

Notes on Some Effects of Inflation, Taxation and Direct Controls

July 1956

These notes by Mr J. M. Dixon expand and further explain some matters raised in Chapter 15, The Rewards of Enterprise, particularly in section II of that chapter, Corporate Capitalism in a Mixed Economy.

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The rate of increase of material welfare in Australia has been considerably slower than in a number of other advanced countries. Some of the reasons for this slow rate of progress have been discussed generally in Chapter 15 and Appendix 33, and there are some important contributory causes which are given closer attention in these notes: inflation and inadequate accounting for inflation; fiscal and taxation measures and controls which ignore inflation and inhibit economic growth by raising costs and making investment in many productivity-raising steps unprofitable.

After much consideration the conclusion was reached that these notes are a necessary exposition and elaboration of major problems affecting corporate capitalism in the mid-twentieth century, especially for those readers who wish to check on some of the underlying and some of the more technical aspects of the situation.

It cannot, perhaps, be claimed that all causes and effects of slow material progress, inflation and so on are identical for the average Australian, the average company and C.S.R. It can, however, be claimed that there are many causes and effects that are common to the community and to companies; that if good for one are good for the other and if bad for one are bad for the other; that, to a very large extent indeed, economic health is indivisible.

The notes are in four main parts:

I. MEASURING REALITIES IN A PERIOD OF UNSTABLE MONEY

Introduction; the inflationary situation; honest stewardship and inaccurate yardsticks; the nature of the problem of accounting for inflation; some effects of inflation on saving and investment; C.S.R.'s interest in problems arising from inflation; some further opinions and actions on accounting for inflation; the level of national savings; wage fixation and negotiation.

2. SOME EFFECTS OF HIGH TAXATION OF COMPANIES

Double taxation of public companies' profits; company tax a cost of production inhibiting productivity; effects of inflation on taxation of company profits; the taxing of governmental and co-operative businesses; company taxation—conclusion.

3. THE LITTLE-KNOWN LOW LEVEL OF COMPANY PROFITS

Company profits and the national income; real returns to shareholders from a sample of company enterprise.

4. PRICE CONTROL AND OTHER DIRECT CONTROLS

These notes are not all-embracing; there are further aspects. Also, they do not follow all the points raised as far as they could be pursued. It is hoped that others may be stimulated to further study of these questions, which are of practical importance. And it has not proved possible to keep the various subjects entirely segregated under the respective headings because the problems are inter-acting.

1. MEASURING REALITIES IN A PERIOD OF UNSTABLE MONEY

Introduction

Engineering, all will agree, has proved itself a remarkable means for promotion of the material progress of the world. Engineering's achievements result from the intense and continuous application of science. In the application of theory to produce practical results the success of engineering, as of science and technology generally, lies essentially in *measurement*—more measurement and measurement of greater accuracy. An engineer can measure the amount of energy in coal and the proportion of that energy lost in combustion, in transit and in turning the wheels of engines. The engineer thinks in terms of the quality of the coal: not every ton of coal is the same, worth the same, capable of producing the same results. Engineers have produced devices and techniques to measure length, weight, heat potential, conductivity and so on; and have also evolved methods of making accurate allowance for change or distortion due to varying conditions of temperature, pressure and other factors.

The accountant and, to a considerable extent, the economist—and therefore governments, businessmen and other members of the public who work from their findings—use money as the principal measuring-rod. And this yardstick is used without application of any standard practice for measuring the quality of the money or of how much, as a yardstick, the money is shrinking or stretching. The engineer would not use an elastic tape measure; moreover he would allow for the effect of temperature in expanding or contracting his metal measuring scale when making delicate and important measurements.

Without some reasonably effective and consistently applied method of adjustment to take care of the varying quality of money as an economic and financial measuring device, applied science can hardly be said to operate. Therefore we are not obtaining in our national and business economics the real benefits, or anything approaching the full benefits, of the scientific method.

Habit and tradition, political convenience and the vested interest in inflation held by some parties appear to be the reasons why these vital principles of science are not paralleled in the field of accountancy. Their application in accountancy might fairly be claimed to be of at least as great importance as the use of similar principles in other fields, because accountancy, with its constant flow of reports to all sections of the community, is intended

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to provide facts and indicators about every activity aimed at maintaining and improving the community's material well-being.

In the sphere of national accounting the United Kingdom Government (and some other governments) has recognized the necessity for making adjustments for inflation. The United Kingdom has improved accuracy in its national income estimates by recognizing the need for adjustment of stock values and of depreciation to allow for inflation. Some of the annual United Kingdom statistics are recalculated in terms of constant prices. It is worthy of note that the lead in practice has been mainly given by governments and governmental instrumentalities, guided by men with high-level training in economics and statistics, in the United Kingdom and elsewhere (but not in Australia or New Zealand).¹ In recent years some accountants and economists have evolved techniques for measuring business and economic realities in a period of unstable money and it is to be hoped that these will have increasing application.

The Inflationary Situation

In material matters, inflation is perhaps the factor which, above all others, readily unleashes man's capacity for excessive optimism, wishful thinking, confused thought and subsequent wrong action. With costs, prices and figure-incomes spiralling, the most experienced of men find themselves losing their grasp of fundamental realities; unable to carry out their responsibilities with a satisfying degree of reliability; unable to exercise normal disciplines over those around them and unable to play a purposeful and effective part in community arrangements. The constantly mounting figures required to record sales, wages, profits, asset values and taxable incomes induce an atmosphere of growth and prosperity and generate psychological attitudes quite divorced from the material realities which the figures are intended to express.

The habit of thinking in terms of money, which is tremendously quick and convenient, and reliable in periods of stable money, carries on into periods when the value of money is unstable. We do not stop to take enough notice of the change in our unit of measurement. Production results, income results, quantities of resources and many other factors are, for quite a time, thought to be bigger and better simply because they show up as a larger number of monetary units. Such is the force of the money habit that these thoughts can continue for a long period without sufficient regard being given to the possibility that production, real incomes, real resources, far from increasing, could actually be stagnant or declining. At the very least, whatever growth is occurring is pitched at a much more gentle slope than that projected in the minds of the thinkers, not to mention the non-thinkers.

Only after a considerable period is it brought home to thinking members of the community that living standards, real quantities of resources and productive capacities do not depend upon the numbers of monetary units put into the pay envelopes or recorded in books and profit statements, but upon the production capacities of our physical assets, the efficiency of our workers and the capability of our managers.

There is a considerable degree of correspondence between the inflationary situations in recent years in the United Kingdom, Australia and New Zealand. In 1956 the United Kingdom Treasury and the Central Office of Information published a popular version of the White Paper, *The Economic Implications of Full Employment*. This says, "It is not every rise in incomes which sends up prices. It is when incomes rise faster than output that prices rise"; and later, "Earnings have risen much more than output-per-man. So labour costs per article have risen about 30%" (from 1950 to 1955).² *The solution the United Kingdom official pamphlet looks to is (a) higher productivity, together with (b) restraint in attempting to raise incomes of all kinds other than as a result of higher real output.*

¹ See below, *Some Further Opinions and Actions on Accounting for Inflation*.

² Regrettably, similar statistical comparisons are not available for Australia. The only Australian indices of productivity, including output per man, known to us (except by working from the national income as in Appendix 33) are incomplete and far from comprehensive.

This, it will be noted, puts emphasis on more production as well as on restraining increases in monetary incomes and expenditure. Discussion in Australia has placed singularly little emphasis on the first and the positive aspect—singularly, because increased production is capable of raising living standards in addition to countering inflation.

The White Paper makes these observations:

We must guard against the false sense of internal prosperity that can be given by continually rising money incomes unaccompanied by the necessary levels of output and exports, which cannot last and must ultimately endanger our long-term prosperity, and with it the whole ideal of full employment as a feature of our national economy.

How fast output rises depends on our success in raising productivity. The achievement of a sustained increase in productivity calls for contributions from both management and labour. Management must strive to ensure the maximum expansion of output by progressive investment in the most efficient capital assets, by the introduction of the most modern industrial techniques and by the elimination of all restrictive practices which inhibit the economic growth of production. The contribution of labour lies in co-operating to the full in the adoption of new methods of working and in setting aside all practices which, however much they may have been justified in the past as means of safeguarding status, conditions of work, or the security of employment itself, are not appropriate in conditions of full employment.

It is difficult enough at any time to sufficiently encourage productive investment and technological progress, to discourage restrictive practices, and to encourage co-operation between labour and management in the utilization of productive resources. But in a period of money inflation it is still more difficult without signs, mileposts and guideposts—without accurate knowledge of the true economic situation and trends. Indeed ignorance and inaccurate information can themselves be the cause of wrong policies and the cause of strained social relations. These points will be further examined.

Honest Stewardship and Inaccurate Yardsticks

Redistribution of the national income, taxation, wage fixation and policies to increase productivity would probably have taken different courses and had a different incidence on sections of the community if authorities of various kinds, from governments and their instrumentalities to arbitration courts, had had more accurate guides to the true facts as to profits, capital, production and wages and had so been led to more accurate methods of measuring the effects of what they were proposing to do. They knew only vaguely and inaccurately because they did not—in fact, could not, from existing data—allow in their thinking for the effects of inflation and for trends that inflation hid. The trade unions—in a strong bargaining position—insisted, successfully in the main, on a continuation of inflation-compensating wage adjustments. (Unions also obtained still further wage increases and shorter hours, which, not being matched by greater output and being an integral part of the greatest cost factor in the community, have had extremely inflationary effects.) The business community and its technical advisers, accountants and, in part, economists, did not likewise effect adjustments. For long, indeed, many could not take their thinking past mere money terms and realize their own position. Confusion of thought and action has arisen because invariably profits, dividends, wages and other matters have been stated misleadingly and compared with one another in money sums of different values—to the continued disadvantage of shareholders, of enterprise and of clear information on many affairs of importance to the community.

The argument here is not directed to the contention that adjustments of wages for inflation—this amount of compensation to wage-earners for inflation—were, or are, necessarily wrong. But applied sectionally these adjustments become a surreptitious way of using inflation to adjust sectional shares of the national income, to the gain of some sections and at the expense of others. These adjustments and the consequences of them have therefore tended to create stealthy transfers; and tended to enhance the development in some quarters of “vested” interests (albeit short-sighted ones) in continuing inflation, extending to some businesses which are assisted by the spending of the higher money incomes.

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If there were a comprehensive accounting for inflation³ almost everyone would realize quickly, and with inescapable impact, what was happening. All would see the results and effective steps would almost certainly be taken against basic causes. The more accurate knowledge and the light thrown upon inflation-caused disparities would help towards actions to remove some of the more potent causes of continuing inflation, as well as some of the causes of social unrest.

Society, not merely business, is in need of new accounting methods to handle accounting in a period of inflation, which it appears will continue to be with us even if not in such a severe form as recently. Without the acceptance of more accurate yardsticks (already known and available) accurate stewardship, in business affairs, in production and distribution, in the economic and social affairs of the nation, is not practicable.

A quick and comprehensive change-over to accounting for inflation would be a lot to expect, but some moves have been made. Each further step is an advance towards better social and economic stewardship and towards progress in its broad sense.

The remarks in these notes about historical-money accountancy are not an attack upon the profession of accountancy any more than the remarks upon the slow growth of national productivity are an attack upon business management. The writer is, however, of the opinion that there will be nothing gained and much lost by withholding a clear and even forthright exposition of the problem. The fact is that leading accountancy bodies, especially in the United Kingdom, have already exhorted accountants to apply new techniques. The medical profession does not decline to take what practical steps it can to relieve cancer because it has not a complete explanation of all its causes and a complete cure for all cases; nor because the steps are unusual and more complex.

The writer acknowledges the genuineness of the traditional attitude of mind of some accountants that they have discharged their professional responsibilities when they have accounted for financial events merely in terms of monetary units. He must, however, express the hope that accountancy will acquire a deeper consciousness of the important gap which must remain unbridged so long as accountancy extends its responsibilities no further than the limits of existing traditions.

In these notes there will be found some exposition of the problem of accounting for inflation and of the far-reaching and damaging consequences of not accounting for it. With the problems of unemployment and cyclical depression solved the great economic problem facing the twentieth century is the solving of the problem of inflation in a period of full employment. The appeal is to the professional accountants to find and apply the solution before the community in exasperation or desperation turns to some other profession or body of experts.

It is most unlikely that adequate cures for inflation will be found and applied until inflation is detected, measured and accounted for comprehensively and quickly wherever and whenever it occurs. It is most desirable that this function be carried out at the professional level with the imprimatur that the accountancy profession can confer upon the results.

Finally, the author acknowledges that exhortation may be easier than practice, but believes nevertheless that a comprehensive accounting for inflation is not really more difficult than many of the calculations and other steps that accountants regularly practise.

The Nature of the Problem of Accounting for Inflation

Although there are certain points concerning which accountants alone are best situated to develop and establish acceptable rules and principles, the nature of the problem of accounting for income (profit and loss) can be posed simply and the *broad* lines of the solution can be presented easily.

³ To *account* for inflation is to measure and record its effects and to present true information. This does not, in itself, necessarily or comprehensively *compensate* individuals, businesses, groups or the nation for inflation. To account accurately for business losses is not to remove the losses but it is a very necessary step towards finding the way to counteract the losses.

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But before proceeding to discuss the solution let us note three of the basic questions to which we require answers:

- (i) What is real profit and how should it be computed?
- (ii) What is the relation (percentagewise) between real profit and the real wealth employed in earning it?
- (iii) What is the difference between real profit for one period and real profit for another period?

The questions are easy of comprehension but, in a period of changing money values, the development of answers requires thought and an understanding of fundamental principles.

The answers to (ii) and (iii) can be given fairly shortly once we have the right answer to the first question.

Most people, including accountants, speak of profit and think of profit as being the excess of earnings over expenses incurred in making those earnings. There is nothing wrong with this. Accountancy, however, goes further and says that the profit so computed must be capable of being located in measured amounts in the financial events of the period. It must be established that a man's profit as so computed will be what he has "consumed" or spent on himself for the period plus the excess (or minus the deficiency) of the amount of wealth which he has left at the end of the period relative to the amount he had at the beginning of the period.

In other words, accountants say that you can measure profit either (a) by calculating the excess of earnings over expenses, or (b) by taking what a man has spent on himself for the period and adding what he has saved for that period or deducting what he has spent in the period out of past savings. Accountancy, in fact, does it both ways because accountants must ensure that their answer is right.

These accountancy principles are unimpeachable. Accountancy only goes wrong by failing to give effect to changes in the measuring power of its yardstick, the £.

Take the case of a man who commences the year with assets worth £10,000 and concludes the year with assets worth £12,000 and assume the record shows that that person has spent £1,000 on his own living arrangements during the year. Accountancy says he has made a profit of £3,000. This is the sum of the £1,000 spent and the £2,000 saved.

This treatment of the matter, however, becomes inadequate in a period of inflation (or of deflation). In a period of inflation the £12,000 of wealth at the end of the period may in truth be worth less than or more than or be the same as the £10,000 of wealth at the commencement of the period—depending on the degree of inflation.

If the cost of things in general has risen during the year by 20 per cent, then this man would require to be possessed of wealth worth £12,000 at the end of the year to be as well off as he was at the beginning of the year when his wealth, measured by a stronger unit of measurement, was recorded at £10,000. The wealth of £12,000 which in fact he has at the end of the year is (in terms of £s of end-of-the-year purchasing power) the same as the £12,000 of wealth which, when measured in £s of the same strength, he had at the beginning. This man, being no better off and no worse off at the end of the year than he was at the beginning, must be held to have made no profit at all up to this stage of the calculation. But as he did withdraw from his wealth and spend £1,000 on himself we are truly entitled to say that his profit for the year was £1,000. This has to be contrasted with the findings of orthodox accountancy that he made a profit of £3,000. Orthodox accountancy is surely wrong.

The orthodox result of historical-money accountancy—placed before management, presented to shareholders, publicized in the press for the consumption of workers, public servants, politicians, judges of the arbitration courts, income tax and price control officials and others—misleads the community and its leaders and legislators, promotes faction and, worst of all, hides the facts on which alone right judgments and right steps can be based.

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Some exposition is required to show the *general nature* of the procedure that will provide a solution.

The first question is how to compute real profit. We have already noted that profit can be computed simply by taking together the amount which a person spends on himself during the year and the amount of his savings (or reduction in savings) during the year. It is simple enough in principle, and correct, to compute a businessman's income, as well as an individual's, in this manner and at the same time to pay regard to any shrinkage of the measuring power of the £ during the year. Here is an example (slightly adapted with the author's approval) by A. R. Mutton:⁴

During the year ended 30 June 1950 the cost of living, the cost of the things we want out of life, the price level generally, rose by 10 per cent—that is, the value of money declined by 9 per cent. A shirt merchant commenced the year with capital of £10,000 wholly represented by 10,000 shirts which had cost him and which were still worth 20s each. He finished the year with a capital of £11,000 wholly represented by 10,000 shirts which had cost him and were still worth 22s each. He made no drawings from his business during the year. According to accountancy, his capital was £10,000 at the beginning of the year and £11,000 at the end of the year and the difference of £1,000 represented his profit for the year. The Prices Branch and the Taxation Department—and, in most cases, the merchant himself—accepted that finding as correct.

The merchant, therefore, pays his income tax and pays his living expenses according to standards of people who earn incomes of £1,000 a year. Tax of £100 and living expenses of £800 make a total of £900 which the merchant can provide only by either reducing his stock of shirts or raising a bank overdraft. He cannot maintain his service to the community or his own prospects for earning income in the future if he reduces his stock of shirts. Therefore he “goes £900 into the red” with his banker. At the end of another inflationary year he still has no more than 10,000 shirts and an overdraft of £1,800. At the end of three years the overdraft is £2,700 and, if this process continues, he must inevitably go out of business *despite the fact that accountancy says he is making a net income and living within it.*

The question which accountancy is asked to answer appears to be: “Is £11,000 worth of shirts at June 1950 better or worse than £10,000 worth of shirts at June 1949?”

Accountancy says: “Yes, £1,000 better because the number 11,000 is 1,000 higher than the number 10,000.”

Economists, some accountants and other critics of historical-money accountancy say that this question and answer are completely unrealistic. The real question, they assert, is “Are 10,000 shirts worth of capital in 1950 better or worse than 10,000 shirts worth of capital in 1949—the shirts being the same size and quality?” The increase of 10 per cent in the value of each shirt has been neither more nor less than the increase of 10 per cent in the cost of things in general. Therefore, the real exchange value of the total stock of shirts in relation to things in general is neither more nor less than it was a year earlier. The final and correct answer appears to be, therefore, “10,000 shirts at June 1950 are no better and no worse than 10,000 shirts at June 1949—not even a button.”

To say that this merchant has made £1,000 profit for the year, is therefore, to say something that is simply wrong.

The same conclusion must be reached if we follow accountancy's other procedure (probably the more familiar one) of determining profit by ascertaining the excess of earnings over

⁴ See “What is Capital Erosion?”, *Rydge's Business Journal*, 1 May 1952.

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expense (by preparing a statement of profit and loss). This is what historical-money accountancy does:

	£
Initial stock of 10,000 shirts at 20s	10,000
Add Purchases of 30,000 shirts at various prices ..	33,000
	43,000
Deduct final stock of 10,000 shirts at 22s	11,000
Giving cost of shirts sold as	32,000
Sales—30,000 shirts at various prices	35,000
Leaving	3,000
Deduct expenses	2,000
Leaving accountancy profit of	1,000

This £1,000 profit confirms the correctness (in historical-money accountancy) of the £1,000 profit arrived at by accountancy through the change in the capital position, as shown earlier.

This treatment of the figures, however, defies the principle of elementary arithmetic that you cannot add or subtract like and unlike things. If you do, the answer does not mean anything. In this case we have Purchases, Sales and Expenses all stated in £'s which, on average, are about middle-of-the-year £'s. The opening stock, however, is stated in beginning-of-the-year £'s and the closing stock in end-of-the-year £'s. The adding together and subtracting of these several classes of £'s can only provide an answer which does not mean anything. The statement says no more than this: "This is what the profit *would have been* if, contrary to truth, all the £'s were the same."

The change in the value of the £ between the dates of purchase and sale brings about the position that each £ in the "cost of shirts sold" is older and stronger than each £ in "sales". Failure to have regard to this difference in £'s results in the profit being overstated by £1,000. The correction of this error brings the final result of the profit and loss statement to a profit of *nil*. This, naturally enough, agrees with the real result already arrived at by measuring the profit through the movement of capital.

The tax the merchant has to pay therefore becomes a tax on his original capital or wealth—not on his income, which does not exist, although it is supposed to be an income tax. And he also has to live on his capital. Real wealth and productive resources are reduced.

The example of the shirts explains what happens in respect of working stocks of goods which turn over fairly quickly in the business world. The shirts are "used up" by the trader in his business and quickly replaced. The problem with other assets, such as plant and machinery, used up more slowly in the course of trade and industry, is fundamentally the same, despite some apparent or superficial differences. Because accounting for many important purposes, such as official statistics, taxation and arriving at profits for shareholders, is usually carried out at yearly intervals, and because the plant and machinery last longer than a year, much of the plant and machinery there at the end of the year was there at the beginning. But it is not the same plant and machinery in real value or intrinsic economic worth because the plant and machinery are now partly worn out, nearer to having to be replaced; they are "depreciated". The business world makes allowance for this, based on experience of how long each type of plant can be expected to last, by charging against the year's operations the estimated cost of the year's "depreciation". Depreciation is a very real cost to business and to the community and is becoming a more and more important cost as we advance from primitive methods and manual labour to more and more "mechanical slaves".

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Here is an example of what happens in a period of inflation when depreciation is calculated from the original cost in terms of historical money only:⁵

Smith started business as a carrier about five years ago with £1,000 used to purchase a truck. He provided for depreciation (and replacement) at the taxation rate of 15 per cent per annum on the historical-money cost and reducing balance. He withdrew from the business the profit left after making provision of these annual sums. The truck now requires replacement and can be sold for its written-down value; he has, therefore, £1,000 for the purpose.

Smith finds, however, that because of *general* inflation, a new lorry of the same capacity will cost £1,500. . . . Smith is therefore forced to buy a smaller lorry which will perform less carrying, unless he borrows £500. In either event, Smith has lost real capital, now possessing either a smaller unit of plant capable of less productive work or a two-thirds interest in a unit of the same capacity as he previously owned in full.

It is fundamental to true assessments of real net income of individuals, of businesses and of the nation that adequate allowance must be made for all goods and assets (working stocks and fixed assets) used up during the period. It should be quite obvious that an adequate allowance for the "using-up" cannot be made in a period of changing money values by reference to original monetary cost, generally referred to as the historical-money cost, or the historical cost.

The principle used in the simple illustration of the shirts holds good for capital invested in debtors, loans, cash and any other asset which is normally recorded in a balance sheet in £s of the vintage existing at the balance sheet date. The position becomes a little more complex when we turn to plant and machinery and those other assets which, like the truck, have lives extending beyond a year, and are conventionally recorded in a present balance sheet in £s of a vintage some years earlier. The manner of computing real profit in those cases has been illustrated in various writings by those accountants and economists who clearly see the need for improved methods.

The second question set out at the beginning of this section is how to compute real capital and relate profits to it. If real profit is known but real capital is not known, no honest relationship between profit and capital can be stated and no honest test can be made of the effectiveness or of the real results of the business.

An experienced chartered accountant in Sydney⁶ recently studied the 1955 results of 34 public companies in Australia. His study included some estimating but he considered his results sufficiently accurate to give in a recent address in Sydney to the Australian Institute of Management (Sydney Division). *For the purpose of illustrating the problem of relating profits to real wealth* it does not matter if more detailed data from a fully-fledged system of accounting for inflation produce slightly different figures. A summary of the results of the study is as follows:

- (a) Whereas these companies have been reported to have paid 1955 dividends averaging 10.8 per cent of their ordinary capital, such dividends were equal to only 2.5 per cent of the fair current value of the net assets employed. (The mathematical absurdity of the traditional procedure of regarding a dividend in current £s as a percentage of £s put into capital a few or many years before will be apparent.)
- (b) The published profits for 1955 were reported in each case by the financial press in terms which related that profit (less preference dividends) to ordinary capital. The average percentage so reported was 21.4 per cent. The profits (even before correction from conventional to real) were on an average equal to only 5 per cent of the fair current worth of the net assets backing for ordinary capital.

⁵ From *The Effect of Inflation on Accounting for Fixed Assets and Depreciation Policy* by E. S. Owens (1956), being an adaptation and improvement of an example in C.S.R.'s "Capital Erosion" booklet (1950).

⁶ A. R. Mutton.

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This reduction by three-quarters (from 10.8 to 2.5 per cent in the case of the dividends and from 21.4 to 5 per cent in the case of the profits) shows the difference between the impression created by conventional reporting and the facts extracted by someone who is prepared to have regard to assets employed and to changes in the value of the £.

Balance sheets which, in accordance with convention, record paid-up capital in various vintages of old £s and which likewise record assets in various vintages of old £s (and mostly in different vintages from the capital) cannot possibly be used as a test of the goodness or badness of profits. Only after all items have been converted from old £s to current £s can we get the best available picture of the amount of real wealth which is being used to produce the real profit. In recent years profits tested in this manner are proved in a large number of cases to be extremely poor—surprisingly so to many who have not chosen to think behind the figures presented by conventional accountancy. Given a sensible presentation of the facts with all items stated in £s of the same vintage, what reactions might we expect when profits are shown to be so poor in relation to resources employed? Management efficiency, tax equities, the division of returns between labour and capital, clear guidance to investors, are but some of the matters of vital importance which will, for the first time, be open to accurate assessment and corrective action.

The third question set out at the beginning of this section, dealing with the trend of profits from year to year, can be disposed of simply. To say that £105,000 of sales (or profits) in 1950 is better than £100,000 of sales (or profits) in 1949 (between which years there was a 9 per cent decline in the value of the £) is to say something that is not only foolish but wrong. Once regard is had to the shrinking value of the £, the figure for the later year is found to be lower in real terms than that for the previous year. Many of the financial page headlines like "Record Profit for XYZ Ltd" are plainly and simply wrong.

The point which is now stressed is that it is of the greatest importance that we should have a proper and sensible system of accounting for inflation. The consequences of not having one are too dangerous and must perpetuate many of the ills from which we have suffered for the past decade.

Some Effects of Inflation on Saving and Investment

Let us take the problem a little further and consider that important section of the community composed of people who, by a combination of instinct, intelligence and training, pursue their natural aims in a purposeful and earnest manner. Prominently represented in this group are those people who possess the capacity to apply themselves to earning the maximum of which they are capable and to accumulating what they can from their earnings in a programme of savings which gives them some property, a feeling of self-reliance, some security, something to help set up their children in life, and which at the same time provides a means to augment their future earnings. In the main these people are energetic, thrifty, and more efficient than others. They are the people who, by being prepared to work and save, provide that constant flow of funds which is translated into an extension of the community's physical productive resources. This is how Western communities achieve constant increases in their standards of living. This is how comparatively young countries like Australia provide the wherewithal to house, feed and clothe a population which may not be with us this year but which will be with us next year. And this is how we make the idea of a property-owning democracy a reality.

This is a very diverse group of people and they accumulate their property in different ways. They include many of our farmers and graziers, householders paying off or improving their homes, private entrepreneurs; and include, too, that very wide group of originating savers who place their savings in government bonds, in savings bank deposits, in Water Board debentures or company debentures, in life assurance policies, in real estate mortgages, in company shares and who, once upon a time, placed them in rentable housing. They are a mixture of rentier investors and entrepreneurial investors. And the numerous rentier investors constitute a large part of the basic source from which originate the funds that, in one or more later stages, are put to use by entrepreneurial organizations and producers.

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In years of inflation a very large proportion of these people are unable to find within the structure of the existing community arrangements any safe avenue for the investment of their savings. Moneys invested in one year in governmental loans or in Water Board or other debentures are repaid some years later not with like £s but with unlike £s—£s which will not stretch as far, will not buy as much. The result is similar if they invest in savings bank deposits, life assurance policies or real estate mortgages. The loss of wealth arising from the depreciation in the currency falls heavily upon these savers and lenders.

It is surely a poor system of accounting—whether we regard it as business accounting, economic accounting or social accounting—which, by not measuring and recording what is happening, permits inflation constantly to eat into the savings which so many industrious and thrifty people have made.

Those who have the care of wealth are obliged to issue periodical reports to those who own the wealth. Orthodox accountancy has established no techniques to ensure that such reports will be issued in terms of real values. Trustees, agents, managers, these and all others concerned with the reports are still required by accountancy conventions to assume that none of the losses arising from the eroding influence of inflation have occurred. Most of the savers of the community have no pattern of thought, no line of action, no organization to seek those changes in the system without which their aims must be frustrated so long as inflation continues.

The saving habit is deeply rooted in our society and has truly vital functions to perform. It has suffered under severe discouragement and the force of it must steadily weaken if savings are left to carry so much of the burden of inflation for the community, especially as newer generations grow up becoming gradually more and more cynical about the value of saving. There is little doubt that inflation—especially inflation not comprehensively accounted for—feeds upon itself and spirally generates more inflation. There is no doubt that uncompensated inflation encourages people to come to the conclusion that the best hedge against inflation is to spend their money now. The money is worth more now than it will be later. "Let us," so they argue, "convert it into material satisfactions while it will buy more of them. If possible let us also capitalize on the situation by getting the motor car, the refrigerator, the washing machine on credit, by hire purchase or time payment or in some such way. We can pay off later in less valuable money. The goods are better holding than the money or an investment which will lose value. If we do lend or invest let us do so at a high rate, say 8 per cent or 10 per cent interest, then if we lose real capital at, say, 5 per cent per annum because of inflation we shall still have 3 per cent or 5 per cent left. But it's a pity we shall be taxed on the basis of the 8 per cent or the 10 per cent so perhaps it is better not to save and lend too much even at such rates. Probably we should still decide to save less and spend more now. We are learning to do the best we can under unaccounted-for and uncompensated inflation. And our children who are not inhibited so much by old-fashioned upbringing and ideas will know even better than we do how to handle the situation—and can fall back on government aid if needs be."

It is no answer to these savers for the more sophisticated to say that they can avoid this erosion of their capital by diverting their savings to forms of investment which will operate as a "hedge against inflation". The community has not as yet provided *any* form of investment which constitutes an *adequate* hedge against inflation. One way or another, every field in which the thrifty may like to invest is subjected to the damaging effects of inflation. The fortunate or the very well-informed may find some particular investments that operate close enough to inflation-compensated incomes to gain for themselves a fair degree of compensation. But virtually every field is affected by governmental controls and/or taxation not conditioned and supported by realistic assessments of community economics, but by the political convenience of the hour powerfully backed by nervousness about departing from the traditional. And, to be fair, the governmental authorities have as yet received little unanimity of professional guidance in the shape of techniques for departing from the traditional or for correcting hazy conceptions.

Investments in real estate might, on the face of things, appear to provide a reasonably adequate hedge against inflation. Quite apart from the impracticability of many small

investors entering that field, however, the subsequent course of inflationary time seemingly must, under present government policies, lead to a controlled rent inevitably giving an inadequate real return.

Ordinary shares in companies might, upon brief thought, be considered a better field in which the savers of the community might invest. Here, however, there are many hazards. For a variety of reasons, casualties amongst companies are numerous. Not many of the investors have sufficient wealth to spread their eggs and so obtain a reasonable chance that what they lose in the casualties will be made good by those businesses which go from strength to strength. Further, it is only a proportion of the savers who can, with any feeling of comfort or safety, enter into the technical language and procedures of the share market. Finally and most importantly, we find in the field of ordinary company shares (as set out later in these notes) that, although there is an inevitable trend for money values of the physical assets which back ordinary shares to move upwards as the value of money itself moves downwards, and although a wise or fortunate selection of ordinary shares is likely to give better results than government bonds, many factors are constantly operating adversely against companies in such a way as to render it unlikely in the generality of cases that inflation (combined with taxation or controls that do not take inflation into account) will take no significant toll.

There will be provided a little later in these notes the results of a number of companies which show in clear fashion the toll which has been taken and is being taken of the savings of those who choose to invest in ordinary shares.

C.S.R.'s Interest in Problems Arising from Inflation

While much of what has just been said does not fall directly and obviously within the responsibilities of C.S.R. the company realizes that it is necessary in such large problems to consider causes, effects and remedies in a wide context. By and large what is good for the general economy throughout the community will not fail to react to the betterment of C.S.R.

Since postwar inflation became apparent, C.S.R. has been interested in its effects on shareholders and on business operations, on forward planning, on depreciation and replacement of assets, on wages and salaries, on profits and dividends. In 1947 the chairman drew the attention of shareholders to this problem. In the same year the general manager commented on the trends, portraying them graphically. Although our physical turnover of goods was higher than in 1937, and monetary turnover higher still, the graphs showed a reduction of 15 per cent in net earnings for shareholders compared with a rise of 8 per cent in earnings, excluding overtime, of our typical Australian wage-earners. Both sets of earnings were expressed in real, not nominal, money values. The general manager's statement pointed out that, in addition, the wage-earner had improved his position in hours, annual leave, amenities and other conditions. And he emphasized that his concern was to bring relevant facts to light rather than to suggest a reversal of gains then accruing to wage-earners. (These trends, of course, applied in a field much wider than that of C.S.R.) "Increased production can bring improvements to both wage-earners and shareholders," the statement concluded.

It is towards increased production that we in C.S.R. continue to look as the basic means of easing the problems of inflation and of expanding productive resources still further as a means, in turn, towards continually raising living standards. In our own spheres we have been active in increasing production. But we have experienced difficulties, we continue to experience them, and we think it equitable, reasonable and in the community interest that public policy should be helping us and productive enterprise generally to overcome them.

One of our biggest problems is to keep our stock of production tools—machines and factories—up-to-date and efficient producers of goods. But such industrial tools cost money—huge sums—and this money must come either from investors or out of earnings. If taxation, price control or other public policies, by disregarding inflation, prevents us or any other company which produces goods and services from earning and keeping sufficient money to buy new tools when present ones wear out, or prevents us from paying shareholders enough

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to enable them to save and to encourage them to invest their savings, then the community's store of productive tools will not increase adequately and material standards will tend to stagnate.

Since 1947 we have continued (not alone) to draw attention to these problems almost every year. In 1950 the company published a booklet, *Capital Erosion and the Income Tax Assessment Act*. This was directed to the need, on the grounds of both equity and the long-term national interest, for relief from income tax generally (not on companies only) of financial provisions made for the purpose of protecting the physical quantum of assets used in production. It called for, and proposed the method for, more truthful and more accurate yardsticks for the assessment of taxable incomes, especially in respect of depreciation.

Some Further Opinions and Actions on Accounting for Inflation

An indication has already been given of some of the simpler mechanics for correcting the error embedded in historical-money accountancy. More detailed expositions are spread through economic and accountancy journals and in some business writings. As far as an index of changing money values is concerned the Australian "C" Series Index of retail prices is good enough to apply pending the development of a better; and if a strong demand existed the Commonwealth Statistician would doubtless provide an even better index.

Individual companies have made a variety of attempts to remove from their stated profits those elements which are present by reason of a convention which assumes that the value of money never changes (or that although it does change it is no concern of accountancy). Those attempts, however, have been, in the main, of a rule-of-thumb type. Moreover, genuine though some attempts have been to keep the thoughts and ambitions of management, shareholders and employees within the limits of realities, the attempts have all too frequently been condemned by representatives of labour and of rentiers as attempts to gain some sectional advantage for business at the expense of other sections of the community.

One company in America, the U.S. Steel Corporation, implemented a comprehensive scheme to present economic realities in its annual reports to its stockholders. This step incurred so much misunderstanding and criticism in accountancy and other circles that the company abandoned its new and enlightening procedure.

Much has since happened to modify if not wholly to remove the objections previously voiced against that attempt by U.S. Steel. It may well be that many who previously criticized would at the present time admit that accounts like those temporarily presented by U.S. Steel constitute a much more truthful picture than do those prepared by conventional techniques. The position remains, however, a difficult one for any business contemplating a departure from traditional standards. Until the accountancy profession develops satisfactory changes from its conventional procedures and is prepared to support fully the use of these new procedures by the business world, it is difficult for individual businesses, no matter how well-informed and willing, to make a serious impression upon the problem. There are real risks in several directions for single companies in being out of step with current convention.

In 1952 the Institute of Chartered Accountants of England and Wales issued a stimulating statement on "Accounting in Relation to Changes in the Purchasing Power of Money". This is too long to quote in full but it included the following:

The Council cannot emphasize too strongly that the significance of accounts prepared on the basis of historical cost is subject to limitations, not the least of which is that the monetary unit in which the accounts are prepared is not a stable unit of measurement. In consequence the results shown by accounts prepared on the basis of historical cost are not a measure of increase or decrease in wealth in terms of purchasing power; nor do the results necessarily represent the amount which can prudently be regarded as available for distribution, having regard to the financial requirements of the business. Similarly the results shown by such accounts are not necessarily suitable for purposes such as price

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*fixing, wage negotiations and taxation,*⁷ unless in using them for these purposes due regard is paid to the amount of profit which has been retained in the business for its maintenance.

That pronouncement of the Institute of Chartered Accountants of England and Wales (known as Recommendation XV) went on to give further warnings to accountants of the errors which could arise from the uncritical use of conventional accounts for many important purposes. The Recommendation concluded, however, with a suggestion to accountants that they continue to use historical cost until a generally acceptable means of reporting real profits had been found.

Other accountancy bodies of the United Kingdom declined to be so cautious. The Association of Certified and Corporate Accountants in 1954 made certain suggestions and recommendations aimed at eliminating from conventional profits the overstatements arising from wrong accounting (because of a change in the value of money) for stocks consumed in production or trading and for the wearing-out of plant.

The Society of Incorporated Accountants and Auditors, also in 1954, issued a statement recording the "anxious consideration" which its Council had given to this problem; noted "the harmful effects on the economy of profit measurements which disregard the implications of changing money values"; and suggested to its members "that encouragement should be given in appropriate cases to wider use of new conventions" (correction of accounting for the cost of goods sold and depreciation).

The Institute of Chartered Accountants of Scotland, again in 1954, issued a statement which, amongst other things, said: "The limitations [of the historical-cost basis of measuring profit] are evident and serious in periods of rapidly-changing money values. The experience of the postwar years has demonstrated a clamant need for new conventions and methods which will compute the profit element in terms of current monetary costs as distinct from historical costs . . . The Council [of the Institute] holds the view that the accountancy bodies, singly and collectively, should now urge their members to take an active part in promoting the practical application of new conventions. . . ."

No accountancy institute in either Australia or New Zealand has as yet, by official pronouncement, given any lead to governments, to the business world or to the investing public on the means of solving this problem. There has, however, been more than a modicum of interest displayed in Australia and New Zealand. Several university men have written quite extensively upon the subject. So also have certain members of the Australian Chartered Accountants' Research Society. A majority of these writers have passed well beyond the broad question (which, in their view, is already answered—against conventional accountancy) and have devoted considerable attention to developing the best type of technique to meet the problem. The writers' plea to them is to put out a general framework incorporating major improvements without waiting for ultimate perfection. The research accountants know the main accounting answers and remedies.

There is an increasing awareness of the nature and effect of the problem among Australian and New Zealand businessmen, some of whom, where circumstances allow, are providing heavily, *out of profits conventionally assessed*, for higher replacement costs, despite lack of assistance from governments in respect of taxation and price fixing.

This procedure of retaining out of conventionally assessed profits the amount which is to be set aside to help to keep real resources intact is clearly not only desirable but absolutely essential if the living arrangements of the community (quite apart from the interests of shareholders) are to be maintained. It is a significant defect of the whole conventional system—indeed it is an economic tragedy—that, in some cases and on some occasions, the real profit is wholly, or almost wholly, absorbed by tax calculated on the unreal profit.⁸ In

⁷ Italics not in original.

⁸ A case-study of the Jantzen company showed that for the year ended 31 March 1953 income tax was 49/9 in the £ on profit. The tax therefore took all the profit and ate into capital. See "What Should Accountants, As Accountants, Do About Changing Money Values?" *The Chartered Accountant in Australia*, February 1955.

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such a case, the real resources cannot be maintained intact. This fact, important though it be to every member of the community, is known to but few. Moreover, the present system, which results in businesses reporting as profit amounts which are not profit, leaves many members of the community deluded; and it leads to increasing social and political tensions between the several sections which consider themselves entitled to contributions from the world of business and production.

In Britain there has recently been a significant development. This was reported on by the *Economist*:⁹ "The Post Office provides full normal depreciation . . . and in respect of telephones . . . the department has tucked away useful little additional sums towards the increased cost of replacements. Yet the telephone account was on the road to insolvency. Normal 'straight line' depreciation, plus the extra sums ploughed back, were deficient by £12½ million a year to replace the equipment at current cost . . . 'A telephone in every home' was a fine slogan. A telephone at a loss in every home is another matter. Wisely, the Postmaster-General has discarded all half measures and moved to a full replacement basis." The Postmaster-General, in his report to parliament, after discussing the need for providing for depreciation on a replacement basis, said "The Government's view is that from 1956-57 onwards provision should be made accordingly" in respect of the telephone system. This means that telephone charges will be increased to cover the higher costs of depreciation on a replacement basis.

The United Kingdom National Income papers have recognized the problem and tried to make allowance for it in national accounting. Although Australia has not followed suit, the Australian National Income papers do seem, by implication, to accept the principle where, for instance, *National Income and Expenditure, 1954-55* (as presented to parliament) says, "There are as yet insufficient price and quantity data available to make satisfactory estimates of all items in terms of constant prices."

The United Kingdom official Blue Book, *National Income and Expenditure, 1946-51*, issued August 1952,¹⁰ states in the Introduction:

It is fundamental to the concept of the national income that it measures what is available to the nation for consumption or adding to wealth *after maintaining capital intact*. This means, *inter alia*, that in reckoning the national income . . . an allowance must be made for the current depreciation of the fixed capital of the nation. The income generated in the production of any commodity must be reckoned after setting aside a provision for the replacement of fixed capital used up during the period. Further, it is the *real* capital of the nation which must be maintained intact *if the measure of the national income is not to give misleading results*.¹¹ The correct measurement of the national income therefore requires that *income shares*¹¹ should be defined after allowing for the current depreciation of capital at current replacement cost.

The publication goes on to say, "unfortunately, however, it has not yet been possible from material available to construct estimates of income on these principles". It suggests that "the 'true' current depreciation of fixed capital is not . . . more than about 10 per cent" of the national income. As recorded depreciation (income tax-based depreciation other than initial allowances) appears to be rather less than 6 per cent of the national income the additional amount required to reach "true" depreciation is, of course, an important proportion in any estimate of the actual national income and, more especially, in any assessment of the shares of it or of depreciation as such.

The United Kingdom 1952 Blue Book deals with stocks of goods and material similarly, in principle, to depreciation and replacement of wearing-out assets, and with more effect in practice, saying, ". . . the contribution of the entrepreneur to the national income must be reckoned after charging as a current cost the *replacement* cost of the materials used in production, which, in general, will be different from their *original* cost. This is not, however, the principle on which normal accountancy is based. . . . The adjustment for stock appreciation . . . is also important since if it were not made the movement of the figures for gross

⁹ Issue of 29 October 1955.

¹⁰ i.e., the 1952 Blue Book.

¹¹ Italics not in original.

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capital formation and the gross national product would be highly misleading in periods when prices were changing rapidly." And, in another place in the same publication, the statement is made, "The stock appreciation element is . . . deducted from the profits as conventionally defined in arriving at the national income. . . ."

The importance of the adjustment of stock values, which the United Kingdom authorities proceeded to make on an estimated basis, is shown by the figures in the Blue Books. The highest adjustment figure is for the 1951 year, shown in the 1954 Blue Book as £Stg. 750,000,000, equal to 6 per cent of the "gross national product".¹²

The United Kingdom National Income Blue Books continue to make adjustments for "stock appreciation". Furthermore, according to a United Nations publication,¹³ the United Kingdom is planning "to prepare estimates on a replacement cost basis for all national accounts"; and "in certain countries, the capital consumption provisions for particular industries are valued at replacement cost: both Ireland and the United States, for example, measure depreciation in agriculture on this principle."

What is correct in principle and practice for national accounting and for the assessment of shares of the national income is surely correct for business accounting, including that of individual entrepreneurs. For, as the United Kingdom 1952 Blue Book says, "... the national income is the total of the incomes of all United Kingdom residents (including . . . British companies and the British Government) so far as they are derived from current economic activity, i.e., from a contribution to 'production' in its widest sense." And "... the national income is a measure of the value of goods and services becoming available to the nation for consumption or adding to wealth." (The real position of a company is clear if we substitute the word "company" for "national" and "nation" in the last quotation.)

If in the United Kingdom (and in some other countries) the leading economists, statisticians and government experts consider that inflation of the price level should be accounted for in respect of the nation's affairs by making stock appreciation adjustments, is there not just as forceful an argument for making similar adjustments within companies and within other businesses? If the United Kingdom considers that, when computing national income, the cost of productive equipment consumed in the process of production should be computed after adjusting for the higher current costs of its replacement, it seems reasonable that a similar adjustment for the cost of replacement of industry's productive equipment should also be made.¹⁴ Both the nation and the company use the forms and conventions of money accounts to record movements in the levels of and in the distribution of physical resources, and to relate one resource to another in common terms. It is the physical realities which matter, both on the national and on the sectional planes of production. If the accountant's and statistician's figures do not reflect an accurate image of that physical reality they are mere distortions; the shadow is mistaken for the substance, like the shadows cast on the wall of the cave in Plato's famous allegory.

The Level of National Savings

It is generally believed that Australians as a nation are big savers, that there is a high level of investment. It is the net saving and net investment that counts. To get a true result

¹² The United Kingdom no longer computes "national income", which is "gross national product" less "depreciation", because the United Kingdom has not yet been able to arrive at a true figure for depreciation and apparently does not wish to record an inaccurate and misleading figure for "national income".

¹³ *Methods of National Income Estimation*, 1955.

¹⁴ C.S.R.'s view (as set out in the "Capital Erosion" booklet) is that the primary, broad and really important general adjustment should be for the degree of *general inflation*. Replacement adjustment is a separate and additional matter which, following an adjustment for general inflation, may be a plus or a minus; it would be of minor importance once the primary adjustment was made. There are arguments of some strength against replacement adjustments for, say, income tax purposes, which arguments do not apply to the primary adjustment for general inflation.

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when the savings are assessed in money terms, there must be an adequate provision for the extent of the consumption of the accumulated stock of productive resources. The monetary savings and monetary investments have meaning only in relation to the physical resources they represent. All through any one accounting period of a year or a series of years the inherited stock of resources available at the beginning (and even those resources added during the period) are being gradually used up. The only real measure of addition to total resources for the year or period of years is the extent to which new resources are created less the extent to which the old resources are dissipated. Again, the using-up can only be adequately assessed in terms of current price levels (or in terms of the same price levels or monetary values by which the new resources are being measured).

This kind of adjustment is not made in the Australian statistics of national income and of national investment and savings. Therefore savings in Australia in recent inflationary years are not nearly as high as is often supposed. And, as Australia has had in recent years more inflation than other countries with which our performance is normally compared, the overstatement of savings is greater in the case of Australia, and a more serious error occurs.

Wage Fixation and Negotiation

Dr R. W. Harman, general manager of C.S.R., in the chapter *People and Work in Factories* has expressed views on various aspects of employer-employee relations, including the need for more informed and more detailed economic data to be available to wage-fixing authorities. Such data is essential, too, to guide the considerations of employers and employees. The wage tribunals have long taken into account the effects of inflation or deflation of money values on the real value of wages, often by specifying automatic adjustment. It seems obvious that the economic data used by the wage-fixing tribunals should take into account the effect of the changes in the value of money not only in some respects but in all respects—for instance, on all parts of the national income statistics, on assessments of trends in company profits, on dividends expressed as a percentage of older and more valuable money, and on the value of assets employed in making the profits. In economics or in social affairs it is absurd, and it is certainly not applied science, to measure profits, or the trend of profits, in terms of current low-value money, without full adjustment for the change in the value of money, for the change in the real value of the assets employed to make the profit, for the change in the real cost in current £s of the wearing-out of the existing level of physical assets.

The absurdity may be illustrated by mentioning that in a period of inflation and under historical-cost accounting a part of the cost of providing for the continuation of production (and therefore of employment) *at existing levels* will appear as a profit instead of as a cost. The assumption that often follows is that as profits appear to have increased it may be possible to use some or all of the higher profits to increase wages. When, in reality, the apparently higher profits do not exist, the results are bad. (It is emphasized again here that much that is published in company reports as profits and held undistributed, and perhaps some of the money distributed as dividends, is really cost; if it is cost but is treated as profit and distributed it becomes a distribution of what is actually capital.)

As a greater increase in earnings than in output is inflationary, accurate figures for, at least, overall national productivity have a most important part to play. Other countries possess indices of productivity. To be of value and not to add merely misleading information, the indices would, of course, need to allow in full for replacement at current prices of all assets consumed in the process of production.

The tremendous importance of the wages question is sometimes minimized. But Professor R. F. Kahn, Cambridge economist, recently said, "In the Keynesian system the money wage is the fulcrum on which the price structure rests. *The behaviour of prices depends on that of the money wages rather than the other way round.*"¹⁵ And a movement of money wages brings about a more or less proportionate movement of prices, after allowance is made for improvements in productivity."

¹⁵ Italics not in original.

And as Oxford economist, Professor J. R. Hicks, said recently when reviewing a book on wages policy which challenged the realism of his own earlier theories: "It is now obvious that the fixing of wages is at the very heart of our economic problem."

2. SOME EFFECTS OF HIGH TAXATION OF COMPANIES

When a number of people pool some of their resources and combine together to do business as a productive organization in the form of a public company in Australia they are taxed twice on their earnings—once as members of the company and again as individuals. From the viewpoint of governments seeking taxation fields to exploit with a minimum of immediate and troublesome political repercussions such associations of individuals pooling their resources appear to be "sitting shots". But the questions still remain to be answered: Is the community's material interest actually served by such high company taxation—is the taxation socially and economically useful or harmful? And is such taxation equitable?

On the question of utility, it is interesting to note the concern now expressed in Western countries about the advances made in the Soviet in technology and in the numbers and quality of technologists. But it is not of much use the Western countries becoming so concerned unless they are to become equally concerned about other important factors that are, relatively, restricting production in those countries. We can be sure that the Russian communists, with their great emphasis on production and materialistic advance, would not hold back by severely-limiting taxation any of their most important means of production. While analogy from communist totalitarian practice is naturally suspect and could not be carried far, it does suggest that policy could well give a higher place to easing the restraints on production and to switching taxation more to the ways in which the fruits of the production are expended, so that the inhibiting effect on increasing total production is minimized. The effect of the present taxation system is considered at more length later in this section of these notes.

Turning to the question of equity it tends to be overlooked that most taxation is, in greater or less degree, confiscation—by government for public use (and much of it necessary usage). In Australia there has recently been much public debate and governmental action on high taxation—the stated purpose being to prevent people and companies from spending their money, which spending is held to be inflationary. In all the debate no one seems to have raised the question of the extent to which these are proper and right procedures. Edmund Burke said: "The great contests for freedom in this country [England] were from the earliest times chiefly on the question of taxing." Whether Burke's observation needs qualification or whether evolution towards a greater degree of democracy, and the welfare state, alter the emphasis on this aspect of the "contest for freedom" may be open to debate. This is not to say that to raise the questions of confiscation, of freedom, of equity, makes a case against all taxation proposals, but at least it suggests that all taxation is still open to full consideration in the light of freedom and equity. Burke's reminder certainly points the way towards emphasis on equity. It clearly becomes more important at high levels of taxing to give great emphasis to equity (and to base the tax on accurate and not on misleading data).

Double Taxation of Public Companies' Profits

The present taxation rate on public company profits in Australia is 8s in the £. But no allowance is now made for the tax already paid by companies when taxing the dividends as personal income of the shareholders. This double taxation system was introduced as a wartime measure only,¹⁶ but has been maintained. There are several points to be made on this matter.

¹⁶ The following remarks were made by the Federal Treasurer, A. W. (now Sir Arthur) Fadden, when introducing double taxation of company dividends—Hansard, 21 November 1940:

"It is proposed to obtain a further addition to individual income tax by abolishing the present rebate of tax in respect to dividends on which company taxation has already been

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The first point relates to *the measurement of the total of the nation's company profits* as an absolute amount and as to the trend in them. When company profits in the prewar and postwar periods are compared the profit figures used are often the profits prior to income tax. As a comparison this is invalid and most misleading, because now those profits will be taxed twice instead of once.

The second point relates to *the comparison of shares of the national income*. As the owners of companies cannot receive more than the profits after company tax is met, and are taxed again on that money as personal income on an equal footing with all other personal incomes, company proprietors' share of the national income is overstated in the official national income statistics *vis-à-vis* other income groupings where income tax makes its impact only once. In the Australian national income papers there is a notation that the company income is stated before deduction of company income tax but many commentators when computing shares of the national income tend to overlook the effect of this. The measurement of company profits as a proportion of the national income is discussed further in a later section of these notes.

The third point is that *the double taxation system amounts to a special discriminatory tax on the corporate way of doing business*, not imposed on other business organizations or on other means of producing the community's goods and services. It is akin in some ways to the special taxes imposed, discriminatorily, against certain luxuries and goods like potable alcohol to discourage their production and consumption as well as to raise revenue. It has a similar result and constitutes a powerful force in discouraging company enterprise and higher levels of productivity by companies. It operates directly to increase the companies' and hence the community's cost structure and to reduce ability to compete in overseas markets. A question of quite fundamental importance is: Is corporate enterprise—one of the principal means developed by Western civilization for making material progress and raising living standards—to be treated as a luxury which we can do without, or of which we can do with less, and, therefore, to be discouraged by a special kind of selective taxation?

One sometimes sees statements about the so-called separate "taxable capacity" of companies. None of such statements, however, gets over the point that the profits from an owner's capital put to work in a partnership, in a retail shop, in a farm, in a carrying business, or by lending to governments, water boards, companies, etc., is taxed once only—as surely it should be; but, if the owner puts the capital to work instead as a share of a company enterprise, the profit is taxed twice (and heavily in the hands of the company). This, it cannot be said too often, requires consideration from the viewpoint of equity, as well as of utility for the community.

The fourth point relates to *the exceptionally severe impact of the double taxation system on shareholders with smaller incomes*. If a shareholder on a small income, such as a widow living on her late husband's savings, has a taxable income of £500 a year she is assessed for personal tax in Australia at £27, i.e., at 1s 1d per £ of taxable income. But, if any of that income comes from dividends from a company, she has already been taxed on it while it was in the hands of the company, at 8s in the £. In her case not only has the tax paid while in the company's hands been very much too high already but the same income will be taxed again. If an Australian has a taxable income of £1,000 a year he is assessed for personal tax at £106, i.e., at a rate of 2s 1d in the £. Personal income tax rates do not reach 8s in the £ until taxable income reaches about £6,500. The injustice that is done all shareholders by the system of double taxation of company dividends is great but, relatively, it reaches exceptional heights (or depths) in respect of shareholders who do not have large incomes. The evidence on the wide

paid. A good deal could be said in favour of a complete rebate of all company taxation, but considerations of revenue and of administrative difficulties make that quite out of the question at the present time. It is proposed as a wartime measure to discontinue the rebate with the hope of reconsidering the whole question when the urgencies of war finance are behind us . . . I doubt if it is wise to put such a load permanently on company enterprise, which plays a large part in the industrial development of Australia, and only the urgent need of revenue has necessitated the increases now proposed as a wartime measure."

spread through the community of C.S.R. shareholdings, and on the number of people of moderate means who own such shares, has been given in this book. There is also the impact of the tax paid by companies under the present system on dividend recipients who are intended to be altogether free of income tax—for example, employee provident and super-annuation funds.

The fifth point is the way in which *double taxation acts as a direct encouragement to companies to become borrowers*, instead of taking in more partners in the risks and ownership of the enterprise.

Some further observations now follow bearing on one or more of these five points. But first it can be noted that in 1953 the Australian Federal Government took an appropriate step in abolishing the special additional tax on income from property which, in respect of company dividends, constituted a kind of triple tax. In respect of dividends this reduction has been more than offset for most shareholders by the recent increase of 1s in the £ in the company tax rate.

The system of double taxation does apply in countries other than Australia. Although qualifications are needed for fine comparisons it can be said, however, that it does not apply in New Zealand; nor in the United Kingdom except in relation to the supplementary tax known as Profits Tax.

Double taxation applies in U.S.A. and Canada, but generally circumstances there have been very favourable to corporate enterprise, especially in that it has not been much concerned with competition from non-taxpaying government and co-operative enterprise. Moreover, the double taxation in those countries has more recently been alleviated—considerably in Canada¹⁷ although not so much in U.S.A.¹⁸

(It is desirable to keep in mind when thinking of the level of taxation in the United States that that nation is still supporting a defence expenditure approaching that of a war economy—much greater relatively than that of Australia.)

When the Secretary of the United States Treasury was introducing the alleviation in respect of dividends, he said:

Dividends are the incentives which provide risk capital. It was risk capital, primarily, which made possible the phenomenal growth of America . . . in the mid-1930s there crept into the tax laws, in confusion attending an experiment with an undistributed profits tax, full double taxation on dividend income. Now, the useful citizen who supplied the risk capital had to run the tax gauntlet twice. First, his share of the company earnings took the full whack of the corporate income tax; next, when the residue reached him as dividends, he had to pay on it the full personal income tax. When this unfair levy was first imposed, Federal taxes were relatively low, so the load was not too tough. Then came the war and its aftermath. As taxes soared, the double levy on dividends soared with them.

A United Kingdom Royal Commission in its final massive report on *The Taxation of Profits and Income* (June 1955) rejected double taxation of company profits in principle. The majority, 11 members, said, "It seems to us a wrong principle to subject the shareholder (whether by deduction at source or otherwise) to income tax liability on his receipt from the company in any way that altogether ignores the fact that the profits from which the dividend is drawn have paid corporation tax in the company's hands. We accept the criticism

¹⁷ The Canadian Federal Government adopted a plan known as the dividend tax credit, under which dividend receivers have the tax on their dividend income reduced by 20 per cent of the dividends.

¹⁸ In U.S.A. as in Canada the alleviation applies at the shareholder or personal level. The whole tax position in U.S.A. is greatly affected by the provision allowing husband and wife to average their incomes before rates of tax are struck. Each party is taxed at the rate applicable to half the joint income. Further, all dividends up to a total of 50 dollars per annum per individual taxpayer are excluded from income and 4 per cent of all further dividends received is allowed as a direct credit against the tax assessed.

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that it is double taxation to treat a company dividend as being wholly a new source of income." (However, after consideration, spread over some pages, of practical difficulties the majority could not find, in the present circumstances in the United Kingdom, a practicable solution which would altogether avoid an element of double taxation in respect of corporation Profits Tax. Double taxation is already avoided in the United Kingdom in respect of Income Tax.)

Double taxation of company profits is having a considerable effect in swinging companies away from ordinary or "equity" capital-raising and is thus turning investors more into rentiers. There is, of course, an important place for finance by borrowing and for rentiers who invest for an interest return and definite repayment of capital. But most people would be sorry to see such a trend away from risk-bearing and ownership towards rentiership. The Secretary of the U.S. Treasury comments:

The double taxation of dividend income has made it increasingly difficult to attract risk capital. . . . Consequently, most funds from outside the business have come from borrowing rather than from the sale of stock [i.e., ordinary shares]. This is not the best way for America's economy to finance its expansion. Bonds, of course, have their proper place, but when a company gets top-heavy with bonded or other debt, it has to watch its fixed charges the way an invalid watches his blood pressure. It moves timidly instead of boldly. It nervously slows down when the going is rough. It shrinks from the uncertainty involved in promising new ventures. In other words, it loses the very spirit which has made this country great. That is why I am so glad to see some reduction in the double taxation of risk capital. Modest as it is, it will halt a dangerous trend and set us back on the road of vigorous advance.

The means to correct or greatly alleviate the double taxation need not be expanded on here. Methods are well known, at least in respect of profits distributed as dividends.

Company Tax a Cost of Production Inhibiting Productivity

It is thought by some, because company tax is levied as a proportion of profits, that it does not operate as a cost and as a brake on development and efficiency. It is desirable that the reasons why this is not so should be quite clear.

At the present rate of Australian public company tax, to earn £100 for the shareholders a company must make £166 13s 4d before tax. Of the £166 13s 4d, 8s in the £ or 40 per cent of that sum, viz. £66 13s 4d, will be taken in company tax. The £66 13s 4d cannot be regarded in any way other than as a cost as it is clearly an expense of carrying on the business for the owners. Only the £100 is available as profit to the shareholders.

Selling prices of goods and services as now traded have become established so that they carry the cost of company tax along with other costs. Where to some small extent this has not yet happened, as in respect of the recent increase in company tax, it is in progress. If it has not occurred the company is becoming an unsuccessful one, although the retrogression may be slow. Unless the company brings about a change in the situation it has no real future. In the longer run it must, to survive, cover the cost of taxation and cover as well the necessary level of distributed and undistributed profits. Certainly new ventures will not be undertaken that will not amply carry the full cost of current rates of company tax.

Take the case of a company which in its business judgment considers that it requires a net profit for shareholders of 10 per cent per annum¹⁹ in order to justify capital expenditure for expansion or greater efficiency of the business, such as an investment in new and improved machinery. The relevant factor is the profit *after tax* because that is all the proprietors

¹⁹ The rate of 10 per cent after tax is used here for illustrative purposes because it provides an easy base for calculations. The actual rate businesses aim for varies with different ventures and depends on many factors, on opinions and on judgments. Many enterprises, in the light of current interest rates, would not consider basing plans for many lines of business on earning a lower rate. The rate may be arrived at by historical-cost accounting methods, thus overstating the real profit in an era of continuing inflation.

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can receive. With tax at 8s in the £ (i.e., a tax rate of 40 per cent on profits) the net percentage return needed, to give 10 per cent after tax on the new capital investment, becomes $\frac{10 \times 100}{60}$; this equals 16 $\frac{2}{3}$ per cent per annum. The extra 6 $\frac{2}{3}$ per cent profit (or, stated more vividly another way, the increasing of required profit margins by two-thirds because of company income tax) has a tremendous effect on business decisions. Countless are the decisions against additional investment for expansion or efficiency entirely because of this extra cost (or of the 7s in the £ tax that has been operative in recent years).

For comparison, consider the cost of tax if it were 4s in the £; then the required return on the new investment would be 12 $\frac{1}{2}$ per cent, to net 10 per cent, which is an added burden of only one-quarter, instead of two-thirds. Instead of requiring to make £166 13s 4d in order to have £100 profit, it would only be necessary to make £125.

Let us illustrate the position even more concretely. For sugar milling, transport and refining in Australia the capital required at current price levels is about £130 per ton of sugar sold per annum. On this capital the extra cost due to company tax, calculated by the methods and at the rates just discussed, would increase the price of refined sugar by £8 13s 4d per ton, or nearly 1d a lb.

There is another way of showing the effects on efficiency of the high tax rate on companies. All directors and members of senior management in manufacturing companies know the effect on their decisions of the facts that working expenses—for operations, maintenance, and so on—are fully allowable deductions when taxable income is assessed and that in the case of a public company 40 per cent of them are now borne by the Treasury. This is a powerful influence which tends to keep out-moded methods operating and tends towards the maintaining and repairing of old equipment, because only 60 per cent of the expense is carried by the business. On the other hand capital investment, especially in long-term fixed assets, runs many risks—risks which are aggravated in an age of inflation, of historical-cost accounting, of inadequate replacement allowances, of threats of nationalization and of direct controls; all these risks tend to raise the required rate of profit, to which two-thirds must be added.

Let us relate this second approach, which is from the expenses side of the question, to the first approach, which was from the profit side. Take the case of a company which, on close examination of its methods, finds that it could save £1,000 annually in wages and all other expenses after allowing for the additional depreciation (and probably at the same time reduce arduous physical work) for a capital expenditure on mechanization of £10,000. This appears to be a profit of 10 per cent and let us assume that, if reasonably certain, it would be enough to satisfy the company's board. But the capital-cum-mechanization method of carrying out the function of production is subject to taxation which the other and more laborious method is not. The progressive method substitutes the cost of profit plus the cost of tax on profit plus the cost of more depreciation for other kinds of expense, more often than not largely labour. But the cost of £1,000 being incurred by the old method of production is fully allowable when tax is assessed and, therefore, in fact does not cost the company £1,000 but only £600 (£1,000 less 40 per cent thereof as tax). The real saving is only £600; and this is 6 per cent on the expenditure of £10,000, whereas the board has decided it requires a net 10 per cent. The board therefore decides against the expenditure and against the mechanization. Productivity receives a set-back.

The answer obtained by this approach is the same as previously arrived at, viz. in order to cover the taxation, the profit margin needs to be two-thirds larger—in the latter example 10 per cent instead of 6 per cent.

These points can be kept in mind, too, for the occasions when management is being criticized for lack of efficiency or lack of progress. While there are, in some situations, other roads towards efficiency, the main long-term route is mechanization and automation. In other words it requires capital, with which must go hand in hand the prospect of profit. Many feasible progressive steps will show a 10 per cent return, or whatever other figure the company requires, but a high proportion of those will not yield the additional two-thirds.

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Effects of Inflation on Taxation of Company Profits

Many countries have taken steps, in differing ways and in varying degrees, to assist productive enterprise with the problem of inflation, in so far as taxation is concerned. Australian tax rules did give some help by initial depreciation allowances a few years ago but this has now been withdrawn except for primary producers. As Australia has had and still has a high degree of inflation it is all the more difficult to appreciate why our tax system continues to tax a part of capital as well as profit (by overstating profit) and so reduces the ability of the business world to expand its resources in order to achieve the greater production which would operate as an anti-inflationary force.²⁰

The latest comprehensive consideration of the question of inflation and taxable incomes known to us is the United Kingdom Royal Commission's Final Report (June 1955) on *The Taxation of Profits and Income*. The whole commission of 14 members (after discussing the matter over some pages and pointing out certain of the consequences of its recommendations) said, "we think that *for the purposes of taxation*"²¹ a system of computing his [a trader's] profits that does not make allowance for these factors [replacement of fixed assets or fall in the purchasing power of money] is preferable to one that does." The Royal Commission, however, had said in its introduction, "We take it as our general premise that there will not be any marked decrease or increase in the purchasing power of money in the United Kingdom"; also, "Indeed, if we had thought that we were obliged to assume a persistent decline in the purchasing power of money, even if a slow one, our examination of the problem of dealing with the inflationary element in profits which are computed without allowance for the decline would have started on a different basis and might have reached a different conclusion." The Royal Commission reported that schemes for allowing more depreciation to offset the effects of inflation have been adopted in Belgium, France, Germany and Italy. The Royal Commission added, "... the problem of the trader is a formidable one when he has to meet at the same time high taxation on his profits and a greatly increased cost of replacement; and therefore some measure for alleviating the weight of taxation of business profits is to be looked for as a normal incident of the tax code." The Commission, having already assumed that inflation would not occur to any considerable degree, stated also that it assumed that business would continue to have available to it either the higher initial depreciation allowances or investment allowances.

On the question of stock valuations the Commission recommended more freedom, including a qualified form of L.I.F.O., the minority of three members dissenting. L.I.F.O. means valuation of trading stocks on the basis of "last in first out". It is in contradistinction to F.I.F.O. ("first in first out") which assumes that the oldest stock is used first. In a period of inflation the use of L.I.F.O. reduces taxable profits and helps with the problem of stock replacement at higher cost. L.I.F.O. has long been available to taxpayers in the United States. L.I.F.O. is not a true accounting for inflation in respect of stock and may lead to further problems. It is a palliative against inflation and high taxation and its use shows how some countries are prepared to assist business with the problems of inflation and taxation.

In arriving at taxable incomes, accounting for inflation, whether in respect of depreciation, stock values or in still wider directions, would affect all business and trading incomes. But,

²⁰ It is ironical that primary producers whose main asset is land which does not depreciate, and who therefore do not face the problem of replacement at inflated cost of their main productive asset, have, unlike industry in general, been allowed special depreciation at 20 per cent per annum on almost all types of plant and improvements acquired since 30th June 1951. They thus would write off the full historical cost of the asset in 5 years. Good luck to them! Certainly primary industry has to compete in overseas markets more than most other industry, and these samples of progress in the tax system should be retained and improved. But the case for freeing from tax those provisions required to counter the effect of inflation on the cost of replacement of assets rests upon much broader grounds than that of export problems.

²¹ Italics not in original.

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restricting the discussion to *companies* in Australia and contrasting the situation with the comments of the United Kingdom Royal Commission, it can be noted that in Australia we have double taxation but neither investment allowances nor initial depreciation allowances. L.I.F.O. is not allowed, nor is any other form of relief. And we are experiencing continuing inflation.

That the failure to take out of profits the element that arises from inflation and is not real profit is not a minor matter has been mentioned in these notes. Many more illustrations could be given but a few will have to suffice.

There is the adjustment, previously referred to, of the United Kingdom national income to the extent of £Stg.750,000,000 in 1954 for stock values alone; this huge figure included no provision for adjustment of depreciation of fixed assets.

The example of the truck owner who lost one-third of the real value of his asset in five years (and lost production capacity) has often been matched in practice, as has the example of the shirt merchant. The example of the Jantzen company (footnote 8) is very striking and based on an actual experience.

There is still a lot of prewar plant in use in Australian industry; indeed much of the plant renewal to be done in the next 5 years will be of prewar plant. Even if we have no more inflation this renewal is going to cost in the vicinity of three times the original cost. Only original cost has been allowed for taxation depreciation purposes and depreciation on that basis is all that has been allowed for in the official national income statistics.

As a further example of what is occurring, suppose a company tries to make provision to the extent of £1,000 for the replacement cost of wearing-out plant being higher in terms of money than the original cost. The additional income set aside for the higher cost of replacement will be assessed as taxable profit so that, with tax at 8s in the £, the company has to make and set aside not £1,000 but £1,666. The inflation, in this example, has made the functioning of the company harder to the extent of £1,000 and the tax system, by ignoring the inflation, has increased this burden to £1,666.

The Taxing of Governmental and Co-operative Businesses

Private corporate enterprise faces in several spheres in Australia the competition of government enterprise which is free of tax and which has almost unlimited new capital available to it substantially irrespective of its efficiency or profit record. In other spheres ordinary companies face the competition of co-operative organizations which are almost free of tax.

Some co-operatives enjoy an extraordinary position under the Income Tax Assessment Act in that they can charge the repayment of certain capital borrowings to whatever taxable profits remain. This tax favouritism for co-operative enterprise, and bias against ordinary company enterprise, is also partly the product of double taxation of public companies. The largest element of discrimination between co-operative and other companies would disappear if double taxation were abolished and if the extraordinary exemption co-operatives enjoy of tax-free repayments of certain capital borrowings were also removed. On another view: the discrimination, although still objectionable in principle, would be less serious, even under the *present system*, if public company tax rates were quite low.

The question of taxing government enterprise seems, strangely, to have attracted little attention in Australia. In the United Kingdom nationalized industries and public utility undertakings are subject to profits tax at the lower (non-distributed) rate and there are some other distinctions. The recent United Kingdom Royal Commission recommended unanimously that the profits of nationalized and public utility undertakings "should be taxed like those of any other trading entity".

At low tax rates (or if government and co-operative business activities were taxed on an equal or near-equal basis) it is unlikely that private enterprise would fear such competition—and would have no basic complaint which it could legitimately make, unless other kinds of favouritism were to apply. But the weight of taxation on ordinary companies has been shown

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to be great and there is a major doubt whether, in the longer run, companies will be able to compete if present conditions persist. Those companies which are not exposed to government or co-operative competition seem scarcely aware of these matters, but considerable fields of company enterprise are feeling the effects. C.S.R. has had to stand aside in recent years and see a government instrumentality provide the capital for a business the company had planned, because the government organization had access to a large volume of cheap governmental capital and would pay no income tax.

Company Taxation—Conclusion

It is regrettable that in recent years there has not been in Australia a comprehensive and public examination and public report on the taxation of profits and income—or an even wider examination of the taxation system—by a body of reputable men of wide experience. There is no adequate counterpart in Australia of the five United Kingdom reports between 1951 and 1955 (the reports of the two Tucker Committees and the three reports of the Royal Commission). There was an inquiry in Australia, by the Commonwealth Committee for Review of Taxation, whose report was made in 1954, but unfortunately published in part only. The non-publication of the rest of its report is regrettable and gives grounds for concern that the unpublished parts were withheld because they were out of line with ministerial or departmental views. The *Report of the Commonwealth Committee on Rates of Depreciation*, dated 31 March 1955, is useful and informative within the strict limits imposed by its terms of reference. These, strangely and despite representations, ruled out consideration of depreciation in the context of inflation.

It is time for basic examination by a very high-ranking body. What were in the past merely potential or minor causes of higher costs, minor brakes on production or minor causes of inequity have become real, effective and major because of the changed circumstances and the combination of factors such as high taxation rates, inflation and the use of old accounting methods inherited from a period of stable money and incapable of handling the effects of inflation. Matters which in prewar times were of potential, academic or theoretical interest have, in the new circumstances, become real problems of great importance.

The foregoing comments about the taxation of companies have been made for the following purposes:

- (a) To show the special discrimination and discouragement exercised against the corporate way of producing the community's material welfare, especially by double taxation and high rates of tax.
- (b) To indicate a matter further developed later in these notes, viz. the national income statistics are misleading (although unintentionally) in respect of company profits, both as to the trend since prewar and as to their share of the national income.
- (c) To highlight the burden and the consequences on production of taxing as profit what is not economic profit but appears as profit under conventional historical-cost accounting in a period of inflation.
- (d) To point out the existence of tax discrimination in favour of government enterprise and co-operatives and against corporate capitalism; and to point to the existence of tax-havens for persons who can organize their activities on a co-operative basis, as an increasing number are doing.

These matters merit consideration in the highest places on the score of equity as well as on the score of the community interest in production for higher living standards and for national survival.

The question of equity might not be so important if taxpaying private corporate enterprise had no competitors, or if tax rates were low; but neither of these conditions applies.

To advocate adjustments in the tax system, reduction of certain taxes, or even a reduction in total taxation revenues is not to lose sight of the need for governmental expenditures in the world we live in. But in the social revolution or evolution that this age is witnessing

taxation is the principal agent of the change. The electorate has in recent years been faced with a clear choice on whether it desires more or less statism and, with the wartime and immediate postwar experiences fresh in mind, it seems to have decided against more of it. A consistent policy would therefore strive to keep governmental expenditure as low as possible and to raise the revenues needed for redistributive and other necessary purposes in ways that would give the least impetus towards statism. Within the limits of the need to raise a certain amount of revenue, differences in effects arise—effects on productivity and on equity—depending on *how* the amount is raised. And, as mentioned in Chapter 15, the fruits of steadily increasing productivity could be used to reduce the proportionate weight of the tax burden, in total and in various directions.

Much of the authoritarian statist attitude towards taxation necessary in wartime (and accepted in such a time though perhaps containing elements of inequity) has been continued in the postwar era. The tax system in Australia still retains part of the wartime characteristics and outlook—an outlook which regards the “stick” as a more convenient instrument than the “carrot” except where the more powerful and articulate groups are concerned. Some important considerations both of general utility and of equity would make for political difficulties—so the outlook runs—because of emotional reactions inherited from a collectivist-minded past which gave little heed to production and assumed that more and more equality is the greatest good, more important than other personal aspirations and more important than progress. “While such emotionally-established concepts developed in the past 50 years may be counterable or modifiable by facts and reason,” so the outlook says, “we had better not stir up anything. Even the reports of expert bodies set up to study these questions may cause inconvenience so we will select what to publish from their findings.”

The submission is that more consideration of the “how” in levying taxes, more attention to taxation on expenditure and less to taxation on income (as income includes saving), more incentives for productive endeavour, less government expenditure of marginal value, less subsidization of some government enterprises, like most of the government railways, which should pay their own way (including the meeting of depreciation and replacement), could alleviate both the gross burden and the incidence of taxation and could result in more equity while encouraging production.

It is interesting that the terms of reference of the recent United Kingdom Royal Commission included this direction: “to consider whether for the purposes of the national economy the present system is the best way of raising the required revenue . . . *due regard being paid to the points of view of the taxpayer and of the Exchequer.*”²² Also, the terms of reference were amended while the Commission was sitting so that it could indicate an order of priority, in so far as its recommendations would entail a loss of total revenue.

As a major instrument of change, the tax system can profoundly influence the course—and the effectiveness—of enterprise, both individual and corporate: for the benefit or detriment of the community and with or without justice to the owners of enterprise in a property-owning democracy.

While many are the points of criticism of the taxation system and while much should be done to improve it and to keep down the level of taxation, it is most important to recognize that controls and changes brought about by general schemes of taxation are tremendously to be preferred to direct controls administered by officials (no matter of how much goodwill and impartiality) on individuals, trades, industries, companies and groups, individually and selectively: such controls as price controls, capital issues controls, fixation of maximum wages, import licensing, permits and licences of multifarious kinds, applied, granted or withheld at the discretion of officials in respect of individual or group cases.

Controls of the latter kind constitute, even more than high taxation, the backdoor to an authoritarian and unfree society, and produce a flaccid economy. Taxation, if too high and falling upon production, energy and enterprise more than on consumption, is likely

²² Italics not in original.

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to have drastically undesirable consequences but the effects of direct controls are even more to be feared.

3. THE LITTLE-KNOWN LOW LEVEL OF COMPANY PROFITS

How high are company profits? Can the actual levels be determined? Although within the compass available here full demonstration is difficult, the conclusion can be indicated at the outset, viz. there seems strong *prima facie* evidence that Australian company profits, despite some zones where profits are high, have not been in recent years nearly as high as popular opinion seems to hold. In fact they have declined and seem to be low in absolute and real terms.

Company Profits and the National Income

In primitive communities there was virtually no capital and, consequently, living standards were low and even miserable. There being virtually no capital, profits would have been virtually nil as a proportion of the community income. This situation still exists in some present-day primitive societies. Material progress has depended greatly upon a steadily increasing total quantum of real capital in the community and therefore upon a long-term trend for profits (as payments for the use of capital to those who save part of their incomes instead of being total consumers) to become a higher proportion of the community or national income. Just as capital equipment and profits have raised the industrial society above the primitive, so more capital equipment and more profits distinguish the economies with high living standards from those at a lower level. An increase in profits—payments for use of capital—as a proportion of the national income does not mean that other kinds of real income are being reduced; the normal situation would be for all or most kinds of income to increase as a result of the productivity derived from the added capital; generally speaking, only a portion of the increased productivity remains with the owners of the capital as profit.

In England recently there has been much discussion about saving and re-investing a good proportion of the national income—of the order of 20 per cent of each year's national income—in order to keep on raising productivity. The conclusion is that as our communities increase their total wealth and capacity to produce so too, although subject to some modifying influences, will total profit of all kinds, if accurately measured, gradually increase as a proportion of the community income. It is the way of progress and it is to be hoped that it will take place on the basis of a "property-owning democracy". The trend for profit to rise as a percentage of community or national income could be disturbed if special or unusual influences operated, or if the rate of reward required for continued saving and investment were to become lower.

Let us examine the trend to use capital tools to reduce the work of men from a different aspect and consider what happens when a capitalist producer decides to make use of capital and machinery in place of manual methods. Take the case of a manufacturing company with a total annual sales revenue of £200,000 and a capital of £100,000. It is making a net profit of £16,666, or 16⅔ per cent on capital, before tax; and £10,000, or 10 per cent, after tax. The board accepts a recommendation by management to spend £20,000 on new machinery which will increase profits by £2,000, while reducing the quantity of work and probably the arduousness of the remaining work. In these examples output, sales revenue and the usage of materials are presumed not to change so that the effect of this kind of advance on the relative positions of profit and wages can be clearly seen free of complicating factors. The position before and after the additional mechanization is shown in the table on the next page.

It will be seen that (in the present state of company taxation in Australia) to spend capital to attain the same level of production by less laborious methods, while maintaining the rate of profit on total capital, the extra tax paid to the government is equal to two-thirds of the net profit made available to the owners in return for the extra capital they have provided. This illustration, therefore, helps to show in a simple example how taxation hinders progressive actions and thus further illustrates a major point made in part 2 under the heading of *Company Tax a Cost of Production Inhibiting Productivity*.

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	<i>Before additional mechanization</i>		<i>After additional mechanization</i>		<i>Differences</i>
	£	£	£	£	£
Capital		100,000		120,000	+ 20,000
Production (in terms of sales revenue)		200,000		200,000	no change
Less Expense of:					
Wages	100,000		95,000		— 5,000
Materials	60,000		60,000		no change
Other items including depreci- ation	23,334		25,000		+ 1,666
		183,334		180,000	— 3,334
Profit prior to tax		16,666		20,000	+ 3,334
Less Expense of company tax ..		6,666		8,000	+ 1,334
Profit after tax		10,000		12,000	+ 2,000
		(= 10 per cent on capital)		(= 10 per cent on capital)	

As percentages of production (sales revenue):

Wages 50.0 per cent 47.5 per cent

Profits

Prior to tax	8.3	„	„	10.0	„	„
Deduct tax	3.3	„	„	4.0	„	„
After tax	5.0	„	„	6.0	„	„

But the main purpose of this example is to show what happens to wages and profits as relative proportions of the final price. It will be seen that, as progress is made by the addition of more mechanical slaves, provided by the owners' capital, the relative importance of profit and of tax in selling price increases, while that of wages decreases. In the example tax increased from 3.3 per cent of production to 4.0 per cent and profit after tax from 5.0 per cent to 6.0 per cent. Wages fell from 50.0 per cent to 47.5 per cent. (The relative proportion of depreciation in selling price also must increase as more plant is employed per unit of output.) In the above statement the main items which become ingredients in the national income are wages and profits. Under full employment the men displaced by the mechanization will be employed in the same company or elsewhere, and let us assume (reasonably) that they receive the same wages in their new employment. (The additional capital is assumed to be new funds, either new savings or possibly new capital from abroad.) Then in the national income statistics we find the abovementioned main items taking effect as follows:

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		<i>Before additional mechanization</i>	<i>After additional mechanization</i>
		£	£
Wages entering n.i.		100,000	100,000
Profit entering n.i.		16,666	20,000

It does not matter for the purposes of this illustration whether we use profit before tax, as is the practice of the national income statisticians, or profit after tax plus the tax—in both cases profit increases its weight in the national income.

There has been an increase of profit as a proportion of the national income without any loss to wage-earners. Total production in the community has been increased because this manufacturing enterprise is getting the same level of output and men have been able to go to other work, so increasing output elsewhere. It cannot be emphasized too much that greater output, once it exceeds the amount necessary to reward the additional capital, is available for the community in lower prices, higher wages, or in some other way.

A frequent result from this kind of mechanization increase would be not as used in this example for simplicity of exposition, viz. the same output for the same total cost (for all expenses and charges, income tax and profit), but a lower cost per unit of output at the same level of output (mainly due, perhaps, to greater savings in wages from the mechanization than postulated here), or lower cost per unit of output due mainly to a higher level of output. In such instances there is an immediate overall gain in productivity available for community use as indicated in the last paragraph.

We now turn to examine the trend of total company profits in Australia as a proportion of the national income.

The survey by Economic Services (Appendix 33) shows that, since 1947, company profits (before tax) and company dividends have held an almost stationary proportion of the national income. (It is a reasonable presumption, based on general evidence of capital-raising, that in this period companies have added to their capital, after allowing for depreciation, also that they have at least held their own with the rest of the community in the increasing of their capital resources and in pursuing progressive methods.)

If we go back to the prewar period we find:

		1938-39	1953-54	1954-55
"Company income" (prior to tax) as percentage of n.i. ²³		10.8	11.8	12.5

The points to note here are that, on first appearances, company income represents a somewhat higher proportion of the national income than before the war. But the comparison is not a true one. There are factors depressing shareholders' profits (distributed and undistributed taken together) not allowed for in this comparison and the result is that real company profits in 1953-54 and 1954-55 were less, as a proportion of the national income, than before the war, despite appearances.²⁴ The reasons why adjustments of these figures are necessary will now be discussed.

- (a) The percentages of company income stated above are in all cases prior to tax. But company tax has now become a double tax because, irrespective of the size of the income of any shareholder, this tax of 7s (or 8s) is paid by the company and the shareholder receives no credit for it when his or her own tax is assessed. Before the war there was, generally speaking, a system of credits or rebates for the share-

²³ Figures calculated from the tables in *National Income and Expenditure 1954-55*.

²⁴ For the record: Leaving out minor qualifications, taxes on the profits of public companies in the immediate prewar period were imposed by the States at varying rates, and by the Commonwealth at about 1s 2d in the £. The overall average prewar tax seems to have amounted to almost 4s in the £. In 1953-54 and 1954-55 the tax on public companies was 7s in the £ and in 1956 was increased to 8s.

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holder in respect of the tax paid by the company. Obviously, the tax of 7s or 8s in the £ applicable without an offset for shareholders, when previously there was an offset of company tax when shareholders were being assessed, means that the pre-tax income of companies has to be heavily reduced before it can be compared with the previous income of companies under the old taxation system.

(b) Adjustments for company tax can be made as follows:

	1938-39		1953-54		1954-55	
	£ million	% n.i.	£ million	% n.i.	£ million	% n.i.
National Income ..	£780m.		£3,842m.		£4,033m.	
Total company income (included in n.i.) ²⁵ ..	£84m.	10.8%	£452m.	11.8%	£505m.	12.5%
Less income tax on companies ²⁶ ..	£15m.	2.0%	£130m.	3.4%	£168m.	4.1%
Company income after company tax ..	£69m.	8.8%	£322m.	8.4%	£337m.	8.4%

An important point is that there has been a fall in company proprietors' share of the national income. Note, too, that (as a percentage of the national income) the owners of companies are contributing about twice as much to government income tax revenues as before the war, *although they are now contributing in full as persons as well* (and at the much higher rates now paid by everyone.)

- (c) But the proper comparison with the prewar position has still not been made. We do not know how to make it arithmetically from available information but it can be indicated. The comparison shown in the last line of figures (of company incomes after tax as 8.8 per cent of national income in 1938-39 and 8.4 per cent in 1954-55) is still far from a valid comparison. The 8.4 per cent in respect of public companies will be fully taxed again, but a high proportion of the prewar 8.8 per cent was substantially tax-free, or lightly taxed, in the hands of the shareholders. *The true comparison would seem to be nearer to 10.8 per cent prewar, vis-à-vis 8.4 per cent in 1954-55.*
- (d) Depreciation and stock valuations used in arriving at taxable incomes (taxable incomes form the basis of the national income statistics) are based on historical-cost accounting and result in profits being overstated in a period of inflation, as experienced in recent years, to a major degree. But, as inflation did not apply significantly in 1938-39, the profits (company income) would not then have been overstated. Therefore, for comparison of shares of the national income, 1938-39 versus 1953-54 and 1954-55, the official figures for the later years are too high. If a true comparison could be made incorporating these adjustments for stocks and depreciation, company profits in recent years would be even poorer in relation to prewar company profits than the above figures indicate. Perhaps a reminder can be given here that, as previously explained in these notes, this adjustment for depreciation and stock values is a correct one to make in computing the national income and shares of the national income. That large sums and important propor-

²⁵ Figures from the official *National Income Papers*. Company income in the *National Income Papers* excludes banks but income tax on companies includes tax on banks. Therefore for this tabulation income tax on companies has been reduced to take out, on a calculated basis, the tax on banks.

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tions of the national income can be involved in these matters has also been demonstrated earlier in these notes.

We now turn to dividends to see if they confirm the trend indicated above. They do so. The comparison is as follows:

*Dividends to resident persons as percentage
of national income²⁸*

1938-39	3.2 per cent
1953-54	2.7 " "
1954-55	2.9 " "

Again the comparison is not true. The prewar 3.2 per cent was substantially tax-free or lightly taxed in the hands of the receivers. The lower recent figures of 2.7 per cent and 2.9 per cent are heavily taxed.²⁷

In Australia it seems clear that company income, as a proportion of the national income, has declined distinctly, whereas the expectation would be for an upward trend to have occurred over the comparatively long term since 1938-39.

Real Returns to Shareholders from a Sample of Company Enterprise

Not long ago we made a study of the return from ownership of company shares based upon a group of well-known companies listed on the Sydney Stock Exchange. The period covered was thirty years, from 1924 to 1954, thus, by design, covering the depression and the postwar inflation.

The sample is not a randomized sample of public companies in Australia but covers 25 companies²⁸ which, taken as a whole and despite some gaps, we believe the ordinary investor would agree represent a reasonable cross-section of industry and trade in Australia as carried on by larger corporations over that period, including many of the "market leaders". Of course, many companies now prominent and successful were not prominent, and some not in existence, in 1924. Some companies then prominent have since failed and gone out of existence. The sample of companies covers banking, brewing, gas, insurance, pastoral industry and wool, retailing, shipping, steel, sugar, trusteeship, other manufacturing, and there are

²⁸ Calculated from the *National Income Papers*; includes dividends received from overseas companies and excludes dividends remitted overseas.

²⁷ The difference between "company income" and "dividends" would seem to be comprised of: company tax; expenses not allowed for taxation purposes but deducted by companies before arriving at actual profits (including some measure of extra depreciation and stock value allowances, being costs not recognized under historical-cost accounting); profits held undistributed; and dividends paid to overseas shareholders, less dividends received by residents from abroad.

²⁸ The sample comprised the following companies:

The Adelaide Steamship Company Ltd.
The Australia Hotel Company Limited.
Australian Consolidated Industries Limited.
The Australian Gas Light Company.
Bank of New South Wales.
British Tobacco Company (Australia) Limited.
The Broken Hill Proprietary Company Limited.
Burns, Philp & Company Limited.
The Colonial Sugar Refining Company Limited.
The Commercial Banking Company of Sydney Ltd.
David Jones Limited.
Edwards Dunlop & Company Limited.

Farmer & Company Limited.
Goldsbrough Mort & Company Limited.
Kandos Cement Company Limited.
Mercantile Mutual Insurance Company Limited.
The Millaquin Sugar Company Limited.
Perpetual Trustee Company (Limited).
The Port Jackson & Manly Steamship Company Limited.
Sargents Limited.
Tooth & Company Limited.
The United Insurance Company Limited.
Washington H. Soul Pattinson & Company Limited.
Winchcombe Carson Limited.
Wunderlich Limited.

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some representatives of mixed industry. Several factors limited the sample to 25 companies. One was that there are fewer companies of prominence which were listed thirty years ago than one would expect. Although there are some whose inclusion would have been possible, their inclusion might have unduly biased the sample towards certain industries. Some companies' affairs proved rather too difficult to follow through reorganizations of capital and reconstructions. An important factor was the surprisingly large volume of work in collecting data and making calculations, and we concluded that the sample we had was good enough and extensive enough to indicate in a broad way the trend for this class of public company.

The method of assessing the results is now described. The calculation assumed an equal original investment in each company, and the purchase of the shares at stock exchange prices at 30 June 1924. The investment on which the return was calculated consists of the cost of the purchase, plus the cost of new issues (all presumed taken up) in cases where new issues were made requiring subscription of capital, or less the sum received where capital was returned. On the income side all dividends payable on the shares after 30 June 1924 were taken into account, including dividends on bonus shares and on other new issues. The investment and the income were corrected by means of the "C" Series Index to a common currency value, viz. 1954 £s. For the final result the average corrected dividend over the period was divided by the average corrected investment. The final average of the results for the 25 companies is a weighted average. The weight given each company is the average investment in it over the whole period. Although original weights were equal, new issues and other capital changes altered the average investment over the period. Naturally, the return shown by the computation as a whole is affected by the stock exchange values at 30 June 1924. (In respect of capital gain or loss the result is affected also by the stock exchange value at 20 June 1954.) The data were obtained and the calculations made by a retired chief accountant of C.S.R. The method was then examined by a senior statistician and the calculations checked by computers working under his supervision.

A further calculation was done on the assumption that all shares were realized at stock exchange values at 30 June 1954. Surprisingly, this showed that there was a small loss—and not a gain—from the change in the capital value (market value) of the shares, after correcting for the fall in the value of the currency. The value of new issues of all kinds, including bonus issues, was included in the capital value as at 30 June 1954. The capital loss, thus expressed in real terms, was equivalent to an annual reduction of dividend of 0.4 per cent. (Since 30 June 1954 the Sydney Stock Exchange index of the market value of ordinary shares has shown, to the time of writing, a very slight increase, but more than offset by the fall in the value of money since June 1954.)

While perhaps the results for any one company, if treated in the way described, would have little meaning except for the hypothetical investor who bought on 30 June 1924 and sold at 30 June 1954, it does seem that the results of the 25 companies are broadly indicative of the trend in these matters. The results for any single company could incorporate a distortion because the market value of its shares at specific dates might be considerably affected by expectations of the moment, by reports of short term effect and even by rumour. The use of a sample of 25 companies should make such distortion negligible.

The same calculations were carried out in money terms, uncorrected, so that these monetary and uncorrected results could be compared with the real results. The results for the thirty years were:

<i>Average return per annum for 25 companies 30 years—1924-54</i>			
		<i>Uncorrected</i>	<i>Real</i>
Average dividend p.a.		6.8 per cent	6.0 per cent
Capital gain (+) or loss (—) expressed, like the dividend, as percentage p.a. of average investment		+ 4.5 per cent	— 0.4 per cent
Overall Result		11.3 per cent	5.6 per cent

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The salient point is that over thirty years the real dividend has been 6.0 per cent per annum and there has been a loss of real capital.

A similar exercise was carried out for the period of 17.3 years from February 1937, the base date used by the Federal Arbitration Court when raising monetary wage margins by the "2½ times formula". The original investment for this period was taken at then current stock exchange values. Otherwise the method was the same and the sample of companies was identical. The results were:

Average return per annum for 25 companies 17.3 years—1937-54

	<i>Uncorrected</i>	<i>Real</i>
Average dividend p.a.	4.6 per cent	3.2 per cent
Capital gain (+) or loss (—) expressed, like the dividend, as percentage p.a. of average investment	+ 1.9 per cent	— 2.9 per cent
Overall Result	6.5 per cent	0.3 per cent

For this period the investment in every company showed a loss of real capital.

It is worthy of comment, too, that since 1940 the investors would have had to pay full personal income tax on the dividends. It is obvious, therefore, that over the period of 17.3 years the overall net result, after payment of personal taxes, must be a minus quantity.

This study of the results of 25 companies, as representative of the more prominent corporate capitalist enterprises in Australia, helps to an understanding of the great disparity between the real economic position and nominal appearances. The effects of failing to account for inflation are large. It also indicates that financial rewards for investors in corporate capitalism are at a much lower level than many suppose, even over a long period; and that they have been exceptionally low since the immediate prewar period.

For comparative purposes the results were calculated for a 5 per cent Commonwealth Government loan, purchased on the market at 30 June 1924, converted at a small discount to a 4 per cent loan in 1931, converted again at par to a 3½ per cent loan in 1951, and sold on the market on 30 June 1954.²⁹ The results for the thirty years were:

Average return per annum for Commonwealth Loan 30 years—1924-54

	<i>Uncorrected</i>	<i>Real</i>
Average interest p.a.	4.2 per cent	4.0 per cent
Capital gain (+) or loss (—) expressed as percentage p.a. of average investment	— 0.2 per cent	— 2.0 per cent
Overall Result	4.0 per cent	2.0 per cent

For the period of 17.3 years the results were:

Average return per annum Commonwealth Loan 17.3 years—1937-54

	<i>Uncorrected</i>	<i>Real</i>
Average interest p.a.	3.8 per cent	2.8 per cent
Capital gain (+) or loss (—) expressed as percentage p.a. of average investment	— 0.6 per cent	— 3.8 per cent
Overall Result	3.2 per cent	— 1.0 per cent

²⁹ Conversions based on an actual experience. Values: 30 June 1924, 7th War Loan market price £95 10s od. 30 June 1954 3½ per cent loan due 1961-64 market value £90 1s 3d.

4. PRICE CONTROL AND OTHER DIRECT CONTROLS

Price controls are required in some circumstances, war being the clearest example. In wartime it is necessary to allocate and ration resources, of men and labour as well as of materials. In those circumstances price control is necessary to hold in check profiteering and inflation and to prevent the diversion of resources needed to prosecute the war. But price controls are only part of the whole range of controls and would be comparatively ineffective on their own. The general system of controls includes other and more powerful controls: the allocation or rationing of materials; the allocation and direction of labour; and, of course, fixation of maximum prices for the most important price in the community, viz. wages, the price of labour.

The great majority of the individuals who make up the community tolerate these conditions because personal and individual goals are placed in the background; the great majority do their best, in the interests of the survival of their society, not to allow such controls to reduce output and production. In normal times these wartime attitudes do not operate and the deeply rooted urge of the individual man to make personal progress and to obtain personal recognition comes to the fore. The way in which this personal urge works in the interest of the community has been referred to in several places in this book; and its reconciliation with the interests of the community has been more particularly discussed in *Corporate Capitalism in a Mixed Economy*, part of Chapter 15, *The Rewards of Enterprise*. It is there pointed out that society needs the energy, vitality and drive which flow from this personal urge.

Most of the price fixing that Australia and New Zealand have experienced since the last war has been, in practice, no more and no less than fixation of profit. And the fixation is generally by reference to a percentage margin on the "funds employed", calculated to return, in current £s, a net income equal to that percentage of the amount of historical money invested.

If, because of this method or of any other method employed by the price control authorities, the level of profits is set on the low side, as has often been the case, the producer loses interest. The producer's reaction is to divert his capital resources, vitality and know-how to other fields where he can profitably apply his urge to use his resources and energies to gain satisfactions for himself—both material satisfaction and the non-material satisfaction of making progress and achieving something worth-while by exercise of his efforts. And these satisfactions apply to the directors and managements of corporations in the same way as to individual entrepreneurs. The more impatiently enterprising the outlook of the producer, firm or business, the greater and quicker the tendency to turn to other fields. If the producer does not transfer his attention in this way then he simply "takes it easy", with the inevitable results on productivity and efficiency.

If withdrawal and transfer are for the time being difficult, the producer keeps going temporarily in the price-fixed field, but this tends to be in a disinterested way, while he looks around and plans other moves. In the price-fixed field efficiency begins to slacken, costs rise and customer service deteriorates. This is the trend although the more conscientious and public spirited producers struggle against the tendency. For little the producer can do will bring him worthwhile advantage of any kind; even more importantly, he experiences a feeling of injustice, under which human beings, although they may keep plodding, will not give of their best. On the material gains side, if the producer puts more effort and organizational skill into efficiency and, as a result, profit rises, it is a momentary rise because, under price control, the theory and the practice is that this is taken away from him in full by decree.

Therefore, in price-controlled zones—and price control tends to be applied to goods of the most importance to the community—costs tend to rise. Short-sighted people feel happier with the thought that profits are low; they do not appreciate that the costs will rise and that, in final prices, costs are many times more important than profits.

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The instincts and motivations of people as producers and entrepreneurs, whether sole operators, partnerships or corporations, have several basic similarities with those of people who work as wage-earners. They all look for progress, rewards, recognition. It is accepted that it is no use expecting a wage-earner to work harder and give greater output unless he obtains reward of some kind: material reward, more recognition, higher status or acclaim. If there is a difference between the wage-earner and the entrepreneur it is that the activity of the entrepreneur is probably more stimulated by rewards and more depressed by the lack of them. Another difference is that the effects for the community of failure in entrepreneurship are greater.

Exceptions can occur to the process of withdrawal from price-fixed zones. They are mostly partial or temporary exceptions. If the profit margin is set at a "normal" or "above-normal" rate, *in the judgment of the producer*, he will probably retain his interest or a good proportion of his interest in efficiency and productivity. His interest could even be enhanced. He may invest more capital or plough back some of the earnings. However, the practical man with a wide-awake view will probably prefer to use some of his available funds and energy to spread his activities. It is a question of confidence. If he has confidence in the future of the price-fixed industry, and in the future views and actions of the price fixers, he will increase his interests and commitments in the price-fixed zone. But his confidence is unlikely to be high except in rare instances, because experience teaches that the profit margin rests on the insecure basis of an official decree. Official decrees of this kind are different from the kind of long-term traditional laws that let everyone know their rights over a long period and are unlikely to be hastily or capriciously varied. Price-fixing decrees are apt to be varied overnight, and politics, with their viewpoint of short-range expediency, party interest and the next election, are always present close behind the official. If the producer is satisfied that his group has sufficient political influence he may go ahead optimistically and with a feeling of confidence. An example of this latter situation in industry other than primary industry does not come readily to mind. But there is an example in respect of farm production in the United Kingdom in postwar years. There both political parties have had a policy of "encouragement prices" for farm production, in order to make the United Kingdom more self-sufficient in food. But, additionally, the farmer vote is most important and the farmers have been highly-organized and most articulate.

Another partial or temporary exception to the trend to withdraw from price-fixed zones may be found in the many-unit industry, where prices have probably been fixed by reference to average-cost or marginal-cost producers, and some producing units will be more fortunate or more efficient than others. The latter may expand optimistically for a while and, if marginal producers continue to be used as the basis for prices, this situation could constitute a major exception extending over quite a long period.

Producers more often than not possess a deep interest in and a feeling for their established industry and established line of goods. Besides, it is the "game they know" and they are reluctant to leave it. Some, thinking optimistically that matters will improve or that "commonsense will prevail", will contemplate and even carry out decisions to expand or spend capital that are really acts of faith. These examples are exceptions or partial exceptions to the trend of events under price control, but they do not alter the trend if the same kind of control continues.

The process of withdrawal from price-fixed zones and industries is not necessarily rapid or easy. Capital in stocks of goods and debtors is often fluid and mobile and can frequently be withdrawn and transferred in a comparatively short time. But capital in fixed assets (buildings, plant and heavy machinery) is generally quite rigid. This kind of capital provides from the price fixers' viewpoint an ideal hostage, which they have not been slow to see and exploit. Even in respect of fixed capital, however, the tendencies and results are the same even if the time sequence takes longer. Maintenance continues, at high cost, of plant that in more normal circumstances would be replaced with plant of improved performance. Attempts, except on the grounds of conscientiousness which do tend to persist for a time, to reduce labour or other operating costs come to seem not worth while. There is a gradual running down of efficiency. Little new thought, money or enterprise goes into dead zones—

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as with sandy, eroding, wasting farm land in drought areas, where the farmers steadily withdraw and potential new ones turn aside after the first brief casual inspection.

While fixed capital has to "take it" longer under price control than fluid capital, it is all the harder, after such experience, to restore confidence in order to obtain reinvestment of fixed capital. It becomes loth to place itself again in the position of a hostage.

Where price fixing is imposed on one or a few firms, or on a specific line of goods and services, in a way that reduces profit below the level which entrepreneurs and investors, *in their own judgment*, consider they require, the results are most direct. There is less room to manoeuvre temporarily than in the many-unit industry. As and when the capital resources can be extracted and employed elsewhere this is done, except in the cases of acts of faith and optimism. Enterprise is killed off rapidly—and with it innovation and tendencies towards economic growth.

The fields to which capital and human enterprise tend to transfer under price control are often the less socially-important activities: speculative trading and opportunistic activities of less permanent social value. A premium is put upon the high, quick return, upon keeping the funds fluid, upon avoidance of commitment to long-term investment and fixed assets of production which might be subjected to unenlightened price control.

Probably rent control is the clearest example of the tendencies of price control. Here the efforts of governments have been directed not so much to the prevention of profiteering in rent as to forcing owners of rentable housing, as a section of the community, to carry a considerable and undue share of the burden of community costs and problems. This has seemed politically expedient on the basis of the short view or of party or sectional interest. It was easy to apply and maintain because the asset was fixed (the hostage firmly held) and the owners were neither politically organized nor articulate. Rent control is referred to here because in it one sees with great clarity the "classical" features of price fixing—and particularly its effects. One effect is that capital and entrepreneurship have been withdrawn from housing; the supply of housing has not increased as it would have in more normal conditions and the housing shortage has persisted. To a considerable degree competitiveness and enterprise went out of house construction. Governments have tended more and more to fill the gap and a distinct impetus has been given to statism and higher taxation.

In some respects there is found under price control a situation similar to that existing under high levels of income tax. The situation, however, is found in a worse form because price control is operated in an entirely discretionary and arbitrary way and there is no appeal; also because price control limits the whole of the profit—not taking a proportion of it only, even if a high one. As nothing the producer can do will bring him any significant gain price controls have a greater effect than high taxation in raising costs and checking progress.

The price fixers often work, too, on the income tax methods of accounting, which means historical-cost accounting, historical-cost depreciation, no adjustment of stock values for higher replacement costs. The effect of these methods is to overstate the amount of profit. This exaggerated amount is then usually brought into percentage relationship with historical-cost capital (or historical-cost shareholders' funds) which, by comparison with current values, is an understatement. The percentage resulting from a bringing together of an overstated profit with an understated amount for capital employed in earning the profit is disastrously astray. By divorcing the situation of business and production from economics, in accordance with convention, price control officials make the percentage figure for profit appear high even when in economic fact it is low or very low. And price control officials, in the opinion of businessmen, are apt also to have very low ideas of reasonable percentage profits and so they make orders forcing the profits down still further. Hard to believe matters can be as bad as that, is it not? Nevertheless each of those three depressing factors do operate under price control: overstated profit, understated capital, low allowable percentage.

The chief popular appeal of price control has been located in a vague and uninformed belief that it makes for equity and that it has the capacity to counteract inflation. In truth it secretly fosters inflationary forces while covering them up and nourishing the growth of

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costs. But the growth of higher costs is hidden from sight and is therefore not appreciated. In short, price control is, in fact, a strong and insidious inflationary force.

Most of the price control known in Australia and New Zealand has devoted its attention to the symptoms of high prices and inflation. It does nothing effective to remove the causes; rather, it aggravates the causes and so makes cure more difficult. When a boiler is blowing off steam one does not promote progress and safety by screwing down the safety valve and thus removing from sight and hearing warning signs of the dangerous (inflationary) pressure.

Controls that do not go beyond constituting reasonable anti-profiteering measures could, in theory, be a different matter from continuing direct decree-law price and profit control as recently experienced in Australia and New Zealand. A form of control that could serve the public interest (in situations where some control is unavoidably required) is one which gives pride of place to the removal of restrictive practices, the increasing of productivity and the reduction of costs. For reasons discussed in these notes and in Chapter 15, this means that what are required are policies which will work *in the opposite direction to traditional price controls* by inducing the use of more tools of production, more capital and the application of more innovation and more entrepreneurship. And these require adequate material rewards; the keeping by the producer of a share of the gains from higher efficiency; and the avoidance of any sense of working in or for an organization or institution that is made to feel itself to be the occupant of an invidious position—where human beings feel that they are operating in a way that does not enjoy the approval of society.

On the matter of financial rewards and assessments of costs, the accounting, to attain the ends just described, would have to account for inflation. There is no sign of an "atmosphere of approval", or feeling of justice, where rewards to those who save and invest do not make allowance for the fall in the value of money, while other sections of the community achieve adjustment for this decline. In today's inflationary circumstances capital and rewards therefor are no longer legitimately assessable in terms of the monetary cost of assets in prewar £s or even in £s of six years ago. The factor that counts in income is current £s, as is recognized in other spheres, especially in respect of wages. Shareholders and management have the same feelings on this matter and the same "rights", if rights there be, as wage-earners.

It is interesting that the United Kingdom Monopolies Commission is instructed, by the Act constituting it, to have regard to "the organization of industry and trade in such a way that their efficiency is progressively increased and new enterprise encouraged". This instruction is consistent, at any rate in theory and ideal, with Keynes's belief in the value of "enterprise" and "animal optimism" as factors which benefit the community as a whole. The instruction requires a level of rewards that will attract new capital and initiative. Where enterprise and optimism are discouraged, or prohibited from existing, by the nature of imposed controls, the benefits to the community wither away.

There is no prospect of business which comes under the more common forms of price control known in Australia and New Zealand being a pace-setter of economic progress. Pace-setters may perform well with reins to guide them and under encouragement. They cannot perform if kept in hobbles, uncared-for and under-nourished; and if placed in a position where optimism, one of the most important of all factors for growth and progress, cannot survive.

The Australian Ministry of Labour Advisory Council said recently,⁸⁰ "... the best assurance of productivity growth probably lies in preserving an economic climate in which rewards, whether of employers or employees, depend on efficient performance."⁸¹ A corollary is that,

⁸⁰ See *Productivity*, Department of Labour and National Service, Melbourne, 8 March 1956.

⁸¹ It is to be noted that price fixation means fixation of *maximum* prices and this in turn usually takes the form of limitation of profit; rewards for higher efficiency are ruled out by decree. The fixation of wages in Australia and New Zealand is of *minimum* wages. There is nothing to prevent employers and employees arranging for higher wages than the legal minimum and this, in fact, is often done; in its most beneficial form the higher wages are linked to better performance and higher output. But employers are naturally disinterested where their shares of the gains from greater productivity are prevented by price control from accruing to them.

fundamentally, an adequate level of rewards should not be withheld or prevented unless performance is inefficient. And the problem then would be to stimulate improved performance.

Price controls in peacetime—other than for a short transitional postwar period—are generally indicative of a static or sick society. There are many examples of this in history.³² The real problem for a society is to work upon the fundamental causes of a situation that leads the society even to contemplate price controls.

Price controls entail too many direct and inherent disadvantages to be a useful economic tool in peacetime. In any case they do not, alone, have continuous worth-while effects, but they have many deleterious ones. For effectiveness there would have to go with them other controls, allocation of resources and positive fixation of wages—for wages, although they have characteristics which distinguish them from other prices, are, in effect, the most important price of all in the economic situation. If inflation could be beaten by price controls (which the writer does not believe) obviously the most important step would be to fix *maximum* wage rates. To be effective the fixation of wage rates would almost certainly need to be followed by the direction of labour and of other resources. With these, the situation would go from bad to worse; general stultification of free effort and free enterprise would result; and only the supporters of the strongest forms of statism wish to see such a condition of affairs.

It is encouraging that Australia and New Zealand have moved away from price control. This could be a step towards policies that will stimulate productivity and attack the causes of inflation; towards policies that will focus attention on causes instead of simultaneously hiding and fostering them underneath price control; towards policies opposed to "static thinking" and the "Maginot mentality"; towards policies of practical economic and social dynamism.

³² For instance, most historians dealing with the decline of the Roman Empire give attention to the economic disorders; and to them as results of a deeper malaise. "The economic evils have their root in moral apathy and paralysis of human will," says De Burgh in *The Legacy of the Ancient World*. Barrow in *The Romans* says: "One of Diocletian's most urgent tasks was the reform of the currency in order to check inflation. Closely connected with this was his attempt to fix maximum prices for goods and services. The edict . . . defines the prices for such things as food, timber, leather, textiles, cosmetics. . . . It fixes the rates for workers, such as shipwrights, silk and wool workers, painters, primary and secondary schoolmasters, and determines a schedule of freight rates; goods on government account were to be carried at cheaper rates. . . . For the purposes of state, work must be done—'essential work'. And so labour and skill were not merely 'directed' but were tied down to the field or bench or dockyard or office. . . . Factories were nationalized. [etc] . . . Thus, there was no incentive to enterprise or initiative or saving; the state effectively killed them all. Production fell, and with it the standard of living; the rigid uniformity of a lifeless society and static mediocrity prevailed. The price of security was the absorption of the individual by the state. . . . In the sphere of government and public life the old ideals have passed away, though the names remain a shadow without substance . . ."