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Public Finance
in Relation to Commerce

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PREFATORY NOTE

In 1903 the late Mr. Joseph Fisher paid the sum of £1,000 to the University of Adelaide for the purpose of promoting, with the income thereof, the study of commerce at the University.

The "Joseph Fisher Lecture in Commerce" was founded as one result of this endowment.

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The present lecture, which is the thirteenth of the series, was delivered by Professor R. C. Mills, LL.M., D.Sc. (Econ.), Professor of Economics in the University of Sydney.

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- *1919—"The Humanizing of Commerce and Industry", by Gerald Mussen, Esq.
- 1921—"Currency and Prices in Australia", by Professor D. B. Copland, M.A.
- 1923—"Money, Credit, and Exchange", by J. Russell Butchart, Esq.
- *1925—"The Guilds", by Sir Henry Braddon, K.B.E., M.L.C.
- 1927—"The Financial and Economic Position of Australia", by the Right Hon. S. M. Bruce, P.C., C.H., M.C.
- 1929—"Public Finance in Relation to Commerce", by Professor R. C. Mills, LL.M., D.Sc. (Econ.).

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PUBLIC FINANCE IN RELATION TO COMMERCE

Mr. Chairman, Ladies and Gentlemen,

THE title of my lecture this evening is: "Public Finance in Relation to Commerce". This covers a wide range of topics, and is capable of treatment from many points of view, for the operations of public finance are manifold, and the manifestations of commerce are various. I shall be unable to do more than select for discussion certain aspects. In the Commonwealth, and in most of the States, acute problems of public finance now confront us, but I do not intend to attempt any original analysis of the financial situation in Australia, still less to propound any startling solution. I shall rather attempt to discuss the nature and meaning of the operations of public finance, and the economic effects of the system as a whole and in its various parts. These latter aspects are less exciting and controversial than the former, but they concern matters which are too often lost sight of in public discussion of the former aspects, to which discussion they are, indeed, an essential preliminary.

(1) PUBLIC FINANCE.

The State is a form of social organization to which every man must belong, and it is usually recognized that the chief activity of the State is government, which includes both legislation and administration.

In order that the State may fulfil its purposes, in order that it may be enabled to exercise its functions, it must have money to expend, and it raises this in the form of annual revenue, or at times, by borrowing. Hence we get the operations of public finance which may be conveniently considered under the heads of revenue, expenditure and debt.

To get an accurate picture of the nature of public finance it is necessary that we survey its operations as a whole instead of concentrating our attention upon one of its aspects. Public finance is concerned with the economic effects of the fact that public authorities raise income from various sources and expend it in various ways. In

each case many competing methods present themselves, and different economic consequences follow from different methods.

“Most of the operations of public finance,” as Dr. Dalton puts it, “resolve themselves into a series of transfers of purchasing power.”¹ In the typical case, the State, on the one hand, takes from some of its citizens by divers methods portion of their incomes which otherwise they would have been able to spend for themselves, and, on the other hand, transfers this revenue as income to another set of people. The latter may be those who render in return certain services to the State, such as judges, military and naval men, and other civil servants; or they may be those who render no such return, such as old age pensioners.

As Professor Pigon puts it: “Every completed act of public finance is alike in form. £100m. are obtained by the Government from the public—and are paid over to certain other persons. This money is purchasing power. When it is taken away, those persons from whom it is taken are constrained to give up certain things (including perhaps some leisure) which they would have had if it had not been taken away. The Government then spends the £100m. It is evident that there is a great number of different ways in which the providers of taxes or fees or loans can modify their purchases and activity in order to furnish the £100m.: and a great number of different ways in which the £100m. can be spent, and in which the output of different sorts of things and services can accordingly be affected.”²

Practical problems of public finance turn largely upon the question whether on balance of advantages and disadvantages it is better to allow a public authority to spend in ways which seem good to it, a little more of the income of individuals, or to allow those individuals to spend that income in ways which seem good to them. To concentrate our attention solely upon the revenue aspect of public finance, or the expenditure aspect, may lead us into misconception. For instance, there is a current notion that every tax is an evil, an exaction with no return. The old view of J. B. Say still commands much popular assent: “The very best of all plans of finance is to spend little and the best of all taxes is that which is least in amount”. It is not uncommon to find the view expressed that because a taxpayer suffers a diminution of his income by a tax, because he loses some purchasing power, that therefore all taxation is a net loss.

¹ “Public Finance,” 1923, p. 9.

² “Public Finance,” 1928, p. 4.

To this there are two answers. In the first place, his loss, which is admitted, is some one else's gain; in the next place, this transferred purchasing power enables the State to exercise functions in the absence of which his income would be at least precarious and, indeed, might not exist. It is true that not all taxes go to provide for the maintenance of internal order and external defence, but this kind of expenditure at least appears to be such a positive good to the taxpayer as to offset some at least of his loss. As might be expected, primitive peoples, when faced with the fact of a tax imposed by their more civilized governors, take this view of the evils of taxation. In Papua, as Sir Hubert Murray writes, there is a tax on all male natives between certain ages. Village councillors are selected to explain that this apparently meaningless exaction has another side. "A Government officer explains to the Councillors, and they pass on to the rest, the real meaning of the tax; he tells them, for instance, that the tax does not go into the pocket of the tax collector, but that it is used to build hospitals, to equip schools, to provide for the travelling medical assistants, and so forth."³

But the idea that all taxation is an evil is difficult to eradicate even from more civilized minds. Connected with this is the idea that if the money taken were left in the hands of the individual it would be spent more wisely than when spent by the Government. Adjectives such as "lavish" and "wasteful" are often applied to Government expenditure, sometimes with good reason, but whether Government or private expenditure is wiser depends, not on its form, but on the circumstances of each case. "Our public expenditure is so lavish," said a chairman of a Sydney bank, "it is easy to pass this unpleasant subject over: so much more pleasant to ignore it, so infinitely comfortable to be a public man of the bold courageous, optimistic order and squander money."⁴ To much the same effect wrote an American banker: "Money in the hands of the Government cannot possibly be anywhere near as productive and fructifying and active as in the hands of individuals."⁵ The answer to such contentions is that private individuals do not necessarily and always spend their incomes more wisely than public authorities. To hold this is not to go so far as Sir Leo Money when he stated that his taxation was the best expenditure that he made and that for which he got the most satisfaction.⁶ Nor is it necessary to accept Mr. Sydney Webb's

³ "Studies in Australian Affairs," 1928, ch. xii: Australia's Policy in Papua, p. 257.

⁴ Mr. Thomas Buckland, S.M. Herald, 30/5/1923.

⁵ Mr. Otto Kahn: Ibid., 15/1/1922.

⁶ Stamp. "Fundamental Principles of Taxation," 1921, p. 51.

view that "Government expenditure is, in fact, far more wisely done (on any view of wisdom) than the average of private expenditure."⁷ All that is contended for is that Government expenditure is not always and everywhere worse than private expenditure. "Since," says Mr. Hartley Withers, "there is so much bad spending in all classes, we have no right to assume, as is often done, that all the money taken by the State and spent, well or ill, by it, would have been well spent if left to 'fructify in the pockets of the people.' It might have gone in race meetings, tango teas, picture palaces, fashionable fripperies, strong drink, or trashy 'literature,' all of which things have their uses in amusing people who do not know how to amuse themselves better, but do not lead to much 'fructification'."⁸

Public finance and private finance are often contrasted, and it is a matter of common complaint that the principles which govern sound private finance should be applied to public finance, but are not. But there are differences between the two which render difficult the application of principles of private finance to public finance.⁹ The first difference is that the State may and does exercise compulsory powers over those within its jurisdiction. The limits to State action are to be found in the practical difficulties of compelling its subjects to obey, but within the limits of its own sphere of action the State is independent, and in time of need may claim the property or even the lives of its citizens. The next difference arises from the fact that the State normally has a longer existence than that of any of its citizens. This means that its attitude to the more distant future may well be different from that of an individual whose views normally do not extend to a period much beyond his own life. For instance, a reasonable time for a return from private expenditure will be shorter than for public expenditure. Lastly, an individual is apt to judge a financial transaction by the pecuniary test. According to whether or not there is a direct monetary return, so he will assess success or failure. While a State, too, may use this test, yet from its very nature a State may also judge a financial operation by the test of indirect or non-monetary return. The general duty of the State being to promote social welfare, it may expend money on such services as education or public health, from which it neither expects nor receives monetary return, but which produce very important indirect returns in social welfare.

⁷ Preface to R. Jones: "Nature and First Principle of Taxation," 1914.

⁸ "Our Money and the State," 1922, p. 75.

⁹ See generally Bastable, "Public Finance," 1903, bk. i, ch. i; and Adams, "Finance," 1899, pp. 26, *et seq.*

(2) COMMERCE AND ITS RELATION TO ECONOMICS AND
PUBLIC FINANCE.

Commerce and industry are frequently contrasted, and a distinction is drawn between the production of goods and their exchange. But the "making" and the "sale" of a motor car are both part and parcel of the same process of changing the form and place of goods until they reach the hands of the final consumer. There is no essential difference between the services rendered to society by commercial men, such as merchants and retailers, and those rendered by manufacturers or "primary producers." Commerce in a narrow sense covers the process of buying and selling goods and its attendant services. But for this discussion we may use the term "commerce" widely enough to cover the whole of what is commonly called "business." Business is conducted for gain by private individuals or groups of individuals. Men are induced to provide goods or services in the hope of the gain arising from their exchange with other goods and services. Success in business is measured, in the main, by the objective test of money income. Commodities and services are thus bought and sold, and the prices which result from these transactions are an indicator at once to producers and consumers. Economics is concerned with explaining why individuals or groups of individuals are as well off as they are, and why some are better off than others. It treats of the prosperity of individuals and of nations, and examines the meaning and causes of that prosperity. Many of the topics with which economics has to deal come within the survey of the business man, e.g., money, banking, international trade, taxation. The point of view, however, is rather different, that of economics being social, that of business being individual. The practical application of economics is to be found in public problems, rather than in the private problems which beset the business man. Economic theory, as it has been said, throws light upon "the business of government rather than the government of business."

Commerce, therefore, is not to be taken to be the practice of economic theory. A man does not make a success of a business by merely applying to it principles of economics. But economics has a practical relation with commerce, because it is constantly dealing with the same field, although from a different point of view. Its study provides the student with a "clear vision of the social goal of business activity,"¹⁰ and makes him realize that the social function of business is the efficient production and distribution of goods.

¹⁰ R. C. McCrea, "Journal of Political Economy," April, 1926, p. 222.

The science of public finance has an intimate association with economics on the one hand and politics on the other. The subjects included in the study lie, as Dr. Dalton has remarked, "on the border line between economics and politics."¹¹ The problems that face us in public finance cannot receive a complete solution merely by the application of the principles of economics. We cannot simply decide on economic grounds alone at what rates an income tax should be levied, or even what is the most appropriate form of such a tax. But every problem of public finance has an important economic aspect, and to neglect this is to set sail on an uncharted sea. Nevertheless, public finance does not, any more than any other branch of economics, lay down a series of practical maxims for the guidance of the harassed statesman. "Finance" may be, as some have put it, "great policy," but policy is dependent upon more things than economics. It is, however, one matter to lay down the principle that the economist should be chary of offering advice outside his own sphere, and another matter to put it into practice. To give advice and not to take it is one of the marks of our common humanity. The very close association of public finance and politics gives to the subject at once its interest and its danger. "Public finance," as Dr. Dalton has put it, "lies very close to practical politics. It is, in this sense, the most live branch of economics. Its precepts and its formulae may change, at the wave of a politician's wand, into the clauses of an Act of Parliament. Here, more easily than anywhere else in economics, theory and practice may play into each other's hands."¹²

It is obvious that the operations of public finance, such as we have described, bear an intimate relation to commerce.

The State normally contents itself with regulating industry and commerce, though in many countries public authorities have gone much further than mere regulation, and have entered into the field of ownership and management, whether of monopolistic concerns, or of those carried on in competition with private enterprise. The success or failure of these enterprises, and the financing of them, and of State regulation, are matters of deep concern for every business man. He is, for example, vitally affected by taxation, which he usually looks upon as a hindrance to industry and commerce. At first sight taxation is a deterrent to enterprise, for it reduces incomes and may lessen incentives to work and to save. In so far as taxation, in particular, makes extensive inroads upon the savings of the community,

¹¹ "Public Finance," 1923, p. 1.

¹² "Economica," June, 1928, p. 221.

all production is affected. It is to be borne in mind that all income, private or public, comes out of one source, viz., production. The operations of public finance may leave unchanged, may lessen, or may even increase the flow of production, but there is no mysterious source of public income like the purse of Fortunatus or the widow's cruse of oil. Rather does it come from the stream of production, whose sources may dry up if drawn upon in a wasteful fashion. Public expenditure, too, is of vital interest to the business man. Waste or inefficiency in Government expenditure represents a wasteful diversion of the community's resources. It is true that production is not the only factor to be considered. Some forms of social expenditure may be justified, even though the provision for them may somewhat lessen production.¹³ But the true test of expenditure is whether, on balance, the advantages which it brings outweigh the effect upon production. And unless this is taken into account it is impossible to pronounce expenditure good or bad.

(3) PUBLIC REVENUE.

The most convenient classification of public revenue appears to be into :

- (a) Economic receipts, or quasi-private income ;
- (b) Compulsory receipts, of which the most important part is taxation.

In each case it is the national dividend which provides the revenue, but in the first case the State, or its agents, produces part of the revenue, while in the second case the State merely compels its subjects to hand over what would otherwise go to them as receivers of the national dividend.

(4) PUBLIC REVENUE IN THE FORM OF ECONOMIC RECEIPTS.

State undertakings, generally speaking, although they serve to swell considerably the volume of gross public revenue, yet contribute little, if anything, to net revenue. It is rare to find net economic receipts from such undertakings providing help in any marked fashion towards meeting the ordinary expenses of government. There are some exceptions, but on the whole State undertakings either produce a deficit which has to be met from some other source of revenue, or they just manage to cover their own working expenses, depreciation, interest, and sinking fund on any borrowed capital.

¹³ Compare Colwyn Committee Report, 1927, pars. 284-5.

This is a matter of common knowledge in the case of Australia, which has gone to greater lengths than most countries in State enterprise. It may be convenient to examine for a moment the reasons for this state of affairs. It is often alleged that State ownership and control of industrial and commercial enterprises is less efficient than private ownership and control. But although this may be true in certain instances, it cannot be accepted as necessary. Comparison is often made between a small well-run private enterprise, with all the advantages of careful and individual supervision, and a State enterprise on a large scale, where many difficulties arise, not so much from the fact of State ownership and control, as from the very size of the operations. Again, State enterprises are subject, as private enterprises even on a similar scale are not, to politically imposed policies, which aim, not at the production of revenue, but at service to the consumer at, or even below, cost. So, in the case of railway management, "developmental lines" may have to be built and operated at a loss by a State railway, when under private management this loss would be cut, if ever incurred.

In so far as State enterprises are less efficient than similar undertakings would be in private hands, there is a net loss to production. To borrow money publicly for the purpose of establishing inefficient State enterprises, whether they are monopolies or in competition with private enterprise, is a wasteful diversion of resources from private industry. But, generally speaking, allowing for reasonable efficiency in Government industries, the effects of raising public revenue in this way will depend upon what price policy is pursued. If the enterprise chooses to charge prices high enough to cover its expenses and make a profit, this is, in effect, a transfer of purchasing power from the users of the service to the State. If, on the other hand, the prices charged are not high enough to cover expenses, the amount of the loss represents a subsidy to the users of the service as a class, from the general body of taxpayers.

(5) THE NATURE OF TAXATION.

Taxation and exaction are often used as synonymous terms. Every Treasurer realizes the truth of Burke's saying. "To tax and to please, no more than to love and to be wise, is not given to men." To most people the payment of taxes is at best a grudging necessity. Few share the opinion of the dignitary of the Church who found the payment of his income tax "an exhilarating duty."¹⁴ Sir Josiah

¹⁴ R. Jones, *op. cit.*, p. 6.

Stamp relates that when he was a Surveyor of Taxes he often felt inclined to put up a prominent notice in his office to this effect: "Please don't say you would be pleased to pay the tax if you'd only got the income, because you wouldn't."¹⁵

We need not try to distinguish very carefully between taxes and other forms of compulsory State revenue. Indeed, the distinction is not always easy to draw. For our purposes it is enough to recognize broadly as taxes those payments to the State which are compulsory, not voluntary, for which no direct *quid pro quo* to the contributor is contemplated, and which are intended predominantly to raise revenue. Such a payment is typified by an income tax, where the willingness or unwillingness of the contributor is legally immaterial, where the payment does not bring a direct return, proportionate to it, and where the predominant intention is that a contribution should be made to State revenues. On the other hand, a fare paid to a State railway is voluntary, in that the contributor is not compelled to use a State railway in the same sense that he is compelled to have an income, and the payment is proportioned to the service which is a direct return for the expenditure. Again a penalty for a breach of traffic regulations is compulsory, and gives no direct return, but its purpose is not so much to raise revenue as to deter people from certain forms of anti-social conduct. But taxation may be used in such a way as to be hardly distinguishable from a penalty. This raises the broader question of the legitimate aims of taxation. Should taxation be "for revenue only," or are other aims allowable? It should first be noticed that taxes undoubtedly do have other aims than merely revenue. Much of the taxation upon various forms of alcohol and tobacco aims both at producing revenue and lessening the consumption of commodities considered socially undesirable. The Federal Land Tax, according to the late Mr. Andrew Fisher, who introduced it into the House of Representatives, had a two-fold object: "While the incidence will tend to break up large estates and help to develop the country from an economic point of view . . . it is a proper kind of taxation for the purposes of raising Commonwealth revenue." Stern critics of other people's vices have found further examples in Amusement Taxes. How prominent the repressive aspect of taxation can be may be seen from an American example of some years ago: "A liquor licence in a certain Western town cost 100 dollars. A tax of 100 dollars was put upon banks. The bankers held up their hands in horror; 'the people think the banks are as undesirable as the saloons'."¹⁶

¹⁵ "Fundamental Principles of Taxation," 1921, p. 54.

¹⁶ Plehn: "Public Finance," 1919 ed., p. 315.

The outstanding example of the use of taxation for other than revenue purposes is to be found in the almost universal use of import duties for the purpose of giving a definite direction to the economic development of a country. Moreover, the effects of the tax may be very different from what were intended. Some of the effects of a tax may be foreseen and intended, others not, and a tax may fail even in its object of producing revenue.

Opinion is divided as to whether "ulterior aims" in taxation are legitimate. On the one hand there is the view that taxation should be "designed with the sole intention of producing necessary revenue."¹⁷ On the other hand there is the view that taxation may be used "as the means of effecting specific social or political purposes."¹⁸ Mr. Stephen Mills, who draws a distinction in these terms, holds that the latter view treats taxation "as a system of morally persuasive penalties" to induce society "to follow the path which leads to the imagined elysium of Socialism," while the former view is correct in maintaining that any other object than revenue "is an alien, unassimilable, and injurious ingredient."¹⁹

But this contrast is too strongly drawn. Those who hold it legitimate to use taxation to promote social welfare are not necessarily socialists, and few even amongst free traders would question the right of the Government to use import duties as a method of directing the economic development of a State. It may be noted that the late Alfred Marshall wrote, in 1917: "The State is under obligation . . . to use its powers for promoting such economic and social adjustments as will make for the wellbeing of the people at large. A chief place amongst these powers is held by its control of the distribution of the burden of taxation."²⁰

Our conclusion is that taxation may legitimately have other aims than merely the production of revenue, but that the effects of a tax are much more important than the ascertained or presumed intention of those who are responsible for its imposition.

¹⁷ Stephen Mills: "Taxation in Australia," 1925, p. 1.

¹⁸ *Ibid.*

¹⁹ *Ibid.*, p. 2.

²⁰ Memorials of Alfred Marshall, 1925, p. 347. Compare Delisle Burns: "Government and Industry," 1921, p. 156, "The principles of adjusting social differences by differential taxation can be used also for remodelling the industrial and economic life of a nation, and there is no reason against such remodelling, since economic life, as it now is, is not necessarily good and is largely the effect of the desires of past generations."

(6) TAXES.

A common classification of taxes is into direct and indirect taxes. The distinction between these is sometimes made to turn upon the incidence or burden of the tax, those taxes being direct whose burden cannot be shifted. Sometimes it is made to turn upon the intention of the public authority which imposes it, a tax being indirect if it is intended that the burden should be shifted. Neither of these distinctions is satisfactory. In the first place, the question of incidence in any given case is a difficult one to be determined, so difficult, in fact, that we could not be safe in distinguishing at first sight, by this means, between a direct tax and an indirect tax. In the next place, the intention of public authorities is no safe guide, for their intention is sometimes undiscoverable and always irrelevant to the question of the incidence of a tax. A distinction may be made between direct taxes of which the burden is open and unconcealed, and indirect taxes whose burden is disguised by being concealed in a transaction or a price. An income tax, for example, exhibits an obvious burden, while a tax on a commodity may be obscured by a price change. In other words, an indirect tax is a comparatively painless extraction from the taxpayer's pocket. But indirect taxes, if less painful, are not always endured in silence, if Walpole is to be believed: "Landed gentlemen," he said, "are like the flocks upon their plains, who suffer themselves to be shorn without resistance; whereas the trading part of the nation resemble the boar, who will not suffer a bristle to be plucked from his back without making the whole parish to echo with his complaints."²¹

The rate of taxation may be progressive, regressive, or proportional. A progressive tax is one in which the rate usually increases with the amount, e.g., of income, taxed; a regressive tax is just the opposite, where the rate decreases as the amount of income increases; while in a proportional tax the rate remains constant.

Regressive taxes, from their very nature, bear more hardly upon those with lower incomes. In practice, too, regression may arise although the form of the tax is proportional. Most taxes on commodities have this effect, not that it is unavoidable, but that in order to raise much revenue from commodity taxes it is advisable to place them upon articles of necessity and of staple consumption. It would be possible to impose such taxes merely upon commodities used by wealthy people, and then the effect would be progressive and not regressive. But while they are imposed, instead, upon articles of common consumption they are regressive in effect, because a greater

²¹ Quoted by Seligman: "Essays in Taxation," 1911, p. 33.

proportion of a smaller income is spent upon such articles than is spent of a larger income. "The man who possesses an income of £1,000 a year," wrote Sir D. Barbour in 1896, "does not, as a rule, drink ten times as much whisky, tea, or beer, or smoke ten times as much tobacco as the man who possesses an income of £100 a year."²² This aspect of regression really arises from the fact of inequality of incomes which is characteristic of most societies, and, in its absence, taxes on articles of general consumption would be much less regressive in effect.

(7) INCOME TAXATION.

To illustrate the effects of taxation upon commerce we may select the income tax for two reasons. In the first place, it is the most important and typical direct tax, and is usually looked upon by business men as a hindrance to production and a deterrent to enterprise. In the second place, the Colwyn Committee recently investigated the effects of the income tax upon the British business community. Its conclusions are interesting, for they fortify economic reasoning, and they were arrived at by a body consisting not merely of economists, but of taxation experts and leading industrialists and commercial men.

In dealing with the effects of a tax upon income it may be remarked once more that the total effects of a given system of public finance will be different from those of taxation alone. Until account is taken of the use made of the proceeds of taxation the effects of raising revenue in this way remain isolated for purposes of analysis, and likely to mislead if attention be concentrated upon them alone.

A payment made by a taxpayer in the form of income tax is a transfer of purchasing power, a deduction from the taxpayer's income, a lessening of the amount which he otherwise would have at his disposal to spend or to save. Production may be affected, because as a result of the tax, work or saving, or both, may be reduced. This will depend upon how capacity to work and to save, and willingness to work and to save are affected. Usually an individual's capacity to work is unharmed by an income tax unless its payment is such that he is unable, out of what is left to him, to provide the necessaries for efficiency. Saving, however, is in most cases reduced, because the lessened income means a reduced capacity to save. As Professor Pigou puts it: "A considerable part of the money taken from the public in taxation is likely, especially if the rate of taxation is high,

²² Quoted by Pigou: "Public Finance," 1928, p. 142.

to come out of what would otherwise have been, or become, capital in the widest sense."²³

We may now consider the effects of the tax upon willingness to work and to save, or more generally the way in which taxpayers react to an income tax. This is a question upon which it is difficult to make accurate generalizations. Dr. Dalton says: "At this point, perhaps, the economist looks hopefully into the eyes of the psychologist, but the latter is apt to return a stony and uncomprehending stare, and to talk of other things, such as the inadequate psychological basis of modern economic theory."²⁴

It is commonly held that taxation always reduces willingness to work and to save. But this does not seem to be universally true. Those who are concerned to provide for themselves and their dependents, those with a fairly rigid standard of life, accustomed to "living up to their income,"²⁵ or those who are attempting to save for a fixed amount of income at the end of a definite period of life, are not likely to work or to save less when faced by an income tax. On the other hand, the view that taxation "acts as a spur" to industry and to saving appears to have no general validity. It may apply in the case of those who desire wealth as an evidence of power and success. Taxation to them may be merely an obstacle, and the higher the obstacle the higher they will jump.²⁶ But Lord Leverhulme's view can hardly be generally shared: "Every raising of the rate at which income tax is levied has been followed by increased efforts, successfully made, to increase incomes out of which to pay the increased tax."²⁷

It would appear that the truth lies somewhere between these views, but possibly nearer to the first than to the second. Income taxation may tend to reduce both willingness to work and willingness to save, but it depends upon the circumstances of the case, and particularly upon whether the tax is moderate or heavy. We may go a little further with this matter, and distinguish between the effects upon willingness to save and those upon willingness to work.

(1) *Saving.*

A great deal of saving in modern times is done vicariously by companies on behalf of their shareholders in withholding from distribution current profits and placing them to reserve. "The saving,

²³ "Economics of Welfare," 1920, p. 598.

²⁴ "Public Finance," 1923, p. 84.

²⁵ cf. Pigou: "Economics of Welfare," 1920, p. 593.

²⁶ Dalton: "Public Finance," 1923, p. 85.

²⁷ Quoted by Dalton: "Public Finance," 1923, p. 85.

while effected on behalf of the shareholders, is done without any volition on their part; it is collective and impersonal."²⁸ The effect of a tax upon those who have the decision as to whether profits should be put to reserve, or distributed in dividends, has been considered for the United Kingdom by the Colwyn Committee. Their general conclusion is that "when a concern is well managed it will not be deflected by high income tax from a sound policy in the matter of reserves." The statistical evidence available to them showed no signs of reserves having been sacrificed to dividends. While admitting that income taxation absorbs much of the savings of companies, and to that extent is a hindrance to accumulation and an obstacle to development, the Committee thought that no great damage had been done to company savings in general even by the high rates of income taxation.²⁹

A great part of saving, too, is done by wealthier people, and is to a certain extent automatic,³⁰ so that in these cases willingness to save is not affected to the same extent as in the case of less wealthy savers. Professor Pigou's view is that an income tax means that the less important uses of an income are curtailed first. These uses may be either consumption or investment. Commonly both are lessened, and, if the taxation be moderate, roughly in proportion to the respective expenditure upon each. In the higher ranges of income, therefore, where the proportion invested is greater, taxation will reduce saving more than in the lower ranges of income. Where the taxation is heavier there is more likelihood that saving will be the main source from which the taxpayer meets the tax, so that the higher the taxation the more likely it is to reduce the amount of what would otherwise be capital.³¹ This view is reinforced by the opinion of the Colwyn Committee on the effect of income taxation in the United Kingdom: "The savings of the income tax paying classes have . . . suffered; the effect has been most severe in the larger incomes liable to high effective rates of tax."³² In this connexion the Committee makes an interesting classification of individuals according to income, concluding that the willingness to save differs in each class, so that the resultant effects upon saving will be different. In the lower range of incomes, up to £500, where the rates are also low, willingness to save is such that probably the tax is paid out of money which would otherwise be spent on consumption, and saving is to this extent

²⁸ Colwyn Committee Report, par. 392, p. 145.

²⁹ See generally pars. 392-402.

³⁰ Colwyn Committee Report, par. 429, p. 161.

³¹ See generally "Economics of Welfare," 1920, pt. iv, ch. ii.

³² Report, par. 441, p. 166.

unaffected. In the middle range, between £500 and £2,000, where the rates are much heavier, the savings of some will be unaffected, but in spite of economies in consumption, savings will be reduced in the majority of cases. In the higher ranges of incomes the deterrent effects upon saving are still more marked.³³

(2) *Enterprise.*

A similar classification is adopted by the Committee in its discussion of the effect of the income tax on work and enterprise.³⁴ In all ranges of incomes for employees and professional men, they consider income taxation has no important effect upon work or enterprise. The case is different with public companies, and still more so with private traders. In so far as the tax tends to restrict the supply of capital, it tends to depress the outlook both of those directing public companies and of those in charge of private concerns. This may lead to a tendency to avoid risks which would otherwise be taken, and therefore "to damping down industrial activity, particularly of the more speculative kind."³⁵ The most important effects, however, concern private business, where the individual controllers are the only ones financially interested, and have to bear the burden of taxation without the possibility of transferring it to the shoulders of the shareholders.

A private trader is in a different position from an employee or a professional man. He neither works for a fixed salary, nor does he carry on largely without material capital. He is lured by the hope of gain arising from his own hard work and initiative, and affected by the ever present possibility of loss. To him saving and enterprise are of great importance, and the individual motive is dominant. "In the struggling business the necessity for fresh capital may be no less urgent than the necessity for hard work and initiative; the trader may have to save in order that the business on which he depends for a livelihood may survive. Again, in the prospering, go-ahead business the will and the ability to expand require to be backed by a continual flow of savings, if they are to be effective."³⁶ In the Committee's opinion work and enterprise are not adversely affected in the lower ranges of income: "Generally speaking, we should regard the psychological effect as neutral for traders with profit up to £500 per

³³ Pars. 365-377.

³⁴ See pars. 343-364.

³⁵ Par. 447, p. 168.

³⁶ Par. 414, p. 156.

annum.”³⁷ In the middle range of incomes, and for some distance beyond, although effects will vary with individuals, probably income taxation “definitely increases the business man’s output of effort.”³⁸ In the higher range of incomes, however, the burden of the tax is formidable, and enterprise is likely to suffer, especially the undertaking of more risky and speculative business. But such statistical evidence as was available led to the conclusion that “it would be difficult to maintain the view that as a whole the enterprise of the wealthy business man is very seriously damaged.”³⁹

These effects upon enterprise and upon saving constitute the real argument against high rates of income tax. It is not merely that individuals dislike paying such taxes, but that the payment reduces savings and lessens enterprise, and consequently tends to a reduced national income and a lessened prosperity. Once again it is to be remembered that we are looking at the question apart altogether from how the revenue is spent. The effect upon saving, for example, will be very different, according to whether the proceeds are used in waging a war, or in paying interest to holders of Government loans, who promptly proceed to invest the money.

Before leaving income tax it will be convenient to examine for a moment the question whether the income tax is “passed on” by traders to consumers in the form of higher prices. This question has often been hotly debated, economists, as a rule, holding the view that the burden of an income tax cannot be shifted, while business men, as a rule, hold that it not only can be, but actually is, shifted in the form of an addition to the price. The Colwyn Committee, whose discussion of this question is most recent, sided with the economists, and were fortified by a statistical analysis prepared for them, which showed, *inter alia*, that the distribution of profit rates in a year of low taxation was almost identical with that of a year of high taxation, although, if the “business” view be right the rate of profit before payment of the tax should be higher in the year of high taxation. It is, however, of little importance which view is right. There is no doubt that the view that all income taxes are simply “passed on” and reflected in price increases is untenable. As Mr. Robertson says: “If you throw enough taxation mud at the business man a good deal of it will stick.”⁴⁰ But, on the other hand, prices may increase as a result of income tax, and it matters little whether this is described

³⁷ Par. 423, p. 159.

³⁸ Par. 424, p. 159.

³⁹ Par. 433, p. 163.

⁴⁰ “Economic Journal,” December, 1927, p. 581.

as resulting from "passing it on" or, more correctly, from a contraction of supply owing to the effect of the tax upon saving and enterprise. The question of the effects of an income tax upon individuals, and consequently upon production, far exceeds in importance the barren question of whether the tax can be passed on. But the possible effects of taxation are often exaggerated. Not long ago the proposal to tax property incomes at a higher rate than work incomes was described by an American writer as "apparently intended merely as an entering wedge leading at best to socialism; at the worst, to Bolshevism, or anarchy."⁴¹ Again the adoption of progressive taxation in Australia has falsified the fears of the alarmists, for neither has the institution of private property been weakened, nor has capital been driven out of the country.⁴² The truth is that, although the current burden of taxation always appears heavy, people have a way of getting used to it, much as they grow accustomed to a new price level after a period of inflation, or adjust themselves to an increased tariff. "It is quite possible," writes Mr. D. H. Robertson, "that as a result of a prolonged high level of taxation business men as a class should revise their conceptions of what constitutes a reasonable rate of reward for enterprise, and it is not impossible that . . . something of the kind has already happened."⁴³

One problem of income taxation which has become more prominent with the growing economic interdependence of communities is that of double taxation,⁴⁴ which occurs when the same income is subject to taxation by two taxing authorities. Its chief importance lies in the effects upon investment, for an investor in a foreign country is deterred by the fact that he will have to pay on his investment income a tax in his own country and a tax in the country of investment. This is of special moment to a country like Australia, which is a borrowing country, because double taxation, in the words of Sir Josiah Stamp, tends to prevent "liquid resources flowing from the places where they are most abundant to the places which need them most."⁴⁵ The obvious method of overcoming the difficulty is for taxing authorities to select either the principle of origin or the principle of residence as the basis for income taxation; either to

⁴¹ W. I. King: "Annals American Academy of Political and Social Science," May, 1921, p. 259.

⁴² Seligman: "Progressive Taxation," 1908, p. 124.

⁴³ "Economic Journal," December, 1927, p. 580.

⁴⁴ See generally Report of League of Nations Committee on Double Taxation, 1923.

⁴⁵ Current Problems in Finance and Government, 1924, p. 190.

tax only income of residents wherever arising, or to tax only income arising within its borders irrespective of who receives it. The trouble arises often because taxing authorities try to tax incomes of all residents, and in addition all income arising within its borders. If one principle alone is to be selected it appears that residence is the better, on the ground that the true subjects for taxation are the inhabitants living within the area subject to the taxing authority. This was recommended by the League of Nations Committee on Double Taxation and by the Committee of the International Chamber of Commerce, though the practice as yet is by no means uniform.

But the problem is not as easy of solution as this, for, as Professor Pigou points out,⁴⁶ not all States are equally strong as tax leviers, and in practice somewhat arbitrary arrangements have to be made so as not to work injustice to the weaker States. In Australia the Commonwealth and the States, generally speaking, adhere strictly to the principle of origin, and do not tax incomes of their residents derived from sources outside their boundaries. But this means that income arising in Australia from foreign investment is taxed by Australian Governments, and therefore double taxation may arise. As far as the United Kingdom and the Dominions are concerned, mutual arrangements were made a few years ago whereby each authority agreed to give some relief to taxpayers subject to both Imperial and Dominion taxation. It has been recently reported that the Federal Government had under discussion an amendment of the Income Tax Act to provide for the taxation of money earned overseas by Australian companies and individuals.⁴⁷ So far no official announcement of a change of policy has been made, but if this were done it would add considerably to the difficulty of adjusting the burden of double taxation.⁴⁸

(8) PUBLIC EXPENDITURE.

Public expenditure is the other side of the shield from public revenue. It is well to distinguish between gross and net expenditure. An analysis of the annual expenditure of the Australian States shows

⁴⁶ "Public Finance," 1928, pp. 191-2.

⁴⁷ Melbourne Stock Exchange Record, 30th June, 1928.

⁴⁸ Double taxation in another form arises in Australia from the exercise of the concurrent powers of direct taxation shared by Commonwealth and States. Space does not permit of treatment here, but reference may be made to articles in the "Economic Record," November, 1926, by Prof. Giblin, and May, 1928, by myself.

that, for long, approximately 60 per cent. has been due to two items. (1) Public Debt, interest and sinking fund, (2) Railways and Tramways working expenses.⁴⁹ Neither of these is a purely net expenditure. In the case of the railways there is to be set against the expenditure the revenue from freights and fares, etc., while in the case of the debt there is to be set against the interest the revenue derived from various public works established by public loans. Taking the two items together, for railways and tramways have been the principal forms of loan expenditure, the net annual expenditure consists in the deficit on all public enterprises, including the interest on loans, from which there has, for one reason or another, been no direct monetary return.

Many of the effects of public expenditure upon production operate in the reverse direction from those of taxation.⁵⁰

In the first place, it is to be borne in mind once more that some Government expenditure is essential to production, and without this expenditure the national dividend would obviously be much reduced. In the next place, a great deal of expenditure in modern States is mere "transfer" expenditure, as Professor Pigou calls it, where those who receive the money raised by taxation have a purchasing power exactly equivalent to that which has been surrendered by the taxpayer.⁵¹ The most important example of this is the expenditure in the form of interest on war loans held internally. The receivers of this interest get from the taxpayers, less cost of collection, a sum which they may use in any way they choose, for spending or for saving. In the third place, a great deal of public expenditure takes the form of services which are directly aimed at improving production. Typical examples may be found in expenditure upon education and training of all kinds, and that upon public health and allied services.

Over and above these forms of expenditure there is that which may be called social expenditure, or expenditure upon various forms of social amelioration, which is becoming increasingly characteristic of governmental policy. It is not easy to measure this kind of expenditure by any economic test. Sometimes, it is true, it has unforeseen effects upon production by increasing the efficiency of the recipient or his family, although the intention was rather to improve the quality of the life of the recipient, or to lessen existing inequalities of income. Cases of this kind of expenditure may be found in widows' pensions.

⁴⁹ "Commonwealth Year Book," No. 21, 1928, p. 380.

⁵⁰ See generally Dalton: "Public Finance," 1923, part iii.

⁵¹ Pigou: "Public Finance," 1928, p. 20.

and possibly in schemes of child endowment. The practical problem of the desirability of such expenditure, and of the amount of such expenditures, may be stated in this way. Given a certain form and amount of State expenditure, which has been determined by historical conditions and previous policy, the spending of more on existing social services, or upon new forms of social services, necessarily involves the raising of more revenue by means of taxation or otherwise. So the problem becomes one of balancing the advantages expected to accrue from the expenditure against the disadvantages of raising the necessary revenue. It is easy enough to state the problem in this way, but this kind of balance is in practice peculiarly difficult, for it is not merely a balancing of economic effects one against the other, but of economic effects against social effects, and there is no certain criterion for this. When the balance is struck it is usually done roughly on an estimate of social good against economic loss, and the economist has no right to complain if the statesman chooses, as a matter of policy, to incur economic loss.

Expenditure may affect production through its effects upon capacity to work and to save, and upon willingness to work and to save. Here it is obvious that some forms of public expenditure, such as provision of free education, may act in the opposite direction from taxation by improving both capacity to work and capacity to save. The effects upon willingness to work and to save are more difficult to estimate. A common argument is that to the extent to which free grants are made by the State to individuals their willingness to work and to save will be reduced. But this does not follow as a general rule any more than, as a general rule, does taxation always act as a deterrent to enterprise. Some forms, for example, of old age pensions have been so devised as to offer direct inducements to individuals to work and to save less than they otherwise might do.⁵² Others appear to have no serious effects one way or the other, and others again directly induce further willingness to work and to save.

Another way in which public expenditure may affect production arises from the fact that the goods and services produced by means of public expenditure are different from those which would have been produced if the individual taxpayers, instead of the Government, had had the choice of how the money should be expended. This was obvious enough in war time, when belligerent Governments diverted resources from normal channels of industry into those which were better calculated to supply the needs of modern warfare. But even

⁵² Cannan: "Economic Outlook," 1912, p. 19.

in peace time such a process is always going on, just as, for example, by protective Customs duties a Government may divert resources from one channel of production into another. In either case production will be different, but not of necessity less. Broadly the effect upon production depends upon whether the collective wisdom of the community as expressed in Government is greater than the sum of individual wisdom of those who would otherwise expend the money, and we should not assume that Government action is always less wise. The case against protection, for example, is sometimes put on the ground that there is always a presumption that Government action will not be as wise as individual action. But if this presumption is to be accepted it is only a *prima facie* presumption, and may be rebutted by evidence such as, for example, that the Government is looking to returns in a more distant future than the individual has in mind. Similarly with expenditure, for example, upon education. This will often produce services different in amount and kind from those which private individuals would have obtained had they not been taxed for this purpose. But we can accept no presumption that one expenditure is necessarily wiser than the other.

(9) PUBLIC DEBT.

It has been said that "the possession of a national debt is one of the first signs of civilization."⁵³ The truth of this saying may be gauged from the fact that the most important cause of public debt has been borrowing for purposes of waging war. The next important cause, which has special relevance for Australia, has been borrowing for the purpose of public works. In form a public loan, whatever be the purpose for which it is used, is a transfer of wealth from private owners to the State. As a result of such transfers there may arise benefits and burdens. If the loan is external, i.e., if the lenders are not members of the borrowing State, the loan represents a benefit, because it means an addition to the total resources of the State, although when the time comes for repayment a similar burden is imposed. If the loan is internal, i.e., if the lenders are subjects of the borrowing State, the total resources of the State are unaltered. It is a mere transfer within the community, and the same is true when repayment is made. In each case payment of interest has to be made during the period of the loan. The payment of interest on an external loan is a burden, because it is a deduction from the national dividend.

⁵³ Quoted by C. K. Hobson: "Export of Capital," 1914, p. xxi.

but there is no similar burden in the case of an internal loan, because the national dividend remains unchanged.

The burden and the benefit will also differ according to how the proceeds of the loan are spent. If they are spent wastefully in such a manner that no economic assets are created out of which an income arises to meet the interest charges, the burden consists in the taxation which has to be levied for the purpose of meeting interest payments. If, however, the proceeds are spent wisely, and an income results large enough to cover interest and other charges, then it is impossible to say that the loan has imposed any net burden, for even if it is an external loan, the burden of interest payments is offset by the addition of income producing assets created by the loan.

When a loan is spent for war purposes it is difficult to say that it has been wasted in one sense, because it may have been necessary to preserve national existence, but it has clearly been wasted in another sense. On the other hand, a loan used for purposes of establishing public works may also be wasted in the latter sense. It is not, of course, the form of borrowing which decides whether or not wealth is destroyed by public borrowing, but the use to which it is put. "The evil that arises is from the waste of war, not from the borrowing."⁵⁴

The "burden" of public debt, therefore, will differ according to whether a loan is external or internal, and according to whether its proceeds are economically or wastefully used.

We may now briefly apply these principles to Australian loan expenditure.⁵⁵

Approximately one-third of the total debt of Commonwealth and States on June 30, 1927, £333,000,000 out of £1,044,000,000 was classified as war debt. In so far as the interest on this sum is payable abroad it is a loss to the national dividend. If this obligation did not exist it would be possible either to reduce taxation or to provide services which now we are forced to go without. In so far as the interest on this sum is payable to Australian holders of war loan there is no such net loss. As in the former case, the money has to be raised by taxation, but the money so raised is, in this case, transferred from taxpayers to stock holders, and, while it reduces the purchasing power of taxpayers, it correspondingly increases the purchasing power of the stock holders.

The remaining two-thirds of the debt has been incurred, for the

⁵⁴ Plehn: "Public Finance," 1919, p. 380.

⁵⁵ For a fuller discussion see my article "Australian Loan Policy": Studies in Australian Affairs, 1928, ch. v.

most part, both by the Commonwealth and by the States, for the purposes of establishing public works. In so far as the net earnings of these enterprises cover interest charges, depreciation, and sinking fund, they involve no burden, for, if the interest goes abroad the capital came from abroad. Actually, however, there is a margin between interest and net revenue, and the difference has to be made up out of taxation. It is not possible to estimate accurately the amount of this margin, for public accounts are not usually presented in such a way as to show beyond doubt the net monetary return from loan expenditure, but it is large enough to warrant the belief that some of the borrowed money has been wasted.⁵⁶ At times loan money has been spent in such a way as to produce indirect or non-monetary returns, that is, the national dividend, out of which taxation comes, has benefited by the expenditure, but no direct Governmental revenue has arisen. Examples of this are expenditure upon harbours, roads, and bridges. There is no way, of course, of adding indirect returns to monetary returns, but the former operate to reduce the margin between interest and revenue. It is not suggested that the borrowing policy of Australia has been unsound; external borrowing for the development of a country in the economic stage in which Australia is can clearly be justified. The principal test is whether the money has been spent in such a way as to produce adequate returns. But that the policy might have been wiser is shown by conspicuous examples of waste.

Finally, I may be allowed to quote my conclusions written in 1928: "The knowledge that there has been some waste in the expenditure of loan moneys, and the suspicion, unallayed by satisfactory figures, that it has been great, have together probably caused much of the adverse criticism of our financial policy from outside investors or their representatives. It may also account for any differences in rates of interest on Australian as compared with other Dominion loans. To overcome this two things are necessary. First, a more careful scrutiny of the proposed objects of loan expenditure and greater economy in spending the loan. Next, more careful estimation and publication of returns to this expenditure, so that our financial situation should be made plain. The Loan Council can do something to achieve the first of these objects, but for both together some further common action on the part of the States and Commonwealth is necessary. In view of our industrial needs, and indeed of our commitments to certain projects and enterprises, Australian public borrowing

⁵⁶ See Report of British Economic Mission, 1929, pp. 7-8.

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is not likely to stop suddenly, but more care could be exercised to promote economy and to prevent waste. This involves a searching examination of the public projects which compete for the expenditure of loan money, and a discriminating selection of those only which are justified, either from their expected direct return in the form of Governmental revenue, or from their no less desirable, though less easily measurable, indirect return in the form of social welfare. In the face of political considerations these decisions are difficult to make, but they are none the less essential to the prosperity and welfare of Australia.⁵⁷

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⁵⁷ Studies in Australian Affairs, 1928, p. 117.