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IS THE NATIONAL DEBT A BURDEN? A CORRECTION

By J. E. MEADE

IN my article in the *Oxford Economic Papers* for June 1958 I made a serious mistake.[1] The point which I overlooked is one which would tend to raise the money price of privately held assets after their quantity had been reduced by the capital levy. The total value of the remaining capital assets would thus be greater than I allowed in my article; but, as I argue in this note, the rise in their price would not normally be great enough to restore the total value of privately held assets to their pre-levy value. Some element of the Pigou-effect (discussed in Section II of my article) would remain.

My blunder was as follows. In Section VI of my article I argued as if the functional relationship expressing the demands for Money, Bills, Bonds, and Equities in terms of the total Money value of assets to be held and of the Money prices of Bills, Bonds, and Equities would be the same before and after the levy. But this is not so because of the lower rate of tax on interest and dividends after the levy. The gross (or *cum* tax) and net (or *ex* tax) yield on Money is always zero; with a gross yield on Bonds of 4 per cent., the net yield is 2 per cent. with a rate of tax of 10*s*. in the £ and 3 per cent. with a rate of tax of 5*s*. in the £. This means that, after the levy, income-yielding assets become so much the more attractive at any given price in terms of Money. This will cause their price to be driven up (i.e. their gross yield or the rate of interest to be driven down) not only because they are now scarce relatively to Money (the point which I made) but also because their net yield is now higher while that on Money remains zero (the point which I overlooked in my article).

Nevertheless, I think that there remains a presumption that the price of income-yielding assets (Bills, Bonds, and Equities) will not rise to the extent necessary to restore the total value of such assets to the pre-levy total. The argument may be put in the form of a *reductio ad absurdum*. Suppose that the rate of interest did fall to the extent necessary to restore the pre-levy total value of all assets. Then there are two reasons why it would rise again.

First, the net rate of yield on such assets would now be *lower* than in the pre-levy situation and this would cause people to desert income-yielding assets for Money, i.e. would cause some rise in the rate of interest. The reason for this is that, while the loss of interest on the national debt is

[1] This mistake has come to light as a result of a correspondence with Mr. John Spraos, to whom I would like to acknowledge my indebtedness.

exactly counterbalanced by a reduction of income tax (assuming income tax to be the only form of tax and a balanced budget to be maintained), the loss of interest on debt is wholly a loss of income from property but the gain through lower tax is spread over earned and unearned income. Thus the tax-free income from property is lower post-levy than pre-levy, so that if the total market value of property is to be the same post-levy as pre-levy the net rate of return on income-yielding property must be lower post-levy than pre-levy. If the tax remission were confined to the remission of tax on income from property, it might be argued that the first presumption in the capital market is that the total value of income-yielding assets will be exactly restored by a fall in the rate of interest; for in this case the amount of Money, the value of other assets, and the net yield on other assets would all remain unchanged; but in so far as some of the tax remission is on earned income the net yield on income-yielding assets is reduced and their value will tend to fall.

Second, suppose that the tax remission were confined to taxation of income from property so that the above considerations would not prevent the value of assets being restored to their pre-levy level. There would now be no Pigou-effect to cause a rise in savings and so a deflation in the demand for consumption goods, and for exactly the same reason there would be no deflationary influence damping down investment of the kind which I mentioned at the bottom of page 173 and top of page 174 in my article. But in so far as the rate of interest affects investment, there would now be an inflationary demand for investment goods because it is the *gross* and not the *net* rate of yield which affects investment incentives. So far nothing would have happened to make people expect a lower gross rate of profit on any given new investment, but the gross rate of interest would have fallen so as to keep the net tax-free rate of yield unchanged. The fall in the rate of interest would cause an inflation; and if monetary policy and not budgetary policy were used to prevent this the amount of Money would have to be reduced and the rate of interest raised again somewhat, so that the total value of assets would fall. Indeed, if on these grounds monetary policy was so devised as to keep the gross rate of interest at its pre-levy level, there would be a completely unmitigated Pigou-effect; the total value of privately held assets would fall by the amount of the levy.

The net effect of this correction is, therefore, to suggest that, while there would still be a Pigou-effect, it might be less marked than I supposed it to be in my article.