 4

But if this system costs the Treasury little or nothing, it is extremely costly to the nation's economic structure.

Paper money, as has been pointed out, is a *debt* of the State; but at the same time it is *money*. Two functions are thus assigned to the same instrument. It is in following through the action of each function, without forgetting their reciprocal interactions and without confusing one with the other — as is often done — that the crux of the concrete problem and the secret of its solution lies.

If we could imagine, for a moment, that the issue of paper money entered into general circulation at one stroke, and if we were to assume, other conditions remaining the same, that the quantity of the circulating medium existing in the country and possessed by each individual were doubled, we should conclude that each individual would find himself possessed of two dollars instead of one; the static problem would resolve itself into the nominal doubling of all prices; people would count two where previously they had counted one, and economic equilibrium would not be disturbed.

The hypothesis, to be sure, is an unreal one; but all it says is that the problem begins and ends within the period intervening between the moment at which the State issues the billion in paper money and the moment at which the billion, as a result of a series of multiple exchanges, has entered and become a definitive part of the general circulation of the country. During this period, every act of exchange yields gains and losses which are due solely to the fact that paper money is being issued; and after the period is ended, the operation is liquidated, leaving behind definitive gains and losses.

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Our problem, therefore, is one of dynamics.

Let us first consider paper money in its exclusively monetary function.

The first billion of inconvertible notes translates itself, as has been pointed out, into a new demand for goods on the part of the State; the prices of these goods rise; thus, for example, there is a rise in the prices of cannon, munitions, copper, etc. Meanwhile, however, the State continues to pay the same prices as before, whenever these prices are fixed by a previous contract, as in the case of the salaries of its officials and the interest on public loans. Similarly, no advantage from the increase in paper money accrues to the producers of goods that are not needed by the State, nor to those whose prices are fixed by law.

Here we have a first series of gains and losses.

The same phenomenon, reduced in dimensions, is repeated in the case of producers of the goods which the State demands in greater quantity than before.

Let us take as an example the producers of arms and munitions. In consequence of the increase in demand and prices, they will be induced, in their turn, to increase their demand for metals and other raw materials and machinery and circulating capital and labour. Meanwhile, however, they will continue to pay the price which they had previously contracted to pay to their purveyors of raw materials and the owners of the factories they have rented and their employees and workers, whose wages do not tend to rise with the same rapidity as do the prices of arms and munitions.

Here is a second series of profits and losses.

This process is repeated as we pass from the manufacturer of arms and munitions to the producer of pig-iron and steel, and so on from one person to another until the whole series of exchanges is completed.

The depreciation of the paper money follows a straight line, from the first recipient of such money to the second, to the third, etc., until it arrives at the last recipient, who at the same moment he receives twice as high a price for the goods that he sells finds that the market-price of the goods he wishes to buy is already twice as high as it was before.

The paper money is then said to have been depreciated, — that is, has lost its former value as compared with *all* other commodities.

This happens, to be sure, only in so far as the paper money that

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has been issued is not redeemed and remains in circulation. It is only then that the issuance of paper money exercises a positive and direct influence on prices. This is specifically the case with respect to the paper money issued on account of the State; but it is not the case with respect to the issue of fiduciary notes by banks. The latter type of issue, in fact, whenever the Bank of Issue functions correctly, *follows* the movement of prices instead of determining it. Here is an example: I sell 100 barrels of wine and receive in payment for them a bill of exchange for \$500, — that is \$5 a barrel; the bank discounts the bill and issues bank-notes in an amount slightly less than \$500; when the bill becomes due, the man who buys my wine pays the bill and the \$500 return to the bank. Let us now suppose that the price of wine has doubled; the buyer gives a bill of exchange for \$1000; the bank discounts it, issuing notes in an amount slightly less than \$1000; when the bill becomes due, the bank collects the notes it previously issued. In each case, when the bill becomes due, the notes previously issued return to the bank and leave the market.<sup>1</sup>

<sup>1</sup> It is, therefore, incorrect to speak, as many recent writers do, of a 'banking inflation' as if it were theoretically necessary that such a phenomenon should develop as a concomitant of fiscal inflation and must take its place even if and to the extent that the State withdraws its notes. It is of course true, as has already been pointed out, that if the bank, under cover of fiscal inflation and the protection and encouragement of the government, and counting on the inconvertibility of all its notes, discounts bills and grants credits which it knows will not be paid at maturity, the condition in question comes to be realized in the case of the banking issue also, in so far as the bank's notes also remain in circulation and hence act on the general level of prices. It is obvious that when there is a rise in the price-level — as the result of government inflation or any other cause — the bank may be expected to discount bills in correspondingly higher amounts; but this by no means implies that it must discount bills which do not grow out of trade and which will be 'paid' at maturity by means of other bills that represent, in whole or in part, renewals of the first set of bills.

Nor is it correct to affirm that notes issued in accordance with sound banking practice influence prices at least during the period they remain in circulation, before they return to the bank, on the ground that if the price of wine in the first exchange between producer and wholesaler was doubled, this increase in price is retained in all subsequent exchanges between wholesaler and retailer and between retailer and consumer. This reasoning finds its typical application when the general rise in prices is a consequence of fiscal inflation. Under such conditions the bank is bound to grant credit in larger nominal amounts in proportion to the nominal increase in prices. But this has nothing to do with the fact that the notes arising from the fiscal inflation remain in circulation like a dead weight, whereas those of the bank enter circulation only to leave it when the bills become due.

Now, the degeneration of the banking function is not necessarily bound up with fiscal inflation; it is due, rather, to two causes:

- (a) The temptation to make large banking profits by printing notes;
- (b) The political pressure exercised by the government when the latter is in the hands of the producing groups. The bank then becomes a quasi-bureaucratic organ for the State's inflation policy.

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### § 5

Once the general rise in prices is effected, some of the gains and losses cease to exist. Thus, wages rise, adjusting themselves to the new nominal prices; old contracts are rewritten; the salaries of government employees are raised; the new purchasers of government securities will make payment in the new depreciated money, etc. etc.

But there are other cases in which the gain and the loss survive and take on a permanent character. In this respect, the class most seriously hurt is that of the savers, in so far as their capital is the fruit of saving accumulated before the currency had depreciated. Within this category the first place is occupied by creditors of the State who subscribed to 'perpetual' loans and whose capital is now reduced from 100 to a real value of 20, or 25, or 30, the interest — at, say, 5 per cent — being reduced in the same proportion.

Capitalists who lent to private individuals find themselves in a somewhat better position; for when the debt contracts become due, these capitalists will be able to share in the rise of the rate of interest which the shortage of 'real' or 'economic' savings produces on the market for private loans.<sup>1</sup>

Conversely, the debtors who have paid a debt of 100 full-value dollars with 100 depreciated dollars obtain a permanent gain.

<sup>1</sup> It has been observed that the discount rate and the rate of interest on bank loans are usually low during an inflationary boom; this results from the circumstance that the supply of paper money increases as fast as it is desired. This cannot help exerting a depressive influence also on the rate of interest for the use of 'economic saving' — that is, real saving in terms of goods — the supply of which has diminished.

If a private person who has lent 100 full-value dollars and at the maturity of the loan receives 100 depreciated dollars should again lend these dollars, he could not make up the loss he has suffered. He will therefore look for a different sort of investment, which will allow him to participate in the rise of prices.

So far as new savings are concerned, the case is rather different. The rate of loan interest on these savings also is relatively low: for example, 6 per cent. In the case of producers, however, the new savings are made out of goods the nominal price of which has risen. Let us imagine an individual who saved and continues to save a barrel of wine, the price of which, as a result of the depreciation of the paper money, has risen from \$20 to \$40. He will continue to collect 6 per cent in interest, but he now collects it on \$40 instead of on \$20; that is, on the same 'economic saving' he will collect 12 per cent.

If the depreciation of paper money still continues, however, he will find himself, at the maturity of the contract, in the same condition as the lender described in the preceding case.

Under inflation, therefore, lending operations, especially if they are made on long term, are not profitable.

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Opposed to the interests of the savers are those of the land-owning class. The price of agricultural products rises, and the value of land rises as a result.<sup>1</sup>

In the case of property consisting of houses the State has thought it desirable to prevent the raising of rentals while all other prices were rising. Thus the owners of houses have been despoiled to the advantage of their tenants.

Without pushing the detailed analysis further, we may conclude that the issue of inconvertible paper money, regarded from the standpoint of its monetary function, temporarily or permanently robs one group in order to enrich others.

### § 6

It was noted above that the price-changes, in so far as they are due merely to the fact of an increase of the monetary medium, show a relatively uniform line of development, which may also be given a statistical basis if it is possible to follow the money as it passes from the first receiver to the second, to the third, and so on.

Some such phenomenon was witnessed upon the discovery of the Californian and Australian gold-mines. The new mass of gold — which was allowed to flow to the mints and be transformed into money freely<sup>2</sup> — to the extent that it entered into circulation, brought about a rise in prices that followed certain definite directions, beginning from the mining centres and proceeding through the series of associated industries or through the series of countries which successively absorbed the new metal.

The paper money inflation which occurred during and after the World War, on the other hand, gave rise to price-changes which did not evidence any tendency toward uniformity.

The changes came about in a spasmodic way, in all directions, at an uncontrolled rate of speed, and took such contradictory forms, even over short periods, that all forecasts became impossible and

<sup>1</sup> Here, also, it is necessary to draw certain distinctions between a share-cropper and a tenant farmer, for example. The former shares the gain with the landowner; the tenant farmer, however, since his contract is often a long-term one, obtains the whole gain for himself.

<sup>2</sup> If the law, for example, denies to the public the right of free coinage, the rapid communication which previously existed between the market for gold as metal and the market for gold as money breaks down or is obstructed, and the price of a claim expressed in dollars differs from the price of the gold contained in the dollars.



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all rational explanation uncertain in the daily course of business.

The difference derives from the fact that the gold was merely *money*, whereas paper money is at one and the same time *money* and a *government obligation*. Paper money, therefore, undergoes the variations which are due to monetary inflation and also those which are due to the state of government credit, the latter depending on the confidence that some dealers have and others do not have, or that the same dealers have at one moment and lose at another, and finally on the soundness of public obligations as compared with other possible investments.

The price-changes due to the increase of money in circulation are an objective quantitative phenomenon, representing the impact of a specific quantity of money on prices; the changes due to the daily purchases and sales of government obligations, on the other hand, are a subjective phenomenon resulting from the judgments of savers, which vary from moment to moment, from place to place, from individual to individual.

### § 7

Let us pause briefly to consider paper money in its second function as a government obligation.

A person who has received a note of \$1000 in exchange for merchandise, and saves it, becomes a creditor of the State, just as a person who subscribes to or buys a \$1000 government bond becomes a creditor of the State; the person who gives the \$1000 note to the seller of the merchandise is like one who has sold on the bond market a government security of equivalent amount. For, as a matter of fact, in order to sell a \$1000 note, it is not necessary to go to the security market, nor to a broker, since in order to find a buyer it is enough to use the note as money in the purchase of any good whatever. The same result would be achieved if, for example, the law should make government securities legal tender for private and public payments.

One difference between the two obligations is that government securities bear interest and assume that the purchaser desires a relatively stable investment. The note does not bear interest, but does carry with it a promise of redemption or a reasonable expectation of redemption.

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Thus, the person who buys a government bond follows the fluctuations in its value, especially in so far as they result from the difference between the rate of interest borne by government bonds and that borne by other bonds, since it is with the income from these bonds that he is particularly concerned. A person who saves \$1000 notes concerns himself with nothing but the variations in their value over a period of time; he buys paper money, for example, when its purchasing power is 60 per cent of its original purchasing power, in order to sell it when its purchasing power, in accordance with his prediction, rises above 60 per cent; and he may also wait until the State redeems the note at 100 per cent, if he is optimistic enough to hope for such a result. The person who saves in paper money has in hand, therefore, a security which is necessarily speculative; whence it follows that the degree of confidence that he has in the credit of the State is the decisive factor so far as this category of operations is concerned.

The quantity of paper money issued is one of the many circumstances that may destroy the holder's confidence in it, if in fact he believes that the increase in the quantity removes the probability that the State is in a position to redeem it in whole or in part, within a short or a long time. It may happen, therefore, and it has happened, that inflation may increase and the general price-level of domestic commodities may rise, without depressing the foreign exchange-value of paper money; and the contrary may also happen.<sup>1</sup>

### § 8

Among the savers who invest in money there is, first, the category of hoarders, who continue to amass paper money, as they previously amassed metallic money, confident that it will remain stable in value over a period of time. The amount of paper money thus hoarded may assume considerable proportions, and during the first stage of inflation — as long as the hoarder continues to have confidence — this fact tends to counteract the effect of the increase in

<sup>1</sup> Among economists there have been extended discussions of the question whether the quantity of paper money or the confidence in it is the cause of the depreciation of paper money. According to the theory expounded above, the *quantity* is directly associated with the monetary function of the note, and *confidence* is associated with its credit function. It goes without saying that there continues to be reciprocal interaction between the two.

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the quantity of money, — an effect which depends not on the quantity issued, but on the quantity spent. Thus the quantity issued may increase, without prices increasing proportionally.

These savers run the risk — if the paper money inflation proceeds quietly — of losing the whole difference between the initial value of the paper money hoarded and the value to which it finally falls at the time it is spent.

For the avoidance of such a danger, without being forced to immobilize their savings in land and houses, the savers have few channels open, since, as we have seen, the solution of lending their money is closed to them.

Some of the savers will then throw all their monetary savings on the market, buying and selling commodities which are rapidly consumable. Others will prefer the market for securities and for foreign bills.

Those who prefer to operate in the securities market will buy securities not with a view to the income they yield, but rather with a view to the future depreciation of paper money, — that is, the higher price that the security will bring. For example, an individual uses 100,000 to acquire industrial shares at 1000; the price per share rises from 1000 to 1200; when he thinks that the rise has reached its limit, he sells and collects 1200. He repeats the operation with other securities which, in his opinion, are bound to rise in price; he buys at 1200 and sells at 1400, and so on. His original saving of 1000 has increased to 1200, to 1400, etc., following exactly the successive inflations of paper money.

Thus it comes about that the formal and apparent negotiation of securities is merely the technical process whereby money is effectively negotiated on its own account as a government obligation which does not bear interest and whose value must be protected.

This becomes more obvious in foreign bills of exchange, in which the Italian saver, say, buys dollars and sells lire, if on the other side there is someone who buys lire and sells dollars. The hoarders, along with others, as soon as they sense danger, buy bills of exchange drawn in dollars and hoard dollars instead of lire. They try to invest their savings in dollars. They are not importers, and do not need dollars to pay for merchandise, since they have imported none from America. Side by side with the trade in bills which arises from the international exchange of merchandise and serves to settle

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international payments — in which money is merely the medium of payment — there takes form and develops an autonomous trade in foreign bills which serves to bring about a direct exchange between dollars and lire as if they were goods in their own right — that is, credit obligations. Hence it may happen that the demand for dollars increases as compared with the demand for lire, and vice versa; and as a consequence the exchange value of the lira, or the value of the paper lira, will fall or rise without there being any increase or diminution in the amount of paper money issued, or any modification in the relationship between imports and exports.

To sum up: the operations just discussed are based on a forecast of growing inflation; but they rest on a belief that the State will pay its debt.

### § 9

As inflation progresses, there will come a point at which confidence is shaken and lost. This is the beginning of a salutary liquidation; in order to salvage what it is still possible to salvage of one's savings, all holders of paper money hasten to get rid of it. This is the salient characteristic of the new situation;<sup>1</sup> but we have not

<sup>1</sup> It has become the prevalent opinion among writers on monetary matters that this general tendency to get rid of paper money increases its 'velocity of circulation'.

This proposition is not exact; or at least it needs several qualifications. The quantity theory assumes: (a) that there is a given quantity of money; (b) that it is in circulation; and (c) that it circulates at a given velocity with reference to a given unit of time.

Velocity increases whenever, assuming that the volume of trade remains the same, this trade is taken care of by a smaller quantity of circulating medium, and vice versa; this comes about to the extent that the system of payment by means of credit-instruments becomes perfected. In the case we are now discussing, however, what happens is that in order to get rid as quickly as possible of the money which is rushing toward precipitous depreciation from day to day and even — as happened in Germany — from hour to hour, the owner hastens to complete in a shorter period of time the exchanges that he used to make over a longer period; thus the worker who has collected his wages hastens to buy provisions for the whole week on the first day of the week, whereas he used to buy them every two or three days. There is, as a result of this, no change either in the total volume of purchases or in the quantity of the circulating medium; there is only a different distribution within a given unit of time, inasmuch as three days of intensive exchange are now followed by three days of less frequent exchange; as a whole, however, the unit of time assumed in the problem has not changed. Everyone competes with everyone else to see who will be the one who runs fastest to rid himself of the paper money: the velocity with which the owners of paper money move their legs is not to be confused with the velocity with which money circulates!

On the other hand, there is an increase in the *quantity* of money in *circulation*, since no one any longer keeps the stock of money which he used to keep with him for his daily purchases. The sum of these small amounts may assume considerable dimensions, and will have the tendency to raise prices.

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said that all this happens at one step. The movement begins with the most far-sighted; it then spreads; and in the end it infects everybody, so that all are dragged along in the same stream.

The crisis presents the characteristics of a gigantic crisis of the securities market; that is, it represents the complete collapse of a government obligation which—because it also performs the functions of money—has unlimited and very rapid repercussions on the whole economic structure of the country.

Summing up: two causes of a permanent character combine to make the value of the paper money varying and uncertain from day to day. First, the quantity, increasing in periodic waves, acts automatically on partial price-levels and then on the general price-level in the direction of a rise of prices; this effect would be present even if the 'quantity of money' had reference to the quantity of gold money instead of inconvertible paper money. Secondly, varying degrees of confidence or lack of confidence in the future convertibility of the notes, in whole or in part, is evidenced by those who buy and sell the paper money as they would any government obligation.<sup>1</sup>

### § 10

The price-changes which are due exclusively to money, when all the other conditions remain equal, create—as we have seen—gains and losses which mutually compensate one another. From this has arisen the opinion that the community, taken as a whole, neither gains nor loses.

On the contrary: the major damage is precisely that which the community suffers, inasmuch as the absolute lack of all stability

<sup>1</sup> Anyone who would wish to explain the concrete phenomena as they were exemplified during and after the War would have to take account, in each separate country, of all the other numerous circumstances which have been created by acts of legislative intervention, and which, therefore, have a temporary character. It is easy to determine the direction in which each act of intervention operates, either strengthening or counteracting the action of well-known general principles; but the sum total of all these acts of intervention, in spite of many attempts, does not provide, and has not provided, an inductive basis for the discovery of new uniformities and new economic laws.

To these contingent factors of a legislative and political nature must be added all the other innumerable factors of an economic character which influence the prices now of one group and now of another group of commodities. The effects of this type of factor have erroneously been put in causal relationship with the fluctuations in the monetary circulation, or confused with these fluctuations, with the result that hasty and inexact criticisms and corrections have been applied to principles which are well known and solidly established by theoretical economics.

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in the value of money upsets the basis on which the structure of exchanges rests,—that is, the whole economic life of modern countries.

'Inflation through successive waves of inconvertible paper money destroys money'; in this is summed up the social damage, which is incalculable. To obtain some notion of its significance, it is necessary to go back to the history and function of money and all the improvements which have been devised therein throughout the centuries in order to make money a unit of value possessing increasing relative stability.

An indication of the seriousness of the social damage is to be found in the fact that, in the end, the public actually repudiates the paper money and begins economic life *ex novo* by returning to barter, or by making exchanges by gold weight, or by substituting a foreign currency.

Once it abandons the naïve idea of punishing private citizens who repudiate paper money, the State adjusts itself to the real conditions of the market by *absolutely stopping all further issues of paper money*.

This is the first step — of a *negative*, but fundamental nature — toward the clearing up of the monetary situation. But in order to provide a real guarantee that the government will not return to the issue of paper money for the sake of 'balancing' the State budget, it is necessary that balancing of the budget be achieved soundly by means of an increase in ordinary revenues.<sup>1</sup>

Hereafter the State must face two *positive* problems, which are connected with the two functions of paper money: (1) it must restore to the country a currency based on gold; and (2) it must pay its debt.

In pure theory, if the State pays its debt, it also solves, by implication, the problem of sound money, because it restores the convertibility of its notes. Hence the problem has a primarily financial character.

<sup>1</sup> This is the only relationship that exists between monetary policy and financial policy, whenever the State, in order to 'balance its budget', had in fact had recourse over a series of preceding years to the issue of paper money, instead of to an increase of taxes.

In pure theory, however, not even this connection between the two policies is a necessary one. This is demonstrated by the fact that there are countries with budgetary deficits which have gold money in circulation. In Italy, on the other hand, an opinion has been allowed to become widespread to the effect that a balanced budget would automatically have been the touchstone for solving the monetary and the economic problems.

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In order to pay its debt the State ought to have recourse to an extraordinary tax on property; still better, to the flotation of one or more ordinary loans; or to an increase in annual taxes, which would serve either to carry the interest charges on State loans or gradually to pay the principal of the State debt.

The repayment is accomplished automatically by destroying as many convertible notes as are collected through the taxes levied for the purpose, or through the proceeds of one or more ordinary loans. Hence gold is not used, and need not be used. Nor need the reserve of the Bank of Issue be reduced; this would be necessary only if the Bank had to *redeem* in gold all the irredeemable notes in circulation!

Far from substituting for the paper inflation a gold inflation — which, for that matter, would be eliminated from the internal market through the necessity for paying for the consequent increase in merchandise imports — the problem consists of '*reducing the quantity*' of the paper circulating medium.

In fact, if the convertibility of the notes which are at present inconvertible is to be resumed, it is axiomatic that their quantity must be reduced, in conformity with a well-known economic law that regulates the distribution among trading nations of the gold money *existing in fact in the world*.<sup>1</sup>

This new policy is initiated at the moment when the State budget goes beyond the period of budgetary equilibrium and enters the period of budgetary surplus, since the surplus represents the annual sum to be devoted either to the gradual repayment of the debt or to the payment of the interest on a loan designed to bring about more rapid retirement of the paper money.<sup>2</sup>

<sup>1</sup> The repayment of paper lire in full-value gold lire, or of paper marks in full-value gold-marks, etc., would presuppose the existence in the world of a gold supply of fantastic proportions. And even if such a gold supply did exist, it would be anti-economic to give it a purely monetary use.

<sup>2</sup> The consideration that paper money, under conditions of inflation, is also a government obligation of the State is of great importance in theory. For it explains, in and of itself (though other contributing circumstances may be present), some divergences that have been repeatedly observed as between internal and external prices.

That every permanent fall in internal prices reacts on the foreign exchanges in the direction of raising the foreign-exchange value of the domestic currency is an obvious truth; but the converse of this proposition has not been demonstrated. Now it has been alleged to be a fact that the fall in internal prices has come about not as a result of the reduction of the paper circulation but as a result of the improvement in the rate of foreign exchange.

Even if we admit that the rate of foreign exchange may improve without a decrease in the quantity of paper money in circulation, no one has as yet explained to us how

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The process of deflation is automatically arrested when the quantity of paper money in circulation again functions in fact as bank-notes, convertible into gold. It is not necessary that the limit be fixed by law in advance.<sup>1</sup>

Only in this way is the double problem of money and the State debt resolved in its entirety. But the solution of the financial problem meets obstacles in the more complex problem of concrete reality.

<sup>1</sup> As a rule, the limit is fixed by law; but such a provision represents an expedient for protection against possible dangers arising out of the policy of the Bank. Similarly, when one speaks of complete revaluation of a depreciated currency, one does not imply that the amount of bank-notes in circulation must return to the limit which prevailed during the pre-war period; for the true limit is a function of the volume of internal trade, which may have increased in the meantime. It is from this circumstance, indeed, that some writers derive the opinion that monetary reconstruction will come about by itself, gradually, in proportion as the development of internal trade requires an increasingly large note circulation. This might happen in countries in which the issue of paper money was relatively moderate; but such hopes would not be likely to be completely realized in practice in those countries in which the paper circulation has become five or ten times as large as the pre-war circulation.

And it is also necessary to bear in mind that if, on the one hand, the volume of internal trade increases, on the other hand methods of payment are being perfected which tend to reduce the monetary use of gold.

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the foreign exchange influences internal prices. Some say that as the exchange improves imports increase, with a resulting increase in the volume of internal trade, which leads to an increase in the value of the paper money in existence. But such people do not notice that if imports increase, exports will also have to increase. At best, the reaction involved is temporary and of small importance.

If we follow the theory developed above, the phenomenon is to be explained differently.

First of all, we must imagine a government that follows the policy of complete revaluation. At the moment when a substantial budgetary surplus is achieved, the possessors of paper money foresee that the government obligation which they hold will rise in value. They therefore sell foreign currency and buy their own currency; others hold on to such amounts of the domestic currency as they are able to save. The domestic currency used in this way is withdrawn from circulation as money, and there is a reduction in the quantity of *circulating* money, which appreciates in value.

If the forecast is not justified by the event, people will again sell domestic currency in order to repurchase foreign currency, and the notes that were being hoarded will be thrown back into circulation. We come back to the point from which we started: that is, the raising or lowering of internal prices resolves itself into a temporary phenomenon. In order that the forecast may continue in the same direction, the forecast of the so-called speculators must be a correct one: that is, there must be an actual reduction in the amount of notes in circulation. This is always the basic presupposition for the partial or total revaluation of paper money.

Those, on the other hand, who hold that such revaluation depends on the course of the foreign exchanges would have to show that, *ceteris paribus* — that is, on the assumption that the volume of internal trade has not increased — it has in fact happened that irredeemable paper money has been definitively revalued without a reduction in its quantity.



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### § 11

If we wish, first of all, to obtain a notion of the quantitative importance which the paper money debt has relatively to the other public debts, we should not compare it with the total of these other debts, in comparison with which it might be and usually is a small matter. Thus, if a State already owed 70 billion in ordinary debts and 10 in paper money, the question of increasing the former to 80 in order to extinguish the latter would not be of great importance and would not be difficult to solve. The problem really lies, however, in the relation between the 10 billion of inconvertible paper and the  $2\frac{1}{2}$  or 3 billion of convertible notes which would be sufficient for the needs of circulation. This relation of 10:3 gives the measure of the effect that the quantity of paper money has on the general level of prices, and gives a more exact idea of the difficulty of the problem.

Broadly speaking, the process of deflation brings about phenomena inverse to those examined during the process of inflation; that is, the average level of prices tends to fall, but the partial price-levels — that is, the prices of the various groups of commodities — do not fall uniformly, so that there are phenomena of gain and of loss in a direction contrary to those observed during the process of inflation.

Consequently, until the new general equilibrium of gold prices is reached, it is inevitable that there should be a new period of disturbances of the equilibrium that had been achieved when the inflation ended and as a result of its ending — an equilibrium to which everybody had by that time adjusted himself.

It seems, therefore, more advantageous to be content with a compromise solution, which consists of fixing (that is, *stabilizing*) the gold value of paper money at the level, or somewhat above the level, to which the process of inflation had made it fall. In any case, the difficulty stated above has been regarded as the chief reason why several States stopped in their progress toward complete revaluation and adopted the system of stabilization, — that is, of partial revaluation.<sup>1</sup>

Once the money is stabilized, the *monetary problem* is solved, since

<sup>1</sup> In fact, Belgium, Italy, and France at first declared that they favoured the complete revaluation of their money. Later they contented themselves with stabilizing it at different levels.

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it is a matter of indifference whether the standard coin is equal to 15 per cent or 25 per cent or 50 per cent or 100 per cent of the former gold coin, provided that a new *monetary unit*, specified by law, is adopted, and provided that the note-holders may exchange their notes freely at the bank-window for their equivalent in gold. This condition represents the necessary minimum.<sup>1</sup>

### § 12

But stabilization does not solve the problem of the State debt; on the contrary, it represents partial or even total repudiation of the original debt.<sup>2</sup> For this reason, the phenomenon demands, from the point of view of Public Finance, a further brief examination.

The issue of paper money has been compared not only to a sort of fee or tax on transfers,<sup>3</sup> but also to an extraordinary tax on property. Thereby paper money would lose its formal character of a debt and the State would no longer be obligated to pay it.

Now, the issue of paper money is not the same thing as an extraordinary tax on property. We established the differences between the two, in the course of our earlier argument. It is true, however, that the State may have recourse to an extraordinary tax on property equal in amount to the debt represented by the paper money and may set one off against the other. Let us suppose that the paper-money debt amounts to 10 billion. The 10 billion which the State owes to the community and the 10 billion which the community would have to pay in taxes offset each other — that is, become a credit and debit, respectively; hence it would be economically advantageous not to cause useless disturbances of the equilibrium already achieved, but to leave things as they are.

Now, this reasoning is obvious with respect to the relationship between the State and community taken as a whole; but it does not

<sup>1</sup> We cannot enter here into details; but it should be noted that if the bank is obliged to convert only when the bearer shows that he is using the gold and gold-exchange to make payments abroad, or when legal provisions make it difficult in practice for the note-holder to have access to the redemption office, or insist that the right to exchange notes for gold be limited to fairly large sums, etc., we have a case of *limping stabilization*.

<sup>2</sup> The repudiation is partial if the stabilization is made at a gold value *higher* than that which would correspond to the degree of depreciation attained by the paper money; it is total if the currency is stabilized at exactly the gold value registered by the currency in the market.

<sup>3</sup> See Book V, chap. II, § 2 n.

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help to solve the fiscal problem, which is a problem of distribution among the various groups of taxpayers.

The tax on property — that is, on the *value* of the property — is not the same thing as a tax on the *quantity* of paper money which each citizen happens to possess. If the latter bore the same relationship to the value of the property owned by each citizen, we could say that stabilization is a means for levying a tax on property which would be perfectly or sufficiently equitable; for, under such circumstances, the so-called credit and debit as between the State and the community would become also a credit and debit as between the State and each individual taxpayer; this would just solve the fiscal problem of distribution.

But such an assumption is unreal, even if the paper money served only as a medium of exchange; since the quantity of money necessary for the conduct of business varies from one business to another. It is all the more unreal whenever paper money functions as a government obligation, or as a means of saving, because not all save, nor do all save to the same extent. The result is entirely to the disadvantage of the group of savers who deal in money and have almost the whole of their property in paper money.

Even this theory, therefore, does not eliminate and does not attenuate the pledge assumed by the State to withdraw the paper money.

We are dealing with matters of credit, in which the observance of the contract is the element that represents the greater and permanent interest of the individual, and, *a fortiori*, of the State. In the field of private economics, in fact, a person who does not pay his debts may really find it impossible to pay them because he has not produced the values which he hoped for and which induced him to contract a loan; in the case of a collective public economy, however, which includes creditors and debtors, the failure to pay means leaving definitively to the debtors wealth that belongs to the creditors. The passage of such wealth from one group to the other, therefore, in conformity with the contract, is a 'problem of distribution'.

### § 13

Undoubtedly, a change in distribution reflects itself in a change in production. It is, in fact, asserted that inflation stimulates production and exports, since the entrepreneur bases his action on the

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expectation of a continuous rise in prices. This depends, above all, on the circumstance that wages do not rise contemporaneously with the rise in the prices of the goods produced; hence the premium on production and export is taken from the wages of the workers. But if the latter were organized in such a way as to obtain an increase in wages sufficient to discount the future depreciation of paper money, the so-called encouragement to production would disappear or would be negligible.<sup>1</sup>

In the second place, inflation encourages the creation and the anti-economic development of marginal enterprises which rest on the easy and uncritical issue of paper credit — that is, on the exploitation of the labouring masses.

For similar reasons, with the positions reversed, it is asserted that deflation discourages production, because as prices fall, the profit of the entrepreneur decreases, since expenses of production and, above all, wages do not fall with the same rapidity; and also because the contraction of bank-credit hastens the collapse of marginal enterprises with the result that unemployment ensues.<sup>2</sup>

From this has arisen the opinion that the crisis which is due to deflation is more damaging to a country than the disturbances due to inflation and that it is therefore best, on the whole, to follow the policy of stabilization and not of revaluation.

Here also it must be noted that if profits and wages were lowered simultaneously during the transitional period — which in any case is necessary in order to pass from a system of paper money prices to a system of gold money prices — the so-called discouragement to production would not exist, or would be negligible.

<sup>1</sup> This is precisely what happened in Germany after the inflation was considerably advanced, when the workers and capitalists, educated to the danger they were running, obtained an actual increase in wages and interest as an insurance premium against further inflation.

<sup>2</sup> The phenomenon of unemployment must be regarded here as an indication of the absolute lowering of the total mass of wages — a lowering that may be expected as a consequence of industrial crisis, but which is concentrated in the unemployment of comparatively few, instead of being spread, in the form of slight reductions, over the wages of all.

This is the result of other causes, among which should be included (a) the fact that the trade unions in the various industries have become closed organizations which no longer permit competition by outsiders; and (b) the fact that trade unions oppose the reduction of wages on *a priori* grounds. Subsidies to the unemployed strengthen the resistance of these organizations and hence increase unemployment and induce the employers more than ever to find more economical forms of business organization by reducing the number of less efficient workers in order that high wages may continue to be paid to the more capable.

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The problem would then be reduced to this: to proceed in such a way that while nominal profits are falling, wages do not resist. It would be a problem of secondary importance.

On the other hand, the fundamental error of the theory under examination lies in attributing to the monetary phenomenon of deflation the phenomena of a crisis which is the necessary consequence of very much more profound and remote economic causes. If, for the moment, we abstract from the influence of money, profound economic causes of the crisis, or, better, of the general depression of the post-war period, are to be found in the destruction of wealth brought about by the long war, the resulting reduction of consumption and saving, the necessity, faced by the colossal war industries, of demobilizing themselves, and the high cost of the capital which they required in order to transform themselves into peace industries, without even having certain knowledge of the new demand curves for their products, which could not coincide with those of the pre-war period.

Similarly, another and greater cause of the depression is to be found in tariff policy, the intensification of which in the direction of protection, besides increasing the general poverty of the various countries, has made it necessary for all exporting industries to find a new, more expensive, and less profitable equilibrium in the internal market.

It was not difficult to foresee that this tremendous task of industrial reconstruction would have increased the costs of plant and equipment, while, given the increased poverty of the country, the prospect was for lower prices. The severity of the depression is thus seen to be due to causes of an economic rather than a monetary character.

Undoubtedly, monetary policy, involving, as it did, inflation on the upswing and deflation on the downswing, aggravated the situation, since the high and rising prices gave an illusion of prosperity and hid the real economic condition of the country.

But inflation could not go on *ad infinitum*. It was inevitable that at a given moment it would be stopped; and when that day came, with the fall in prices that it brought with it, it marked and intensified the outbreak of the crisis.

If this point, which is fundamental, is admitted, then deflation, when it begins, is to be regarded as the next step which follows, without interruption, upon the stopping of inflation.

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Now, the effects of the crisis may be attenuated by deflating slowly — that is, by lengthening the period which is necessary for the achievement of the new equilibrium of gold prices. In this way, the gradual fall of prices—in so far as it is due to deflation—can be kept within the limits of those normal fluctuations for which every entrepreneur must be prepared.

The policy of slow deflation, however, is to be contrasted with a policy of rapid deflation, which has the advantage of accelerating the liquidation of the crisis through the disappearance of ailing industries. This is a benefit for the general economic structure, the recovery of which it hastens. Moreover, it has the specific effect of provoking a contraction of the demand for labour — that is, of leading to the reduction of wages, thus making it easier for those enterprises which are sound to overcome the crisis.

### § 14

Between these two extremes there is the problem of deflationary policy in the concrete case. Such policy may be carried out with more or less speed, according to a whole set of factual circumstances, which vary, necessarily, from country to country, and whose absolute and relative evaluation goes beyond the competence of pure economic theory.

Speaking generally, it may be said, in the first place, that the plan for revaluation adopted must be public and that it must be put into execution some time — for example, a year — after its approval, so that (*a*) no one is taken by surprise and all the agents of production are prepared for a nominal and temporary reduction of their remuneration in view of the increasing purchasing power of money; (*b*) some entrepreneurs may be able to adapt their conditions of supply to decreasing prices in the future; and (*c*) that the deflation should not affect current contracts in process of execution.

In the second place, the execution of the plan for revaluation becomes one of the tasks of the bank of issue, above all in countries where the paper circulation consists both of issues made for the account of the State and of those made for the account of trade, but which, as a matter of form, all represent a debt of the bank.

Thus it is that the monetary and financial problem is necessarily interconnected with a banking problem.

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If the bank has advanced strictly commercial credit on its own account, all of its notes which remain in circulation after those representing the State debt have been withdrawn automatically become convertible again. But if in fact — as has happened — the Bank, on its own initiative or as the result of State pressure, issues paper money for the salvaging of shaky and moribund industries, or has abused the provision of irredeemability in its own private interest, or has been lavish in granting credit to the manufacturers of arms and munitions in order to expand production to the maximum and without regard to any strict economic criterion, then the so-called commercial circulation is, in fact, inconvertible — that is, it represents a real case of 'banking inflation' very similar to that of government inflation. It may, however, be regarded as representing in large part an indirect fiscal inflation.

Hence the bank of issue also must adopt, in accord and in co-operation with the State, a deflationary policy with respect to the so-called commercial circulation. The two policies, however, always present notable differences.

The State, in fact, in order to pay its debt, must obtain from taxes or loans the quantity of notes with which it proposes to pay the debt that it has contracted directly or indirectly with the bank; credit and debit offset each other when the notes are physically destroyed. The State must proceed *automatically*, devoting to this purpose a fixed sum annually — for example, 100 or 500 or 1000 million a year.

This fixed sum reduces the circulation at a uniform and slightly progressive rate; for if, for example, 500 million a year is 5 per cent of the annual circulation of 10 billion, the next year it goes up to 5·26 per cent of the residual circulation, the following year to 5·55 per cent, and then to 5·88 per cent, and so on. Thus the effect of the deflationary process on the general level of prices is small in the beginning; subsequently, however, it becomes increasingly intensified, and it is helped along also by the speculation which is bound to proceed upon the assumption that the value of the paper money will increase.

It is not so in the case of the bank. The reduction in the amount of its circulation may be effected according as and to the extent that its notes come back to the bank in payment of discounted bills, or in payment of whatever form of credit was granted. Only at a second

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stage will it be able to contract its circulation, by reducing the amount of credit which it grants to trade in the future.

If the bank, as we have suggested, has granted credit which is not destined — either as the result of a tacit understanding, or by express agreement — to be extinguished at maturity, but is merely written off and renewed, the return of the notes also becomes slower and banking deflation requires a longer period of time, which is determinable *a priori* only with difficulty.<sup>1</sup>

### § 15

In addition, it must be noted that it would hardly be wise banking policy to reduce the granting of new credits automatically, by a rigid quantity per annum and by an equal amount for all customers.

The bank, which is in a position to recognize and follow the evolution of the industrial crisis, is the organ best suited to discriminate between businesses that can be rehabilitated if they are not deprived of credit and the weak businesses that have been kept alive artificially by inflation, to which credit should be refused in order that their failure may be hastened. It is the bank that must choose the most convenient moment for restricting credit and thereby contract, *as a whole*, the quantity of notes in circulation.

Moreover, it is not impossible that the bank may at times attenuate the rigorous effects of State deflation by taking over part of the State circulation.<sup>2</sup> In short: several of the consequences feared from a rigorous deflation may be attenuated by banking policy during the transitional period which is necessary before the complete revaluation of paper money can be achieved.

During this period, the bank must be sufficiently free from pressure in its distribution of credit; and it must not be subjected to influences of a political character. It is for the State to control banking policy, in order that it may prevent its plan for revaluation from being completely frustrated.

The task of the State itself, on the other hand, is to adopt, during the transitional period, a rigorous policy of economy; since it is

<sup>1</sup> The plans for revaluation usually fix this period and impose it on the bank; but this provision is an empirical and, in most cases, an illusory one.

<sup>2</sup> This does not imply agreement with the theory — which we have already refuted — of those who hold that if the State reduces its circulation, the bank of issue takes its place, as if this substitution were a theoretical necessity or a right of the bank.



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hardly probable that the taxpayers will be able to bear the burden occasioned by the old taxes, which increases automatically with the revaluation of paper money, and to pay, in addition, new taxes designed to support a prodigal policy of public expenditures.

Thus we have, at such times, another necessary connection between the policy of monetary reconstruction and fiscal policy.

To sum up: the influence that a deflationary policy exercises on production is far from having the importance that people have wished to attribute to it. It remains a secondary accompanying factor, wholly inadequate to explain the policy of stabilization which has prevailed.

### § 16

On the contrary, one result of the circumstance that the public cannot be unaware of deflation — in contrast with its attitude during the process of inflation — is that the mere announcement of a deflationary policy is enough to bring into action all the forces of friction — that is, to provoke the immediate resistance of all those whose interests are opposed to such a policy.

It is here that we find an adequate explanation of the difficulty of carrying through a deflationary policy.

The banks of issue that have misused their credit for their own benefit by discounting bills of exchange not destined to be paid at maturity no longer possess the assets which are necessary in order to be able to meet their demand obligations to the holders of paper money; hence they oppose a deflation that brings with it a return to convertibility of the notes.

The ordinary commercial banks are opposed, because they would not find it so easy to rediscount as they used to find it; and their customers are opposed because they would find it more difficult to discount their bills; entrepreneurs are opposed, because they wish to avoid friction with their workers; the labouring class is opposed, because it is unwilling to accept a present reduction of wages in anticipation of a future increase in the purchasing power of money; State functionaries are opposed for the same reasons; the taxpayers are opposed because they are exposed to the danger of having to pay their high taxes in money which continues to appreciate. Their demands are willingly granted by a government which will not resign itself to the necessity for reducing public expenditures.

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We have here a spontaneous coalition of interests which isolates and leaves undefended the group made up of those whose preponderant interest lies in the fact that they are creditors of the State; and this explains why the policy of stabilization has prevailed in those countries in which monetary policy is dominated by the groups whose interests are best served by such a policy.

### § 17

Whatever the monetary policy adopted by the State as a means of disposing of the loan which is contracted in the form of paper money, it is reflected in all other existing public debts. For, if the paper money is completely revalued, the original value is, to be sure, restored to the old creditors who had subscribed to public loans in gold money; but a premium is accorded to the subscribers of those loans which were floated during the period of depreciated paper money. If, on the other hand, the lira, for example, is stabilized at 30 gold *centesimi* instead of 100, the financial burden represented by all ordinary debts which were contracted when the lira was worth more than 30 gold *centesimi* is lightened — that is, less is paid in real interest and in real capital than was received by the borrower — in this case, the State. Similarly, so far as those loans which were contracted when the lira was worth 20 gold *centesimi* are concerned, the State budget is burdened by a sum greater than that which was received.

Now, if the dates of issue of all State contracts, the amounts involved in such contracts, and the value of the money in which they were contracted are known, it is easy to put these contracts on a comparable basis by reducing all of them to a given gold value.

For example: let us suppose that before the War a loan subscribed in full-value gold money amounted to 16 billion; that during and after the War three other loans of 16 billion each were successively contracted; but that the first was contracted when money was depreciated 25 per cent, the second when it was depreciated 50 per cent, and the third when it was depreciated 75 per cent.

Altogether we have a nominal debt of 64 billion, involving, at 5 per cent, a nominal interest burden of 3,200,000,000.

If the State, in returning to a currency which has been completely revalued, would have to pay this 3200 million in gold, instead

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of in depreciated money, we should have an increase in the budget which would be very considerable and by no means justified.

On the other hand, if we preserve the gold value of the old loan of 16 billion, the second 16, translated into gold, are equivalent to 12 billion, the third to 8 billion, and the fourth to 4. Altogether, there are 40 billion, with an interest burden, at 5 per cent, of 2 billion in gold.

The increase in the budgetary burden, therefore, is not represented by the difference between 3200 million in paper and 3200 million in gold, but by the difference between 3200 million in paper and 2000 million in gold.

If we take, as an example, a lira stabilized at a gold value of 32 *centesimi*, the 3200 million would be worth  $3200 \times 32 = 1024$  billion; hence the increase in the budgetary burden, as a result of the revaluation in the example given, would be 976 million in gold.

It should be added that the real fiscal burden which is represented by the higher taxes would not be measured by the whole 976 million, since it would be necessary to take into account and deduct the direct compensations which many, perhaps very many, taxpayers would find in their own budgets.

In fact, if we imagine a patrimony composed of land and government securities, the greater tax levied on the income from land would find an immediate compensation in the greater purchasing power of the interest paid by the State; and to the diminution of the capital-value of the immobile property would correspond the increase in the price of the government securities.

If, in addition, the tax were general, so that it fell also on interest on the public debt, the tax-rate levied on all incomes would be lower; and within the budget of the owners of government securities the new tax would find an immediate compensation in the greater purchasing power of the interest paid by the State.

One should not lose sight of the fact that the operation just described aims only to distribute the fiscal burden with the greatest possible degree of equality between those citizens who are creditors of the State by virtue of the fact that they lent money to the State, and the citizens who are debtors of the State by virtue of the fact that they owe taxes; but financial policy may have other aims besides this one.

In fact, the choice between revaluation and stabilization represents a complex problem which has elements of both an economic

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and a political character. Many arguments are adduced in *defence* of one policy or the other. But theory does not provide arguments in defence of either of the two; it merely analyses and explains. Now, the analysis of the opposed forces allows us to explain the final result, which has been different in different countries, and to arrive at the following conclusion: namely, that in the countries in which it has been possible to revalue depreciated currency, the State has completely honoured its pledges and has distributed the tax-burden equally among all the taxpayers; and that in the countries in which it has seemed convenient or necessary to stop at stabilization, the State has not fulfilled its pledges, and has made permanent, for the benefit of those groups whose political influence preponderates, the inequalities brought about by inflation.

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<sup>1</sup> Prepared by Luigi Einaudi.

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4. *La funzione della banca (The Function of Banks)*. Reprinted from *Rendiconti della R. Accademia dei Lincei, Classe di scienze morali*, vol. VII, No. 1. Rome, 1898. Pp. 36.

Theory of the bank as an organization distinct from credit institutions.

5. *Scienza delle finanze (Science of Finance)*. Lectures, reported by V. Lionelli and summarized under the direction of A. de Viti de Marco. Rome, Manuzio, 1923. Pp. 285.

This is the first printed edition of the lectures given by De Viti at the University of Rome. It was prefaced by the following note 'To the reader', dated January 1, 1923:

'After some hesitation and solely in order to add to the effectiveness of instruction, I have been led to publish this broad summary of my lectures as they were carefully reported by Signor Leonelli.

'It is a "summary", because I have left out everything which, in the form of elaboration, examples, and references to general economics, makes a more or less extended part of oral lectures.

'This summary includes, however, those theories which are already to be found in the mimeographed report of the lectures I gave at the University of Pavia (1886-87) and which have been elaborated and completed from that time up to the present.

'It is only the theory of shifting that has undergone a radical change; and this change dates from between 1910 and 1912.

'Nevertheless, I do not mean to say that the present publication represents my final scientific formulation.

'In making these references to my earlier pedagogical labours, I wish to thank those of my colleagues who have paid me the signal honour of taking account, in their valuable writings, of my mimeographed lectures, whether or not they mentioned their existence.'

6. *I primi principii dell'economia finanziaria (First Principles of Public Finance)*. Rome, Sampaolesi, 1928. Pp. 400.

Third printed edition of the university course, on which the German translation of 1932 was based. It was prefaced by the following Note, dated December 1, 1927, at Rome:

'The reader will find in this third edition neither references to other authors nor the usual expository account of their doctrines, along with the victorious confutation of these doctrines in the usual academic manner. This is a method that I have abandoned com-

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pletely because the authors, dead or living, whose theories would thus be expounded and interpreted and refuted are not present to defend themselves.

'The absence of citations does not mean, however, that I aspire to originality and that I owe nothing or little to those who have preceded me.

'To them I owe everything; but I could not to-day establish with precision just what I owe to whom, since this book is, above all, an *independent* elaboration — as it matured under the continuous stimulus of teaching — of the theories and opinions of the greatest economists. These theories and opinions are in fact to a large extent well known, and constitute the scientific heritage of all scholars.

'I have, moreover, avoided useless polemics with those with whom I disagree, since, in accordance with the general set of ideas which I laid down in 1886-87 — in my *Il carattere teorico dell'economia finanziaria* — I have proposed to undertake a *positive* exposition of the theories of Public Finance which, starting from the premises of that earlier publication, arrive at the logical conclusion by virtue of their own content.

'Whether this publication is, because of its organic conception of the subject or because of some particular characteristic of its own, a contribution, however small it may be, to the progress of the theory of Public Finance — and this is the author's hope — only competent critics can say.'

7. *Un trentennio di lotte politiche (Thirty Years of Political Struggle)*. Rome, *Collezione Meridionale*, 1930. Pp. xxii, 480.

This is a collection of twenty essays, articles, and speeches by De Viti, representing the history of the political thought and practical action of De Viti and the group of which he could, from 1894 to 1922, be considered the leader. A suggestive preface clarifies the position that De Viti took against privileged groups or those desirous of privilege before, during, and after the War. The essays end with 1922, when, with the advent of Fascism, the liberal group of De Viti was dissolved. An accurate 'historical note' by Umberto Zanotti-Bianco, editor of the series in which the volume appeared, tells of the vicissitudes of the anti-protectionist movement in Italy, and an appendix by Ernesto Rossi recounts the vicissitudes of the tariff question after the War and the more recent intensification of protectionism.

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8. *Finanza straordinaria*. Appendix to *I primi principii dell'economia finanziaria*. Rome, Sampaolesi, 1932. P. 66.

Contains Book V of the *Principii* (No. 6, above), and has been incorporated with the rest of the work.

9. *Grundlehren der Finanzwirtschaft*. Tübingen, J. C. B. Mohr (Paul Siebeck), 1932. Pp. xxviii, 334.

This is the German translation of *I primi principii* and *Finanza straordinaria*. The volume bears the following dedication: 'I dedicate this volume to those students of the University of Rome who, succeeding each other during my forty years of teaching, have been my most effective collaborators.' There is a preface by Oskar Morgenstern, a preface by the Author, in which he thanks Luigi Cardelli and Ernesto Rossi for their help in revising the volume, and an introduction, with bibliography, by Luigi Einaudi.

10. *Principii di economia finanziaria (Principles of Public Finance)*. Turin, Giulio Einaudi, 1934. Pp. xxxii, 425. The 'definitive' edition, with an introduction by Luigi Einaudi. The present translation is based upon this edition.

11. *Die Funktion der Bank*. Vienna, Julius Springer, 1935. A translation of No. 4, above.



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