

# STAFF PAPERS

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"Through the publication of *Staff Papers*, the Fund is making available some of the work of members of its staff. The Fund believes that these papers will be found helpful by government officials, by professional economists, and by others concerned with monetary and financial problems. Much of what is now presented is quite provisional. On some international monetary problems, final and definitive views are scarcely to be expected in the near future, and several alternative, or even conflicting, approaches may profitably be explored. The views presented in these papers are not, therefore, to be interpreted as necessarily indicating the position of the Executive Board or of the officials of the Fund."

The authors of the papers in this issue have received considerable assistance from their colleagues on the staff of the Fund. This general statement of indebtedness may be accepted in place of a detailed list of acknowledgments.

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# Trends in the Flow of International Private Capital, 1957-65

Marcus Diamond \*

**S**UBSTANTIAL GROWTH has occurred in the flow of private capital over the last eight or nine years. Nevertheless, it is a common contention, at least among the less developed countries, that a good deal more could be usefully absorbed. By its very nature, however, private capital tends to flow toward areas of greatest potential yield, and these are not always the less developed countries. This paper attempts to review developments in the flow of private capital during 1957-65 within the limitations of the basic data.

Despite appreciable progress since World War II in the compilation of balance of payments statistics, global analysis of private capital flows remains a particularly frustrating field of study. Even a high degree of sophistication in the collection and compilation of capital flow data is no guarantee of incontestable accuracy. This fact is indicated, for instance, by the U.S. balance of payments estimates, which in each of the last six years have shown substantial debit errors and omissions (aggregating almost \$5 billion) directly following a succession of years of large credit errors and omissions. While the absolute amount of errors and omissions cannot be entirely attributed to capital movements, substantial changes in errors and omissions are likely to reflect to a large extent changes in unrecorded capital transactions.

This paper is divided into five sections. The first section examines the statistics on a broad global basis in an attempt to gauge the rough magnitude of flows between the industrial and nonindustrial countries, analyzed between long-term and short-term capital. In the second and third sections, more detailed consideration is given separately to individual countries' figures for long-term and short-term flows and the magnitude of countries' errors and omissions items. In the first three sections, the review is based on the annual averages for two four-year periods, 1957-60 and 1961-64. Section IV examines the annual figures to determine, where possible, the effect of trend and random influences. In Section V, detailed consideration is given to the U.S. figures for private

\* Mr. Diamond, a graduate of the University of Sydney, Australia, was an economist in the Research and Statistics Department of the Fund at the time this paper was prepared. He was then on leave from the Reserve Bank of Australia and has since returned to the service of that institution.

capital flows. It should be noted that the paper as a whole deals only with statistics for some 74 countries reporting data on their balance of payments to the Fund and, therefore, falls short of universal coverage.

Before proceeding with a review of developments, it may be useful to outline some of the broad problems of aggregating the data, and of reconciling the statistics of flows between countries and areas. The difficulties stem from differences of definition, timing, and coverage. The data used were obtained primarily from the Fund's *Balance of Payments Yearbooks*, for which the principles of classification are, as far as possible, uniform from country to country. In the *Yearbook*, movements of capital are classified by the sector of the domestic creditor or debtor involved in transactions with foreigners—the five sectors being the “private” and “central” monetary sectors, the “central” and “local” government sectors, and the private nonmonetary sector. This paper is limited to a consideration of private monetary and nonmonetary (including local government) sector capital movements only. Central government capital movements are not examined, but the errors and omissions item for each country is taken into consideration.

Although the *Yearbook* sectors are defined on an institutional basis, the main purpose of the sector classification itself is to distinguish assets and liabilities with different behavior. The border line between the sectors depends to some extent on the behavior and functions of the underlying transactions. In the *Yearbook*, public corporations whose international transactions are similar to those of private corporations are classified with the private sector. But transactions of public corporations that are instruments of central government policy are allocated to the sector for central government and are not, therefore, included in this study. Liabilities of one sector, e.g., the private nonmonetary sector, that are guaranteed by another sector, e.g., the central government sector, are allocated to the sector of the debtor rather than to that of the guarantor. By definition, the global figures for private capital movements contain asymmetries, because certain transactions classified as inflows of private capital by one country are represented as outflows of government capital by the other party to the transactions (e.g., foreign private sector borrowings from the U.S. Export-Import Bank). Conversely, outflows of private capital from one country may be inflows of government capital for the borrower (e.g., loan subscriptions by U.S. private individuals to issues by foreign governments in the U.S. market).

Several other sources of asymmetry should be borne in mind in interpreting aggregate capital flow figures. For instance, asymmetry results when capital, recorded for the private sector of the recipient, comes from international nonmonetary institutions such as the International Bank for

Reconstruction and Development (World Bank), whose own transactions are not covered in the tables. Some asymmetry also results from the fact that reinvestment by foreign-owned subsidiary companies of their undistributed earnings is not universally included by reporting countries. Timing may also be a problem, but the magnitude of its influence is difficult to assess. Two four-year periods (1957–60 and 1961–64) have been set up in the analysis in an attempt to minimize the effects of timing disparities, although annual data are also separately analyzed.

Finally, of course, coverage is undoubtedly deficient. This paper covers 14 industrial and some 60 nonindustrial countries. A considerable gap is created by the omission, because of a dearth of statistics, of about 40 other countries and dependent territories, together with the Soviet countries and Mainland China. Among the important omissions are the overseas franc area countries, some Middle East oil-producing countries, and Hong Kong. These missing countries and territories are likely to have been, on balance, net importers of private capital.

## **I. Flows of Capital from the Industrial to the Nonindustrial Countries**

The published statistics confirm, as Table 1 shows, the long-accepted notion that the total net flow of private capital from the industrial to the nonindustrial countries is substantial. This flow seems to be clearly demonstrable, however, only for long-term capital; for short-term capital the reverse situation may more usually apply.

On long-term account, there seems to be a reasonably clear indication that the net outflow of private capital from the industrial to the nonindustrial countries has averaged over US\$2 billion a year in the past decade. In both 1963 and 1964 it exceeded \$3 billion; in 1965 preliminary figures suggest a very sharp rise to \$4.8 billion (Table 1). The negative "residual" item for long-term capital that is observed in the table is the result of many influences, some of which may have offsetting signs. However, two factors are especially important. First, the "residual" is partly explained by the failure of many countries to record the profits due, but not remitted, of subsidiaries operating in those countries (the capital outflow figures for the United States and the United Kingdom in this paper include undistributed earnings of more than \$1 billion a year, but much of this is not reflected in counterpart capital receipts figures among the beneficiary countries). Second, the negative "residual" may also be explained by the omission from the table of many less developed countries that are likely to have been net recipients of long-term capital, but for which no data are available.

On short-term account, the industrial countries have clearly been net recipients. However, the "residual" for net short-term capital suggests considerable asymmetry in the reporting of short-term capital flows, and the direction of the net flows between industrial and nonindustrial countries is difficult to pinpoint, given the incomplete coverage of the data. In fact, it is widely held that net movements of short-term capital have not

TABLE 1. NET PRIVATE CAPITAL FLOWS AND ERRORS AND OMISSIONS, AVERAGES 1957-60 AND 1961-64, AND 1965 <sup>1</sup>

(In millions of U.S. dollars)

	Long-Term Capital <sup>2</sup> (Net)	Short-Term Capital <sup>3</sup> (Net)	Countries' Errors and Omissions (Net)	Total
Average 1957-60				
Industrial countries <sup>4</sup>	-2,010	595	1,010	-405
Nonindustrial countries <sup>5</sup>	1,770	100	-520	1,350
Residual	-240	695	490	945
Average 1961-64				
Industrial countries <sup>4</sup>	-2,470	430	280	-1,760
Nonindustrial countries <sup>5</sup>	2,070	130	-420	1,780
Residual	-400	560	-140	20
1965				
Industrial countries <sup>4</sup>	-4,770	430	780	-3,560
Nonindustrial countries <sup>5</sup>	2,850	-185	-30	2,635
Residual	-1,920	245	750	-925

Sources: International Monetary Fund, *Balance of Payments Yearbook*, for various years, and country publications.

<sup>1</sup> Outflow (-).

<sup>2</sup> Covers direct investment (including, where published, reinvested earnings), portfolio investment, loans, long-term commercial credits, local government long-term capital, and miscellaneous transactions such as purchases and sales of noncommercial real estate.

<sup>3</sup> Includes changes in commercial bank assets and liabilities, mainly of a short-term character (for the United States and United Kingdom, in any sector's liquid or quasi-liquid liabilities to foreign nonofficial holders), private sector deposits in foreign banks and other liquid foreign assets, commercial short-term debt, and miscellaneous transactions.

<sup>4</sup> The United States; EEC countries (Belgium-Luxembourg, France, Germany, Italy, and the Netherlands); EFTA countries excluding Portugal (Austria, Denmark, Norway, Sweden, Switzerland, and the United Kingdom); Canada; and Japan.

<sup>5</sup> About 60 countries; omits about 40 countries and territories, including the Soviet countries, Mainland China, overseas franc area countries, some Middle East oil-producing countries, and Hong Kong.

been from the industrial to the nonindustrial countries, but rather that there has been a persistent, if volatile, net flow of such capital in the opposite direction, stimulated by political or economic instability in the countries in which the flows originate. The published figures actually show a net inflow of short-term capital to the nonindustrial countries over the two four-year periods, but the large negative net errors and omissions item for these countries suggests that some capital outflows have passed unidentified. Flows so stimulated are probably rarely reversed, being reflected in a steady build-up of private deposits or other assets in North America and Europe. On the other hand, trade credits are also important in the short-term capital flow figures (and probably also in the errors and omissions items) for the nonindustrial countries. Such credits are constantly being reversed on settlement of the debt, but there tends to be a steady long-run rise in the outstanding total of these credits, making for a net short-term capital inflow into the nonindustrial countries. Whether this inflow is large enough to offset the outflows that result from political and related factors is difficult to determine.

Undoubtedly some of the figures missing from the short-term capital column in the table are hidden in the "errors and omissions" column. So far as short-term capital flight is inspired by political unrest, it is likely to be of a type that cannot accurately be identified, so that it may appear as a negative entry in the "errors and omissions" items of the nonindustrial countries—provided, of course, that there has been a corresponding credit entry recorded elsewhere in the balance of payments of the country concerned. However, a rather frequent method of exporting capital entirely eludes the balance of payments statistics of the capital-losing country; this outflow occurs when an exporter in nonindustrial country A underinvoices his exports, the margin going into a private account in perhaps industrial country B, the country importing the merchandise. Then, if country B records the transaction accurately, there is in Table 1 a recorded short-term capital inflow for the industrial country, but no recorded capital outflow for the nonindustrial country and, as a result, asymmetry in the short-term capital figures. A similar asymmetry can arise from overinvoicing of imports.

While reasonably satisfactory conclusions can be drawn from the figures in Table 1 for net long-term and short-term capital, it is naturally more difficult to interpret the "errors and omissions" column of the table. As suggested above, part of the net negative figure for the nonindustrial countries probably belongs in the "short-term capital" column. But it is more difficult to allocate the net positive errors and omissions of the industrial countries. To some extent, no doubt, unrecorded current account items contribute to the errors and omissions of the industrial

countries, but it is likely that unrecorded capital is the more significant element. Two countries have especially large net errors and omissions. Switzerland, for which little private sector capital is identified, contributed heavily before 1965 to the credit errors and omissions figures for the industrial countries (about \$700 million a year during 1961–64). There could be inadequate coverage of some of Switzerland's current account items (for instance, travel receipts), but since many types of capital transactions are not revealed in its published balance of payments statistics, there is some reason to believe that the credit for net errors and omissions reflects in large part unrecorded capital inflows. It is impossible to determine the exact magnitude of this private capital flow into Switzerland, much less to divide it into long-term and short-term; the figures suggest that it might in many years have been of the order of \$300–500 million. The United States also has a particularly large net errors and omissions item. During 1957–59 the entry was positive; during 1960–65 it was negative and averaged some \$800 million a year. (Consideration is given to this in Section IV, below.)

## II. The Pattern of Long-Term Private Capital Flows

Although there has been a net outflow of long-term capital from the industrial countries as a group, the predominant sources of this net flow in 1957–60 and 1961–64 were the United States and the United Kingdom (Table 2).

For these two periods, Table 2 divides long-term private capital into direct investment inflows and outflows, and other (net) long-term capital. The persistent negative asymmetry for direct investment and positive residual for other long-term capital suggests that some outflows classified as direct investment are not so recorded among the inflows of the recipients. These figures are also influenced by the asymmetrical treatment of undistributed profits and by incomplete country coverage (an assessment of the effect of which is attempted at the end of this section). Despite these problems, some useful conclusions can be drawn from the figures.

### DIRECT INVESTMENT

The total supply of direct investment funds (emanating almost exclusively from industrial countries) grew at an impressive rate. In the first four-year period it averaged \$3.8 billion a year, and by the second four-year period, some \$4.7 billion (by 1964 it reached \$5.5 billion, and by 1965, more than \$6.7 billion—annual figures are considered in a later

section). The main supplier of this direct investment capital was the United States, which accounted for roughly 70 per cent of the total. U.K. direct investment abroad accounted for nearly 15 per cent and the European Economic Community (EEC) countries for slightly less.

The direction of the flow of direct investment is also interesting. Almost 50 per cent of the recorded gross outflows from the industrial countries went to other industrial countries. Of the annual average gross outflow from the industrial countries of over \$4.7 billion in the period 1961-64, some \$2.2 billion represented investment in other industrial countries. Recorded direct investment receipts of the nonindustrial countries covered by this study amounted to \$1.1 billion a year during the second four-year period, of which some \$0.5 billion went to the 12 more developed nonindustrial countries.

The pattern of growth in direct investment from the first to the second four-year period suggests a decrease in the flow to the nonindustrial countries as a group. Most of the decline, however, was in the receipts of certain Latin American countries. Direct investment claims of the industrial countries rose by about 24 per cent, or roughly 6 per cent a year. But receipts by the industrial countries rose by 40 per cent, or almost 10 per cent a year. Among the industrial countries, the EEC countries were the pace setters. Direct investment in these countries averaged \$890 million a year during the second four-year period, considerably more than double the annual rate of the preceding four years. Part of this increase represented direct investment by EEC members in partner countries within the group. But U.S. direct investment in the EEC area also rose appreciably.

Despite the change in direct investment in nonindustrial countries shown by the aggregate figures, all the areas, except Latin America, registered appreciably greater direct investment receipts in the second than in the first four-year period. The deterioration for the Latin American group was quite widespread, but it affected particularly the larger countries. Argentina, Brazil, Chile, and Peru, for instance, experienced a collective decline in annual net inflow of some \$330 million between the two four-year periods. In addition, Venezuela, a particular case because of the significance of foreign oil investment, changed from being a net receiver of some \$240 million annually for the first four-year period to experiencing net disinvestment of about \$100 million annually in the second four-year period. Among the other Latin American countries, Mexico appears to have been the only one to receive a significant increase, in absolute terms, in direct investment capital between the two four-year periods.



TABLE 2. NET LONG-TERM PRIVATE CAPITAL FLOWS, AVERAGES 1957-60 AND 1961-64  
(In millions of U.S. dollars)

	Average 1957-60				Average 1961-64			
	Direct investment Outflows	Inflows	Other net long-term <sup>1</sup>	Total	Direct investment Outflows	Inflows	Other net long-term <sup>1</sup>	Total
<b>Industrial countries</b>								
United States <sup>2</sup>	-2,830	330	-780	-3,280	-3,210	310	-1,180	-4,080
United Kingdom <sup>2</sup>	-510 <sup>s</sup>	310 <sup>s</sup>	-160	-360	-670 <sup>s</sup>	480 <sup>s</sup>	—	-190
Subtotal	-3,340	640	-940	-3,640	-3,880	790	-1,180	-4,270
Belgium	...	... <sup>4</sup>	-60	-60	...	... <sup>4</sup>	80	80
France <sup>2</sup>	-10 <sup>s</sup>	30 <sup>s</sup>	330	350	-100	280	350	530
Germany <sup>2</sup>	-120	60	20	-40	-220	200	280	260
Italy	-60	220	-10 <sup>s</sup>	150	-170	350	-270 <sup>s</sup>	-90
Netherlands	-170	50	200	80	-120	60	60	—
Subtotal	-360	360	480	480	-610	890	500	780
Other EFTA countries <sup>7</sup>	— <sup>s</sup>	20 <sup>s</sup>	50 <sup>s</sup>	70	-60 <sup>s</sup>	110 <sup>s</sup>	160 <sup>s</sup>	210
Canada	-60	550	610 <sup>10</sup>	1,100	-100	360	360 <sup>10</sup>	620
Japan <sup>2</sup>	-50	20	10	-20	-90	80	200	190
Total industrial	-3,810	1,590	210	-2,010	-4,740	2,230	40	-2,470

Nonindustrial countries							
More developed <sup>11</sup>	—	330	60	390	—	510	880
Latin America	—	860	150	1,010	—	280	590
Africa/Middle East	—	160	70	230	—	250	290
Other Asia	—	70	70	140	—	90	310
Total nonindustrial	—	1,420	350	1,770	—	1,130	2,070
Grand total	—3,810	3,010	560	—240	—4,740	3,360	—400
Asymmetry	—800		560	—240	—1,380	980	—400

Sources: See Table 1.

<sup>1</sup> Including, where available, commercial bank and local government long-term capital.

<sup>2</sup> Including reinvested earnings.

<sup>3</sup> Transactions of oil and insurance companies appropriate to this item are included indistinguishably in "Other net long-term." Figures for 1957 are estimated.

<sup>4</sup> Not available separately; included with "Other net long-term."

<sup>5</sup> For 1957–59 not available separately; included with "Other net long-term."

<sup>6</sup> Includes an adjustment for repatriated Italian banknotes, a part of which, if details were available, would be more accurately classified as short term (see Table 5).

<sup>7</sup> Excluding Portugal.

<sup>8</sup> For Austria, direct investment figures not available separately; included with "Other net long-term." For Switzerland and for Sweden (before 1962), direct investment figures are not available and are part of errors and omissions (see Section III).

<sup>9</sup> For Switzerland, includes issues and redemptions only of foreign bonds in Switzerland.

<sup>10</sup> Includes some local government short-term capital.

<sup>11</sup> Australia, Cyprus, Finland, Greece, Iceland, Ireland, New Zealand, Portugal, South Africa, Spain, Turkey, and Yugoslavia. For Australia, data cover fiscal years ended June 30.

## OTHER LONG-TERM CAPITAL

For practical reasons, these figures have been shown net in Table 2—in fact, many countries do not publish separate receipt and payment figures for this item, and even if they did, a further subdivision by asset and liability would be necessary to permit a thorough interpretation of the flows. For the United States, the most important transactions included in “other long-term capital” are U.S. commercial bank long-term loans to foreigners and portfolio transactions in existing securities and in new issues, a rather less significant role being played by nonbank long-term loans and trade credits. For the other industrial countries, the inflow figures, in principle, cover receipts from non-U.S. sources, plus the bulk of the total outflow of “other long-term capital” from the U.S. private sector. For the nonindustrial countries, the inflow figures include receipts from non-U.S. sources, plus the rest of the outflow of “other long-term capital” from the U.S. private sector,<sup>1</sup> plus some capital from the U.S. Government sector, together with some from international nonmonetary institutions.

The figures for “other long-term capital” in the table include a certain amount of direct investment capital that for various reasons is not separately identifiable. Nevertheless, they suggest that, on a net basis especially, the dominating, almost exclusive, source of supply is the United States. The significance of the United Kingdom is rather marginal—in fact, the net outflow figure in the table is mostly explained by the fact that the United Kingdom includes direct investments by oil and insurance companies indistinguishably in “other long-term capital.”

Table 2 also suggests that in the second four-year period Italy was an important net exporter of “other long-term capital.” However, interpretation of the figures for Italy is especially difficult. In recent years, Italians have found it profitable, for taxation and other reasons, to deposit Italian lira banknotes in accounts abroad and to reinvest subsequently in Italian securities from the foreign address. Since these investments cannot be distinguished from bona fide investments by “genuine” foreigners, the balance of payments statistics for investment receipts from foreigners as published by Italy are known to be overstated. However, the aggregate value of repatriated banknotes is known, and while some of these notes were probably legitimately exported in settlement for goods and services purchased abroad or, especially in 1962 and 1963, as genuine flight capital, the entire figure for repatriated notes has in this paper been entered as a debit against Italy’s “other long-term capital” credit figures. If it were possible to include only the genuine outflow, and

<sup>1</sup> Outflows of long-term capital from the U.S. nonmonetary sector to foreign monetary sectors are assumed to be negligible.

to eliminate funds for current payments, the "other long-term capital" outflow figure for Italy in Table 2 would be smaller or perhaps be replaced by an inflow. In any case, most of the net debit entry probably represents a correction of the overstatement of the normally published inflow of "other long-term capital" rather than a genuine outflow of such capital.

The U.S. outflow was mainly in the form of subscriptions to new foreign issues on the U.S. market and U.S. commercial bank long-term loans to foreigners. The new issues averaged about \$1.0 billion a year in 1961-64 while long-term loans by U.S. banks averaged \$0.5 billion a year. The new foreign issues floated on the U.S. market were placed primarily by Canada. Of the average of \$1.0 billion a year for new issues in 1961-64, Canada took a little more than 50 per cent. The balance was fairly evenly divided among Japan, Western Europe, Latin America, and the rest of the world (see Table 9). The bulk of the outflow of commercial banks' long-term capital went to Western Europe, Canada, and Japan.

Some of the large and persistent positive residual for other net long-term capital in Table 2 is probably an offset to the similarly persistent large negative residual for direct investment. But much of it is explained by the fact that some private sector loan receipts had their counterpart as outflows from foreign government sectors, or from international non-monetary institutions such as the International Bank for Reconstruction and Development (World Bank), the International Development Association, and the Inter-American Development Bank.

Although the asymmetries present in the "other long-term capital" figures make interpretation difficult, genuine growth in the flow of this capital apparently occurred from the first to the second four-year period, mainly benefiting Japan and the nonindustrial countries. For Canada (still the leading individual recipient) the inflow in the second period was little more than half that during 1957-60, while the average net inflow into the EEC countries was almost unchanged. Japan, however, became an important new recipient, borrowing especially heavily in 1962, 1963, and 1964 from the United States and Europe; furthermore the net receipts of the nonindustrial countries as a group rose to some \$940 million a year for 1961-64, almost three times the average annual inflow for 1957-60. Table 2 shows that most areas within the nonindustrial group benefited. The exception was Africa/Middle East, where two or three of the politically more volatile members experienced a reduced net inflow or a net outflow. The more developed nonindustrial countries, with the exception of South Africa where there was a persistent net outflow for the entire period, received greatly enlarged inflows.

Before leaving this analysis of long-term capital, it may be useful to

try to suggest the rough order of magnitude of the factors affecting the "residual" items for long-term capital in the tables above. This is attempted in Table 3, but it should be borne in mind that the estimates in that table lean very heavily on elements of subjective judgment.

TABLE 3. RECONCILIATION OF LONG-TERM PRIVATE CAPITAL FLOWS,  
AVERAGES 1957-60 AND 1961-64

(In millions of U.S. dollars)

	Average	
	1957-60	1961-64
<b>Direct investment</b>		
Recorded net increase in direct investment claims	-3,810	-4,740
Recorded net increase in direct investment liabilities	3,010	3,360
Recorded net excess of outflows	-800	-1,380
Factors contributing to the net excess		
Net reinvested earnings credits not recorded	-550	-800
Direct investment claims classified "other long-term"	300	200
Direct investment liabilities classified "other long-term"	-400	-500
Incomplete country coverage	-100	-200
Other	-50	-80
<b>Total</b>	<b>-800</b>	<b>-1,380</b>
<b>Other long-term capital</b>		
Recorded net excess of inflows	560	980
Factors contributing to the net excess		
Direct investment (net) liabilities classified "other long-term"	100	300
Private recorded inflows from foreign nonprivate	400	600
Private recorded outflows to foreign nonprivate	-200	-300
Other	260	380
<b>Total</b>	<b>560</b>	<b>980</b>

Source: The figures above contain a number of personal estimates, based in part on a variety of published information including statistics from the International Monetary Fund, *Balance of Payments Yearbook*, and the U. S. Department of Commerce, *Survey of Current Business*, for various years.

### III. The Pattern of Short-Term Private Capital Flows and Countries' Errors and Omissions

From the preceding section, it is obvious that global analysis of private long-term capital flows is beset with problems. It is even more difficult

to present a clear picture of private short-term capital flows. From time to time, crises in exchange markets have considerably disturbed an already volatile time series. For these reasons, the four-year time periods chosen for the over-all analysis may not be the best for a review of short-term flows. However, in a later section, annual figures are examined for evidence, such as there is, of trend and random movement. Table 4 gives details of changes in commercial bank assets and liabilities together with countries' other net short-term capital statistics and their published figures for net errors and omissions. These data lead to some interesting conclusions.

#### COMMERCIAL BANKS <sup>2</sup>

The figures in Table 4 represent changes in the foreign short-term assets and liabilities of commercial banks in the reporting countries. Unlike the direct investment claims and liabilities, the commercial bank asset and liability columns are not in theory mutually symmetrical; an increase in commercial bank assets (capital outflow) of one country is often not matched by an increase in the liabilities of a commercial bank in another. For example, the increase may have its counterpart in an increase in the liabilities or a decrease in the assets of a foreign central monetary authority. The matching entry may also occur in the private sector and will, errors and omissions excepted, appear in the figures of "other net short-term capital." On the other hand, many of the industrial countries are at pains to maintain a relatively well-balanced commercial bank net position with quite large changes in both gross assets and liabilities. The review is here virtually confined, therefore, to observing the rate of growth of commercial bank assets and liabilities and the distribution of this rate of growth between countries.

There has in fact been a quite appreciable rate of increase in the accumulation of foreign claims by the world's commercial banks. This increase probably reflects not only the development of the Euro-currency market but also increased claims in the form of trade credits of a traditional type extended by the industrial countries, together with some regular accumulation of foreign exchange assets. In 1957-60, commercial bank short-term claims rose by \$1.0 billion a year (excluding the United Kingdom, Switzerland, and Canada, for which full details are not available). In the period 1961-64, claims rose by \$2.7 billion a year (excluding again the United Kingdom and Switzerland, but including Canada). Leaving aside Canada, the accumulation of claims in the second period

<sup>2</sup> For the United Kingdom and the United States, the classification of liabilities is, in principle, by foreign rather than domestic sector. The figures for liabilities also include certain liabilities of the nonmonetary sector such as government securities.

TABLE 4. FLOWS OF COMMERCIAL BANK AND OTHER PRIVATE SHORT-TERM CAPITAL  
AND NET ERRORS AND OMISSIONS, AVERAGES 1957-60 AND 1961-64

(In millions of U. S. dollars)

	Average 1957-60				Average 1961-64			
	Commercial banks <sup>1</sup>		Other (net) short- term	Countries' errors and omissions (net)	Commercial banks <sup>1</sup>		Other (net) short- term	Countries' errors and omissions (net)
	Claims	Liabil- ities			Claims	Liabil- ities		
<b>Industrial countries</b>								
United States	-420	300	-55	290	-940	830	-285	-880
United Kingdom	...	500 <sup>2</sup>	...	235	...	-205 <sup>2</sup>	—	10
Subtotal	-420	800	-55	525	-940	625	-285	-870
Belgium	-45	35	-10	-25	-120	220	-5	15
France	-5	115	-35	15	-195	310	-80	50
Germany	-95	110	30	175	-180	185	75	135
Italy	-135	135	...	-35	-170	340	-65	-5
Netherlands	-125	5	20	5	-75	125	20	45
Subtotal	-405	400	5	135	-740	1,180	-55	240
Other EFTA countries <sup>4</sup>	-105	80	5	310	-100	85	60	890
Canada	...	...	185 <sup>5</sup>	...	-430	415	230 <sup>5</sup>	...
Japan	-80	185	—	40	-335	600	120	20
Total industrial	-1,010	1,465	140	1,010	-2,545	2,905	70	280

## Nonindustrial countries

More developed <sup>6</sup>	—	5	35	30	—20	55	—5	140
Latin America	60	—30	—35	—255	—50	60	—55	—235
Africa/Middle East	—60	80	30	—235	—	135	40	—165
Other Asia	5	—10	20	—60	—40	25	—15	—160
Total nonindustrial	<u>5</u>	<u>45</u>	<u>50</u>	<u>—520</u>	<u>—110</u>	<u>275</u>	<u>—35</u>	<u>—420</u>
Grand total	—1,005	1,510	190	490	—2,655	3,180	35	—140

Sources: See Table 1.

<sup>1</sup> Increase (—) in assets or decrease (—) in liabilities is capital outflow. For the United States and the United Kingdom, figures do not include liabilities to and claims on foreign official holders, but include certain liabilities of the nonbank sector.

<sup>2</sup> Liabilities net of claims, and for 1957–60 including private short-term capital.

<sup>3</sup> Included with errors and omissions.

<sup>4</sup> Excluding Portugal. For Sweden other short-term capital, and for Switzerland other short-term capital and most commercial bank capital, is included with errors and omissions.

<sup>5</sup> Includes net errors and omissions and, for 1957–60, commercial bank capital.

<sup>6</sup> Australia, Cyprus, Finland, Greece, Iceland, Ireland, New Zealand, Portugal, South Africa, Spain, Turkey, and Yugoslavia. For Australia, data cover fiscal years ended June 30.



was double that in the first. Increases in claims of the U.S. commercial banks accounted for roughly one third of the total. The EEC countries as a group increased their claims substantially, especially Belgium, France, and Germany; for Japan the average increase in the second four-year period was more than four times greater than the average increase in the period 1957–60. Details are not available for 1957–60, but increases in claims of Canada's commercial banks were very large in 1961–64. In the nonindustrial countries the asset holdings of the commercial banks expanded in the second period after little change in the first period; however, this expansion was more than offset by the accumulation of liabilities.

Commercial bank liabilities increased at a somewhat slower rate than that of assets, from an annual average of \$1.5 billion a year in 1957–60 to \$2.8 billion a year (excluding Canada) in 1961–64. Again the over-all totals are affected by the exclusion, through lack of data, of Switzerland, while the liability change shown for the United Kingdom in the table is actually net of claims. The increase in commercial bank liabilities to foreign nonofficial holders in the second period was more than double that in the first for the United States and the EEC countries, while the increase in Canada's commercial bank liabilities, at least in the second period, almost matched the rise in assets. For the United Kingdom, a net increase in liabilities (net of claims) of \$500 million a year during 1957–60 was replaced by a net decrease of over \$200 million<sup>3</sup> a year during 1961–64. In the nonindustrial countries, accumulation of liabilities by commercial banks also speeded up, largely reflecting credits obtained from the industrial countries.

The commercial banks in nonindustrial countries received some net capital inflow in both periods, and the inflow in the second period was a little larger than in the first. Still the amount was small compared with that received on net long-term account. As for the flows among the industrial countries, so many factors were present that it is very difficult to separate in the four-year aggregates the flows that resulted from trade credits from flows stimulated by interest differentials or from those that were purely speculative. The growth of the Euro-currency market (a function of all these influences) has produced, and been produced by, the build-up of a complex network of claims and deposit liabilities among the commercial banks of the industrial countries.

<sup>3</sup> This enormous swing in the U.K. figures is entirely the result of the events of 1960 and 1961 (see Table 6). In 1960, which falls in the first four-year period, there was a build-up of liabilities (net of claims) of \$1.4 billion; in 1961, which appears in the second four-year period, these net liabilities were run down by more than \$1.2 billion. The counterpart of these changes is spread among many countries in the table.

OTHER PRIVATE SHORT-TERM CAPITAL AND COUNTRIES'  
NET ERRORS AND OMISSIONS <sup>4</sup>

The figures for other private short-term capital shown in Table 4 are the net result of changes in the private nonmonetary sector's short-term assets and liabilities. These liabilities represent short-term obligations to foreigners, mainly in the form of trade credits but also in the form of deposits by others than banks. Assets include foreign exchange holdings of the private sector and deposits in foreign banks, as well as private holdings of foreign government and corporate short-term obligations. Also included are short-term commercial claims arising from the financing of trade.

Although many reservations must be kept in mind in interpreting the data, the figures in Table 4 suggest some interesting features. Among the industrial countries, several were consistent net exporters of (other) short-term capital. The most important of these in recent years was the United States, for which net outflows occurred every year during 1959-64. Furthermore the size of the U.S. errors and omissions item suggests some unrecorded short-term capital outflows. For a number of years before 1959, however, the United States apparently had been a consistent net recipient of this type of capital. The U.S. figures are considered in more detail in Section V. Consistent net outflows of "other short-term private capital" were also recorded for France and Italy and, to a lesser extent, for Belgium and Norway during the period considered.

Among the recipient countries, Canada seems to have been the most prominent, although the figures shown in Table 4 for 1957-60 are a composite of commercial bank and other short-term capital and include errors and omissions. Both Germany and Japan were important recipients of such short-term capital during the second four-year period. The large errors and omissions for "other EFTA <sup>5</sup> countries" is chiefly due to the figure for Switzerland, and it may be a reflection of some unrecorded short-term capital inflows, both commercial bank and other.

Among the nonindustrial countries, there seems to have been a considerable net outflow, part of it identified, but the bulk of it unidentified. The dominant influences in this movement probably were a fairly gradual increase in short-term trade credits received (capital inflow associated

<sup>4</sup> Private nonbank short-term capital movements, because of the statistical difficulties in estimating them, are regarded as among the least complete of balance of payments data reported to the Fund. Unfortunately, they may be extremely important in a country's balance of payments, particularly during times of speculative pressure or when large changes in the flows of merchandise are handled through short-term trade credits. Since inadequate recording of short-term capital flows is considered an important source of errors and omissions, the two sets of figures are here examined together.

<sup>5</sup> European Free Trade Association.

with increased liabilities to foreigners), rather more than offset by increases in deposits of residents of these countries in foreign banks, located in North America and Europe (capital outflow associated with increased foreign assets). Logically, the second influence might be expected to be less pervasive among the more developed nonindustrial countries, an expectation supported by the net inflow figures for other short-term capital plus the errors and omissions item for these countries in Table 4. In contrast, the picture for the Latin American countries was one of substantial net outflow; U.S. figures for bank liabilities to foreigners suggest a steady build-up of deposits by Latin Americans. For the Africa/Middle East group, the "other short-term capital" figures suggest an inflow that probably resulted mainly from expanding trade credits, but the rather large negative errors and omissions also suggest possible unrecorded capital outflow. A similar pattern is apparent in the figures for the other Asia group.

#### IV. Trends in the Annual Figures

While the comparison of annual averages for the two four-year periods, by smoothing random fluctuations, provides a fairly accurate indication of the magnitudes involved in the private capital flows of recent years, a brief look at the annual figures is also in order for purposes of distinguishing the trend, if any, and, especially for short-term capital, the rough extent of random and speculative influences. Annual figures for long-term capital are given in Table 5, changes in commercial bank assets and liabilities in Table 6, and details of other private short-term capital and countries' errors and omissions in Table 7.

##### LONG-TERM CAPITAL

With the exception of 1957 and 1960, which appear to have been years of abnormally high investment, the total of countries' direct investment abroad, as reflected in recorded increases in claims, moved steadily upward; it rose from about \$3.0 billion in 1958 to \$5.5 billion in 1964 and to almost \$6.8 billion in 1965 (Table 5 and Chart 1). Between 1958 and 1965, U.S. direct investment abroad (which includes reinvested earnings) more than doubled, reaching \$4.9 billion. U.K. direct investment abroad, which runs about one fifth as large as that of the United States, almost doubled; it was \$760 million in 1965, and probably would have been greater if details of oil and insurance company investments included in "other long-term capital" were available separately. The aggregate annual increase in direct investment claims of the EEC

CHART 1. CHANGES IN DIRECT INVESTMENT CLAIMS, 1957-65  
(In billions of U.S. dollars)

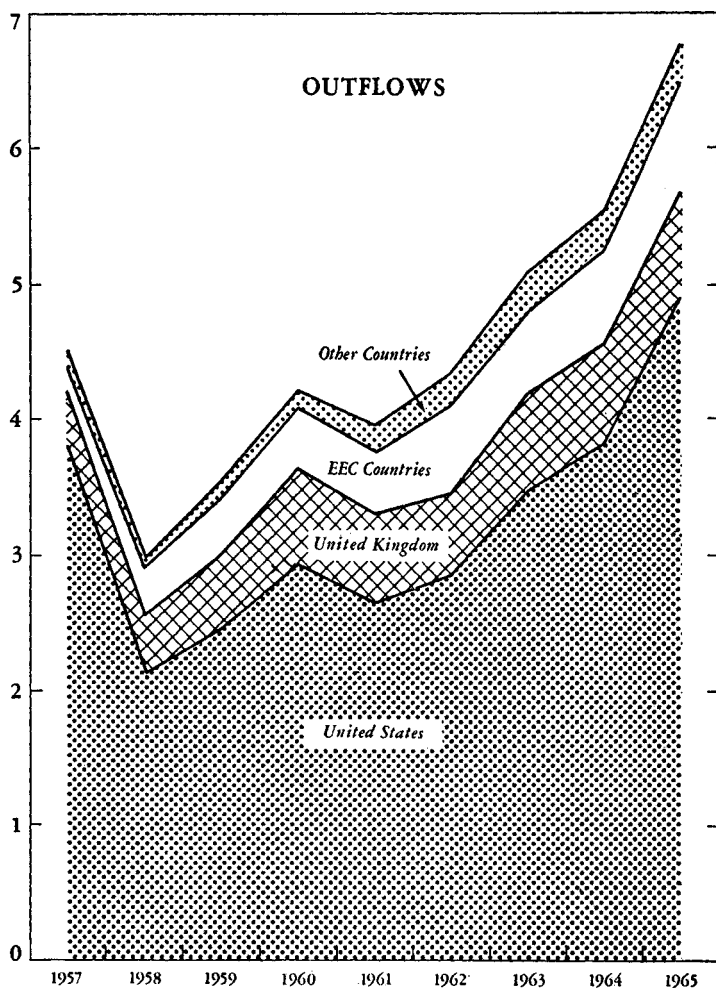


TABLE 5. NET LONG-TERM PRIVATE CAPITAL FLOWS, 1957-65 <sup>1</sup>  
(In millions of U. S. dollars)

	1957	1958	1959	1960	1961	1962	1963	1964	1965
<b>Direct investment claims</b>									
United States	-3,800	-2,130	-2,460	-2,940	-2,650	-2,850	-3,480	-3,830	-4,900
United Kingdom	-400	-400	-550	-700	-640	-590	-710	-730	-760
EEC countries	-200	-380	-420	-440	-480	-660	-610	-690	-830
Other	-100	-80	-130	-140	-190	-240	-290	-290	-270
<b>Total claims</b>	<b>-4,500</b>	<b>-2,990</b>	<b>-3,560</b>	<b>-4,220</b>	<b>-3,960</b>	<b>-4,340</b>	<b>-5,090</b>	<b>-5,540</b>	<b>-6,760</b>
<b>Direct investment liabilities</b>									
United States	270	250	470	310	310	350	230	320	430
United Kingdom	200	240	410	380	670	360	450	450	450
EEC countries	150	180	390	750	570	860	860	1,290	1,350
Canada <sup>2</sup>	530	430	570	670	510	470	220	240	360
Other industrial	40	20	30	60	140	150	250	240	250
<b>Total industrial</b>	<b>1,190</b>	<b>1,120</b>	<b>1,870</b>	<b>2,170</b>	<b>2,200</b>	<b>2,190</b>	<b>2,010</b>	<b>2,540</b>	<b>2,840</b>
More developed nonindustrial	220	340	370	390	580	400	480	590	700
Latin America	1,570	730	740	380	290	210	250	380	370
Other nonindustrial	220	190	210	320	180	170	530	480	720
<b>Total nonindustrial</b>	<b>2,010</b>	<b>1,260</b>	<b>1,320</b>	<b>1,090</b>	<b>1,050</b>	<b>780</b>	<b>1,260</b>	<b>1,450</b>	<b>1,790</b>
<b>Total liabilities</b>	<b>3,200</b>	<b>2,380</b>	<b>3,190</b>	<b>3,260</b>	<b>3,250</b>	<b>2,970</b>	<b>3,270</b>	<b>3,990</b>	<b>4,630</b>
<b>Asymmetry</b>	<b>-1,300</b>	<b>-610</b>	<b>-370</b>	<b>-960</b>	<b>-710</b>	<b>-1,370</b>	<b>-1,820</b>	<b>-1,550</b>	<b>-2,130</b>

## Other net long-term private capital

United States	-620	-1,470	-460	-570	-650	-1,090	-1,360	-1,640	-1,350 <sup>a</sup>
United Kingdom	-280	-240	-240	120	200	360	-160	-410	-70
Subtotal	-900	-1,710	-700	-450	-450	-730	-1,520	-2,050	-1,420
EEC countries <sup>4</sup>	400	700	580	250	650	170	330	830	330
Canada	830	670	660	280	380	80	350	630	300
Other industrial	50	230	90	-110	—	340	700	390	-60
More developed nonindustrial	40	90	40	40	330	300	360	470	610
Other nonindustrial	270	230	270	400	410	570	480	830	450
Subtotal	1,590	1,920	1,640	860	1,770	1,460	2,220	3,150	1,630
Asymmetry	690	210	940	410	1,320	730	700	1,100	210

Sources: See Table 1.

<sup>1</sup> Figures for 1965 are preliminary and include estimates. Footnotes to Table 2 apply also to this table but figures may differ slightly because of rounding. For Australia, figures relate to fiscal years ended June 30.

<sup>2</sup> Canadian published figures (which do not include reinvested earnings, investments other than those of the controlling interests, and intercompany balances).

<sup>3</sup> Contains offset for reinvestments by Canada on account of Columbia River Treaty.

<sup>4</sup> For Italy, includes debit adjustments for total repatriated Italian banknotes. A significant proportion of the banknote movement is thought to result from the export of notes by Italians for subsequent long-term investment in Italy under a foreign address for tax avoidance and other purposes. Alternatively, some of the movement undoubtedly reflected genuine short-term flight capital, particularly in 1962 and 1963, when an adjustment would have been appropriate to the short-term capital figures in Table 7. (The proportion of the movement that reflects genuine payment for goods and services is probably small.) Since there is no way of accurately separating these elements, the entire adjustment has here been made to the "other net long-term capital" figures.

countries quadrupled. In 1965, total direct investment abroad by the EEC countries exceeded that of the United Kingdom (although the figures include some inter-investment among the EEC countries).

Chart 2 shows that, as recipients of direct investment, the industrial countries are also prominent, at times absorbing more than one half of the gross outflows from industrial countries. Among these countries, the significant developments in the annual figures during 1957-65 provided in Table 5 were (1) the spectacular upswing in investment receipts by the EEC countries (from \$150 million in 1957 to \$1,350 million in 1965, some of which was intra-EEC investment); (2) a steady inflow into the United Kingdom (the high figure for 1961 reflects a \$370 million Ford Motor Company investment); (3) a large relative increase in investment receipts by the "other industrial" countries (other EFTA and Japan) from \$40 million in 1957 to \$250 million in 1965, with Denmark and Japan accounting for most of the increase; and (4) an apparent substantial tapering off of direct investment in Canada<sup>6</sup> since the high inflow of 1960.

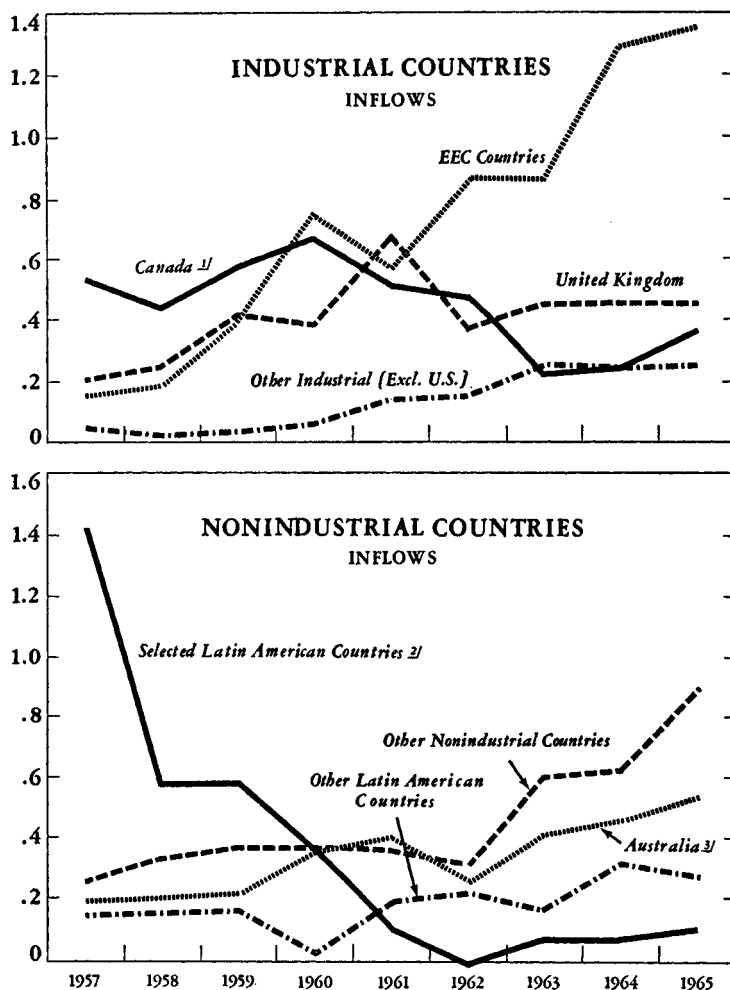
The annual figures in Chart 2 also provide an interesting picture of the direct investment receipts of the nonindustrial countries. For the more developed nonindustrial countries, Table 5 suggests a rapidly increasing flow of direct investment receipts (except in 1962, when Australia's receipts fell sharply at the time of a domestic recession). Steady growth in direct investment liabilities during this period was also recorded by many other nonindustrial countries in Europe, Africa, and Asia, but especially by Greece, Turkey, Israel, Nigeria, Thailand, and Malaysia.

In direct contrast to the virtually universal growth of direct investment in this period was the experience of the Latin American countries as a group, as Table 5 shows. For these countries, direct investment fell dramatically, from \$1.6 billion in 1957 (when it was unusually high) to less than \$0.3 billion in 1961, 1962, and 1963. This fall was due mainly to lower investments in Argentina, Brazil, Chile, Peru, and Venezuela (see Chart 2).

Annual figures for "other net long-term private capital" are also provided in Table 5, and are illustrated in Chart 3. As has been explained previously, the outflow and inflow figures for "other net long-term private

<sup>6</sup> The capital figures shown here and elsewhere in this paper, except in the U.S. statistics in Section V, are as published by Canada. The Canadian published figures on direct investment do not include undistributed profits, investments by foreigners in the direct investment company other than investments by the controlling interest, or intercompany balances, all of which (in conformity with international practice) are in the U.S. direct investment statistics. The flows indicated by the Canadian statistics are thus generally lower than those shown in U.S. statistics for direct investment, but greater for other items of the capital accounts.

CHART 2. CHANGES IN DIRECT INVESTMENT LIABILITIES, 1957-65  
(In billions of U.S. dollars)



<sup>1</sup> Canadian published figures (which are considerably lower than U.S. published figures of direct investment in Canada (see footnote 2, Table 5)).

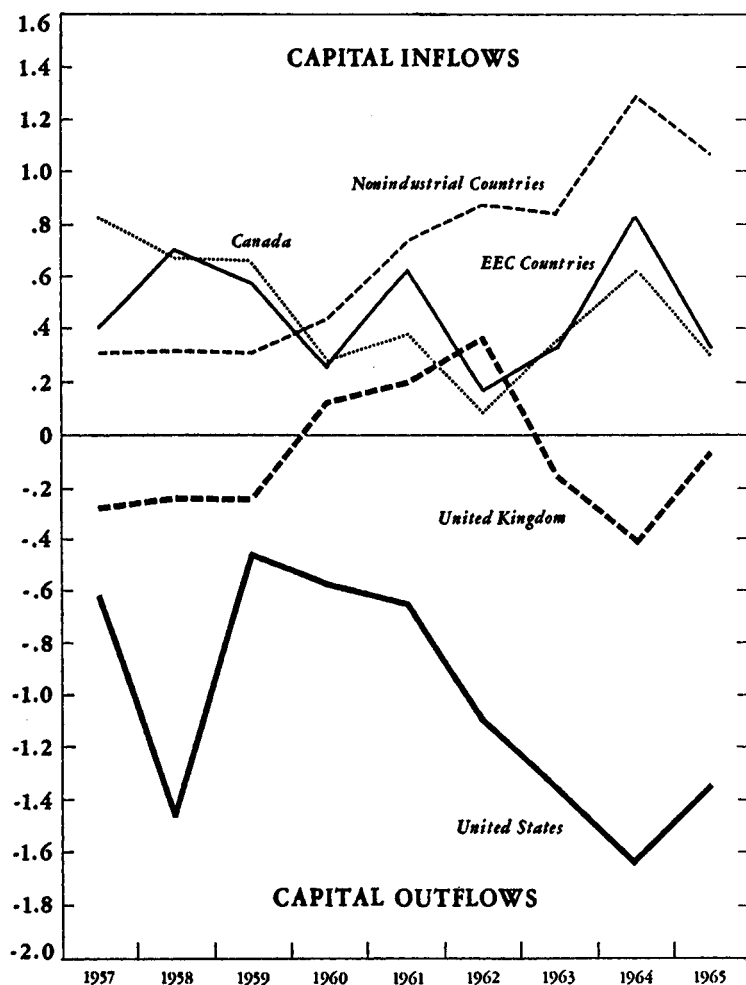
<sup>2</sup> Argentina, Brazil, Chile, Peru, and Venezuela.

<sup>3</sup> Fiscal years ended June 30.



CHART 3. LONG-TERM PRIVATE CAPITAL FLOWS (OTHER THAN DIRECT INVESTMENT), 1957-65

(In billions of U.S. dollars)



capital" are not, by definition, symmetrical. Nevertheless, much of the outflow from the large suppliers of this type of capital (the United States and the United Kingdom) is probably reflected in inflows into the private sector of the other industrial and the nonindustrial countries. Chart 3 seems to suggest that for some countries, trend is a powerful influence, while for others cyclical influences may predominate.

It would be reasonable to expect a fairly strong trend component in the U.S. figures, interrupted from time to time by special factors such as the unusually heavy loan flotations on the U.S. market in 1958 and the directives aimed at restraining capital outflow in 1965. In contrast there has perhaps been a more dominant cyclical influence<sup>7</sup> on the figures for the United Kingdom, which may have a counterpart in the figures for the EEC and Canada (in Chart 3, it can be seen that these three sets of figures tend to converge in 1962 and then diverge again in 1963 and 1964). On the other hand, for the nonindustrial countries, Chart 3 seems to suggest that the "other long-term private capital" inflow is primarily a function of trend. The United States, as the dominant supplier of this type of capital, seems to be subject not only to a steadily growing long-run demand for resources emanating mainly from the nonindustrial countries but also to a demand from the other industrial countries tending to be influenced by cyclical patterns.

#### SHORT-TERM CAPITAL

Annual figures for short-term capital flows, and countries' net errors and omissions, are provided in Tables 6 and 7. As might be expected, the figures are much affected by random movements. Nevertheless, several general features are distinguishable:

(1) The official program for improving the U.S. balance of payments was probably the dominant reason for the striking reversal in 1965 in the traditional capital outflow associated with increased U.S. commercial bank short-term claims on the foreign private sector (Table 6). This movement was largely offset by the lower inflow in 1965 associated with U.S. commercial bank liabilities to the foreign private sector; however, a marked improvement occurred in the U.S. "other net short-term capital" figures (Table 7), also mainly because of the balance of payments program. The total improvement in 1965 for the United States, on these three items plus the lower negative errors and omissions, amounted to \$2.1 billion.

(2) The EEC countries experienced a particularly heavy build-up of

<sup>7</sup> There were also speculative influences. Events leading up to and surrounding the sterling crises in 1961 and 1964 have reduced the likelihood of identifying regularities in the figures.

TABLE 6. CHANGES IN COMMERCIAL BANK CLAIMS AND LIABILITIES, 1957-65<sup>1</sup>

(In millions of U. S. dollars)

	1957	1958	1959	1960	1961	1962	1963	1964	1965
<b>Commercial bank claims<sup>2</sup></b>									
United States	-260	-350	-60	-990	-1,130	-320	-780	-1,520	320
United Kingdom <sup>3</sup>	...	...	...	...	...	...	-1,090	-1,420	-990
EEC countries	-30	-340	-770	-475	-895	-950	-230	-890	-2,215
Canada <sup>4</sup>	...	...	...	...	-610	70	-465	-710	590
Japan	40	-45	-115	-200	-230	-85	-440	-600	-370
Other industrial <sup>5</sup>	-100	-120	-150	-55	-80	10	-270	-70	-240
Nonindustrial	60	-70	30	-10	-215	30	-260	10	-185
<b>Total claims</b>	<b>(-290)</b>	<b>(-925)</b>	<b>(-1,065)</b>	<b>(-1,730)</b>	<b>(-3,160)</b>	<b>(-1,245)</b>	<b>-3,535</b>	<b>-5,200</b>	<b>-3,090</b>
<b>Commercial bank liabilities<sup>2</sup></b>									
United States <sup>6</sup>	(60)	(50)	(1,160)	-50	680	—	850	1,800	420
United Kingdom <sup>3</sup>	(-80)	(580)	(150)	(1,350)	(-1,210)	(310)	1,090	1,500	980
EEC countries	200	150	550	690	1,255	1,310	1,470	670	1,440
Canada <sup>4</sup>	...	...	...	...	790	65	350	455	-200
Japan	-40	-30	215	595	780	100	850	670	85
Other industrial <sup>5</sup>	25	45	75	170	90	30	115	95	140
Nonindustrial	-90	30	5	230	130	215	370	390	220
<b>Total liabilities</b>	<b>(75)</b>	<b>(825)</b>	<b>(2,155)</b>	<b>(2,985)</b>	<b>(2,515)</b>	<b>(2,030)</b>	<b>5,095</b>	<b>5,580</b>	<b>3,085</b>

Sources: See Table 1.

<sup>1</sup> Figures for 1965 are preliminary and include estimates. Footnotes to Table 4 apply also to this table, but figures may differ slightly because of rounding. The totals shown in parentheses for 1957-62 are not comparable with the totals for 1963-65 (see footnotes 3, 4, and 6).

<sup>2</sup> Excluding, where available, long-term.

<sup>3</sup> For 1957-62, liability figures are available only net of claims.

<sup>4</sup> For 1957-60, commercial bank assets and liabilities are included with "other net short-term capital" (see Table 7). Also, for 1965, full details of commercial bank foreign assets and liabilities are not available; shown are changes in "selected foreign currency assets and liabilities of chartered banks in Canada," which is the major component of commercial bank foreign assets and liabilities.

<sup>5</sup> For Switzerland, the commercial bank figures cover only issues and redemptions of foreign bonds in Switzerland. All other private capital, both long-term and short-term, is included in errors and omissions (see Table 7).

<sup>6</sup> For 1957-60, excludes liabilities to nonbanks, details of which are not available separately.

commercial bank claims throughout most of the period, but especially in 1965, when Italy's claims expanded enormously. In total, however, the increase in EEC countries' liabilities more than matched the build-up of their claims. For Canada, large increases in claims in 1961, 1963, and 1964 occurred in conjunction with increases in liabilities. In 1965 the pattern changed, and both claims and liabilities fell sharply. In Japan, commercial bank liability increases consistently exceeded asset increases until 1965, when the rate of increase of liabilities fell off sharply. The figures for each of these countries have been greatly influenced by the growth of the Euro-currency market and, in 1965, by the U.S. measures of capital restraint.

(3) Capital outflows dominated the U.S. figures for "other net short-term capital" (Table 7) during 1960-64; this dominance was probably due to an expansion in short-term trade credits granted and a build-up in deposits of U.S. corporations abroad. A sharp reversal of the latter movement in 1965 was the main factor in the "other short-term capital" inflow in that year.

(4) The Canadian figures for "other net short-term capital" for 1957-60 are affected by the inclusion of changes in commercial bank assets and liabilities. Since 1960, there has been a steady inflow, a reflection partly of reductions by residents in bank balances held abroad and partly of increased borrowing from nonresidents by Canadian finance companies. However, an additional factor was probably a steady expansion in intercompany accounts of direct investment companies operating in Canada; Canadian statistics treat these accounts as short-term capital rather than direct investment.

(5) The figures for errors and omissions of the United States (Table 7) changed from consistently positive to consistently negative, beginning in 1960. The similarity in pattern to the behavior of the U.S. figures for "other net short-term capital" suggests that some of the U.S. errors and omissions relate to that item.

(6) The errors and omissions item for Switzerland includes virtually all private long-term and short-term capital and is usually positive. During 1960-64 this item was exceptionally large and positive.

(7) Attempts to rationalize the interarea flows that are suggested by the statistics of short-term capital and errors and omissions are hazardous. The outflow from the United States of short-term nonmonetary capital (including some of the negative errors and omissions item) during 1960-64 had its counterpart in inflows into both the other industrial and the nonindustrial countries. However, for the nonindustrial countries, there was probably throughout this period an offsetting outflow of short-term capital (and negative errors and omissions), so that the net result was as seen in Table 7—net outflows from both the United

TABLE 7. OTHER NET SHORT-TERM PRIVATE CAPITAL AND COUNTRIES' ERRORS AND OMISSIONS, 1957-65 <sup>1</sup>  
(In millions of U. S. dollars)

	1957	1958	1959	1960	1961	1962	1963	1964	1965
Other net short-term private capital									
United States	70	150	-10	-440	-260	-330	-30	-510	580
United Kingdom	...	...	...	...	-20	40	-180	160	260
EEC countries	90	80	-290	150	-40	-50	—	-130	-570
Canada <sup>2</sup>	(80)	(60)	(320)	(280)	290	180	160	280	230
Other industrial	50	20	-80	40	30	220	130	330	-30
Total industrial	(290)	(310)	(-60)	(30)	—	60	80	130	470
More developed nonindustrial	-40	100	10	40	-70	-40	-20	110	30
Latin America	20	-200	-60	90	-10	-80	-260	120	-110
Other nonindustrial	180	50	-20	30	40	40	80	-50	-140
Total nonindustrial	160	-50	-70	160	-40	-80	-200	180	-220
Asymmetry	(450)	(260)	(-130)	(190)	-40	-20	-120	310	250

## Countries' errors and omissions

United States	1,180	510	420	-940	-1,010	-1,160	-350	-1,010	-430
United Kingdom	270	140	-190	720	-70	250	-190	60	290
EEC countries	390	-60	-130	340	160	340	-30	500	690
Switzerland <sup>3</sup>	90	170	-20	450	1,020	750	610	600	-40
Other industrial <sup>4</sup>	130	230	150	190	200	110	180	160	270
<b>Total industrial</b>	<b>2,060</b>	<b>990</b>	<b>230</b>	<b>760</b>	<b>300</b>	<b>290</b>	<b>220</b>	<b>310</b>	<b>780</b>
More developed nonindustrial	-20	—	40	—	160	20	220	170	250
Latin America	-370	-230	-40	-380	-50	-310	-20	-550	50
Other nonindustrial	-280	-240	-290	-250	-180	10	-540	-590	-330
<b>Total nonindustrial</b>	<b>-670</b>	<b>-470</b>	<b>-290</b>	<b>-630</b>	<b>-70</b>	<b>-280</b>	<b>-340</b>	<b>-970</b>	<b>-30</b>
<b>Net total</b>	<b>1,390</b>	<b>520</b>	<b>-60</b>	<b>130</b>	<b>230</b>	<b>10</b>	<b>-120</b>	<b>-660</b>	<b>750</b>

Sources: See Table 1.

<sup>1</sup> Figures for 1965 are preliminary and include estimates. Footnotes to Table 4 apply also to this table but figures may differ slightly because of rounding. Figures shown in parentheses are not completely comparable with those that follow in the time series (see footnote 2).

<sup>2</sup> Including net errors and omissions and, for 1957-60, net commercial bank assets and liabilities.

<sup>3</sup> See footnote 4, Table 6.

<sup>4</sup> See footnote 2, above.

States and the less developed countries and net inflows into Europe and Canada.

## V. Details of Private Capital Flows for the United States

Because of the dominant position of the United States among the world's capital markets, it is perhaps useful to examine briefly the pattern of capital flows into and out of that country since 1957. Table 8 separates the components of long-term and short-term capital into changes in claims of U.S. residents on foreigners and liabilities of U.S. residents to foreigners. Charts 4 and 5 illustrate the changes that have occurred during the period.

### LONG-TERM CAPITAL

Although the profits retained by U.S. subsidiaries for reinvestment did not greatly increase during the period, they continued to be a significant component of total U.S. direct investment abroad. However, direct investment abroad by U.S. companies, other than through reinvested earnings, climbed at a rapid rate—it almost trebled (see Chart 4) between 1958<sup>8</sup> and 1965; in 1965 it increased by almost \$1 billion (some 40 per cent). Purchases by U.S. residents of new foreign issues (capital outflow), which averaged about \$600 million a year during 1957-61, rose to almost double that level in each of the years 1962-65. This sharp rise, however, was offset to some extent by reductions in U.S. claims (capital inflow) associated with increased redemptions and sales of outstanding foreign issues.

Changes in the level of foreign investment in the United States were not especially significant for most of the years under study, although Chart 4 suggests a falling trend in the net capital inflow since 1959. There was a steady inflow of direct investment, averaging a little over \$300 million a year, but portfolio investment tended to fall away in recent years, especially in 1965, when a large capital outflow produced by sales of U.S. corporate securities by the U.K. authorities aggregated some \$500 million.

From 1964 to 1965 the net long-term private capital outflow from the United States (see Table 8) increased from \$5.2 billion to \$5.8 billion, which at first glance suggests that the special balance of payments guidelines produced little tangible improvement in 1965. Three factors

<sup>8</sup> The year 1957 was one of exceptionally heavy U.S. direct investment abroad in Canada and, especially, in Venezuela.

should be borne in mind in this connection, however. Firstly, long-term capital flows, especially direct investment, react less quickly to policy changes than other types of capital flow, since investment plans are usually formalized some time in advance of their execution. In fact, although the outflow of U.S. direct investment abroad reached a peak of \$2.1 billion (excluding undistributed profits) in the first half of 1965, this figure fell to \$1.3 billion in the second half of the year, some 10 per cent below the outflow for the second half of 1964. Secondly, the outflow of U.S. commercial bank long-term capital, which reacts more quickly to policy directives than direct investment capital flows, did in fact fall markedly in 1965, as Table 8 shows. Finally, the sale of U.S. securities by the U.K. authorities introduced an extraordinary element of some \$0.5 billion to the outflows in 1965.

The principal recipients of U.S. direct investment, investment in new issues, and commercial bank long-term capital can be seen from Table 9. The table serves to highlight the discrepancy between the U.S. statistics of direct investment in Canada and the Canadian statistics of total direct investment from abroad shown in Table 5. The latter exclude not only undistributed profits but also increases in intercompany accounts which are included with Canada's short-term capital inflow figures. While the Canadian authorities feel that their method of presenting the figures is better suited to domestic usage, the U.S. figures of direct investment in Canada are probably more compatible with universal practice. The latter figures (Table 9) show clearly the recent very high volume of U.S. direct investment in Canada, especially in 1965.

The United Kingdom also received an appreciable volume of U.S. direct investment during the period—a little over \$3.4 billion compared with Canada's \$7.8 billion for the nine years. During the same period Germany received almost \$2 billion, and France and Australia over \$1 billion each. U. S. direct investment in Latin America, which reached a very high level in 1957, has since roughly stabilized at a level of \$400-600 million a year.

Table 9 illustrates the dominance of Canadian issues in the market for new issues in the United States. However, Canada is much less important as a recipient of U.S. commercial bank long-term loans. Before 1963, U.S. commercial bank long-term claims increased by less than \$200 million a year but in 1963 and 1964 they expanded rapidly, with most European countries, but especially Italy, benefiting. In 1965 this flow to Europe was reversed and long-term claims on Western Europe actually fell by over \$100 million. The enlarged outflow in 1963 and 1964 also benefited the nonindustrial countries. The area breakdown of these claims for 1965 suggests that official requests for balance of payments restraints bearing more heavily on the industrial countries were



TABLE 8. UNITED STATES: PRIVATE CAPITAL FLOWS, 1957-65 <sup>1</sup>

(In millions of U. S. dollars)

	1957	1958	1959	1960	1961	1962	1963	1964	1965
Long-term capital (including commercial bank)									
Changes in U.S. capital (claims on foreigners)									
Direct investment									
Reinvested earnings	-1,363	-945	-1,089	-1,266	-1,054	-1,198	-1,505	-1,417	-1,525
Other	-2,442	-1,181	-1,372	-1,674	-1,599	-1,654	-1,976	-2,416	-3,371
Foreign securities									
New issues	-597	-955	-624	-555	-523	-1,076	-1,250	-1,063	-1,206
Other	127	-295	-44	-108	-239	107	146	386	448
Commercial bank									
long-term	-349	-152	-181	-155	-136	-127	-754	-941	-231
Other	-40	-42	-77	-45	-127	-131	163	-139 <sup>2</sup>	-121 <sup>2</sup>
Total U.S. capital	-4,664	-3,570	-3,387	-3,803	-3,678	-4,079	-5,176	-5,590	-6,006
Changes in foreign capital (liabilities to foreigners)									
Direct investment	272	254	471	315	311	346	231	322	429
Long-term claims on U.S. commercial banks	9	-8	-1	6	-5	5	62	237	186
Other (including corporate securities)	235	-17	472	283	379	135	269	-123	-424
Total foreign capital	516	229	942	604	685	486	562	436	191
Total long-term capital	-4,148	-3,341	-2,445	-3,199	-2,993	-3,593	-4,614	-5,154	-5,815

Short-term capital (including commercial bank)									
Changes in U.S. capital (claims on foreigners)									
Commercial banks	-256	-351	-57	-995	-1,125	-324	-781	-1,523	325
Other	-20	40	-20	-353	-431	-220	-4	-623	436
Total U.S. capital	-276	-311	-77	-1,348	-1,556	-544	-785	-2,146	761
Changes in foreign capital (liabilities to foreigners)									
Commercial banks									
Short-term liabilities to commercial banks	60	48	1,158	140	586	-138	470	1,454	116
Short-term liabilities to nonbanks (non-official)									
Other	94	106	12	-188	90	140	385	345	306
				-90	175	-115	-23	113	146
Total foreign capital	(154)	(154)	(1,170)	-138	851	-113	832	1,912	568
Total short-term capital	(-122)	(-157)	(1,093)	-1,486	-705	-657	47	-234	1,329

Sources: U. S. Department of Commerce, *Survey of Current Business*, September 1965, June 1966, and September 1966.

<sup>1</sup> The totals shown in parentheses for 1957-59 are not comparable with the totals for 1960-65.

<sup>2</sup> Contains offset for reinvestments by Canada on account of Columbia River Treaty.

CHART 4. U.S. LONG-TERM PRIVATE CAPITAL FLOWS, 1957-65  
(In billions of U.S. dollars)

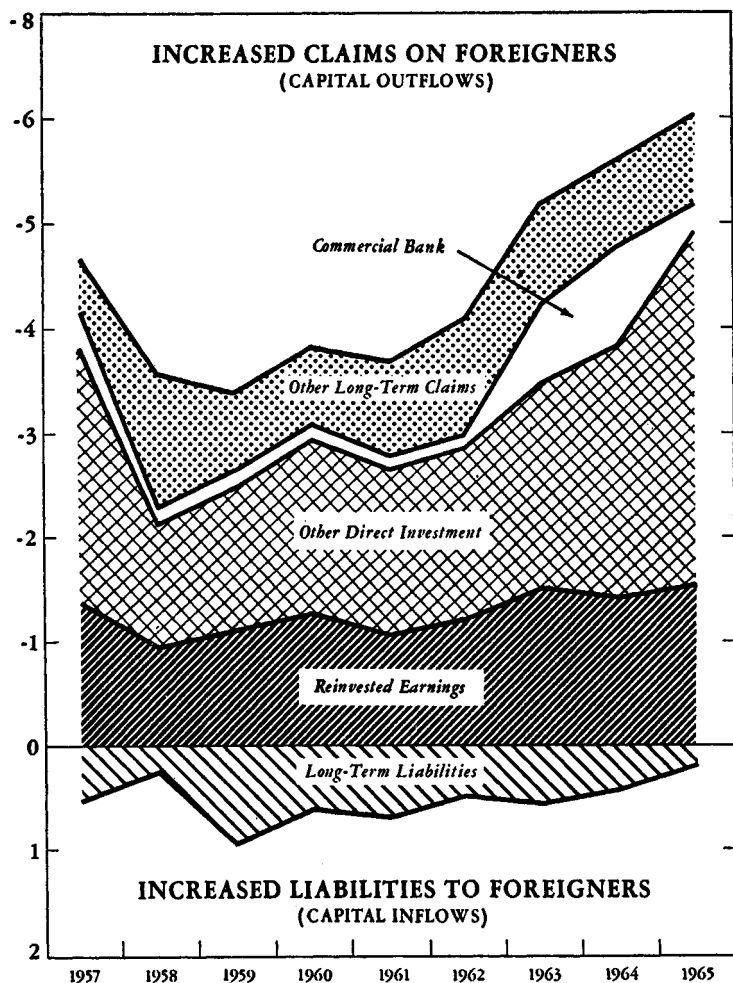


CHART 5. U.S. COMMERCIAL BANK AND OTHER SHORT-TERM  
PRIVATE CAPITAL FLOWS, 1957-65

(In billions of U.S. dollars)

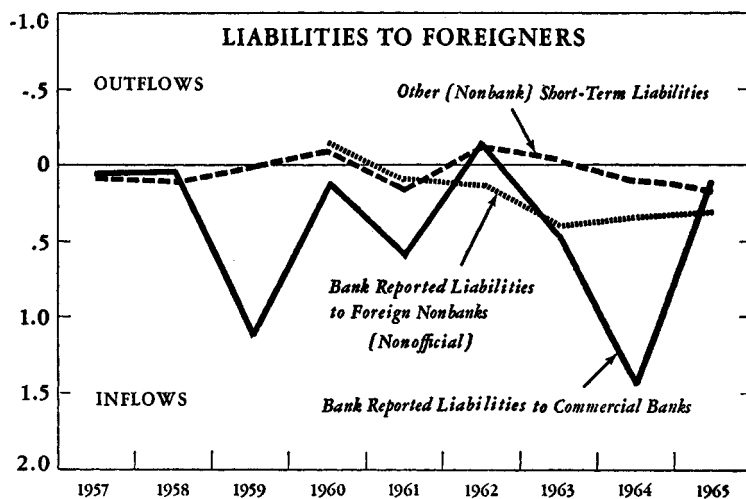
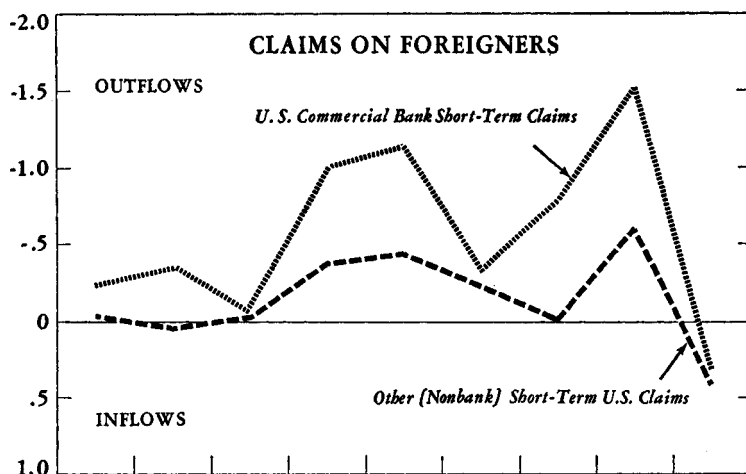


TABLE 9. RECIPIENTS OF U. S. DIRECT INVESTMENT, PORTFOLIO INVESTMENT IN NEW ISSUES,  
AND COMMERCIAL BANK LONG-TERM CAPITAL, 1957-65 <sup>1</sup>*(In millions of U. S. dollars)*

	1957	1958	1959	1960	1961	1962	1963	1964	1965
<b>U. S. direct investment abroad <sup>1</sup></b>									
Western Europe	580	430	750	1,320	1,060	1,110	1,440	1,780	1,810
United Kingdom	330	170	330	750	320	250	340	380	570
France	50	80	80	100	100	140	200	190	160
Germany	110	80	140	210	170	290	280	290	310
Canada	1,030	700	810	760	570	680	1,000	760	1,440
Japan	20	—	30	30	50	70	100	110	70
Total industrial	1,630	1,130	1,590	2,110	1,680	1,860	2,540	2,650	3,320
Australia	40	70	90	110	100	140	170	190	210
Latin America	1,550	520	490	430	500	360	420	540	600
Brazil	90	50	70	120	50	80	50	10	80
Mexico	80	10	10	50	170	130	40	130	130
Venezuela	910	190	30	-90	40	-160	—	-20	-60
All other	590	410	290	290	370	490	350	450	770
Total nonindustrial	2,180	1,000	870	830	970	990	940	1,180	1,580
Total	<u>3,810</u>	<u>2,130</u>	<u>2,460</u>	<u>2,940</u>	<u>2,650</u>	<u>2,850</u>	<u>3,480</u>	<u>3,830</u>	<u>4,900</u>
<b>U. S. portfolio investment in new foreign issues</b>									
Western Europe	25	45	80	25	55	195	270	35	95
Canada	325	365	435	220	235	455	695	700	710
Japan	—	—	20	15	60	100	165	—	50
Total industrial	350	410	535	260	350	750	1,130	735	855

Latin America	—	110	10	105	20	100	35	210	35
Other <sup>2</sup>	245	435	80	190	155	225	85	120	315
Total nonindustrial	245	545	90	295	175	325	120	330	350
Total	595	955	625	555	525	1,075	1,250	1,065	1,205
U. S. commercial bank long-term claims									
United Kingdom	64	-44	-40	-35	-4	15	13	39	-1
Other Western Europe	66	75	12	35	131	69	475	550	-108
Canada	32	27	-1	-28	-2	30	-14	-17	19
Japan	6	4	3	3	4	51	155	136	15
Total industrial	168	62	-26	-25	129	165	629	708	-75
Nonindustrial countries	181	90	207	180	7	-38	125	233	306
Total	349	152	181	155	136	127	754	941	231

Sources: U. S. Department of Commerce, *Survey of Current Business*, and U. S. Treasury, *Bulletin*, various issues.

<sup>1</sup> Includes reinvested earnings. Figures for 1965 are preliminary. Minus sign indicates net U. S. disinvestment or net inflow to the United States. Some figures are rounded.

<sup>2</sup> Includes subscriptions to new issues of World Bank.

for the most part met. However, the major beneficiary of the increase in the flow to the nonindustrial countries from 1964 to 1965 was Australia.

#### COMMERCIAL BANK AND OTHER SHORT-TERM CAPITAL

U.S. commercial bank short-term claims on foreigners in the years 1960 through 1964 rose (capital outflow) by an average of \$0.9 billion a year (Table 8). In 1964 the flow had risen to \$1.5 billion, but in 1965, partly as a result of the balance of payments program, this outflow was replaced by a (net) inflow of \$0.3 billion. Short-term claims of other U.S. private institutions rose by an average of over \$300 million a year during 1960-64. In 1965 this outflow was also reversed and claims were reduced by over \$400 million. The turnabout in U.S. short-term claims on foreigners from 1964 to 1965 was almost \$3 billion. During the period under study, U.S. liabilities to nonofficial foreigners (capital inflow) accumulated, but these accumulations by no means matched the rise in U.S. claims. Chart 5 illustrates the volatile nature of these short-term capital flows, especially those of the commercial banks.

A detailed area breakdown of the commercial bank and other short-term private capital figures used in this paper is not available for any year before 1964. For 1964 and 1965, however, the figures are given in Table 10. From these figures, it is possible to distinguish the areas most affected by the \$1.6 billion reversal in the commercial bank and other private short-term capital flows that occurred between 1964 and 1965, some of which was attributable to the U.S. balance of payments program (but part of which may also have been due to adjustments following the 1964 disturbances surrounding sterling). On the claims side (U.S. capital) the outflow of \$2.1 billion in 1964 was replaced by an inflow of \$0.8 billion in 1965. Of this \$2.9 billion reversal, Western Europe accounted for \$0.4 billion, Canada \$1.3 billion, Japan \$0.6 billion, and Latin America \$0.6 billion. The outflow to other nonindustrial countries decreased slightly.

Partly offsetting the \$2.9 billion change in the U.S. claims position was a reduction of \$1.4 billion in the capital inflow, associated with increases in U.S. liabilities to the foreign nonofficial sector. Receipts from Western Europe fell by \$0.8 billion and from Japan by almost \$0.2 billion, while the 1964 inflow from Canada of \$0.2 billion was replaced by an outflow (reduction in liabilities) of \$0.4 billion. The inflow from Latin America was also lower, but that from the other nonindustrial countries increased by \$0.2 billion.

When changes in claims are netted against changes in liabilities, the brunt of the reversal in flows in 1965 appears to have been borne not by European countries but by Canada, Japan, and Latin America (see

Table 10). In this respect, however, Canada was an important intermediary for heavy flows from Europe to the United States. The net inflow of \$1.1 billion from the industrial countries in 1965 was an increase of some \$0.8 billion from the previous year. However, the nonindustrial countries were also adversely affected. The net flow of short-term capital from the United States to these countries in 1964 totaled some \$520 million, but in 1965 it was replaced by a flow back to the United States of about \$240 million. Political and other disturbances in the less developed countries, however, rather than the special U.S. balance of payments guidelines, may have had most to do with the reversal.



TABLE 10. AREA BREAKDOWN OF U. S. COMMERCIAL BANK AND OTHER  
SHORT-TERM PRIVATE CAPITAL FLOWS, 1964 AND 1965 <sup>1</sup>

(In millions of U. S. dollars)

40

INTERNATIONAL MONETARY FUND STAFF PAPERS

	Industrial Countries				Latin America	Other	Grand Total
	Western Europe	Canada	Japan	Total			
1964							
Changes in U.S. claims							
Commercial bank short-term	-280	-85	-480	-845	-500	-175	-1,520
Other short-term private	-145	-335	-20	-500	-95	-30	-625
Total	-425	-420	-500	-1,345	-595	-205	-2,145
Changes in U.S. liabilities							
Commercial bank short-term <sup>2</sup>	1,060	180	330	1,570	235	-5	1,800
Other short-term private	50	5	10	65	15	35	115
Total	1,110	185	340	1,635	250	30	1,915
Net capital flow	685	-235	-160	290	-345	-175	-230
1965							
Changes in U.S. claims							
Commercial bank short-term	40	410	60	510	-70	-115	325
Other short-term private	-15	440	10	435	30	-30	435
Total	25	850	70	945	-40	-145	760
Changes in U.S. liabilities							
Commercial bank short-term <sup>2</sup>	205	-380	175	—	170	250	420
Other short-term private	115	20	5	140	-5	10	145
Total	320	-360	180	140	165	260	565
Net capital flow	345	490	250	1,085	125	115	1,325

Sources: U.S. Department of Commerce, *Survey of Current Business*, March and June 1966.

<sup>1</sup> All figures are rounded, and those for 1965 are preliminary. Capital outflow (—).

<sup>2</sup> Breakdown partly estimated—excludes liabilities to foreign official.

## Evolution des mouvements de capitaux privés internationaux, 1957-1965

### *Résumé*

Malgré l'accroissement considérable des mouvements de capitaux privés au cours des huit ou neuf dernières années, nombreux sont ceux qui soutiennent, au moins dans les pays en voie de développement, qu'un volume beaucoup plus important de capitaux pourrait être utilement absorbé. Par leur nature même, les capitaux privés ont cependant tendance à se diriger là où le rendement éventuel est maximum, et les pays moins développés ne répondent pas toujours à cette exigence.

Les statistiques relatives aux capitaux privés, telles qu'elles sont publiées dans les pays où l'on dispose de ces renseignements (pays dont 14 sont industrialisés, 12 plus développés mais non industrialisés, et 48 moins développés), donnent à penser qu'il s'est produit une augmentation continue des sorties nettes de capitaux à long terme en provenance des pays industrialisés, sorties s'échelonnant entre 2,0 milliards de dollars en 1958 et 4,8 milliards de dollars en 1965. Les Etats-Unis restent le principal fournisseur de capitaux à long terme aux pays moins développés, bien que leur part de l'ensemble des sorties nettes en provenance du groupe industrialisé ait diminué, tombant de plus de 80 pour cent pendant les dernières années 1950 à environ 50 pour cent à l'heure actuelle. Une partie de plus en plus importante des capitaux nécessaires provient des autres pays industrialisés et des institutions internationales.

La situation est moins nette en ce qui concerne les mouvements de capitaux privés à court terme, puisque ces mouvements sont certainement loin d'être tous enregistrés et que, d'autre part, leur nature imprévisible donne lieu à des variations considérables d'une année à l'autre. Dans l'ensemble, au cours des neuf dernières années, il semble que les mouvements nets de capitaux à long terme vers les pays moins développés aient été contrebalancés en partie par un retour net de capitaux à court terme provenant de ces pays. Les recettes nettes de capitaux privés à court terme enregistrées par les pays industrialisés (y compris les erreurs et omissions nettes des divers pays) ont atteint en moyenne environ 1 milliard de dollars par an au cours de cette période. Les 60 pays non industrialisés sur lesquels porte notre analyse ont enregistré en moyenne une perte nette de capitaux privés à court terme (y compris les erreurs et omissions) d'environ 0,4 milliard de dollars par an.

## Tendencia observada en la corriente de capital privado internacional durante los años 1957-65

### *Resumen*

A pesar del considerable crecimiento que durante el transcurso de los últimos ocho o nueve años ha experimentado la corriente de capital privado, se sostiene a menudo, al menos entre los países en vías de desarrollo, que se podría absorber aún provechosamente un volumen mucho mayor. Sin embargo, el capital privado, por su misma naturaleza, tiende a afluir hacia las regiones que presentan mejores posibilidades de producir el máximo rendimiento, y éstas no siempre son los países menos desarrollados.

Las cifras disponibles sobre capital privado de aquellos países que publican esos datos (14 países industriales, 12 países no industriales más desarrollados, y 48 países menos desarrollados), parecen indicar que en la cuenta de capital a largo plazo de los países industriales se ha observado un aumento continuo en la salida neta, que ha oscilado entre US\$2.000 millones en 1958 y US\$4.800 millones en 1965. Estados Unidos sigue a la cabeza como principal proveedor de capital privado a largo plazo a los países menos desarrollados, pero su participación en la salida neta total de capital del grupo de países industriales se ha reducido de más del 80 por ciento que era en los últimos años del decenio de 1950, a un 50 por ciento aproximadamente que es en la actualidad. Una porción creciente del capital que se necesita ha provenido de los demás países industriales y de los organismos internacionales.

El aspecto que presenta la corriente de capital privado a corto plazo es menos definido, puesto que no cabe duda de que gran parte de esa corriente no aparece registrada, en tanto que por su naturaleza volátil ha dado origen a grandes fluctuaciones de un año a otro. En conjunto, durante los últimos nueve años, parte de la afluencia neta de capital a largo plazo hacia los países menos desarrollados ha sido aparentemente neutralizada por una corriente neta inversa de capital a corto plazo procedente de esos países. Durante el período que se analiza, el promedio de los ingresos de capital privado a corto plazo de los países industriales (teniendo en cuenta la partida de errores y omisiones netos de los países) fue de unos US\$1.000 millones anuales. Los 60 países no industriales que figuran en nuestro análisis registraron una pérdida neta media de capital privado a corto plazo de unos US\$400 millones al año (habida cuenta de los errores y omisiones).

# Foreign Currency Issues on European Security Markets

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THE INTERNATIONAL CAPITAL MARKET is a market in which investors deal in securities that represent, for them, foreign assets. Final claims on borrowers, or the assets to which the securities give title, are usually to be made in countries outside the legal jurisdiction of the holder of the claim. The more active part of the international capital market is concerned with facilitating the transfer of outstanding domestic securities between resident and foreign investors, such as a British resident investing in American securities sold in New York. International transactions in outstanding securities, however, are difficult to quantify and are generally subject to relatively loose exchange controls. Although, in most respects, the heart of the international capital market is the trade in outstanding securities carried out by nonresidents (activities which might be called its transfer of ownership function), attention is generally concentrated on the issue of securities by nonresidents on domestic security markets (activities which might be called its new issue function).<sup>1</sup> The two functions—the new issue and transfer functions—necessarily merge and both result in an international redistribution of capital resources. Nevertheless, national monetary authorities have exercised much closer control over the issue of new foreign securities on domestic security markets (often by direct control) than over resident investors' dealings in securities on foreign securities markets (often controlled by differential taxes and exchange rates).<sup>2</sup>

The asymmetry both in type and in extent of controls on the international capital market has tended to produce, since World War II and

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<sup>1</sup> Theoretically, there is little difference between a nonresident buying an American security in New York and a U.S. company issuing securities abroad to be bought by foreigners. Economically, however, the latter transaction might involve the raising of new capital while the former could be regarded as an international transfer of existing assets.

<sup>2</sup> The U.S. Interest Equalization Tax is almost unique in its nondiscriminatory application to the purchase of both new foreign issues (with certain exemptions) and outstanding foreign securities other than those held by U.S. residents as of August 1963; its main effect, however, was to virtually freeze the volume of outstanding foreign securities in the New York market.

particularly since the early 1960's, a series of attempts to widen the new issue function of the international capital market by increasing the facilities for borrowers to raise loans—usually by the issue of long-term bonds—in security markets of which the borrowers are nonresident and, in addition, to encourage investors to purchase new foreign securities which can also be regarded as nonresident issues. The most effective extension of the international capital market has been to denominate bonds in U.S. dollars—a reserve currency—and to issue such bonds by making use of the capital market machinery of a reserve currency center—London or, latterly, New York—on behalf of third country lenders and borrowers. The new international capital market, in short, is foreign to both borrower and lender and thereby escapes the usual sort of control on the issuance of new foreign securities.

This “new” international capital market has grown up not only because of the existence of various types of long-established controls but also in response to more recently imposed controls on the international movements of long-term funds and securities. The most important of the new restrictions resulted from the announcement and later retroactive imposition in the United States of an Interest Equalization Tax on the issue of foreign securities by certain countries, effective from August 1963. The effect of the tax was not only to shut off the supply of international capital flowing from the United States to the developed countries but also, initially, to immobilize the extremely efficient machinery of the New York capital market for the issue of foreign securities for the developed countries.

The New York market was shut off to foreigners at a time when foreign lenders were eager to acquire high-yielding securities denominated in U.S. dollars.<sup>3</sup> Demand for these securities had grown throughout the postwar period, partly because of the stability of the exchange value of the U.S. dollar (which thus came to be regarded as a hedge against devaluation) and partly because of the relative ease with which securities could be disposed of on a broad securities market such as New York. The foreign demand for U.S. dollar-denominated securities has not abated with the passage of the Interest Equalization Tax. It has been met, however, by the issuance of bonds denominated in U.S. dollars in markets outside the United States for both U.S. and other borrowers, supplemented by a relatively small number of issues denominated in other currencies. Such issues are often called Euro-currency bonds, although there is little direct link with the Euro-

<sup>3</sup> U.S. official balance of payments statistics suggest that a large proportion of new foreign loans issued in New York between 1961 and mid-1963 was actually purchased by foreigners; to this extent New York was becoming an entrepôt capital market.

currency money market. This paper refers to such bond issues as foreign currency issues, since the currency in which the bonds are denominated is usually foreign to both lender and borrower. It is the purpose here to analyze various aspects of the latest extension of the international capital market in the form of foreign currency new issues.

## **Development of the Foreign Currency New Issues Market**

Throughout the post-1945 period there has been an acute world-wide shortage of long-term capital. The scarcity of capital in many countries—exhibited by rising domestic prices and periodic balance of payments crises—has been so severe that relatively tight and long-standing controls against the export of capital have been in force more or less throughout the postwar period. Where and when controls have been relaxed, private investor enthusiasm for foreign securities, contrasted with the growth of direct investment, has often been weak. The breakdown in investor confidence characteristic of the 1930's was not completely overcome in the 1950's and early 1960's. This lack of confidence has been based on, among other factors, the fear of inflation, exchange control, and exchange rate changes.

As one means of overcoming investor reluctance, particularly in Europe, and also of minimizing the effects of controls on new foreign issues and international capital transactions, bond issues on behalf of foreign borrowers have been made in foreign currencies (i.e., in currencies other than that of the market of issue or of the borrower). A variant of the foreign currency issue has been the provision of currency options (i.e., a multi-currency issue) for payment of principal and interest and, occasionally, for the initial subscription. These options reduce the exchange risk for the investor purchasing the bonds, and any change in the exchange rates in which the bond was issued would give the investor a capital gain to the extent of the relative appreciation of one of the currencies.

The currency option (i.e., the ability to demand repayment of a foreign issue in more than one currency) is an old technique and was used, for example, by Canadian borrowers in New York who permitted repayment of principal and interest in sterling or in U.S. dollars at the rate of \$4.86 to the pound. The most fundamental form of a foreign issue giving safeguard from the exchange rate risk is the denomination of the security in terms of gold or to include a gold clause guarantee in the prospectus. Gold clauses were frequently used before 1914 and during the period of unstable exchange rates and

violent inflations in the 1920's. Since gold clauses are now generally forbidden, the principle of an exchange rate guarantee is exemplified, but without implying a gold guarantee, by issues denominated in units of account with a relatively large number of reference currencies—including, possibly, the domestic currency of the lender.<sup>4</sup>

The unit of account as a basis for new foreign issues was introduced (for a Portuguese borrower) in February 1961, and in 1963 and again in 1966 the technique achieved some popularity. Multi-currency loans, or loans with currency options to the lender, were reintroduced in the mid-1950's. The first important postwar loan with a currency option, for South Africa, was floated in New York in December 1955 with an option of principal and interest payable in Swiss francs. During 1956–62 about 10 important new public issues incorporated an option for one or more currencies. For example, an issue for Petrofina of Belgium in 1957 is quoted in Amsterdam and denominated in U.S. dollars, but bondholders have a currency option in Canadian dollars, Belgian and Swiss francs, and Dutch guilders. Similarly, an issue for the Government of Argentina in 1961 contained a currency option of seven currencies other than U.S. dollars, in which the loan was nominally denominated. Apart from issues containing a multi-currency option, the popular single-currency option was normally between U.S. dollars and deutsche mark; a loan sponsored in New York for the City of Oslo in June 1960, however, contained a currency option in sterling.

By the early 1960's the technique of floating foreign currency issues, with or without currency options, was well established, though used on a very small scale, partly because the bulk of issues on behalf of European or other borrowers was made on the New York or Swiss markets. In those markets there was little need to tempt investors with currency options, as U.S. dollars and Swiss francs were regarded as the strongest international currencies.<sup>5</sup> In 1963 and early 1964, however, severe restrictions were placed on foreign issues in both the United States and Switzerland. By then, however, European investors had become fairly active in absorbing foreign issues, particularly those issued in New York. The expansion of the foreign currency new issues market is largely a consequence of those new restrictions and of a concerted attempt to maintain and widen European investor interest in foreign new issues.

<sup>4</sup> Cf. James C. Ingram, "Unit-of-Account Bonds: Their Meaning and Function," *Moorgate and Wall Street* (London), Autumn 1964, pp. 65–80, especially pp. 66–74, and Jean O. M. van der Mensbrugghe, "Bond Issues in European Units of Account," *Staff Papers*, Vol. XI (1964), pp. 446–56.

<sup>5</sup> Just as in the period before 1914, when few foreign loans issued in London and Paris were denominated in other than sterling or French francs.

An increasing proportion of new foreign security issues on New York (after about 1960) and Swiss markets had been for the industrial nations of Western Europe, Canada, Japan, and the international institutions. It was the industrial countries which thus found themselves virtually excluded from the main international capital markets of the world in mid-1963. The effective closure of the New York market and the restricted access to the Swiss market to European and Japanese borrowers came at an inopportune moment for the industrial countries.

The only feasible alternative source of international funds was Western Europe itself. In fact, just before the announcement of the Interest Equalization Tax, the Euro-dollar market in London was tapped for funds for a foreign currency issue for the Government of Belgium. This issue, made in May 1963, for \$20 million with a three-year maturity, was handled in London and subscribed for in Euro-dollars. This operation opened a new phase in tapping a large capital market dealing in foreign funds. The earlier issues denominated in units of account could be regarded as a specific attempt to internationalize the foreign new issues market in Europe by issuing an international security. Before the announcement of the U.S. intention to impose an Interest Equalization Tax, the British authorities had already inaugurated a policy (in late 1962) of reviving the use of London as an international capital market. This policy led fairly quickly to the London merchant banks experimenting with foreign currency issues—*vide* the Belgian loan of May 1963.

In October 1962 the Governor of the Bank of England declared: "The time has now come when the City once again might well provide an international capital market. . . . This entrepôt business in capital . . . would fill a vital and vacant role in Europe in mobilising foreign capital for world economic development." <sup>6</sup> Steps were taken to make the London new issues market more attractive to nonresidents when, in the Budget of 1963, the 2 per cent stamp duty on security transfers was cut to 1 per cent (with effect from August 1963). The issue of bearer securities in London was again permitted though subject to stamp duty (2 per cent on market value for issues by foreigners) if securities were delivered in London. In May 1963 the Bank of England extended the facilities of the London market to certain groups of borrowers to raise funds in sterling, and by October 1963 the Chancellor of the Exchequer announced that foreign currency loans were being "allowed almost without restriction."

The London market quickly responded to the official invitation to

<sup>6</sup> "Speech by the Governor of the Bank of England," *Quarterly Bulletin*, Bank of England, Vol. II (1962), p. 265.



greater international activity, taking good advantage of its position. The institutional structure of the London market is well suited to the issue of loans, and the market has a long tradition in the issuance of overseas loans. There was no question that the issuing houses in London could and were prepared to handle the loans. In addition, British financial connections overseas, particularly in Europe, are based on a correspondent system, not by directly owned representative offices and branches. This system has the benefit of close and continuous contact with the local financial institutions, and the placing of loans with foreign institutions is based on a long-standing customer-banker relationship rather than on a competitive basis. Further, the cost of placing an issue in London is somewhat lower than in continental centers and, on average, no higher than in New York. Finally, London not only provided the advantages of a broad securities market, which could accommodate fairly active trading conditions, but was also the center of the Euro-dollar market from which funds could be drawn for use as a float or short-term prop to the long-term dollar bond issues.

These were some of the advantages which gave London an early lead in the sponsoring and underwriting of the issues of foreign currency bonds. The placing of the bonds, however, has always been a cooperative business, and the underwriting syndicates and selling groups are large and international (see below). Gradually the London institutions that had been active in this market lost their lead as the market grew and the type of client changed. The German banks became more actively interested and have often acted as cosponsors. More significantly, U.S. banks have increasingly taken the leading position in the sponsorship of these loans.

A number of developments explain this ascendancy of the U.S. banks. In the first place, many borrowers, particularly Europeans, desired to have their bonds quoted on the New York stock exchange, even though few bonds would be sold immediately to U.S. investors. This required the issuance of a prospectus approved by the Securities and Exchange Commission and virtually full compliance with U.S. corporation and securities law. Obviously the U.S. banks were in the best position to advise and handle such matters. Further, the U.S. banks have built up their European financial connections and, consequently, have greatly increased their placing power with European institutions. Another impetus to U.S. participation in this market came from the growing activity of U.S. corporations, or their overseas financial subsidiaries, in issuing dollar-denominated obligations to foreigners. U.S. borrowers use mainly their New York bankers to handle the issue of their securities abroad.

Broadly speaking, the relatively quick changes in the organization of the market have been due to the need to sell bonds to an international investment public which is fairly small and geographically widespread. Most of the leading sponsoring houses are in New York and London because these centers have a complicated network of overseas bank branches, offices, and close correspondent banking relationships. Both are international banking centers containing many foreign financial representatives. Both have large stock exchanges and provide good and relatively cheap trading facilities. They are, in short, convenient and economical international financial centers which are accustomed to coordinating the task of placing new issues of international securities in a number of different and smaller European financial centers. Neither market provides more than a small part of the funds subscribed to international bond issues. Their coordinating procedures must therefore be efficient. Strong competition for the issuance of international loans prevails among continental financial centers. As the bulk of the bonds is placed in continental Europe, in time London and, to a lesser extent, New York may be bypassed as entrepôt markets. The belated entry of the Swiss banks as underwriters in September 1966 could change the order of importance of the issuing markets fairly quickly. Though London and New York houses often sponsor the issue, the success of the market depends on the cooperative effort of a large number of financial institutions throughout Europe to place the loans with international investors. The organization of the market is more complicated than that of most domestic capital markets, as its main function is to induce foreign investors to take up a wide variety of foreign bonds.

### **Organization of the Market**

The new issue market for foreign currency bonds in Europe is mainly a placement market; no active attempt is made to sell the securities initially on a direct and competitively open basis to the general investing public. All the issues are fully underwritten and initially placed before the loan is announced; the published prospectus is simply an information advertisement to the general public, or a legal requirement to obtain a stock exchange quotation. It is not an invitation to the public to subscribe to the issue. An issue is not brought forward to the market if the sponsors have not succeeded in both fully underwriting it and placing it with the selling groups. General public investment, of course, is possible after the securities are

quoted on a stock exchange (usually in Luxembourg and in either London or New York), and an open market is established. The volume of trading in these bonds, however, is not very high; in fact, the low volume might be regarded as a measure of the success of the placement system.

The technique of making the issue follows the New York pattern rather than the usual London pattern, which involves only one issuing house, a group of underwriters, and a broker who is prepared to make a market in the new issue. For foreign currency issues, the pattern is usually as follows: An initial syndicate—normally a minimum of 4 or 5 members, of which 1 or 2 members will actively head the syndicate—agrees to subscribe for the issue at a given price (i.e., the issue price) less a commission of about  $2\frac{1}{2}$  per cent. The syndicate then makes arrangements with a group of underwriters—containing perhaps 10–50 members, among them bankers, brokers, and dealers—which agrees to place firmly a part of the bonds at a commission of usually  $1\frac{1}{2}$  per cent of the nominal amount of the bonds. The underwriters and the subscribing syndicate itself form selling groups or sometimes act largely as the selling group itself. When the underwriting-selling group sells to recognized security dealers, it can concede  $\frac{1}{2}$  per cent of the nominal amount of the bonds from its commission of  $1\frac{1}{2}$  per cent. The principal underwriters comprise, in total, about 100 of the leading European banks, of which as many as 50 may be involved in marketing a single issue.

The sponsoring syndicate (or issuing and subscribing consortium) chooses the membership of the underwriting and selling groups, so as to achieve a wide geographic coverage within Europe, and attempts to allocate a specific portion of the loan to each country represented by the underwriting group. Members of the underwriting group of one country are not expected to try to place the bonds in another country; the national tranche of the loan, therefore, is based on the assessed absorptive capacity of the various local markets. Recently, however, the selling groups have tended to crisscross national boundaries, thereby intensifying competition in each market. In addition, the syndicate itself endeavors to arrange for securities to be sold direct to those members of the selling group not represented in the underwriting group, particularly the Swiss banks which were not normally represented as underwriters until September 1966. For this purpose, about 50 per cent of the total issue is often reserved for the leading bank or banks of the underwriting group or for the group itself. In this manner, virtually the whole of the European capital market is tapped for funds, and the careful arrangements in placing the securities are such that the

syndicate is assured that the whole of the loan will be taken up. Competition is avoided in the placing of the bonds; at least formally, there is little undercutting of the price of issue and no problem of clearing the market as occurs in New York.<sup>7</sup> However, members of the underwriting and selling groups, especially the banks, are often themselves investors. Therefore, they often subscribe for a larger amount of bonds than they intend to hold, and still earn brokerage even if they sell a portion of the newly issued bonds below par; they simply cut their commission rate and allow the lower rate to be reflected in a lower selling price on the market.

The leading members of the sponsoring syndicate are normally drawn from London, New York, Belgium-Luxembourg, and Germany. Generally, the syndicate includes at least a British and a U.S. house; some syndicates have consisted entirely of U.S. houses (particularly for U.S. borrowers) even though the bonds were sold outside the United States. Many syndicates include a leading bank of the borrowing country, particularly for Scandinavian, Japanese, and U.S. borrowers. They rarely included a Swiss issuing house before September 1966, partly because the securities are not usually quoted on Swiss stock exchanges, but mainly because the banks in Switzerland need authorization from the Swiss National Bank to participate in the syndicate or underwriting groups. Authorization by the National Bank is not automatic for this reason: the banks, while acting as underwriters, are firmly committed to support the issue, and this commitment might drain off funds from the Swiss market and cause a rise in domestic interest rates. Furthermore, Switzerland levies a 2 per cent stamp duty on new issues; in addition, it requires foreigners to pay a 3 per cent coupon tax on interest payments. These two taxes add about 1 per cent to the interest rate cost of the issue. The statutory internal taxes effectively discourage Swiss participation—by reducing profits—in the issuing and underwriting of these loans, but not of course in subscribing for the issues underwritten and issued elsewhere.

Underwriting groups are chosen not only for the size of their own resources and capacity to absorb the issues if the need arises, but also for their financial contacts, placing ability, and expertise in forming national selling groups, which in turn will place the issue at a virtually fixed price. The whole efficiency of the foreign currency bond market in Europe rests on the ability to place the bonds, from the outset, in relatively firm hands.

All this does not imply that there is no market for these securities.

<sup>7</sup> The terms of sale of the securities to the selling groups may expressly provide that the selling groups have to hold the new securities for a certain period or incur a penalty of reimbursement of the entire commission.

Most of the issues are quoted in Luxembourg and in London or New York; a few, particularly those having strong German participation and those denominated in deutsche mark as well as other currencies, are quoted in Germany. There are no new issue taxes in London or Luxembourg, and the costs of obtaining a stock exchange quotation are relatively low. Luxembourg has the further advantage that the transfer of securities is tax free. A stamp duty is imposed on the transfer of foreign bearer bonds in London if the bonds are for delivery in London. The rules of the London Stock Exchange do not require, however, that, though transactions in bonds occur in London, the bonds need be physically delivered in London; payment of the stamp duty can therefore be avoided by arranging for delivery of the bonds in Luxembourg. Another important consideration is that, under Luxembourg law, dividends and interest paid by holding (and financial subsidiary) companies registered in Luxembourg can be paid without deducting the withholding tax—an important consideration for many international investors. It is usual, therefore, for almost all the foreign currency bonds to have a Luxembourg quotation or be regarded as a foreign issue of a Luxembourg registered subsidiary or holding company. Although a number of the foreign currency bond issues are quoted in New York, virtually no transactions are made there, mainly because of the incidence of the Interest Equalization Tax.

Foreign currency bonds are quoted on at least two stock exchanges, but little trade is carried out after the first six months of issue; even during the initial period, the bulk of the trade is interbank. Furthermore, much of the interbank trade is handled in an over-the-counter market centered on Zürich, though a leading brokerage house in London also provides extensive dealing facilities. Transactions are based on London and Luxembourg prices.

The foreign currency bond market is essentially a placement market, particularly in the complicated initial selling procedure; nevertheless it is based on the principle of the public new issues market. About 85 per cent of the foreign currency bonds issued between mid-1963 and the end of 1966 had stock exchange quotations. This emphasis on making public issues contrasts with the tendency in New York for a growing proportion of issues (especially of foreign issues before the announcement of the Interest Equalization Tax in July 1963) to take the form of private placements without a stock exchange quotation.<sup>8</sup>

<sup>8</sup> During 1962, non-Canadian noninternational institutions raised \$476 million by public issue and \$150 million by private placement; in 1963 the corresponding totals were \$411 million (excluding a \$115 million issue for the Shell Funding Corporation) and \$183 million. Indeed, during the first seven months of 1963, only 13 issues were publicly offered for non-Canadian noninternational institutions, but well over three times that number were privately placed.

The preponderance of foreign public issues in Europe denominated in U.S. dollars, compared with similar borrowings through the private placement market in 1962 and the first half of 1963 in New York, might well reflect the relatively limited availability of funds by the leading institutional investors in Europe, many of which are, in any case, prohibited from investing a large proportion of their assets in foreign securities. The public issue technique seems to be necessary in Europe to attract as wide a range of investors as possible and, at the same time, provide a means—through public quotation of the security—by which the securities could be sold or generally marketed if the need arises to dispose of the assets or to attract new potential investors (including U.S. investors at present excluded by the Interest Equalization Tax). A further consideration is that exchange control requirements in some European countries permit the purchase of foreign securities only if those securities are quoted on a foreign stock exchange. The public issue technique, however, is a more costly form of borrowing than privately placing new securities, a fact which presumably accounts for the general trend toward making private placements rather than public issues in New York.

Although bonds are issued for a multitude of borrowers, most of the issues are denominated in U.S. dollars (Table 1). Some bond issues have an option in deutsche mark, or are denominated in deutsche mark or deutsche mark and external account sterling.<sup>9</sup> In one issue, the Swiss franc was used as the currency unit for a bond issue made in London in 1963. The predominant use of the U.S. dollar can be ascribed to a number of reasons.

First, a number of the borrowers in the foreign currency bond market had been increasing borrowers in the New York market before 1963. They had begun a tradition of borrowing in U.S. dollars, which it was convenient to continue. Second, from both the investor and borrower point of view, securities denominated in U.S. dollars offered a good chance of exchange rate stability. Third, through the operation of the Euro-dollar market and with the relatively large private holdings of U.S. dollars in Europe, the U.S. dollar has been increasingly regarded as a capital investment medium in Europe; it was almost

<sup>9</sup> Technically, the German authorities regard all issues denominated in deutsche mark as being ordinary foreign issues made on the German domestic capital market. In effect, however, most, if not all, foreign issues denominated in deutsche mark are sold outside Germany and are priced so that they appeal only to foreigners. They are also sold in the same way as foreign currency bonds. New foreign issues floated in Germany yield, on the average, about 2 percentage points less than domestic bond yields. Since foreign issues denominated in deutsche mark have all the characteristics of foreign currency bonds, they are regarded as such in this paper.

inevitable that this consideration would induce investors to absorb dollar-denominated foreign securities. In short, no other currency is so widely used on an international scale in Europe as the U.S. dollar for both international transactions and international investment. As pointed out above, there were also apparent advantages in having newly issued foreign bonds quoted on the New York Stock Exchange.

TABLE 1. FOREIGN CURRENCY NEW ISSUES ON EUROPEAN SECURITY MARKETS,  
BY CURRENCY DENOMINATED, 1957-66

(In millions of U.S. dollars)

	Denominated in			With Currency Options	Total
	U.S. dollars	Other currencies	Units of account		
1957-62	—	—	10	174	184
1963	103	29	48	—	180
1964	483	92	10	44	629
1965	627	353	—	136	1,116
1966 <sup>1</sup>	1,200	196	76	20	1,492

<sup>1</sup> Preliminary.

A further consideration leading to the widespread use of the U.S. dollar as a capital investment currency in Europe has been the restrictions on, or disadvantages in, the use of some of the leading European currencies.

For example, the deutsche mark has been in relative short supply for nonresidents owing to the prolonged balance of payments surplus and the capital-importing activities of the commercial banks. This currency also is comparatively expensive to borrow. From a long-run borrowing aspect, the relative hardness of the currency also made it an exchange risk in the sense of possible upward valuation against other leading currencies, a fact which would have increased the relative burden of repayment of debt.

As another example, the Swiss franc has been difficult to use outside Switzerland—except for specific loans raised by foreigners on the Swiss capital market—mainly because the Swiss authorities have objected to and resisted any tendency to internationalize the franc. Among other things, they have objected to loans that are denominated in Swiss francs and issued outside Switzerland because of the effect these issues would have on the level of domestic interest rates. It has been claimed, further, that the Swiss economy is too small to support a reserve currency and that the volume of Swiss francs available to nonresidents must, consequently, be strictly controlled (hence the restrictions on

the inward movement of capital in early 1964). On the whole the views of the Swiss authorities have been respected.

The Netherlands guilder has not been used because few loans have been directly sponsored by Dutch banks but mainly because the Dutch banks operate extensively in U.S. dollars. The Netherlands monetary authorities have also been reluctant to extend the international use of their currency for many of the reasons which influenced the Swiss authorities. The use of sterling, of course, has been restricted for residents (except through purchase of dollars at a substantial premium), and holders of external account sterling have tended to be also holders of dollars which they have used for investment purposes.

Loans with the option of deutsche mark or sterling have had some speculative attraction in terms of possible long-run exchange rate changes giving an appreciation of one currency against the other to the investor. Recently, however, such optional loans have not been popular with investors nor, for obvious reasons, with borrowers. Neither have the Belgian banks, which have been active in the international bond market, had much success with their experiment of creating a new type of international security denominated in units of account. The U.S. dollar, on the other hand, has been readily accepted as a convenient and cheap medium for long-term capital investment.

### **Borrowers and Lenders**

Distribution of foreign currency loans by country is shown in Table 2 and by type of borrower in Table 3. Europe has accounted for nearly half of the total amount of loans issued since 1957. As a group, the Scandinavian countries, particularly Norway and Denmark, have taken about one fifth of this amount although they were exceeded by the countries of the European Economic Community in 1966. The United States, entering the market only in the second half of 1965, dominated it in 1966 and by the end of the year accounted for nearly one third of the total issued since 1957. International institutions (largely the European Coal and Steel Community and European Investment Bank) have borrowed steadily, accounting for roughly 8 per cent of the total. Japan was a large borrower only in 1964. Together these countries, predominantly industrialized or with high per capita income, have taken more than four fifths of the total; less than 2 per cent has gone to the less developed countries.

A number of reasons may be advanced for the heavy borrowing by the comparatively rich, industrialized countries. A common feature was



their reliance on the New York market, from which they, though not the less developed countries, were excluded after mid-1963. Denmark borrowed heavily in 1964 to encourage a long-term capital inflow as a means of building up international reserves, as well as to obtain lower interest rates than those prevailing in the domestic market. Norwegian borrowing resulted from the continuing and large-scale investment

TABLE 2. FOREIGN CURRENCY NEW ISSUES ON EUROPEAN SECURITY MARKETS,  
BY COUNTRY OF BORROWER, 1957-66  
(In millions of U.S. dollars)

	1957-62	1963	1964	1965	1966 <sup>1</sup>	Total
<b>Europe</b>						
Denmark	—	21	136	35	58	250
Finland	—	5	26	11	13	55
Norway	10	12	107	117	20	265
Sweden	—	—	—	71	40	111
<b>Total, Scandinavia</b>	<u>10</u>	<u>38</u>	<u>269</u>	<u>234</u>	<u>131</u>	<u>681</u>
Belgium	84	40	—	20	30	174
Germany	—	—	—	42	65	107
France	—	—	—	30	15	45
Italy	—	33	49	45	60	187
Netherlands	—	—	—	37	25	62
<b>Total, EEC countries</b>	<u>84</u>	<u>73</u>	<u>49</u>	<u>174</u>	<u>195</u>	<u>575</u>
Austria	25	10	18	12	52	117
Ireland	—	—	—	—	20	20
Portugal	10	13	20	—	29	72
Switzerland	—	—	13	15	—	28
United Kingdom	—	—	—	25	40	65
<b>Total, other Europe</b>	<u>35</u>	<u>23</u>	<u>51</u>	<u>52</u>	<u>141</u>	<u>302</u>
<b>Total, Europe</b>	<u>129</u>	<u>134</u>	<u>369</u>	<u>460</u>	<u>467</u>	<u>1,558</u>
<b>Other countries</b>						
Argentina	25	—	—	—	—	25
Australia	—	—	—	50	25	75
Israel	—	—	5	—	—	5
Japan	—	25	135	35	—	195
Mexico	—	—	—	—	35	35
New Zealand	—	—	—	20	25	45
South Africa	15	—	—	82	50	147
United States	—	—	—	341	715	1,056
<b>Total</b>	<u>40</u>	<u>25</u>	<u>140</u>	<u>528</u>	<u>850</u>	<u>1,583</u>
<b>International institutions</b>	15	21	120	128	175	459
<b>Grand total</b>	<u>184</u>	<u>180</u>	<u>629</u>	<u>1,116</u>	<u>1,492</u>	<u>3,600</u>

<sup>1</sup> Preliminary.

boom, particularly in capital intensive industries, at a time when domestic credit was directly rationed. Borrowing by Belgium reflected, in part, the Government's long-run policy of borrowing abroad for budgetary reasons. Italy, Japan, and some of the smaller countries found it considerably cheaper to borrow abroad than to finance their investment demands at home. The United States entered the market largely as a consequence of the application of guidelines by the U.S. authorities to U.S. foreign investment abroad.

TABLE 3. FOREIGN CURRENCY NEW ISSUES ON EUROPEAN SECURITY MARKETS,  
BY CATEGORY OF BORROWER, 1957-66

(In millions of U.S. dollars)

	1957-62	1963	1964	1965	1966 <sup>1</sup>	Total
Central government	54	40	88	140	115	437
Local authority	10	14	120	82	20	246
Public utilities in public sector	30	22	84	65	80	281
Other public sector	10	43	52	42	102	249
Commercial and industrial	65	40	165	659	1,027	1,956
International	15	21	120	128	147	431
Total	184	180	629	1,116	1,492	3,600

<sup>1</sup> Preliminary.

By category of borrower, nearly half the total of issues has been on account of private industrial and commercial borrowers; the proportion increased sharply once the U.S. corporations became heavy borrowers. The international institutions have borrowed only slightly less than the central governments, mainly those of Norway, Denmark, and Belgium. Other public sector borrowing on behalf of local authorities or state enterprises and publicly owned utilities has accounted for nearly one fourth of total borrowing.

The bulk of all loans issued, including over 10 per cent of the commercial and industrial issues, have some form of state or central government guarantee attached to them; consequently, the market is characterized almost uniformly by high-quality paper. If a guarantee is not possible, as on loans to international institutions, the indirect backing to the borrower is sufficient to give the paper a high-quality rating. Though most of the industrial and commercial issues do not have government backing, the bond issues (e.g., those of overseas U.S. corporations) are commonly unconditionally guaranteed by the parent companies, many of which command the highest investment rating. Nevertheless, concessions are made to subscribers of industrial issues in the market, not only in the form of higher interest rates and more currency options but also in the issuance of convertible debentures

having attractive conversion rights into common stock or equity in the future. The technique of issuing convertible debentures was used mainly by Japanese firms in late 1963 and early 1964 and by U.S. firms in late 1965 and the first half of 1966.

As pointed out above, the market for foreign currency issues is overwhelmingly a bond market. Only five small issues of equities have been handled through this market, and these represented about 2 per cent of the total funds raised. This proportion will rise, of course, as subscribers to convertible debenture issues exercise their right of conversion. Although the average quality of the bonds issued has been comparatively high, the average size of the bond issues has been less than \$18 million. Maturity of the bonds issued has ranged from 3 to 25 years and has averaged about 12 years. In no sense, therefore, has the market been burdened with overlong maturities or overhung with large stocks of single issues. The relative small size of issue and short maturity (characteristic of a placement market) reflect, in part, the geographic spread of the market. It thus seems to be an exceptionally favorable market for investment—offering a wide variety of guaranteed bonds and attractively priced convertible debentures, virtually free of tax, with high yields and public quotations. Furthermore, the noninterest rate concessions granted by the borrower, in the interests of making a market, seem fairly generous.<sup>10</sup>

Nevertheless, investors have not been readily forthcoming, and the market has developed to its present size only by patient and continuous expansion of the range of investors through extending the range and number of the sponsoring and underwriting consortia. In terms of number and size of issues, the market has at times been overpressed with consequent short periods of virtual standstill in placing new issues on the market. These periods of “indigestion” tend to confirm the view that there is relatively little use of short-term funds, particularly Euro-

<sup>10</sup> In July and August 1966, some significant changes occurred in the manner of tapping funds for the foreign currency issue market. The overseas subsidiary of IBM Corporation arranged a \$35 million line of credit from 14 banks in Europe to be used when needed in a period of 3–5 years. Indeed, this technique of arranging credit lines (usually on an overdraft basis) from international consortia of banks, with the credit denominated in various currencies, has expanded rapidly since the IBM arrangement. About 15 such arrangements, involving more than \$400 million, have been concluded. Furthermore, a number of formal private placements were made without public quotation (i.e., there was no quotation of the bonds on any stock exchange, and the placements were handled by far fewer financial houses than has been usual in this market). Also, in December 1966, two important banks (Bank of America and Banque de Paris et des Pays-Bas) formed a joint company to issue bonds on the foreign currency market; the proceeds were to be reloaned to customers not willing to make a formal issue themselves. These changes may well be forerunners of fundamental shifts in the form of medium-term financing by public issues.

dollars, in continuously supporting successive bond issues. Furthermore, the system of placing bonds firmly from the outset would militate against appealing to investors dealing in largely short-term funds.

Although there are strong indications that the source of funds used in the foreign currency new issues market is not, on any extensive scale, the Euro-dollar market,<sup>11</sup> it is difficult to determine quantitatively where the investment dollars come from. The Euro-dollar market, however, does play some role; for example, the two \$20 million, three-year loans for the Government of Belgium in 1963 were directly subscribed for in Euro-dollars, as was a similar loan issued in mid-1966. Furthermore, those underwriters unable to unload their bonds at agreed prices often prefer to extend their commitments until bond prices improve, and they tend to carry their inventory of bonds with the use of Euro-dollars borrowed at relatively short-term. To this extent, the Euro-dollar market provides a useful ancillary source of funds. The relationship between the foreign currency bond market and the Euro-dollar market is essentially two way.

Apart from the Euro-dollar market, five main sources of funds can be drawn upon to finance foreign currency new issues. First, countries running a surplus on their international accounts may invest funds in the United States, or in the foreign currency new issues market, or, if short-term investment is desired, in the Euro-dollar market. An important source of such funds, which are generally invested long term, is likely to be the Middle East rather than the European dollar-surplus countries (e.g., Italy), which prefer to invest short term in the Euro-dollar market.

A second source of funds may become available from nonresidents (and, possibly, some U.S. residents) switching out of relatively low-yielding U.S. domestic securities into higher-yielding foreign securities denominated in dollars, particularly when (as in issues of overseas subsidiaries of U.S. companies) the quality of the security is comparable. Many U.S. corporate stocks now have two market quotations, and the temptation to switch funds from the low-yielding New York stock to the high-yielding European stock is strong. U.S. balance of payments statistics suggest such switching became fairly substantial as soon as U.S. corporations began to issue securities abroad.<sup>12</sup>

<sup>11</sup> Indeed, the Bank for International Settlements (BIS) has suggested that "it is extremely likely that the proceeds of dollar bonds issued in Europe will, to the extent that they are not required for immediate spending by the borrowers, in the meantime be placed in the Euro-dollar market. Furthermore, the European banks that underwrite these bond issues need to maintain a pool of dollars . . . and that part of it is kept in the Euro-dollar market" (*Thirty-Sixth Annual Report* (Basle, Switzerland, 1966), p. 142).

<sup>12</sup> Cf. *Survey of Current Business*, U.S. Department of Commerce, Vol. 46, March 1966, p. 28. BIS has suggested that "as much as one-third of the funds

A third source of funds may be found in countries which retain their privilege of borrowing comparatively cheap dollars from the United States (and, again, U.S. residents themselves), and reinvest dollars in the foreign currency bond market. To some extent, this applied to Canada until certain foreign bond issues specifically excluded Canadian investors; in March 1966 the Canadian authorities requested 450 Canadian financial institutions not to subscribe to foreign dollar bond issues.

The fourth main source of funds is the traditionally famous, and possibly much exaggerated, but constantly replenished, pool of flight capital from the politically disturbed and economically mismanaged parts of the world which finds refuge and income in certain European countries.

The fifth, and potentially the most important, source of funds is "subscribers. . . mainly residents of continental [European] countries, [who] simply convert domestic currencies into the necessary foreign exchange, thus indirectly affecting the central reserves."<sup>18</sup> Few countries on the Continent have regulations that impede the flow of international direct or portfolio investment, and, from the viewpoint of the national monetary authorities, foreign currency bond issues are a type of international portfolio investment. Broadly, then, the main sources of funds for investment in the foreign dollar securities market are the structural balance of payments surplus countries, countries experiencing capital flight, and the central official reserves of, mainly, continental European countries.

It is impossible to state accurately the extent to which each of these sources contributed funds to the foreign currencies issues market. It is also difficult, though something can be said, to analyze the broad geographical distribution of the initial investors. The foreign currency bonds are not yet old enough for a close analysis of data held by the paying agents to be worthwhile, and initial purchases of the bonds—for which data are not publicly available—are not necessarily good guides to discovering the eventual and firm distribution of the bonds. National balance of payments data are not much help in this matter.

Some notion of the initial distribution of the issues can be gleaned from the remarks of market commentators made at the time of issue in the press and elsewhere. Further sources of information are the comments of bankers and market operators on the functioning of the international bond market. Table 4 contains some rough guesses as to initial

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raised by these [U.S.] corporations in Europe has been derived from switching out of other dollar securities or diverting potential new purchases from the U.S. domestic market" (*loc. cit.*, p. 51).

<sup>18</sup> BIS, *loc. cit.*, p. 51.

subscribers, based mainly on press comments at the time of the issues. Taking London first, it is generally believed that some London-based dollars are used in the foreign currency bond market there; for example, three Belgian Government loans were taken up in Euro-dollars and were largely absorbed in London with the residue of the first two loans taken up by Canadian banks.

This sort of operation seems rare, but dollars—Euro- and “official”—are used in the foreign currency securities market mainly to provide a float to allow brokers to take up a certain volume of bonds and thus be in the position to make a market. Owing to the thinness of trading in the foreign currency bond market, it is impossible to ensure a ready and quick sale of the bonds; initial subscribers, therefore, must expect to have to hold the bonds for some time after the time of issue. The periods of “indigestion” which arise in the market are largely the consequence of the failure of long-term investors to be continuously in the market and the reluctance of other investors to overcommit themselves with the use of funds borrowed at short term. However, given the relatively small amount of trading and the necessity of allowing the brokers to deal readily in the bonds, officially owned dollars are made available to the

TABLE 4. ESTIMATED INITIAL SOURCES OF FUNDS IN THE FOREIGN CURRENCY NEW ISSUES MARKET, 1957-66

	Million U.S. Dollars
United Kingdom (Euro-dollar market and London market sources)	200
Middle East (mainly oil-exporting territories of the sterling area)	225
Hong Kong	65
Bahamas	115
Total, sterling area	605
Canada	225
United States	115
Total, North America	340
Scandinavia	100
Belgium	220
Netherlands	175
Germany	30
Italy	215
France	60
Other Europe	50
Total, continental Europe (excluding Switzerland)	850
Switzerland and rest of world	1,805
Grand total	3,600

London market on a six-month basis for the purpose of making a market. After six months, the dollars have to be returned to the Bank of England, and the brokers then have to borrow Euro-dollars or purchase dollars by paying the dollar premium if they continue to hold bonds.

The same considerations apply to other potential London-based investors intending to make a long-term investment in the securities. The supply of dollars to finance the issues must be found outside the official pool of dollars in London—this means purchasing investment dollars at a premium, using Euro-dollars, borrowing dollars from New York, or selling already owned foreign currency assets. Taking into account the cost of obtaining dollars through these means, the U.K. tax on unearned income, and the relative bond rates in London, the London investors have little incentive to purchase any straightforward foreign currency bond issue. Indeed, it is believed that only nominal amounts of the “straight” bond issues have been bought for long-term investment. On the other hand, issues of convertible debentures (e.g., those of Japanese companies in late 1963 and U.S. corporations in 1965–66) or bonds with some equity rights attached (e.g., the Istituto per la Ricostruzione Industriale issue in London in July 1964) are believed to have attracted London investors. It is improbable that British reserves were used to finance the limited domestic subscription for these issues, particularly as, for example, two British investment trusts raised \$19 million in New York in 1964 to invest in dollar securities and apparently used part of these to acquire some of the European dollar issues. In total, then, the London subscription—including the Euro-dollar loans but excluding the use of “float dollars”—is not likely to have exceeded 5 per cent of the total volume of bonds issued.

Participation from the outer sterling area has probably been on a larger scale. By far the largest and continuous investors of the sterling-using countries are believed to be the Middle East countries, which possess large quantities of sterling and dollars and are known to be following a policy of diversifying the currency element of their reserves and investments. Furthermore, these countries are particularly attracted by the tax-free advantages in holding foreign currency bonds. Middle East participation in this market is difficult to assess largely because some of the funds are invested through Swiss intermediaries. Nevertheless, there is also direct “official” investment, and, perhaps, \$225 million is a reasonable minimum figure for such investment.

The Hong Kong market—through the free dollar market there—has also provided funds for investment in European issues of dollar bonds. The issues of bonds on behalf of Japanese borrowers have been

relatively attractive to Hong Kong investors, and since Hong Kong banks are traditionally large-scale dealers in U.S. securities, presumably they took up some of the convertible debentures issued by U.S. corporations. Conceivably as much as \$65 million was invested. It is impossible to estimate how much of this amount represented genuine Hong Kong investment and how much came from outside the sterling area and the remainder of Southeast Asia for investment through Hong Kong banks. Hong Kong plays a role in the Far East similar to that of Switzerland in Western Europe, though on a smaller scale, as a channel for acquiring effectively tax-free investments.

From early 1965, financial trusts and other monetary institutions established in the Bahamas have been reported to be interested in subscribing for high-yielding international bonds—including foreign currency issues. Buying has been reported in the press as persistent, though not on a large scale; further, some institutions in the Bahamas were receiving funds direct from the larger capital markets and simply reinvested these funds. It is unlikely that the Bahamas supplied investment funds of over \$115 million.

In all, sterling area investment in these bonds may have amounted to \$605 million, or about 17 per cent of the total. It needs to be reiterated that this amount did not necessarily represent the extent of the drain from sterling area reserves, as some capital was “imported” specifically for reinvestment in assets denominated in non-sterling currency. Rather, the relatively high rate of investment in these bonds might measure the importance of London, Hong Kong, and the Bahamas as entrepôt money and capital markets.

Press reports and market commentaries also suggest considerable North American buying of bonds issued, particularly the convertible debentures issued by U.S. corporations, up to about March 1966. A fairly frequently mentioned figure for Canadian buying has been about 10 per cent of the total of issues made up to the end of March 1966. It has also been thought that some U.S. residents had invested in some of the outstandingly attractive convertible debenture offerings of the U.S. corporations abroad. As a best guess, then, North American subscription for new foreign currency bonds could well amount to about \$340 million.

The bulk of the foreign currency issues floated in Europe in 1957–66 were absorbed by European investors. On the basis of initial subscription, it seems that Belgium (with Luxembourg), the Netherlands, and Switzerland were the most important investors. The issues denominated in units of account were particularly popular in Belgium; two Belgian banks played the leading part not only in developing this type of issue



but also in sponsoring and underwriting the issues. In all, it is believed that Belgium and the Netherlands between them absorbed slightly more than 10 per cent of the total issues denominated in foreign currencies—or about \$395 million. This estimate would also accord with their participation in the underwriting and selling group arrangements in arranging the flotation of the securities.

A large proportion of the foreign currency issues was on behalf of Scandinavian borrowers—outstandingly Norwegian and Danish. Scandinavian investors are also believed to have subscribed for part of the issues, but their participation has tended to increase after the bonds have been issued. Scandinavian banks, however, have been active members of the managing syndicates for those loans issued by Scandinavian borrowers. Nevertheless, it is unlikely that initial Scandinavian participation exceeded \$100 million of the total issued.

Germany is a further source of funds for investment in these bonds. German banks participate quite actively in the underwriting and selling group arrangements of the bond issues. In terms of domestic interest rates, however, the bonds are not attractively priced, and domestic German investment is believed to be rather low—perhaps only \$30 million of the foreign currency bonds issued since 1957. It has been estimated that German investors had absorbed not more than 50 per cent of the foreign issues floated in Germany up to the end of 1964. It is unlikely that domestic investors have subscribed for any issues yielding less than 6 per cent or that German residents bought any foreign bonds in 1965 and 1966. German capital centers, like London and New York, have, in practice, an important business in floating “transit loans.” Indeed, as a means of attracting foreign capital, German companies have established overseas affiliates—usually in Luxembourg—for the express purpose of issuing bonds to foreigners who would thereby avoid paying the German withholding tax. French and Italian investment, particularly since early in 1966, has increased markedly, and Italy is now a significant factor in determining the future supply of funds in the market; together they might have absorbed as much as \$275 million of new issues.

Switzerland is regarded as the most important single investor in the foreign currency bond market. It has been estimated that 40 per cent of each issue was directly subscribed for on Swiss account, but the actual participation was likely to be higher. During the course of 1966 the Swiss banks reduced their direct subscription quite markedly until in September 1966 they entered the market as formal underwriters and, on that basis alone, tended to take about a third of an issue. Assuming this estimate to be near the mark and taking into account a substantial

non-European residual item, then about \$1,805 million was absorbed on Swiss and on non-European accounts (most of which would have been activated through Switzerland), or about 50 per cent of the total. It is impossible, however, to estimate the extent of Swiss subscription on behalf of Swiss residents and on behalf of nonresidents. Switzerland is considered a "tax haven" country and is also the recipient of a great deal of flight capital—not all of it on short-term account. It is improbable, however, that the bulk of investment was on Swiss domestic account. The estimated volume of relatively liquid nonresident funds has been put at about Sw F 9.5 billion at the end of 1963<sup>14</sup> (compared with Sw F 7.0 billion at the end of 1960), and it is likely that the large Swiss subscription reflects the investment of long-term flight money resident in Switzerland (including funds switched out of securities quoted in Switzerland), the investment of funds sent into the country specifically for the purpose of buying international bonds, and finally—and possibly least—foreign investment by Swiss individuals and institutions.

### Structure of Interest Rates

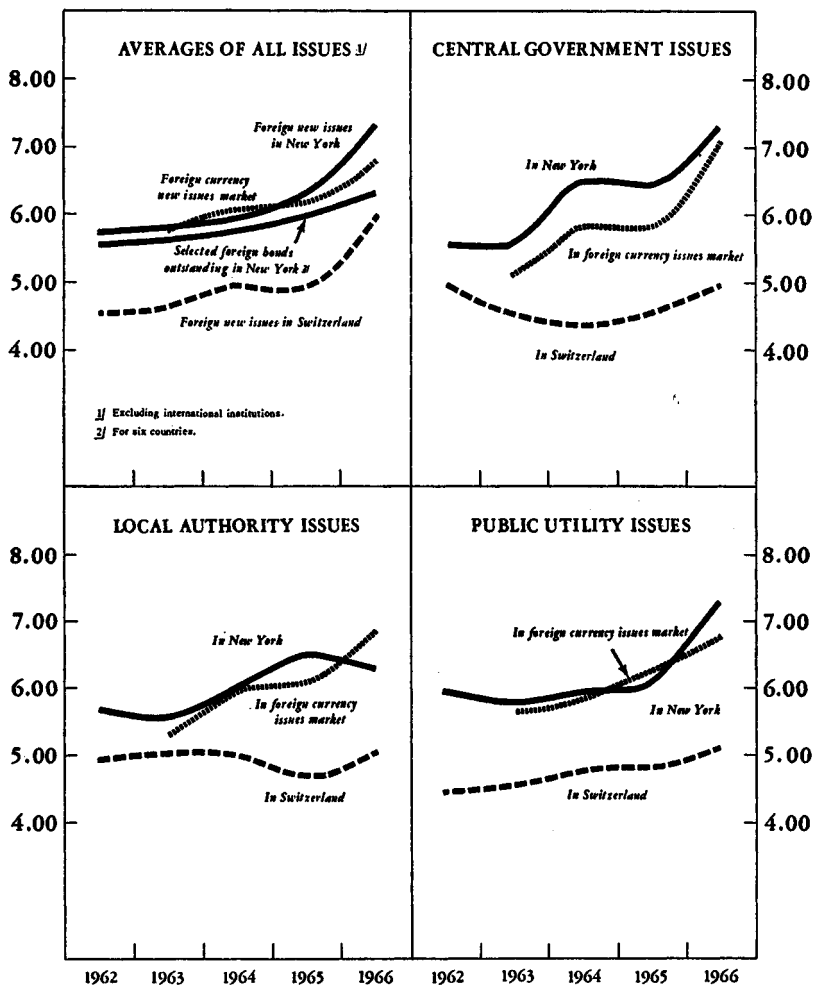
Except for Switzerland, the foreign currency new issues market is, from the point of view of interest costs, about the cheapest source of international long-term capital raised in the form of issues of securities. As shown in Chart 1, the average interest cost of foreign currency issues is very close to interest costs charged in New York in 1963 and 1964, and falls below the New York average in 1965 and 1966. The high yields on new foreign issues in New York in 1965 and 1966, compared with new issue yields on the foreign currency market, can be largely explained by the growing difference between the borrowers in New York as a result of the Interest Equalization Tax and those on the foreign currency issues market. The comparative cheapness of Switzerland as a source of long-term funds for foreigners is strikingly clear. Only Japan and Norway have needed to offer, mainly in 1964, slightly higher yields in the foreign currency new issues market compared with the interest costs of their foreign borrowing elsewhere, particularly in Germany.

Among the countries listed as borrowers in the foreign currency bond market in the Appendix, Table 5, only Norway, Sweden, Portugal, Switzerland, and the United States found it relatively more expensive to

<sup>14</sup> Total foreign investment in Switzerland at the end of 1960 was estimated at \$4.0 billion (Poul Høst-Madsen, "How Much Capital Flight from Developing Countries," *Finance and Development*, The Fund and Bank Review, Vol. II, March 1965, p. 27).

CHART 1. STRUCTURE OF YIELDS OF FOREIGN ISSUES,  
BY CATEGORY OF LOAN, 1962-66

(In per cent per annum)



borrow in the foreign currency bond market than at home.<sup>15</sup> In some countries (e.g., Belgium, Denmark, Germany, Japan, and the United Kingdom) the differential between the higher cost of borrowing at home and the cost of borrowing abroad up to late 1965 exceeded 1 per cent. Since early 1966, with the general equalization of interest rates within Europe (except Germany, which has maintained its differential) and with the very rapid rise of long-term interest rates in New York, differentials have narrowed considerably. In short, there have been strong interest cost incentives to utilize the foreign currency new issues market.

The relatively low yield on foreign currency issues is, on the surface, somewhat surprising, particularly in the light of the increased mobility of even long-term funds between the European securities markets. The market has grown, largely as a result of administrative actions by various governments (United States, Germany, Switzerland, and the United Kingdom) to insulate their markets, which are the leading international securities markets. To the extent that the market has grown because of restrictions, it can properly be called a "parallel" market and might be expected to disappear when these restrictions are removed. A characteristic of this kind of market, however, is that it is usually less efficient. That is, its costs are usually higher than those in the more permanently based securities markets, which function on a more or less continuous flow of investible funds and proffered securities. The permanence of their institutionalization generally gives them an advantage over a market which has grown in consequence of a conscious attempt to rechannel or cut off the flow of funds from their previous course. Usually, the costs of dislocation are relatively high.

Operations of the foreign currency new issues market, however, seem to show the opposite (as does the Euro-dollar market in comparison with other short-term money markets). This market has managed to attract a stream of investors prepared to take up issues at yields averaging less than those prevailing in most of the leading international capital markets.

<sup>15</sup> For Norway and Sweden, the interest cost of borrowing abroad exceeded the cost of borrowing at home by an average of about 0.5 per cent; for Portugal, 1 per cent; and for U.S. corporations (excluding issues of convertible debentures), 1.65 per cent. On this basis, U.S. corporation issues are treated as foreign issues in relation to the New York market, and they have to pay the interest rate broadly applicable to foreign issues in New York, thus incurring a sharp rise in the cost of money which they have traditionally needed to pay. To overcome the high interest cost, U.S. corporations have turned increasingly to issuing convertible debentures with a coupon yield of about 5 per cent. It should also be added that the high-cost money raised by U.S. corporations is generally used to finance their overseas business. Compliance with U.S. guidelines on overseas investment, however, has reduced the profitability of overseas investment to the extent that the U.S. corporations have raised funds abroad rather than export funds from the New York market.

Part of the explanation of this phenomenon would seem to be that almost all the issues are free of income or withholding tax of the borrowing countries, and since most bonds are issued in bearer form and held outside the country of the investor, domestic income taxes can also often be avoided. The gross yields on such securities can for practical purposes be regarded as virtually tax free, giving a relatively high net yield compared with net yields elsewhere. A further explanation is that the relatively low interest costs in this market is due partly to the generally high creditworthiness of the borrowers themselves. Many of the countries represented in the list of borrowers in the foreign currency new issues market are generally regarded as prime borrowers in the international capital markets and can therefore command the lowest interest costs. Because of the greater element of risk for industrial and commercial issues, these issues are often made more attractive in the form of convertible debentures (such as the Japanese issues in 1963 and 1964) or have currency options (such as some Finnish and Swedish industrial issues). In short, the different rating for many borrowers often takes the form of special inducements rather than of large discrepancies in interest costs and yields.

Still another explanation is to be found in the general management of the new issues market. Because of the widespread use of the placement technique and the relatively careful regulation of the pace at which issues are brought forward, the periods of a heavy overhang of securities in the market are few and relatively short. Consequently, there is no need to throw large blocks of securities on the market to meet the requirements of new borrowers wishing or able to persuade issuing houses to handle a loan on their behalf.<sup>16</sup> In any case, cooperation between the various financial houses handling the new issues seems to take the form both of regulating the flow of issues—presumably because most of the issuing houses appeal largely to the same group of investors whose support in taking up the issue is crucial to the issuing house in handling the loan in the first instance—and of initially absorbing the whole new issue as it comes on the market. Additions to the supply of bonds are restricted and issue prices are carefully tailored to a specific and reasonably small investment clientele.

Two further points, however, are of some significance in helping to explain the relatively low bond yield in the foreign currency new issues

<sup>16</sup> There are, of course, periods of "indigestion" in the market, and prices have fallen soon after the issue has been made, particularly in early 1964 and again in late 1965 and early 1966. Up to mid-1966, however, there had been no serious break in prices or obvious overstrain in this market, and it may be premature to introduce, following the proposal by S. G. Warburg, a form of capital issues committee made up of the leading underwriting houses to regulate the pace of issues in the market (*The Times* (London), March 29, 1966, p. 15).

market. One point is that the restrictions imposed by the Swiss authorities in early 1964, together with the imposition of the withholding tax on foreign ownership of domestic securities in Germany also in 1964, effectively reduced the supply of securities which had been heavily bought by international investors. The introduction of a withholding tax on foreign-held German securities led to a substantial reduction in nonresidents' holdings of such securities and to some switching into foreign securities denominated in deutsche mark, which are not subject to tax. Foreign demand for foreign issues in both Switzerland and Germany pushed yields so low that, by the first half of 1965, yields on foreign securities in Switzerland and Germany averaged less than on domestic securities. This situation has continued in Germany, though not in Switzerland.

The second point is that the U.S. monetary authorities have not imposed any restrictions on the use of the dollar as an international currency. Since the U.S. dollar does not seem to have lost any of its attractions as an investment currency for private holders, foreigners can deal easily in dollar issues quoted in New York or elsewhere. This ability of foreigners to switch between New York and other centers has helped greatly to determine and stabilize interest rates and yields in the foreign currency bond market. The yield in New York on foreign issues is, in a broad sense, the effective minimum yield which could be offered to investors in the foreign currency new issues market. If yields in the foreign currency bond market fell below the yields for comparable foreign securities in New York, foreigners would tend to buy outstanding foreign bonds in New York. Furthermore, net yields on foreign securities quoted in New York are, on balance, higher than those on foreign issues in Switzerland and (since the imposition of the withholding tax) those on domestic issues in Germany. An important alternative investment for those holding U.S. dollars without wishing to convert them or invest them at long term is the Euro-currency markets; in fact, long-term yields in the foreign currency bond market tended to be about 1.25 to 1.50 per cent above the three-month U.S. dollar deposit rate in London although the sharp rise in Euro-dollar rates since May 1966 has changed this relationship. In general, the main high-yielding investments denominated in U.S. dollars and available for foreigners—yields on foreign securities in New York and Euro-dollar deposits in Europe—provide a maximum price for new issues of securities denominated in U.S. dollars.<sup>17</sup> Swiss

<sup>17</sup> That yields of foreign issues on domestic security markets play an important role in determining the yield of foreign currency issues denominated in particular currencies, or having currency options, is illustrated by the following events: In October 1963 a foreign currency issue, denominated in Swiss francs, was made in London for the City of Copenhagen to yield about 5.06 per cent, and a foreign issue was made in Switzerland for a local authority to yield about 5 per cent. On

financial institutions, however, have absorbed, on average, about half of the foreign currency bond issues, and the yields on foreign currency bonds must also be sufficiently attractive in relation to yields in the Swiss market (more particularly since early 1964 in relation to the yield on foreign securities in the Swiss securities market). Again yields on new issues in the foreign currency bond market have averaged about 1.25 per cent above yields on comparable bonds in the Swiss market (though, again, this margin widened considerably during the first half of 1966 as a result of the extraordinarily sharp rise in Euro-dollar deposit rates), or about the same margin as with the interest rate on three-month dollar deposits in London. (See Appendix, Tables 6–8.)

The significant determinants of a minimum rate in the foreign currency bond market would seem to be, then, the ruling interest rate on foreign securities in New York and a margin of about 1.25 per cent above foreign issues in Switzerland. It is probable, given a continued stream of new foreign issues in Switzerland and active Swiss investor participation in international issues and in contrast to the consequences of the “freezing in” effect of the Interest Equalization Tax in New York,<sup>18</sup> that the key determinant of the yield on new foreign currency issues is the yield on foreign securities in Switzerland plus a margin which is likely to vary in accordance with changing investment opportunities in other foreign markets—but especially in markets dealing extensively in U.S. dollars (i.e., the Euro-dollar market and New York itself).

The gap between the yields of foreign issues in New York and Switzerland, however, has not significantly widened between 1963 and 1966. Both markets, therefore, have continued to exercise their influence on the foreign currency bond market, partly because most new issues in the foreign currency bond market are aimed specifically at Swiss investors, and the yield on foreign currency issues has risen with the rise in yields on foreign securities in Switzerland and New York. The yield on foreign currency bonds (and the attraction of favorably priced convertible debenture issues) has not been unattractive to an extent that would encourage international investors to take up assets denominated in

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the other hand, U.S. dollar issues made in London about the same time were yielding over 5.65 per cent, or about the same as the average yield for foreign issues in New York. Issues denominated in deutsche mark or in deutsche mark and sterling tend to yield even more than issues denominated in U.S. dollars. The difference cannot be fully discounted by the higher risk attached to some of the borrowers who had made issues in this form. To a relatively small extent, there is a structure of interest rates in this market, a structure determined in part by the currency denomination of the bonds and in part by the level of yields of foreign issues on domestic security markets.

<sup>18</sup> So that most foreign bond issues in New York have shortening maturities.

alternative currencies or place funds in the Euro-dollar market.<sup>19</sup> That yields on foreign currency bonds have not, on the whole, needed to be higher than a comparable foreign bond in New York is a measure of the thoroughness with which the European market has been tapped for funds and the still strong private investor demand for assets denominated in U.S. dollars.

If the pattern of alternative international investment opportunities changes drastically, however, under the stress of *generally* rising interest rates, the position and importance of the foreign currency bond market is likely to shift in the sense that borrowers rather than lenders will tend to withdraw from the market. (No such change took place through 1966; hence the market continued to expand.) If lending rates are determined mainly by yields on foreign securities in New York and Switzerland, borrowing rates are determined largely by the cost of money in the domestic market of the borrower and/or in the foreign market in which the borrower intends to invest. Given the risk of borrowing in a foreign currency and taking into account a relationship between the relative profitability of domestic investment and domestic money interest costs, it might be preferable, under conditions of high and rising international interest rates, to borrow domestically rather than abroad.

How far rates in the foreign currency bond market could rise above what has here been called the minimum rate will depend, to a very great extent, on the trend in Euro-dollar deposit rates (the most obvious short-term dollar investment outlet). If the rise in interest rates in the Euro-dollar market is considerable and sustained and if the level of Euro-dollar rates tends to exceed the level of short-term and long-term rates in various domestic money and capital markets, it is very likely that the whole pattern of international portfolio investment will change. The higher the level of Euro-dollar rates, the more likely that the structure of interest rates in the foreign currency bond market will be influenced more by Euro-dollar rates than by long-term rates for foreign securities in New York and Switzerland. Under these conditions, the flow of new issues on the foreign currency bond market could dry up while interest rates—or effective yields—are likely to remain high. The elasticity of substitution of borrowers between domestic and the foreign currency bond markets is likely, at generally high levels of interest rates, to be high.

<sup>19</sup> Notwithstanding that the rise in yields on domestic German securities is now higher than on most foreign securities even after payment of the 25 per cent withholding tax in Germany.



## Conclusion

It has been argued in this paper that the main basis for the growth of the foreign currency bond market has been the asymmetry between the relative tightness of controls on the issuance of new foreign securities on domestic security markets and the relatively loose controls on international portfolio investment by residents of most of the countries in Western Europe and, until August 1963, of the United States. As a result of this asymmetry, attempts have been made to widen the international new capital issues market by arranging for new foreign issues in a manner which could be regarded as nonresident for both borrower and lender. An important impetus to this development came from an attempt by London, with official encouragement, to assume the role of an entrepôt capital market, an attempt greatly stimulated by the announcement of an Interest Equalization Tax on borrowing in New York by the developed countries. The use of a currency other than sterling was an essential prerequisite—in order to safeguard international reserves in the United Kingdom—to the development of London as an entrepôt capital market. In this manner the institutional structure of the capital market of one reserve currency country was geared to the currency of another reserve currency country. The U.S. dollar was used because it is probably the most widely used currency in Europe for the purpose of international investment and is most readily available in large amounts within Europe itself.

Further developments in the organization of the market, especially the emergence of New York, German, and Swiss markets as entrepôt new issue centers and the use of external account sterling, deutsche mark, and Swiss francs as currency denominations for bond issues, have been, essentially, elaborations of the original technique. The denomination of bonds in hard currencies has also probably increased investor confidence in acquiring foreign bonds.

The widespread use of the process of issuing foreign currency bonds, however, has introduced a new element of fluidity into the structure of European capital markets and in the international mobility of long-term funds. Conceptually, a new issue of foreign currency bonds is comparable in its effects on the level of domestic saving as an ordinary foreign issue on an individual European security market—or, indeed, comparable in its effects as the long-standing habit of European investors to acquire a portfolio predominantly of outstanding international securities. To some extent, therefore, the foreign currency bond market could have drained off savings from various individual European capital markets. It is unlikely that such a “drain” has had significant effects on individual

domestic markets for two reasons: First, European countries have themselves been the most important group of borrowers in this market, and no individual European country except Switzerland has been a heavy lender in the market. Further, it would be reasonable to infer that one of the chief consequences of the growth of the foreign currency bond market has led to a redistribution of capital resources within Europe which might well have had some equalizing effect on the level of European interest rates. Secondly, on the basis of very tentative estimates regarding the initial subscription of these bonds, it would seem that the new international bond market has been supported to a considerable extent by long-term funds from outside Europe. On both grounds, it could be said that the foreign currency bond market not only has led to an international redistribution of long-term capital on market criteria but also has tended to augment the stock of long-term investible funds by mobilizing funds (European and other) that might well have remained in official stocks or in other forms of short-term investments. In this sense the market—by mobilizing and channeling funds for long-term investment—has been an important addition to the structure of the world's capital markets.

The foreign currency bond market has, in essence, been grafted onto the present structure of European capital markets. It would be difficult to conclude that the development of the foreign currency bond market has had anything more than an informal integrative influence on the European markets. Those markets are still fragmented. From some points of view, they have become more so since 1964 with the onset of new controls on the working of some of the leading security markets. Indeed, the foreign currency bond market has developed largely in consequence of some of those controls and, to that extent, bears a relationship to the domestic capital markets in Europe similar in kind, if not in degree, to the relationship that the Euro-currency money markets bear to the domestic money markets in Europe.

It would be extremely hazardous to forecast either the future growth or demise of this new international bond market. The Euro-dollar market has grown rapidly despite the changes in some of the conditions, particularly the level of U.S. short-term interest rates, which gave rise to it. The foreign currency bond market has already established itself as a useful, relatively inexpensive international capital market in which to operate. Its successful growth can be partly explained by the thorough way in which international investors have been encouraged to place funds in this market. It is unlikely that the complicated organizational structure which has been built up to achieve this end will be dismantled as controls on various capital markets—especially New York—are removed.

Future growth might well turn more on the continued attraction of the market for high-grade borrowers rather than ensuring a steady, though probably not spectacular, stream of investible funds. The traditional international investor, particularly those who desire to denominate their assets in U.S. dollars, have as an alternative to investment in the foreign currency bond market the vast array of securities available in the U.S. securities market and, for short term, the Euro-dollar market. International borrowers, however, have a greater range of alternative sources of funds, particularly the domestic markets in which they intend to invest as well as the older international capital markets like Switzerland and New York. Through 1966, interest costs in the foreign currency bond market did not exceed (with few exceptions) those prevailing in most leading domestic security markets.<sup>20</sup> If, however, a fairly large discrepancy should arise between bond yields in the international market and in various domestic markets, borrowers might switch their sources of funds. The extent to which international interest rates (both short-term and long-term) can and do move independently of domestic interest rates in important money and capital markets has been no part of this paper; but the consequences of large-scale changes in the structure of interest rate differentials both within and between national markets have profound significance for the development of emerging and seemingly independent international money and capital markets.

<sup>20</sup> The rise vis-à-vis domestic securities in New York is the exception, but the relevant comparison is with the yield on foreign securities quoted in New York; in this respect the rise in interest rates on foreign currency bonds has not been out of line.

## APPENDIX

TABLE 5. STRUCTURE OF YIELDS OF FOREIGN CURRENCY NEW ISSUES ON EUROPEAN SECURITY MARKETS, BY COUNTRY OF BORROWER, 1963-66

*(In per cent per annum)*

	1963	1964	1965	1966 <sup>1</sup>
<b>Europe</b>				
Denmark	5.32	5.76	6.65	6.77
Finland	6.13	6.52	6.90	7.36
Norway	5.60	5.78	5.95	6.66
Sweden	—	—	6.14	7.06
Belgium	5.12	—	6.00	6.40
Germany	—	—	6.11	6.67
France	—	—	6.08	6.79
Italy	5.61	6.03	6.36	6.55
Netherlands	—	—	6.17	6.81
Austria	6.01	6.06	5.98	7.15
Ireland	—	—	—	7.21
Portugal	5.68	5.95	—	7.08
Switzerland	—	—	6.13	—
United Kingdom	—	—	5.85	6.16
<b>Other countries</b>				
Australia	—	—	5.77	6.72
Israel	—	6.50	—	—
Japan	6.33	6.34	6.30	—
Mexico	—	—	—	7.08
New Zealand	—	—	5.98	6.93
South Africa	—	—	—	6.62
United States	—	—	5.58	5.92
<b>International</b>	5.55	5.48	5.85	6.69

<sup>1</sup> Preliminary.

TABLE 6. STRUCTURE OF YIELDS OF FOREIGN NEW ISSUES IN NEW YORK, 1963-66

*(In per cent per annum)*

	1963	1964	1965	1966 <sup>1</sup>
Australia	5.15	—	—	—
Denmark	5.52	—	—	—
Finland	6.20	6.18	6.60	—
Italy	5.60	—	—	—
Japan	6.16	—	6.18	—
Norway	5.44	—	—	—
International	—	4.50	—	5.37
Mexico	6.78	6.78	6.63	7.37
Portugal	—	—	5.95	—
Malaysia	—	—	5.65	—
Philippines	—	—	6.63	—
Jamaica	—	—	—	7.10

<sup>1</sup> Preliminary.

TABLE 7. STRUCTURE OF YIELDS OF FOREIGN NEW ISSUES IN SWITZERLAND, 1963-66

*(In per cent per annum)*

	1963	1964	1965	1966 <sup>1</sup>
Austria	4.50	—	5.00	—
Belgium	4.50	—	—	5.12
Finland	—	—	—	6.00
France	4.67	4.84	4.75	5.62
Germany	4.40	4.51	4.63	6.35 <sup>2</sup>
International <sup>3</sup>	—	—	4.75	5.75
Japan	—	5.70	—	—
Luxembourg	4.50	—	4.75	6.07 <sup>4</sup>
Netherlands	—	—	—	5.00
Norway	4.65	5.00	5.03	—
Portugal	—	6.03 <sup>5</sup>	—	—
South Africa	—	—	—	6.50 <sup>6</sup>
Spain	5.10	5.15	—	—
United Kingdom	4.50	4.50	4.96	5.38
United States	—	—	—	4.87

<sup>1</sup> Preliminary.<sup>2</sup> Includes an international issue made elsewhere.<sup>3</sup> International Bank for Reconstruction and Development and Inter-American Development Bank.<sup>4</sup> Includes one finance company and two investment companies, two of the issues denominated in deutsche mark.<sup>5</sup> Includes international issue by Government of Portugal.<sup>6</sup> Includes industrial bond denominated in deutsche mark.

TABLE 8. STRUCTURE OF YIELDS OF FOREIGN ISSUES,  
BY CATEGORY OF LOAN,<sup>1</sup> 1962-66  
(In per cent per annum)

	1962	1963	1964	1965	1966 <sup>2</sup>
Central government					
In New York	5.59	5.57	6.48 (5.52)	6.39 (5.65)	7.30 (6.23)
In foreign currency issues market	—	5.12	5.87	5.80	7.03
In Switzerland	4.50	4.50 (4.26)	(4.39) (5.13) <sup>8</sup>	(4.54)	(4.93)
Local authority					
In New York	5.70	5.54	6.00 (5.73)	6.48 (5.87)	(6.29)
In foreign currency issues market	—	5.30	5.96	6.02	6.88
In Switzerland	(4.95)	5.00 (4.40)	5.00 (4.53)	(4.61)	5.09
Public utilities in public sector					
In New York	5.95	5.74	5.95 (5.82)	6.03 (5.98)	7.26 (6.19)
In foreign currency issues market	—	5.65	5.85	6.22	6.76
In Switzerland	4.42	4.52	4.79	4.79	(5.12)
Commercial and industrial					
In New York	6.40	6.42	6.89 (5.89)	(6.01)	6.44 (6.35)
In foreign currency issues market	—	6.28	6.51	6.09	6.84
In Switzerland	4.47	4.61	5.08	4.96	5.68
International					
In New York	5.01	(4.92)	4.50 (4.89)	(5.05)	5.37 (5.59) <sup>4</sup>
In foreign currency issues market	—	5.55	5.45	5.75	6.51 <sup>5</sup>
In Switzerland	4.25	(4.14)	(4.23)	4.75 (4.51)	5.75 (5.26) <sup>6</sup>

<sup>1</sup> Figures in parentheses are redemption yields of a selection of outstanding bonds in the market; the remainder are redemption yields on new issues. The selection of bonds already outstanding was based largely on borrowers who also used the foreign currency new issues market. The new issues yields for New York (which exclude Canadian borrowers) are influenced by the changes in the type of borrowers who used the New York market after the announcement of the U.S. Interest Equalization Tax; the yield on outstanding bonds on the New York market is influenced by the high credit standing of borrowers using the market before the imposition of the Interest Equalization Tax; owing to the restricted supply of such bonds, their price has kept up remarkably, leading to a considerable gap between the average yield on new foreign issues and yield on outstandings.

<sup>2</sup> Preliminary.

<sup>8</sup> Includes part of the \$20 million loan for Portugal at 5¾ per cent taken directly by the Swiss banks; the bulk of the issue, however, was underwritten through the London market.

<sup>4</sup> Largely Inter-American Development Bank, IBRD, and European Coal and Steel Community.

<sup>5</sup> Largely European Coal and Steel Community, European Investment Bank, and Council of Europe.

<sup>6</sup> Largely European Coal and Steel Community and IBRD.

## Emissions en devises sur les Bourses européennes

### *Résumé*

Le présent article décrit la croissance et l'évolution d'un secteur du marché international des capitaux spécialisé dans l'émission de valeurs libellées en monnaies différentes de celles des souscripteurs, et fréquemment, des émetteurs eux-mêmes. Ces émissions sont lancées sur des marchés de capitaux — principalement Londres et New York — qui ne fournissent virtuellement aucune des ressources d'épargne absorbées par les nouvelles émissions dont le marché est connu sous le nom de marché des nouvelles émissions en devises. On a prétendu que ce marché devait son existence aux contrôles relativement sévères qui régissent l'émission de valeurs étrangères sur les marchés nationaux des capitaux, et la souplesse des contrôles qui s'exercent sur les résidents qui achètent des valeurs étrangères à l'extérieur. En faisant jouer à certains grands marchés des capitaux le rôle d'entrepôts, il est possible de considérer une nouvelle émission libellée en une monnaie "étrangère" comme non-résidente à la fois du point de vue du souscripteur et de l'émetteur, et d'éviter ainsi les problèmes que posent différentes catégories de contrôles.

L'article décrit la structure institutionnelle du marché et les modalités de lancement des nouvelles émissions, et souligne la complexité des arrangements internationaux auxquels il faut normalement avoir recours pour assurer le succès d'une émission. Il estime également le volume des nouvelles émissions en devises et l'importance et la nature des ressources d'épargne qui, au départ, ont financé le marché. Il analyse les facteurs qui déterminent les taux d'intérêt sur le marché, et en conclut que le taux d'intérêt effectif minimum sera vraisemblablement le même que celui que le marché de New York applique aux valeurs étrangères de même nature, et d'environ 1,25 pour cent supérieur au taux d'intérêt de valeurs étrangères de même nature cotées en Suisse. Le plafond des taux d'intérêt dépendra vraisemblablement des taux des Euro-devises, et, du fait de la facilité avec laquelle les emprunteurs peuvent passer d'un marché à l'autre, du niveau des taux d'intérêt en vigueur sur les différents marchés monétaires nationaux. En conclusion, l'article estime qu'il se peut très bien qu'à l'avenir ce soit l'attrait que ce marché continuera d'exercer sur les emprunteurs de premier ordre qui en déterminera l'expansion et non les difficultés d'approvisionnement en capitaux.

## Las emisiones de valores en moneda extranjera en los mercados europeos

### *Resumen*

Este artículo trata del crecimiento y evolución de un sector del mercado internacional de capitales que se ocupa de lanzar emisiones de valores denominados en monedas distintas de las de los subscriptores y, frecuentemente, de las de los emisores. Dichas emisiones se lanzan en mercados de capital—principalmente Londres y Nueva York—que en la práctica no proporcionan ninguno de los ahorros que se emplean para esas emisiones. A este mercado se le denomina mercado de nuevas emisiones de valores en moneda extranjera. Se sostiene que su surgimiento se debe en gran parte al relativo rigor de los controles sobre las emisiones extranjeras de valores en los mercados nacionales de capital y a la laxitud de los controles que se imponen a los residentes que compran valores extranjeros fuera del país. Al utilizar los grandes mercados de capital como mercados intermediarios, una nueva emisión denominada en moneda “extranjera” puede ser considerada como no residente, tanto por el emisor como por el subscriptor, y de ese modo se pueden eludir los problemas inherentes a los diversos tipos de controles.

También se reseñan la organización institucional del mercado y los procedimientos seguidos para lanzar las nuevas emisiones; se pone de relieve la complejidad de los arreglos internacionales que por lo general es necesario hacer para asegurar el éxito de la nueva emisión. El artículo contiene una estimación del volumen aproximado que alcanzan las nuevas emisiones en moneda extranjera, y también las fuentes que probablemente han suministrado los fondos inicialmente empleados en el mercado. Al analizar los factores determinantes de las tasas de interés que rigen en el mercado se llega a la conclusión de que es probable que la tasa efectiva mínima sea igual a la que prevalece en el mercado de Nueva York para valores extranjeros análogos y que supere a la de los valores extranjeros comparables que se cotizan en Suiza por un margen de alrededor de 1,25 por ciento. Es probable que la tasa máxima de interés dependa de las tasas a corto plazo para los valores en Eurodivisas y, dada la facilidad que tienen los prestatarios para cambiar de un mercado a otro, del nivel de las tasas predominantes en diversos mercados monetarios nacionales. El artículo concluye expresando que es posible que el futuro crecimiento del mercado dependa más de la continua atracción que logre ejercer sobre los inversionistas de importancia que de los problemas de suministro de fondos.



# Monetary Expansion and Economic Development

Hannan Ezekiel \*

**T**HE LOW RATE of saving in less developed countries is one of the important obstacles to their rapid growth. While various measures to raise the rate of saving have been taken in some of these countries, the extremely low levels of income prevailing in them put fairly narrow limits on what can be achieved in this direction. Against this background, there has been a tendency to use monetary expansion as a source of finance for investment.

## Permissible Monetary Expansion

One of the forms in which savings become available is through a limited expansion of the stock of money, which helps to finance investment in the economy and thus to produce an expansion of output. Money holdings generally tend to rise as real income increases.<sup>1</sup> If, however, monetary expansion outstrips the growth in the amount of money that the community is willing to hold because of increases in real income, people may be persuaded to hold this amount of money only by a rise in prices, which has the effect of raising national income in money terms more than real national income. Alternatively, excessive monetary expansion may produce an expansion of imports and a contraction of exports, so that external reserves tend to contract. An expansion in the stock of money which is greater than that which people are willing to hold, given the rise in real income which has taken place over the period, is therefore likely

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<sup>1</sup> Jacques J. Polak, "The Capacity of the Banking System to Finance Development," in *Memoria, V Reunión de Técnicos de los Bancos Centrales del Continente Americano*, Vol. 2 (Bogotá, 1957), pp. 171-81.

The savings implicit in increased holdings of money are additional to those usually listed in programs of economic development and can, therefore, be considered separately here. They are not, however, additional to savings in the national income accounting sense, where savings are defined as income minus consumption.

to produce either excessive price increases in the economy or pressures on external reserves, or both. To that extent such an expansion in the stock of money cannot be considered as savings in the sense adopted here. The amount of monetary expansion which can take place without creating such pressures cannot therefore exceed certain limits, which depend on the growth in real income over any given period and on the proportion of their real income which people are willing to hold in the form of money.

Assuming that the proportion of income held in the form of money remains constant, it can be shown that the permissible increase in the stock of money in any year  $t$ , is given by the following expression:

$$\Delta M_t = b_t k_{t-1} Y_{t-1} \quad (1)$$

or

$$\Delta M_t = b_t M_{t-1} \quad (1a)$$

where  $M_{t-1}$  = stock of money in year  $t-1$ ;  $\Delta M_t = M_t - M_{t-1}$ ;  $Y_{t-1}$  = real income in year  $t-1$ ;  $k_{t-1} = \frac{M_{t-1}}{Y_{t-1}}$  is the proportion of income held in the form of money; and  $b_t = \frac{Y_t - Y_{t-1}}{Y_{t-1}}$  is the annual rate of increase of real income.

In many less developed countries since World War II, the proportion of income which people have been willing to hold in the form of money has tended to increase. If the assumption that  $k$  is constant is dropped, the extent of permissible monetary expansion clearly depends also on the rate at which this proportion is tending to increase. When this rate is taken into consideration, the expression for the increase in the stock of money in any year changes into

$$\Delta M_t = b_t k_{t-1} Y_{t-1} \left( 1 + a + \frac{a}{b_t} \right) \quad (2)$$

or

$$\Delta M_t = b_t M_{t-1} \left( 1 + a + \frac{a}{b_t} \right) \quad (2a)$$

where  $a$  is the annual rate of change in  $k$  expressed as a fraction of  $k$ , i.e.,

$$a = \frac{k_t - k_{t-1}}{k_{t-1}}.$$

## Monetary Expansion and Investment

The permissible amount of monetary expansion calculated in this way for a particular year can be related to the amount of investment in the

economy during that year. The amount of investment necessary to make income grow at the specified rate depends on the amount of increase in income and on the capital-output ratio prevailing in the economy. Assuming that investment in one year brings about an increase in income in the next, it can be shown that the amount of investment is given by the expression:

$$I_t = cb_{t+1} Y_{t-1} (1 + b_t) \quad (3)$$

where  $I_t$  = investment in year  $t$ ;  $c$  = the incremental capital-output ratio; and  $b_{t+1} = \frac{Y_{t+1} - Y_t}{Y_t}$ .

If the whole of the increase in the stock of money could be used to finance the sort of investment that is necessary to increase income at the given rate, the proportion of investment that could be financed in a noninflationary manner by the increase in the stock of money is given, when the  $k$  ratio is constant, by

$$\frac{\Delta M_t}{I_t} = \frac{b_t k_{t-1}}{cb_{t+1} (1 + b_t)} \quad (4)$$

and, when the  $k$  ratio is changing, by

$$\frac{\Delta M_t}{I_t} = \frac{b_t k_{t-1} \left(1 + a + \frac{a}{b_t}\right)}{cb_{t+1} (1 + b_t)} \quad (5)$$

If the rate at which income is growing is constant over the relevant period, i.e., if  $b_{t+1} = b_t$ , then these two equations resolve into the simpler ones given below:

$$\frac{\Delta M_t}{I_t} = \frac{k_{t-1}}{c(1 + b_t)} \quad (6)$$

and

$$\frac{\Delta M_t}{I_t} = \frac{k_{t-1} \left(1 + a + \frac{a}{b_t}\right)}{c(1 + b_t)} \quad (7)$$

The significance of these expressions in quantitative terms may be illustrated by making certain reasonable assumptions about the values of the various ratios. Assume first a rate of increase of real national income of 5 per cent per annum and a capital-output ratio of 3. In equation (6), it is assumed that  $k$  is constant. In equation (7), where  $k$  is assumed to increase,  $a$  (the rate of change of  $k$ ) may be given the value of 0.05; i.e., it may be assumed that the  $k$  ratio is increasing at the

rate of 5 per cent per annum. On this basis, the result obtained for equation (6) is  $0.317 k_{t-1}$  and for equation (7) is  $0.651 k_{t-1}$ . The latter is more than twice the former indicating how important a role a positive rate of change in the  $k$  ratio plays in these calculations. If alternative values of 0.2 and 0.3 are assumed for  $k_{t-1}$ , then, for equation (6), it is found that the permissible expansion of the stock of money constitutes 6.3 and 9.5 per cent, respectively, of investment in the year. For the same values of  $k_{t-1}$ , for equation (7), the permissible expansion of the stock of money would constitute 13.0 and 19.5 per cent, respectively, of such investment.

### Inventories and External Reserves

The capital-output ratio used in these calculations is normally based on the fixed investment necessary to produce an increase in output. The results of the calculations made above may, therefore, be interpreted as showing the proportion of fixed investment that can be financed from the savings implicit in monetary expansion. Under this interpretation, the entire volume of savings in the more usual sense of the term would finance the rest of such fixed investment. If this approach is adopted, however, the savings implicit in monetary expansion cannot really be treated as being available in full for financing fixed investment. Such monetary expansion must first help to finance whatever expansion is necessary in the country's holdings of inventories and in its holdings of external reserves.

As the economy expands, inventory expansion is likely to proceed at a more or less equal pace. The same applies to reserve expansion, though the extent of desirable reserve expansion will depend also on the initial level of reserves, the extent to which trade expansion accompanies or helps to foster the growth in national income, and variations in the tendency toward fluctuations in the country's balance of payments. If the initial level of reserves is too high, some drawing down of reserves may be justified. If it is too low, there may be a case for first building them up to adequate levels. If the present level of reserves is more or less adequate, a less developed country may consider it advisable to ensure growth in reserves at a rate commensurate with growth in the country's national income.

It should be clear that the use of the savings implicit in permissible monetary expansion for the purpose of financing necessary inventory expansion and reserve growth does not imply any dissipation of such savings. Such use of these savings can in fact be regarded as investment

necessary for the growth of the economy. It is because this investment was not taken into account above in calculating the investment necessary to produce the required growth of the economy that provision for separate financing of such investment must be made.

It is possible to treat investment in inventories and in reserves as a part of the total investment in the economy necessary to produce the desired growth in income. The effect would be to raise the value of the incremental capital-output ratio,  $c$  (used for the purposes of the calculations earlier in the paper). However, the needs of such investment are often neglected in calculating the capital-output ratio for the economy and must then be taken care of separately. In practice, it is convenient to consider the investment needs underlying the capital-output ratio in terms of fixed investment only, and there is no objection to doing so provided the needs of the other two types of investment are taken into account separately. The reason is that the mechanics of monetary expansion are such as to make it useful to treat the needs of inventory expansion and reserve growth separately from those of fixed investment, and to consider these needs as first charges on the form of savings represented by the permissible expansion in the stock of money. The expansion of a country's foreign reserves automatically accounts for an equivalent expansion of its stock of money. Again, the financing of inventory expansion is the traditional function of monetary expansion. If left to themselves, inventory expansion and reserve growth are likely to absorb automatically whatever portion they need of the savings which permissible monetary expansion represents. Any excess of such savings over these needs may then be usefully related to the volume of fixed investment in the economy.

Assuming that both inventories and foreign reserves grow at the same rate as the national income, so that their ratios to national income remain unchanged as income grows, the volume of financing required for these two purposes is given by:

$$\Delta F_t + \Delta V_t = b_t Y_{t-1} (e + g) \quad (8)$$

where  $F_{t-1}$  = foreign reserves in the year  $t-1$ ;  $e = \frac{F_{t-1}}{Y_{t-1}}$ ;  $\Delta F_t = F_t - F_{t-1}$ ;

$g = \frac{V_{t-1}}{Y_{t-1}}$ ;  $V_{t-1}$  = inventories in the year  $t-1$ ; and  $\Delta V_t = V_t - V_{t-1}$ .

### Financing of Fixed Investment

Only to the extent that permissible monetary expansion in any country is greater than the requirements of inventory accumulation and the

expansion of foreign reserves can this form of savings be used to finance fixed investment. The excess of the expansion in the stock of money over the requirements of these two purposes is given by the two expressions below, depending on whether  $k$  is constant or is tending to change over time.

$$\Delta M_t - (\Delta F_t + \Delta V_t) = b_t Y_{t-1} [k_{t-1} - (e + g)] \quad (9)$$

$$\Delta M_t - (\Delta F_t + \Delta V_t) = b_t Y_{t-1} \left[ k_{t-1} \left( 1 + a + \frac{a}{b_t} \right) - (e + g) \right] \quad (10)$$

The result will be positive only if the first term within the large brackets is greater than the second. The possibility of the result being negative, or at best very small if positive, is clearly much greater if  $k$  tends to be constant as in equation (9). The result is more likely to be positive and relatively large where the tendency of the proportion of income held in the form of money to increase is at all strong, i.e., where the value of  $a$  is positive and large relative to  $b_t$ . In either case, the result would, of course, depend on the value of  $k_{t-1}$  and, given  $g$  (which might not vary much between countries), on the value of  $e$ .

If permissible monetary expansion is not adequate to cover the needs of inventory expansion and reserve growth, the excess of the latter over the former would have to be added to the volume of fixed investment for the financing of which savings in the more usual sense of the term must be found. Alternatively, we could say that the available volume of savings in the usual sense of the term would have to be reduced by this excess to find out how much fixed investment in the economy it is possible to finance.

The expressions for the proportion of fixed investment that can be financed by the excess of permissible monetary expansion over the needs of inventory expansion and reserve growth, provided there is such an excess, are given by:

$$\frac{\Delta M_t - (\Delta F_t + \Delta V_t)}{I_t} = \frac{b_t [k_{t-1} - (e + g)]}{cb_{t+1} (1 + b_t)} \quad (11)$$

$$\frac{\Delta M_t - (\Delta F_t + \Delta V_t)}{I_t} = \frac{b_t \left[ k_{t-1} \left( 1 + a + \frac{a}{b_t} \right) - (e + g) \right]}{cb_{t+1} (1 + b_t)} \quad (12)$$

If the rate of growth of income is constant, so that  $b_{t+1} = b_t$ , these equations will resolve into the simpler ones given below:

$$\frac{\Delta M_t - (\Delta F_t + \Delta V_t)}{I_t} = \frac{k_{t-1} - (e + g)}{c(1 + b_t)} \quad (13)$$

$$\frac{\Delta M_t - (\Delta F_t + \Delta V_t)}{I_t} = \frac{k_{t-1} \left( 1 + a + \frac{a}{b_t} \right) - (e + g)}{c(1 + b_t)} \quad (14)$$

### Conclusion

Equation 14 shows that, on the given assumptions, the proportion of fixed investment that can be financed from monetary expansion, after allowing for the financing of the expansion of inventories and foreign reserves, depends on the values of a few simple elements, namely,

$k_{t-1}$ , the initial proportion of income held in the form of money (0.2 or 0.3)

$a$ , the annual rate of change in  $k$  (0.05)

$b_t$ , the annual rate of growth of income (0.05)

$e$ , the ratio of foreign reserves to income (0.01)

$g$ , the ratio of inventories to income (0.01)

$c$ , the incremental capital-output ratio (3.00).

If, for illustrative purposes, these elements are given the values shown in the parentheses against them, the proportion of fixed investment that could be financed by monetary expansion would be 6 per cent or 13 per cent, depending on whether the value of  $k_{t-1}$  was taken at 0.2 or at 0.3. The proportion of fixed investment that can be financed by monetary expansion in any particular country can easily be calculated by inserting the appropriate values of these elements into the equation.

## Expansion monétaire et développement économique

*Résumé*

Une certaine expansion de la masse monétaire constitue une des formes de l'épargne. Cette expansion contribue au financement des investissements, et donc à l'accroissement de la production. Une expansion excessive de la masse monétaire risque cependant de provoquer soit des hausses de prix, soit des pressions s'exerçant sur les réserves en devises, l'un de ces effets n'excluant d'ailleurs pas nécessairement l'autre. Les limites de l'expansion monétaire admissible dépendent de la progression du revenu réel et de la proportion de son revenu réel que le public est disposé à détenir sous forme de monnaie. Elles dépendent également du taux auquel cette proportion a tendance à s'accroître.

Etant donné que l'expansion monétaire doit d'abord financer l'accroissement nécessaire des stocks et l'augmentation souhaitée des réserves en devises, on ne saurait considérer qu'elle puisse être consacrée en totalité au financement de l'investissement dans l'équipement. L'accroissement des stocks se fait généralement au même rythme que celui du revenu. Dans l'ensemble, on peut admettre que la progression des réserves en devises a lieu elle aussi au même rythme que celle du revenu.

En admettant que le revenu augmente à un taux constant, l'auteur montre que, dans ces conditions, la proportion de l'investissement dans l'équipement que l'on peut financer à partir de l'excédent de l'expansion monétaire admissible par rapport aux besoins de l'expansion des stocks et de l'accroissement des réserves, si tant est qu'un tel excédent existe, peut se représenter comme suit :

$$\frac{k_{t-1} \left( 1 + a + \frac{a}{b_t} \right) - (e + g)}{c(1 + b_t)}$$

où  $k_{t-1}$  représente la proportion initiale de revenu détenue sous forme de monnaie,  $a$  est le taux annuel de changement de cette proportion,  $b_t$  est le taux annuel d'accroissement du revenu,  $e$  est le rapport entre les réserves en devises et le revenu,  $g$  est le rapport entre les stocks et le revenu, et  $c$  est le rapport marginal capital/production.



## La expansión monetaria y el desarrollo económico

### Resumen

Una de las formas de mantener ahorros consiste en una expansión limitada del medio circulante. Esta expansión ayuda a financiar las inversiones y, por ende, a aumentar la producción. Ahora bien, una expansión excesiva del medio circulante traería probablemente consigo un alza de los precios, o presiones sobre las reservas externas, o ambas cosas a la vez. Los límites de una expansión monetaria permisible dependen del crecimiento del ingreso real y de la proporción de sus propios ingresos reales que el público esté dispuesto a mantener en forma de dinero, así como también del ritmo en que dicha proporción tienda a aumentar.

Puesto que la expansión monetaria debe en primer lugar financiar el incremento necesario de los inventarios y la deseada expansión de las reservas externas, no se le puede considerar como enteramente disponible para el financiamiento de inversiones fijas. Es probable que el incremento de los inventarios guarde proporción con el crecimiento del ingreso. En general, cabe suponer que la expansión de las reservas externas también marche al unísono con el crecimiento del ingreso.

Partiendo de la hipótesis de que el ingreso crece a una tasa constante, la proporción de las inversiones fijas que puede financiarse con el excedente de una expansión monetaria permisible, una vez cubiertas las necesidades de incrementar los inventarios y las reservas, caso de que exista dicho excedente, se demuestra de acuerdo con estas suposiciones como equivalente a la ecuación

$$\frac{k_{t-1} \left( 1 + a + \frac{a}{b_t} \right) - (e + g)}{c(1 + b_t)}$$

representando  $k_{t-1}$  la proporción inicial del ingreso que se mantiene en forma de dinero,  $a$  el porcentaje anual de variación de dicha proporción,  $b_t$  la tasa anual de crecimiento del ingreso,  $e$  la razón entre las reservas externas y el ingreso,  $g$  la razón entre las existencias y el ingreso y  $c$  la razón incremental capital-producción.

# The Taxation of Land Value

George E. Lent \*

**E**CONOMIC DEVELOPMENT is frequently accompanied by the growth of population and its increased concentration in urban areas, which imposes greater demands on the government for the provision of essential services, sometimes at a considerable cost. A real problem arises in financing this cost and equitably apportioning it among the members of the community. Because population growth and higher standards of living inevitably enhance the value of land, many governments have sought ways of allocating this cost among the landowners who benefit directly and indirectly from rising land values.

The philosophy that landowners should bear this cost originated partly in the classical theory of land rent as an unearned increment, arising either from the location of land or from the differential bounties of nature as to fertility of soil and deposits of natural resources. According to Ricardo, rent from land is essentially a private expropriation of its natural productivity or site value (location) which does not originate in human effort or skill.<sup>1</sup> A tax on such unearned increases in land value therefore does not impair use of the land or deter production. This view was supported by J.S. Mill, who remarked:

... Suppose that there is a kind of income which constantly tends to increase without any exertion or sacrifice on the part of the owners: those owners constituting a class in the community, whom the natural course of things progressively enriches, consistently with complete passiveness on their own part. In such a case it would be no violation of the principles on which private property is grounded, if the state should appropriate this increase of wealth, or part of it, as it arises. This would not properly be taking anything from anybody; it would merely be applying an accession of wealth, created by circumstances, to the benefit of society, instead of allowing it to become an unearned appendage to the riches of a particular class.<sup>2</sup>

This principle underlies the theory of the "single tax" on land, developed by Henry George,<sup>3</sup> which has considerably influenced property tax policies, especially in English-speaking countries.

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<sup>1</sup> David Ricardo, *Principles of Political Economy and Taxation* (first published 1817).

<sup>2</sup> John Stuart Mill, *Principles of Political Economy* (Toronto, 1965), p. 819 (first published 1848).

<sup>3</sup> *Progress and Poverty*, Book VIII, Ch. III (first published 1879).

Although few if any fiscal experts now believe that a single tax on rents would meet the requirements of modern government, persons still defend the taxation of increments in land value as a valid principle. These persons hold that the substantial increases in value accruing to holders of urban as well as suburban and agricultural land represent a reservoir of value which can properly be tapped to meet the social needs of developing communities without adverse effects on incentives. This paper describes the major applications of this principle in different countries; it also discusses the problems encountered and the necessary conditions of the successful application of this principle.

The principal applications may be summarized as follows:

(1) Recurrent (annual) tax on land values under a property-tax system based on capital values. (This tax may take the form of a property tax limited to urban and rural land values, as in Jamaica, New Zealand, and some Australian jurisdictions, or to agricultural land values, as in some Latin American countries; or it may take the form of a differentially higher rate on land, as in parts of Canada, East Africa, South Africa, and Denmark.)

(2) Periodic tax on increments in land value. (This tax may be based on increases in land value between valuation dates even though not "realized" by sale, as in the United Kingdom and Germany early in this century, and more recently in Denmark and Italy; or it may be based on capital gains realized from the sale of land and other property, as a special tax limited to gains realized on the subdivision of urban land, or as a tax embraced by capital-gains taxes of more general application.)

(3) Special assessment, or land betterment tax, which apportions the costs of publicly created improvements among the benefiting property owners. (Such special assessments, justified by the direct benefit theory, have a long history in the United States, Canada, the United Kingdom, and many other countries.)

### **Annual Taxes on Unimproved Land Values**

Annual taxes on the value of property—including land and improvements—are widely employed. When assessed values are kept current with changing values, they provide an appropriate method for allocating the cost of government to property owners who enjoy rising real estate values. If the tax is limited to the site value of land or if land is taxed more heavily than improvements, the property tax can be made an even more effective instrument for taxing increments in value and encourag-

ing more productive use of land. This view is supported by many prominent fiscal experts.<sup>4</sup> Professor Shoup and his associates in their report on Venezuela declared: "We believe that the theoretical case for a differentiated tax, in a country with rapidly increasing urbanization, is so strong that it merits careful consideration."<sup>5</sup>

A tax on site value, resting on an economic surplus, does not impair economic incentives to make more productive use of the land. Indeed, if land is assessed to reflect its most productive use, such taxation can be employed to encourage the use of idle land and to put underutilized land to more effective use. It is argued that if the tax is assessed on the potential output of agricultural land—that is, the output which the land would yield if it were managed with average efficiency—it would give the maximum incentive to improve land and increase its output.<sup>6</sup>

The justice of such a policy is strongly defended in countries where ownership of land is sought as a refuge from inflation. The diversion of capital to investment in land tends to accentuate the rise in land prices and provides a hedge against erosion of capital values. By effectively taxing such appreciated values under a property tax, a government can better apportion its rising costs among those realizing the greatest benefits.

## APPLICATIONS

Taxes on unimproved land value have historically been applied in Australia, New Zealand, Canada, South Africa, and East Africa, and more recently in Jamaica, Trinidad and Tobago, and Barbados. Most Latin American countries limit the tax on agricultural properties to unimproved land values. Similar practices are followed elsewhere, especially in Denmark.

<sup>4</sup> For an excellent summary of the principles involved and their application, see Haskell P. Wald, *Taxation of Agricultural Land in Underdeveloped Countries* (Cambridge, Massachusetts, 1959), pp. 71–126.

<sup>5</sup> Commission to Study the Fiscal System of Venezuela, *The Fiscal System of Venezuela: A Report* (Baltimore, 1959), p. 340, hereafter cited as the *Shoup Commission Report*. (The Commission consisted of Carl S. Shoup, Director; John F. Due; Lyle C. Fitch; Sir Donald MacDougall; Oliver S. Oldman; and Stanley S. Surrey.)

<sup>6</sup> N. Kaldor, "The Role of Taxation in Economic Development," in *Problems in Economic Development*, E.A.G. Robinson, ed., International Economic Association (London, 1965), p. 179, and Haskell P. Wald, "Reform of Agricultural Taxation to Promote Economic Development in Latin America," in *Fiscal Policy for Economic Growth in Latin America*, papers and proceedings of a conference held in Santiago, Chile, December 1962, and issued by the Joint Tax Program of the Organization of American States, Inter-American Development Bank, and Economic Commission for Latin America (Baltimore, 1965), p. 326.

*Australia and New Zealand*

The original Australian federal land tax was levied at steeply graduated rates on "unimproved land value."<sup>7</sup> Federal rates are applied to the total value of land held by one individual anywhere in the Commonwealth. There is considerable evidence that the tax operated in accordance with the classical theory, by contributing to the breakup of large estates into smaller and more productive units, although the influence of the tax cannot be clearly distinguished from that of government settlement policies, which greatly stimulated this movement. The land tax, never a large revenue producer, gradually deteriorated as large estates were broken up. Finally, in 1952, the Commonwealth relinquished the land tax to the states. Unimproved land value taxes continue to be employed by the Australian states and by New Zealand, together with taxes on improvements and rental value; but because of exemptions and low rates, they no longer are fiscally important.

At present the land tax is a significant factor only in business decisions involving land with a high value—almost exclusively urban land. For this land, however, the tax can be important since industrial and commercial property reaches the maximum rate—about 3 per cent in Queensland and New South Wales—fairly quickly.<sup>8</sup>

*Canada*

Henry George's philosophy had considerable appeal in western Canada: British Columbia adopted site-value taxation before the turn of the century and the Prairie Provinces during the first decade of this century.<sup>9</sup> By 1914, two thirds of the municipalities in British Columbia (including Victoria and Vancouver), all in Alberta, and a quarter in Saskatchewan had fully exempted improvements from property tax. Since then, however, the valuation of land alone in these provinces has given way to the inclusion of buildings as well, except on agricultural land. Improvements are still favored by applying the tax only to a part of their assessed value. Today municipal taxes apply to as much as 75 per cent of the assessed value of improvements in British Columbia, 60 per cent in Alberta, 66½ per cent in Manitoba, and generally 60 per

<sup>7</sup> For an excellent historical analysis of the Australian and New Zealand property tax systems, see A.M. Woodruff and L.L. Ecker-Racz, "Property Taxes and Land Use Patterns in Australia and New Zealand," *The Tax Executive*, Vol. XVIII (1965), pp. 16–63. See also Edwin R.A. Seligman, *Essays in Taxation*, 9th ed. (New York, 1921), pp. 516–31.

<sup>8</sup> Woodruff and Ecker-Racz, *op. cit.*, pp. 32–33.

<sup>9</sup> For a brief history and critical appraisal of Canadian experience, see F.H. Finnis, "Site Valuation and Local Government," *Canadian Tax Journal*, Vol. XI (1963), pp. 118–19.

cent in Saskatchewan. Except for Ontario during 1920–24, no other Canadian provinces have ever limited the property tax to land.

### Denmark

Denmark has had a long and interesting history of land taxation.<sup>10</sup> In the tax reform of 1903, a real estate tax based on commercial values replaced the Central Government's land tax that had been in existence for almost 300 years. By 1926 a special tax on land was adopted, as advocated by the small farmers who came under the influence of Henry George's ideas. Although the entire property continued to be assessed at its market value, the land was separately assessed as if it belonged to a "middle-sized farm and was cultivated with an average effort." The difference between the two values—essentially improvements—was called the remainder value (*restvaerdi*).

The assessed value of the land was then taxed at a somewhat higher rate than the remainder value, originally 1.5 per mil against 1.1 per mil after deduction of a fixed amount. By 1937, rates were increased to 6.0 per mil on land and 4.5 per mil on the remainder. In 1957 the Central Government's tax on remainder value was frozen, and in 1961 that of all other authorities was frozen. No taxes were levied on new buildings.

Since 1930/31 the tax on land has accounted for about 60 per cent of property-tax revenues. In 1962/63 the tax on increments in land value (*grundstigningskyld*), described below, accounted for about 8 per cent of the total property taxes; hence in these years site-value taxes were about twice as important as taxes on improvements. The persistence of the Henry George school of thought is evidenced by the relative decline in the tax on improvements (*restvaerdi*) since the 1920's. However, there is mounting sentiment for abandoning the tax on land as well.

### East Africa

In contrast to the practice in West Africa, where property taxes are generally limited to the value of improvements, East Africa has successfully taxed unimproved urban land values for many years.<sup>11</sup> Except for Uganda's Kingdom of Buganda and certain plantation areas in Tanzania, there is little private ownership of land in rural areas, and therefore little scope for extensive taxation outside cities and towns. Kenya's munici-

<sup>10</sup> For a good account, see Kjeld Philip, *Skattepolitik* (Copenhagen, 1965), pp. 476–88.

<sup>11</sup> For a good survey, see John F. Due, *Taxation and Economic Development in Tropical Africa* (Cambridge, Massachusetts, 1963), pp. 102–18.

palities have employed site-value taxation for more than 30 years; Uganda's cities tax land at a rate of  $1\frac{1}{2}$  per cent, against  $\frac{1}{4}$  of 1 per cent on improvements; and Dar es Salaam and urban council areas in Tanzania have taxed only site value since the early 1950's. Cities in Rhodesia, Malawi, and Zambia also tax land at a much higher rate than the rate for improvements.

Nairobi's site-value tax is representative of the best practices in Kenya. Although most of the land is leased from the state, the discounted present value of rents is generally taken as the property base. Revaluations are required every 5 years, but every 3 years is the rule in practice. Although many problems arise, the system is believed to be much simpler than one covering improvements.

At a rate of about 2 per cent, set by the city council, the property tax accounts for almost half of Nairobi's total city government revenue. The site-value basis is accepted as highly satisfactory and is generally believed to be a major factor contributing to the city's modernization.

### *Jamaica*

More recently, Jamaica has instituted a program for the introduction of a separate tax on site value, which has gone into effect for most of its parishes. In December 1956, Jamaica's Parliament passed a Land Valuation Law which provided for the revaluation of all land and the taxation of unimproved land values. This action marked the culmination of a series of reports recommending the use of site values, dating from the turn of the century to the 1956 report of J.F.N. Murray.<sup>12</sup>

The work of revaluation was started in June 1957, in St. Catherine Parish, under the supervision of a newly created Commissioner of Valuation, and in April 1959 this parish went on the new basis. By January 1965 the revaluation had been about half completed, far behind the 5-year target period and the 3-year period originally estimated by Murray. In the process, the valuation assigned to many individual large plots was increased by as much as 30 times and more over the old valuation.<sup>13</sup>

<sup>12</sup> J.F.N. Murray, *Report to the Government of Jamaica on Valuation, Land Taxation and Rating* (Kingston, 1957). Murray recommended that a progressive rate be applied to the unimproved value of all lands held in one ownership. In addition, he recommended a flat rate based on capital value that would supplement the site-value tax.

<sup>13</sup> For a review and appraisal of this experience, see Daniel M. Holland, "The Taxation of Unimproved Land Value in Jamaica," in *Proceedings of the . . . Conference on Taxation, 1965*, National Tax Association (Harrisburg, Pennsylvania, 1966), pp. 442-70.

*Latin America*

In Latin America, agricultural property taxes are substantially limited to land values, whereas urban taxes generally cover the value of improvements as well. Property taxes are not in effect in all Latin American states (there are none, for example, in the Dominican Republic or Peru), and even where they are in effect, they have generally fallen into neglect. In recent years, however, major steps to restore the property tax have been taken in Chile, Colombia, Costa Rica, Panama, and Uruguay, where large-scale revaluation programs have been undertaken.

Taxes on property are the most important source of local government finance in Colombia. Including special assessments, they accounted for about 63 per cent of total municipal tax revenues in 1963.<sup>14</sup> Most of this revenue was realized from a general property tax with a basic rate of 4 per mil.

In 1960 the income tax law of Colombia authorized departmental capitals and cities with a population over 100,000 to impose a property tax of up to 2 per cent on developed urban land and up to 4 per cent on undeveloped urban land.<sup>15</sup> The tax is limited to land values of residential properties of over 1,000 square meters. These measures were intended to promote more efficient utilization of land, especially that held for speculative reasons, and, by increasing the availability of land, to encourage housing development. Several cities have indicated their interest, but implementation of the provision has been delayed because of the requirement that they adopt an approved master city plan which delineates the urbanized lands.<sup>16</sup>

Chile is of special interest because of the standards adopted to measure the market values of land. An appraisal of Chile's rural areas was required in 1956 for the first time; but this program failed because it depended largely on self-appraisal by the property owners themselves. The law of November 16, 1962 decreed a general reappraisal of all real property; for farmland it required that appraisals be based on scientific soil classification in terms of potential-use capacity, with appropriate adjustments for the factors of location. The revaluation, however, has been based essentially on 100 per cent of current market values of the land. Farms are appraised in terms of provincial average values; individual values are determined in consultation with a provincial

<sup>14</sup> Richard M. Bird, "Local Property Taxes in Colombia," in *Proceedings of the . . . Conference on Taxation, 1965* (cited in fn. 13), p. 482.

<sup>15</sup> Harvard Law School, *World Tax Series: Taxation in Colombia* (Chicago, 1964), pp. 138-40. These rates represent ceilings inclusive of all property tax rates except special assessments.

<sup>16</sup> Bird, *op. cit.*, p. 494.



commission of five accredited agricultural engineers. A formula was devised to calculate indices of potential-use capacity and the effect of the factors of location and distance; on the basis of this formula, individual property values were calculated by the use of a computer. The reassessment of all urban and rural properties, completed in May 1965, had the effect in general of tripling the previous assessments, slightly more on the rural side.

## EVALUATION

Despite strong support of taxes limited to site value on equity grounds (as a tax on windfall gains) and on economic grounds (as an incentive for encouraging better use of land, including more productive cultivation of the soil and capital improvements), many have objected to these taxes on grounds of possible hardships to property owners, as well as administrative feasibility and equitable apportionment of government costs.

### *Equity considerations*

One objection raised against adoption of site-value taxation is its effect on property owners who did not anticipate any increase in taxes when they bought the land.<sup>17</sup> Moreover, much land is in the hands of those who paid current values and do not enjoy any unearned increment.<sup>18</sup> Many property owners would therefore be penalized if the entire current burden of the property tax were reallocated to them; when property taxes are heavy, the current net rent of land, and hence its capital value, might be sharply reduced. However, an increase in taxes is a risk faced by all taxpayers, and the discriminatory effects of the increase must be evaluated against alternative measures. Revaluation of property for real estate tax purposes would simply result in a redistribution of tax burdens between those holding different ratios of land value to total capital value.

Professor and Mrs. Hicks expressed much concern over the effects of such redistribution on property owners in Jamaica.<sup>19</sup> Since the derating of improvements would reduce the total value of property assessed, and entail a greatly increased rate, the owners of property with little improvement would be faced with sharply increased taxes. This possibility suggests the desirability of making a gradual transition from a capital-value to site-value tax if such a step is taken. The shift to a differentially

<sup>17</sup> *Shoup Commission Report*, p. 339.

<sup>18</sup> See Dick Netzer, *Economics of the Property Tax*, The Brookings Institution (Washington, 1966), p. 209.

<sup>19</sup> J.R. Hicks and U.K. Hicks, *Report on Finance and Taxation in Jamaica* (Kingston, 1955), p. 137.

heavier tax on site value in Pittsburgh, Pennsylvania, was completed over a 12-year period.

Despite the drastic change effected by the revaluations in Jamaica, they do not appear to have had serious repercussions on the landowners.<sup>20</sup> Some large property owners were induced to sell because of the additional cost of carrying the property; although they may have realized less than they otherwise might have because of the capitalization of the increased tax, there is no evidence of actual loss by comparison with original cost. Such division of properties as occurred, of course, is consistent with the objectives of the site-value tax. One reason for the little disturbance in Jamaica is the low property-tax rate.

Some believe that the exemption of improvements of urban property may fail to allocate many costs of local government properly in proportion to the direct benefits received. Moreover, it is argued that the exemption would favor owners of luxury homes, hotels, and other valuable improvements, and tend to place a heavier burden on those less able to pay. For this reason, Murray proposed that Jamaica enact a real estate tax for municipalities covering improvements as well as land so as to apportion municipal costs more equitably.<sup>21</sup>

### *Effects on land use*

One of the principal benefits claimed for the exemption of improvements is its effect in stimulating the development of vacant sites. There is considerable evidence, for example, that site valuation in Canada helped to break up large landholdings and encouraged subdivisions.<sup>22</sup> Yet development must await favorable economic conditions for expansion, and many subdivided lands in Canada remained undeveloped for years.

Contrary to the claims made for site-value taxation, there is no evidence that the tax on unimproved land values has had much if any effect on the pattern of land use in Australia.<sup>23</sup> No differences in this respect are discernible between communities using site value and those using a broader property-tax base. This result is attributed to the homestead exemption and generally low rates. However, the earlier graduated land taxes administered by the Commonwealth of Australia and the Central Government of New Zealand undoubtedly helped to break up large estates, and contributed to the realization of the Governments' political objectives.

While admitting the merits of a site-value tax in providing an incentive

<sup>20</sup> Holland, *op. cit.*

<sup>21</sup> Murray, *op. cit.*, p. i.

<sup>22</sup> Finnis, *op. cit.*, p. 119.

<sup>23</sup> Woodruff and Ecker-Racz, *op. cit.*, p. 62.

to the improvement of land, Professor and Mrs. Hicks saw no merit in derating the value of improvements already in place. For this and other reasons of equity, they advocated instead an exemption limited to new improvements for several years after these are made.<sup>24</sup>

### *Administrative considerations*

The taxation of unimproved property values has been opposed because of the alleged difficulty of establishing separate values for land and improvements. However, experience in Australia, Chile, Jamaica, New Zealand, Uruguay, and many other countries refutes this claim. Values established in Jamaica have been found acceptable by most taxpayers;<sup>25</sup> there were many appeals but these can be expected under any reassessment program. In Australia and New Zealand these complaints are seldom heard, and experts are agreed on the administrative simplicity of appraising large numbers of land parcels by the use of modern techniques. Once bench-mark values are established in different areas, it is relatively easy to extrapolate these values to separate properties by the use of land-value maps or "cadastral maps."<sup>26</sup> Although land-value maps do not make difficult valuations easy or provide a substitute for the necessary evidence on which valuations are properly based, they should form an integral part of any system of land-value taxation.

The Hickses' report on Jamaica expressed doubts about the ability of assessors to catch the development value in their appraisals, that is, the difference between the value of land in its present use and its prospective value in future more productive use.<sup>27</sup> It is this increment that speculators anticipate in acquiring property for future development. According to Murray, however, it is precisely this value that is reflected in current market prices of land and should be accepted by the assessors, rather than its value in its present use.<sup>28</sup>

Determination of site values shares a problem common to any real estate tax: that is, the difficult technical task of instituting and maintaining assessments in line with changing property values. The establishment of a satisfactory property cadastre for any country is a major undertaking that is both time consuming and costly. The task requires not only technically skilled assessors but also a substantial government investment. This is evidenced by the experience in Jamaica: revaluation, initiated in June 1957, was only about half finished 7½ years later, in January 1965. Chile's valuation program took almost 3 years to complete; and Uruguay's

<sup>24</sup> J.R. and U.K. Hicks, *op. cit.*, p. 139.

<sup>25</sup> Holland, *op. cit.*, p. 449.

<sup>26</sup> Woodruff and Ecker-Racz, *op. cit.*, p. 58.

<sup>27</sup> J.R. and U.K. Hicks, *op. cit.*, p. 134.

<sup>28</sup> Murray, *op. cit.*, p. 6.

latest reassessment took over 5 years to complete. With the best of technical assistance and an adequate, trained staff, a minimum of 3–5 years would be required to cover a small country satisfactorily, depending on the adequacy of land records. But short cuts can be taken, especially in treating small, low-value holdings and avoiding a survey of each individual plot.

Australian and New Zealand experts forcefully argue that substantial savings in cost are realized and the quality of assessment raised if the property tax is limited to site value.<sup>29</sup> It is dangerous to generalize about costs because of differences in quality; but the institution of a cadastre by experts for a small country (40,000–50,000 square miles in area) would involve an estimated US\$3–4 million, spread over 3–4 years.

### *Other considerations*

The feasibility of site-value taxation partly depends, of course, on the system of land tenure in effect. Where agricultural property is communally owned or there is no adequate system of land registration, as in much of equatorial Africa, property taxes are impracticable.<sup>30</sup> Even here, however, the possibilities of urban land taxation are undeveloped, especially in West Africa. In the view of Professor Due, the general field of land taxation offers equatorial African states perhaps the greatest opportunity for improvement in their tax structures.<sup>31</sup> Even in East Africa and Central Africa (Rhodesia, Malawi, and Zambia), where extensive areas are owned by the state or by district councils, land taxes have effectively been assessed on the capitalized rental values of long-term leases.

Taxes on property values are also impractical in rural areas where low population densities result in low land values. However, the possibility of anticipating rising land values should not be overlooked.

### *Summary of evaluation*

Expert opinion varies on the feasibility and desirability of site-value taxation. Although it is defensible on equity grounds as a tax which rests substantially on unearned increments, some experts maintain that it fails to allocate the costs of government properly to those owning buildings which largely give rise to the government services entailed. On economic grounds, the taxation of unimproved land provides an incentive for its more efficient utilization, but a temporary exemption of improve-

<sup>29</sup> Woodruff and Ecker-Racz, *op. cit.*, pp. 58 and 62–63.

<sup>30</sup> Due, *op. cit.*, pp. 102–18.

<sup>31</sup> *Ibid.*, p. 118.

ments might accomplish much the same purpose. Opinion also differs on the comparative administrative efficiency of determining the value of land separately from the value of buildings, although the weight of expert opinion and logic would appear to support the superiority of separation. These opposing points of view may explain the middle ground taken by real estate taxes in many countries with differentially higher rates on land value.

Once a system of property taxation is established, it becomes embedded in existing values and there is great resistance to change.<sup>82</sup> Although Australian municipalities have shifted from one form to another, the effect of the tax has been mitigated by the generally low rates and the persistence of state and municipal overlapping systems which alter only the "mix," or the relative weight of tax on land and improvements. One of the most radical experiments in recent years is that in Jamaica, the full effects of which will not be known for several years.

#### CONDITIONS FOR SUCCESS

Successful implementation of a tax on land values requires not only a clear system of title registration and a well-designed tax structure but also a high order of administration. Experience in Australia, New Zealand, East Africa, Canada, and elsewhere points to the following minimum standards:

(1) Site value should be interpreted not as value in current use (or "use value") but as the capital sum which the title to the land might be

<sup>82</sup> One of the few systematic comparisons of the alternative systems of property taxation in the United Kingdom was made by the Committee of Enquiry of the Ministry of Housing and Local Government on the Rating of Site Values, over a five-year period, 1947-52. Although a majority of the Committee declared against a site-value system, the minority supported it. Skepticism about the merits of site valuation, which apparently originated in institutional and legal factors, is evidenced by the following excerpts from the majority report: "On the main issue before us of whether the imposition of a site value rate is practicable or desirable, the great preponderance of evidence was opposed to the introduction of such a rate, and we were impressed by the reasoned arguments both in regard to its undesirability and the practical difficulties in respect of its application" (Ministry of Housing and Local Government, Scottish Home Government, *The Rating of Site Values: Report of the Committee of Enquiry* (London, 1952), p. 72). The Committee took as its terms of reference the Town and Country Planning Act, 1947 (described in the Appendix), which limited its consideration to value in use. The Committee concluded that "the only effect of a site value rate on existing use value would be a shift of burden as between individuals and classes of property," but that there was "no evidence that there would be either advantage or equity in altering the relative amount of rates borne by those classes of property or persons" (*ibid.*, p. 76). Moreover, the Committee was impressed by the administrative difficulties, the prospects of litigation, and the undesirability of diverting much-needed manpower for the relatively small revenues involved. The minority report, however, concluded that "the rating of site values is both practicable and desirable" (*ibid.*, p. 97), and charged that the majority's adherence to a concept of "the existing-use value" vitiated the conclusions reached (*ibid.*, p. 77).

expected to bring in a bona fide sale, regardless of use. Also, the tax base should be defined as "site value" rather than the value of unimproved land.<sup>83</sup> Improvements are generally defined to include both visible and invisible site improvements such as the cost of clearing land and drainage. The concept of site value employed in the recent statutes of Jamaica, Trinidad and Tobago, and Barbados does not exclude the value of such invisible, nonstructural improvements.

(2) Assessment should be organized in single departments covering areas large enough to support qualified experts. For most countries this may mean a centralized cadastre covering both urban and rural areas, properly decentralized for administrative efficiency. A good example of such organization is provided by Uruguay, which has an independent commission (*Dirección General de Catastro y Administración de Inmuebles Nacionales*) responsible to the Minister of Finance. This office is charged with the valuation of all urban and rural real estate in Uruguay and the maintenance of up-to-date records of property ownership. It records all property transfers and thus maintains an inventory of all privately held real estate in the country, including its description, ownership, and assessed value. It operates through 19 field officers—one in each department of the country.

(3) Personnel should be of professional quality, trained in the latest techniques of property-tax administration and valuation procedures. They should desirably hold civil service status so as to maintain independence from political influence.

(4) Assessments should be kept current, on a systematic basis, with 4–5 year reassessments legally required and adequately supported by budgetary appropriations. More frequent reassessments should be undertaken in areas of rapidly changing values, such as urban and suburban developments. Under inflationary conditions, where the general price level is rising rapidly, interim adjustments by the use of indexes should be made.

### **Taxation of Increments in Land Value**

Rather than levy an annual low-rate tax on the value of land periodically reassessed to reflect whatever changes in value may have taken place, as described above, many governments have attempted to tax the increases in the value of land (or total property) over a period of time. Such taxes may be levied at the time of transfer of the property or on periodic unrealized increases in value. In many countries, realized

<sup>83</sup> See Woodruff and Ecker-Racz, *op. cit.*, p. 34.

increments on the sale or exchange of real estate are covered by capital-gains taxes; but in some countries, special provisions for taxing increases in real property values exist independently. The latter provisions are generally calculated to assess the so-called development value or increase in value of land converted from agricultural to industrial or residential use.

## EARLY HISTORY

One of the earliest experiments in the taxation of increments in land value originated in the German colony of Kiauchau, China, in 1898. Anticipating the considerable increases in land values that would result from large expenditures for the construction of harbors and other public improvements, the Government took measures to ensure that part of the gains would be recouped.<sup>84</sup> The famous land ordinance of 1898 provided for both a direct increment tax (*direkte Zuwachssteuer*) and an indirect increment tax. The former imposed a tax equal to one third of the increase in value after deducting the cost of improvements; the latter enacted a similar tax on the increase in value every 25 years.

The Kiauchau experiment with a tax on unrealized increments in value attracted the attention of German municipalities; beginning in 1904 with the city of Frankfurt, its use spread by 1910 to about 4,500 cities and towns, covering about one fourth of the total German population. The tax was generally applied to the difference between the last purchase price and the current selling price of the real estate, with an exemption for the cost of improvements. The rate was typically graduated with the percentage increase in value, with no tax on the first 10–30 per cent increase in value, and rose to a maximum rate of 25–30 per cent.

In February 1911, these municipal taxes were superseded by a new German Imperial Increment Tax Law (*Wertzuwachssteuer*), under which the tax applied to the increment in the whole value of rental property, with 40 per cent of the proceeds going to the municipalities and 10 per cent to the states to cover cost of administration. The tax was graduated along similar lines, reaching a rate of 30 per cent on all increments of value over 290 per cent of the 1885 value.<sup>85</sup> In 1913, the Imperial Government replaced this law by a new act (*Besitzsteuergesetz*), which provided for a graduated tax on increments in property

<sup>84</sup> For a good description of this and similar German taxes, see Seligman (1921), *op. cit.*, pp. 505–15. On the enactment of the imperial tax referred to below, see Gustav Cohn, "Taxation of Unearned Increment in Germany," *The Economic Journal*, Vol. XXI (1911), pp. 212–22, and Karl Bräuer, "Wertzuwachssteuer (Grundstücksgewinnsteuer)," in *Handwörterbuch der Staatswissenschaften*, Vol. VIII (Jena, 1928), pp. 1017–42.

<sup>85</sup> J.C. Stamp, "The Incidence of Increment Duties," *The Economic Journal*, Vol. XXIII (1913), p. 201.

value over 3-year periods, the first falling due on December 31, 1916.<sup>86</sup> The rate ranged from  $\frac{3}{4}$  of 1 per cent to  $1\frac{1}{2}$  per cent on the increased value. This tax was superseded by the Act of 1922, which imposed a tax graded from 1 per cent to 10 per cent, depending on the amount of the property (*Vermögenszuwachssteuer*);<sup>87</sup> it was repealed in 1925.

In Great Britain, the Finance (1909–10) Act imposed a somewhat more comprehensive tax on increments in the site value of land.<sup>88</sup> The tax was payable on all land on the following occasions: (1) sale, (2) lease for more than 14 years, (3) transfer at death of owner, and (4) after 15 years during which the land had not changed hands. The tax of 20 per cent applied to an increase in site value over its value at April 30, 1909. Exemptions were provided for the first 10 per cent increase in value, as well as for certain agricultural land, the value of small holdings, and leases of tenements or flats in an apartment house. In order to fix the initial values as at April 30, 1909, the Government undertook a cadastral survey of all landholdings in the United Kingdom, comparable in scope to the eleventh-century Domesday Book.

This tax encountered considerable legal problems, and the basis of valuation of land was declared invalid because it failed to comply with the statute. In the budget for 1920/21, the Chancellor of the Exchequer declared that the 1910 duties were unworkable and had produced little revenue. Accordingly, the Act was repealed in the Finance Act of 1920, and the revenue was returned to the contributors.<sup>89</sup>

#### TAXATION OF UNREALIZED INCREMENTS

In recent years, few attempts have been made to tax increments in land value before they are realized by a sale or another form of transfer. The taxation of realized capital gains, described below, has been found to be a more fruitful approach.

<sup>86</sup> Gustav Cohn, "German Experiments in Fiscal Legislation," *The Economic Journal*, Vol. XXIII (1913), pp. 544–45, and Edwin R.A. Seligman, "Comparative Tax Burdens in the Twentieth Century," *Political Science Quarterly*, Vol. 39 (1924), pp. 124–25.

<sup>87</sup> T. Pistorius, "Direkte Zuwachs- und Kriegsgewinnsteuer," in *Handbuch der Finanzwissenschaft*, Vol. 2 (Tübingen, 1927), p. 175. In 1919, a special tax was imposed on individuals on the increment of all property value (*Kriegsabgabe vom Vermögenszuwachs*), graduated from 10 per cent on the first DM 10,000 to 100 per cent on increases over DM 375,000 (*ibid.*).

<sup>88</sup> H. Ronald Parker, "The History of Compensation and Betterment since 1900," in *Land Values: The Report of the Proceedings of a Colloquium Held in London on March 13 and 14, 1965, Under the Auspices of the Acton Society Trust*, Peter Hall, ed. (London, 1965), pp. 65–72. See also Seligman (1921), *op. cit.*, pp. 491–94.

<sup>89</sup> *The Rating of Site Values* . . . (cited in fn. 32), p. 20.



*Denmark*

Denmark's *grundstigningskyld* offers perhaps the best modern example of a tax on unrealized increases in land value.<sup>40</sup> Enacted in 1933, it provided for a tax on increases in the real value of land between two assessment dates, taken at 4-year intervals. Initially the tax base was determined after deduction of (1) a market supplement, calculated as a percentage of the original value to reflect the general increase in land values, and (2) an assessment error, usually 10 per cent of the original land value. The original base was one half of the increment less the deduction for the supplement; in 1950 the base was increased to three fourths of the increment; and in 1958 the full amount of the increment was made taxable and the deduction for the assessment error was eliminated.

The tax, at an annual rate of 4 per cent, was intended to reflect a "normal rate of interest." Since the interest on long-term mortgage loans averaged 5 per cent in the 1940's and 6 per cent in the 1950's and in recent years has exceeded 8 per cent, the tax did not succeed in fully capturing increments in land value due to rising economic rents.

At the time of its abolition, in 1964, the *grundstigningskyld* accounted for about 8 per cent of all property-tax revenues. Its repeal reflected a growing sentiment for the abolition of all property taxes in Denmark.

*United Kingdom*

Since 1947, the United Kingdom has undertaken an interesting experiment in controlling the development of land under a system whereby the development value is captured by the state.<sup>41</sup> The Town and Country Planning Act of 1947 provided that all development of land required planning permission. The owner of land could buy back the right to develop land only by paying a "development charge," which was supposed to be equal to the difference between its value in use and its market value for new development purposes. Any private builder who intended to develop or change the use of his land had to apply for planning permission and to pay the "land charge" equal to 100 per cent of the development value. The Central Land Board, established to administer the Act, could also buy land on a compulsory basis in order to dispose of it for development.

The Central Land Board was not successful in achieving its objective of capturing the development value. Most transactions in land were

<sup>40</sup> See Philip, *op. cit.* This tax evolved out of the "railroad levy" introduced in 1910 to tax increases in land value induced by the railroad. It was made available to municipalities in 1926.

<sup>41</sup> See Appendix, p. 116, for a more detailed review.

undertaken at prices higher than the existing-use value, and an increase in the costs of building was not prevented.<sup>42</sup> This can be explained partly by the fact that the 100 per cent "development charge" did not leave an inducement for the owner to develop his site, and if he sold his land he asked for more than the existing-use value; the purchaser was liable not only for the "development charge" but also for the excess price to the seller. In 1953 the "development charge" was removed, and one year later all private restrictions on sales of land were abolished. Development of a two-price system for land—one for land compulsorily purchased and the other for free, private sales—finally forced the Government in 1959 to adopt the market value as the basis for compensation paid on occasions of compulsory purchase.

Finally, in 1965, the British Government proposed the establishment of a special Land Commission, which would have the powers of compulsory purchase of land and of imposition of a levy on the development value of land.<sup>43</sup> The Government's two main objectives are (1) to ensure that the right land is available at the right time for the implementation of national, regional, and local plans and (2) to ensure that a substantial part of the development value created by the community is returned to the community.

The Land Commission proposal includes payment of a land levy on the development value of land. This development value is defined as the increase in value attributable to the prospects of "material development," as distinguished from the value in current use. The basis for determining the development value is the market value of the land at the time when it reflects the increment in value due to development, for example, its change from agricultural use to housing. Anyone whose land has risen in value between the time of purchase and the time he develops it will have to pay the levy in addition to the cost of development; the levy applies even to the additional value that accrues during the construction period.

The initial rate of tax proposed is 40 per cent, with provision for increasing it to 45 per cent and eventually to 50 per cent. The Government decided to exclude the development value from the recently enacted 30 per cent tax on long-term capital gains and to consider the land levy an allowable expense in the case of the short-term capital-gains tax.

<sup>42</sup> *Central Land Board: Report for 1950-51*, House of Lords Papers and Bills (London, 1951).

<sup>43</sup> Minister of Land and Natural Resources and the Secretary of State for Scotland, *The Land Commission*, Cmnd. 2771 (London, 1965), hereafter cited as *The Land Commission*, Cmnd. 2771.

*Italy*

In 1963, Italy enacted a tax on increases in the value of building lots, which all communities with a population of 30,000 or more are required to impose.<sup>44</sup> This new tax replaced a "specific" betterment contribution on increases in value of developed rural and urban property. The basis of the new tax is the increase in value over a period of 10 years, as measured by the difference between the initial and the final value of the lot determined by assessment for registration and succession taxes. The tax is to be imposed 10 years from the date of enactment and every succeeding 10 years afterward. However, to accelerate the application of the tax and to increase its yield, the Government authorized communes to impose the tax retroactively as at the time of its enactment, with respect to the previous 10-year increase in value.

The rates are based on a complex progressive scale, depending on the average annual rate of gain over the initial value. Rates range between 15 and 30 per cent of the increase in value.

**TAXATION OF REALIZED INCREMENTS**

In recent years, a number of countries have enacted special taxes on the increment in the value of land realized at the time of its transfer. Many of these are aimed at the gains on the sale of property that have accompanied the expansion of urban areas. Examples may be found in the Middle East, Africa, Asia, and South America. In other countries, capital gains on the sale of real estate are covered by a capital-gains tax of general application.

*Israel*

The special tax on gains realized from the sale of land is illustrated by Israel's Land Betterment Tax, introduced in 1949 and amended in 1963.<sup>45</sup> The tax is based on the difference between the sales price and acquisition cost of real estate. The tax rate varies with the relative size of the unearned increment and the length of time the land is held. The rate is 20 per cent if the increment does not exceed 200 per cent; 30 per cent if it is between 200 and 400 per cent; and 40 per cent if it

<sup>44</sup> Harvard Law School, *World Tax Series: Taxation in Italy* (Chicago, 1965), pp. 265-70.

<sup>45</sup> *Bulletin for International Fiscal Documentation* (Amsterdam), Vol. XVIII (1964), pp. 13-14. The law was amended in 1963 because of widespread evasion of the original tax, which was based on transfer of legal ownership via registration with the Land Registry Office. Speculative transactions remained untaxed because of failure to register the transfer. The new tax applies to the mere transfer of contractual rights in land.

exceeds 400 per cent. These rates apply if land is transferred within 2 years; a rate reduction of  $\frac{1}{2}$  per cent a year is made for the next 13 years, and 1 per cent for every year thereafter. If the betterment tax does not exceed I£ 1,500, the assessee is exempted; if the tax is between I£ 1,500 and I£ 2,000, the rate is halved. In 1963/64 the betterment tax accounted for 24 per cent of total property-tax collections, but for only about 1 per cent of total tax revenues.

### *Africa*

Special provisions for the taxation of long-term capital gains in Africa below the Sahara are a recent innovation. In April 1965, Ghana introduced a tax on capital gains realized from the sale of land, buildings, and business assets; sales of agricultural land are exempted, thus limiting the tax to gains realized on urban property. The tax rate ranges from 50 per cent on assets held 1–7 years to 10 per cent on assets held 21 years and over. The Malagasy Republic taxes gains realized from the sale of land at rates graduated from 10 per cent on gains of FMG 80,000–500,000 to 30 per cent on those in excess of FMG 1,000,000. Information on experience with these taxes is not available.

### *Latin America and elsewhere*

In Latin America, capital-gains taxes limited substantially to real property are in effect in several countries. In 1946, Argentina extended the coverage of its income tax to certain capital gains, at a 20 per cent rate. Since then the law has undergone many changes in coverage and rates; in 1961 a general rate of 5 per cent was introduced, and on January 1, 1963, gains from the sale of urban subdivisions were made subject to a 10 per cent rate. Bolivia has had, since 1958, a 4 per cent tax on gains realized from the sale of urban real property and a 10 per cent rate on gains realized from the sale of rural property. Colombia's capital-gains tax, enacted in 1960, is limited to gains realized on the sale of real estate. The basic rate is the normal income tax rate, ranging from 5 per cent to 51 per cent; capital gains as calculated for purposes of this tax are reduced by 10 per cent for each year the property is held (including the years before the capital-gains tax was introduced). Gains realized on the sale of real estate are also covered by provisions of the income tax laws in Brazil, Chile, Ecuador, El Salvador, Mexico, Panama, Peru, and Venezuela.

Other developing countries, such as India, Indonesia, Pakistan, and the Philippines, also have capital-gains taxes of general application, including gains realized on the sale of real estate. In the Republic of

China the Agrarian Act of 1946 instituted a special tax on the net increment in value of land, levied when the land is transferred or, in the absence of transfer, after 10 years.

#### EVALUATION OF TAXATION OF INCREMENTS IN LAND VALUE

Properly designed and administered, special taxes on increases in the value of land can capture for the government increments in land value that accrue to property owners. They can be justified on equity and economic grounds as taxes on unearned increments that reflect, in large part, community-created values stemming from the growth of population and increased urbanization. Such taxes on gains, nevertheless, are subject to certain limitations as to revenue yield, equity, economic effects, and administration, that tend to restrict their effectiveness.

##### *Revenue yield*

Although reliable data are scanty, there is reason to believe that such taxes have produced little revenue. This situation is attributable not only to ineffective enforcement but also to the relatively small share of personal income represented by capital gains realized on the sale of property. Because of various exemptions and adjustments and the need for moderate rates (described below), the potential yield has been small—equivalent perhaps to no more than 2–3 per cent of the personal income tax. We have seen that the tax on unrealized increments contributed about 8 per cent of Denmark's property-tax revenues, and 24 per cent of Israel's property-tax revenues and 1 per cent or less of its total tax revenues. The British land values duties imposed by the Finance (1909–10) Act yielded meager revenues, which were finally refunded.

##### *Effect of inflation*

It is virtually impossible to isolate the real appreciation in property values from the effects of the inflation which tends to characterize many developing countries. Attempts to adjust prices of land by commodity or other price indexes may mitigate this problem somewhat. Many countries provide for the arbitrary exemption of portions of the increases in the value of property, depending on the length of the period for which it has been held; others adjust the original cost by a price index. The reduction of rates as the length of the holding period increases tends to offset inflationary effects, but any such rate schedule cannot anticipate the rate of inflation, if any, and is bound to be arbitrary.

On the other hand, some experts deny the need for such an adjustment for inflation, maintaining that property holders are especially sheltered

against a decline in the value of money. The purchase of real estate is an established hedge against general price increases, and, it is argued, no one is in a better position to pay taxes under these conditions than large landowners.

### *The lock-in effect of high taxes*

Taxes based on the realization of increments in property values tend to inhibit the sale of land and result in higher reservation prices. If tax rates are very high, this lock-in effect may result in substantial withholding of property from development. At the same time, such a tax tends to curb speculative land transactions. The strengthening of Israel's Land Betterment Tax in 1963, for example, is reported to have brought speculative land transactions to a standstill and to have resulted in a considerable reduction of prices outside big cities.<sup>46</sup> One virtue of the taxation of unrealized increments in value—such as annual taxes on unimproved land values—is to spur more productive use of the land through its sale or improvement. Rather than tending to enhance the value of land through locked-in gains, it encourages sale and therefore lower land values.

### *Administrative problems*

Taxation of increments in land value (or development value) encounters serious administrative problems. As regards realized gains, not only is it sometimes impossible to identify all transactions resulting in effective sales or transfers of ownership, but it is also difficult to establish the gains because of the ease with which both the original cost and the price at which the sales took place can be concealed. Countries with an efficient system for the registration of titles to land have a check at least on the transactions that are registered. The revenue administration office needs only provide for an effective reporting system by the land registrars. However, it is possible to avoid the tax by arranging contracts of sale without actually effecting transfers of title, as is reported to occur in Israel; avoidance may also be accomplished by incorporating a land company and effecting changes in ownership through sale of bearer stock. Unusual technical and legal problems may arise in the administration of some types of land increment taxes, as illustrated by the United Kingdom's 1947 Act to recapture development values.<sup>47</sup>

<sup>46</sup> E.W. Klimowsky, "Capital Gains Taxation in Israel—Modifications," *Bulletin for International Fiscal Documentation*, loc. cit., p. 455.

<sup>47</sup> For a review of these problems and conditions for a successful program, see P.H. Clark, "Site Value Rating and the Recovery of Betterment," in *Land Values* . . . (cited in fn. 38), pp. 73–96.

Taxation of increments in land value is greatly facilitated by a system of property taxation. A property cadastre is of course indispensable to the administration of a tax on unrealized increments. Such a tax is no better than the reliability and efficiency with which such a cadastre is maintained and kept up to date. A cadastre of current real-estate values also facilitates the effective administration of a tax on gains realized from the sale of land. It is not only important to the establishment of original cost, or the cost as of the date of enactment of a land increment tax; it is also a useful bench mark with reference to which current sales values can be confirmed. Because of the ease with which sales prices can be falsified, some countries set a minimum price at the cadastral value; this is frequently adjusted by an index of land prices based on changes in the cost of living or in rents.

### Special Assessments (Land-Betterment Taxes)

Another major device for taxing increases in the value of property is the special assessment, better known in the United Kingdom and elsewhere as a land-betterment tax. A special assessment may be defined as "a compulsory contribution, levied in proportion to the benefits derived, to defray the costs of a specific improvement to property undertaken in the public interest."<sup>48</sup> Such a betterment tax is defended by the principle that "persons whose property has clearly been increased in market value by an improvement effected by local authorities, should specially contribute to the cost of the improvement."<sup>49</sup>

#### HISTORICAL BACKGROUND AND PRESENT-DAY USE

Special assessments were instituted in England in 1662, when the city of Westminster was authorized to charge the cost of widening the streets to the abutting property owners in proportion to the benefits received.<sup>50</sup> A similar system was introduced in colonial America by the Province of New York, in 1691, when an act authorized the Common Council of Cities to impose a tax in proportion to the benefits received from public

<sup>48</sup> Seligman (1921), *op. cit.*, p. 414.

<sup>49</sup> *Report from the Select Committee of the House of Lords on Town Improvements (Betterment)*, 1894 (cited by Seligman (1921), *op. cit.*, p. 433). The Uthwatt Report (*Expert Committee on Compensation and Betterment, Final Report*, Cmd. 6386 (London, 1942)) attempted to expand the concept of betterment to include the "enhancement in the value of property arising from general community influences, such as the growth of urban population" (pars. 260 and 276). This study follows the more restricted concept.

<sup>50</sup> Victor Rosewater, *Special Assessments: A Study in Municipal Finance* (New York, 1893), p. 9.

improvements. In the United States, this method of financing local improvements was used increasingly, until by 1893 it was authorized by the legislatures of 42 of the 44 states then existing. At the peak of its popularity, in the 1920's, many U.S. cities financed 20 per cent or more of their budgets this way. During the depression of the 1930's, however, special assessments declined. By 1960 they accounted for only 2.5 per cent of city revenues.<sup>51</sup>

Special assessments are also employed in many other countries, not only within the British Commonwealth but also in Latin America.

In 1947, Venezuelan governments at all levels were authorized to use the special-assessment device.<sup>52</sup> The law provides for a levy of up to three fourths of the increase in value of property arising from public improvements (such as widening of streets, avenues, or plazas and construction of irrigation or drainage projects) which benefit the property. To establish the increase in value, the law provides for an appraisal before and after the improvement. The contribution required may be paid immediately, or in 10 annual installments with the addition of a 25 per cent charge. Apparently little use has been made of this provision.<sup>53</sup>

In Colombia, the department capitals and other cities with over 25,000 population are empowered to assess the cost of public improvements to benefiting property owners.<sup>54</sup> Municipalities have considerable flexibility in making special assessments, and they need not be limited to the cost of improvements but may tax the amount of increases in land values. The usual practice is to assess the actual or budgeted cost plus 20 per cent. The assessment is usually payable over a period of years into a special revolving fund which is used to finance public works.

Special assessments in Colombia in recent years have yielded about 30 per cent of property tax revenues.<sup>55</sup> Their importance, however, varies considerably from department to department. In 1959, they accounted for as much revenue in Bogotá as real property taxes—15.2 per cent of total revenues.<sup>56</sup>

In Ecuador, the *Ley de Régimen Municipal* authorizes municipalities to levy special assessments on property owners whose property increases in value as a result of a public improvement. The levy is 20 per cent

<sup>51</sup> International 'City Managers' Association, *Municipal Finance Administration*, 6th ed. (Chicago, 1962), hereafter cited as *Municipal Finance Administration*, p. 114.

<sup>52</sup> *Ley de Expropiación por Causa de Utilidad Pública o Social*.

<sup>53</sup> Shoup Commission Report, p. 337.

<sup>54</sup> Joint Tax Program of the Organization of American States and the Inter-American Development Bank, *Fiscal Survey of Colombia* (Baltimore, 1965), p. 136.

<sup>55</sup> Bird, *op. cit.*, p. 492.

<sup>56</sup> *Fiscal Survey of Colombia* (cited in fn. 54), p. 140.



of the difference in the cadastral value before and after the improvement. Payment may be made in a lump sum or in 10 annual installments, at the option of the assessee.

Uruguay also makes extensive use of special or additional property-tax rates to finance public improvements such as sanitation, highways, bridges, and streets. Since 1919, for example, the National Government has levied taxes on those benefiting from sanitary improvements. Urban and suburban properties are subject to a rate of 1 per mil, and rural properties to 2 per mil on property values in excess of Ur\$100,000. Montevideo levies special rates on property abutting city road projects such as the *Rambla Sur*, *Rambla Costanera*, and *Ave. Agraciada*.

Greece also has a system of betterment levies. Property benefiting from new public works is subject to 15 per cent of the consequent increase in its capital value as ascertained on completion of the work, provided the total amount charged does not exceed 50 per cent of the cost.<sup>57</sup> The levy is payable in six annual installments, except that the whole becomes due upon transfer of ownership.

## PROCEDURES

The procedures for special-assessment financing in the United States provide a good example of modern practice.<sup>58</sup> These procedures generally offer the affected property owners two opportunities to be heard—first, on whether or not the improvement should be authorized and, second, on the amount of assessments to be levied against each property. The following pattern, in general, is followed:

- (1) Initiation of the project by property owners, administrative recommendation, or the city council.
- (2) Adoption by the city council of a resolution authorizing an investigation and setting a hearing date.
- (3) Preparation of an administrative report analyzing need, estimated cost, boundaries of benefiting property holders, and similar matters.
- (4) Holding of public hearing, on sufficient notice, on whether improvement should be authorized.
- (5) Adoption by the city council of a resolution of intent to proceed. This presents the nature of the improvement, describes the benefit district and method of payment, authorizes advertising for bids, orders preparation of assessment roll, and sets the date for a public hearing.
- (6) Obtaining of bids (or estimates prepared by engineering department) and preparation of the assessment roll.

<sup>57</sup> George Break and Ralph Turvey, *Studies in Greek Taxation*, Center of Planning and Economic Research (Athens, 1964), p. 82.

<sup>58</sup> *Municipal Finance Administration*, pp. 111–30.

- (7) Holding of public hearing on amounts of assessment.
- (8) Confirmation of assessment roll and awarding of contract.

#### ALLOCATION OF COST

A major question arises as to how much of the cost of the improvement should be allocated to property owners directly affected and how much to the rest of the community. This allocation revolves on a decision of how much of the improvement is a special benefit as distinguished from the benefit enjoyed by the community at large. In some states, this allocation is prescribed by law; in others, standard formulas have been developed depending on the nature of the improvement and its location. About 80 per cent of the cities in the United States share part of these costs.

Determining the most equitable method of allocating the cost of the special benefit is perhaps the most difficult part of the special-assessment process. Authorizing laws generally provide that the cost must be charged in proportion to the special benefits conferred. Five major methods are employed:

(1) The front footage method is the most common one in the United States.<sup>59</sup> According to this method, the total frontage facing the improvement is divided into the cost, and the number of feet of each parcel fronting the improvement is multiplied by the cost per foot. This method is most suitable for sidewalk, curb, and gutter improvements, but it disregards the depth, value, and location of the lot.

(2) The area method takes into account the entire zone of improvement, with the cost proportioned to the total area of each lot benefited. This method is employed most frequently for sewer construction.

(3) Another method sometimes used is the value of the unimproved land. This method is limited by the fact that two pieces of land of equal value may not benefit equally from the improvement.

(4) The benefit zone method is a refinement which takes into account the proximity of the land to the improvement as well as the front footage. This method may be especially suitable for streets, parks, parking lots, and like improvements.

(5) The fifth method uses the actual cost of the work done for each parcel.

Attempts to measure the value of the land before and after the improvement as a basis for allocating the cost are bound to be arbitrary in practice because of the well-known lack of precision in establishing

<sup>59</sup> *The Municipal Year Book, 1959* reported that 570 of 835 reporting cities use the method exclusively, and 183 use a combination of footage and area (*ibid.*, p. 121).

values, especially in the absence of market transactions. If an undue part of the cost of improvements is imposed on benefiting property, public improvements may be deterred by the resistance of property owners, especially when the assessment exceeds the cost of the project.<sup>60</sup>

### FINANCING METHODS

Unless the assessment against each property owner is modest, some means must be found to finance payment of the charge over a period of years. In the United States, advance payments are often obtained for smaller projects; assessments are made on the basis of estimates, and payment is made while the construction progresses. For most improvements, however, special-assessment bonds are issued. Preferably, these are serial bonds secured by a lien on all the properties in the special-assessment area. Some cities establish revolving funds, financed by the issuance of general credit obligations. Special-assessment collections over a period are used to replenish these funds and make capital available for future projects. Other cities give special liens or warrants on the property to the contractor, who may sell them to banks; this method is strongly condemned because it generally results in inflating the cost of the improvement.

### RECENT DEVELOPMENTS

Special assessments traditionally have been employed in urban areas to finance suburban developments as well as improvements to older areas of the community. More recently, however, they have found a new role in financing nonurban projects that offers promising prospects.

#### *Urban and suburban financing*

Special assessments, though in widespread use in one form or another, apparently are declining in importance for financing urban developments. In the United States they reached their peak during the boom of the 1920's; during the ensuing Great Depression, many special-assessment securities defaulted, and security holders lost heavily because the securities had no backing other than the property of the assessees.

Today, U.S. cities have become more selective in their use of special assessments. The method of financing subdivision improvements especially has greatly altered. As a result of new planning and zoning requirements, contractors are increasingly being required to undertake the necessary improvements in advance of subdivision, recouping the

<sup>60</sup> Cf. Bird, *op. cit.*, p. 492.

cost in the sale or lease of the property.<sup>61</sup> Moreover, Federal Housing Authority regulations require urban facilities to be completed before mortgages are insured. The cost of the improvements is then incorporated in the sales price of the building, and is usually financed over a period of years in the amortization of the mortgage on the property. Temporary financing is furnished through construction loans.

### *Agricultural areas*

Increasing recognition is being given to the financing of improvements in nonurban areas through the use of special assessments. There seems to be a definite place for special-assessment financing in the fiscal programs of developing countries. Its precise role in any individual country depends on the size and composition of the public program and the comparative suitability of other financing methods.

The special-assessment technique appears to be especially well-suited to drainage, flood control, and irrigation projects, and to be somewhat more limited in financing highway transportation projects. One of the best-known projects financed by special assessment was the \$33 million Miami (Ohio) Flood Control Project, involving the apportionment of costs to 77,000 separate parcels of property.<sup>62</sup> The methods employed here were so successful that it has served as a model for many subsequent projects of the same type. The general principle involved in apportioning the cost was based on the estimated difference in value of property with and without flood protection.

Because property owners are in effect purchasing an improvement to their property, it is important to give maximum weight to the benefit-cost aspect of the project. One of the best safeguards is to limit the special-assessment technique to projects where the benefit-cost ratio is especially high. This policy will better ensure that the price to each property owner is within reasonable limits of the benefits received. (The benefits of the Miami Flood Control Project were estimated at \$77 million, against a cost of \$33 million.)

Several developing countries have provided for the financing of irrigation projects through this technique, sometimes in connection with land-reform programs. The 1946 Agrarian Law of the Republic of China instituted a construction benefit charge similar to a special assessment to meet the costs of agrarian and water improvements. In Colombia, the Land Reform Act of 1961 provides for the payment of a "betterment"

<sup>61</sup> *Municipal Finance Administration*, p. 114.

<sup>62</sup> See International Bank for Reconstruction and Development, *The Use of Special Assessments to Finance Development Projects*, Appendix I (unpublished mimeographed paper, July 15, 1953).

tax on land benefiting from irrigation projects, collected on unexpropriated land in irrigation districts. In Tunisia, 1960 and 1963 legislation on land reform in irrigation zones requires the owners of the land benefited to contribute their share of the cost either in the form of a parcel of land or the proceeds of its sale.<sup>68</sup>

As we have seen, it will usually be necessary to allow property owners to pay their special assessments over a period of years, unless the amounts are small. In the interim, the authorities must find a means of financing the improvement outlays. This may be a difficult task in less developed countries where bonds cannot be readily sold to local investors. It is also necessary to take account of the delay in collection of special assessments in evaluating the possible inflationary effects of a project that is to be paid for in this way.

<sup>68</sup> See E.H. Jacoby, "Problems of Land Taxation," *Information on Land Reform, Land Settlement and Co-operatives*, Food and Agriculture Organization, No. 2 (Rome, 1965), pp. 9-10.

## APPENDIX

### British Taxation of Increments in Value of Land After World War II <sup>64</sup>

In September 1965, the British Government submitted a White Paper to Parliament proposing the establishment of a special Land Commission, which would have the authority to purchase land on a compulsory basis and to impose a levy on its development value.<sup>65</sup> The Government's proposal has two main objectives: (1) to ensure that the right land is available at the right time for the implementation of national, regional, and local plans and (2) to ensure that a substantial part of the development value created by the community is returned to the community, thereby reducing the cost of land for essential purposes.

The Government's proposal has to be understood in the light of postwar attempts to implement control over development planning and to tax increments in land value within the framework of the Town and Country Planning Act, 1947, as amended in 1952, 1953, 1954, and 1959. The 1965 White Paper proposing the establishment of a Land Commission would further amend this Act.

#### Development Charge—Town and Country Planning Act of 1947

In 1947 the Labor Government passed the Town and Country Planning Act for the purpose of gaining effective control over all types of physical development—i.e., "the carrying out of building, engineering, mining or other operations, in, on, over or under land, or the making of any material change in the use of any buildings or other land." Thus, the Act provided that all land development

<sup>64</sup> Prepared by Carl-Heinz Tretner, economist in the Fiscal Affairs Department. Mr. Tretner studied at the University of California in Los Angeles, the Institut d'Etudes Politiques in Paris, and the University of Cologne, where he was an assistant. Before joining the Fund staff, he was assistant treasurer with the German branch of an international oil firm.

<sup>65</sup> *The Land Commission*, Cmnd. 2771.

required planning permission. Indeed, it took away the existing rights to develop the land possessed by many owners, and transferred the financial benefits from the development of land to the state. The owner of land could buy back the right of development from the Central Land Board, by paying a so-called development charge, which was supposed to equal the difference between the value of land with and without the benefit of permission to carry out certain specified developments. In this way, the element of development value should be eliminated from the market price of land, and the price of land should be expected to equal its value for "existing use." In addition, the Central Land Board was authorized to buy land on a compulsory basis in order to dispose of it for development.

On the one hand, any private builder who intended to develop or change the use of his land had to apply for planning permission and subsequently had to pay the "land charge," which comprised 100 per cent of the development value. On the other hand, those who were refused permission to develop were, in general, not paid any compensation. However, if land became incapable of reasonably beneficial use in its existing state, and permission to develop was refused (or was granted subject to conditions which prevented its being made capable of reasonably beneficial use), the owner could serve on the county borough or county district council a purchase notice requiring them to buy the land. If the Minister of Town and Country Planning agreed that the land was not capable of reasonably beneficial use in its existing state, the council was required to buy the land at its existing-use value. Furthermore, compensation was payable if another permission of less value was granted.<sup>66</sup> This compensation was equivalent to the depreciation of the value of the land as a result of the Act. It was aimed at covering mainly land acquired prior to the Act at prices which included a prospective development value.

### Experience

The "development charge" was not envisaged as a tax at all, but as the freely negotiated price of permission to develop.<sup>67</sup> After one year of experience, it became clear that the concept of the "freely negotiated" charge had certain shortcomings. Summing up the initial experience, *The Economist* stated in May 1949:

It is not the fault of the Board, but of the Planning Act, that the fixing of development charges at present follows rather arbitrary and experimental lines, and is accompanied by a good deal of haggling and inconsistency. The Board is attempting to evolve new principles of valuation, appropriate to the new conditions created by the 1947 Act, but numerous cases—such as that of the club whose development charge was reduced from £60,000 to £35,000 at the first protest—show that these principles are anything but exact. The Board is continually tempted to charge what the traffic will bear; and this gives a general impression of unfairness and arbitrariness to its clients.<sup>68</sup>

The vagueness of the concept of "existing-use value" and "development value" was caused mainly by exclusion of many elements that a market valuation would include. Arbitrariness of valuation was increased by the fact that the "development charge" was determined by the same institution that finally collected the money, and that there was no appeal from its decision.<sup>69</sup>

In its first annual report, in 1949, the Central Land Board conceded that the object of the Act—that all land should change hands at its value for "existing use," without the element of the development value—had not been achieved. Most transactions in land were continuously undertaken at prices higher than the existing-use value, and thus an inflation in the price of houses and other build-

<sup>66</sup> *The Rating of Site Values* . . . (cited in fn. 32), p. 26.

<sup>67</sup> *The Economist*, May 10, 1947, p. 701.

<sup>68</sup> *The Economist*, May 14, 1949, p. 881.

<sup>69</sup> *The Economist*, November 15, 1952, p. 433.

ings was not prevented. Even in the following year the Board was not successful in stopping this practice.<sup>70</sup> Its failure can be explained by the fact that the 100 per cent "development charge" did not leave an inducement for the owner of land to develop his site; furthermore, if he sold his land he asked for more than the existing-use value of the land. As the buyer was liable for the "development charge," he had apparently paid the market price to the seller, and in addition he paid the "development charge" which was determined by the Central Land Board. If the landowner was forced by the Board to sell, he received just the existing-use value. As the Board hardly used its power for compulsory purchase, it was possible that two markets for land came into existence.<sup>71</sup>

When the Conservative Party came to power it removed the "development charge," in 1953. One year later, when the restrictions on the private sale of land had been removed, the two-price system for land—one for the compulsory purchased land and the other for free, private sales—became fully evident. "Prices paid when land with development value was sold privately were higher than those paid when such land was acquired compulsorily for public purposes."<sup>72</sup> This finally forced the Government, in 1959, to establish the free market value as the amount of compensation to be paid on occasions of compulsory purchases.

Although the main criticism of the Act of 1947 had been directed against its adverse effects on the supply of land caused by a 100 per cent charge,<sup>73</sup> objections had also been raised against its practical application. It turned out that the "development charge" was too closely tied to the process of granting planning permission. The principle of levying a "development charge" on *any* increment in value of land proved to be impracticable. It resulted, in some cases, in the imposition of a "development charge" when the front room of a cottage was changed into a village shop, or a goal post was placed in a field and it was used for sport.<sup>74</sup>

## Land Levy on Development Value—the 1965 Land Commission Proposal

### *Basis for assessment*

The 1965 Land Commission proposal provides for the payment of a land levy on the development value of land. The development value is defined as the increase in value attributable to the prospects of "material development." This value is distinct from the current-use value (i.e., the value of land in its previous designation). In contrast to the valuation practice under the original Town and Country Planning Act of 1947, the basis for determining the current-use value and the development value is the market value for land. This is intended to ensure that the owner of land will receive the same price regardless of whether he is selling to a private purchaser or to a public body.

To arrive at the development value, a so-called base value—either the current-use value or the price the seller paid for the land plus an allowance for improvements—is subtracted from the new value of land (i.e., the market price at the time when it reflects the increment in value due to development). The basic condition for charging the levy is the change in the use of the land, as for example, from agricultural purposes to housing.

To avoid tax evasion on the occasion of the introduction of the levy, the White Paper provides in Section 29:

Owners selling land will be able to claim for this purpose the price paid if they bought the land before the date on which this Paper is published. If they have

<sup>70</sup> *Central Land Board* . . . (cited in fn. 42).

<sup>71</sup> Parker, *op. cit.*, pp. 65–67 and 71.

<sup>72</sup> *The Land Commission*, Cmd. 2771, p. 4.

<sup>73</sup> See Alan Day, "The Case for Betterment Charges," in *Land Values* . . . (cited in fn. 38), p. 100.

<sup>74</sup> *The Economist*, November 15, 1952, p. 433.

bought the land between that date and the appointed day, when the powers of the Commission come into operation and transactions become subject to levy, the price they have paid will not be recognised as the base value for the calculation of the levy.<sup>75</sup>

### *Application*

The levy will be imposed on the development value realized in private transactions, as well as in sales of land to public authorities under compulsory purchase power or by agreement. It will apply not only when the development value is realized by transactions, but also when the value is increased by the actual development of land and has not been realized in a previous transaction. Anyone whose land has risen in value between the time of purchase and the time he develops it may have to pay the levy. The levy will even be charged on additional value that accrues at the time building actually takes place.<sup>76</sup>

... Thus, to give a simple example, if a piece of agricultural land worth £300 as such is sold for £3,000 with a planning permission for housing, levy would apply to the difference between the market value and the agricultural value, i.e., £2,700. If the land is developed immediately thereafter the market value at point of development would still be £3,000 and no more would be payable. However, if the land was not developed for, say, three years, by which time market values had risen and the value of the land was then £3,500, levy at the time of development would be payable on the additional £500 then realised. It may happen that the land changes hands more than once before development. For example, the agricultural land worth £300 as such might have been sold first without a planning permission, but with some hope that one would be granted, for £1,000. The development value realised in the first sale would then have been £700, which would have been subject to levy. If the man who bought for £1,000 later sold for £3,000 and there had meanwhile been no increase in the agricultural value of land, he would be realising a further £2,000 development value; so he would have to pay levy on £2,000.<sup>77</sup>

There will be no charge on the development value of Crown land, or on land which a person owned at the date of publication of the White Paper and on which he intended to build a single house for occupancy by his family.

In summary, the following basic changes are made from the "development charge" of the Town and Country Planning Act:

- (1) The new development levy will not take all of the development value.
- (2) In case of compulsory purchase, the valuation is to be made on the basis of the market price.
- (3) Additional value accruing before the building takes place will be charged regardless of the fact that no transaction takes place.
- (4) Normally, the seller, rather than the buyer, has to pay the land levy.

### *Tax rate*

The initial rate of the levy will be fixed at 40 per cent. However, the Government has indicated that it intends to raise the rate progressively to 45 per cent and later to 50 per cent at reasonably short intervals.

The Government has decided to exclude the development value from the long-term capital-gains tax and to consider the land levy as an allowable expense in the case of the short-term capital gain which is taxed as ordinary income.<sup>78</sup> Hence,

<sup>75</sup> *The Land Commission*, Cmnd. 2771, sec. 29.

<sup>76</sup> *Loc. cit.*, sec. 26.

<sup>77</sup> *Loc. cit.*

<sup>78</sup> "Land Commission Proposals," *The Financial Times* (London), October 21, 1965, p. 20.



the capital-gains tax will only apply to those profits on the sale of land which are attributable to an increase in the market value for the existing use of land. While up to now the development value realized in transactions has been taxed as capital gains, those increments in the value of land which are now realized by development will be subject to the new levy. Furthermore, the proposed tax rate of the development levy is 40 per cent, against the 30 per cent capital-gains tax rate.

### *Evaluation*

As the levy will not be charged on the increase in the existing-use value, it will be difficult to break down the total increase in value into the development value, on one hand, and the increase in the existing-use value, on the other. Questions will occur, for example, how to prove that the selling profit for a farm is exactly increased by a certain amount in expectation of planning permission. The solution of the valuation problems will require a large professional staff, which will make the development levy quite expensive to collect.

During parliamentary debate, the proposal that the land charge be administered by the Land Commission was opposed, and it was recommended that Inland Revenue should assess and collect the levy.<sup>79</sup>

There might be a certain reluctance to apply for development permission because of the tax; this is reasonable as long as there is a possibility that the development levy will be abolished one day, e.g., by a new government. However, the major opposition party does not oppose the levy, although it is very critical of the establishment of a powerful Land Commission.

An unwillingness to develop may also be caused by lack of available funds to pay the levy. Land developers will then wait for highly profitable investments, with the result that rent (e.g., for housing) may go up. In the parliamentary debate it was alleged that the levy might in some cases discourage industrial modernization and expansion.

A development levy might be payable if a manufacturer had around his factory a large area of land upon which he wished to put an extension to his factory. In order to do that he would have to apply for planning permission. . . . When he put up the building he would have developed the land. The development would probably be a "material development". It would be required to extend his business and, in certain cases, to modernise his business. It would rank as development attracting a development levy. Thus, under the White Paper a manufacturer who modernised or expanded would not only have to finance the modernisation or expansion but pay a levy because he had expanded.<sup>80</sup>

If they expect an increment in the existing-use value, landowners may hesitate to apply for planning permission because the capital-gains tax rate on the existing-use value is only 30 per cent. But independently of their consideration, public planning may already have caused a development value, and thus establish a liability for the land levy when they finally sell.

Whether the tax will be shifted to the buyer will depend mainly on the landowners' attitude toward withholding land from sale. Shifting would occur if the land levy caused owners to withhold land from the market or development, thereby curtailing the supply of land for development. If the levy were thought to be temporary, this effect might be highly important. If, however, landowners are reconciled to a permanent tax, any influence on the supply would appear to be minor. Any postponement of sale motivated by the fact that the appreciation in value of land may occur at a faster rate than the potential earnings of interest on the resulting sales profit is counteracted by two factors.

First of all, the plan to raise the rate to 45 per cent and then to 50 per cent

<sup>79</sup> House of Commons, Parliamentary Debates, *Weekly Hansard*, No. 671, November 8–11, 1965, col. 372, and No. 687, March 6–12, 1966, cols. 606–732.

<sup>80</sup> *Loc. cit.*, No. 671, November 8–11, 1965, col. 483.

is presumably aimed to provide an incentive to get land on the market more quickly.<sup>81</sup> Secondly, the compulsory purchase power of the Land Commission may force people to sell. Subsequently, the Land Commission may dispose of the land to those who are willing to develop it, thus increasing the supply of land and keeping prices down. Besides, the Land Commission may even offer land under its market price.

The market price will be essentially influenced by the compulsory purchases of the Land Commission, and in this way counteract the tendency for the tax to be shifted to the buyers. Indeed, the Government has disclosed plans for compulsory purchase, in case "the levy may be used by some landowners to create an artificial market value prejudicial against a private developer."<sup>82</sup>

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<sup>81</sup> *The Financial Times*, September 23, 1965.

<sup>82</sup> House of Commons, Parliamentary Debates, *Weekly Hansard*, No. 671, November 8-11, 1965, col. 398.

## Imposition de la valeur des propriétés non bâties

### *Résumé*

La poussée démographique et le progrès économique entraînant une hausse de valeur de la propriété foncière, de nombreux gouvernements ont cherché les moyens de faire couvrir certaines dépenses publiques par les propriétaires fonciers qui bénéficient de ce relèvement.

Parmi les méthodes d'imposition de la rente économique, on peut citer l'impôt annuel sur la valeur actuelle du sol. Bien que cet impôt encourage une meilleure utilisation du sol, il est possible qu'une exonération temporaire accordée en faveur des aménagements du sol puisse fournir un stimulant approprié et plus équitable. Il semble que l'imposition distincte de la valeur des propriétés non bâties soit plus efficace et plus précise qu'une imposition globale couvrant notamment les aménagements. Mais tout régime rentable d'imposition foncière exige l'adoption de normes juridiques rationnelles de valeur, un personnel d'évaluation bien formé, et un cadastre à jour représentant les valeurs courantes.

Une autre méthode consiste à imposer les plus-values foncières, au moyen de taxes périodiques sur les accroissements de valeur enregistrés entre les dates d'évaluation, ou bien en ne taxant les gains qu'au moment de la vente. Les taxes périodiques susmentionnées exigent, pour être mises en œuvre avec succès, une très grande précision dans la mesure des changements de valeur.

Bien que l'imposition des bénéfices réalisés sur les ventes foncières puisse se justifier en ce sens qu'elle permet de tirer avantage des plus-values résultant indirectement de l'accroissement démographique et de l'urbanisation, ces impôts sont soumis à certaines limitations : il n'est pas facile d'isoler les effets de l'inflation sur les augmentations de valeur de la propriété foncière; les impôts en question sont défavorables aux transferts fonciers et freinent l'aménagement des sols; le pointage de toutes les transactions et la détermination du montant des gains impossibles soulèvent de nombreuses difficultés d'ordre administratif; enfin, le rendement de ces impôts est faible.

L'imposition spéciale (taxe sur les aménagements fonciers) constitue elle aussi une des principales méthodes d'imposition des plus-values. Les partisans de cette taxe font valoir qu'elle permet de répartir les coûts des aménagements publics en fonction des avantages qu'ils procurent. Il est cependant fort difficile de déterminer la proportion de l'aménagement qui correspond à un avantage spécial pouvant être mis à la charge des propriétaires fonciers.

## Tributación sobre el valor de la tierra

### *Resumen*

En vista de que el crecimiento demográfico y el progreso económico encarecen el precio de la tierra, muchos gobiernos han tratado de encontrar la forma de hacer que los costos públicos recaigan en los terratenientes que resultan beneficiados de esa plusvalía.

Un método de gravar la renta económica es el de establecer un impuesto anual sobre el valor de los terrenos. Aun cuando este impuesto contribuye a que se haga mejor uso de los mismos, pudiera suceder que la exención tributaria temporal sobre las mejoras que se les hagan proporcionara incentivos adecuados de una manera más equitativa. Se considera que es más eficaz y exacto gravar separadamente el valor de la tierra sin las mejoras que se le hagan, que hacer una tasación global con inclusión de dichas mejoras. No obstante, para que un sistema de gravación de la propiedad inmueble tenga éxito, es menester establecer normas jurídicas de tasación adecuadas, contar con peritos competentes, y con un catastro actualizado que refleje el valor actual de las propiedades.

Otro método consiste en establecer, bien un impuesto de plusvalía que aumente periódicamente de acuerdo con los incrementos de valor que se produzcan entre las fechas de tasación, o un impuesto que se cobre sólo sobre las utilidades que se obtengan cuando se efectúe su venta. El éxito del primer método requiere un alto nivel de exactitud al calcular las variaciones que se registran en el valor de la propiedad.

Ahora bien, aunque la gravación de las utilidades obtenidas de la venta de la tierra puede justificarse como medio de que la plusvalía que se origine a causa del crecimiento demográfico y de la urbanización se convierta en una fuente de ingresos tributarios, tales impuestos están sujetos a ciertas limitaciones, a saber: es difícil aislar los efectos que la inflación ejerce sobre la plusvalía de la tierra; la gravación en el momento de la venta inhibe el traspaso de la tierra y sus edificaciones; existen muchos problemas de orden administrativo que impiden averiguar las transacciones que debieran gravarse, y determinar el monto de utilidad imponible; y finalmente, los ingresos tributarios que se obtienen son limitados.

Otro medio importante de gravar la plusvalía consiste en una tributación especial (impuesto de saneamiento y urbanización de la tierra). Se ha abogado por este impuesto porque constituye un medio de repartir el costo de las mejoras públicas en proporción a los beneficios recibidos. Sin embargo, surge un importante problema al determinar qué proporción de la mejora constituye un beneficio especial que se debiera cargar a los propietarios de los bienes raíces.

# The Taxation of Net Wealth

Noboru Tanabe \*

**A**N ANNUAL TAX on net wealth has often been suggested by tax experts as a desirable supplement to the income tax. The basic reason for the suggestion is the belief that income is not a sufficient measure of taxable capacity, and that more effective personal taxation can be achieved by a supplemental tax on net wealth. It is also held that there is a strong case for such a tax on grounds of equity, economic effects, and administrative efficiency.

Typical of the recent views are those expressed by Nicholas Kaldor in his reports to the Governments of India and Ceylon, which led to the adoption of net wealth taxes in those countries.<sup>1</sup> Recently, the Santiago conference on fiscal policy for economic growth in Latin America and reports on taxation in Greece and Australia recommended the introduction of a net wealth tax as an integral part of the income tax system.<sup>2</sup> Also, the EEC (European Economic Community) Fiscal and Financial Committee's report on tax harmonization (the Neumark Committee's report) proposed that methods of general taxation of wealth to complement personal income tax should be studied.<sup>3</sup> In Italy the Five-Year Plan contemplates the adoption of a net wealth tax in order to maintain the present distinction between income from property and income from labor.<sup>4</sup> These reports generally conclude that the ownership of property confers advantages which are

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<sup>1</sup> Nicholas Kaldor, *Indian Tax Reform*, Department of Economic Affairs (New Delhi, 1956), pp. 19–28, and *Suggestions for a Comprehensive Reform of Direct Taxation*, Government of Ceylon (Colombo, 1960), pp. 13–14.

<sup>2</sup> "Report of the Conference," in *Fiscal Policy for Economic Growth in Latin America*, papers and proceedings of a conference held in Santiago, Chile, December 1962, and issued by the Joint Tax Program of the Organization of American States, Inter-American Development Bank, and Economic Commission for Latin America (Baltimore, 1965), p. 421; George F. Break and Ralph Turvey, *Studies in Greek Taxation*, Center of Planning and Economic Research (Athens, 1964), pp. 162–80; and R.I. Downing and others, *Taxation in Australia* (Melbourne, 1964), pp. 109–18.

<sup>3</sup> H. Thurston, *The EEC Reports on Tax Harmonization* (Amsterdam, 1963), pp. 127–28 and 155.

<sup>4</sup> Cesare Cosciani, "The Tax Reform as Contemplated in the Five-Year Plan," *Review of the Economic Conditions in Italy*, Banco di Roma (1965), Vol. XIX, p. 137.

distinct from and additional to the income derived from such property. The Santiago conference also asserted that the insufficiency of public revenue in Latin American countries is due, in part, to the failure of the tax system to impose effective levies on the wealthy classes, and that any major reform of the tax system should allocate a greater share of the burden to the wealthy classes. This subject has had fairly wide discussion.<sup>5</sup>

The term "net wealth tax" is usually defined as a tax annually imposed on the net value of all assets less liabilities of particular taxpayers—especially individuals. This definition distinguishes the net wealth tax from other types of taxation of net wealth, such as death duties and a capital levy; the former are imposed only at infrequent intervals—once a generation—while the latter is a one-time charge, usually with the primary purpose of redeeming a wartime national debt. The net wealth tax is really intended to tax the annual yield of capital rather than the principal itself as do death duties or a capital levy, even though it is levied on the value of the principal. Since it taxes net wealth, it also differs from property taxes imposed on the gross value of property—primarily real property—in a number of countries. The net wealth tax gives consideration to the taxpayer's taxable capacity through the deduction of all outstanding liabilities and personal exemptions as well as through other devices, while the property tax generally does not take these factors into account. The net wealth tax is therefore deemed to be imposed on the person of the taxpayer, while the property tax is often deemed to be imposed on an object—the property itself.

Despite its possible advantages, the net wealth tax has been adopted in only a few countries because of certain limitations. Some believe that the net wealth tax is very difficult to administer, particularly as regards tracing the property owners and valuing assets. Also, the tax has limited revenue possibilities, its primary objective being greater equity. It may also have other questionable features, including problems for the taxpayer in finding resources with which to pay the tax.

This paper surveys the characteristics of an annual net wealth tax, mainly through an analysis of the experience in various countries, and attempts to evaluate its role in the tax structure, with special reference to developing countries.

<sup>5</sup> In England, an annual taxation of wealth has been recently proposed by *The Economist*, January 15–21, 1966, pp. 217–19. In the United States there has been little discussion of a net wealth tax partly because of its uncertain constitutionality at the federal level. See William Vickrey, *Agenda for Progressive Taxation* (New York, 1947), p. 12; and Richard Goode, *The Individual Income Tax*, The Brookings Institution (Washington, 1964), p. 13. A selected bibliography on the subject is given in Appendix I, p. 156.

## I. Historical Survey

Annual taxation of net wealth is not new. Although its actual application has been limited, the net wealth tax has been in effect for a long time in some European countries. Swiss cantons have had a continuous experience with this form of tax, dating from the thirteenth century. Since the early 1900's, the net wealth tax has been accepted in several other European countries. Sweden, Norway, and Denmark have employed it as a standard feature of their revenue systems for over a half century, and the Netherlands introduced it in 1914. In Germany the net wealth tax, which appeared in 1922, was originally modeled after the corresponding Prussian tax of 1819.

In contrast to its long European history, the net wealth tax is of very recent origin in the Far East. India adopted it in 1957 and Ceylon in 1959, following Kaldor's recommendations. Pakistan introduced it more recently, in 1963, after the report of the Taxation Enquiry Committee. Japan adopted a net wealth tax in 1950, as recommended by the Shoup Mission, but repealed it in 1953.

In Latin America, the net wealth tax of Colombia has been regarded since its inception in 1935 as complementary to, and an integral part of, the general income tax. Uruguay introduced a net wealth tax applicable only for 1964, but later extended its application for the three years 1965-67. In 1939, Nicaragua adopted a tax similar to the net wealth tax (*el impuesto directo sobre el capital*) but replaced it in 1962 with two taxes—the real estate tax and the personal property tax. Chile's patrimonial tax, introduced in 1965, was originally conceived as a net wealth tax but was converted to a tax on the presumptive income from capital equal to 8 per cent of taxpayers' assets, net of directly related liabilities.

Adoption of a net wealth tax has been supported on several grounds, but mainly on those of equity. It is generally recognized that income alone is an inadequate measure of ability to pay, in terms of effective personal taxation. Although ability to pay or taxable capacity, of course, is not a quantity susceptible of measurement, the tax has been intended to reduce possible discriminatory effects of an income tax that does not fully take into account the benefits of property ownership. Other factors influencing the adoption of net wealth taxes have been the desire to curb undue concentration of wealth, encourage more productive use of capital, minimize the disincentive effects of net income taxation, and promote greater efficiency in income tax administration.

### HEAVIER TAXATION OF PROPERTY INCOME

In Sweden, which relies strongly on income taxation at the national and local levels, the net wealth tax was originally motivated by a desire

to impose a heavier burden on income from capital than on income from other sources. It was an integral part of the income tax from 1910, when it became a general annual levy and was called "the national income and wealth tax," until the adoption of the present form of a separate net wealth tax in 1948. After computing his income, a Swedish taxpayer was required to add to it a small part of his taxable wealth ( $\frac{1}{60}$  before 1938) to get his total taxable income. It was estimated that under the combined measure, income from property would bear a tax burden one third larger than that imposed on other income.<sup>6</sup>

In Colombia, the net wealth tax has always been viewed as part of the income tax system.<sup>7</sup> A major purpose of the net wealth tax has been to tax income from capital at a higher rate than income from wages and personal services, a purpose which had previously been achieved under the income tax by a differential schedular rate structure. India, Ceylon, and Pakistan, in line with their Governments' policies of democratic socialism, aimed at a more effective and more equitable personal taxation of the wealthier classes by the use of a net wealth tax to supplement the income tax.

The basic reason for placing a heavier burden on property income seems to be the belief that property income is obtained with less effort and is usually more permanent. Moreover, property itself confers certain advantages on its owner in addition to the income it yields: it serves as a reserve of spending power in emergencies and thus reduces the need to save out of income; it provides security for old age and unemployment; it gives the owner better access to credit; and it confers social status and prestige. Under the unitary income tax system, those who have the same income generally incur the same tax liability, regardless of the kind of income they earn and of the value of wealth they hold.<sup>8</sup> Wealth not yielding any income is not subject to tax. Two persons with the same income are not equally well off, however, if one has greater wealth than the other. An extreme example is the position of a beggar who has neither income nor property, compared with the position of a wealthy person who keeps the whole of his wealth in the form of jewelry and

<sup>6</sup> Harvard Law School, *World Tax Series: Taxation in Sweden* (Boston, 1959), hereafter cited as *Taxation in Sweden*, p. 619.

<sup>7</sup> Harvard Law School, *World Tax Series: Taxation in Colombia* (Chicago, 1964), hereafter cited as *Taxation in Colombia*, pp. 436-37.

<sup>8</sup> Preferential taxation of earned income may be achieved even under the income tax system by application of a separate rate schedule (the schedular income tax system) or by exclusion of part of earned income from the taxable income. It is believed, however, that these devices only partially meet the equity problem because they cannot reach most wealth yielding no money income, as discussed below.



gold. By the test of income alone, the taxable capacity of both is nil, yet the wealthy person clearly has ability to pay taxes. Thus, it is argued that a basic limitation of the income tax is its tendency to discriminate against those persons who have not accumulated wealth, compared with those who have.<sup>9</sup>

In this context, the Finance Minister of Ceylon stated in the budget speech for 1958/59:

The basic reason for the imposition of a tax on net wealth is that the present system of taxation discriminates between the property-owner and the man who derives income from work and effort. The unfairness of measuring taxable capacity by the yardstick of income alone can easily be seen when it is considered that under the present system a man who derives an income of, say, Cey Rs 50,000 by dint of hard work, and another who derives the same income from property pays the same tax. If you carry the example a little further and consider the economic position, after their death, of the dependents of these two persons, the unfairness of the present system becomes absolutely clear.<sup>10</sup>

Since income and wealth constitute two distinct sources of what may be called "spending power," a combination of separate taxes on each would be more closely related to taxable capacity than would either tax by itself.

#### PREVENTING UNDUE CONCENTRATION OF WEALTH

Another reason for introducing a tax on net wealth has been to assist in checking the growth of large concentrations of wealth. Reflecting the special conditions in Pakistan, the net wealth tax was designed to discourage the concentration of wealth in the hands of a few families, as well as generally to promote greater equality. The Taxation Enquiry Committee of Pakistan examined the then existing system of income taxation and reported special factors favoring the introduction of a net wealth tax in Pakistan:

Turning to the special conditions in Pakistan, the accumulation of large fortunes in the decade since Independence underlines the failure of the system of income taxation in the country in its function of preventing undue concentration of wealth. Despite sharply progressive marginal rates, the equalitarian objective has not been achieved partly because of tax evasion and avoidance and partly because accumulations have taken place in fields outside the scope of income tax such as through capital gains. . . . We feel that even apart from the theoretical justification for it, a wealth tax in our conditions would confer several advantages. In the first place it would assist in promoting the objective of equality and preventing undue concentration of wealth.<sup>11</sup>

<sup>9</sup> Kaldor (1956), *op. cit.*, pp. 20-21; John F. Due, "Net Worth Taxation," *Public Finance* (The Hague), Vol. XV (1960), p. 315.

<sup>10</sup> Ceylon, Ministry of Finance, *Budget Speech, 1958-1959* (Colombo, 1958), p. 37.

<sup>11</sup> Pakistan, Taxation Enquiry Committee, *Interim Report (Central Taxation)* (Karachi, 1959), p. 72.

It was pointed out that the degree of concentration in the ownership of property has not been reduced, even in highly advanced countries possessing some form of progressive personal taxation, generally based on "income."<sup>12</sup> However, this problem is believed to be more serious for developing countries where there is an unusual imbalance in the distribution of wealth between a small group of very wealthy people and the mass of poor people. The Pakistan report states that although no definite estimates were available, the economy was characterized by glaring inequalities of income and wealth and by extremes of opulence and poverty. These inequalities were believed to result mainly from centuries of landlordism and undue privileges, in which heredity, custom, and environment had all played a part. Even greater concern was expressed over reports that disparities in income and wealth appeared to have been aggravated after independence. The tax system had also been ineffective in adequately taxing the gains from capital appreciation and unearned increments which had acted as important sources of inequality.<sup>13</sup> These circumstances were believed to require the imposition of an annual tax falling directly on wealth, a tax which would also automatically reach a substantial part of capital gains over a period of years.

This point of view was also reflected in the Shoup Mission report on Japanese taxation, which stated:

A further advantage of a net worth tax over increasing the top rates of the income tax is that the net worth tax is a superior and more selective means of preventing the growth of undue concentration of economic power. Control over the economy is more nearly related to the ownership of wealth than to the receipt of income. Indeed, even very large incomes received as salary, or as royalties for a popular novel, or the like, do not represent the same danger to the preservation of democracy as would a comparable income derived from securities or other property. The taxpayer with the latter type of income will pay more, if the net worth tax is in effect, than the taxpayer with earned income. Hence the effect of the tax system will be concentrated where it is most needed.<sup>14</sup>

... the accumulation of huge fortunes that threaten to concentrate the control

<sup>12</sup> Kaldor pointed out the failure of progressive taxation to attain its objectives in advanced countries: "Thus in the United Kingdom, though the combined income and surtax rates for the last 15 years have exceeded 90% in the top brackets, and estate duties reached a maximum of 80%, vast new fortunes are still being made, and the degree of concentration in the ownership of wealth—as measured, e.g., by the percentage of persons owning one-third of the national wealth, etc.—has not been reduced. The same is true, I believe, of the United States and other Western countries" (Kaldor (1956), *op. cit.*, p. 8).

<sup>13</sup> Pakistan, Taxation Enquiry Committee, *loc. cit.*, pp. 9–10, 16, and 72–75.

<sup>14</sup> U.S. Tax Mission to Japan, *Report on Japanese Taxation by the Shoup Mission*, General Headquarters, Supreme Commander for the Allied Powers, Vol. I (Tokyo, 1949), hereafter cited as the *Shoup Mission Report*, p. 83. The Mission consisted of Carl S. Shoup, Director; Howard R. Bowen; Jerome B. Cohen; Rolland F. Hatfield; Stanley S. Surrey; William Vickrey, and William C. Warren.

of the economic system in the hands of a few wealthy individuals . . . is a danger of particular significance to Japan. Unless such accumulations are prevented by the tax system, they are almost certain to arise, sooner or later.<sup>15</sup>

This was not the primary purpose of the net wealth tax recommended, as mentioned below, but was emphasized as one of the advantages of adopting a net wealth tax in Japan, the economy of which had long been controlled by a few families until their power was curbed, soon after the Second World War.

#### ENCOURAGING RISK OF CAPITAL AND MORE PRODUCTIVE USE OF WEALTH

It is also claimed that the use of a net wealth tax encourages greater risk taking and channels wealth into more productive use because the tax places the same burden on the same property value, without regard to its yield. In other words, a net wealth tax discourages the holding of unproductive properties, and stimulates productive investment for money income to meet tax payments.

Colombia introduced a net wealth tax with two declared purposes: (1) to impose a higher rate of tax on unearned income, as mentioned above, and (2) at the same time, to impose a burden upon landowners who withhold their property from use. The tax was intended to penalize wealthy people who fail to exploit their property to the fullest possible advantage in the national interest. It was expected to encourage risk taking and to induce owners to employ their wealth in more productive use. Pakistan and Japan also recognized this effect as one of the advantages of a net wealth tax.

Income taxation applies generally only to money income and does not reach the security and liquidity benefits of cash, gold, jewelry, uncultivated land, and the like. Even though a reform of the income tax could catch some of the imputed gains by arbitrary assessment, it could not catch the security and liquidity benefits as such. The net wealth tax imposes the same tax on any given value of property, whether held in money, jewelry, or uncultivated land, yielding no money income at all, or invested in safe securities or in risky industrial shares. It is maintained that the tax thereby provides greater equity among those who have different types of properties. In this regard, it is claimed that the net wealth tax tends to encourage economic development. By taxing net wealth, it is likely to push funds out of cash and out of no-income or low-income investments into higher yield investments. Thus, in reducing security and liquidity preference, it promotes risk taking and more pro-

<sup>15</sup> *Ibid.*, p. 81.

ductive use of wealth.<sup>16</sup> This view is emphasized in a country such as Colombia, where substantial resources are not productively used.<sup>17</sup>

#### EFFECTIVE TAXATION OF HIGH-INCOME GROUPS

The primary purpose of the net wealth tax adopted in Japan was to supplement the progression of the personal income tax in the top income groups. A similar purpose was served in India. In both countries introduction of the tax was accompanied by a reduction in higher bracket income tax rates.

World War II produced in the Japanese economy a disastrous breakdown, which touched off an inflationary spiral. Under these conditions the highly progressive income tax rates and low personal exemptions stimulated widespread tax evasion and avoidance. Moreover, the entire tax service was disorganized and unable to cope with this evasion. Tax officials were young, inexperienced, and underpaid, and office procedures were inadequate. Thus, although the Japanese income tax system was nominally a very progressive one, individuals were effectively taxed at only a small part of their real liabilities. Wealthy taxpayers, in particular, legally escaped heavy taxation because of the exclusion of capital gains, extensive deductions for business expenses, and other devices.

The Shoup Mission believed that the then top income tax rates, ranging up to 85 per cent, were much too high in relation to standards of compliance and enforcement. Nevertheless, they also recognized the need for substantial progression:

... we cannot be satisfied with the degree of high-level progression in the tax system that is reflected by nothing much more than an income tax that is limited to a 50 or 60 per cent top rate. Every progressive tax system worthy of the name must provide a substantial obstacle to the accumulation of huge fortunes. . . .<sup>18</sup>

The Mission therefore recommended the introduction of an annual low-rate tax on the net wealth of well-to-do individuals as the most satisfactory solution to the problem.

They believed that such a tax would fill the gap left by the reduction in the top rates of the income tax, and would not be subject to most of

<sup>16</sup> Due (1960), *op. cit.*, p. 318. Dino Jarach suggests that the taxation of wealth fulfills the "productivist" principle for the reason that it falls upon potential rather than actual income—see "Taxes on Net Wealth, Inheritances, and Gifts," in *Fiscal Policy for Economic Growth in Latin America* (cited in fn. 2), p. 202; and Cesare Cosciani, *Istituzioni di Scienza delle Finanze* (Turin, 1961), pp. 210–48.

<sup>17</sup> See Albert O. Hirschman, *Journeys Toward Progress: Studies of Economic Policy-Making in Latin America*, Twentieth Century Fund (New York, 1963), pp. 117–38.

<sup>18</sup> *Shoup Mission Report*, p. 81.

the difficulties that militated against high income tax rates. The combination of income tax and net wealth tax might have less effect on incentives than would an income tax with the same degree of progression standing alone. This is graphically illustrated by the fact that an income tax rate of 110 per cent would kill incentives, whereas the combination of a 50 per cent income tax and a 9 per cent net wealth tax (which would produce the same total tax assuming that the owner of the wealth earned 15 per cent on it) would still leave the individual with an incentive to increase his income, since he would be able to retain half of the increase.<sup>19</sup>

The net wealth taxes in both India and Ceylon followed Kaldor's recommendation to base progressive taxation on several yardsticks of taxable capacity, such as total wealth, income, and expenditure, instead of a single measure such as income. The net wealth tax was therefore introduced not only because of the inherent merits claimed for it, but also because it was considered essential to a comprehensive system of personal taxation. Ceylon provided a net wealth tax in a single "Personal Tax Law" consisting of taxes on net wealth, expenditure, and gifts. India introduced it separately from other taxes on expenditure and gifts but combined with the reduction of top-bracket income tax rates. The Finance Minister of India stated in his budget speech for 1957/58:

... I mentioned earlier the reliefs in income-tax at top levels of income which I am introducing this year. These reliefs are meant as an encouragement to larger effort and greater initiative on the basis of which alone a healthy and progressive economy can be built up. It is necessary at the same time to adopt other measures which are egalitarian in intent but which do not have a disincentive effect. The Tax on Wealth that I am now proposing is one such measure. . . . This will thus be a progressive tax which, together with the surcharges I have recommended in respect of income-tax on unearned incomes, will contribute towards a more effective taxation of the richer classes without diminishing incentives to earn in the process.<sup>20</sup>

#### PROMOTING EFFICIENCY OF INCOME TAX ADMINISTRATION

Almost all relevant reports, recommendations, and speeches suggest that a supplementary tax on net wealth promotes the efficiency of income

<sup>19</sup> *Ibid.*, pp. 77–89. The same idea of a net wealth tax as a capstone to the progressive system is discussed by Vickrey (a member of the Shoup Mission), *op. cit.*, pp. 362–63: "Thus, practical considerations may impose limits on the degree of progression obtainable with income, spending, and succession taxes alone. If still steeper progression is desired, a tax on net worth may provide a possible method of topping off the tax structure. Such a net worth tax would not be considered an important element in the revenue system, but rather a means of achieving a redistribution of wealth at the top of the scale more rapidly than is possible with the other taxes alone. . . . Such a net worth tax would be an acceptable substitute for the continuation of the graduation in the upper ranges of income, spending, or succession taxes." See also Ursula K. Hicks, *Public Finance* (London, 1964), p. 213.

<sup>20</sup> India, Ministry of Finance, *Budget, 1957–58: Finance Minister's Speech* (New Delhi, 1957), p. 12.

tax administration. They claim that investment income is a function of wealth and that assessment of taxes on both income and wealth by the same taxing authority improves the administrative efficiency of the system because these two taxes, administered together, provide a better check on evasion and concealment than a tax on either alone.

Effective administration of an income tax requires that, even in the absence of a net wealth tax, the net wealth of taxpayers be calculated every year as a check on the investment income declared. The net wealth approach is generally regarded as a useful tool for auditing income tax returns over a period of years. As a matter of practice, however, annual information on the net wealth of individuals—such as balance sheets—has not generally been demanded, even in countries with well-developed income taxes. The absence of requirements for this information has been singled out as one of the weakest links in the enforcement chain for the administration of taxes on incomes—especially large incomes.

India aimed, in a somewhat broader way, at the elimination of tax evasion through the institution of a comprehensive and evasion-proof system of taxation, based on Kaldor's report. According to his theory, the five taxes—on income, capital gains, annual wealth, personal expenditure, and gifts—should all be assessed simultaneously, on the basis of a single comprehensive return provided by the taxpayer. They are self-checking in character, both in the sense that concealment or understatement of items in order to minimize liability to some of the taxes may involve an added liability with regard to others, and in the sense that the information furnished by a taxpayer in the interest of preventing overassessment of his own liabilities automatically brings to light the receipts and gains made by other taxpayers.<sup>21</sup> Although India did not adopt a single comprehensive return as Kaldor recommended, it did coordinate the administration of the net wealth tax (and expenditures tax) closely with that of the income tax.

The administration of the net wealth tax, then, is usually integrated with that of the income tax. In general, the income tax authorities also serve as the net wealth tax authorities; administration and procedures governing the net wealth tax closely parallel those of the income tax. In Sweden, the Netherlands, and Colombia, taxpayers must report their assets and liabilities for the computation of net wealth on the same forms that are used for the income tax returns.

## II. Tax and Rate Structure in Principal Countries

An annual tax on net wealth has been adopted as a supplement to the tax on income in about 14 countries, but its form differs widely. The net

<sup>21</sup> Kaldor (1956), *op. cit.*, pp. 13–16.

wealth tax has been levied as an integral part of, independently of, or in partial substitution for, the income tax. In other words, there are different types of the tax, depending on its primary function: for example, the combined income and wealth tax in Sweden; the separate net wealth tax, generally supplementary to the income tax, in most of the other countries having such a tax; and the independent tax as in Uruguay. The structure of a net wealth tax thus varies according to the intent of the tax and the general social philosophy of the government. Appendix II (p. 159) presents a summary of the main features of the net wealth tax in 14 countries: Sweden, Norway, Denmark, Finland, Germany, the Netherlands, Switzerland, Luxembourg, Japan, India, Ceylon, Pakistan, Colombia, and Uruguay. Although other countries have property-tax provisions that combine some elements of net wealth taxation, these are believed to be the only ones with net wealth taxes as defined in this study.

### TAXPAYERS

The net wealth tax is generally payable by individuals, including non-residents. Since the property of a wife and minor children is aggregated and taxed in the hands of the husband in most countries, the tax may be said to fall on families.<sup>22</sup> As a tax on individuals, the net wealth tax of Sweden also applies effectively to unincorporated businesses and partnerships. Of the 14 countries, 9 do not impose the tax on corporations, the net wealth of which is taxed only on the shares of the individuals who own them; however, some countries (Sweden and India) impose it on nonresident companies, since the equity of resident shareholders is subject to tax.<sup>23</sup>

Germany and four other countries (Finland, Luxembourg, Norway, and Uruguay) impose the tax on resident corporations. The net wealth tax in Germany (Prussia), originally imposed only on individuals, has been extended to corporations, in order to place the same tax burden on all businesses competing in the same market, regardless of their juridical form. On the whole, a net wealth tax on corporations does not serve the same purpose of securing equity in the distribution of the burden of taxation as a similar tax on individuals. Kaldor insisted that a net wealth tax on corporations could be designed as an alternative to a higher rate of profits taxation because it would have some favorable

<sup>22</sup> India and Pakistan do not provide for aggregation of a family's property, in principle, but have provisions to limit avoidance by inordinate transfer of property to dependents or other persons.

<sup>23</sup> Recently, Ceylon adopted a special additional levy of 10 per cent of income in lieu of the net wealth tax on nonresident companies which own immovable property situated in Ceylon.

economic effects on corporations, such as penalizing firms which earn a low rate of profit on the capital which they employ, and favoring those firms having high earning power. For this reason, he suggested that more burden be put on corporations in the form of a net wealth tax, and less in the form of a profits tax—particularly in the present stages of developing countries, since it would be well worthwhile to offer special inducements to corporations which efficiently use the resources at their command.<sup>24</sup>

A net wealth tax on corporations, however, would generally discriminate against shareholders if the securities of corporations are also subject to the tax. The EEC reports on tax harmonization consider it important to avoid double taxation by not applying the net wealth tax to legal entities:

Such a regulation seems above all necessary in order to prevent distortions of competition of a tax origin, because the importance of a tax on wealth differs under conditions otherwise equal, according to whether the principal (or secondary) role is played in the country or in a branch of industry by businesses employing primarily capital or labor.<sup>25</sup>

Pakistan, India, and Colombia once had a net wealth tax on corporations, but they rescinded it. Pakistan removed the net wealth tax on private companies because of certain anomalies created by the tax, especially as to shareholders belonging to the middle classes who are themselves not liable for the personal net wealth tax but, unlike the large shareholders, do not get a rebate for the tax paid by the private companies in which they hold shares. Pakistan also experienced administrative difficulties in correlating the assessment of the shareholders liable to the net wealth tax with the assessment of the corporation in which they hold shares. To compensate for the loss of revenue resulting from the abolition of the tax on private companies, the net wealth tax rate on individuals was raised.<sup>26</sup> One of the motives cited by the Colombian Government for rescinding the tax on corporations, in 1960, was the desire to attract foreign capital by eliminating international double taxation. Although the Colombian tax legislation considers the tax on net wealth an integral part of the income tax structure, the United States

<sup>24</sup> Nicholas Kaldor, "Tax Reform in India," *The Economic Weekly*, tenth annual number, Vol. XI (Bombay, 1959), pp. 195–98. In some Latin American countries a similar tax on corporations was designed as a substitute for an inheritance tax on individuals, principally because of the widespread evasion as to corporate shares—especially those in bearer form. In Uruguay, such a tax on corporations has been in effect since 1910—long before the adoption of its net wealth tax. A similar tax was enacted in Argentina in 1951. This substitute tax might have some advantage in that it makes larger tax collections possible and is relatively easy to administer. See Jarach, *op. cit.*, p. 208.

<sup>25</sup> H. Thurston, *op. cit.*, p. 128.

<sup>26</sup> Pakistan, Finance Minister, *Budget Speech for Fiscal Year 1964/65* (Karachi, 1964), pp. 19–20.



has not permitted taxpayers in the United States to credit this tax against their U.S. income tax. The U.S. Treasury ruled that the tax is a tax on capital, bearing no relationship to income and payable even when there is no taxable income.<sup>27</sup>

#### TAX BASE

The net wealth tax is generally assessed on the taxpayer's total net wealth, that is, all assets net of liabilities. Thus, taxable assets include not only real property such as land, buildings, and other improvements attached to land but also tangible personal property and intangibles such as machinery, animals, inventories of raw materials and goods for sale, farm and forest products, mineral rights, patents, and cars for business use; and jewelry, currency, bank deposits, notes, stocks, bonds, and mortgages.

For the sake of equity, it is important to cover all forms of property. The actual system of the net wealth tax in practice today, however, provides a variety of exclusions from the tax base for administrative, incentive, or constitutional reasons. Most countries exclude personal and household effects, life insurance policies, and pension rights. In addition, jewelry is exempt up to a prescribed amount in Germany, the Netherlands, and Ceylon; and assets used for scientific research in India and Ceylon. Switzerland excludes all livestock; Uruguay excludes all stocks of corporations and government securities. Colombia has a number of special exemptions as incentives for certain investments, while Sweden excludes certain assets, mostly because of the excessive administrative difficulties involved. India does not assess the tax on agricultural land, including trees and growing crops, because of constitutional limitations on the powers of the Central Government.

Residents are generally taxed on all their property, whether at home or abroad; nonresidents are usually liable to the tax only on property located in the taxing country. In almost all countries, the property of members of a family is aggregated and taxed in the hands of the husband, as stated above.

#### EXEMPTION LIMIT

Certain exemptions are always made for the value of small properties. Additional personal exemptions are allowed in several countries for dependents, including high limits for old people and invalids. The exemption limit, however, varies greatly among different countries (Table 1). In absolute terms, it ranges from as low as \$2,000 or slightly more in

<sup>27</sup> *Taxation in Colombia*, p. 438.

TABLE 1. NET WEALTH TAX EXEMPTIONS FOR SINGLE PERSONS IN RELATION TO PER CAPITA INCOME

		Exemptions <sup>1</sup>		Per Capita Income in U.S. Dollars <sup>1</sup>	Ratio of Col. 2 to Col. 3 (4)
		As stated (1)	U.S. dollars (2)		
Luxembourg	Lux F 100,000		2,000	1,301	1.5
Colombia	Col\$20,000		2,222	261	8.5
Switzerland	Sw F 10,000		2,314	1,685	1.4
Norway	NKr 20,000		2,801	1,178	2.4
Finland	Fmk 12,500		3,906	1,046	3.7
Uruguay	Ur\$250,000 <sup>2</sup>		4,174 <sup>2</sup>	576 <sup>2</sup>	7.3
Germany	DM 20,000		5,000	1,250	4.0
Netherlands	f. 40,000 <sup>3</sup>		11,049 <sup>3</sup>	1,130 <sup>3</sup>	9.8
Denmark	DKr 90,000		13,030	1,339	9.7
Japan	¥ 5,000,000 <sup>4</sup>		13,888 <sup>4</sup>	180 <sup>4</sup>	77.2
Sweden	SKr 80,000		15,464	1,893	8.2
India	Rs 200,000		41,999 <sup>5</sup>	78 <sup>5</sup>	538.4 <sup>5</sup>
Ceylon	Cey Rs 200,000 <sup>5</sup>		42,105 <sup>5</sup>	124 <sup>5</sup>	339.6
Pakistan	PRs 400,000 <sup>5</sup>		83,682 <sup>5</sup>	78 <sup>5</sup>	1,072.8

Sources: Appendix II and calculations based on data from *International Financial Statistics*, January 1966.

<sup>1</sup> 1963 unless otherwise specified.

<sup>2</sup> 1965.

<sup>3</sup> 1964.

<sup>4</sup> 1953, when law was repealed.

<sup>5</sup> At 1963 exchange rate (US\$1.00 = Rs 4.76).

Luxembourg, Colombia, and Switzerland to about \$42,000 in India and Ceylon, and to nearly \$84,000 in Pakistan.

Compared with the per capita income in each country, the exemptions may be classified into three groups: the first group includes the lowest exemption limits—from about 1½ to 4 times the per capita income (Switzerland, Luxembourg, Norway, Finland, and Germany); the second group, limits of 7 to 10 times the per capita income (Colombia, Uruguay, the Netherlands, Denmark, and Sweden); and the third group, limits of 80 to 1,000 times the per capita income (Japan, India, Ceylon, and Pakistan). In general, the countries with higher per capita incomes provide relatively lower exemption limits, while those with lower per capita incomes provide higher exemption limits.<sup>28</sup>

More important, the exemptions depend on the purpose of the tax, the rate of the tax, and the administrative considerations in each country. If the tax is designed primarily to lessen the undue concentration of

<sup>28</sup> The Spearman coefficient of the rank correlation between the per capita income and the exemption limit of the tax is 0.46, covering all 14 countries shown in Table 1. It rises, however, to 0.78, if only countries with lower per capita income (Uruguay, Colombia, Japan, Ceylon, India, and Pakistan) are considered.

wealth or to supplement the progression of the personal income tax on high-income groups, it provides high exemptions, as in Pakistan, India, Ceylon, and Japan. High exemptions may also be recommended for administrative convenience in order to limit the number of cases to be dealt with, rather than as a matter of principle. Norway's increase in the exemption limit in 1952 reduced the number of persons liable to the net wealth tax from 350,000 to 160,000.<sup>29</sup>

Some high-income earners own little property and would receive an unwarranted bonus from such a high exemption. Professor Due has suggested, therefore, that the exemption, if given, should more logically be related to both total net wealth held and income; persons with incomes below a certain figure would be exempt from tax on wealth up to a certain amount.<sup>30</sup> Until 1952/53, Norway had such an exemption related to income size, which was NKr 5,000 for those with taxable incomes and NKr 20,000 for those with incomes below the taxable level.<sup>31</sup>

As contrasted with the foregoing discussion, the tax may be conceived as one of widely varied applications, but with low exemptions. It may be a general supplement to the income tax, as in Luxembourg, Switzerland, and other European countries. Also, it may be possible to make it perform much the same function—of encouraging the productive use of the property—as the land tax or the property tax in many countries.<sup>32</sup> As a reverse application of a minimum limit, Germany provides for the taxation of a presumptive minimum amount of net wealth. If the amount of their actual taxable net wealth is less than the applicable minimum, resident entities are subject to a minimum tax. The minimum amounts are DM 50,000 for corporations, partnerships limited by shares, and mining companies, and DM 20,000 for limited liability companies. Other entities are subject to the tax only if their total net wealth is greater than DM 10,000.

## VALUATION

Most countries adopt the fair market value as a basic criterion of value. However, many specific rules for certain classes of assets are provided in elaborate measures, for example, going concern value, capitalized value, yield value, cadastral value, or special assessed value. In any case, both the fair market value and other specific values are quite separate from the book value used for income tax purposes. Norway uses the book value, in principle, but it does not allow any deduction for statutory or

<sup>29</sup> Janet A. Fisher, "Taxation of Personal Incomes and Net Worth in Norway," *National Tax Journal*, Vol. XI (1958), p. 90.

<sup>30</sup> Due (1960), *op. cit.*, p. 311.

<sup>31</sup> Fisher, *op. cit.*, p. 90.

<sup>32</sup> Kaldor (1960), *op. cit.*, p. 13.

free reserve. Moreover, the book values of certain assets (such as real estate and investments) may be revised by the authorities where such book values are lower than the estimated sales value of the assets.

The valuation rule for the net wealth tax is closely related to that for the real property tax, the inheritance tax, the gift tax, and other taxes which require the valuation of property for tax purposes. Colombia uses a cadastral value both for purposes of the net wealth tax and the real property tax. Japan designed its net wealth tax valuation to correspond with the valuation rule provided in the inheritance and gift tax laws. For individuals, Uruguay's valuation also follows the inheritance tax laws but differs for corporations. Germany has a unified federal valuation law which applies to the net wealth tax, the real property tax, the inheritance tax, the gift tax, the trade tax on business capital, income tax, and Equalization of Burdens Law, notwithstanding the fact that they are administered by different authorities—federal, state, and municipal.

#### TAX RATES

In most countries the rate structure of net wealth taxes applicable to individuals is progressive. Exceptions are Germany, the Netherlands, Luxembourg, and Uruguay, where proportional tax rates are provided for individuals. The choice between progressive and proportional tax rates also depends on the intended use of the levy, the relationship to the income tax rate, and other considerations of the government.

If a primary purpose of the tax is to break up large fortunes or to supplement the progression of the income tax on high incomes, progression is indicated. Progression may be justified on the basis of the same arguments as those which support it for income taxation. However, progressive taxation of wealth tends to spread ownership of property among various members of the family and other interested parties to even a greater extent than progressive taxation of income does. This tendency results in troublesome questions relating to the definition of the taxable unit. Therefore, if the tax is intended only as a general supplement to the income tax rather than as the primary means of ensuring a progressive tax structure, a proportional rate structure may be suitable. Also, a proportional rate may be appropriate for corporations if they are taxed—as in a number of countries, not only countries applying a proportional rate to individuals (Germany, the Netherlands, Luxembourg, and Uruguay), but also those applying progressive tax rates to individuals (Norway and Finland).

Whether the tax is progressive or proportional, all countries keep the rate schedule low enough for the tax to be payable out of income. A

tax of 2 per cent on net wealth, for example, would be equivalent to a tax of 40 per cent on income derived from net wealth on which the yield is 5 per cent. Basic tax rates for individuals in the 14 countries, ranging from 0.2 per cent to 3.0 per cent, are shown below.<sup>88</sup>

PROGRESSIVE RATES <sup>1</sup>

	<i>Per cent</i>		<i>Per cent</i>
Switzerland	0.2-0.6	Ceylon <sup>2</sup>	0.5-2.0
Colombia	0.1-1.5	India	1.0-2.0
Norway	0.6-1.7	Pakistan <sup>2</sup>	1.0-2.0
Sweden	0.5-1.8	Denmark	1.2-2.3
Finland	0.4-2.0	Japan <sup>3</sup>	0.5-3.0

PROPORTIONAL RATES <sup>1</sup>

Netherlands <sup>2</sup>	0.5	Uruguay <sup>4</sup>	1.0
Luxembourg	0.5	Germany	1.0

<sup>1</sup> 1963 unless otherwise specified.

<sup>2</sup> 1964.

<sup>3</sup> 1953, when law was repealed.

<sup>4</sup> 1965; in addition, Uruguay imposes a 1 per cent substitute inheritance tax on the net capital of corporations.

## CEILING

Some countries provide a ceiling to ensure that the average or marginal rate of joint income and wealth tax does not exceed a certain maximum percentage of income. Sweden has two kinds of rules for ceilings—the “80 per cent” rule and the “30 times income” rule. The total of the national income tax, the local income tax, and the national tax on net wealth assessed against a taxpayer for an income year may not exceed 80 per cent of the taxpayer’s combined net reported income from all sources. Also, the amount of taxable wealth may in no case exceed a sum which is 30 times the taxpayer’s income. In neither case, however, may these ceilings reduce the tax on wealth by more than 50 per cent below the tax which would have been payable without ceilings. Similar systems are provided in Denmark, the Netherlands, and Ceylon.

As shown above, a net wealth tax aims at effective taxation of net wealth, which itself has several economic and social advantages, apart from its yield of money income. Moreover, one of the roles of the tax is to penalize low-yield or no-yield investors who withhold their property from productive use, and to make them put it to productive use. As a matter of fact, problems might arise from the serious burden placed upon persons who have wealth but little or no current income (see

<sup>88</sup> In some countries (Germany and Denmark) the effective burden of the net wealth tax on individuals is less than that based on nominal rates, because the taxpayer can deduct the net wealth tax in computing taxable income for income tax purposes.

below). These problems suggest the need for an appropriate exemption and for a relatively low rate, as well as for a certain ceiling on net wealth tax liability.

#### ADMINISTRATION

Reflecting one of its roles, the administration of the net wealth tax is usually link with that of the income tax. A typical example of administrative integration is shown in Sweden: one form of return and one collection system cover the net wealth tax and two income taxes—national and local. Assessment, valuation, review, and appeal are handled by the same officers and agencies who deal with the income taxes. The preliminary taxes required to be paid by each taxpayer under the pay-as-you-earn system are designed to cover the amount due under the net wealth tax, as well as amounts due under the national and local income taxes. The tax authorities may use one tax as a check on the other. A taxpayer with large increases in net wealth, and who has reported only small amounts of income, may invite special scrutiny from the tax authorities.<sup>84</sup>

In Japan the net wealth tax was administered by net wealth tax officers, and not by those who administered the income tax. An exchange of information was intended to achieve a functional coordination of both taxes. However, the result was far below expectations, and this contributed to the repeal of the net wealth tax after a few years' experience.

Since a net wealth tax presents great difficulties of administration—especially in discovering the true owners of property and in valuing net wealth—several devices have been incorporated into its administration. To meet the problem of discovery, India tightened methods of registration and transfer of property ownership. Under Indian law, gifts and non-testamentary transfers exceeding Rs 100 in value are not effective unless registered. Transfer of nonagricultural property valued at more than Rs 100,000 may not be registered without a certificate from a wealth tax officer permitting such registration.

To simplify the valuation procedure, Sweden and Germany usually revise the valuation of real properties and other assets at intervals of several years. The wealth tax officer in India and Pakistan determines the value of the net wealth; however, any decision he makes may be appealed.

The net wealth tax is usually a national tax levied by the central government. The problem of finding all property, especially intangibles, the necessity of unifying the valuation rule, and the role of the tax virtually preclude the use of the tax below the national level. Germany meets

<sup>84</sup> *Taxation in Sweden*, pp. 643–44.

these requirements to the extent that a unified valuation law is provided; however, local authorities in some countries (Norway, Germany, and Switzerland) have their own net wealth taxes.

### CONTRIBUTION TO REVENUE

Net wealth taxes contribute only a small part of total tax revenue in almost all countries, as shown by the available data below:

#### CONTRIBUTION OF NET WEALTH TAXES TO TOTAL NATIONAL TAX REVENUE

	<i>Per cent</i>		<i>Per cent</i>
Japan (1952/53)	0.3	India (1959/60)	1.8
Pakistan (1964/65)	0.8	Ceylon (1964/65)	2.0
Netherlands (1960)	1.5	Norway (1962/63)	2.4
Sweden (1958/59)	1.5	Denmark (1958/59)	2.5
		Uruguay (1965)	2.6

#### CONTRIBUTION OF NET WEALTH TAXES TO AGGREGATE GOVERNMENT REVENUE AT ALL LEVELS

Germany (1960)	1.6	Colombia (1961)	4.4
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In most countries, net wealth taxes account for 1.5 per cent to 2.6 per cent of the total national tax revenue (the Netherlands, Sweden, India, Ceylon, Norway, Denmark, and Uruguay). In Germany its share is little higher—1.6 per cent of aggregate revenue at all government levels. Only in Colombia does the tax occupy a relatively important position—over 4 per cent of aggregate government revenue. In Japan the yield was very minor—only 0.3 per cent of total national tax revenue, and in Pakistan it was less than 1 per cent of the total. It is significant that the higher ratios were in countries which assessed corporations as well as individuals.

The net wealth tax, however, may have greater significance for revenue than these figures suggest if it helps improve compliance with the income tax. Income taxes on individuals and corporations together contribute some 50 per cent of total national tax revenues in Sweden, Colombia, and Japan; 30 per cent in Denmark and India; and 20 per cent in Norway and Pakistan.

### III. Evaluation of Net Wealth Taxation

The foregoing analysis of the objectives and structure of annual taxes on net wealth indicates that the tax has advantages not realized by the income tax alone, and suggests several possibilities for the role of the tax in modern revenue systems. This section evaluates the role of these taxes

in the tax structure under four headings—equity considerations, economic effects (including problems of shifting), administrative efficiency, and revenue yield. Expect as noted, the theoretical treatment assumes complete coverage and effective administration of the tax. Also, this evaluation covers mainly the tax on individuals, with incidental reference to the tax on corporations.

### EQUITY CONSIDERATIONS

The main argument on equity grounds for a net wealth tax is that income, taken by itself, is an inadequate yardstick of taxable capacity. As mentioned above, taxation based on income alone tends to discriminate against persons who have not yet accumulated wealth. In practice, the income tax never reaches capital gains until they are realized; even when realized, the gains usually receive favorable treatment relative to other income. It also taxes more heavily the holders of high-yield securities and risky investments, thereby favoring holders of low-yield and no-yield investments, who enjoy greater security and may also benefit from liquidity. Some of these equity problems can be met under an income tax by placing a heavier burden on property income, by including imputed rental value of homes and capital gains in taxable income, and by closing other legislative loopholes. However, these income tax approaches encounter numerous administrative problems. Moreover, they cannot touch most property producing no income and cannot adjust the tax burden between gains from security or liquidity and those from risk taking.

A net wealth tax supplement to the income tax places a heavier overall burden on persons having accumulated wealth or receiving property incomes, on the principle that the ownership of property is a separate measure of taxable capacity. Such a tax reaches a substantial part of capital appreciation over a period of years. It also treats with greater equity those who hold various types of securities and investments, through equal taxation on the same property value, whether risky industrial shares or safe securities, cash, or gold yielding no money income at all.

When income tax rates are high, equitable taxation usually suffers from inefficiency of administration. Beyond a certain level of compliance and enforcement, unusually high marginal rates of income taxation encourage evasion and avoidance, and yield little revenue. A net wealth tax, by making acceptable a reduction in top marginal rates of income tax, permits greater over-all progression in the tax structure than is possible with income taxation alone. The administrative cross-checks thereby provided serve to prevent evasion without serious adverse economic effects on incentives or on production and investment (see below).



*Limitations of design and administration*

Advocates of a net wealth tax assume that the tax is well designed and effectively administered. In actual practice, however, the tax may involve various statutory exemptions (mentioned above), administrative ineffectiveness in discovering the true owner of certain types of assets—particularly intangibles—and unrealistic valuations of property, analyzed in the following section in detail. Unless these problems are solved, the introduction of a tax on net wealth produces new inequities.

One of the principal reasons for Japan's repeal of the net wealth tax was the sharp imbalance of its burden between those who owned cash, jewelry, bank deposits, securities, and the like—which were very difficult for tax authorities to trace—and those with real property that was relatively easy to identify. The difficulty of discovering the true owners of intangibles was intensified by Japan's policy of protecting private saving in the form of anonymous deposit accounts, bearer shares, and the like. A recent survey of the Japanese tax system stated: "The net worth tax proved inequitable because most of the burden fell on real property owners whose net worth is easily identified. Consequently, this tax was rescinded in 1953. The maximum income tax rate was accordingly raised from 55% to 65%." <sup>35</sup>

Nicaragua's experience in this respect is also relevant. The Nicaraguan net wealth tax (*el impuesto directo sobre el capital*) was replaced by two taxes in 1962—the real estate tax and the personal property tax—because of three problems: incomplete declaration of taxpayers, under-valuation of assets, and evasion of tax. In order to resolve these problems, the Fiscal Commission recommended that the real estate tax be separated from the personal property tax, and that first priority be given to a cadastral survey which could provide effective identification and realistic valuation of land, where most of the country's wealth was concentrated. <sup>36</sup>

*Payment problems*

Taxation of net wealth is also likely to present a problem to many taxpayers who have property but little or no current income, forcing them to dispose of part of their assets in order to pay the tax. These taxpayers are not generally convinced of the merits of the argument that the ownership of wealth represents taxable capacity as such, quite apart from the

<sup>35</sup> Japan, Tax Bureau, Ministry of Finance, *An Outline of Japanese Taxes*, 1964 (Tokyo, 1964), p. 8.

<sup>36</sup> Nicaragua, La Comisión Fiscal, *Informe de la Comisión Fiscal, Consideraciones Relativas a la Situación Fiscal de Nicaragua y la Necesidad de su Reforma* (Managua, 1961), pp. 45–48 and 67–69.

money income which it may yield, and resist the tax because they lack funds for paying it. If the amount of wealth possessed is small, serious hardship can result; even owners of large estates may be penalized if they are compelled to sell property at depressed prices.

Norwegian tax statistics for 1950/51 show a low correlation between taxable net wealth and taxable income. About 40 per cent of the taxpayers with taxable net wealth of NKr 20,000–50,000 (US\$2,000–7,000) reported no taxable income. A fairly large number of farmers owning their own land had very low incomes and some had no source of support besides their capital. Even if fully invested, more capital than this would be required to yield a taxable income.<sup>87</sup> Some solution of these problems may be provided by appropriate minimum exemptions, moderate tax rates, and reasonable ceilings. However, the problem may still be serious for some property owners with little money income. An ad hoc committee on the Danish income and net wealth tax, which recommended increasing the exemption of the net wealth tax to support private saving, stated: "Even after an increase in the exemption has been introduced, there still exists a possibility for the tax administration to reduce the net wealth tax liability. There is a social interest to do this in cases where old or sick persons, widows, etc., have to live from a capital invested in low-yielding assets."<sup>88</sup>

India's chambers of commerce and industry were opposed to Kaldor's recommendation of a net wealth tax for India, stating:

The tax on property is sought to be justified on grounds of equity. Yet in practice it can be a very inequitable tax. It is common knowledge that income from different kinds of property of the same value differs. If the tax is levied on the value of property, the person who has a larger income on his property will be in a better position to pay the tax than another whose investments yield little or no income. Productive enterprises have a long period of gestation and a person holding a share in a new enterprise may not receive any dividend for the first few years. He will nonetheless be liable to pay a tax based on the market value of his shares. He may thus be forced to consume his capital to be able to meet his tax liability.<sup>89</sup>

Japan faced the same problem of taxing holders of net wealth with little money income. Forests represented one of the largest sources of wealth subject to Japan's net wealth tax. All agricultural land had been released by the land reform, and other wealth was still in an unsettled condition after the war. Since forests yielded little or no current income, the owners had insufficient funds to pay the tax unless the property was sold. They complained vigorously and resisted imposition of the tax as

<sup>87</sup> Fisher, *op. cit.*, p. 88.

<sup>88</sup> Skattelovskommissionen, *Skattelovskommissionens Betaenkning* [Report of the Committee for Taxation], II Del (Copenhagen, 1950), pp. 97–98.

<sup>89</sup> Federation of Indian Chambers of Commerce and Industry, *Kaldor's Report on Indian Tax Reform—An Analysis* (New Delhi, 1957), p. 16.

inequitable. Thus, some of the equity and economic advantages claimed for the tax by its proponents were not realized in Japan because conservation of forests was also important for the recovery of the damaged economy.<sup>40</sup>

### *Other equity considerations*

An annual net wealth tax is generally justified on the basis that income from property is obtained with less effort and is usually more permanent than income from work, and that property itself confers advantages on its owner independent of and additional to the income it yields. The difference in taxable capacity between both types of incomes, however, may have narrowed in some countries where the active employment-promoting policy of the government, combined with extensive social insurance systems, favors wage and salary earners.

Also, it is suggested, wealth is a very incomplete index of taxable capacity because it excludes the economic resources of persons who depend on earnings from personal services:

Suppose that "A" is a doctor, a very successful one, whereas "B" occupies himself, or pretends to occupy himself, by dabbling about in his real estate business that barely pays its expenses. The larger income of "A" arises from his earnings as a doctor, not from any greater rate of return on his investments. "B" is simply incapable of earning any important sum by self-employment or

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<sup>40</sup> There were perhaps six reasons leading to the abolition of the net wealth tax in Japan, including the first two, mentioned above:

(1) The tax presented difficulties in discovering intangibles, resulting in a discriminatory burden on real property owners.

(2) A serious burden was placed on holders of wealth, particularly owners of forests, with little or no current income.

(3) The valuation of assets and liabilities also presented difficulties for tax administration. Since there are many individual business enterprises and closely held corporations (about 90 per cent of the total number of corporations) in Japan, valuation of quotas and shares of these enterprises with no public sales was a serious administrative problem.

(4) Coordination of the income tax and the net wealth tax was incomplete because the net wealth tax was administered by the net wealth tax officers in a different manner from that in which the income tax was administered. Also, the cross checking between personal income and related property through the use of additional information provided by taxpayers was not easy for tax officers because of arbitrary personal and household expenditures which disturbed a reasonable relationship between personal consumption and changes in accrued income and property.

(5) Although the tax aimed at encouraging wealth to shift to more productive use, the result was quite beyond that expected because such a shift required so many considerations in addition to the form of taxation, and the tax was adopted under unsatisfactory conditions for investment after the war.

(6) The tax produced only a small part of total tax revenue, compared with its costly administration.

See Kikuzo Watanabe, *Zei no Riron to Zissai* [Theory and Practice of Taxation] (Tokyo, 1955), pp. 246-47.

by working for others. What is fair tax treatment of the two people in question (under wealth taxation)?<sup>41</sup>

Wealth, as usually defined, does not include the expectation of future income from personal effort or the capitalized earning power of people because the right to receive all such income cannot be bought and sold. Thus, it is argued, wealth does not rival income as the primary index of ability to pay; it has a claim for consideration only as a supplementary index.<sup>42</sup>

### ECONOMIC EFFECTS

Several economic advantages and disadvantages are claimed for the net wealth tax as a partial substitute for the income tax on property income. Some of its advantages reinforce the equity case for the tax; but on the whole, the actual effect is not always certain because so many considerations—in addition to the form of taxation—influence economic behavior. The economic effects of a net wealth tax are sometimes exaggerated: no measurable effects on total investment, saving, and the like can be expected because of the very limited burden of the tax on the economy as a whole.<sup>43</sup>

The adverse effects of a net wealth tax on investment are probably less per unit of revenue than those of an income tax on property income since the former rests directly on the total sum accumulated by the person, regardless of the gain from it. As shown above, in principle, it is imposed equally on the same property value whether the property is held in cash, gold, or jewelry yielding no income at all, or is invested in industrial shares with high returns. On the other hand, the income tax discriminates against high-income investments by taxing additional gains from risk bearing, while not taxing at all the liquidity gains from cash or near-cash investment. Also, the net wealth tax liability is increased only if the income from investment is added to net wealth, whereas income tax liability is assessed on income from any successful investment, whether it is consumed or saved. Even if all yields of investment are added to net wealth, under certain conditions the net gain from investing is greater

<sup>41</sup> Earl R. Rolph and George F. Break, *Public Finance* (New York, 1961), p. 196. See also Break and Turvey, *op. cit.*, pp. 175–77.

<sup>42</sup> Goode, *op. cit.*, pp. 21–22. While Rolph and Break suggest that human capital should be included in the base of a net wealth tax, Goode does not agree with their suggestion because of the infeasibility of measuring human capital with a degree of accuracy, and of dangers of infringement on personal liberties in applying a tax on the present value of potential earnings.

<sup>43</sup> Goode, *op. cit.*, pp. 38–57, compares the economic effects of the income tax with those of the net wealth tax and the expenditure tax. See also Due (1960), *op. cit.*, pp. 312–13 and 316–19.

under the net wealth tax than under the income tax.<sup>44</sup> These advantages may be still greater if the income tax is progressive.

The difference between the net wealth tax and the income tax in restricting risk taking can be narrowed by allowing loss offsets under the income tax. Indeed, with complete loss offsets, the income tax may actually stimulate risk taking in the economy.<sup>45</sup> In practice, however, loss offsets are incomplete in all income taxes. Furthermore, the reward for risk taking is only part of the necessary returns on investment.

Advocates of the net wealth tax often claim that the tax tends to push investments out of cash and other low-income assets into more productive use, generally with higher yields, by making it more expensive to hoard money or gold and to hold inactive properties. In order to avoid paying the tax out of capital, the owners of such properties may be forced to use them in more profitable ways; owners of unused land, for example, are induced to cultivate it. Any such relative shift toward more risky ventures stimulates economic development.

Taxation of net wealth seems likely to be less favorable to private saving than taxation of income because the tax falls on accumulated savings.<sup>46</sup> The net wealth tax cannot be avoided simply by holding the saving in cash form, as can the income tax. Since all savings give rise to annual additional tax liability, the net wealth tax may have greater effect than an income tax raising the same amount of revenue. In addition, the tax is more likely to be paid out of capital than an income tax, because

<sup>44</sup> Goode, *op. cit.*, p. 47, illustrates this gain by the following example, assuming that the net worth tax accrues at the end of the year on the capital plus earnings during the year:

	<i>With only income tax (tax rate 50%)</i>	<i>With only net wealth tax (tax rate 2%)</i>
<b>Hoarding</b>		
Cash, beginning of year	\$1,000	\$1,000
Gross yield	0	0
Tax liability	0	20
Balance, end of year	1,000	980
<b>Investment</b>		
Investment, beginning of year	1,000	1,000
Gross yield (4%)	40	40
Tax liability	20	20.80
Balance, end of year	1,020	1,019.20
Net gain due to investing	20	39.20

<sup>45</sup> Richard A. Musgrave, *The Theory of Public Finance* (New York, 1959), pp. 325-27.

<sup>46</sup> Kaldor suggested the introduction of an expenditure tax that would reach so-called spending power as a measure of taxable capacity of individuals, and thereby avoid possible disincentive effects of net wealth and income taxes on savings. See Nicholas Kaldor, *An Expenditure Tax* (London, 1955), pp. 79-101.

persons who have no current income incur some liability for the tax. Thus, it may check the potential rate of capital formation more than an income tax. However, it is also argued that to the extent to which corporate income is saved to provide funds for business expansion, the more favorable treatment given to equity investment by the tax may tend to result in greater savings. Likewise, psychologically, the wealth tax with lower rates, spread over the entire accumulation, may have a less deterrent effect than an income tax with highly progressive rates concentrated on the earnings from additional saving. On the whole, the net effect on saving is unpredictable.<sup>47</sup>

Some insist that the net wealth tax affects the relative desirability of various forms of consumption expenditures.<sup>48</sup> Since the purchase of durable consumables increases tax liability, taxpayers may be induced to buy more nondurables and fewer durables. In particular, heavy expenditures on housing and the like are discouraged. If the discouraging effect on homes is widespread, as is likely under the general property tax, it is usually regarded as objectionable because of the social desirability of housing. Rather than shift expenditures from durable to nondurable forms, however, a net wealth tax might generally induce more hiding of cash, gold, or jewelry, as discussed in the following section.

A net wealth tax has no direct effect on earnings from personal effort, and presumably little, if any, on the degree of effort. On the other hand, an income tax clearly reduces the reward for work—particularly under progressivity. Nevertheless, we cannot be sure whether the net wealth tax causes more or less willingness to work than an income tax because of the uncertain influence of income taxation itself on work.

As for shifting, the usual view is that a net wealth tax on individuals is not shifted to others because of its general and personal character, particularly if the net wealth consists exclusively of residential real property and personal intangibles or of tangibles unrelated to any business purpose.

Another view, however, is that the tax may be partly shifted. Due insists that some direct shifting may occur in three circumstances:

The market for new real estate mortgages is highly imperfect, and lenders might be able to pass the tax on in the form of higher interest rates. On rental housing, shifting would be possible under conditions of scarce supply, and perhaps over a longer period through the effects on the construction of new rental housing. Small business firms might seek to shift, but competition, particularly with large corporations, would make price increases difficult.<sup>49</sup>

The first circumstance seems to assume that net wealth taxpayers are

<sup>47</sup> Due (1960), *op. cit.*, p. 318.

<sup>48</sup> *Ibid.*, p. 319.

<sup>49</sup> *Ibid.*, p. 313. See also John F. Due, *Government Finance: An Economic Analysis*, rev. ed. (Homewood, Illinois, 1959), pp. 379–80.

real-estate mortgage lenders rather than owners of real estate, but this assumption is not warranted. In general practice, the tax is imposed on the owners of real property, and its taxable base is the net value of the real property, excluding such related liability as existing mortgages. In the other two circumstances the shifting would interfere somewhat with the desired distribution of burden, but a very limited amount of shifting is not of great significance and should not seriously reduce the general equity of the tax, as Due himself states.

#### ADMINISTRATIVE EFFICIENCY

It is strongly argued that a net wealth tax promotes efficiency in income tax administration. A supplementary tax on net wealth can help reduce evasion of the income tax by providing information for cross-checks. An examination of a man's property ownership (if disclosed) usually leads to the discovery of concealed income just as an examination of his income receipts (if disclosed) leads to the discovery of concealed property. A tax on both property and income, therefore, should improve the administrative efficiency of the system and provide a better check on evasion and concealment than a tax on either alone. In order to realize this advantage, the administration of the net wealth tax is usually integrated with that of the income tax, as noted above.

The possibilities of such administrative improvement, however, are limited and cannot be attained without considerable effort and cost. For instance, cross checking does not cover all income and property; it cannot cover income earned from professional or vocational activities, or certain properties which do not yield any income. Also, it is not easy for tax officers to cross-check personal income and related property because of the difficulty of determining a reasonable relationship between personal and household consumption, and changes in accrued income and assets and liabilities. Personal and household expenditures vary greatly with many factors other than income, and any arbitrary determination is subject to prolonged controversy, especially where records are inadequate.

Japan's difficulties in administering the net wealth tax contributed to the abolition of this tax after a few years' experience. However, other countries, especially in Europe, have found the net wealth tax a useful adjunct to the enforcement of the income tax.

An annual net wealth tax presents special problems of assessment on account of difficulties in discovering the true owners of the property and in valuation.

*Problems of discovery*

Major problems arise in the identification of property ownership. Cash, gold, jewelry, and other forms of property which do not usually bear owners' names are very difficult to uncover. Also, the true ownership of securities and other properties is difficult to determine if the ownership is recorded under fictitious names and addresses. Bearer securities or numbered deposit accounts are always a source of trouble for tax administrators. The administration of the income tax, death duties, and gift tax already faces these difficulties, and the introduction of a net wealth tax may not raise formidable new problems. An annual net wealth tax does, however, place an additional premium on the concealment of property and may intensify efforts to evade tax. Therefore, if a net wealth tax is introduced under conditions of weak administrative capabilities, the tax may create new inequities.

We have seen how Japan failed in effectively taxing net wealth, mainly because of the identification problem, and how its tax discriminated against real property owners whose net wealth is easily identified, in favor of those with intangibles and other properties which are difficult to trace. In the United States also, administration of the general property tax has encountered great difficulties in discovering intangibles and household property. Thus, Goode concludes:

Granted that the federal government might be more efficient than local assessors, and that there would be advantages in linking wealth tax and income tax assessments, it still does not seem realistic to contemplate a wealth tax with low exemptions and broad coverage. A tax limited to a small number of rich persons might be feasible, and the tax could be extended to a somewhat larger group if it were thought to have great social and economic advantages. As an instrument for checking the concentration of wealth, an annual tax on net worth does not seem to have great advantages over an integrated system of income, estate, and gift taxes, and it might be easier to improve the existing income and transfer taxes than to introduce a new tax on wealth.<sup>50</sup>

Because of difficulties in discovery, as well as valuation, the Santiago conference on fiscal policy recognized that the net wealth tax requires a highly efficient tax administration, and that introduction of this tax in the near future may be advisable only in countries possessing these administrative prerequisites.<sup>51</sup>

A successful system for the discovery of property necessitates the administration of a net wealth tax on a national basis; many taxpayers, regardless of their residence, own properties throughout the country. It is also essential to tighten methods of registration and transfer of property ownership. A net wealth tax cannot be administered efficiently without the adoption of an improved system of property registration. The elimina-

<sup>50</sup> Goode, *op. cit.*, p. 32.

<sup>51</sup> *Fiscal Policy for Economic Growth in Latin America* (cited in fn. 2), p. 421.



tion of bearer securities and numbered deposit accounts is also essential for successful enforcement.

### *Problems of valuation*

Any tax based on current value encounters more severe and troublesome problems of valuation than a tax based on income or receipts. Valuation is not difficult for property traded in the open market, such as stocks and bonds of larger corporations. Value can also be easily placed on cash, bank deposits, notes, and mortgages not in default, if discovered; but troublesome problems arise in the valuation of real estate, private businesses, and oil wells and other mineral rights, which are seldom sold.

Cadastral values are usually used in the valuation of real property. Colombia's experience with the net wealth and real estate taxes, however, shows cadastral values to be incomplete and generally much below current values. As a result, owners of real property pay the tax on inadequate values, and much discrimination arises because of uneven valuation.<sup>52</sup> The obvious remedy is to bring cadastral values up to date and make them uniform, but that remedy is costly and time consuming. This problem, of course, is not peculiar to the net wealth tax: the property and property-transfer taxes in many countries are also generally based on cadastral values. A net wealth tax, however, compounds the injustices of a property tax and other taxes based on inadequate valuation procedures.

The greatest difficulties arise with individual business enterprises and closely held corporations with no public sales of shares. In Japan the proper valuation of shares of these enterprises was a major difficulty, since about 90 per cent of the total number of corporations are regarded as family corporations. In Latin America, the practice of converting individual properties into shares in companies gives rise to problems not only of valuation but also of tax jurisdiction and fiscal evasion.<sup>53</sup>

Several approaches to a solution of valuation problems have been suggested. Kaldor recommended to the Government of India that all property should be valued at the book value instead of at the current market value. This meant, in effect, that all items of property would be valued at the cost at which they entered the accounts; they would continue to be valued at that cost (subject to reduction for depreciation allowed by income tax authorities) until the property passed out of the account through sale, gift, or bequest. Property, therefore, would have to be valued (1) initially, only when the tax is introduced and the accounts

<sup>52</sup> See Hirschman, *op. cit.*, pp. 117-38.

<sup>53</sup> See Jarach, *op. cit.*, p. 200.

are set up, and (2) subsequently, only when the property was transferred to a different owner other than by sale.<sup>54</sup>

Goode criticizes this book-value approach:

If items were assessed at book value or original cost until a transaction occurred, . . . the wealth tax would lose much of its advantage as a supplementary measure of economic capacity. Failure to take account of unrealized appreciation or decreases in the value of assets would be a more serious defect in a wealth tax than in an income tax. Any particular gain or loss affects wealth in all subsequent years but affects income of only one year; hence later actual or constructive realization will do more to make up for the earlier omission of accrued gains and losses under the income tax than under the wealth tax. A wealth tax on book value, like a tax on realized income, imposes an additional liability when appreciated assets are sold and hence may deter economically desirable switches of investments.<sup>55</sup>

Another approach is self-assessment of the property by the owners, coupled with a self-enforcing device. The law may entitle the government to buy any piece of property at the value placed on it by the taxpayer, or at a certain percentage above that value. Self-assessment at much less than true market value permits the government to buy the property and resell it at a profit. Fear of this action may prevent underassessment. Enforcing honesty through the threat of expropriation based on the self-assessed value is an ancient idea, and has often been suggested by various economists.<sup>56</sup> These self-enforcing approaches, however, are very questionable and arbitrary procedures, which would of necessity be limited to real estate, and would create serious legal problems and problems of equity.

Most problems of discovery and valuation discussed above are encountered not only in the administration of the net wealth tax, but also in the administration of the income tax, death duties, the gift tax, the property tax, taxes on transfer of property, and other taxes. Additional effort to overcome these problems, therefore, may be worthwhile in

<sup>54</sup> Kaldor (1956), *op. cit.*, p. 25. However, India did not accept his suggestion, and provided annual valuation based on the current market value of the property.

<sup>55</sup> Goode, *op. cit.*, p. 32.

<sup>56</sup> Among various suggestions, Hirschman, *op. cit.*, pp. 117-38, refers to those made to Colombia by several foreign experts, while Kaldor (1956), *op. cit.*, pp. 25-26, proposed a similar device to the Indian Government. A more sophisticated device would require that self-assessed values be placed on public record, and any individual or enterprise would be free to make a bona fide bid to purchase the property. In the event that such a bid exceeded the owner's declared value by a significant amount, the owner, if he chose not to sell, would be required to revalue his property up to the amount which had been bid. See Arnold C. Harberger, "Issues of Tax Reform for Latin America," and discussion, pp. 119-34, and "Report of the Conference," pp. 405-18 and 420, in *Fiscal Policy for Economic Growth in Latin America* (cited in fn. 2). For a more thorough and systematic treatment see John Strasma, "Market-Enforced Self-Assessment for Real Estate Taxes-I, II" *Bulletin for International Fiscal Documentation* (Amsterdam), Vol. XIX (1965), pp. 353-63 and 397-414.

order to promote efficiency and effectiveness of tax administration as a whole. Long experience with the net wealth tax in the Scandinavian countries, the Netherlands, Germany, and other countries suggests that these administrative difficulties are not insuperable.<sup>57</sup>

#### REVENUE YIELD

In all the countries that have employed a net wealth tax, the yield has been small. The primary objective has been not to raise additional revenue from the net wealth tax itself but to supplement the income tax. The assignment of the major role to the income tax rather than the net wealth tax is advisable because the income tax generally is based on a more satisfactory index of taxable capacity, is better correlated with the availability of the funds for its payment, and is almost always easier to assess. There seems to be no reason, therefore, for attempting to collect any large amount of revenue by means of a net wealth tax.

As noted above, however, amounts collected in the form of net wealth tax may understate its revenue significance. In addition to the small direct yield of the net wealth tax, there may be a considerable contribution in the form of greater income tax revenue. Moreover, the substantial administrative costs of the net wealth tax should not be considered alone, but in conjunction with the cost of the income tax, death duties, the gift tax, the property tax, and other taxes, the administration of which is related to that of the net wealth tax. Assessment, valuation, review, and other aspects of administration of the net wealth tax give valuable information and opportunities for cross-checks on the taxation of capital gains, estates, gifts, property, and other forms of wealth.

### IV. Conclusions

A net wealth tax, if well designed and effectively administered, can supplement a personal income tax and achieve greater equity in personal taxation. Such a tax has important attributes that cannot be realized by the taxation of money incomes alone: it falls directly on accumulated wealth, effectively distinguishes earned and unearned income, reaches a substantial part of unrealized capital gains and nonmonetary imputed income from property, places an equal burden on the same property value regardless of its yield, and makes possible greater progressivity, especially for higher income groups.

A net wealth tax in combination with an income tax could thus achieve

<sup>57</sup> Break and Turvey, *op. cit.*, pp. 165–80, concentrate their discussion of a net wealth tax on problems of administration.

a better distribution of taxes in accordance with individual capacity to pay. Moreover, the tax could also serve as an instrument of socioeconomic reform by redistributing wealth, curbing undue concentration of fortunes, and activating more productive use of assets. In these respects, taxation of net wealth would serve the national objectives of developing countries, which frequently wish to reduce extreme inequalities in wealth, income, and consumption.

To be effective, however, a net wealth tax requires highly skilled and costly administration. If its administrative prerequisites could not be met, the tax would not serve the purposes mentioned above; its adoption in these circumstances would be likely to introduce new inequities. Even the more basic income taxation itself plays a limited role in most developing countries and suffers from widespread evasion, and poor administration and enforcement. Moreover, existing property and inheritance taxes, which have many of the attributes of a net wealth tax, are poorly administered in most of these countries. It seems unrealistic for countries not possessing the necessary skills for effective administration of other direct taxes to attempt, in addition, a new tax on net wealth, especially considering its limited revenue possibilities. In other words, the social aspirations of developing countries may not always be adequately supported by the means of implementing them.

The promotion of social and economic development may take precedence over the objective of tax equity, and the policies of many governments in protecting certain types of properties such as bearer shares and numbered deposit accounts greatly limit the possibilities of progressive taxation of income and wealth. In practice, a net wealth tax often discriminates against owners of real estate, which cannot be concealed, and registered securities. Also, the net wealth tax may involve a payment problem, stemming from annual taxation of wealth yielding little or no money income. The result may be a serious burden on owners of real property which is not readily marketable.

A major part of what could be accomplished by a net wealth tax could be achieved by taxes on income, property, inheritances, and gifts, if these taxes are well designed and effectively administered. It might be easier to improve existing taxes than to introduce a new and complex tax. One of the first steps might be an improvement of the cadastre for the property tax system, as the Nicaraguan example indicates. A strengthened income tax administration would also serve part of the objectives of net wealth taxation, and might be easier to achieve or be even more desirable, as Japanese experience shows. Therefore, the socioeconomic requirement must be especially great and administrative capacity strong to warrant the adoption of a net wealth tax.

In any event, a net wealth tax should be considered as an addition to

a system of comprehensive personal taxes—one intended particularly to supplement the basic income tax and to improve related property taxes. It should not be considered in isolation. Its cost, revenue, and merits should be evaluated in relation to personal taxation as a whole. The long history of the net wealth tax in some European countries and their fairly successful experience with it indicate that this tax can play a worthwhile part in a modern revenue system, provided that the administrative difficulties are overcome.

## APPENDIX

### I. Bibliography

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## II. Net Wealth Tax in Principal Countries <sup>1</sup>

Tax and Year First Enacted	Taxpayer	Tax Base and Exemptions			Basis of Valuation	Tax Rates (Including Ceiling)	Revenue Importance
		Assets covered	Assets excluded	Fixed amount exempt			
SWEDEN							
1910 National Tax	(1) Individuals, undivided estates, family trusts and certain minor entities whose members do not own an interest in the entities' wealth, and foreign corporations.  (2) Husband and wife's wealth aggregated (also minor child's if living at home).	(1) Residents: Every kind of property (real or movable; tangible or intangible; foreign or domestic).  (2) Nonresidents: Certain assets located or invested in Sweden (real property located in Sweden, assets of a business carried on in Sweden and interests in Swedish economic corporations and partnerships).	Furniture, domestic utensils for indoor use; food supplies for use of family; cash held in a household fund; life insurance policies, pension rights; works of art, collections, paintings, copyrights, (if not for business); trademarks, other good will.	(1) SKr 80,000 (\$15,464) for individuals, undivided estates, family trusts, and foreign corporations.  (2) SKr 5,000 (\$966) for certain other entities.  (\$1 = SKr 5.173)	(1) Valuation on the basis of conditions at the end of the taxpayer's income year.  (2) Items shall be taken at the value they would bring at a sale under normal conditions.  (3) For certain classes of assets, specific rules are provided (assessed value for real estate, yield value for securities of widely held companies, etc.).  (4) Real property is ordinarily valued every fifth year.	(1) Progressive rates: 0.5-1.8% with an exception of a flat rate of 0.15% for certain minor entities.  (2) Ceiling: (a) 80% rule—The total of the national and local income taxes and the net wealth tax shall not exceed 80% of the taxpayer's combined net income from all sources for the income year in question. (b) 30 times income rule—The amount of taxable wealth shall not exceed 30 times the taxpayer's income. (c) In both cases with proviso that these ceilings shall not reduce the original taxable wealth by more than 50%.	1.5% of total national tax revenue (1958/59).
NORWAY							
1911 National and local tax.	Individuals and corporations.	(Substantially same as in Sweden)		(1) National tax (a) Nkr 20,000 (\$2,801) for single persons. (b) Nkr 30,000 (\$4,200) for taxpayers with dependents. (c) Nkr 5,000 (\$700) for corporations.  (2) Local tax: Nkr 1,000 (\$140) for corporations.  (\$1 = Nkr 7.143)	(1) In principle, at the book value.  (2) No deduction for statutory or free reserves.  (3) The book values of certain assets (real estate, buildings, investments, etc.) may be revised where they are lower than their estimated sales value.	(1) National tax (a) Progressive: 0.6-1.7% for single persons (lower rates for family members). (b) Proportional: 0.2% for domestic corporations. (c) Proportional: 0.7% for corporations domiciled abroad.  (2) Local tax (a) Rates vary according to the municipality. (b) Proportional: 0.6% in Oslo.	2.4% of total national tax revenue (1961).



## II. Net Wealth Tax in Principal Countries <sup>1</sup> (continued)

Tax and Year First Enacted	Taxpayer	Assets covered	Assets excluded	Fixed amount exempt	Basis of Valuation	Tax Rates (Including Ceiling)	Revenue Importance
DENMARK							
1904 National Tax	(1) Individuals, and decedents' estates.  (2) Joint taxation of family members to the same extent as in the case of income tax.	(1) Residents: All assets, whether located in Denmark or abroad.  (2) Nonresidents: Real estate, and investment in a domestic enterprise, the yield of which is subject to income tax.	Personal and household effects; life insurance policies, pension rights, etc.	DKr 90,000 (\$13,030)  (\$1 = DKr 6.907)	(1) In principle, at the market value.  (2) Special rules apply to real property.  (3) Business assets are taken at their written down book value.	(1) Progressive: 1.2-2.3%.  (2) Ceiling: Where the taxable income does not amount to at least 3% of the taxable net wealth for the same tax year, the net wealth tax is reduced by 5% of the tax due for each 2 per thousand of the net wealth value by which the assessed income is under 3% of the net wealth. If the income is not positive, the net wealth tax is reduced by 80%.	2.5% of total national tax revenue (1962/63)
FINLAND							
National Tax	Individuals and corporations.	All assets, including the capital value of patents, copyrights and the life interest in an estate.	Personal and household effects; works of art; capital value of pension rights arising from employment; conditional rights.	(1) Fmk 12,500 (\$3,906).  (2) Fmk 3,000 (\$937) for married couples.  (3) Fmk 1,500 (\$469) for minor children.  (4) Fmk 30,000 (\$9,370) for corporations.  (\$1 = Fmk 3.2)		(1) Progressive: 0.4-2% for individuals.  (2) Proportional: 1% for corporations.	

1922  
Local tax,  
originally  
modeled on  
Prussian tax  
of 1893.

(1) Individuals, corporations and other entities.

(2) Married individuals' wealth assessed jointly (also minor child's if resident).

(1) Residents: "Total property," which consists of agricultural property, real property, business property, and other property.

(2) Nonresidents: "Domestic property," which has a situs in the territory of the Federal Republic or West Berlin.

Personal and household effects; jewelry not exceeding DM 10,000; art objects by living German artists; the first DM 1,000 in the value of the total amount of bank accounts; pension rights, the first DM 10,000 of life insurance, certain copyrights and unprotected inventions.

#### GERMANY

(1) Resident individuals

(a) DM 20,000 (\$5,000) for the taxpayer.

(b) DM 20,000 (\$5,000) for the taxpayer's wife.

(c) DM 20,000 (\$5,000) for each child.

(d) DM 5,000 (\$1,250) additional for old people and invalids.

(2) Resident entities: Resident entities of the commercial law are taxed on a certain minimum net wealth if the amount of their actual net wealth is less than the applicable minimum, i.e., DM 50,000 (\$12,500) for corporations, limited partnerships, and mining companies, and DM 20,000 (\$5,000) for limited liability companies. Other entities are subject to the tax only if their total property is greater than DM 10,000 (\$2,500).

(3) Nonresidents: DM 2,000 (\$500).

(\$1 = DM 4)

(1) All property is divided into four major classifications: agricultural, real property, business, and other property.

(2) The valuation rules such as fair market rule, going concern rule, and special tax rule are applied to an economic unit or to separate property according to its classification.

(3) The principal assessment of the tax is ordinarily made in intervals of three years for business property, other than real property, and of six years for real and other property. The value of the taxpayer's net wealth is determined as at the beginning of that period.

(1) Proportional: 1% with a special flat rate of 0.75% for the portion of the net wealth subject to the capital levy under the Equalization of Burden Law.

(2) No ceiling, but individuals are permitted to deduct the net wealth tax in computing taxable income for income tax purposes.

1.6% of all federal, state, and municipal tax revenue (1960).

## II. Net Wealth Tax in Principal Countries <sup>1</sup> (continued)

Tax and Year First Enacted	Taxpayer	Tax Base and Exemptions			Basis of Valuation	Tax Rates (Including Ceiling)	Revenue Importance
		Assets covered	Assets excluded	Fixed amount exempt			
NETHERLANDS <sup>a</sup>							
1914 National	Individuals	(1) Assets are defined as objects to which value can be ascribed in economic transactions rather than as items which have monetary value.	Personal and household effects; life insurance policies, pension rights; jewelry up to f. 5,000, articles of art and science.	(1)f. 40,000 (\$11,049) for single persons.	(1) Immovable—the selling price.	(1) Proportional: 0.5%.	1.5% of the total national tax revenue (1960).
		(2) Resident individuals: world-wide assets		(2)f. 55,000 (\$15,193) for married couples.	(2) Claims secured by mortgage—par value.	(2) Ceiling: The sum of the income tax and the net wealth tax limited to 80% of the taxable income of the calendar year.	
		(3) Nonresident individuals: only the part of their assets allocable to the Netherlands.		(3)f. 13,500 (\$3,729) for minor children. (4)f. 35,000 (\$9,667) additional for old people and invalids. (\$1 = f. 3.62)	(3) Securities—based on stock exchange quotations, when traded. (4) The cash value of annuities according to prescribed tables. (5) Other assets—their cash value.		
SWITZERLAND							
The 13th century; 1719 with the use of income tax. <sup>a</sup>	Individuals (separate capital tax on corporations). <sup>a</sup>	Personal and household effects (in most cantons only up to prescribed value); stocks of business (up to prescribed value); livestock; (life insurance policies taxable at surrender value). <sup>a</sup>		(1) Sw F 10,000 (\$2,314). (2) Old people and invalids up to Sw F 30,000 (\$6,953). <sup>a</sup> (\$1 = Sw F 4.32)		Progressive: 0.2–0.6% separate capital tax on corporations. Proportional: 0.15%. <sup>a</sup>	Average for 8 cantons = 15% of combined income plus net wealth tax revenue.

1952 National	Individuals and companies.			<u>LUXEMBOURG</u> Lux F 100,000 (\$2,000) for each member of family.  (\$1 = Lux F 50)	(1) Proportional: 0.5% for individuals and public companies.  (2) Proportional: 0.2% for private companies.		
<hr/>							
1950 National tax, repealed in 1953.	Individuals	(1) Residents except foreign nationals: all assets owned by the taxpayer.  (2) Others: assets located in Japan.  (3) Husband and wife's wealth aggregated (also minor child's if living at home).	Personal and household effects; assets used in scientific research if not for business; national treasure and other important art objects designated by laws up to ¥ 1,000,000 if not for business; jewelry up to ¥ 30,000, works of art up to ¥ 20,000.	<u>JAPAN <sup>4</sup></u> ¥ 5,000,000 (\$13,888)  (\$1 = ¥ 360)	(1) Basically designed to correspond with the valuation rule provided in the Inheritance and Gift Tax Law.  (2) Basic standard the fair market value of the asset, except where different measures of the valuation provided.  (3) Real property ordinarily taken at the capitalized value based upon the valuation standard of the old land tax and house tax.	(1) Progressive: 0.5-3%.  (2) No ceiling.	0.3% of total national tax revenue (1952/53).

## II. Net Wealth Tax in Principal Countries <sup>1</sup> (continued)

Tax and Year First Enacted	Taxpayer	Assets covered	Assets excluded	Fixed amount exempt	Basis of Valuation	Tax Rates (Including Ceiling)	Revenue Importance
INDIA							
1957 National Tax	Individuals, Hindu undivided families, Indian trust, decedents' estates, foreign corporations and other entities.	(1) Basically, the aggregate value of all assets owned by the taxpayer: property of every description, movable or immovable.  (2) Ordinary residents: world-wide assets.  (3) Others: assets located in India.  (4) No aggregation of family assets, except certain assets transferred by a husband to his wife or minor child.	Household effects: jewelry up to Rs 25,000; animals; all assets used in agriculture; professional equipment up to Rs 20,000 in value; assets used in scientific research; certain securities, loans and deposits; patents and copyrights if not for business; pension rights and insurance policies.	(1) Rs 200,000 (\$41,999) for individuals.  (2) Rs 400,000 (\$83,999) for Hindu undivided families.  (\$1 = Rs 4.762)	(1) The value of any asset is the price it would command on an open market on the valuation date.  (2) The net value of the business assets may be determined as a whole instead of determining the value of each asset separately.	(1) Progressive: 1-2%.  (2) The rate schedule for Hindu undivided families is slightly lower than the individual rate schedule.  (3) Additional progressive tax rates applicable to urban properties in excess of certain exemption limits: 1-4%.  (4) No ceiling: 50% of the tax on foreign net wealth of resident citizens and Hindu undivided families, and 50% of the tax on the domestic net wealth of nonresident aliens.	1.8% of total national tax revenue (1959/60).
CEYLON <sup>2</sup>							
1959 National Tax	Individuals and Hindu undivided families.	(1) Residents: world-wide assets.  (2) Nonresidents: assets located in Ceylon.  (3) Family assets aggregated.	Assets subject to the expenditure tax; life insurance policies, pension rights; assets used in scientific research; works of art; jewelry up to Rs 25,000; national bonds.	Cey Rs 200,000 (\$42,105) only for single persons.  (\$1 = Cey Rs 4.75)	(1) Basically at fair market value.  (2) Business assets may be taken at a value as whole instead of the separate valuation of each asset and liability.	(1) Progressive: 0.5-2%.  (2) Ceiling: The total of taxes on income and net wealth shall not exceed 80% of the taxpayer's income.	As "the personal tax" consisting of the net wealth tax, the expenditure tax, and the gift tax, 2% of total national tax revenue (1964/65).

PAKISTAN <sup>a</sup>						
1963 National Tax	Individuals and Hindu undivided families.	All assets including assets transferred to wife or minor child for inadequate consideration and revocable transfer to a person or association.	Personal and household effects: assets used in agriculture; one residential house owned and occupied by the assessee; animals; rights to annuities; patents or copyrights; property held under trust or other legal obligation for public purposes of a charitable or religious nature.	PRs 400,000 (\$83,682)  (\$1 = PRs 4.78)	(1) Generally at the price which, in the opinion of the Wealth Tax Officer, it would fetch if it were sold on the open market.  (2) For trade and business, based on reliable book accounts.	Progressive: 1-2% for individuals and Hindu undivided families.  0.8% of total national tax revenue (1964/65).
COLOMBIA						
1935 National Tax	Individuals, decedents' estates, and properties held for others under a restrictive gift or legacy.	(1) All property rights having a monetary value, owned within the country on December 31 of the tax year.  (2) Property rights are considered to have a monetary value if they can be used in any way to obtain income.  (3) Property rights including tangible or intangible properties such as good will.	Property outside Colombia; all property legally or physically incapable of producing income for the owner (personal and household effects, works of art, etc.); workers' and middle-class houses and apartments within certain limitations; investment in agricultural machinery, cattle, timberland, mines and petroleum, tourist hotels, automobile plants, publishing, basic industries; assets used in fishing.	Col\$20,000 (\$2,222) only in the case of net wealth of not over Col\$200,000 (\$22,222).  (\$1 = Col\$9.0)	(1) The Income Tax Law provides the norms governing the valuation of the assets and rights comprising net wealth.  (2) In general, cost price is established with exceptions such as face value, market value, assessed value, etc.  (3) The value of intangible assets such as good-will is taken at the figure determined by the Division of National Taxes.	(1) Progressive: 0.1-1.5%.  (2) Ceiling: If a taxpayer can show that his net income is less than the net wealth tax payable, the net wealth tax is limited to the amount of the net income.  4.4% of aggregate government revenues (1961).

## II. Net Wealth Tax in Principal Countries <sup>1</sup>(concluded)

Tax and Year First Enacted	Taxpayer	Tax Base and Exemptions			Basis of Valuation	Tax Rates (Including Ceiling)	Revenue Importance
		Assets covered	Assets excluded	Fixed amount exempt			
URUGUAY <sup>5</sup>							
1964 National Tax, effective only for a four- year period (1964-67).	Individuals, families, decedents' estates, and corporations.	All assets located, placed, or utilized economically in the Republic and abroad.	Loans and/or deposits in foreign currency from foreign persons; legal or physical, established abroad; stocks or corpora- tions; national and municipal public bonds, obligations issued by the Mortgage Bank, and drafts and bonds of the Treasury.	(1) Ur\$250,000 (\$4,174) for individ- uals.  (2) Ur\$500,000 (\$8,348) for family groups.  (\$1 = Ur\$59.90)	(1) Basically accord- ing to the valuation rules of the Inheri- tance and Gift Tax Law.  (2) Industrial machinery and equip- ment are taken at 50% of the cost of acquisi- tion or production with revaluation, after allowance for amortization.	Proportional: 1%	2.6% of total national tax revenue (1965).

Source: Appendix I.

<sup>1</sup> Information as of 1963 unless otherwise specified.

<sup>2</sup> 1964.

<sup>3</sup> Zürich Canton.

<sup>4</sup> 1953, when law was repealed.

<sup>5</sup> 1965.

## Impôt sur la fortune nette

### *Résumé*

Cet article expose les caractéristiques d'un impôt annuel sur la fortune (nette), basé sur une analyse du fonctionnement de cet impôt dans quatorze pays, et en évalue le rôle dans le système d'imposition, en se référant plus particulièrement aux pays en voie de développement.

Un impôt sur la fortune peut compléter utilement un impôt sur le revenu des personnes physiques de manière à répartir plus équitablement la charge fiscale qui grève ces personnes et d'atteindre certains objectifs économiques et sociaux. Cet impôt frappe directement la fortune acquise; il établit une distinction entre revenus de travail et autres revenus; il frappe les gains de capitaux non réalisés et les revenus imputés du patrimoine; il fait peser une charge égale sur la valeur identique des biens meubles et immeubles quel qu'en soit le rendement; et il permet une progressivité plus grande. On pourrait également utiliser un impôt sur la fortune comme instrument de réforme pour redistribuer la fortune, en éviter une concentration excessive, et faciliter un emploi plus productif des biens.

Malgré les avantages que présente l'impôt sur la fortune, les pays qui l'ont adopté sont relativement rares. En effet, pour être efficace, un impôt sur la fortune exige un appareil administratif extrêmement coûteux et spécialisé en l'absence duquel il n'atteindrait pas ses objectifs. Son introduction dans un pays où cet appareil ferait défaut entraînerait de nouvelles injustices et créerait d'autres problèmes. Etant donné que la plupart des objectifs qu'un impôt sur la fortune se proposerait d'atteindre peuvent l'être également par l'imposition des revenus et du patrimoine, les pays en voie de développement auraient peut-être intérêt à améliorer leurs systèmes d'imposition des revenus des personnes physiques plutôt que d'introduire un impôt nouveau et complexe à faible rendement.

Quoi qu'il en soit, il ne faudrait pas considérer un impôt sur la fortune isolément mais plutôt comme supplément d'un système d'imposition globale des personnes physiques adopté plus spécialement en vue de compléter l'impôt de base qu'est l'impôt sur le revenu et d'améliorer les impôts sur le patrimoine. L'expérience de certains pays européens en matière d'impôt sur la fortune prouve que cet impôt est susceptible de jouer un rôle important dans un système fiscal moderne, à condition que les difficultés administratives qu'il soulève soient résolues.



## Impuesto Sobre la Riqueza Neta

### *Resumen*

En este artículo se describen las características de un impuesto anual sobre la riqueza neta, y basándose en el análisis de los resultados obtenidos en 14 países, se evalúa su función dentro de la estructura tributaria, particularmente en lo que se refiere a los países en desarrollo.

El impuesto sobre la riqueza neta puede ser útil para complementar el impuesto sobre la renta individual, a fin de lograr una mayor equidad en la tributación personal y alcanzar ciertos objetivos sociales y económicos. Dicho impuesto recae directamente sobre la riqueza acumulada; establece una distinción entre los ingresos provenientes del trabajo y los de las inversiones; grava también las ganancias eventuales de capital y la renta imputada de la propiedad; establece una carga igual sobre bienes de idéntico valor, independientemente de su rendimiento; y permite que haya un escalonamiento más progresivo de la tributación. El impuesto sobre la riqueza neta podría servir también como instrumento de reforma para redistribuir la riqueza, evitar la concentración indebida de fortunas, y dar impulso al uso más productivo de los bienes.

A pesar de sus posibles ventajas, los países que han adoptado el impuesto sobre la riqueza neta son relativamente pocos. Para que dicho impuesto sea eficaz, se requiere una estructura administrativa altamente especializada y costosa; de no existir este requisito no se podrán alcanzar los objetivos que con él se persiguen; si se adoptara en esas circunstancias traería probablemente consigo nuevas inequidades y otros problemas. Como gran parte de lo que podría conseguirse mediante un impuesto sobre la riqueza neta puede también obtenerse mediante impuestos sobre los ingresos y sobre los bienes, para los países en desarrollo sería quizá más fácil y más realista mejorar sus actuales sistemas de tributación personal en vez de introducir un impuesto nuevo y complicado cuyo rendimiento es relativamente pequeño.

De todas maneras, el impuesto sobre la riqueza neta no debe considerarse aisladamente, sino como complemento del sistema general de tributación personal, y especialmente del impuesto básico sobre la renta, y como una forma de mejorar el sistema de impuestos conexos sobre los bienes. La experiencia de algunos países europeos con el impuesto sobre la riqueza neta indica que si se pueden superar las dificultades administrativas que entraña puede desempeñar una función importante en un sistema fiscal moderno.

# Cost Inflation and Incomes Policy in Industrial Countries

Anne Romanis\*

**T**HIS PAPER describes the nature of cost inflation in industrial economies pursuing full-employment policies. Its purpose is to indicate why the underlying tendencies to internally generated cost inflation are likely to be stronger in some economies than in others, when a certain moderate rate of unemployment is maintained, and to draw some conclusions concerning the scope for incomes policy. The strength of upward pressure on costs in an economy is broadly determined by the relation between the rates at which money wages and productivity tend to rise at a given level of unemployment. It will be argued that the rate at which money wages rise is likely to be influenced (1) by the underlying flexibility of the labor market situation and (2) by the degree of "organization" which prevails in product and labor markets. Such features of the labor market as the rate of growth of the population of working age, possibilities of increasing participation in the active labor force, and the scope for reducing underemployment in technically backward sectors, such as peasant agriculture and small-scale distribution, condition the bargaining power of the unions and determine the likelihood of wages and prices being bid up by scarcities. The degree of "organization," which comprehends such features of the economy as the extent of unionization of labor, the extent to which the pricing policies of employers are deliberately or spontaneously coordinated, and the extent to which firms are subject to competition from foreign concerns whose costs do not move in line with domestic wage increases, strongly influence the likelihood of widespread cost pressure eventuating in an economy. Productivity growth is also likely to vary considerably as between countries, depending on the state of technology and the resources becoming available for investment. The economies which, by reason of the circumstances just described, are most likely to experience quite rapid increases in money wages are probably not those in

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which the underlying conditions are most conducive to rapid increases in productivity.

## I. The Process of Cost Inflation

### THE NATURE OF WAGE BARGAINING BY UNIONS

Entrepreneurs and unions have come to assume that, by and large, rising productivity in the economy should be reflected in rising money wages and stable prices rather than in stable money wages and falling prices.<sup>1</sup> Union members expect to secure increases in money wages over time, and will press such claims unless their bargaining position is too weak to permit them to do so. In general, union members expect some percentage increase in money wages each year, and expect this percentage to exceed any rise in the cost of living. Even when the cost of living is stable, there is some minimum range of increase which is considered the least worth bargaining over.<sup>2</sup> However, the aggressiveness with which union members are prepared to press for wage increases tends to diminish above a certain customary range.<sup>3</sup> Wage cost inflation is, therefore, less likely when productivity growth is very rapid and exceeds that range, than when productivity growth is slight and falls short of the percentage increase in money wages which union members have come to expect each year.

It is difficult to organize wage earners in sectors such as peasant agriculture, small-scale manufacturing and handicrafts, distribution, and personal services, where the typical concerns are small family businesses employing few, if any, wage earners and little capital equipment. Even if a union were to be successfully organized, in these circumstances its power to raise wages would be circumscribed by the considerable scope for substituting alternative labor (of the entrepreneur and his dependents) or additional capital for wage labor: faced with unemployment, many wage earners themselves would be likely to swell the ranks of family helpers or the self-employed.<sup>4</sup>

<sup>1</sup> See J.R. Hicks, "The Instability of Wages," *The Three Banks Review* (Edinburgh), No. 31, September 1956, pp. 3-19.

<sup>2</sup> This may have an important influence on the form of wage claims: additional paid holidays or a reduction in weekly hours may appear a more substantial gain than a 1 or 2 per cent increase in wage rates.

<sup>3</sup> In the sense that, if the cost of living were rising by 1 or 2 per cent a year, the rank and file would be less inclined to strike and more prepared to compromise and accept a 6 per cent rise against a claim for an 8 per cent rise when the union was in a strong bargaining position, than to accept 3 per cent against a 4 per cent claim even when the union was in a weaker position.

<sup>4</sup> Differences between countries with regard to the underlying labor market situation and structure of employment are illustrated in Tables 1 and 2 and discussed in Section III, below.

It is usually easier to organize wage earners in industries where the freedom of entry of new enterprises is restricted by the need for substantial capital or technical know-how. This is so both because such industries are often characterized by the concentration of considerable numbers of wage earners in relatively few concerns and because capital-intensive techniques imply more or less fixed manning requirements in the short to medium term. Thus, it is as a rule easier for labor to restrain wage competition in those sectors where employers are most favorably placed to restrain price competition. Since it is more difficult for entrepreneurs or labor to restrain entry and competition in the sectors characterized by large numbers of small-scale producers, the population dependent on those sectors tends to increase and per capita incomes there tend to decline relative to those in the more technically developed sectors when there is persistent unemployment in the more developed sectors or when aggregate demand is tending to rise more slowly than the potential labor force. Owing to this process, weak demand for labor relative to the growth in labor supply in the past tends to be reflected in current weakness of labor organization and union bargaining power and a low level of output per worker over the economy as a whole.

Generally speaking, union members expect their union to secure larger than usual increases when bargaining conditions are exceptionally good. However, they also expect the union to ensure that their earnings rise in line with those of other wage earners. Thus, if any important union succeeds in exploiting an exceptionally favorable bargaining position to secure an unusually large increase in wages and benefits, its success tends to raise the scale of wage claims elsewhere, even if bargaining conditions for other unions remain unchanged. Increases in earnings under existing wage agreements, such as those resulting from higher overtime pay when activity increases, or from higher piecework earnings when productivity rises, may have a similar effect in stimulating wage claims from other groups of workers.

Since the object of a trade union is to advance the interests of its members, the coverage of the different unions and the area to which individual wage bargains relate strongly influence the considerations that are taken into account in pressing wage claims. Competitive union behavior is a potent factor in cost inflation. Just as the individual seller in a market comprising many small producers cannot hope to prevent prices from falling by holding back supplies, so a union which is too small to influence the general movement of wages cannot hope by its forbearance to prevent wages from rising. The small union has no reason to sacrifice the specific interests of its members because the wage increase that it secures may give rise to claims elsewhere, the combined result of which may be to force up the cost of living or to create a threat of unem-

ployment. "Even if each unionist believed that the effect of a series of wage increases in different industries would be nullified by the resulting inflation, it would still be good policy for each union to try to get its increases first and make them bigger than the average."<sup>5</sup> On the other hand, where the individual unions are very large or the union movement is strongly coordinated and the central organization exercises considerable control over the wage claims of individual unions, attention is more likely to be paid to the fact that wages generally cannot rise much faster than productivity without causing price inflation, probable repercussions on the balance of payments, and adverse effects on employment in export and import-competing sectors.

The pattern of wage negotiations can be broadly characterized as highly coordinated in the Scandinavian countries; coordinated in Austria, Germany, and, at least until recently, the Netherlands; and competitive in the United Kingdom, Belgium, France, and Italy. In the United States, Canada, and Japan, where wage bargaining takes place predominantly at the plant level, negotiations are more strongly influenced by the "capacity to pay" of particular enterprises, and hence decisions to press particular wage claims are reached somewhat more independently than in European countries. These differences seem to stem mainly from differences in the context in which unions developed. In general, the unions tend to be organized in a few large units with strong central direction, often with powerful central coordinating federations, in those countries where they developed in a context of large firms or of strongly coordinated resistance to wage claims by the employers.<sup>6</sup> In other words, the character of union structure seems to be determined largely by the character of the employers' organizations. On the whole, owing partly to less widespread unionization, but also partly to geographical and institutional factors tending to create distinct regional labor markets, there is a real contrast between the United States and Canada, on the one hand, and most European countries, on the other, in the extent to which wages differ and move differently in various regions.<sup>7</sup> There is a similar but less marked contrast between the highly unified labor markets of the United Kingdom and the Netherlands and the regional differentiation of Italy and France.

<sup>5</sup> Charles O. Hardy, "Prospects of Inflation in the Transition Period," *Prices, Wages, and Employment*, Post-War Economic Studies, No. 4, Board of Governors of the Federal Reserve System (Washington, 1946), p. 24. See also Edward H. Chamberlin, "Labor Union Power and Cost-Inflation," in *Inflation*, Proceedings of a Conference Held by the International Economic Association, edited by D.C. Hague (New York, 1962), p. 226.

<sup>6</sup> Differences in the wage bargaining situation in various industrial countries are illustrated in Table 3 and discussed further in Section III, below.

<sup>7</sup> This difference was clearly brought out in the study by the Organization for Economic Cooperation and Development, *Wages and Labour Mobility*, Economic Studies, Economic Policy Committee, Working Party 4 (Paris, 1965).

*Negotiated wage increases and wage drift*

In considering how increases in wage costs come about, it is necessary to distinguish between (1) negotiated wage increases, which essentially represent a compromise, determined by the bargaining strength of the two sides, between a price at which unions would wish to supply their members' labor and a price at which entrepreneurs hope to employ that labor; and (2) other increases in effective rates of pay per unit of labor brought about by arrangements outside the procedures of collective wage bargaining between the union and several employers in an industry, which give rise to so-called wage drift.

## NEGOTIATED WAGE INCREASES IN A PARTICULAR INDUSTRY

For the sake of simplicity, it may be useful initially to assume that all wages and salaries are in practice determined by collective agreement between the union and employers in the industry. It should be noted that though this simplifying assumption implies that wages are not bid up by individual employers competing for labor, the employers in any particular industry faced with highly favorable demand conditions as a group might concede, or even propose, an increase in wages to the union in the course of wage negotiations in order to attract additional manpower into the industry.

*Influence of degree of unionization*

It is clear that the attitude of both unions and employers toward wage claims will be strongly conditioned by the extent to which they expect the prospective wage increase to apply to all firms in the industry. The unions are likely to be less aggressive in pressing wage claims if they believe that the wage increases may not apply to all the workers actually employed or potentially available for employment in an industry (or craft); and the employers, if they hold similar views, will be less permissive in granting wage increases. Hence, if there is a large pool of unorganized low-wage manpower in the economy and the possibility exists of shifting production to a rural area and paying lower wages there, the bargaining power of unions in the established industrial areas will be somewhat circumscribed. Moreover, even if the unions in the existing industrial areas do succeed in pushing up wages, the influence of this on costs in the economy as a whole will be mitigated insofar as the effect is to encourage the transfer of production to regions where wages are lower. The possibility of substituting lower paid women workers for men may also have similar effects in restraining wage pres-

tures in the countries where only a small proportion of the potential female labor force has been employed and organized.

The influence of unemployment (or disguised unemployment) is strongly conditioned by the effective degree of unionization. If a union is able to compel all employers in an industry<sup>8</sup> to pay collectively negotiated rates, the existence even of massive long-term unemployment *outside* the industry need not influence the attitude of the union and its members toward putting forward wage claims. Thus, if an industry is fully and effectively unionized, an increase in unemployment outside the industry may have little influence on the attitude of workers in that industry concerning the wage rates at which they are willing to supply their labor. Only when the union has reason to believe that, because of an actual or prospective weakening in sales or profits, employers in their particular industry are more determined not to raise wages and less likely to yield to union pressures (such as strikes, working to rule, and overtime bans), are wage claims likely to be moderated because the general level of unemployment has risen.

On the employers' side, once the effective degree of unionization is such that an increase in negotiated wages will apply throughout an industry, each employer can assume that his competitors' wage costs will rise more or less in line with his own,<sup>9</sup> and the employers may, therefore, be less afraid to raise wages. This in turn strengthens the bargaining position of the unions.

A priori it would seem that, because of the greater likelihood of coordinated price behavior, the risk of wage increases pushing up prices is greater when wage negotiations take place on an industry-wide basis, as in many European countries, than when they take place at different times in different concerns, as in the United States and Canada. Other factors, however, such as the greater vulnerability of individual enterprises to strike pressure, work in the opposite direction. Wage claims may have more effect in squeezing profits when negotiations take place with individual concerns. The typical sequence may then be for the union first to press a wage claim against a highly profitable concern, using "capacity to pay" arguments; if the concern accedes, it may not be inclined to raise prices before the union has used this wage settlement as a lever to secure wage increases generally throughout the industry. In such a case, there will be a lag between the initial wage increase and the raising of prices, and wage increases will have some temporary effect in squeezing profit margins, particularly in the most profitable concerns.

<sup>8</sup> Or all employers of a particular occupational group in the case of craft unions.

<sup>9</sup> Chamberlin, *op. cit.*, p. 224.

*Influence of extent of "organization" among employers*

The extent to which the price behavior of entrepreneurs is deliberately, or spontaneously, coordinated strongly influences the danger of cost pressure. This complex subject cannot be adequately treated within this study, but the importance of the degree of certainty attaching to entrepreneurs' expectations concerning the probable price behavior of their competitors should be stressed. If some firms are actively seeking to expand their shares of the market by their pricing policies, the risk that they may not pass on higher wage costs in higher prices will be clear to other concerns; and firms generally will be less prepared to accede to union pressure than in a more stable market situation. When a more stable situation exists in an imperfectly competitive market comprising many or few firms, individual employers who are faced with a wage claim which, if successful, will apply to all wage earners (or all wage or salary earners of a certain type) within the industry, can foresee the prospective price behavior of their competitors quite clearly, since they can expect the behavior of other entrepreneurs to be conditioned by much the same considerations as their own. Consequently, the risks for the individual employer of allowing wages (or other monopolistically determined costs<sup>10</sup>) to rise are smaller, and resistance to granting wage claims (or to paying higher prices for other items entering into production) is likely to be weaker, than in more fluid market conditions.

While a stable market situation may apply in different circumstances, a priori such a situation would appear more likely to exist in the more highly developed industrial economies where the scope for expansion of the advanced sectors, and for advances in technique and changes in the scale of production, is relatively small. Unless quite marked fluctuations in demand are commonly experienced, firms in general are unlikely to maintain large reserves of unutilized capacity. The firm which employs price competition in order to expand its share of the market is, therefore, presumably seeking to increase its capacity and probably is increasing that of the industry. Consequently, such practical difficulties as pressure on the building sector that interferes with investment schemes, or difficulties in recruiting more labor, are liable to restrict the extent of price competition in an economy. Moreover, the gains from expanding capacity and securing a larger share of the total market will appear more certain to the firm if the industry as a whole is tending to expand. Thus, to risk a generalization, entrepreneurs in an economy undergoing rapid development of the industrial sector in a technologically "backward" setting (as, for instance, in Japan and

<sup>10</sup> Which may include the cost of raw materials, manufactured components, equipment, or services.



Italy) may be more independent in their behavior and hence more inclined to resist union wage claims than employers in an economy in which the room for expansion of technically advanced production is smaller (as in the United Kingdom and Sweden).

If a stable market situation exists in an industry, entrepreneurs can expect that prices will continue to be determined on some conventional cost-plus basis because each concern is mindful of the lowering of profits per unit of output that could result from the resumption of price competition. No firm can afford to raise prices alone, and no firm is willing to initiate price reductions alone for fear of unleashing a price war. But, so long as the demand curve for the industry is somewhat inelastic, it is possible for all firms acting in unison to count on raising prices without experiencing a drop of the same proportion in quantities sold. In stable markets, an increase in negotiated wages throughout an industry not only raises costs throughout the industry but, by doing so, increases the possibility of raising prices, since it creates a situation in which all firms are inclined to raise prices more or less simultaneously. It should be noted that price increases for basic products which constitute an important element in the cost of the products of another industry or industries are likely to have an exactly analogous effect in this respect.

In the modern world, many circumstances restrict freedom of entry into various sectors or occupations and enable existing producers to keep up prices and realize a certain habitual margin of profit per unit of output. Imperfect knowledge on the part of both producers and consumers, limited mobility of factors, technological progress and limited diffusion of the latest know-how, scarcity of skills, important economies of scale even for very large enterprises, and scope for product differentiation by advertising are all important in this connection.<sup>11</sup>

Since it is in practice difficult for new firms to enter an industry, it cannot be assumed that the output of the industry will be expanded so long as any additional profit can be made by doing so. The existing rate of profit does not therefore represent the *minimum* return required to induce producers to supply the actual (or planned) level of output.<sup>12</sup> Hence, a raising of wage costs by union action need not involve a reduction in present (or planned) output whenever demand for the industry's output is not perfectly inelastic.

<sup>11</sup> See Piero Sraffa, "The Laws of Returns Under Competitive Conditions," *The Economic Journal*, Vol. XXXVI (1926), pp. 535-50.

<sup>12</sup> For example, in a highly monopolistic industry, comprising a few firms exploiting a new product or technique (where it may be relatively easy to organize the workers, especially if there are heavy capital requirements or special factors anchoring production in a particular area), the union may be able to push wages above the going wage rate in other industries, somewhat reducing the exceptionally high monopoly profits of firms in the industry.

The factors which tend to restrict entry of new firms into certain industries, of course, militate against the equalization of rates of return to capital and management in different industries and restrict alternative employment opportunities for management and capital. Consequently, it does not follow that higher wages obtained at the expense of profits and remuneration of management in a particular industry will necessarily reduce the returns to capital and management below those elsewhere, and provide inducement to entrepreneurs to contract the industry. Nor does it follow that a reduction in returns below those obtaining elsewhere would quickly lead to reduced employment in the industry in question, since it is difficult for management and capital employed in a particular industry to shift out of that industry into more profitable fields. Eventually, if the rates of return were to remain below those which could be obtained in accessible alternative openings for management and capital over a prolonged period, the lower returns might lead to disinvestment and reduced willingness of entrepreneurs to enter, or to remain in, the industry. However, such an outcome would depend on a number of factors, such as whether returns to capital and management in other industries had also been squeezed by rising wage costs in the meantime or whether higher wage costs throughout the economy had been accommodated by monetary policy, making it possible for firms generally to raise their prices.

In an advanced economy, demand for an industry's output is usually somewhat inelastic. The bounds of an industry are extended by mergers between the producers of goods that constitute alternative objects of expenditure; and the elasticity of demand is also reduced by product differentiation, advertising, and the like. The existence of imperfect competition in other product markets, or in the supply of labor and other factors to industries producing competing goods, renders demand for each industry's output somewhat inelastic. This is so because the elasticity of demand for the output of any industry is determined not only by the extent to which a rise in the price of the product tends to cause buyers to switch to other goods, but also by the response of producers of those other goods to increased demand for their products. (If, for instance, there were to be no increase in the supply of the other goods for which demand had tended to increase, their prices would merely tend to rise until buyers were satisfied with about the same pattern of expenditure as before,<sup>13</sup> and the demand for the original industry's product would be almost or completely inelastic.) Thus, when a union succeeds in pushing up costs to all existing or potential producers in an

<sup>13</sup> That is, unless the consequent price increase was so large as to have significant income effects or to influence the choice between spending and saving.

industry, producers may find that higher wages can be passed on to the consumer with little or no reduction in the total output of the industry, provided that higher prices in this industry induce equivalent increases in prices or costs, rather than expansion of output, in other sectors. When this tends to occur, the widespread existence of monopolistic conditions in product and labor markets in effect renders the general price level unstable in the face of upward cost pressure originating in a single industry.

It follows from this description that price behavior in a single industry cannot be fully understood in isolation, without taking into account the behavior of management and labor in other sectors and the degree of control exercised by the monetary and fiscal authorities in the interest of maintaining price stability. The nature of generalized cost inflation in the industrial economy as a whole is discussed in Section II.

### *Influence of openness of the economy*

It may be useful to consider how the openness of the economy influences wage bargaining within particular industries. Where the production of certain products is concentrated in the hands of a few very large concerns in several countries, producers may be able to reach market-sharing arrangements without fear of attracting new entrants. In general, however, a stable market situation is much more likely to exist among firms in a single country than among firms in different countries. A principal reason for this is that changes in wages and other costs are more likely to be experienced in common by firms within an industry in one country than by firms in different countries. The relative unit costs of firms in different countries are more liable to change over time, both as a result of differences in the bargaining power of the unions and as a result of changes in national policies affecting the pressure of demand on national resources or the conditions for foreign trade (such as budgetary and monetary policies, tariffs, and exchange rates). Thus, the inducement for firms in different countries to seek to expand their share of an international market by lowering prices is liable to vary considerably over time, and may sometimes be very strong.

Entrepreneurs in export-oriented industries, or in industries selling in a home market where imports are of major importance, are aware that their foreign competitors' costs are not raised by domestic wage increases. Hence managements are more likely to resist union wage demands, since they have less assurance of being able to raise prices in line with rising costs. There is, consequently, less danger of internally generated cost inflation in small countries, such as the Netherlands and Sweden, where very large concerns are inevitably dependent on exports and even

those firms which depend mainly on the home market are generally competing with more or less close substitutes produced abroad, than in larger countries. It is possible, however, that the exceptionally large size of the United States tends to reduce the risk of cost inflation, by allowing regional conditions to have more influence on wage rates<sup>14</sup> and by reducing the tendency toward "organized" price behavior in the home market.

#### THE IMPACT OF WAGE DRIFT<sup>15</sup>

In practice, wage and salary payments are not determined exclusively by collective agreements between unions and employers, and increases in effective rates of pay per unit of labor also result from arrangements outside the recognized procedures of collective bargaining between the union and employers. It is customary to regard wage drift as reflecting demand pull, but though the extent of wage drift is likely to be related to the scarcity of manpower available to those sectors where collective bargaining applies, wage drift is not occasioned solely by pressure of demand for labor. It is apt to occur whenever systems of payments by results are applied, as a consequence of learning on the job and improvements in the organization of production after piece rates are established. Furthermore, the most progressive enterprises in each industry, which are successful in achieving above-average increases in productivity, frequently are willing to pay higher wages than those stipulated in the collective agreement for the industry (or to grant increases in wages before the agreement is revised), in order to facilitate the introduction of new methods, to reduce labor turnover, or to command the pick of available manpower.

At any given level of aggregate demand, wage drift will usually be greatest in those industries, or economies, where systems of payment by

<sup>14</sup> Regional considerations apparently have greater influence in wage determination in the United States and Canada than in many European countries, but this is in part the result of the lower degree of unionization.

<sup>15</sup> In statistical studies, wage drift is usually defined as the difference between the actual rate of increase in earnings and the rate of increase which would have resulted from the provisions of the collective wage agreements concerning changes in time and piece rates, overtime rates, etc. Complications may arise in using this concept, however, when the growth of actual earnings is influenced by marked changes in the degree of utilization of labor. See Bent Hansen and Gösta Rehn, "On Wage Drift," in *25 Economic Essays in Honour of Erik Lindahl* (Stockholm, 1956), pp. 87-138. For a description of how wage drift arises and an analysis of its importance in various cases, see also E.H. Phelps Brown, "Wage Drift," *Economica*, Vol. XXIX (1962), pp. 339-56, and G. Rehn, *Wage Drift in Sweden*, Trade Union Research Department, European Productivity Agency (Paris, 1959). The last is an English summary of *Löneglidning; Rapport från expertgrupp tillsall at SAF och LO* (Stockholm, 1957).

results are most prevalent,<sup>16</sup> and where the actual process of wage determination in the individual plant or enterprise is least closely regulated by the procedures of collective bargaining. Since the majority of union members cannot raise their earnings by increasing effort per unit of time, the timing and scale of a union's wage claims tend to be strongly influenced by changes in average earnings per unit of time in similar occupations. Thus, regardless of whether increases in pieceworkers' average earnings per hour (or per week) are earned by greater labor input or justified by higher output per hour, they are liable to give rise to claims on behalf of timeworkers elsewhere. The classic example of this process is to be found in the postwar history of wage negotiations in the engineering and shipbuilding industries in the United Kingdom. All the authorities on the subject emphasize the vital role of workshop bargaining over piece rates in providing the stimulus for claims elsewhere in the plant or elsewhere in the industry.<sup>17</sup> Recent empirical studies of wage drift have emphasized the difficulties that incentive schemes may cause.<sup>18</sup>

The character of union organization at the plant or local level has an important bearing on the likelihood of wage drift. If all the workers in a plant are organized in one union with a single representative, the wage structure will tend to be formalized, and the employer will be conscious that increases in certain workers' earnings will quickly give rise to claims by other workers. The risk of cost pressure originating in wage drift may be reduced by a tradition (such as exists in the Netherlands<sup>19</sup> and Germany<sup>20</sup>) of systematic job evaluation recognized by the unions and of written agreements covering many aspects of rate and earnings adjustments, resulting in an accepted concept of an orderly wage

<sup>16</sup> See Shirley W. Lerner, "Wage Drift, Wage Fixing and Drift Statistics," *The Manchester School of Economic and Social Studies*, Vol. XXXIII (1965), pp. 155-77.

<sup>17</sup> See National Incomes Commission, *Agreements of November-December 1963 in the Engineering and Shipbuilding Industries*, Report No. 4, Cmnd. 2583 (London, 1965); Phelps Brown, *op. cit.*; K.G.J.C. Knowles and D.J. Robertson, "Earnings in Engineering, 1926-1948," *Bulletin of the Oxford University Institute of Statistics*, Vol. 13 (1951), pp. 179-200; and T.P. Hill and K.G.J.C. Knowles, "The Variability of Engineering Earnings," *ibid.*, Vol. 18 (1956), pp. 97-139.

<sup>18</sup> See, for example, Denis Pym, "Is There a Future for Wage Incentive Schemes?" *British Journal of Industrial Relations*, Vol. II (1964), pp. 379-97.

<sup>19</sup> See Martin P. Oettinger, "Nation-wide Job Evaluation in the Netherlands," *Industrial Relations* (Berkeley), October 1964, pp. 45-59.

<sup>20</sup> In Germany the trade unions themselves, led by the engineering and metal-working unions, are pressing for a revision of the traditional occupational classifications to make them more appropriate for modern industrial conditions. See Heinz Markmann (Senior Economist, Deutscher Gewerkschaftsbund), "Incomes Policy in Germany: A Trade Union View," *British Journal of Industrial Relations*, Vol. II (1964), pp. 322-39, especially pp. 332-33.

structure for the plant (or industry) as a whole.<sup>21</sup> Wage increases for particular workers or groups are likely to be granted less lightly where earning differentials are explicitly fixed than where they are not fixed, but strong pressures for other workers' earnings to be brought into line are subsequently liable to develop. In sum, the risk of wage drift occurring is reduced when it can be foreseen to have unfavorable repercussions for the employer concerned.

Clearly, the extent of pressure on negotiated wage rates arising from wage drift is likely to be related to the tightness of the underlying labor market situation in the economy.<sup>22</sup> Wages actually paid are obviously more likely to rise faster than is provided for in collective agreements if employers are competing for scarce labor. The employers' attitude toward the labor market situation, conditioned by past experience and knowledge of such factors as population trends, is therefore of considerable importance in influencing the likelihood of wage drift. If the labor force is growing rapidly and there are many new entrants, or if there are large numbers of workers in low-productivity sectors willing to take up industrial employment at going wage rates, the tendency for employers to offer higher wages to overcome local labor shortages may only appear when reported unemployment has almost disappeared, if then. To the extent that employers are able to hire more workers at going wage rates instead of offering higher wages or having recourse to overtime, one major cause of wage claims by other groups of workers in the same plants or industries, i.e., to maintain their relative position in the earnings scale, is avoided.<sup>23</sup> If, on the other hand, large employers are inclined to regard the available labor supply as a more or less fixed pool from which they must secure an increasing share in order to expand production, they are likely to fight for scarce supplies of labor with wage incentives of all kinds.

Wage drift is liable to be an important factor in cost inflation because

<sup>21</sup> It has been suggested that in the United Kingdom wage drift "has occurred sometimes on the initiative and generally without the active resistance of management," and that wage drift "will be checked only as managers accept responsibility for their domestic wage structures, and move away from extemporization and its chain reactions towards, for instance, the negotiation and consistent application of works agreements" (Phelps Brown, *op. cit.*, p. 353).

<sup>22</sup> Under conditions of heavy and persistent unemployment, there may be some converse tendency to "negative wage drift," in that collective agreements may be less effectively enforced; if employees are conscious of competing for jobs, pressure on costs may be reduced by the weaker attitude of workers toward the establishment of wage-fixing practices at the plant level (i.e., less insistence on payment of the rate for the job, "loose" piece rate fixing, and the like).

<sup>23</sup> John Corina's unpublished doctoral dissertation, *Trade Unions and Wage Restraint*, prepared at Nuffield College, Oxford, in 1962, clearly demonstrates the importance of this process in causing the collapse of the 1949-50 pay pause in the United Kingdom.

the organization and the behavior of unions are such that increases in wages offered to certain workers serve to trigger claims for increases in negotiated wages by other groups. Though the scale of wage drift depends on employers' attitudes and decisions, it strongly influences the decisions of unions and their members on whether to press for increases in negotiated wage rates. This process is of considerable importance since it means that wage increases which employers in one industry are willing to offer, because of rising productivity or increasing demand, are liable to result in cost pressure from unions in other industries.<sup>24</sup>

#### HOW THE SPREAD OF WAGE INCREASES INFLUENCES BUSINESS EXPECTATIONS

Both the danger that a successful wage claim in one sector will set off widespread cost pressure throughout the economy and the risk that general cost pressure may arise from wage drift in particular industries depend on the extent of unionization in the economy and the bargaining strength of the unions in various sectors. Each of these processes will, of course, pose a less serious problem in an economy where wage comparisons tend to be confined to a single enterprise, a particular locality or region, or a group of related industries, than in an economy where each union is concerned to maintain its position in the national scale of earnings. It is no accident that the problem of wage drift has commanded so much attention in Sweden, where the system of wage negotiations is highly centralized and there is a long tradition of solidarity in the labor movement and coordination of incomes in different sectors, and in the United Kingdom, where wage bargaining usually centers around a set of so-called league tables showing relative wages in different occupations at various dates.

The probable spread of upward wage movements has an important influence on the extent to which managements are prepared to accede

<sup>24</sup> Increases in negotiated wages that exceed productivity gains are often regarded as evidence of cost-push. However, this view is an oversimplification, because when demand for labor is strong, increases in negotiated wages may merely serve to bring official rates more closely into line with wages already being paid by employers in the industry. This point was not made clear in the main text of *The Problem of Rising Prices*, by William Fellner, Milton Gilbert, Bent Hansen, Richard Kahn, Friedrich Lutz, and Pieter de Wolff, Organization for European Economic Cooperation, Paris, 1961 (hereafter cited as *The Problem of Rising Prices*). However, in the separate note on Wage Drift (p. 67), the OEEC experts conceded that indications of wages actually being paid, and hence of the current rate of drift, were often an important factor in wage negotiations, and advanced the view that "generally speaking the collective agreements have provided a large number of moving pegs to which the wages actually paid have remained tethered." The analogy does not, of course, rule out the possibility that the pegs were moved precisely because the correspondence between wages actually being paid and official rates was becoming strained.

to union wage claims and to tolerate, or even initiate, wage drift, since it influences their views concerning the risk they take if they let costs rise.<sup>25</sup> So long as increases in wages and other money incomes are confined to a few sectors of the economy, they will of course not tend to color the views of producers generally concerning the possibility of selling the same quantities of output at higher prices. Increases in the purchasing power of those dependent on certain sectors will be, in part if not entirely, offset by reductions in the real purchasing power of the population dependent on other sectors of the economy. But the wider the spread of an increase in wages and the more nearly the country in question approximates a closed economy, the greater the influence which the increase in wages is liable to have on the prospective level of aggregate demand. In this respect, too, the danger of internally generated cost inflation is likely to be less pronounced in small countries where one third to one half of all goods and services are sold abroad, than in larger countries where the bulk of all goods and services produced is sold in the home market.<sup>26</sup>

Insofar as a country approximates a closed economy, the aggregate demand and supply curves are not independent of each other but are closely related. Where virtually all wages are subject to collective bargaining and self-employment has been reduced to relatively small proportions (as in the United Kingdom), a situation may arise where

the coverage of the collective bargain has been tacitly extended from the industry to the whole economy in the sense that an "annual round" of wage settlements has become an accepted institution—settlements coming at much the same time are made for much the same amount. This spontaneous coordination extends beyond the bounds of each separate industry the assurance that other firms' costs are being raised equally.<sup>27</sup>

This context influences employers' attitudes, making them more ready to accede to wage claims unless they are primarily selling abroad. As Jack Downie noted,

If any particular set of employers know that the rate of wage increase they grant will be generalized throughout the economy, they will not be restrained from granting it by the knowledge that it will be necessary to raise prices to compensate for it.<sup>28</sup>

<sup>25</sup> Phelps Brown, *op. cit.*, p. 354. The individual employer "may even suspect that the general round of wage increases will generate sufficient demand to absorb an undiminished supply at higher prices" (Paul Streeten, "Wages, Prices and Productivity," *Kyklos* (Basle), Vol. XV (1962), p. 725).

<sup>26</sup> See Table 3, below.

<sup>27</sup> E. H. Phelps Brown, *The Economics of Labor* (New Haven and London, 1962), p. 174.

<sup>28</sup> Jack Downie (late Chief Economist, Organization for Economic Cooperation and Development), "The Importance of Knowing What You Want," in Part III, "What Can We Learn from European Experience?" of *Unemployment and the American Economy* [First Conference on Unemployment and the American Economy, Berkeley, California, 1963], edited by Arthur M. Ross (New York, 1964), p. 163.



Of course, as Downie went on to say, if the authorities were able to keep the money supply constant, the rise in prices would eventually be halted through lower pressure of demand on resources and through unemployment of labor and capacity caused by rising interest rates and scarcity of credit. But in order to make it impossible for entrepreneurs to count on being able to raise their prices in those economies where the institutional factors are strongly conducive to the rapid spread of wage increases, the authorities would have to pursue an extremely active monetary (or fiscal) policy, deliberately cutting back aggregate purchasing power at the first sign of any large wage increase. Such a policy is hardly likely to be politically feasible in the situation described, and even if it were politically feasible, it would probably not be practicable or desirable for other reasons.

It is true that the likelihood of generalized cost pressure developing is strongly influenced by employers' expectations, which are conditioned by the extent to which upward movements of costs and prices have in the past been accommodated by the monetary authorities. However, if the government is committed to preventing more than minimal unemployment, employers may reasonably suppose that the authorities will permit and, if need be, promote the expansion of the monetary circulation necessary to allow production to be maintained at higher prices.<sup>29</sup>

The analysis in this section has indicated that where there are a number of firms in an imperfectly competitive market, the danger of cost pressure eventuating is essentially the combined result of the degree of "organization" both of labor and of entrepreneurs—that is to say, the effective unionization of workers and the extent to which employers are able to maintain, or push up, prices by reason of individual monopoly power or by open or tacit coordination of their pricing policies. In practice, wage costs tend to rise while there are still unemployed resources in the economy, not solely because of pressure by the unions but also because an increase in wages throughout an industry provides a favorable situation for entrepreneurs to raise their prices more or less simultaneously. Employers may be prepared to let wage costs rise if their effective joint monopoly power enables them to maintain profits.<sup>30</sup> Consequently, the role of monopolistic pricing in inducing cost inflation is not confined to the efforts of producers to raise profit margins;<sup>31</sup> its importance derives from the power of groups of entre-

<sup>29</sup> Phelps Brown, *loc. cit.*

<sup>30</sup> Profits per unit of output will rise by the same proportion as unit wage costs where oligopoly pricing is based on a percentage mark-up on costs.

<sup>31</sup> As, for example, the OEEC experts imply (*The Problem of Rising Prices*, p. 69).

preneurs (matching that of the unions to maintain wages) to maintain existing profit margins, if need be by raising prices, when there are still unemployed resources in the economy.<sup>32</sup>

When "organization" extends to many industries and sectors of the economy, an increase in wages or prices in one industry may set in motion the process of cost-push in other industries, either by encouraging entrepreneurs in competing industries to seek higher returns for management and capital by charging the higher prices which the market will now bear, or by stimulating union pressure for wage increases in other sectors. The power of entrepreneurs in each industry jointly to raise prices without fear of the consequences is substantially increased, since they can foresee increases in prices for other products and in aggregate monetary demand.

## II. Effectiveness of Aggregate Demand Policy in Countering Cost Inflation

### NATURE OF GENERALIZED COST INFLATION

In a world of imperfect competition, it is unreasonable to suppose that whenever prices rise there is "excess demand,"<sup>33</sup> and that unless "excess demand" exists, entrepreneurs are prevented from raising their prices by the authorities' control over the monetary situation. Obviously, in each economy there is some level of aggregate monetary demand so high that market prices would rise solely because of scarcities, even if there were no cost-push by entrepreneurs or unions; conversely, there is some level of aggregate demand so low that entrepreneurs and union members would be unable, or unwilling, to push up or even maintain prices and wages by concerted action, since they would be competing for such restricted markets and employment openings. However, owing to the scope for monopolistic behavior, prices and wages are apt to rise before there is a situation of excess demand, as entrepreneurs and unions take advantage of a strengthening sellers' market to raise their respective

<sup>32</sup> It is misleading to suggest that, if "collective bargaining results in wage increases greater than the supply and demand forces alone would have yielded" and in excess of the growth in productivity, this is the result of wage-push and not, in part, a consequence of the fact that the monopolistic power of certain producers enables them to pass on increased costs to the buyer (*The Problem of Rising Prices*, pp. 45-46).

<sup>33</sup> "Excess demand" was defined by the OEEC experts as a "volume of aggregate demand which could not be met at existing prices without exerting undue pressure on productive resources [so that] capacity becomes strained, a general shortage of labor develops and prices and wages are bid up by buyers and employers competing for scarce resources" (*The Problem of Rising Prices*, p. 33).

prices; and some upward pressures on wages and/or prices may persist even at a low level of output and employment.

Policy is therefore usually concerned with a range of demand within which increases in the general price level are not solely due to pressure of demand or to cost-push.<sup>84</sup> At any given level of activity within this range, there will be some greater or lesser tendency for prices and wages to move upward, depending on (1) the pressure of demand upon existing capacity and labor resources, and hence the extent to which scarcity of particular outputs or factors of production causes bidding up of certain prices or wages, and (2) the degree of "organization" prevailing in product and labor markets, and hence the extent to which entrepreneurs and union members are able and inclined to push up prices and/or wages autonomously in particular sectors or to ensure that their earnings rise in line with increases occurring elsewhere in the economy.

Whenever a comparatively high level of activity prevails, the authorities will probably be able to reduce the rate of inflation, at least temporarily, by lowering the level of aggregate demand and so creating a greater margin of spare capacity and unemployed manpower. Although a moderate reduction in the level of demand that is not expected to be permanent is unlikely to produce a permanent change in the pricing policy of firms, employers will be less prepared for the time being to raise prices in the context of rising inventories and declining utilization of capacity. Wage increases may be postponed both because of greater resistance on the part of employers and because the bargaining position of the unions is weaker as the weapons of strike and working to rule lose much of their effectiveness in this context. If any union succeeds in pressing a substantial wage claim, there will be less likelihood than usual of this giving rise to wage claims in other sectors; and if any industry raises its prices, causing demand to be diverted to other goods and services, the price increase will be less likely to induce other increases owing to the underutilization of capacity created by the change in aggregate demand policy.

#### INTERPRETATION OF THE PHILLIPS CURVE ANALYSIS

It is, therefore, to be expected that the rate of increase of money wages will vary with the level of activity and of unemployment in the course of cyclical fluctuations, since wage increases can be postponed or accelerated and so are likely to be bunched in the most favorable periods.

<sup>84</sup> See Lord Kahn's evidence before the Radcliffe Committee: Committee on the Working of the Monetary System, *Principal Memoranda of Evidence* (London, 1960), Vol. 3, p. 142, especially pars. 35-37. Lord Kahn, a member of the OEEC expert group, disassociated himself from their analysis in terms of excess demand (*The Problem of Rising Prices*, footnote 1 on p. 33).

Such a relation has in fact been found to exist in the well-known Phillips curve analysis<sup>35</sup> and other empirical studies.<sup>36</sup> There is, however, a difficulty in interpreting these results. It is commonly suggested that the relation observed between the rate at which money wages actually increased and the rate of unemployment in periods when the level of unemployment was subject to marked short-term fluctuations can be taken to indicate the rate at which money wages would be likely to increase if a certain level of unemployment were to be maintained continuously. Professor Paish's recent study<sup>37</sup> provides an admirably clear statement of this thesis. However, to take Professor Paish's example, it seems questionable whether the rate of increase in wages observed to be associated in the United Kingdom with an unemployment rate of 2¼ per cent, occurring for short periods when unemployment was usually much lower, provides a valid indication of the rate at which wages would tend to rise if unemployment were maintained at 2¼ per cent of the labor force for a longer period. The rate of increase might well prove substantially higher in these circumstances, and perhaps not very much lower than the average rate of increase over the postwar period, when unemployment averaged 1.6 per cent.

An accurate assessment of the "trade off" between maintaining a higher level of unemployment than has been customary in some European countries in recent years, and achieving a greater degree of price stability, would clearly be very useful to policymakers. As Pierre Massé remarked about the experience of France, if a 5 per cent annual growth rate could have been achieved with price stability, it would probably have been preferable to a growth rate of 5½ per cent followed

<sup>35</sup> A.W. Phillips, "Employment, Inflation and Growth," and "The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957," *Economica*, Vol. XXV (1958), pp. 283-99, and Vol. XXIX (1962), pp. 1-16.

<sup>36</sup> Such as L.A. Dicks-Mireaux and J.C.R. Dow, "The Determinants of Wage Inflation, United Kingdom 1946-56," *Journal of the Royal Statistical Society*, Vol. 122, pt. 2 (1959), pp. 145-83; Richard G. Lipsey, "The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1862-1957: A Further Analysis," *Economica*, Vol. XXVII (1960), pp. 1-31; and L.R. Klein and R. J. Ball, "Some Econometrics of the Determination of Absolute Prices and Wages," *The Economic Journal*, Vol. LXIX (1959), pp. 465-82. However, Rattan J. Bhatia did not find a significant relationship in his study, "Unemployment and the Rate of Change of Money Earnings in the United States, 1900-1958," *Economica*, Vol. XXVIII (1961), pp. 286-96; and K.B. Griffin concluded that, with regard to the postwar U.S. data, "the notion of the Phillips curve can be subjected to any interpretation one desires!" ("A Note on Wages, Prices and Unemployment," *Bulletin of the Oxford University Institute of Statistics*, Vol. 24 (1962), pp. 379-85).

<sup>37</sup> F.W. Paish, "The Limits of Incomes Policies," in *Policy for Incomes?* by F.W. Paish and Josselyn Hennessy, Institute of Economic Affairs, Hobart Papers, No. 29 (London, 1966), pp. 11-46.

by a check to expansion. However, he doubted whether lasting price stability could be achieved by such a small safety margin. The attempt to secure stability by restraining aggregate demand was, he believed, more likely to result in a relatively low rate of growth and quite significant unemployment; and he doubted whether such a solution would be tolerated for long in France.<sup>38</sup>

Unfortunately, the Phillips curve type of analysis does not provide an adequate measure of the relation between unemployment and cost pressure. As has been seen, such statistical studies are likely to overstate the sensitivity of the rate of increase in money wages to the level of unemployment over the medium to long term. Furthermore, such studies fail to take into account the influence of the level of aggregate demand on the rate of growth of productivity. Even if the rate of increase in money wages were to be reduced by maintaining a somewhat higher level of unemployment, upward pressure on costs would not be similarly reduced if productivity growth also was sensitive to the level of activity and to demand in the economy both in the short and longer run.

#### FEASIBILITY OF EFFECTIVE AGGREGATE DEMAND POLICY

In practice, even in the short run, the feasibility of countering cost inflation by monetary and fiscal policies depends on the importance attached by the electorate (or those who ultimately decide government policy) to the maintenance of high employment in the economy. If the cost of attaining greater price stability by restraining domestic demand is held to be too high by those with a voice in political decisions, restraint will be regarded as a temporary measure and the policies applied will have only a limited effect on the attitudes of management and unions.<sup>39</sup> Employers accustomed to difficulties of recruitment will be disinclined to lay off workers because of a temporary reduction in demand. Employment and the wage bill will then be rather insensitive to reductions in aggregate demand, whereas productivity and profits will be highly vulnerable.<sup>40</sup> If it appears easier to make up the investment later rather

<sup>38</sup> Pierre Massé, *Rapport sur la politique des revenus établi à la suite de la Conférence des revenus (octobre 1963-janvier 1964)*, La Documentation Française, Recueils et Monographies, N° 47 (Paris, 1964), p. 7.

<sup>39</sup> In such a case, the position of the authorities necessarily "contains an important element of bluff. [If] any government [tries] to give absolute priority to price stability [and] this involves heavy unemployment, it may not remain in office."—Sir Donald MacDougall, "Inflation in the United Kingdom," *The Economic Record*, Vol. XXXV (1959), p. 387.

<sup>40</sup> This course of development has been well described in France—see Jean Marchal, "Les conditions de l'équilibre macroéconomique dans la stabilité des prix," *Revue Economique* (Paris), N° 6 (1964), pp. 853–67—and in the United Kingdom—see J.C.R. Dow, *The Management of the British Economy*, National Institute of Economic and Social Research, Economic and Social Studies, XXII

than to restore a depleted labor force (particularly should the firm acquire the reputation of a "bad employer"), employers may prefer to postpone investment rather than to cut down the wage bill by layoffs; employers in a squeeze because of tighter credit conditions and declining profits may even choose to cut back investment rather than reject wage claims.<sup>41</sup> Reducing the level of aggregate demand will then bear more heavily upon investment than upon consumption.

The authorities can prevent very rapid cost inflation by avoiding a situation of severe pressure on the labor market. However, below that degree of excessive pressure on labor resources, in the long run the tendency for costs to rise in the organized sectors of the economy would probably not be much reduced by continuously maintaining a somewhat lower level of demand relative to labor resources. Many of the forces restricting the entry of new firms or the employment of nonunion labor in unionized industries would not be much less powerful merely because the rate of unemployment was maintained at, say, 3-4 per cent instead of 1-2 per cent in an economy with little self-employment; or because the self-employed population in agriculture was declining more slowly in an economy with a large peasant agriculture. In many industries a stable market situation might not be much less likely to exist just on this account; the size of the industry would be adapted to the habitual level of demand; the demand curve for the industry as a whole would still be somewhat inelastic; and the inducement for producers to raise prices in line with wages in order not to risk erosion of profit margins would still apply. In those cases where the greater availability of labor did encourage increased competition, the result might well be the appearance (or survival) of a greater number of small concerns using labor-intensive rather than advanced techniques.

Should aggregate demand policies result in the maintenance of a considerable margin of unutilized capacity intermittently over a period of years, this situation would seem likely to reduce the incentives for investment in the economy, especially in those sectors subject to fluctuations in demand, and hence to slow down the growth in capacity and the speed with which improvements in technique resulting in higher productivity are taken up. Thus, although the bargaining power of the unions and the tendencies to wage drift would probably be somewhat weaker than if the industrial sector were expanding more rapidly, the growth of productivity would probably also be lower. Even if prices

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(London, 1964), and H.M. Treasury, *Economic Report on 1964* (London, 1965), published as a supplement to *Economic Trends*, No. 137, March 1965.

<sup>41</sup> Such behavior is not irrational if rejecting a wage claim exposes the concern to the risk of a prolonged strike and a substantial loss of profits which cannot be made up in the future, or to the possibility of a permanent reduction in its share of the market (Marchal, *op. cit.*, p. 855; Massé, *op. cit.*, p. 7).

were to rise less rapidly in these circumstances, the gain achieved would not be easy to assess. Greater observed price stability associated with less advance in technology is not necessarily preferable to an apparently faster rise of prices associated with more improvement of existing products and greater development of new goods and services (both of which are notoriously difficult to measure statistically).<sup>42</sup>

The observations made above suggest that it may be misleading to assume that a country can, in some meaningful sense, always count on achieving a lower rate of cost inflation and a strengthening of its international competitive position merely by maintaining a lower level of demand pressure and somewhat higher unemployment.

### III. Factors Influencing Cost Inflation in Particular Countries

Sections I and II of this paper have sought to describe the nature of cost inflation in an industrial country. An attempt can now be made to see why some countries may be less likely than others to encounter internally generated cost inflation.

Upward pressure on costs in an industrial country can be regarded as roughly determined by (1) the rate at which money wages tend to rise when a certain level of unemployment is maintained in the economy—that is to say, the relationship which the Phillips curve unfortunately fails to measure, (2) the rate of growth of productivity, and (3) the level of unemployment which the authorities choose to maintain.<sup>43</sup>

#### RELATION BETWEEN THE UNEMPLOYMENT RATE AND WAGE INCREASES

Other things being equal, in any economy a certain rate of increase (or decline) in money wages and prices is likely to be associated with a given level of activity and rate of unemployment. However, the rate at which wages will tend to rise when a certain proportion of the labor force is unemployed is likely to differ considerably in different countries. As has been seen, the tendency for wages to move upward will be influenced by (1) the pressure of demand on supply in the labor market, which conditions the bargaining power of the labor unions and deter-

<sup>42</sup> See H.A. Turner and H. Zoetewij, *Prices, Wages, and Income Policies in Industrialised Market Economies*, International Labor Office (Geneva, 1966), pp. 30–31.

<sup>43</sup> This framework of exposition is similar to that used by Professor Duesenberry in a paper presented to the American Finance Association in December 1965: J. Duesenberry, "Domestic Policy Objectives and the Balance of Payments," *The Journal of Finance*, May 1966, pp. 345–53.

mines the likelihood of prices and wages being bid up as a result of scarcities, and (2) the degree of "organization" which prevails in product and labor markets.

### *Elements of flexibility in the labor market*

A certain unemployment rate may be associated in different economies with widely differing degrees of tension in the labor market. Unemployment does not constitute the principal element of flexibility in an economy where large numbers of young persons are joining the labor force each year; nor in one where there are large numbers of persons willing to transfer from technically backward, low-income sectors to better paid employment or where there are large numbers of men (or women) willing to enter or rejoin the labor force if more jobs become available. The important differences between various industrial countries with regard to such elements of flexibility in the labor market are illustrated in Table 1.

In recent years the growth of the population of working age has amounted each year to about 2 per cent of the labor force in Canada, the Netherlands, Germany,<sup>44</sup> and Japan. It is now about that rate in France and the United States. The growth rate has recently been only about half as great in Denmark, Italy, Norway, Sweden, and the United Kingdom, and it has been negligible in Austria and Belgium.

The reduction of the agricultural labor force has in recent years been at an annual rate approaching or exceeding 1 per cent of the active labor force in Canada, Denmark, France, Germany, Italy, and Japan, whereas it has been of minor importance in Belgium, the United Kingdom, and the United States.

The proportion of men of working age outside agriculture who were not members of the active labor force in 1964 ranged from as high as 12–15 per cent in Belgium, Canada, France, Italy, and Japan, to no more than 3–6 per cent in Austria, Denmark, Germany, and the United Kingdom. Similarly, more than 70 per cent of all women of working age outside agriculture were not members of the active labor force in Italy and the Netherlands, more than 50 per cent in Austria, Denmark, Germany, Japan, and the United States, and less than 50 per cent in Sweden and the United Kingdom. These differences are, of course, related to differences in the age structure of the population. (They are, for example, associated with differences in the proportion of the adult population which is still undergoing full-time education, or which has retired, or which, in the case of women, is occupied in bringing up

<sup>44</sup> The present growth rate in Germany is considerably lower owing to the low birth rate in the years immediately after the war.



TABLE 1. FACTORS INFLUENCING THE DEGREE OF PRESSURE IN THE LABOR MARKET <sup>1</sup>

Average Annual Growth of Potential Labor Force, 1960-64 <sup>2</sup>		Employment in Agriculture as Per Cent of Potential Labor Force, 1964		Activity Rates Outside Agriculture, 1964 <sup>3</sup>			Average Unemployment Rate, Adjusted, 1960-64 <sup>4</sup>		
				Men		Women			
Austria	0.0	United Kingdom	2.7	United Kingdom	97	Sweden	52	Germany	0.8
Belgium	0.1	Belgium	3.9	Denmark	96	United Kingdom	51	Netherlands	0.8
		United States	4.1	Germany	95				
		Netherlands	5.6	Austria	94				
		Canada	5.6						
Italy	0.8	Germany <sup>5</sup>	8.5	Sweden	92	Denmark	48	Austria	1.2
United Kingdom	0.8	Sweden	9.2	Netherlands	91	Austria	47	Japan	1.2
Norway <sup>5</sup>	0.9	Norway	10.4	Norway	91	Japan	45	France	1.3
Sweden	0.9			United States	90	Germany	44	Norway	1.3
Denmark	1.1					United States	43	United Kingdom	1.5
								Sweden	2.0
								Denmark	2.0
								Belgium	2.4
United States	1.6	France	12.1	Canada	88	France	37	Italy	3.6
France	1.7	Denmark	12.9	France	88	Belgium	37	United States	5.8
Canada	1.9	Italy	14.5	Japan	87	Canada	34	Canada	6.4
Netherlands	1.9	Austria	15.2	Belgium	87	Norway	34		
Germany	2.0	Japan	18.4	Italy	85	Netherlands	27		
Japan	2.4					Italy	24		

Source: Based on data from Organization for Economic Cooperation and Development, *Manpower Statistics, 1954-1964* (Paris, 1965).

<sup>1</sup> Countries are ranked in descending order according as the feature of the labor market situation illustrated appears to create less likelihood of cost pressure. The three groupings in each column roughly distinguish those countries in which the degree of pressure in the labor market resulting from each feature would seem to be great, moderate, or slight.

<sup>2</sup> Population aged 15-64.

<sup>3</sup> Activity rates appear higher in agriculture than in other sectors because the concept of employment in agriculture differs from that in other sectors. Consequently, it is necessary to exclude agriculture in order to have a more or less comparable measure of the activity rates in the different countries. Figures show the percentage of all men or women, outside agriculture, who are members of the active labor force.

<sup>4</sup> Adjusted to exclude self-employed persons and unpaid family help in agriculture, i.e., the figures show the average number of unemployed in 1960-64 as a per cent of the labor force outside agriculture plus wage earners in agriculture.

<sup>5</sup> 1960-63.

<sup>6</sup> 1963.

children.) Nevertheless, they represent a real element of greater or lesser flexibility in the labor market.

The data in Table 1 suggest that in certain industrial economies, notably Japan, France, Italy, Canada, the Netherlands, and the United States in approximately that order, there is likely to be a considerable element of flexibility in the labor market, even when a low rate of unemployment is maintained. At the other end of the scale, the United Kingdom, Germany, and Sweden would appear to be the countries more likely to encounter severe tension in the labor market at a low level of unemployment. Austria, Belgium, Denmark, and Norway appear to be in an intermediate position.

It should be noted that the reduction of employment in technically backward sectors need not raise the production costs there. The largely unorganized workers in those sectors will not be in a much better position to secure increases in hourly wages until marked shortages of labor are experienced—unless there should happen to be a great increase in demand for the output of the sectors resulting in upward pressure on prices. As the number of persons dependent on agriculture or retail distribution is reduced, those remaining may well be ready to work more intensively, or for longer hours, in return for higher per capita incomes which do not raise unit labor costs. If unit labor costs do rise, there is likely to be scope for reducing labor inputs by rationalizing the scale of production, so as to permit more efficient use of labor and greater mechanization. Indeed, a rise in hourly labor costs to a level more nearly commensurate with that in the advanced sectors is actually needed in order to stimulate the employment of more capital and so to bring the productivity of labor more into line with that in the advanced industrial areas of the economy.

Marked increases in prices and wages in the less advanced sectors frequently stem from sharply increased demands upon those sectors following rapid development of the industrial sectors; or from deliberate intervention by the authorities to ensure that incomes of politically powerful groups, such as farmers, increase in line with those in the advanced sectors. Often the inability of the less advanced sectors to meet greatly increased demands from other sectors would not be alleviated even if the existing small-scale enterprises were to retain more labor. In these circumstances, the appropriate remedy must be to encourage rationalization and possibly greater dependence on imports. When the authorities intervene to support agricultural incomes, a continuing

reduction of the agricultural labor force may actually be necessary if inflationary increases in the cost of food are to be avoided.<sup>45</sup>

*"Organization" of product and labor markets*

Important differences also exist with respect to the degree of "organization" of product and labor markets in the various industrial countries, but these are much more difficult to measure. Some rough indicators can be found concerning the coverage and strength of labor unions, and the effect of certain structural factors conditioning their bargaining power; but there is little basis on which to judge how far employers in each country are in a position to determine the prices at which they sell their output, or are subject to price competition. One element of some importance in this connection, namely, the openness of the economy, can, however, be roughly measured.

The proportion of incomes in each economy potentially the subject of union pressure for wage increases would seem to be related to the proportion of wage and salary earners in the labor force. However, it may be best to consider the relative scale of self-employment in agriculture as a special factor since government fixing of agricultural prices in most industrial countries renders the position of farmers' organizations vis-à-vis the authorities in some ways analogous to that of a union vis-à-vis the employers. Then, because it is difficult for the unions to organize workers or to press successful wage claims in sectors comprising numerous small family enterprises, the ratio of wage and salary earners to workers on own account (employers, self-employed, and unpaid family help) may provide one rough indicator of the scope for union pressure for wage increases in the nonagricultural sectors of various economies. (The ratio may indeed constitute something of an index of the degree of "organization" likely to exist on the side both of employers and of labor in different economies.) The figures given in Table 2 suggest that, on this account, the scope for union action may be greater in the United Kingdom and Sweden, and lower in Italy and Japan, than in other industrial countries.

The coverage and effective bargaining power of labor unions differ greatly as between industrial economies, both for historical reasons (such as the time period over which labor organization has been carried out and the legal impediments or encouragements to such organization) and because the bargaining power of unions is conditioned by the extent

<sup>45</sup> Since expenditure on food does not rise in line with income as the standard of living rises, it is virtually impossible for agricultural incomes to rise as fast as those in manufacturing and services, at the same time as the relative prices of food and other consumer goods remain unchanged, unless the proportion of the population engaged in agriculture is declining.

TABLE 2. RELATIVE IMPORTANCE OF WAGE AND SALARIED EMPLOYMENT AND SELF-EMPLOYMENT, 1964<sup>1</sup>

	Percentage of Civilian Labor Force					Ratio of Wage and Salary Earners to Workers on Own Account Outside Agriculture <sup>5</sup>	
	Wage and salary earners <sup>2</sup>	Workers on Own Account <sup>3</sup>					
		All sectors	Agriculture	Other sectors			
				Total	Unpaid family help <sup>4</sup>		
United Kingdom <sup>6</sup>	91.3	8.7	2.0	6.7	1.7	United Kingdom	13
United States	86.4	13.6	4.3	9.3	0.8	Sweden	12
Sweden	85.0	15.0	8.1	6.9	0.6		
Canada	83.5	16.5	7.6	8.9	0.9	Canada	9
						United States	8
Germany	79.7	20.3	10.1	10.2	2.4	Netherlands	8
Netherlands <sup>7</sup>	79.0	21.0	9.0	12.0	...	Denmark	8
Denmark	76.2	23.8	15.3	8.5	...	Germany	7
Norway	74.0	26.0	14.8	11.2	0.8	Austria	7
France	73.8	26.2	11.5	14.6	3.7	Norway	6
Belgium	73.3	26.7	5.3	21.4	6.9	France	6
Austria <sup>8</sup>	73.0	27.0	17.0	10.0	2.4	Belgium	6
Italy	65.1	34.9	14.7	20.2	4.4	Italy	3
Japan	57.3	42.7	24.7	17.9	3.0	Japan	3

Source: Based on data from Organization for Economic Cooperation and Development, *Manpower Statistics, 1954-1964* (Paris, 1965).

<sup>1</sup> Countries are ranked in descending order according as the feature of the labor market situation illustrated appears to create less likelihood of cost pressure. The three groupings roughly distinguish those countries in which the degree of pressure in the labor market resulting from each feature would seem to be great, moderate, or slight.

<sup>2</sup> Including all unemployed.

<sup>3</sup> Employers, self-employed, and unpaid family help.

<sup>4</sup> The figures for the United Kingdom, France, Belgium, and Austria are author's estimates.

<sup>5</sup> The figures for the United Kingdom, Denmark, Norway, France, and Belgium are partly based on author's estimates indicated in footnotes 4, 6, and 7.

<sup>6</sup> The figures have been adjusted to include estimates of unpaid family help, which is not covered in the national sources.

<sup>7</sup> All figures are author's estimates.

<sup>8</sup> 1963 data.

of coordinated resistance to wage claims on the part of employers. Some of these differences in the wage bargaining situation are summarized in Table 3.

The effective coverage of the unions is not very satisfactorily indicated by the number of paid-up union members, owing to marked differences in the proportion of wage earners who actively support unions but fail to pay their dues. The paid-up union membership tends to be higher in a strongly coordinated labor movement or where the unions administer benefits such as pensions or insurance. Allowing for this factor, it is probably safe to conclude that the effective coverage of the unions is not much lower in Italy or the United Kingdom than in the Scandinavian countries, Belgium, and Austria, that it is somewhat lower in Germany, the Netherlands, and Japan, and lower again in Canada, France, and the United States (see Table 3, footnote 4).

The pressure for wage increases actually exerted by the unions is conditioned both by the extent of coordination between employers in wage bargaining and the relative openness of the economy. These factors are not unrelated. Broadly speaking, strongly coordinated employers' federations came into being in those economies where the leading enterprises were exposed to foreign competition when they first encountered widespread pressure for wage increases from the developing unions. Thus, in five of the six smallest and most open industrial economies—and in only one large economy, Germany—powerful coordinated employers' federations face coordinated labor unions, whose structure was dictated by the need to bargain with highly centralized employers' organizations; on the other hand, in six of the seven bigger industrial economies, largely uncoordinated labor unions face uncoordinated employers' organizations.

The former group includes, besides Germany, the three Scandinavian countries, Austria, and the Netherlands, but excludes Belgium. It appears that the important factors encouraging a high degree of coordination among employers in these countries were their relatively late industrial development and need to challenge established industrial centers such as the United Kingdom, Belgium, and France; the greater predominance of large-scale enterprises by this time; and the wider threat posed by industrial unions than by the small-craft unions originally established in the older centers.

Despite their dependence on foreign markets, industrialists in the United Kingdom and Belgium did not have the same inducement to coordinate their wage bargaining at the time when unions were developing because they possessed a commanding technical leadership and

TABLE 3. INDICATORS OF STRUCTURAL AND INSTITUTIONAL FACTORS INFLUENCING THE LIKELIHOOD OF COST INFLATION

	Openness of Economy <sup>1</sup>	Character of Wage Bargaining by		Degree of Unionization <sup>4</sup>	Scope for Union Pressure on Account of		
		Employers' federations <sup>2</sup>	Unions <sup>3</sup>		Flexibility of labor market <sup>5</sup>	Structure of employment <sup>6</sup>	
I. Countries of uncoordinated wage bargaining							
United Kingdom	Slight 20	Uncoordinated	Competitive	Great	Great	Great	
France	Slight 14	Uncoordinated	Competitive	Slight	Slight	Medium	
United States	Slight 5	Uncoordinated	Independent	Slight	Slight	Medium	
Canada	Medium 25	Uncoordinated	Independent	Slight	Slight	Medium	
Belgium	Great 37	Uncoordinated	Competitive	Great	Medium	Medium	
II. Countries of coordinated wage bargaining							
Germany	Slight 19	Coordinated	Coordinated	Medium	Great	Medium	
Sweden	Medium 26	Coordinated	Coordinated	Great	Great	Great	
Austria	Medium 26	Coordinated	Coordinated	Great	Medium	Medium	
Denmark	Great 31	Coordinated	Coordinated	Great	Medium	Medium	
Norway	Great 42	Coordinated	Coordinated	Great	Medium	Medium	
Netherlands	Great 47	Coordinated <sup>7</sup>	Coordinated <sup>7</sup>	Medium	Medium	Medium	
III. Countries where the scope for union action is limited by the labor market situation							
Italy	Slight 17	Uncoordinated	Competitive	Great	Very slight	Slight	
Japan	Slight 12	Uncoordinated	Independent	Medium	Very slight	Slight	

Sources: Based on data from U.S. Department of Labor, *Directory of Labor Organizations: Europe* (1965), *Western Hemisphere* (1964), and *Asia and Australasia* (1963); U.S. Bureau of the Census, *Statistical Abstract of the United States*, 1965; Organization for Economic Cooperation and Development, *Manpower Statistics, 1954-1964*, and *General Statistics: National Accounts*, January 1965.

<sup>1</sup> The figures show the average of exports and imports of goods and services expressed as a percentage of gross national product in 1964.

<sup>2</sup> The characterization is based on the description given in the accompanying text.

<sup>3</sup> The characterization is based on the description given in the first part of Section I of the text.

<sup>4</sup> The ratio of paid-up union members to wage earners in each country is shown below. However, as noted in the text, these ratios are liable to be influenced by marked differences in the proportion of wage earners who actively support the unions but fail to pay their dues. This proportion is probably higher in Italy, the United Kingdom, and France than in the other countries.

Sweden	67	Netherlands	41	Canada	27
Austria	62	Germany	37	United States	25
Norway	62	Japan	33	France	21
Denmark	61				
Belgium	59				
Italy	49				
United Kingdom	37				

<sup>5</sup> The characterization is based on the summarization of Table 1 in the text above.

<sup>6</sup> The characterization is based on the three groupings shown in the last column of Table 2.

<sup>7</sup> The coordination of both employers and unions in wage bargaining has weakened considerably in the Netherlands in recent years.

because union pressure for wage increases developed gradually in a highly localized and uncoordinated manner. In France and the United States, industries developed to supply a large and protected home market, and the development of the union movement in these countries—as also in Canada and Japan—was not such as to pose a serious threat of concerted pressure for wage increases. In France, the threat of union pressure was tempered by the fragmentation of the unions and their weak legal status vis-à-vis the individual employer. In North America and Japan, the employers had little stimulus to coordinate their opposition to the unions, since for historical and legal reasons, the unions were organized to bargain with individual enterprises.

Japan and Italy are probably best regarded as countries where, for various reasons, concerted union pressure for wage increases is only now becoming a possibility. Effective union action was, broadly speaking, prohibited by law during the prewar periods when much industrialization was taking place in these countries; and since the war the bargaining power of the unions has been restricted by the large number of new entrants to the industrial labor force from sectors of low-income self-employment. Somewhat the same position existed during the 1950's in Germany, as the unions were only gradually rebuilding their organization and finances after having been disbanded by law from 1933 to 1945, and there was over this period a very large influx of refugees.

It is now possible to sum up this analysis as follows. In five of the seven larger industrial economies, there exists a considerable element of flexibility in the underlying labor market situation even at a low level of unemployment. This is especially true of Japan, Italy, and France; it is also true to a lesser extent of Canada and the United States. The effective degree of unionization among wage earners is comparatively slight in three of these countries (France, Canada, and the United States). In Japan and Italy, the unions cover a higher proportion of wage earners but their bargaining power is circumscribed by the exceptionally large proportion of self-employed workers in the labor force.

In the other two large economies, Germany and the United Kingdom, and also in Sweden, a greater degree of tension in the labor market is likely to exist at a low level of unemployment. In Germany and Sweden, but not in the United Kingdom so far (if one excludes the present emergency wage freeze imposed by the authorities), coordinated wage bargaining by the employers and unions tends to lessen tendencies to competitive wage claims.

In the other smaller industrial economies, the degree of tension in the

labor market at a low level of unemployment is probably less than in Sweden, or than in Germany and the United Kingdom. The openness of these economies limits the possibility of upward movements of costs in excess of those experienced in other countries. Except in Belgium, this fact has been reflected in coordinated wage bargaining by the employers leading to coordinated wage claims from the unions. In Belgium, unions and employers' organizations still remain highly fragmented and uncoordinated, as they have historically always been. Until a few years ago, however, the bargaining power of unions was limited by relatively heavy unemployment.

It is difficult to assign weights to the various factors covered in Table 3, but the information given there suggests that the underlying tendencies to cost inflation are likely to be greater in Belgium, France, Germany, Sweden, and the United Kingdom than in Austria, Canada, Denmark, Italy, the Netherlands, Norway, or the United States. The tendencies to cost inflation are probably least powerful in Italy and Japan.

#### PRODUCTIVITY GROWTH

Much more study is needed of the factors determining the growth of productivity in the different industrial countries, and of the relation between the demand for labor and the growth of productivity within an economy. It seems reasonable to assume that at any period there is some potential range of productivity growth in each industrial country and that the actual growth of productivity is related to the strength of internal and external demands upon the economy's resources. The potential range of productivity growth is likely to vary as between countries, depending on the existing state of technology. Thus, in economies where industrial techniques have lagged, it may be possible to achieve rapid increases in per capita output by the application of advanced techniques already in use elsewhere, provided that adequate resources can be secured for investment. As against this, the more advanced economies may be better placed to apply the latest and most complex techniques (such as automation). In general, the most highly advanced economies with the highest per capita income may be expected to dispose of greater resources for investment and hence to be in a better position to achieve gains in productivity. However, this need not be the case in a world of unfettered international trade and foreign investment. If there is great scope for the adoption of modern techniques in the less organized economies, and if the level of hourly wages is relatively low at the ruling exchange rates and remains so owing to the less effective organization and weaker



bargaining power of the unions in those economies, enterprises may be able to realize very high rates of profit on exports with which to finance a rapid expansion of modern industrial capacity, and high rates of profit may encourage substantial investment of foreign capital.

The relative importance of domestic and export markets to producers in the economy is very likely to influence the relation between the level of demand maintained within the economy and the growth of productivity in that economy. For enterprises predominantly selling abroad, a lowering of domestic demand will have comparatively slight effect on total sales while possibly moderating the rise in costs relative to that occurring in other countries; thus profits and so resources available for investment will probably tend to increase. For enterprises predominantly selling in the home market, however, the lowering of domestic demand, besides reducing costs, is likely to result in smaller total sales and lower total profits (since export sales are a minor part of total output, the increased profits from expanded exports are unlikely to counterbalance the reduction in profits in the home market). Investment and the growth of productivity are therefore liable to be reduced when a lower level of demand is maintained.

#### LEVEL OF UNEMPLOYMENT MAINTAINED

In practice, the level of unemployment maintained in an economy tends to be determined by such factors as the occupational distribution of the population, the extent of unionization, and the nature of political representation in the country, rather than to be "chosen" by the authorities. The problem of cost inflation is thus compounded by the fact that the criteria of full employment are most stringent in those economies where the labor force is most fully organized and the danger of generalized cost pressure at a given level of unemployment is greatest. In those economies, the authorities are likely to be under considerable pressure to maintain a lower margin of unutilized labor resources and to give the full-employment objective more weight in relation to other policy objectives, such as price stability, than is the practice in economies where the labor unions are less powerful.

#### TENDENCIES TO COST INFLATION IN DIFFERENT COUNTRIES

The foregoing description suggests that the level of unemployment which is likely to be maintained and the rates at which money wages and productivity tend to rise when a certain level of unemployment is maintained are not independent and that their influence is likely to be mutually reinforcing. Thus, in one economy there may be a willingness on the part of the electorate to tolerate a relatively high degree of

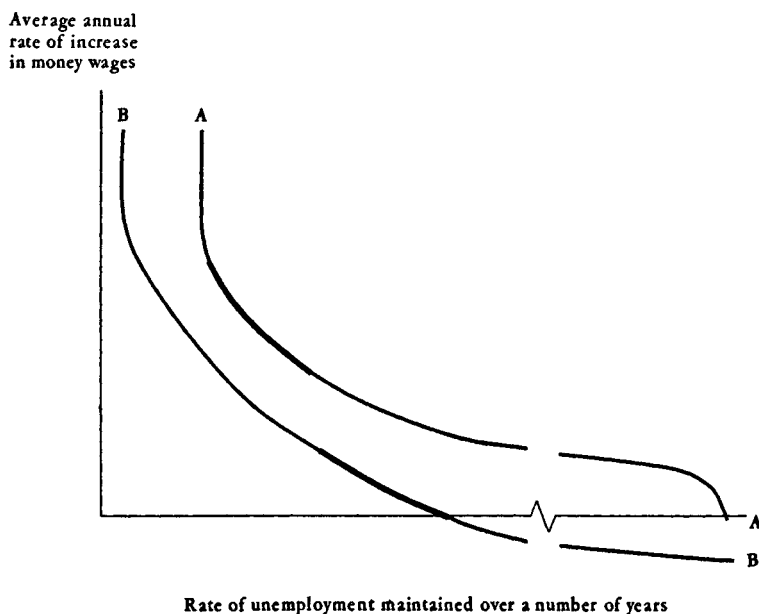
unemployment; a relatively slight tendency for wages to increase at a given level of unemployment; and a potentially high rate of productivity growth. In another economy, the electorate may be strongly disinclined to tolerate the maintenance of more than minimal unemployment; wages may tend to increase more rapidly at a given level of unemployment; and the potential rate of productivity growth may be relatively low.

The description given above prompts certain tentative conclusions concerning the relation which is likely to exist in different economies between the rate of increase in wages and the level of unemployment maintained over a period of years. In a relatively closed and highly "organized" economy—that is to say, one in which there are powerful, widely based labor unions and rather stable conditions of imperfect competition in many product markets—there will probably be some level of activity at which favorable demand conditions in particular sectors, reflected in increasing profits and, probably, in wage drift, will tend to induce quite large wage increases over a broad area of the economy. This will cause unavoidable pressure on prices in the sectors where productivity growth is lower than average, and induce further wage claims stemming from increases in the cost of living. In other words, above some critical level of demand pressure, there will be a sharply increasing tendency to price and wage inflation. Below this critical level, however, there may be a range of levels of activity within which the rate of wage increase is not very sensitive to differences in the levels of activity and unemployment, and is mainly determined by the strength of autonomous cost-push in particular sectors of the economy. A curve of this nature is indicated by A-A in Chart 1.

In a less industrialized and less highly "organized" economy (i.e., one in which greater competition prevails in product markets and the unions are confined to a narrow area of the economy), increasing profits and wage drift in particular sectors will have less influence on the rate at which wages and prices rise in the economy as a whole. Owing to a lower degree of organization of wage earners, the rate at which wages tend to rise will be more sensitive to the level of unemployment and underemployment maintained in the economy. A curve of this nature is indicated by the curve B-B in Chart 1.

If, as has been suggested, the former economy also has the lower political tolerance for unemployment, the authorities there may be virtually precluded from consistently maintaining a level of unemployment at which money wages do not rise faster than those in the less highly "organized" economy. The competitive position of the more "organized" economy need not be weakened as a result of this situation, provided that the rate of growth of productivity is also higher than in the less "organized" economy at each level of unemployment. However,

CHART I. RELATION BETWEEN RATE OF INCREASE IN MONEY WAGES AND RATE OF UNEMPLOYMENT MAINTAINED OVER A NUMBER OF YEARS IN A HIGHLY "ORGANIZED" ECONOMY (A) AND IN A LESS "ORGANIZED" ECONOMY (B)



Note: The darker portion of each curve represents the range of unemployment rates which is "politically tolerable" to the electorate.

as has been seen above, there seems no reason to believe that this must necessarily be the case. If not, such a situation may pose balance of payments problems for the more highly "organized" economies. Nevertheless, the strengthening of the competitive position of the less industrialized countries vis-à-vis the more highly "organized" economies is desirable from an international standpoint, since it tends to promote fuller employment in the industrial world as a whole and to narrow disparities between average per capita income in industrial countries, whereas the strengthening or maintenance of the competitive position of the countries with the highest per capita income would almost certainly tend to widen such disparities.

The modifications to Duesenberry's framework of ideas suggested here serve to reinforce his contention that tendencies to payments disequilibria of a long-term character are more or less inherent under a system of fixed exchange rates, given the objectives of national

economic policies and certain dynamic aspects of the international economy. It would, however, seem more difficult for any country to check the growth in its deficit and improve its competitive position in the longer run by increasing the level of unemployment, than Duesenberry's analysis might suggest. It might perhaps be more realistic to regard some maximum level of unemployment in the medium term as a politically determined constraint upon economic policymakers, which in practice has priority over other policy objectives.

A country which encounters severe cost inflation when it maintains a politically tolerable level of unemployment may seek to slow down the rate of inflation in a number of ways. The authorities may try to make it more difficult for producers to raise prices in line with wages by eliminating legal or other restraints to competition and barriers to new entrants to certain industries; they may seek to reduce obstacles to the attainment of higher productivity, such as restrictive union policies and obsolete systems of wage payments; they may seek to strengthen labor market mechanisms in order to secure greater mobility and lessen the likelihood of the bidding-up of wages; and they may try to reduce the strength of cost-push by means of incomes policy. The description of the process of cost inflation in this paper prompts certain tentative conclusions concerning the scope for incomes policy.

#### **IV. The Scope for Incomes Policy**

The achievement and maintenance of full employment, comprehending in the term the absorption of underemployment hitherto apparent as abnormally low labor productivity in certain sectors, constitutes a new situation in many industrial countries, and one that is likely to require specific measures to restrain cost inflation. The analysis in this paper suggests that tendencies to cost inflation are likely to intensify in future because (1) the proportion of incomes and prices determined in noncompetitive markets is likely to increase with increasing industrial employment, growing unionization, and the increasing scale of enterprises; (2) longer experience of a consistently high level of aggregate demand, and of low unemployment with reduced possibilities of shifting labor out of low productivity occupations, may tend to encourage a more aggressive attitude on the part of labor and a more permissive attitude on the part of employers toward wage increases, leading to a strengthening in the bargaining position of the unions; and (3) with growing international integration, the area of "organized" price behavior may extend increasingly over national boundaries to firms in different

countries, so that the discipline of international competition becomes less effective.

The practicability of incomes policy—that is to say, of deliberate intervention by the authorities in the process of price formation for labor and products aimed at preventing gross (untaxed) money incomes from rising excessively in relation to the growth of national output in real terms—is likely to differ widely as between industrial countries. It may well be easier to establish an effective system for influencing the determination of incomes from employment in those countries where the underlying labor market situation and institutions are less conducive to cost inflation; and vice versa. The unions are more likely to cooperate when their position is, for various reasons, comparatively weak; and the existence of strongly centralized and coordinated institutions on the part of employers and unions, which is needed for the effective implementation of a systematic incomes policy, is itself a factor tending to lessen the severity of wage cost pressure in the economy. Thus, it would seem that if all countries were to adopt incomes policy measures in order to maintain price stability, the effect might be to increase rather than to moderate disparities in the movement of costs as between countries.

In practice, however, the inducement to adopt an incomes policy is in stronger in some economies than in others. The inducement is greatest where relative price stability is needed to facilitate expansion of employment,<sup>46</sup> either before or when the employment objective is met, or to improve a critical balance of payments position.

In an economy where there is little possibility of expanding employment or of increasing the degree of utilization of manpower resources, and which is not in deficit in its external transactions on current account, incomes policy cannot be expected to prevent costs and prices from rising at more or less the same rate as in other countries—that is unless the external sector is of very minor importance, as in the United States. Otherwise, if labor costs are kept stable when prices in other countries are rising fairly rapidly, increasing demand and profits in the export and import-competing sectors will create pressure on the labor market and probably give rise to an increasing surplus on current account. The bidding up of wages by employers in the expanding sectors is almost bound to occur—as it did in the Netherlands in the early 1960's. Even if the unions exercise some restraint in putting forward wage claims, as in Sweden, wages in the export and import-competing sectors will tend to drift upward more or less in line with those in competitor countries. At

<sup>46</sup> Including the need to provide more jobs in other sectors to permit the absorption of manpower out of low-productivity employment in agriculture and services.

a certain point, prices in protected sectors, such as services and construction, will tend to be adjusted steeply upward to take advantage of the growth in money demand from other sectors and to cover increased costs resulting from heavy wage drift brought about by employers' efforts to attract, or retain, labor.

If the authorities intend to maintain balance of payments equilibrium and a fixed exchange rate, they cannot hope to secure much greater price stability than is being achieved in other countries, unless there is scope for expanding employment<sup>47</sup> and for improving an adverse external balance. Thus the goal of incomes policy can only be to prevent costs from rising faster than in other industrial countries. This is a fact which increases the practical problems of implementing systematic measures of incomes policy by making it difficult to state in advance any general and invariable criteria for permissible increases in money incomes. A policy aimed at securing internal price stability by preventing money incomes from rising faster than productivity is far easier to grasp than a policy which allows incomes to rise considerably faster than productivity in one period, but not in another. However, except possibly in the largest economies, the attempt to prevent money incomes from rising faster than productivity under full employment conditions is doomed to failure if wages and prices are rising rapidly in neighboring countries; and the apparent failure of incomes policy in these circumstances may later render its implementation ineffective when the international situation calls for a greater degree of restraint. It would therefore seem that active intervention by the authorities, designed to ensure that money incomes generally do not rise faster than productivity, might best be limited to those economies where there is a definite need to prevent costs and prices from rising *as fast* as in other countries.

The inducement to adopt an incomes policy would then arise in two very different situations: (1) where the tendencies to cost inflation are relatively moderate but the incentive to maintain the advantage is strong, owing to the need to provide for continued expansion of employment opportunities; and (2) where the tendencies to cost inflation are particularly strong and have led to deterioration of the competitive position and of the external balance, and there is a pressing need to improve the situation if the full-employment objective is to continue to be realized. In such circumstances, the need is to ensure that in the future costs and prices rise less rapidly than those elsewhere.

<sup>47</sup> Even if unemployment is very low, there may be scope for expanding employment, as a result of an increasing population of working age, substantial immigration, or the possibility of reducing underemployment in backward sectors. It may be remarked that substantial immigration is more likely to be permitted in countries where the extent of unionization is not great.

Obviously, situation (1) represents an easier task for incomes policy, and past experience suggests that it is more likely to be possible to secure the implementation of incomes policy in these circumstances. To the extent that certain countries successfully achieve their objectives in situation (1), the problem of countries in situation (2) of course becomes more intractable.

When it appears necessary to strengthen considerably the incentives to export and to lessen substantially the incentives to import in order to right the current account balance at a level of activity corresponding to the full-employment objective, internal costs and prices will need to be lowered substantially in relation to those abroad. This will be possible at unchanged exchange rates, provided that prices elsewhere are rising fairly rapidly and internal prices and unit wage costs can be held virtually stable (or even reduced). However, it may in practice be difficult, if not impossible, to achieve internal price stability without reducing the level of internal activity well below the desired full-employment objective, at least temporarily.

To conclude, it would seem desirable to distinguish two different situations: first, where there is a general need to counter tendencies to creeping inflation when full-employment policies are actively pursued; second, where there is a more specific need to ensure that internal costs and prices in a particular economy rise less than those in other industrial countries. One may usefully conceive of two different types of policy as suited for these two different situations. The first, which has been characterized as institutional engineering, would be generally applicable, and would cover a wide range of efforts to remedy particular features of the economy which tend to create or reinforce tendencies to cost pressure. The second would comprise more systematic attempts to implement an incomes policy with the cooperation of the parties concerned in wage negotiations and price determination, in order to keep wage and prices increases, within limits, more or less clearly stated in advance.

## Inflation par la hausse des coûts et politique des revenus dans les pays industriels

### *Résumé*

Cet article décrit la nature de l'inflation par la hausse des coûts dont souffrent les pays industriels qui poursuivent des politiques de plein emploi. Pour pouvoir comprendre la manière complexe selon laquelle les facteurs qui déterminent la force des poussées inflationnistes sur les coûts agissent les uns sur les autres dans différents pays, il est essentiel de se faire une idée relativement exacte du processus selon lequel les salaires sont déterminés dans les industries oligopolistiques dans lesquelles les salariés sont organisés en syndicats. La première section énumère les facteurs qui influencent les négociations syndicales en matière de salaires et décrit la façon dont se produisent les augmentations de salaires; elle étudie d'abord les augmentations de salaires négociées entre les divers syndicats et plusieurs employeurs et, ensuite, les autres décisions en matière de salaires qui donnent lieu à des glissements de salaires. La deuxième section discute l'influence que le niveau de la demande exerce sur l'inflation par la hausse des coûts et le succès de la politique régissant la demande globale comme instrument de contrôle de cette inflation.

La hausse des salaires est influencée 1) par la pression que la demande exerce sur l'offre sur le marché de la main-d'œuvre, ce qui détermine le pouvoir de négociation des syndicats et entraîne une surenchère des prix et des salaires résultant de pénuries dans ces domaines, et 2) par la mesure dans laquelle une certaine "organisation" peut freiner le libre jeu de la concurrence sur le marché des produits et de la main-d'œuvre, ce qui permet aux employeurs et salariés de coordonner chacun dans leur domaine leurs politiques des prix. Un taux donné de chômage ira vraisemblablement de pair avec des degrés de tension divers sur les marchés nationaux de la main-d'œuvre, selon le taux de croissance de la population adulte et la marge de réduction du sous-emploi qui existe dans les secteurs techniquement arriérés ou d'augmentation du taux d'activité de la main-d'œuvre parmi la population adulte. L'étendue de "l'organisation" diffère aussi considérablement selon les pays. Il existe des différences notables entre les effectifs réels des syndicats, et leur pouvoir de négociation dépend de la structure du marché de la main-d'œuvre et du degré de coordination entre employeurs lors de négociations de salaires. Il est plus difficile de juger dans quelle mesure les employeurs de chaque pays sont à même de déterminer les prix auxquels ils vendent leur production, mais on peut mesurer un



élément relativement important — c'est-à-dire la mesure dans laquelle une économie est ouverte aux influences extérieures. La troisième section s'efforce d'indiquer dans quelle mesure les pays industriels diffèrent à tous ces égards. La section finale formule certaines conclusions en ce qui concerne la portée d'une politique des revenus dans le cadre de l'analyse précédente.

## La inflación provocada por el alza de los costos y la política de ingresos en los países industriales

### *Resumen*

En este artículo se describe la naturaleza de la inflación provocada por el alza de los costos en las economías industriales que persiguen políticas de pleno empleo. Para poder comprender la acción recíproca compleja entre los diversos factores que intervienen, lo cual determina la fuerza de la presión alcista sobre los costos en los diferentes países, es esencial formarse una idea más o menos cabal de cómo se determinan los salarios en las industrias oligopolistas cuyos obreros se encuentran organizados en sindicatos. La primera parte de este artículo describe los factores que influyen en las negociaciones sindicales en materia de salarios y la forma en que se efectúan los aumentos de los mismos. En primer lugar, se analizan las negociaciones sobre los aumentos de salarios que se llevan a cabo entre los diversos sindicatos y varios patronos y, en segundo lugar, otras decisiones ajenas a esos contratos colectivos, que dan lugar a desviaciones alcistas de los salarios. En la segunda parte se analiza la influencia del nivel de la demanda sobre el ritmo de la inflación de los costos y la eficacia de una política de restringir la demanda global como medio de coartar dicha inflación.

En la tendencia a ocurrir movimientos ascendentes de salarios influyen: 1) la presión que la demanda ejerce sobre la oferta en el mercado de la mano de obra, que es un factor determinante del poder de negociación de los sindicatos y determina la probabilidad de que por la escasez de la oferta se pujan los precios y los salarios, y 2) el grado de "organización" de los mercados de productos y de mano de obra que es el factor taxativo de la competencia en esos mercados y que permite a patronos y asalariados coordinar sus respectivas políticas de precios.

El grado de tensión en un mercado nacional de mano de obra, asociado a cierta tasa de desempleo, depende del incremento que experi-

mente la fuerza obrera como resultado del crecimiento demográfico normal, y de la posibilidad de reducir el subempleo en los sectores técnicamente atrasados o de elevar la proporción de trabajadores adultos que forman parte de la fuerza obrera activa. También difiere mucho de un país a otro dicho grado de "organización". Hay considerables diferencias en el número de asalariados cubiertos por las negociaciones colectivas obrero-patronales, y el poder de negociación de los sindicatos viene condicionado por los aspectos estructurales del mercado de la mano de obra y al grado de coordinación que existe entre los patronos a efectos de las negociaciones sobre salarios. Resulta más difícil juzgar hasta qué punto las empresas de cada país pueden determinar los precios de venta de su producción; pero hay un elemento de cierta importancia capaz de ser ponderado, y es el grado en que la economía está abierta al exterior. La tercera parte de este estudio trata de las diferencias que se registran en estos aspectos en los diversos países industriales. En la última parte se llega a ciertas conclusiones en cuanto a las posibilidades para una política de ingresos.