

THE BRITISH TARIFF SYSTEM

E. B. McGuire

ROUTLEDGE LIBRARY EDITIONS:
INTERNATIONAL TRADE POLICY



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Volume 5

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First published in 1939 by Methuen & Co. Ltd.

This edition first published in 2018

by Routledge

2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Routledge

711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

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British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

ISBN: 978-1-138-06323-5 (Set)

ISBN: 978-1-315-14339-2 (Set) (ebk)

ISBN: 978-1-138-10604-8 (Volume 5) (hbk)

ISBN: 978-1-315-09941-5 (Volume 5) (ebk)

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THE BRITISH TARIFF SYSTEM

by

E. B. McGUIRE

B.SC.(ECON.)LOND.

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Commissioners of Customs and Excise accept
no responsibility for its contents*



METHUEN & CO. LTD. LONDON
36 Essex Street, Strand, W.C.2

First published in 1939

PRINTED IN GREAT BRITAIN

PREFACE

THIS book is an account of the tariff of the United Kingdom but does not intentionally advocate any particular policy. It deals with the more permanent features, for a description of the tariff itself at any particular moment would have little value. Such a description would be out of date before it could be published. When any rates or tariff headings are mentioned, they are intended as examples to illustrate some principle rather than for their own significance. For this reason the reader should bear in mind that the book represents the position in December 1938.

When the chemist or the mathematician puts forward his views as to how some problem in his department of knowledge should be tackled, the ordinary citizen will leave all discussion to experts, for he knows that he does not understand the subject. With tariff problems, however, such as the question as to whether protective duties on imports are the best solution for industrial depression, he feels confident to pronounce a verdict, although he may have had no economic training and may know little of the technical factors involved. Often his judgment is swayed by speakers or writers who are, themselves, ill-qualified to expound with such seeming authority, or who have a particular axe to grind. At critical times, such as in the autumn of 1931, the arguments for or against a tariff policy pour in upon the citizen from every side. In many cases the short view with immediate results appears attractive. One has but to pile up a protective duty and the difficulty is solved. Alternatively, free trade is the only possible course. Sometimes the less attractive long view may present itself, but very rarely does our citizen ever hear of the technical difficulties of administering the tax so easily proposed. Again, from time to time, trade bodies desire some form of protection, usually an import duty, to help them in their competition with the foreigner for the home market. Not infrequently their representatives come to the Import Duties Advisory Committee or other Authority with naïve proposals for a comprehensive

import duty which, if applied as proposed, might do more harm than good to the industry in question. Perhaps the difficulties of definition have not been realized. It is hoped that this book may help the uninformed citizen to make his decision when political parties angle for his support for some tariff policy, and that trade associations and similar bodies may find in it some assistance in solving their problems of international trade.

There are many books written on the more abstract views of tariff questions, but they are of little help to the individual who needs practical advice for a particular purpose. Generally, these works concentrate on import duties, and quite often they seem to assume that taxes are actually paid on all dutiable imports. The reliefs for imports which are subsequently exported, bonded warehouses for example, are frequently overlooked. When dealing with the tariffs of some countries this might not be a serious omission, but it is an important matter in the United Kingdom with its great entrepôt trade. Again, it is quite rare to find any work on a tariff even mentioning excise duties. Usually the term 'tariff' is unqualified, but is nevertheless taken to mean import duties only. Yet excise duties are an integral part of any tariff system where revenue is concerned, and are not unimportant in other cases. Writers of former times did not forget to stress these factors. The broadsheets of the early eighteenth century attacked in the most violent language Walpole's introduction of the bonded warehousing system, and the extension of the Excise. They complained, for instance, that the Excise laws filched from the subject the rights of the Magna Carta and trial by jury; that the citizen's house was liable 'to the Inspection by little Officers, as often as they pleased, by Day and by Night'; and that traders were interrupted in the carrying on of their trade by the neglect and blunders of the Excise officers in making out permits. The aim of this book is to explain and discuss the principles underlying the duties and the management of a customs and excise tariff from all aspects, and their application in the United Kingdom.

The earlier chapters are introductory to the main subject. Those readers unacquainted with economics may find

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Chapter II rather difficult. While the material in this chapter is proper to any study of a tariff, it may be advisable to pass it over at the first reading. Continuity will not be affected.

The information in this book is drawn from many sources, and many of these are mentioned, but many more are omitted simply because their origin is now forgotten.

I desire to thank the Controller, H.M. Stationery Office, for his permission to use material and extracts contained in official publications. I also wish to place on record the help of many friends in the London School of Economics, and the Customs and Excise Department, in particular Dr. H. Finer for his encouragement and help in the early stages of this work, and Mr. B. R. Hardaker, who has read the manuscript and proofs.

E. B. McGUIRE

HARROW,

December 1938

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I

THE POLITICAL BACKGROUND

A TARIFF is used for economic, political, and ethical ends, the emphasis falling on one or other of these ends in varying degree according to the needs of the nation and its social habits. An adequate appreciation of the tariff of any country therefore requires a recognition of the political and economic life of the nation, for these factors are the determining influences as to the aims and extent of its tariff. Sound criticism is only possible if the limitations imposed by these factors are understood.

Laws, whether connected with taxation or not, are but the expression of the desires of the nation as interpreted by its government. They must be in harmony with a widespread decision among individuals that they are desirable, otherwise the only basis these laws have for obedience is the extensive use of force. If taxes are imposed which do not accord with public opinion, evasion will be rife and will not be regarded as dishonourable. The position will arise in the nation of two opposing camps, the government and the tax evaders, with public sympathy going to the latter. In these circumstances the government must ultimately resign its authority or revise its taxes. Popular prejudice, due to ignorance and fanned by vested interests, may have to be met by a government even in connexion with a desirable tax, and the educational standard of the taxpayers as a whole must be borne in mind in any proposal to impose taxes, and particularly with protective tariffs. The same remarks apply when it is proposed to remove taxes.

When a government proposes changes in its system of taxation, or if it wishes to forestall widespread discontent with an existing system, it must arrange channels through which the currents of public opinion may flow, and where the strength and direction of the flow may be tested. In this country the key positions for these tests are found in the political parties. Not only do political parties test the current, they also try to

divert it to suit their party politics by propaganda and other methods of educating the public.

We must recognize the political party as a vital factor in the formulation of tariff policy. It is the means by which the government and its parliamentary opposition get some idea of the trend of opinion. The party organs are in the best position to feel the general reaction of the public through the success or failure of meetings, press campaigns, and so on. This task is not easy, however, and sometimes the party finds it cannot accurately assess public feeling. For example, in 1924, the Conservative government felt doubtful as to whether its proposal to initiate a protective policy was in accord with public opinion. The party organs could give no decided answer, and rather than risk proceeding directly against such opinion, the party leaders preferred to test the proposal by a general election. A procedure such as this amounts to a referendum, and in 1924 the electorate decided against the protective tariff.

As the law stands at present, a general election must be held at intervals not exceeding five years. On these occasions the ordinary British citizen suddenly finds himself, often to his own surprise, sovereign for a day. By his vote he can seal the fate of a political party for the next few years. At such times party propaganda reaches its pinnacle of intensity, and the voter is approached by letter, the canvasser, the press, and the broadcaster to support this or that policy. Not infrequently tariff questions form a prominent feature of an election campaign, and the voter has put before him all sorts of economic or other reasons why import taxes should or should not be imposed. In the great majority of cases he has no knowledge or training to form a considered judgment on such difficult problems, and there is little doubt that he is swayed one way or the other by the skill with which arguments are presented, rather than by their validity. The sledgehammer propaganda of the poster has more value at an election time than any scientific exposition.

The elector casts his vote and one of the political parties gains a majority in the House of Commons. The King calls on the leader of this party to form a government, that is, to select men to become the political heads of the departments. Normally these men are drawn from the leader's party, but

political cross-currents sometimes occur, and Ministers are chosen from other parties. From among the Ministers the leader, or Prime Minister, forms his Cabinet, and it is here that the real powers of government are concentrated. In recent times the Cabinet has tended to become rather large, some twenty or more members, and for really important issues there is a marked inclination towards a further concentration of power into the hands of a few more important Ministers, that is, the formation of another Cabinet within the official Cabinet. In budgetary matters the concentration is still greater, being invested in the Chancellor of the Exchequer alone, with possibly the confidence of the Premier on broad issues. It is a rigid custom for the Cabinet to present a unanimous decision, and dissensions within its ranks are not revealed until they become so acute as to cause resignations. Tariff policy has been a very potent reason for such resignations when coalition governments have been in office. This cohesion in the Cabinet lends itself to strong party government since a schism does not easily occur. But from the viewpoint of the citizen, it means that he is driven to giving his vote to a party whatever the abilities of the candidates in his constituency.

Legislation is a complicated matter to-day, so much so that although in theory any member of Parliament can initiate legislation, in practice any important measure must be undertaken or sponsored by the government, and, by convention, all money bills are introduced by the government. Before a bill can be submitted to Parliament, detailed inquiries have to be made, perhaps a Royal Commission set up, statistics prepared and examined, and finally the intricate and difficult work of drafting has to be done. Expert technical and legal knowledge is necessary to ascertain the effects of the new bill on existing laws, and to word the bill without ambiguity. The Cabinet, resolving upon the broad lines of policy, have at their disposal the financial resources of the State, and the knowledge and experience residing in the departments. These resources are not open to the ordinary member. He is, however, far from being a mere 'rubber stamp' for government proposals.

Every bill must pass through three readings interspersed with a committee and report stages in the House of Commons,

and a similar procedure in the Lords before receiving the Royal Assent and becoming law. During each stage of a bill the private member performs a useful function as a critic, both in open debate and in service on committees, when by suggestion or by exposing flaws, he can persuade the government to modify its original proposals. The history of a number of important duties in the Customs and Excise tariff provides examples of concessions to such criticism.

The Ministers of the government are the political heads of the State departments, and as such direct the activities of these departments for which they are held responsible to the legislature. The revenue departments have the Chancellor of the Exchequer as their political head. The Civil Service provides the permanent staff for the departments and remains anonymous behind the Minister. This staff is recruited almost exclusively by open competitive examinations held under the Civil Service Commissioners, an independent body first set up in 1855. There are three broad grades in the Civil Service, the administrative, executive, and clerical grades, and the syllabus of the entrance examinations for each grade is roughly parallel to stages in the country's educational system. There is also a certain amount of movement from grade to grade by way of promotion. Since it is reasonable to assume that ability to pass these tests cannot be related to belief in any political creed, and as the examinations are non-political in character, the personnel of the Civil Service as a whole represents a random political sample of the nation. At the same time this sample is drawn by strata, with the greatest power for national good or ill residing in the few occupying the higher administrative posts. So far these few have always maintained a tradition of loyalty to their political masters of whatever creed; without that loyalty these masters would be helpless. But these few men have never yet been put to the very severe test of serving a government with an absolute majority and violently opposed to the wealthier classes from which, owing to better educational facilities, the men have been mainly drawn. There is, however, no reason to doubt continued loyalty even in these circumstances.

The organization and functions of the Civil Service are

worthy of a short description. The men in the higher administrative posts maintain continuity in policy when Cabinets change, unless Ministers deliberately make a break; they place before the Minister material facts in relation to his policy, and advise him how best to meet changing circumstances; and they assist the Minister in his day-to-day departmental problems, e.g. in answering questions asked in Parliament or by the public. The most important posts are found in the Treasury, where national revenue and spending are co-ordinated and controlled. The Boards of the revenue department consist solely of Civil Servants of the administrative grade. A number of important posts under these Boards are also filled by members of this grade. The executive grades apply the laws, and rules framed within these laws, in accordance with the policy laid down by the administrative officials. They also advise these latter officials on technical details of administration. The clerical grades undertake the large blocks of work of a routine nature. In addition to these grades there are a very large number of State employees belonging to industrial grades, but they are only indirectly connected with tariff administration, e.g. postal officials. Such is the Civil Service. By laws, service regulations, and by a code of conduct not precisely stated, but none the less distinct in its purpose, the political leaders of the nation have in this Civil Service, an efficient and loyal instrument for translating intention into accomplishment with the greatest impartiality possible in this imperfect world.

Tariff laws, like any other laws, are of little use unless they prescribe for infringements penalties that are adequate but not unreasonable. If the penalties are inadequate, the laws become ineffective; if unreasonable, juries would be reluctant to convict. The penalties prescribed in the Customs or Excise laws follow the normal practice, that is, they are maximum punishments. Within that limitation the actual punishment inflicted is left to judicial discretion.¹

¹ Sometimes, however, minimum penalties are prescribed. Thus in the Customs and Inland Revenue Act, 1879, sec. 10, if three or more persons assemble goods to run them through the Customs, the minimum penalty is £100 each. This position has been modified by recent laws relating to first offences.

To make laws and prescribe penalties is not enough; the laws must be administered in a manner considered just by public opinion. The judge must be able to decide, without fear or favour, as to the meaning of an Act, or whether in fact a law has been transgressed. The whole purpose of a law can be frustrated by insufficient penalties, or by harsh sentences. For these reasons the judges are by conventions and by laws made independent, as far as possible, of any undue political influence. The Judiciary stands between the Executive and the private citizen, with the Crown forces at its disposal to enforce its judgments. Subordinate legislation has encroached on this position somewhat of late years.

Actions in respect of Customs and Excise laws may arise from offences, or because an individual is challenging an Executive decision. They may be civil or criminal, and may be heard in any one of the various courts according to the circumstances. A brief outline of the personnel and relationship of the different courts will make clearer the procedure in any particular case.

The Petty Sessions or Police Court is the lowest law court. Its jurisdiction is strictly limited. It is presided over by a bench of at least two unpaid magistrates appointed on the advice of the Lord Chancellor; or by a stipendiary magistrate appointed from among barristers by the Home Secretary, on a petition from a borough. Criminal proceedings are initiated in this court. A *prima facie* serious case is referred to the High Court; but if the case can be dealt with summarily this course is adopted, provided that where penalties are heavy, the accused person is first given the option of trial by jury in a higher court. Most revenue offences are dealt with at the Petty Sessions.

The Quarter Sessions is the appeal court from decisions in the Petty Sessions. It can also act as a court of first instance for most criminal offences. This court has little civil jurisdiction beyond business regarding liquor licences and local rates. In a borough the court sits under a Recorder, who is a barrister appointed by the Crown; elsewhere the court sits under a chairman with legal training and a bench of magistrates drawn from the County or justices division. Appeal from decisions lies in the Court of Criminal Appeal, provided the Quarter

Sessions was not itself acting as a court of appeal from the Petty Sessions.

On the civil side the County Court is the parallel of the Quarter Sessions. It is presided over by a judge appointed by the Lord Chancellor, and he tries civil actions not involving more than £100. Appeal lies to the High Court.

Above these courts is the Supreme Court of Judicature, divided into the High Court of Justice and the Court of Appeal. Its judges are appointed for life by the Crown, and are removable only on an address to the King by both Houses of Parliament. These courts are involved in revenue cases when the issues are exceptional; for example, to obtain a ruling on the law or to hear appeals. A decision to take a revenue case to the High Court rather than the Police Court often depends upon whether a high penalty is desired in preference to publicity. In the High Court there is no publicity if the penalty sued for is paid into the court before the trial of the action. The authorities cannot insist on a trial in these circumstances. The opposite is the case with Police Court proceedings.

The structure of the Judiciary in Scotland is somewhat different. The lowest court is the Police Court sitting under a Bailie, who need not have any legal training. Next comes the Sheriff's Court. The Sheriff is a legally trained man, and his court has concurrent jurisdiction with the Police Court, but he has power to impose heavier sentences. This court also deals with civil cases. Revenue cases can be brought before either the Police Court or the Sheriff's Court in the first instance. Above these courts are the Court of Session for civil actions, and the Scottish High Court for criminal cases and appeals.

At the summit of the legal edifice stands the House of Lords. For legal matters, its membership consists of the Lord Chancellor, six Supreme Court judges who are life peers, and any other member of the Lords with legal standing. The Lord Chancellor, who presides, is a Cabinet Minister; but although this is a political appointment it is by custom only given to a leading member of the legal profession. The Lords is the final court of appeal for civil cases. In exceptional circumstances it deals with criminal appeals.

There are two kinds of legislation; that which is legally supreme, and that which may be regarded as subordinate. The tariff and its administration exhibit both sorts, and a short discussion on their distinctive features and merits is desirable; especially as the subordinate legislation has very greatly increased of late years, accompanied by much controversy.¹

In English law an Act of Parliament is supreme.² This means that no court of law will pronounce on the validity of an Act on the grounds, for example, that it is contrary to public policy. It means also that Parliament can amend or repeal any Act by the same procedure as that by which the original Act came into being. In our modern complex society it is not possible for Parliament to provide for details in its Acts to meet all contingencies. Firstly, all the repercussions of an Act cannot be foreseen. Secondly, and what has special importance in tariff legislation, parliamentary procedure, which has been designed to protect the subject from an arbitrary Executive, is often too slow and cumbersome to meet emergencies demanding prompt action. Thirdly, tariff changes are often dependent on negotiations with foreign governments, and would be unlikely to succeed if each stage had to be discussed openly in Parliament before proceeding further. For these reasons an Act of Parliament dealing with such complex matters as tariff administration, is confined to laying down broad principles within which the Executive may work. Thus Parliament retains its legal sovereignty by defining the Executive's field of action, and at the same time delegates to experts its authority to legislate for every detail.

Delegated legislation takes three forms in tariff administration: Orders in Council, Statutory Rules and Orders, and Departmental Regulations.

An Order in Council replaces the ancient method of a King's proclamation. It is an order issued by the King on the advice of the Privy Council; in practice this means on the advice of the Cabinet. The process results from the dictum that 'the King can do no wrong', since the Minister who countersigns or seals the order cannot shift responsibility from his

¹ e.g. *The New Despotism*, by Lord Hewart.

² See *The Law of the Constitution*, by A. V. Dicey.

own shoulders. In passing, it is worth noting that this principle applies to all actions by the government or its officials. Legislation by Order in Council is very speedy, and is very useful where the Executive requires powers to carry through delicate negotiations. It can be used whether or not Parliament is in session.

Statutory Rules and Orders constitute legislation of the detailed kind which the parent Act contemplated, but where the House of Commons has retained the right of scrutiny and approval before they become operative in law. The procedure is for an Act to delegate to specified persons authority to frame rules, and to have these rules laid on the table of the House for a certain number of days. During that time any member can examine the proposed rules, raise objections, and the Commons can in theory reject them. In practice, rejection is forestalled by withdrawing the rules; but the Commons may also modify them. The process is less rapid than that for an Order in Council, and it cannot be completed when Parliament is not sitting; but it is quicker, less cumbersome, and better adapted to meet changing conditions than the passage of an Act.

Departmental Regulations may be issued under the authority of an Act direct, by virtue of an Order in Council, or under Statutory Rules and Orders. They are rapid in action, and issued solely by the experts of the department. For this reason great care must be taken by them not to let their expert views obscure general issues, and perhaps antagonize Parliament and the public. The scope for Departmental Regulations is usually much more limited than for other inferior legislation.

All these arrangements for subordinate legislation have certain characteristics in common. In the first place, since it is delegated legislation, it must not go outside the terms of the parent Act, and therefore any Court may pronounce upon its validity. Thus a person accused of an offence against Statutory Rules and Orders may challenge the Crown on the ground that the Orders themselves are not within the powers granted by Parliament. He may, in addition, proceed against officials, as private persons, for any damage suffered because of the enforcement of an Order pronounced as void. Secondly, it is

the function of the Judiciary to decide upon the meaning of an Act of Parliament, and therefore the Executive must guard against any temptation, however fascinating, to frame rules which have the effect of interpreting an Act rather than amplifying its provisions. Thirdly, all these orders must be made public through recognized channels, e.g. the *London Gazette*. Fourthly, all subordinate legislation which has successfully passed these three barriers has the full force of law.

Delegated legislation has been dealt with rather more fully than the other parts of the British political machinery because of the very extensive use made of it in tariff administration, particularly since 1932.

Two main objections are current regarding such legislation. It is argued in the first place, that it is hardly possible for any man to keep abreast of the Acts themselves, and the law will not acquit any one merely on the grounds of ignorance; and, secondly, to permit a number of subordinate legislatures simply makes the position utterly impossible. These contentions are only partly true. It is not necessary for the individual to be acquainted with all legislation. He is only required to know the law in respect of his own activities, not the whole of the law. The other objection is that some Acts have been so broadly drawn that a State body can frame almost any rules, and in fact can in some cases usurp the functions of the Courts to try offenders. This is particularly the case respecting Marketing Boards whose objects are complementary to those of the tariff. There is truth in the objection, but that is not to say it is a bad thing. What is really happening is the setting up of special courts for technical matters; an imperfect reproduction of the administrative law found abroad. Decisions and penalties are in the hands of experts, though admittedly they are connected with the issue of the orders, and are bound up with the success or failure of their policy. Against tyrannous orders, however, there must be set the freedom in this country for public sentiment to find expression. Any gross breach of Parliament's intentions could not last long. The only real bases for objection are: firstly, the time lag between an abuse of power committed by a department, and its remedy by Parliament; and, secondly, the immunity given to officials,

since they can only be attacked in the Courts if they act outside the terms of the parent legislation.

What can be said of the expert to whom so much authority is delegated? The civil servant, spending his life with tariff administration is, like the doctor or engineer, a specialist on one part only of the affairs of the community. As an expert he is apt to be impatient with the ordinary citizen; to him the politician, ignorant of the complexities of his mystery, is inclined to be regarded as a hindrance with whom it would be as well to dispense. But it is the ordinary citizen who, though not interested in technical niceties, is vitally interested in ultimate results. And it is the politician who acts as the citizen's broker; it is he who gives a sense of proportion to the intensity of the expert's opinion.¹

This short account of the political framework within which the tariff must work would be incomplete without some observations on the provisions in law by which the citizen can obtain redress if wronged by the government or its servants. First of all, there is no strict definition of the 'Crown'. That mythical being represents different things according to circumstances, and is a conveniently illusory entity for many purposes.² For the purpose of contract, it may be regarded as the King acting through his Ministers. The citizen cannot sue the Crown for wrongs such as a breach of contract, but he may proceed by Petition of Right, and this amounts to the same thing. The conditions for such a procedure do not usually arise in tariff administration. The more likely circumstance is a wrong committed by an official, either on his own initiative or by virtue of written or oral instructions from a higher official. The citizen cannot proceed by Petition of Right, but must proceed against the official who actually committed the offence. Damages would be recoverable from that official. No real injustice arises in practice, because of the limits of the official's assets, since the government always pays the damages awarded. Alternatively, Parliament can relieve the official of all liability by passing an Act of Indemnity, in which case the citizen has no redress.³

¹ Cf. *The Limitations of the Expert*, by H. Laski.

² Cf. *The Governance of England*, by Sydney Low.

³ Cf. *The Law of the Constitution*, by A. V. Dicey.

II

THE ECONOMIC BACKGROUND

THE disturbances caused to the country's economic life by tariff changes are so widespread and diffused, that it becomes impossible to do more than examine major effects. Only in a few instances can the minor or more remote effects be accurately traced. Yet to appreciate these effects and avoid fallacious reasoning, some elementary knowledge of the principles of economic science is necessary. The account in this chapter is merely intended to arm the reader unacquainted with the modern method of economic analysis. Those aspects more nearly connected with the study of a tariff are stressed, particularly such subjects as the theory of comparative costs. The discussion is not critical, and it should be borne in mind that some of the statements made would not find universal agreement among economists. The subject of international trade bristles with controversy on its economic as well as on its political side, and reference should be made to the many works available if a fuller exposition is desired.

Economics is the science of the use of scarce means to attain ends of varying importance. The ends themselves must be complementary in the sense that some particular end must be the most desirable of a number. The means must be scarce in relation to the end desired, and capable of being graded in order of their value to the purpose in hand. Means are of no value in themselves. Thus if it is desired to stimulate some particular industry, the means adopted may be either a protective tariff, a subsidy, or some other method of State control. Economic science does not pretend to pronounce upon the means or the ends as being good or bad in themselves, that is a question of ethics; but confines itself to studying the relationship between the means that can be used and the end desired.

There is no division in modern science of goods or services between those which are economic, and those which are not. Their economic significance depends upon their employment in satisfying wants, and not on their inherent qualities. They

must, however, always be related to time and place. Goods of like technical qualities available at different times or in different places must be regarded as different goods, however alike they may be for certain statistical purposes. For instance, tea at import is not the same thing as tea leaving a warehouse for consumption, and the effects of a tax would differ accordingly even if the rate were the same. Arbitrary distinction is usually made between production goods and consumption goods, depending on their remoteness from consumption. A tax on silk cocoons would have different results from a similar rate of tax on silk handkerchiefs. Some goods are complementary to each other; that is, consumption of one is bound up with consumption of the other. Thus tobacco and matches, or whisky and soda are complementary. All these notions are vitally important from the point of view of taxation.

We live in a dynamic society. Population, technical knowledge, and our environment generally are in a state of continual change. The study of economic phenomena direct under such conditions would be too difficult, so abstraction is made of specific relationships, disturbing elements are then introduced one by one, and conclusions modified. The usual approach is to imagine a static condition, and determine the equilibrium position; that is, the resultant of the forces considered. Next, this equilibrium is compared with another equilibrium after some disturbing factor has been introduced. Finally, the dynamic condition is studied and the movements are examined during the changes from one equilibrium towards another. The last stage accords with actual experience, for the equilibrium position is never reached; the tendency towards one position changes direction almost as soon as it appears. In relation to import duties, for example, every variation in a duty carries repercussions through other duties perhaps, and through the use of other commodities almost certainly. Readjustments in trade have to work themselves out, but before tranquillity is established, further changes in one or other of the duties may occur which will set up new stresses in the economic machine.

The relative value of goods or services determines whether or not exchange will take place. These values originate with the individual. He possesses either goods or services which

he is prepared to exchange only if it is to his advantage; that is, these possessions have a subjective value. He will grade these goods, probably subconsciously, in the order of their utility to him, and will be prepared to exchange part of any particular commodity if he has a surfeit of it in relation to the rest of his goods, and if his reserve price is obtainable, so as to get something which appears to him to be more desirable. These readjustments of his holdings will go on until the expectation of satisfying his desires is maximized. The final equilibrium position represents the margin to which exchange will be pushed. As he relinquishes part of his holdings, so his subjective valuations rise till they equal the valuations of the market, or the objective values. Any further exchange would involve the expectation of loss.¹

The amount actually exchanged is not solely dependent on quantities of holdings, but also on the rate of change in the demand as quantities change hands, and also on the rate at which substitution will occur if demand is difficult to satisfy. The term elasticity of demand represents a ratio of the proportionate change in the amount demanded to the proportionate change in price, when changes in supply are small. The ratio can be expressed: $\text{Elasticity} = \frac{\text{Percentage change in demand}}{\text{Percentage change in price}}$. This ratio is unity when a given percentage change in price is accompanied by an equal percentage change in demand. If the ratio is less than unity, an increase in price would cause a smaller proportionate fall in demand. The elasticity will of course vary with large changes in supply; thus while it might be greater than unity with a small aggregate supply, it might be less than unity when the supply is large. A change in a tax normally causes an alteration in price, so that it becomes important to know the elasticity of demand, or at least on which side of unity it lies, if the effect of the tax is to be estimated. A tax on a commodity where the demand is highly elastic will reduce consumption greatly, and should therefore be avoided unless there are strong reasons to the contrary. It should be remembered that there may be no immediate substantial change in supply with a rise in price due to a tax. A recent example of

¹ See *The Common Sense of Political Economy*, by P. H. Wicksteed, for an exhaustive account of the marginal utility theory.

this principle was the rise in the beer tax in 1932 which was accompanied by a greater proportionate fall in demand. Supply took some little time to readjust itself. Substitution is intimately connected with changes in demand, and its elasticity is complementary. If substitution is easy, the elasticity of demand tends to be high; any rise in price causes a greater fall in demand because of available substitutes.

So far the point of view of the individual has been examined. But it is the composite valuations of a number of individuals that fixes the market price, and equilibrium is the condition when the exchanges effected have resulted in each person bringing this scale of valuations in harmony with the market valuations. At this point supply and demand equate, provided monetary manipulations are ruled out.

The foregoing deals only with exchange for consumption, but similar reasoning can be applied in the case of production. The individual faced with alternative technical opportunities for production will place a reservation on his own productive power, and distribute his available resources to maximize his return. Allowance must be made, of course, for ignorance of all possible opportunities. He will, for example, forgo altogether some of his resources and specialize others in combination with individuals similarly situated, in order to get increased returns. An entrepreneur will utilize the productive factors available to him so that his net return is at a maximum. In other words, the resources will each be employed up to the margin where further employment involves loss. This is the ideal or equilibrium position.

With technical progress there will always be a continuous process of the transfer of productive factors with the object of attaining this illusive ideal. Fluctuations in employment and the demand for capital are major manifestations of these changes. The imposition or alteration of a tax has a similar effect.

The increasing application of a factor in production may bring in a smaller, equal, or greater return. This is referred to as a condition of decreasing, constant, or increasing returns. A tax which restricts the use of a factor operating under increasing returns is likely to retard production more than if returns are decreasing. It should be borne in mind, however,

that the ultimate condition is always decreasing returns if the goods are to continue to have an economic value, that is, if they are not to become free goods.

For the present, let disturbances originating solely from monetary causes be ignored. Then the costs of production can be conceived as the value of the labour if it were used in alternative ways. Labour here is taken to mean services of the past as well as the present. In these conditions the prices of products must be harmonious with labour costs; thus, if the labour costs of one article are double those of another, then its price will also be double. This brings us to the theory of comparative costs, which is fundamental to an analysis of production. International trade is simply a special case.

For simplicity of exposition which does not affect the principle involved, constant returns will be assumed, and purely monetary disturbances will be ruled out. Let us suppose two groups of people, A and B, both producing coal and iron, and that though there is some mobility of labour within each group, there is practically none between them without much loss of efficiency. These are roughly the conditions of two countries, and we may imagine, for example, that group A is the United Kingdom and group B is Sweden. Three possibilities arise. Country A may be more efficient in producing coal than B; while B may be more efficient with iron production. Specialization and exchange, or the division of labour, are obviously advantageous whether we consider groups or nations. Again, group A may be *equally* superior to B at both the production of coal and iron, and exchange has no advantages. Now if A is *unequally* superior to B not only is exchange advantageous, but unequal incomes can accrue to the two groups. Since this is the commonest case in international trade, let us examine an imaginary simplified example:

<i>Group or Nation</i>	<i>Units produced per day</i>		<i>Costs in terms of the other product</i>	
	Coal	Iron	A unit of coal	A unit of iron
A	4	3	= $\frac{3}{4}$ of iron	= $1\frac{1}{3}$ of coal
B	2	2	= 1 of iron	= 1 of coal

In one day A can either produce 4 units of coal or 3 units of iron; hence for a unit of iron A sacrifices the ability to produce $1\frac{1}{3}$ units of coal, while B sacrifices only 1 unit of coal. There will still be room for advantageous exchange if A concentrates on coal and B on iron. This obvious result when the facts are properly set out is nevertheless very frequently overlooked or ignored. One has but to look at some of the fallacious arguments which form the bases of tariff policies in various countries to see how the obvious is ignored or missed; policies which profess to increase a nation's productivity as apart from the politics of national safety or well-being. Let us suppose the efficiency of B to produce coal improves because, for example, a restrictive tax has been removed. Let B's ratio change from 2 : 2 to 3 : 2. Now, B will only sacrifice $\frac{2}{3}$ units of iron for 1 unit of coal; but group B must also sacrifice $1\frac{1}{2}$ units of coal for 1 of iron. The figures for A are still $\frac{3}{4}$ and 1 respectively; therefore it will now pay A to concentrate on iron and get his coal from B, since A's cost for coal are $\frac{3}{4}$ iron as against B's $\frac{2}{3}$, and his costs for iron are only $1\frac{1}{3}$ coal against B's $1\frac{1}{2}$.

The examples have dealt with cost ratios, but these do not determine the actual rate at which exchange will take place. This rate lies between the cost ratios, but the actual rate operative is settled by the play of demand and the bargaining abilities of the two groups. This rate at which exchange takes place is called the 'terms of trade' in the theory of international trade.

The effects of money can now be shown in the typical case first discussed. Money production costs and money incomes are to be introduced. It will be assumed that both countries have their currencies on the same basis, say, the gold standard, and that an influx or efflux of gold is allowed to affect the currencies freely. Let us suppose that both currencies are such that £1 has exactly the same purchasing power in both countries. Costs will press equally, and in the first case quoted coal production in group B will cost twice as much as in A; for iron the costs will be greater for B in the ratio of 3 : 2. Under these circumstances B will buy both coal and iron from A. Suppose, now, that the flow of gold from country B to A occasioned by these purchases reacts on costs through

the expanded basis for currency in A, and the contraction in B, so that a position is reached when the £1 in B is worth £1 10s. in A. Now, the ratios of costs in A and B become for coal as 3 : 4, and for iron as 1 : 1. It still pays B to import coal, but the import of iron is a matter of indifference. Let the continued trade in coal cause currencies to change still further till £1 in B is worth £2 in A. The costs of coal and iron for A and B respectively become as 1 : 1, and 4 : 3, so that it now pays A to import iron from B, while the trade in coal ceases. Hence trade will settle down between the limits when £1 in B is worth £1 10s. and £2 in A, so long as the efficiency of production in each country remains unchanged.

To exhaust the subject, costs may be taken to include transport charges, and tariffs, quotas, and bounties can be similarly included. If the currencies are managed, the free operation above must be suitably modified, for this will be reflected in the costs. The generalizations for two commodities can be extended to many, but the reasoning is rather complicated,¹ though it is more nearly related to the actual conditions of international trade.

Considering only two countries gives, of course, a limited view of international trade. If more than two countries are examined the same reasoning can be applied, but a note of warning must be added. While each country will gain by specializing according to its comparative costs, and if any one dropped out it would suffer disadvantage, it would be bad logic to presume the reverse. Thus if two countries are exchanging and producing to their mutual advantage, there is no ground for supposing that the entry of a third country will favour both the other two; it may injure both. Free trade arguments which are otherwise sound, often fall into this trap. Whether the third country will improve the position of either or both the other two depends on the terms of trade which follow its intrusion. It is true to say, however, that the three countries taken as a whole will benefit. This point should be carefully considered if it is proposed to extend trade by removing a protective duty.

¹ Professor Edgeworth has devised a method, where, by the use of logarithmic scales for production costs in each country, the division between imports and exports can be read off.

The theory of comparative costs demonstrates that unequal income standards and advantageous exchange are not inconsistent with each other, and thus disposes of certain looser protection arguments. It also demonstrates the forces driving towards specialization, and towards the elimination of industries in one or other country. Operating against such elimination, however, are the forces such as decreasing returns, and the psychology of patriotism. Nevertheless it is incorrect to say that foreign competition will not injure an efficient domestic industry; a favourite free trade argument. The industry may be more efficient, but if its comparative costs are greater than those of its foreign competitor, it cannot continue.

Specialization in an industry at first means increasing returns, but eventually diminishing returns will supervene, and the optimal size of the productive unit emerges. In some industries where overhead charges are small, this unit is likely to be small also. In other cases such as railways, the optimal size of the unit will be great, so much so that monopoly conditions will protrude even in a competitive economy. Monopolies have a peculiar fascination for Chancellors of the Exchequer, as they are generally regarded as sources of a tax revenue which cannot be passed on to the consumer. The grounds for supposing a tax to rest solely or mainly with the monopolist are based on the idea that he maximizes his revenue by restricting output and reducing costs, while at the same time he only partially satisfies the possible demand with an enhanced price. But if his costs are raised by a tax, the principles of the elasticity of demand and substitution come into play, so that while some of the tax may stick, the consumer in most cases will also have to shoulder some of the burden.

Discriminating prices and dumping are the problems most discussed in relation to monopolies and tariffs. These are only possible if the monopolist can divide his markets effectively. This division is not difficult with the aid of national boundaries, but for discrimination there must also be a difference in the elasticity of demand. For if the elasticity is the same, then the output and price which maximizes returns in one market, will also maximize returns in the other. Conversely, if the elasticity of demand is not the same, but prices

and output are equal for each market, then one of the markets is not giving maximum returns, and it will pay the monopolist either to transfer some supplies from one market to the other, or to discriminate with prices. The former case arises, for example, with standardized prices, where there is wide advertising, or where special packing is difficult. The latter case can be seen in fashion prices, or a doctor's charges. In the field of international trade, the transference of stocks is called dumping, and it might be added that such dumping does not mean exporting below production costs. This condition may occur if there has been over-production due to an error of judgment and losses are being cut, or as a temporary measure to oust competitors by undercutting their prices; but as a permanent state one would have to assume that the producer is a philanthropist with unlimited resources and a preference for foreigners.

In very few instances do goods appear ready for consumption as soon as production factors have been applied. Generally production extends over a period and the conception of capital emerges. Capital goods are those used to produce articles for final consumption. The more capital goods that are used, the more roundabout are the methods of production, and the greater are the quantities of consumption goods which can be turned out. This short mention of capital is made merely because the taxation of commodities is indirectly connected with capital accumulation. Given the resources available at a particular moment, individuals can either devote them to increasing capital goods or spending them on consumption direct. Saving is therefore the postponement of present consumption. Commodity taxes may have a considerable influence on the direction in which the resources will be used. A tax which drives out present consumption may force income into production goods, prolong or expand roundabout methods, and ultimately increase the quantities of consumption goods. The receipts from the tax may be spent with the same object, for example, in road-making. If the tax is applied at some intermediate point, it may, by the rise in price at that point, cause production to slow up more than the effects of the tax justify and some income to be diverted elsewhere, or to the