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Taxation in the New State

J. A. Hobson

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First published in 1919, *Taxation in the New State* explores the practical application of tax policy to the financial situation of post-World War I Britain. Hobson assesses policy according to the tax payer's ability to bear the burden and draws a distinction between 'cost' and 'surplus'. He proposes a number of reforms and considers the pitfalls of attempting the find required revenue using ordinary taxation in a post-war financial crisis.

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TAXATION
IN THE NEW STATE

BY

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PREFACE

EVEN before the war the growing need of large revenue in order to meet the new demands upon the modern State was bringing the problem of taxation into a place of increased prominence in the politics of every civilized nation. Non-remunerative State services were continually increasing in number, scope, and intricacy, and the annual bills kept mounting up. In some countries the increased expenditure could be largely met out of income from public properties or remunerative services. But in Great Britain and in other countries the pressure for increased tax revenue was strongly felt; and new sources of this revenue were being explored. The war, with its legacies of indebtedness and its large sudden demands of State expenditure for reconstruction, must force every intelligent citizen to consider closely how a tax-income, at least three or four times as large as the pre-war sum, can best be raised. It will be evident at once that no multiplication of minor devices can suffice, but that a thorough exploration of the taxable resources of the nation must be undertaken.

These chapters are an attempt to establish and apply to the financial situation in front of us certain intelligible principles of tax policy. Recognizing that the normal annual tax-income can only be derived from the incomes of the several members of the nation, and consists of a portion of the wealth constituting the annual product of the nation reckoned in money or in goods and services, we are confronted first with the necessity of distinguishing the portions of personal incomes that have ability to bear taxation from those that have not such ability.

I have made it my first object to win, by means of a brief analysis of the various elements in income, a clear definition of 'ability to bear.' While there is nothing novel in the distinction which I draw between 'costs' and 'surplus,' I am convinced that neither in the theory nor the practice of taxation has this distinction been adequately realized. Though modern State finance has been moving empirically towards a recognition of the fundamental truth that only surplus income, *i.e.* economically unnecessary payments to owners of some factor of production, possesses a true 'ability to bear,' economists and statesmen alike still cling to the looser and defective statement of this principle conveyed in the first of Adam Smith's four maxims of taxation. That maxim declares that "The subject of every State ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State."

Now, theory and practice alike attest the need of amending this maxim by a recognition that such parts of the revenue of any one as are physically or morally necessary to evoke and maintain the output of productive power which serves to create this revenue, should be excluded from the purview of this test as possessing no ability to bear taxation. All taxes which fall directly or indirectly upon this part of revenue are bad taxes, impairing the sources of production if they are borne, and causing waste and confusion if, as will usually happen, they are shifted on to some surplus element of revenue.

But while it is not difficult to establish in general terms the justice and utility of confining taxation to surplus elements of income, the difficulty or impossibility of accurately ascertaining and measuring such surpluses as they emerge in the intricacies of actual industry and commerce compels State financiers to have recourse to less direct expedients for the application of their principles. Alike in the case of the immediate taxation of income, and of the deferred taxation of accumulated income through Death Duties, the two chief instruments of revenue for the modern State, the assumption is adopted that surplus wealth with 'ability to bear' varies directly with the size of the income or the estate. Our Income-Tax is thus in main outline conformable to the distinction here made between costs and surplus. The exemption limit with allowances asserts the principle that a small necessary income has no ability to bear taxation, while the progressive graduation assumes that ability rises proportionably with the dimensions of the taxable body.

But, in order to make this method of taxation thoroughly effective, certain reforms are needed. Exempted income should evidently have regard to the number of those who depend upon it for their maintenance, and progressive graduation should be more continuous and more progressive. Proposals for achieving these reforms are discussed.

Indirect taxes are generally worse than worthless for purposes of revenue, producing little, costing much, and interfering with the general productivity of industry and commerce. In the few cases where it is desirable to retain them, considerations not of revenue, but of public order, health, or the prevention of extravagance and waste determine their retention. A tariff on imports is found to be peculiarly injurious in its incidence and shifting, for it can never be directed so as to make the foreigners pay any proportion of the tax sufficient to compensate the injuries which it inflicts upon home industries and real income.

In the first part of this volume these principles and policies of reformed taxation are set out in their general bearings. The second part treats of the financial emergency in which the State must find itself as soon as the war-borrowing ceases and annual expenditure must be met out of annual revenue. The difficulties and dangers of attempting to find the required revenue by any ordinary processes of annual taxation are discussed, and it is urged that an emergency levy upon capital is requisite in order to effect such a reduction of war-indebtedness as will bring the annual revenue within the compass of safe taxation. Two proposals for a levy are described, one confined to war-made wealth, the other of a general character, and the respective merits and defects of the two are discussed. A concluding chapter deals with the adjustments between national and local taxation demanded by the application of the principle of 'ability to bear' to local services, if there is to be effective and economical co-operation of national and local government in the performance of the services and the provision of the money expended on them.

I wish to express my deep indebtedness to Mr Sidney Webb for valuable aid rendered in the preparation and correction of this work.

J. A. HOBSON

HAMPSTEAD
May 1919

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§ 1. EVERY modern State needs a rapidly increasing revenue in order to undertake new expensive public services or to improve old ones. Some of these increasing revenues may be got from the annual yield of public properties or services. Where, as in Germany, the State has been the owner of railways and canals, large forests and mines, as well as the postal, telegraphic and other remunerative businesses, the rents and profits derived from these sources may defray in large part the cost of the non-remunerative services, such as defence, police, public health and education. If the British State can acquire upon reasonable terms and operate or lease advantageously our railways, mines, electric plant and certain other services and industries hitherto left to private enterprise, it is possible that we too may derive a large part of our State and municipal revenues from such remunerative sources. But our present situation, in which the Post Office is the only large self-supporting and profit-earning branch of our Central Government, is one which forces us to look to tax revenues as the effective sources for meeting the enormous increase of State expenditure that immediately confronts us. No close forecast of the amount of tax revenue required is relevant to my present task. It may suffice to remind readers that, unless some emergency levy sensibly reduces the burden of war debt, the interest and sinking fund upon our national debt alone will for a good many years to come be nearly double the amount of our total pre-war revenue from all sources. To this must be added a large provision for war pensions, hospitals, land settlements, training schools and industrial equipment for injured soldiers. Large necessary commitments have been made for public expenditure on housing, health and education, roads and afforestation. Unremunerative public works or other contributions towards unemployed insurance, at any rate during the period called 'reconstruction,' will probably form a considerable item of expense. Many of the war 'controls' must probably be retained either temporarily or permanently, and all departments of the civil government, enlarged in staff and functions for the duration of the war, will struggle not unsuccessfully against 'cutting down.' Thus the State will remain a much bigger body to support after the war than before. And the expense of keeping it will have expanded almost automatically to meet the rise of prices and the consequent increase in cost of living. For there is no likelihood of such a fall of prices for a long time to come as to bring salaries and wages down to anything approaching the pre-war level. An increased expenditure of 25 per cent. from this source is a low estimate.

§ 2. These considerations make it evident that our State must provide itself with a tax revenue enormously exceeding the amount, approximately 165 millions, provided by the 1913-14 Budget. Until the burden of the debt is considerably reduced, it looks as if the tax revenue must be at least four times as large as the pre-war amount. This alarming statement should, of course, be mitigated by the reflection that the monetary sources of tax revenue, money incomes and values of capital, will be found to have risen along with the rises in price-levels, though not to a corresponding extent. Thus there will be a considerable increase in the monetary size of the taxable body of wealth.

At the same time the necessary revenue will be so great as to bring issues of tax-policy into the forefront of practical politics, and to compel officials and politicians and the general public to bestow a far greater attention than hitherto upon methods of taxation. At a time when industry and commerce, dislocated by the war, are exposed to all the risks and difficulties of reconstruction, under new conditions of national and world markets, coping with various shortages of materials and transport, and subjected to new forms of State and inter-State control, all enlargements of existing taxes and all experiments in new taxation, with their intricate reactions, will be matters of grave concern to the business classes and to the workers whose wages and employment are affected. Before the war the irregularities and inequalities of the income-tax evoked some grumbling, but the toll was seldom felt to be oppressive. The post-war income-tax must be so heavy as to convert these moderate discontents into clamorous grievances. The propertied classes will be confronted with demands from the State which they will be certain to denounce as confiscation, unjust in itself and crippling to business enterprise. Every class in the community will be concerned to defend itself against taxation which seems to it excessive, and to make alternative proposals for shifting as much of it as possible on to others.

§ 3. No issue will more certainly sharpen class feeling and inflame political passion unless sane counsels prevail and intelligible rules of equity and sound economy for taxation gain general acceptance. But to establish such general rules, and win for them a general acceptance, is no easy matter. For our taxing system has grown up in the same atmosphere of groping empiricism as our other governmental institutions. It has been the offspring of expediency and passing opportunity, not of clearly recognized and consistently applied principles of fiscal theory. Even that chief instrument of modern taxation, the income-tax, first adopted as an emergency measure in the French war at the end of the eighteenth century, was only firmly embedded in our fiscal system as a permanency half a century ago, and the predominant position which it now occupies is a more recent acquisition. The same is true of the other taxing measure next in productivity, the 'Death Duties.' Not until the increase and graduation of these inheritance taxes in Sir William Harcourt's Budget of 1894 was the importance of this great source of revenue established. Historical investigation can, indeed, trace certain guiding principles, or general tendencies, in the development of State-taxing systems, both in this country and in the whole civilized world. In most modern States the tendency has been to draw an increasing proportion of the tax revenue from direct taxes, signifying by this term a tax demanded from a person which he is presumed to have to bear out of his own resources and to be unable to shift on to anybody else's shoulders. In not a few modern States, however, this tendency has been countered in recent times by the adoption of a high protective tariff upon imports, the real incidence of which is not deemed either by its upholders or opponents to fall wholly or mainly upon the persons who pay the duties to the customs officers. In certain sparsely peopled or chiefly agricultural communities the practical difficulties of assessment and collection have also favoured the retention of indirect taxation. But the general trend, especially in popularly governed States, has been to collect an increasing share of the revenue by direct taxation. A second and related tendency has been to do away with those specific taxes, earmarked for some special public service, which characterized the early fiscal system of most countries and which still largely survive in our municipal and county rating systems. Convenience and elasticity of expenditure in the modern State are in such strong conflict with the specific tax that this method of taxation has virtually disappeared, leaving the State full liberty to dispose of its whole revenue according to its annual estimate of its several requirements. The application of the policy of graduation to many modern taxes is also a world-wide tendency, indicating a general acceptance of a particular interpretation of the economic and ethical maxim that taxation should be levied in accordance with ability to pay.

§ 4. Accepting ability to pay as the supreme canon of economy and equity, I shall direct my inquiry to a detailed consideration of the validity of various proposals for the application of this test. But it is first essential to recognize precisely what the process called taxation does with the money that is paid to the State by the taxpayer. The revenue which our State takes by taxation during the year, its income, is expended during the year in what we may term public consumption. It goes for the payment of wages and salaries and pensions of the persons employed by the State in the military, naval and civil services, for the purchase and consumption during the year of stores, tools and other equipment demanded by these services, including considerable outlays in buildings such as ships, barracks, hospitals, arsenals, docks, roads and other works of repair or development. A not inconsiderable proportion of this whole annual expenditure goes into objects of future productive utility such as would rightly rank under capital expenditure. What taxation does, then, is to take certain portions of the income of private citizens which they would have spent or saved and to hand it over to the State to spend or save. It is of importance clearly to recognize that virtually the whole of taxation is deducted from the current income of the taxpayers. Even if it be assessed and imposed upon capital, it is almost entirely paid out of income. Where provision has been made beforehand for payment of Death Duties by insurance, this, of course, is evident. But even where it is permissible to pay Death Duties or other taxes in Government bonds or other scrip transferring capital ownership, the result is the same. For, when the State converts these capital values into cash by putting them on the market, the proceeds represent current income of the purchasers.

Even the case of a special levy upon capital is only exceptional in so far as it is paid, not out of current income, but in securities which are not put upon the market by the Government but are held as a public property. Such a levy, however, stands outside the normal process of taxation for State revenue which we are now examining, and will be left for separate consideration. It does not impair the validity of the rule that all taxes in the last resort are transfers of income from individual citizens to the State. The *basis* of taxation may often be land, capital values of various sorts, or capitalized earning power of individuals, as in a capitation tax, but the incidence of the tax is in all cases upon some form of money income, or real income. In a modern State it is always a transfer of spending or saving power from individuals to the State.

§ 5. This gives us the true starting point in our interpretation of the canon of 'ability to pay' as the criterion of sound taxation. Before, however, we proceed to examine the different elements of income in order to discover how much, if any, 'ability to pay' they severally possess, it may be well to state in advance two basic considerations which must guide us in our task, the full significance of which will only appear when our analysis of income in respect of taxability has been completed.

A sound tax must conform to two negative conditions, which will be found vitally connected with one another:

(1) It must not remove or impair any instrument of, or incentive to, essential or useful processes of production.

(2) It must not remove or impair any essential or useful element of consumption.

In other words, the really taxable elements of income, those which have a true 'ability to bear' taxation, must be those that are unnecessary to maintain or promote socially serviceable processes of production or consumption. The one condition relates to the origins or sources of income, the other to the uses to which income is applied.

CHAPTER II

THE TAXABLE SURPLUS

§ 1. IN any investigation of taxation in its bearing upon the different sources or kinds of income we cannot avoid discussing the problems of the shifting and incidence of the various taxes. For in testing the validity and utility of each tax we must have a clear idea, first of the element of income upon which a given tax finally settles, or the person who really pays, and secondly, of the disturbances and damages it may cause in the 'shifting' process which may occur before the final settlement is reached.

Economic theory presents a sharp division between the kinds or sources of income which are in this sense taxable and those which are not, though many practical difficulties, as we shall recognize, beset the application of the theory. All incomes, apart from pensions or certain other fixed allowances, are payments to the owners of some requisite of production in respect of the services rendered by that requisite to the actual production of wealth. Or, put in another way, the monetary value of all goods or services that are produced and sold, after provision has been made for the maintenance and repair of plant, materials and other elements of the capital fabric, is distributed in various proportions as income to the capitalists, workers, landowners, business men, professional men, whose personal activities or property help to produce this wealth. The wealth itself is real income; the price of it, broken up into various payments to owners of the factors of production, is money income. Much of this income is physically and morally necessary to secure the continued use of the factor of production whose owner receives it. The workers in industry cannot go on working unless a certain wage, enabling them to repair the physical energy they have given out, is continuously paid to them. Nor is it enough that the actual workers at any given time are thus maintained. The subsistence wage must not only keep existing labour in physical efficiency, it must provide for a constant flow of young labour into the industry to take the place of those fallen out from declining powers or death. This does not, of course, necessarily mean that a subsistence wage for an individual worker, or even the standard wage in a particular trade, must be enough to enable him to keep a wife and bring up a family. For