the tax base were eliminated by the adoption of a system of 'cumulative averaging' of income, or something like it, we should get much nearer to an equitable system of taxing in accordance with taxable capacity than under the existing methods.

THE PROBLEM OF CAPITAL GAINS

But we have so far ignored another difficulty about including capital gains in taxable income with other casual or non-recurrent gains and receipts. This is the problem of reckoning the additional taxable capacity which results from a capital gain. As will be argued below, while some kinds of capital gains give rise to the same spending power as other types of earnings, this cannot be said of other kinds of capital gains, so that no *uniform* treatment of these gains can show satisfactory results; nor is the one kind of gain easily distinguishable from the other.

'Capital appreciation' covers a multitude of sins. In some cases, it is merely a concealed form of interest or dividend payment—this is the case for example, with the annual appreciation in the value of real property due to the approaching termination of an existing lease; the appreciation of bonds issued at a discount as the date of redemption grows nearer; or the appreciation of securities of all kinds, due to the ploughing back of profits and the consequent rise in earnings' prospects; the appreciation in the value of a developing mine or oil-well. In all these cases the appreciation in the value of assets is not (or need not be) of a fortuitous character but is something which is fully expected beforehand; the owner holds such assets in the prospect of definite capital appreciation and this appreciation is part of the 'normal' yield the expectation of which determined its actual valuation by the market. Capital appreciation of this kind is logically indistinguishable from other forms of income from capital, and ought definitely to be included in Income, however narrowly defined.

The other forms of capital appreciation reflect a change in market expectations during the period in which the appreciation in value occurs; they are fortuitous in the sense that they could not have taken place if the market had foreseen the course of prices beforehand.[1] The fact that they are fortuitous does not in itself justify any difference in treatment for tax purposes—a gain is still a gain, even if it is a pure windfall. However, from the point of view of the enhancement of the spending power which such gains represent a distinction must be made between capital gains which reflect the expectation of higher future earnings of the assets and those which reflect a fall in interest rates (i.e., the rates at which expected future earnings are discounted); and with gains of the former kind, a further distinction should be made according to whether the rise in expected earnings is in *real terms* or merely in terms of *money*.

Capital gains which reflect higher real earnings of assets represent a genuine accrual of wealth—they make any recipient of ~~such gains~~ better off in much the same way as any other kind of non-recurrent or irregular gains or receipts. But a rise in capital ~~values~~ which proceeds *pari passu* with a general rise in prices does not make the owner of assets *absolutely* better off, even though it makes him relatively better off in comparison with other owners of disposable wealth whose assets have not increased in value in the same way. A man who owned £100,000 worth of assets and had an income of £5,000 a year will be no better off or worse off if, as a result of an inflation in the course of which all prices are doubled, his income rises to £10,000 a year and his capital assets to £200,000. The additional £100,000 worth of capital does not represent any addition to his spending power; and if it were included in his taxable income over the period, he would be taxed too heavily in relation to another man whose income had equally risen from £5,000 to £10,000 a year, but who, deriving it from personal earning power rather than disposable wealth, has no capital appreciation associated with it. (The tax on capital appreciation in this case would be more in the nature of a capital levy which cuts earning power permanently rather than a tax on current income.) In times of in-

[1] Strictly speaking, only that part of the capital appreciation of particular assets can be deemed to be 'fortuitous' which exceeds the normal rate of return on investments of that character.

flation (or deflation) therefore Income defined as 'consumption plus net capital appreciation' does not provide a reasonable measure of taxable capacity as between incomes from property and incomes from work. At the same time the *exclusion* of capital appreciation from Income does not provide a reasonable measure of taxable capacity either, since it fails to do justice as between those (the shareholders) whose capital wealth did increase with the general rise in prices and the others (the bondholders) whose wealth remained constant in money value.

Indeed this problem of finding a uniform measure of taxable capacity in times of changing prices is not peculiar to capital appreciation but is rooted in the taxation of savings as such and therefore inevitably associated with the choice of income rather than consumption or property value as the basis of taxation. During a period when the general price level is changing comparisons between individuals may legitimately be made in money terms in respect of their relative spending—since whether prices are rising or not, it may be assumed that equal expenditure in terms of money value in any given period represents claims of equal real value on goods and services. Similarly if the value of a man's property is taken as the basis of taxation it may be assumed that, irrespective of whether prices are changing or not, differences in the real wealth of different individuals at any one point of time are accurately measured by the market values of their possessions. But when income is chosen as the base for taxation there is the additional problem that the relationship between the real savings of different individuals is not measured by their savings in terms of money value in times of changing prices. Equal amounts of savings in money terms (irrespective of whether these savings represent unspent dividend income, capital appreciation or capital gains) may represent a greater or lesser addition to wealth in real terms according as the ratio of savings during the period to the value of the capital existing at the beginning of the period is greater or smaller.[1] The problem therefore does not arise merely in connec-

[1] The problem therefore is not that money income ceases to provide an index to real income unless it is adjusted for the change in prices. The problem is that

tion with capital gains though it is undoubtedly accentuated through the inclusion of capital gains in taxable income.

We may now turn to the other type of capital appreciation which reflects a fall in interest rates rather than the expectation of higher earning power. This in a sense is in an intermediate category between the two cases discussed above; since the rise in capital values in this case means an increase in the amount of goods and services which the possession of wealth as such commands, but without a corresponding increase in the flow of real income accruing from that wealth. There is therefore an increment in spending power due to the rise in capital values, but one which is not identical with that accruing from a corresponding increase in capital values which reflects a rise in expected real income. For in so far as a capital gain is realized and spent, or realized and the proceeds used to take advantage of a new favourable investment opportunity, the benefit derived from the gain is equivalent to that of any other casual profit. If however it is not so realized, there is clearly only a smaller benefit—even though, for reasons explained earlier, a rise in capital values as such is of some advantage to the holder. Again, treating the two kinds of capital gains in the same way is not an equitable method of measuring taxable capacities; nor could equity be attained by exempting the one and not the other, even if such a procedure were feasible which it certainly is not.[1]

no such allowance can be made simply by adjusting money income for price changes. As far as the money income is currently spent no such allowance need be made for a comparison of the relative taxable capacity of different individuals. To the extent that income includes savings (whether positive or negative) the necessary correction for the change in prices needs to be made not for the savings, but for the capital values at the end of the period—which means that the extent of the price correction required for savings varies from individual to individual, according to the relationship of current savings to capital values at the beginning of the period; the necessary correction for income as a whole varies both with that relation and the relation of savings to income.

[1] Proponents of the Income Tax principle might argue, I suppose, that in an ideal world capital values should be adjusted for changes in the price level and changes in the level of interest rates: that the element of capital appreciation due to the former should be neglected, and that due to the change in interest rates taxed at a special favourable rate. But this latter kind of adjustment (unlike the former) is conceptually impossible, as well as being totally impracticable. The 'interest rates' at which the expected future earnings of particular assets are dis-

These problems cannot be satisfactorily overcome by treating capital gains as a form of wealth accrual *sui generis*, and taxing them at special rates—as is effectively the case, for example, in the United States. It is not that capital gains *as such* provide less spending power than other forms of profit; there are some kinds of capital gains which represent the same kind of spending power as conventional income; other kinds which represent none at all; and yet others which are in-between; these types moreover shade into one another gradually and imperceptibly. These difficulties arise, in fact, from the limitations of the income concept as such rather than from any defect in its legislative application. There is no 'ideal' definition of Income (at least none that could be objectively defined and measured) which, if adopted, would measure the amount of 'net accretion of economic power' of an individual (Haig) or the amount which each individual could spend in any particular year and 'still be as well off at the end of the period as he was at the beginning' (Hicks).[1] The search for the 'true' measure of the spending capacity or the true 'increment of economic power' is a chase of a will-o'-the-wisp.

The arguments that can be advanced to show that capital appreciation does not necessarily represent an added source of wealth are generally employed to justify their exclusion from the scope of taxable income altogether. Yet it can be easily demonstrated that the exclusion of capital gains from taxable income produces even more absurd results than their inclusion. For these untaxed forms of spending power are not distributed at random, but are inherently linked with the ownership of property; their neglect creates therefore a serious discrimination in tax treatment against those who make their living by personal effort. It opens the door, moreover, to tax avoidance (and particularly to surtax avoidance) on the widest scale, since the facilities of the capital market offer almost unlimited scope for

counted cannot be inferred from their current dividend or earnings yields, or from the rates of interest on bonds of various maturities; and it is not possible to say, in any particular case, how far the rise in share values was due to a rise in dividend expectations or a fall in the rate at which those dividends are discounted.

[1] Cf. *Value and Capital*, ch. XIV *passim*.

converting taxable income into tax-exempt capital appreciation. This can be done not only through the purchase of particular classes of securities whose dividend yield is low in relation to their earnings, or whose entire yield consists of expected appreciation, but more generally through the sale of securities 'cum dividend' and their re-purchase 'ex-dividend' which can normally be accomplished on terms that relieve the holder of surtax if not of income tax.[1]

'The whole procedure', wrote Henry Simons in reviewing the American tax system in 1938[2], 'involves a subtle kind of moral and political dishonesty. One senses here a grand scheme of deception whereby enormous surtaxes are voted in exchange for promises that they will not be made effective. Thus the politicians may point with pride to the rates, while quietly reminding their wealthy constituents of the loopholes.' Alas, these words are as applicable to present-day Britain as to pre-war America.[3]

THE CASE FOR AN EXPENDITURE TAX

The analysis above has shown that any system which sets out to tax Consumption plus Saving is bound to fall long or short of its objective, with serious consequences for equity as between persons. The sources of spending power are numerous, and the nominal accruals arising from the different sources cannot be reduced to a common denominator, except on some highly arbitrary basis. It has been shown that our present Income Tax

[1] The existing provisions against 'bond-washing' (originally introduced in the 1937 Finance Act) only prevent this means of tax avoidance when the sale and re-purchase is accomplished 'in the same or any collateral agreement'; they do not apply to cases when it is accomplished through two successive transactions. These provisions are only effective (and probably were only intended to be effective) against large-scale transactions of this kind undertaken between financial institutions.

[2] *Personal Income Taxation*, p. 219.

[3] That the present very high rates of taxation are largely spurious in the case of large incomes from property is shown by the fact that in 1951–52 there were only thirty-six net incomes in Britain in excess of £6,000 a year and only 1,202 in excess of £4,000 a year. (Cf. Inland Revenue 96th Report, Cmd. 9030, Table 56.) It would not be contested that the number of families in this country living at a standard far in excess of these amounts must run into many thousands. Cf. also Chapter VIII, pp. 226–229 below.

Professor Pigou said, are the 'ideal objects of taxation in their announcement aspect'.[1]

The proper distinction for the purpose of the measurement of taxable capacity therefore is not between accruals and windfalls, or between expected and unexpected gains, but between genuine and fictitious gains. The exclusion of 'windfalls' from taxable income could in fact only be justified if it could be shown that the gains in the windfall category are of the fictitious kind, and not the genuine kind. But there is no such presumption. Fortuitous gains can be genuine; and as we have seen, expected gains can also be fictitious.

Capital appreciation represents a genuine gain whenever it secures for the recipient an increased command over both consumption goods and income yielding resources—i.e., an increase in the purchasing power of his wealth in terms of commodities whether viewed as a *stock* or as a *flow*. In the normal case a gain which represents increased command in terms of the one also implies increased command in terms of the other. But it is possible to think of cases where this is not so. Thus when there is a general rise in capital values due to a general fall in interest rates, the purchasing power of capital resources in terms of consumption goods is higher than before. But the resulting capital appreciation does not (or at any rate need not) make any one capitalist better off relatively to others; it does not secure him an increased command over capital assets. Whilst the aggregate purchasing power (in terms of consumption goods) of his capital resources has gone up, the flow of real income that he expects to derive from his capital has not; so that his 'spending power' is not higher—or at any rate not appreciably higher—than before.[2] Similarly if in times of inflation there is a rise of ordinary shares, the gain of the shareholders is genuine enough in relation to other capitalists (whose capital values have not increased); yet, it would be wrong to treat such an appreciation as Income in the same way as one which implied a corresponding increased command over consumption goods.

It follows from this that the ideal definition of Income, as a measure of taxable capacity, is to be thought of, not as Consumption plus

[1] *Op. cit.* p. 156.

[2] As we have seen earlier (p. 32) an increase in the value of capital resources in *relation to income* does represent an increase in spending power, but this increase is not of the same order as one which secures for the recipient an equivalent appreciation of capital values and a correspondingly larger command over future income. Hence capital appreciation of the former type cannot be regarded as part of Income in the same way as the latter type; and it may be considered that a more appropriate method of taxing benefits from capital appreciation which merely represent a fall in interest rates is through an annual tax on capital, rather than through a tax on capital gains.

Actual Capital Accumulation (*à la* Haig) nor as Consumption plus Capital Accumulation Excluding Windfalls (the accountancy ideal) but as Consumption plus *Real* Capital Accumulation, where the term '*Real* Capital Accumulation' is to be understood as Actual Capital Accumulation subjected to a double series of corrections: first, for the change in the general level of prices (of consumers' goods), and second, for the change in the general level of interest rates.

The correction for the change in the general level of prices could be regarded as an 'index number problem'—i.e. a problem that is in principle capable of being dealt with in terms of approximative solutions though not of exact solutions.[1] But the correction for the general level of interest rates is not just an index number problem: for the true change in interest rates, as we have attempted to demonstrate above, is not something that can be inferred from market data. When the general level of share values goes up it is not possible to say how far the rise represents increased expectations of profits and how far it represents increased confidence resulting in a lower rate at which the expected profits are discounted. Thus the problem of *defining* individual Income, quite apart from any problem of practical measurement, appears in principle insoluble.

VI

SOCIAL INCOME AND INDIVIDUAL INCOME

Contrary to what is often supposed, the concept of Social Income does not suffer from quite the same ambiguity and vagueness as that of individual Income; at any rate the arbitrariness in the former is of a different character, and raises less intractable problems than in the latter. The reason for this is that Social Income consists of the value of consumption plus the *value of the increase* in the stock of goods in existence (and not the *real increase in the value* of capital assets); and the measurement of a change in the stock of goods raises lesser problems than the measurement of the *real* change in their individual value. The change in the quantity of social capital, between any two

[1] It must be borne in mind however that what needs to be corrected for price changes is not the saving, or the Capital Appreciation for the year, but the total value of assets at the end of the year by the change in prices in the course of the year. Such a correction is therefore only feasible for Accrued Income (which reckons unrealized capital appreciation, and not only realized) and not for Realized Income. Even if net realized capital gains were assumed to correspond to total net gains, realized and unrealized, it would not be possible to make the correction without knowing the total capital value at the beginning of the year.