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THE CAPITAL LEVY IN THEORY AND PRACTICE

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ABSTRACT

A capital levy is a one-time tax on all wealth holders with the goal of retiring public debt. This paper reconsiders the historical debate over the capital levy in a contingent capital taxation framework. This shows how in theory the imposition of a levy can be welfare improving when adopted to redress debt problems created by special circumstances, even if its nonrecurrence cannot be guaranteed. If the contingencies in response to which the levy is imposed are fully anticipated, independently verifiable and not under government control, then saving and investment should not fall following the imposition of the levy, nor should the government find it more difficult to raise revenues subsequently.

In practice, serious problems stand in the way of implementation. A capital levy has profound distribution consequences. Property owners are sure to resist its adoption. In a democratic society, their objections are guaranteed to cause delay. This provides an opportunity for capital flight, reducing the prospective yield, and allows the special circumstances providing the justification for the levy to recede in the past. The only successful levies occur in cases like post-World War II Japan, where important elements of the democratic process are suppressed and where the fact that the levy was imposed by an outside power minimized the negative impact on the reputation of subsequent sovereign governments.

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I. Introduction

Debt management is a topic of considerable concern within Europe today. Italy, Belgium and Ireland all have debt-to-GDP ratios of around 100 per cent. Debt service consequently absorbs a significant share of government revenues, and shocks to real interest rates or economic growth threaten to launch debt/income ratios onto an explosive path. Substantial attention is devoted to alternative strategies for minimizing these dangers and costs (Giavazzi and Spaventa, 1988). These include budget surpluses designed to retire debt, inflationary policies designed to erode its real value, and capital levies designed to eliminate the debt burden at the stroke of a pen.

A capital levy in which a one-time tax is levied on all wealth holders with the goal of retiring public debt is the most controversial solution to the problem.^{1/} The reasons for controversy are clear. A capital levy has prominent distributional consequences. It transfers wealth from asset holders to taxpayers who pay in the monies used to service the debt or to the beneficiaries of public programs that are crowded out by debt service costs. Alternatives such as inflation, forced conversion and debt retirement have distributional implications as well, but those consequences are usually less pronounced and hence not so hotly contested.

Moreover, it is not even clear that a capital levy can succeed in lowering the cost of debt service, properly measured, or enable the government to achieve its other objectives. On the one hand, by reducing the debt overhang a capital levy indisputably lowers short-run debt service costs. If it leaves other taxes unchanged, the government is able to expand the provision of services. If spending on items other than debt service remains unchanged, the authorities are able to lower taxes, which permits increased private-sector consumption and saving. On the other hand, if it

is believed that the exceptional tax on wealth will be repeated, the capital levy will discourage saving. Governments which utilize the capital levy may develop a reputation for doing so repeatedly, encouraging capital flight, eroding the domestic tax base and undermining their capacity to service debt and finance social programs.

Two recent literatures, one theoretical and one empirical, bear directly on these questions.^{2/} On the empirical side, there is a growing literature on LDC debt. Two conclusions of this literature are that the debt overhang of the developing countries has significantly undermined their growth performance, and that sovereign default has often failed to bring about a significant rise in the subsequent cost of borrowing. Both conclusions have favorable implications for the efficacy of a capital levy. They suggest that there are conditions under which benefits of reducing a domestic debt overhang are substantial, and that there are plausible circumstances in which the damage to capital market access is minimal. On the theoretical side, recent work on time consistency highlights the fundamental problem with a capital levy. If governments could make a credible commitment not to repeat it, a one-time levy would be unambiguously beneficial, since it would eliminate the deadweight burden of the debt without discouraging saving. In the absence of a commitment mechanism, however, the government will have an incentive to renege on its promise not to repeat the levy. Official statements that the levy is nonrecurrent will not be credible. The optimal policy will be time inconsistent.^{3/}

A recent article by Grossman and Van Huyck (1988) has begun to bring these two literatures together. Grossman and Van Huyck treat sovereign debt as a contingent claim. They suggest that bondholders recognize that if certain contingencies arise, governments will be forced to reduce or suspend

debt service. Investors demand ex ante risk premia as compensation. If the contingencies are widely understood and readily verified, then the government will be able to default partially or completely in response to an unfavorable state of the world without violating its implicit contract with the creditors or damaging its capital market access. An obvious example is public debt issued in time of war. Purchasers presumably realize that the government's ability to honor this debt depends on whether the country emerges from the war victorious. If it triumphs, then the debt will be serviced in full out of domestic or foreign resources. If it is defeated or suffers extensive damage, then the debt will be repudiated or fall into default.^{4/}

It is tempting to conceptualize capital taxation analogously. Capital taxes could be modeled as a contingent claim, whose value is high in states of the world where the government's obligations for items other than programatic spending are unusually large, the social returns to spending are unusually high, or conventional revenues are unusually low. It is in response to such contingencies that one should expect to observe a capital levy. If the contingencies in response to which the capital levy is imposed are widely understood, readily verifiable and not subject to government control, then saving and investment should not fall following the adoption of the levy.^{5/}

It turns out to be straightforward to reinterpret the historical debate over the efficacy of the capital levy in this light. Yet when one turns to evidence on the operation of such levies, one encounters a most disconcerting fact. One finds virtually no examples of successful peacetime capital levies. I argue that this is no coincidence. In a democracy, there is no independent authority to verify to the satisfaction of savers that the realization of the state of the world in fact justifies a capital levy.

Even if savers recognize that capital taxation is a contingent claim, they retain the incentive to dispute that the relevant contingency has arisen. Neither is there a mechanism to prevent the government from pursuing policies that strengthen the case for capital taxation -- for example, increasing ordinary expenditures as levy receipts roll in. Savers will accuse the government of succumbing to moral hazard and resist the levy on those grounds. They will continue to oppose the levy for distributional reasons. If the levy is imposed at all, typically this will occur only at the end of a protracted and divisive political debate. Since, by the time the levy is adopted, the exogenous shock providing the justification has receded into the past, investors will feel entitled to evade it.

Equally important, time will have permitted investors to shelter their assets. Even in a contingent capital taxation setting, investors have an incentive to move their capital abroad if they can anticipate the timing of unusually high capital taxes. If there is an extended delay between proposal and implementation of the levy, capital flight is likely to render the measure ineffectual. I argue that such delay is an intrinsic characteristic of tax policy in a democracy.

I point to some measures governments have adopted in an effort to circumvent these obstacles. Exchange controls have been utilized to minimize capital flight. Statutes segregating levy receipts from ordinary tax revenues and mandating that they be devoted to debt retirement rather than ordinary expenditure have been utilized to minimize moral hazard. The story is analogous to Sargent's (1982) emphasis on statutes strengthening central bank independence in bringing post-World War I hyperinflations to a halt. Such fiscal restrictions, like Gramm-Rudman, can be thought of as an investment in precommitment on the part of government. If the authorities

promise to devote levy receipts to debt retirement but fail to do so, they suffer embarrassment, which is supposed to serve as a deterrent to fiscal profligacy. But in contrast to the episodes with which Sargent is concerned, I find these investments in precommitment to have been largely ineffectual.

The body of the paper is organized into four sections. Section II formalizes the notion of capital taxation as a contingent claim. Section III then reinterprets the historical debate on the capital levy in terms of theories of time consistency and excusable default. This literature reached its most sophisticated stage in Britain in the 1920s. Contributors constitute a galaxy of economic stars: Edgeworth, Hicks, Hobson, Keynes, Pigou and Stamp, to name a few. Hence my examination of the literature focuses on the British debate in the 1920s.

Section IV then provides a catalog of failed capital levies, mainly from the aftermath of World War I. In each case, I argue, the capacity of governments to utilize the capital levy as an instrument of contingent taxation was hindered by the difficulty of verifying that the relevant contingencies obtained. The decision was reached via a political process which provided scope for political resistance motivated by distributional interests. The longer the levy was delayed, the less compelling the exogenous shock providing the justification appeared, the greater the scope for capital flight, and the less successful the impost.^{6/}

Section V analyzes the exception that proves the rule: the Japanese capital levy after World War II. This is the single example of a major, successful peacetime capital levy of which I am aware. The Japanese case, in which a levy was imposed in a period of foreign military occupation when domestic distributional conflicts were totally suppressed, reaffirms the importance of political impediments to successful implementation.^{7/}

II. A Positive Theory of the Capital Levy: Capital Taxation as a Contingent Claim

In this section I analyze capital taxation as a contingent claim. The approach parallels Grossman and Van Huyck's (1988) analysis of foreign borrowing and sovereign default.

I assume that the government's objective in period j is to maximize the expectation of present and future utility from government spending g .

$$U_j = u(g_j) + E_j \sum_{i=j+1}^{\infty} u(g_i) \quad (1)$$

where $u' > 0$, $u'' < 0$, and $u'(0) = \infty$.

The benevolent interpretation is that government provides a public good, the malevolent one that the government is maximizing its own consumption. For simplicity, I assume no discounting.

In addition to capital taxes, the government receives lump-sum revenues q . An example is oil reserves like those discovered in the North Sea by Britain and Norway. q depends on the state of the world z (assumed stationary). The government cannot borrow, lend, or print money. Its budget constraint is:

$$g_j = q(z_j) + trK \quad (2)$$

where K is the amount of capital subject to taxation, r is the gross domestic rate of return, and t is the ad valorem capital tax rate.

I abstract from the consumption and savings decisions of households, focusing exclusively on their decision of whether to invest their savings at home or abroad. (This enables me to ignore the opportunity costs of

government spending.) I assume that the quantity of accumulated savings (capital) is fixed at \bar{K} .⁸ Capital invested abroad yields a rate of return r^* . (Precisely, r^* is one plus the foreign rate of return.) The domestic government cannot tax capital invested abroad. (I assume that the foreign government imposes no taxes either.) This extreme assumption is designed to capture the notion that the foreign investments are more difficult to tax than domestic ones. The gross rate of return on capital invested at home exceeds the return on capital invested abroad ($r > r^*$).⁹ After domestic capital taxes are imposed, the net return is $(1-t)r$. The rate of domestic capital taxation t depends on the state of the world ($t = t(z)$).

Savers decide in period $j-1$ whether to invest at home or abroad in period j . I assume a large number of risk-neutral savers. They will invest all of their savings abroad unless the expected value of the after tax return on domestic capital in period j conditional on information available in period $j-1$ at least equals the (expected) alternative risk-free return r^* .

$$\sum_z p(z_j) r[1-t(e(z_j))] \geq r^* \quad (3)$$

where $r[1-t(e(z_j))]$ is the net-of-tax rate of return that savers in period $j-1$ expect to receive in period j as a function of the realization $z(j)$.

(Note that $t(e)$ denotes the expected tax rate.)

II.1 Contingent Capital Taxation with Commitment

Imagine that the government can commit irrevocably in period $j-1$ to a state-contingent capital tax policy for period j , given by:

$$t_j = T_{j-1}(z_j) \quad (4)$$

Because of the commitment, taxpayers' expectations of capital taxes will be verified:

$$T_{e,j-1}(z_j) = T_{j-1}(z_j) \quad (5)$$

The government has no effective choice regarding the level of spending in the current period, which is given by the sum of its state-contingent capital tax revenues plus its lump-sum revenues $q(z)$.

The government maximizes its objective function (1) subject to its budget constraint (2), the constraint that after-tax capital income at home not fall short of the rate of return available abroad (3), and the rationality of expectations. Given the form of the objective function (separability and no discounting), government spending is the same in each period. (3) holds as an equality. Capital taxes are high in states of the world in which alternative revenues are low. In bad states, capital taxes can reduce the domestic net return below the return available abroad, so long as in good states the domestic return exceeds that available abroad by a sufficient margin that (3) holds as an equality.

This analysis assumes that savers must decide in period $j-1$ whether to invest at home or abroad in period j , after which the government selects the current rate of capital taxation in light of the realization of $q(z_j)$. What happens if instead there are lags in the authorities' response, or if savers are able to redeploy their capital after the government announces current tax policy? Savers will move their capital abroad in any period when $r(1-t) < r^*$, even if eq. (3) holds over time. The authorities' ability to utilize the capital levy, even in the presence of a commitment

technology, will be vitiated by delays in implementation that facilitate capital flight.

II.2 Contingent Capital Taxation without Commitment

As the historical analysis below will remind us, governments cannot irrevocably commit to a sequence of state-contingent capital taxes. What are the implications in the present context?

Assume that the government ignores any effect of its current actions on expectations of its future actions. (This assumption will be relaxed momentarily.) Then the optimal tax policy for the current period is a capital levy at a rate of 100 per cent. This maximizes government expenditure in the current period and, absent any impact on expectations of future policies, has no damaging repercussions. Specifically, the capital levy does not reduce the government's anticipated ability to finance its expenditures in the future.

It is unrealistic, of course, to assume that the government can ignore the effect of its current actions on expectations of its future actions. If savers correctly perceive that the government will face the same problem and arrive at the same solution in the next period, they would anticipate that the capital levy would be repeated. They would shift their capital abroad, where it is free of taxation, and government spending in all subsequent periods would be $q(z)$. The government would be unable to smooth its spending over time. The outcome is suboptimal in the sense that a policy that involved capital taxes at rates somewhat lower than a 100% capital levy in bad states of the world and taxes much lower than a 100% capital levy in good states would yield higher expected utility, if only savers could be convinced to expect such a policy.

II.3 Contingent Capital Taxation in Reputational Equilibrium

Subsection II.1 treated expectations as a control variable. Subsection II.2 treated them as a given. This section treats them as determined by government policy. I consider reputational equilibria in which the capital taxes that savers in period $j-1$ expect the government to impose in period j are self-confirming. Whatever the realization of z_j , the expected present value of the government's utility is at least as large if the government validates savers' capital tax policy expectations as it would be if the government imposes a 100% capital levy. Given the setup, the equilibrium state-contingent tax policy, $T^*(z_j)$, is time invariant.

Assume that if government policy does not confirm savers' expectations, capital flight results. Savers refuse to repatriate their capital so long as memory of the violation of expectations lingers. This memory lingers for f periods. $f = \infty$ is the well known "grim trigger strategy."^{10/} Experimental studies like Axelrod (1984) have shown more forgiving strategies ($f < \infty$) to perform better. An alternative rationale for $f < \infty$, adopted by Grossman and Van Huyck, is that the current generation of savers has limited memory and recalls the violation of expectations for only f periods.^{11/}

If the government does pursue policies in violation of expectations, it will impose a value of $t=1$. Whether the government benefits from this policy depends on whether or not:

$$U(q(z_j) + r\bar{K}) - U(q(z_j) + T^*(z_j)r\bar{K}) < \quad (6)$$

$$\sum_{i=j+1}^{j+f} E(i) [U(i)(q(z_i) + T^*(z_i)r\bar{K}) - U(i)(q(z_i))]$$

Thus, the government will have no incentive to violate investors' expectations if the benefits of increased government spending in the current period due to a rate of capital taxation in excess of that anticipated given $z = z_j$ falls short of the costs of inability to tax capital for the next f periods. In this case, the reputational equilibrium is sustainable.

In summary, if other sources of revenue (alternatively, other government commitments or the benefits of government spending) vary randomly over time, it will be optimal for capital taxes to vary with the realization of the random shock. Ideally, the government would precommit to a sequence of capital taxes whose average level was constrained by the differential between the gross rate of return domestically and the return available in foreign tax havens. In exceptionally bad states of the world, exceptionally high capital taxes would be levied, and conversely in exceptionally good states. In reality, no commitment technology is available. Government will have an incentive to renege on its commitment, assuming no reputational effects. Knowing this, savers will shift their capital to tax havens, and the government will be unable to utilize capital taxes. But if reputational effects are sufficiently powerful, it may be possible to sustain contingent capital taxes in the absence of a commitment mechanism. But even in the presence of reputational effects or a commitment technology, delays in implementation may render a capital levy ineffectual.

III. The Debate Over the Capital Levy

It is straightforward to reinterpret the historical debate over the capital levy in this light. Here I focus on the British debate between the wars.

The stated rationale for a capital levy in Britain after World War I was to reduce the economic costs of the debt overhang. Britain had

accumulated a substantial public debt as a result of the war (see section IV below). The debt burden was seen as having a variety of depressing economic effects. J. A. Hobson (1920, p.197), for example, focused on the tendency of the debt overhang to raise the rate of interest, which slowed postwar reconstruction, impeded the expansion of industry and commerce, and depressed the housing industry. He advocated a one-time levy which, by drastically reducing the costs of debt service and levels of income and profit taxation, promised to stimulate saving, investment and economic growth. A further cost was the need to constrain spending on the provision of public goods in order to devote scarce resources to debt service.

"Expenditure . . . upon new enterprises such as assistance to housing schemes, and on the development of existing services, such as education, is inevitably restricted," read the Minority Report of the Colwyn Committee (1927, p.358). The young economist Hugh Dalton (1923, pp.11-2), later to rise to greater fame, put the case as follows:

"To pay away a million pounds of taxation a day for education, health and housing would be a bold and hopeful adventure. To pay it away for capital development in our fundamental home industries -- coal-mining, transport, electric power, etc. -- or even in new sources of supply of foodstuffs and raw materials in distant lands, might be a defensible scheme of investment in the social interest...But what we are now doing is to pay it away for nothing, as a permanent annual tribute to the holders of War Loan and other public securities. The sums thus paid away are, indeed, partly reinvested, but are largely spent on the immediate enjoyments of the recipients, who are rendering no present service in return for what they receive and who, just because they have this assured source of future income, are in many cases the less inclined to work and save."

Finally, a heavy debt burden increased the fragility of the government's fiscal position and heightened the difficulty of financing budget deficits. A one-time levy, by eliminating the overhang, could actually enhance the government's subsequent ability to borrow. This was the position argued by Pigou in his testimony to the Colwyn Committee (1927a, p.266).

Much of the debate revolved around the question of whether saving and investment would be discouraged by the imposition of a capital levy or encouraged by subsequent tax reductions. According to Edgeworth (1919, p.11), "I am inclined to think that the check to accumulation would be considerable." Still, this did not necessarily render a levy undesirable. "The advantages of a capital levy, less by its attendant dangers, are to be weighed against the continuance of the present regime with all its evils."

As the discussion evolved, observers began to distinguish different types of levies and different circumstances. "All the economic effects of a levy would depend a great deal on the psychological reactions," reminded the Colwyn Committee (1927a, p.259). Much hinged on whether or not investors expected the levy to be repeated. "The possibility of a periodic levy on capital," admitted even Philip Snowden (1920, p.79), a staunch advocate of the policy, "would discourage saving, it would keep the commercial world in a continual state of uncertainty, and it would arrest trade enterprise." But, he continued, these evils would follow only if the levy was repeated periodically. Such fears "need not be entertained in regard to a special levy on capital once and for all for the purpose of reducing the National Debt." (Emphasis added.)

Some described the capital levy using phrases that sound suspiciously like contingent capital taxation. In the words of the Minority Report of the Colwyn Committee (1927a, p.406), "the effect of a levy on future savings clearly depends to a considerable extent upon the confidence of levy payers that the Capital Levy is an exceptional operation designed to meet exceptional circumstances and not to be forthwith repeated." The majority (pp.295-6) concurred that "exceptional circumstances are required to reconcile the owner of capital wealth to the levy idea." Hicks, Hicks and

Rostas (1941, p.180), reviewing the implications of the post-WWI debate for post-WWII policy, concluded that "A capital levy is not capable of being adopted as a regular part of a fiscal system; it is only suitable for use in special emergencies."

Proponents distinguished the likely effects of a one-time levy in the exceptional circumstances of the postwar world from high levels of recurrent capital taxation. Because it was imposed as a result of independently verified, well understood contingencies, the post-war levy would not discourage saving and investment. There was no reason to anticipate that the public would regard a levy as an abrogation of their contingent claims, or anticipate that the government would utilize it repeatedly in the future.^{12/} In the exceptional circumstances of the early 1920s, there was no reason to expect that imposition of a levy would increase the perceived probability of its future repetition. Hence individuals would have no reason to reduce their saving or to engage in capital flight. It was essential, therefore, that informed discussion distinguish an exceptional levy imposed under extraordinary circumstances from recurrent capital taxation. "[T]his recognition of the obvious folly of failing to distinguish between this unprecedented emergency and the ordinary needs of State finance will remove the apprehension of future raids from operating on the minds of the saving classes so as to prevent them from saving. . . . It is reasonable to regard this war-emergency as so exceptional and so severe that nothing resembling it is likely to recur in our time."^{13/}

Some proponents of the policy admitted that the kind of levy under contemplation exceeded the levels of capital taxation justified by the contingencies that had arisen. They insisted, however, that a nonrecurrent levy at rates exceeding those implicit in the social contract between government and taxpayer, by eliminating the debt overhang at one fell swoop,

could enhance national welfare so long as savers were guaranteed that the exceptional levy would not be repeated. (This is the case of binding commitment in Subsection II.2 above.) To the objection that a capital levy would discourage saving and enterprise, Hobson (1920, pp.209-10) responded, "I do not admit that a graduated emergency levy on capital will carry any appreciable danger of this sort," so long as it was not repeated. "For this reason the advocates of a levy insist strongly on its emergency character, and the opponents on the apprehension of its repetition." As Stamp (1924, p.235) put it, when the "no-repetition of the levy has been fully guaranteed," saving is likely to be encouraged, since the subsequent tax burden will fall. "The satisfactory economic consequences of a levy would be at their maximum possible point." (This is the case where commitment permits a higher level of social welfare to be achieved than in the absence of a guarantee, as in Fischer, 1980). But, Stamp went on, "It is equally clear that where the right to repeat the levy is expressly left open, and where there is to be no relief to the future taxation of those who have paid it, the consequences are at the point of minimum advantage." (This is the case, in Subsection II.2 above, where absence of a commitment technology and of reputational effects prevents government from smoothing its expenditure.)

All too many advocates of a levy, while acknowledging the importance of insuring nonrecurrence, failed to recognize the time consistency problem. Dalton's solution was to have the present generation of politicians pledge themselves against repetition. No mention was made of the incentive to renege, or of the incentive of the private sector to adapt its behavior accordingly. The Co-operative Congress thought it sufficient for all parties to aver their commitment that the levy "would not be repeated within any conditions that could now be foreseen." The Trades Union Congress

embraced Sir Josiah Stamp's suggestion that receipts be issued to those who paid the levy and that these be imprinted with a solemn oath that the tax would not be repeated for 25 years.^{14/} Hobson (1920, p.210) similarly failed to acknowledge the time consistency problem. "If the State discovers that it can once 'raid' capital advantageously, will it not recur periodically to this method? The answer is 'No, not if you accredit it with any true regard to the economic interests of the nation, or even to the future interests of public revenue.' It will not do so, precisely because of the soundness of the objection that is raised to such recurrence."

Opponents of the levy, such as the majority of the Colwyn Committee (1927, p.259), rejected the argument that the sort of capital levy under consideration would be received as the consequence of an independently verified, fully anticipated contingency, concluding that a levy, "unless it were accompanied by some kind of guarantee, would give rise in greater or less degree to the fear of repetition." The problem was that there existed no commitment technology, or guarantee, to insure nonrepetition of the levy. Even Hugh Dalton (1923, pp.65-66) admitted, "There can, in the nature of the case, be no such guarantee. If the Levy were once made, and if it were subsequently proposed to repeat it, that proposal would have to be considered on its merits in the light of the subsequent situation. . . ." Similarly, representatives of the Trades Union Congress (Colwyn Committee, 1927b, p. 587) reluctantly admitted, "We are aware that no guarantee of non-repetition can be absolutely secure." The Colwyn Committee (1927a, p.259) concluded that "an absolute guarantee against the repetition of a levy would be constitutionally impossible in this country."

In the absence of a commitment mechanism, governments were advised to heed the reputational effects of a levy.^{15/} The Colwyn Committee (1927, pp.295-6) referred to the "political suspicion" to which a levy would give

rise -- suspicion presumably of repetition. Pethick-Lawrence (1918, pp.52-3) emphasized reputational effects when contrasting the capital levy with debt cancellation. All this was an argument against imposing a capital levy in excess of that which could be justified on the basis of independently verified, fully anticipated contingencies. Larger levies would undermine the government's ability to utilize capital taxes in the future.16/

Finally there was the danger that delays in implementation would render the levy ineffectual. Anticipating exceptionally high rates of capital taxation, savers would move their assets abroad. In addition to disturbing domestic financial markets, this would reduce the yield. The obvious solution was for governments to adopt the levy quickly. But as time wore on and the debate remained deadlocked, the policy lost its attractiveness in the eyes of some observers. The probability of compliance declined with the passage of time.17/

Some advocates of the levy minimized the danger of capital flight. Dalton (1923, p.62) argued it could not reduce the burden of the levy, since the levy would be applied to all wealth wherever its domicile. Others such as Scott (1918, p.250) and Pigou (1918, p.143) acknowledged the difficulty of identifying and taxing flight capital. The solution of Pethick-Lawrence (1918, p.79) was to coordinate capital levies internationally.

IV. The History of the Capital Levy

Levies on capital have been contemplated ever since governments existed to exploit the power of taxation.18/ The ancient Greeks used periodic capital taxes at rates varying from one to four per cent. It is said that these levies were phenomenally successful because property owners, out of vanity, overstated the value of their assets! In modern times, capital levies have come under consideration following every period of major

military expenditure and rapidly rising debt/income ratios. Archibald Hutchison, a British Member of Parliament, proposed a 10 per cent levy on all property in 1714. Ricardo urged the adoption of a levy following the Napoleonic wars.^{19/} Following the Franco-Prussian war, Menier suggested that the French public debt be retired through the adoption of a one per cent capital levy. In the 1890s, a capital levy was discussed in Germany as a way of financing the expenditures needed to achieve naval parity with Britain.

None of these proposals were adopted. For examples where capital levies were actually implemented, we must turn to the 20th century. The high point of the capital levy debate came after World War I. Not only had debt/income ratios reached high levels as a result of the war, but returning to the gold standard at prewar parities implied deflation and hence even heavier real debt burdens. Many of the new states of Central and Eastern Europe found themselves saddled with public debts but endowed with few resources out of which to service them. Finally, the distribution of the tax burden, and of income and wealth in general, was up in the air, particularly so long as the prospect of socialist revolution loomed, as it did throughout the European Continent in the immediate aftermath of the war, and as new political entities representing the working class vied with established parties for political control.

Italy

The Italian capital tax of 1920 is the closest approximation to a successful capital levy in the 1920s. Italy emerged from the war with a significant debt burden. Fiscal capacity was strained by the ambitious spending programs of the postwar Socialist Government, which wished to maintain its wartime subsidies on foodstuffs and other consumer goods and to

initiate a variety of new social programs. Thus, the source of the fiscal problem was not simply extraordinary wartime expenditures but a permanent rise in the state's fiscal needs. This rendered less than credible assurances by the advocates of a levy that it would both eliminate the fiscal problem and be nonrecurrent.

In the summer of 1919, shortly after coming to power, the Nitti Government appointed a commission of experts to study the levy idea. Its charge was to design "an extraordinary tax on property."^{20/} The commission's proposal was for a one-time tax on the increment to wealth since 1914, plus a forced loan bearing interest at one per cent and repayable in 60 years, to be allocated to taxpayers on the basis of property values. The rates of this proposed increment levy, which depended on the value of property before and after the war, ranged from 3.33 per cent on small properties with no increment to 53.33 per cent on large estates accumulated since 1914. Payment in full was to be due on January 1, 1920, with provision for deferral by owners of illiquid assets for up to eight years.

When in the autumn of 1919 these details became known, "the usual storm of abuse and panic immediately arose."^{21/} The strongest opposition came from owners of real estate who might be forced to resort to distress sales. Bankers feared a run on deposits. Spokesmen for joint stock companies warned of a stock market crash. Proponents of the plan found it difficult to counter their opposition because of the complexity of the commission's scheme, in particular the difficulty of determining the wartime increment to wealth.

In 1920, the initial proposal was superceded by a straightforward capital levy, or "extraordinary tax on capital." The rates, graduated from

4.5 to 50 per cent, looked impressive. But payment could be stretched out over 20 years, which reduced annual rates to 0.225-2.5 per cent, little different from a modest tax on dividends and capital gains. Thus, the one-time capital levy was transformed into a permanent increase in rates of capital taxation, reflecting the permanently higher levels of government expenditure which created the need for the measure. Rates of taxation were adjusted to circumstances: they were raised temporarily in 1921, to finance increased government spending on subsidies, and reduced to previous levels in 1922; the valuation of property was revised repeatedly with changes in the price level and in the profitability of different sectors, thus altering the effective tax rate. Capital taxation made a useful contribution to the public sector's revenue needs throughout the interwar years, but to call these policies a capital levy rather than capital income taxation would be misleading.

Czechoslovakia

Czechoslovakia provides the other marginally successful example of a capital levy after World War I. The levy law was passed by the National Assembly in April 1920. Two distinct taxes were adopted: a levy on all property, and a surtax on the wartime increment. Both were progressive, with rates for the capital levy ranging from 3 to 30 per cent and rates for the increment tax reaching 40 per cent. A separate levy with rates ranging from 3 to 20 per cent was imposed on corporate property. Collection was to be complete within three years.

The success of the levy was mixed. The authorities met with resistance in 1920-21, but significant amounts of revenue were raised in 1922-23. In these years the two levies provided the majority of direct tax revenues.^{22/} But then new concessions were introduced, especially once financial

instability in Central Europe began to disrupt foreign trade. Taxpayers were allowed to pay in installments over many years without additional interest charges. In 1924 levy receipts fell to a third of direct tax revenues and declined steadily thereafter.

What accounts for the unusual success of the Czech levy? First, the levy fell mainly on a small ethnic German minority that was unable to mount effective political resistance or to delay adoption. With political opposition minimized, the authorities were able to move quickly toward implementation.

Second, the government succeeded in minimizing capital flight. In March 1919, when property values were assessed, financial relations with other countries were effectively severed.^{23/} Assessment followed immediately upon the conclusion of hostilities and preceded by more than a year passage of the levy law. Other countries attempted to pursue a similar strategy but failed. Czech experience reveals a further advantage of initiating the process in the immediate aftermath of war: with rail and road transport still disrupted, shifting assets abroad was more difficult than it was to become subsequently. Capital flight still reached significant levels, as Van Sickle (1931, p.176) notes, but it was not as debilitating as in subsequent cases.

Third, it seems likely that the way the Czech authorities structured their budget encouraged compliance. The administration of the levy was completely sequestered from the day-to-day operations of the Ministry of Finance. Levy revenues were explicitly allocated to the special costs of establishing an newly-independent nation. They were used to extinguish obligations taken over from the Austro-Hungarian Bank and to meet "the most pressing needs of the Czechoslovak State arising from the establishment of its independence. . . ." ^{24/} The government was prevented from using levy

receipts to defray current state budget deficits. This lent credibility to claims that the levy was an extraordinary tax whose repetition was unlikely.

Austria

The Austrian levy was an abject failure. It had been under discussion since 1917. Gustav Stolper wrote a series of articles in which a levy figured in his plan for postwar reconstruction. Joseph Schumpeter, in his capacity as finance minister, included a modest levy in his 1919 budget proposal.^{25/} But political wrangling over the levy and over the general question of who should defray the costs of postwar reconstruction and adjustment led to fatal delays in implementation. Feuding between the Social Democrats, representing urban laborers, and the Christian Socialists, representing small farmers and shopkeepers, left postwar tax policy deadlocked. The Social Democrats were understandably more supportive of the levy idea than the Christian Socialists. Even when the two parties formed a coalition government, they found it difficult to resolve the issue.^{26/}

Political sparring dragged on for over than a year until property values were assessed in the summer of 1920. Except for the decision to drop the distinction between total property and the post-1914 increment, the plan was virtually identical to its Czech predecessor. But by the time assessment took place, asset holders had had more than a year to prepare. Reconstruction of the transportation and communication networks had facilitated capital flight. Anti-evasion legislation, including laws requiring those taking assets out of the country to declare their intention to the authorities a month in advance and to pay a 30-50 per cent tax, proved ineffectual. Capital flight heightened objections to the levy on grounds of equity, leading to further resistance and evasion. Small savers and agriculturalists ill placed to engage in capital flight demanded and

received favorable treatment by tax assessors. The valuation process was reduced to a "joke."²⁷ The Christian Socialists secured exemptions for Church property, while the Social Democrats obtained exemptions for newly-created public utilities. Moreover, the authorities failed to segregate levy receipts from ordinary revenues and expenditures of the state, casting doubt on their characterization of the measure as extraordinary and nonrecurrent.

With capital flight and erosion of the tax base came financial instability and, ultimately, hyperinflation. The effects of the hyperinflation are the subject of an extensive literature. One effect was to liquidate levy obligations. As soon as they were established, property assessments were outdated. By delaying payment, taxpayers could virtually eliminate their obligations. In addition to liquidating the tax base, hyperinflation undermined the very rationale for exceptional capital taxation. The burden of public debt which provided the justification for a levy was effectively eliminated by inflation. By 1922, the levy had been written off. As part of the League of Nations stabilization agreement, it was converted into an annual property tax at extremely low rates. The revenues raised by the levy, over its 2 1/2 years of operation, amounted to little more than a third of the ordinary tax revenues collected in the first six months following the stabilization.

Hungary

Hungary also attempted, in 1920-1, to impose a levy along Czech lines. As in Austria, implementation was impeded by postwar political instability, including a short-lived Communist experiment. Once a semblance of political stability was restored, the government attempted to impose a levy. All property was blocked and registered, to be reacquired by payment in cash or

kind, at rates ranging from 5 to 20 per cent. The Hungarian levy differed from its Czech and Austrian counterparts by taxing different assets at different rates. The advantage was administrative ease: individuals were simply required to cede a given percentage of each type of security, or a certain share of their land, without complicated assessments. The disadvantage was the perception of inequity: one person who held foreign exchange might be required to cede 20 per cent, while another who held domestic bank deposits might pay only 5 per cent.

As in Czechoslovakia, levy receipts were initially segregated from other government revenues and earmarked for debt retirement. As the budgetary crisis deepened, however, the distinction was eliminated, and levy receipts were used to finance ordinary expenditures. Arguably, this failure to earmark receipts for debt retirement weakened the argument that the levy was an extraordinary tax.

The Hungarian levy was actively resisted by the landowners, who utilized delaying tactics. The large landowners had long dominated local politics.^{28/} Because their assets were largely illiquid, rendering capital flight impractical, they had the most at stake. Some capital flight surely took place, mainly by urban wealthholders with liquid assets, but it probably was less important than in Austria. In any case, the Finance Minister's decision to include the levy as part of his 1920 budget, thereby provoking capital flight, was widely cited as a cause of the hyperinflation. Thus, when the Finance Minister was forced to resign as a consequence of the inflationary chaos, the levy was revoked. As one of the fiscal reforms adopted in conjunction with the 1924 League of Nations stabilization agreement, remaining vestiges of the levy were converted into a regular property tax at low rates.

Germany

The outcome in Germany was the same; only the political cleavages differed. Germany had attempted to employ various forms of nonrecurrent capital taxation to finance the war. The euphemistically-named National Distress Contribution of 1920 was only the latest in this series of supposedly nonrecurrent levies; hence assurances that it was not to be repeated were received skeptically. In addition, much of the support for the levy by the parties of the Left was based not merely on the need to finance extraordinary expenditures, but on the desire to achieve a more equal income distribution. Thus, the equity issues that inevitably complicate use of the instrument were especially prominent in the German case.

The most effective opposition to the measure came not from landowners but from business. Economists added their voices to the chorus of those questioning the measure's practicability.^{29/} As in Austria and Hungary, opponents relied on delaying tactics. Capital flight provoked by the levy did not play a direct role in the German hyperinflation of 1923, for the levy was effectively abolished by the end of 1921, although its failure may have played a role in the fiscal crisis facing the state in 1922. But imposition of the levy surely encouraged capital flight in 1920, which well may have contributed to the 70 per cent rise in the price level between May 1919 and May 1920. Since property values were to be assessed on December 31, 1919, the tax base was quickly eroded. Nominal rates ranged from 10 per cent on small properties to 65 per cent on the large estates.

In order to overcome opposition to the levy idea, its supporters acceded to demands that payment be spread over 30 years (as long as 50 years for landowners). Only 5 per cent interest was charged on arrears. Thus,

the levy as implemented did little to resolve the fiscal crisis. As an unindexed tax, it created a natural constituency for policies with an inflationary bias. By the end of 1921 inflation was underway. The real value of receipts diminished rapidly, both because of the erosion of the tax base and because of the increased incentive to delay payment. In early 1922 the government enacted new measures to accelerate payment of small liabilities, but these proved inadequate to offset the effects of continued inflation. Levy receipts fell to negligible levels. In April 1922 the capital levy was converted into a conventional property tax at low rates.

France

The capital levy was intensely debated in France and Britain but adopted in neither country. In France, exceptional political fragmentation stood in the way. Parliament was fragmented into an unusually large number of parties, intensifying the difficulty of forming a coalition in support of a levy. Income distribution, while only one of a range of issues on which parties disagreed, figured prominently in political maneuvering. Although there existed a broad range of opinion in agreement that contingencies justifying extraordinary taxation had occurred, parties disagreed on the appropriate tax base, some pushing for exceptional income taxes, others for exceptional excise duties on consumption, still others for a capital levy. For more than half a decade, consensus proved impossible to achieve.

On fringes of the political spectrum, there was dissent from the view that the relevant contingencies had in fact occurred. It was argued, particularly on the Right, that extraordinary taxes to finance postwar reconstruction were superfluous because Germany would pay. Budget deficits had the desirable effect of keeping the pressure on Germany and the Reparations Commission. Thus, there was a natural incentive to delay

resolution of the fiscal crisis. The longer delay persisted, the further the events justifying extraordinary taxation receded into the past.

The extremity of the budgetary crisis was the central factor favorably inclining Frenchmen toward some form of exceptional taxation. In 1920, for example, when a capital levy was first seriously contemplated, the central government budget deficit amounted to 150 per cent of revenues. In part this reflected the extraordinary reconstruction needs of the economy, but it also reflected political exigencies. Government expenditures were segregated into a nonrecoverable budget, whose deficit was about 33 per cent of revenues, and recoverable expenditures on special account, all of which were to be financed out of German reparations. In the meantime, bonds were issued to finance recoverable expenditures, adding to the debt overhang.

The outgoing Clemenceau Government's 1920 budget projected substantial amounts of new revenue, to be raised in part through two new levies on the increment to wealth. The first would have imposed a progressive tax on the increment to wealth between 1914 and 1919. The second would have imposed a special tax on increases in the value of real estate and business concerns accruing over the last 25 years. Rates would have averaged around 20 per cent. The incoming Millerand Government regarded these levies as impractical and eliminated them from its program. Its Finance Minister, Francois-Marsal, a banker, noted that a levy on accumulated savings penalized the frugal, rewarded the spendthrift, and was likely to discourage saving.^{30/}

The French finances staggered on through 1926, with one finance minister replacing another on average at four-month intervals. The reparations tangle remained at the root of the problem: reinforcing the unwillingness to compromise of the proponents of indirect tax increases,

expenditure reductions and the capital levy was blind faith that German transfers would eventually fill the budgetary gap. Only with the failure of the Ruhr occupation and the acceleration of inflation did politicians begin to acknowledge that the solution had to be found at home.

This realization was one factor underlying the formation of the Cartel des Gauches, a coalition of left-of-center parties all of which preferred a capital levy to indirect tax increases and expenditure reductions. The Bloc National of centrist parties had obtained breathing space in early 1924 by adopting modest expenditure economies and raising taxes by 20 per cent. Its defeat at the polls in May of that year and the accession to power of the Cartel des Gauches are widely ascribed to the unpopularity of these fiscal measures. Compared to the Bloc National, the Cartel was less virulently anti-German and hence more inclined to seek a solution to the fiscal deadlock at home. The capital levy was its official policy. Unfortunately, the Cartel did not possess a Parliamentary majority, and some of its own members opposed extraordinary capital taxes. Clementel resigned as finance minister in April 1925 when the Cabinet rejected his proposal to increase income taxes by 50 per cent, preferring a 10 per cent levy on all wealth to be payable over no more than 10 years. His successor de Monzie, to subdue the most fervent opposition, recast the levy as a forced loan but was no more successful securing adoption.^{31/}

By the autumn of 1925 inflation and exchange-rate depreciation were threatening to run out of control. Endless discussion of a levy, unaccompanied by decisive action, provoked capital flight and rendered investors hesitant to absorb new bond issues, fueling the monetary inflation.^{32/} The current Finance Minister, Painleve, embraced both the income tax increase favored by the center and the capital levy favored by the Left. To minimize problems of valuation, the levy was to be assessed

mainly on income from assets rather than their capital value: 150 per cent of the rental value of real estate, 50 per cent of average annual profits of businesses, 15 per cent of annual income on securities. Payment would extend over as many as 14 years. Inclusion of the levy in the fiscal package is sometimes ascribed to the need to buttress support on the Left. It met with understandable opposition from business and the Right, who referred to it as "an infringement of the right of property . . . pure collectivism."^{33/} In addition there was dissent within the Cartel; combining the levy with an income tax increase did not defuse the opposition of its more moderate members.^{34/} The stability of the Government was called into question. The occasion for its fall was Painlevé's proposal to temporarily suspend amortization of government bonds, a drastic step to which he was led by inability to make more rapid progress on the fiscal front. This ended serious discussion of the capital levy.

Britain

Great Britain emerged from World War I with a greatly increased internal debt burden. Interest payments as a share of budgetary receipts rose from less than 10 per cent in 1913-14 to 22 per cent in 1919-20. Not only might the taxation required to service this debt hinder recovery from the war, but the overhang posed a challenge to policies designed to restore the prewar sterling parity. Returning to gold at \$4.86 required deflation; as the price level fell, the debt burden rose, to 30 per cent of budgetary receipts in 1922-23 and as much as 36 per cent in 1925-26.

The capital levy was Labour's preferred solution to the problem. As early as 1916, the Fabian Research Society, in a pamphlet authored by Sidney Webb, proposed a 10 per cent levy on capital. In 1918 Sydney Arnold, a Labour MP, raised the issue in the House of Commons. Pethick-Lawrence

(1918) published an articulate statement of the Labour case for the levy. By 1920 the levy had become a plank in the financial platform of the Labour Party.

The ruling coalition, which drew support from property owners, had only limited sympathy for the idea. Chancellor of the Exchequer Austen Chamberlain rejected the levy in 1919 as a fatal deterrent to saving.^{35/} Private parties reiterated his warning. The Manchester Chamber of Commerce adopted a resolution in March of 1920 warning that "confiscation of capital" would severely disrupt the expansion and development of industry.^{36/}

Significantly, Labour advocated a levy not only to eliminate the debt overhang but also as a means of effecting a socially desirable redistribution of income. It envisaged a revolution not merely in the national finances but in the distribution of income and wealth.^{37/} Labour could point to large fortunes acquired through war profiteering as a source of particularly unjustifiable income inequality. To cultivate support for the levy by focusing attention on these cases, Labour MPs modified their proposal in 1920 from a levy on all property to a special tax on war wealth. Unfortunately, limiting the tax base to the wartime increment greatly reduced the prospective yield. This fueled the argument that the administrative costs of a levy might swamp the benefits. The ruling Liberal-Conservative coalition was nonetheless sufficiently attracted to the idea of a limited levy to appoint a Parliamentary committee, which in 1920 submitted a plan for a special tax on war wealth, to be applied to the 1914-1919 increment to property values.

Among the submissions to the committee were memoranda from the Board of Inland Revenue. The Revenue Authority expressed skepticism about the practicability of a levy, warning of disruptions to financial markets if

property owners were forced to liquidate assets. It recommended stretching out payments over ten years, so that the levy could be paid out of income rather than principal. Supporters of the levy, such as Pigou, objected that this would effectively transform the levy into a recurrent income tax with serious disincentive effects.

Talk of new taxes was deferred by the 1921 recession. Proposals for a levy were then subjected to electoral debate. The First Labour Government made no attempt at implementation upon taking office in 1923, however. It shunned the levy for the same reasons that it embraced the gold standard. First, Labour was concerned to reassure the financial community and demonstrate its ability to govern. Second, as a minority government, it relied on the support of the Liberals, who were firm believers in laissez faire and staunch opponents of the levy.

With the passage of time, support for the levy idea began to dissolve. Conservatives and Liberals, who opposed the Labour notion that income redistribution was desirable, succeeded in delaying implementation. As World War I receded into the past, the contingency providing the justification for extraordinary capital taxation became increasingly remote, and the perceived likelihood of active resistance grew. By the mid-'twenties, Britain had lived with the war debt for nearly a decade, without overly disastrous consequences.^{38/} Property owners pointed to this when challenging the notion that exceptional circumstances justified extraordinary capital taxes. Moreover, with Britain's restoration of gold convertibility in 1925, the last barrier to international capital mobility was removed. No longer was there any impediment to capital flight by investors potentially subject to the levy. Not only did this threaten to greatly reduce the yield, but capital flight might bring down the gold standard edifice that had been so laboriously reconstructed. Keynes,

initially a proponent of the levy, had by the 1923 General Election become an opponent. Sir Josiah Stamp, also an early advocate, concluded by 1924 that the nation was long longer willing to tolerate the compromises in equity that might have been justified earlier by extraordinary wartime contingencies.^{39/}

The last gasp of the levy campaign was the Minority Report of the Committee on National Debt and Taxation (the Colwyn Committee). Though approving the levy in principal, the minority suggested substituting, on grounds of practicability, a surtax on investment incomes to be applied to debt retirement. They acknowledged, however, that the case for the levy weakened as the shock of the war receded into the past. Viability of the levy hinged upon it being "accepted with general good will," and the prospects for this grew increasingly dim as the extraordinary wartime shock grew increasingly remote.^{40/} The majority put the point more strongly. "Unless a levy were accepted with more good will than it would be possible to anticipate under present conditions, it would be highly injurious to the social and industrial life of the community."^{41/} "Immediately after the War the argument for a levy was much stronger than it is now. . . . In particular, the end of the War was a unique occasion which the more wealthy classes of the nation might well have been asked to mark by a special and personal contribution. In present circumstances the advocates of a levy have a far weaker case."^{42/}

The majority paid considerable attention to fears that the levy, once employed, might be resorted to again, with disastrous implications for savings. In addition to the impracticability of constitutional guarantees, they pointed to the unwillingness of the proponents to agree to segregate levy receipts from other government revenues. While some proponents urged

devoting the receipts exclusively to retire debt, thereby maximizing the association of the levy with the war debt and, by reducing the debt burden, eliminating much of the rationale for another levy, others recommended instead reducing income taxation or increasing spending on social services.^{43/}

In 1927 the Labour Party Conference endorsed the surtax proposed by the Minority Report of the Colwyn Committee, acknowledging that the prerequisites for a successful one-time levy were no longer present. By the time Labour reclaimed office in 1929, however, the onset of the Depression and the decline of the stock market rendered new capital taxes beside the point. Eliminating the scourge of unemployment, rather than fine tuning the income distribution, became the central goal of Labour and its opponents alike.

V. The Japanese Levy After World War II

An exception to the rule that 20th century capital levies have been unsuccessful is the Japanese levy following World War II.^{45/} The Japanese capital levy of 1946-47 was one component of a sweeping political and economic overhaul which included tax reform, land reform and constitutional reform. The levy's first objective was to reduce the internal debt burden inherited from wartime. The national debt had risen from 31 billion yen in March 1941 to more than 202 billion yen in March of 1946 (or from roughly 84 to 130 per cent of national income).^{46/} Reducing this burden was seen as essential for economic recovery.

The levy's second objective was to provide finance for the recovery program. Not only was there an exceptional need for public expenditure to finance physical reconstruction and housing for occupation forces, but economic devastation caused normal tax revenues to lag: with 40 per cent of

all urban areas in ruins, taxes as a share of national income had fallen from 13 per cent in 1944 to barely 7 per cent in 1946.

The third objective of the levy was to reduce income inequality. Significantly, this was not an attempt to effect a comprehensive redistribution of wealth. Rather, it was an effort to reduce the wealthholdings of a small minority of exceptionally rich individuals. The perception, particularly among the American occupiers, was that the fulminations of this small minority -- the Zaibatsu or clique of owners of great holding companies -- had been responsible for promoting pro-war sentiment. According to a memo from Allied headquarters to the Japanese government, these individuals had profited handsomely from the war. A levy on their assets would demonstrate that war was unprofitable and contribute to the growth of peaceful and democratic forces.^{47/} Of the three rationales for the levy, this sociopolitical argument was the most important.

The levy was imposed on households whose property was worth at least 100,000 yen on March 3, 1946. Rates rose from 10 per cent on those properties to 90 per cent on estates worth more than 15 million yen. Initial projections put the yield of the levy at 120 per cent of normal 1946/47 tax revenues and nine per cent of privately-owned national wealth. To minimize underassessment, the law featured a provision entitling the government to purchase property outright at its assessed value. While this provision seems to have been rarely utilized, its existence may have discouraged abuse of the valuation process.^{48/}

Administrative difficulties led to some delay in implementation. Collection, scheduled to take place in the summer of 1946, did not get underway until the end of the year. Although the nominal yield was quite close to projections, the levy's real value was eroded by inflation. The

retail price level in Tokyo more than doubled between March 1946, when property values were assessed, and March 1947, when most payment took place. Nonetheless, this was a remarkable record in comparison with the Central European levies discussed in the previous section.

What accounts for the singular success of the 1946-47 Japanese capital levy? One factor is that the exceptional circumstances of the immediate postwar period limited the scope for evasion. Another is that a levy whose incidence was limited largely to the two or three percent of richest families minimized the scope for effective political resistance. (For a parallel, see the discussion of Czechoslovakia above.) The vast majority of asset holders considered themselves to be exempt. But surely the most important factor was the Allied occupation. If European experience after World War I documents the obstacles to a capital levy in a democratic society, Japanese experience after World War II provides proof by counterexample. With important elements of democracy in suspension, the levy could be quickly and effectively implemented. One might go further and argue that only when political sovereignty is suspended can the measure be pushed through with such alacrity. Under normal circumstances, the argument would run, the wealthy individuals subject to the levy inevitably exercise a disproportionate influence over policy formulation; only when those normal circumstances are in abeyance can the measure be pushed through with a minimum of dispute and delay.

In 1946-47, Japan's sovereignty was radically abridged. While the Japanese government continued to exist, occupation forces possessed absolute authority. Directives and orders were issued by Supreme Commander for the Allied Powers (SCAP) to the Japanese Cabinet, which was responsible for carrying them out. Even when the Japanese government resisted Occupation

initiatives, such as the economic provisions of the Initial Postsurrender Policy, it ultimately had no option but to accede. And even when no formal directives were issued, SCAP's influence was pervasive.^{49/} This is evident in the adoption of the new constitution, which coincided with the capital levy law.^{50/} When in February 1946 MacArthur rejected the plan for constitutional reform offered by the Japanese government, his staff simply drafted a replacement. Historians continue to debate whether compulsion was involved in the government's decision to accept MacArthur's draft and present it to the Diet, and in the latter's decision to pass it quickly. Even if no direct compulsion occurred, MacArthur clearly had the power to use it if his proposals met with resistance. Next to far-reaching constitutional reform, the demand that the government adopt a capital levy was of relatively little consequence.

VI. Conclusion

In this paper I have recast the debate over the capital levy in a contingent capital taxation framework. This shows how in theory the imposition of a levy can be welfare improving when adopted to redress debt problems created by special circumstances, even if its nonrecurrence cannot be guaranteed. If the contingencies in response to which the levy is imposed are fully anticipated, independently verifiable and not under government control, then saving and investment should not fall following the imposition of the levy, nor should the government find it more difficult to raise revenues.

In practice, as opposed to theory, serious problems stand in the way of implementation. A capital levy has profound distributional consequences. Property owners are certain to resist its adoption. In a democratic society, their objections are all but guaranteed to cause delay. This

provides opportunity for capital flight, reducing the prospective yield, and allows the special circumstances providing the justification for the levy to recede into the past. The only successful levies occur in cases like post-World War II Japan, where important elements of the democratic process are suppressed and where the fact that the levy was imposed by an outside power minimized the negative impact on the reputation of subsequent sovereign governments. These findings are not encouraging for those who might advocate a capital levy to redress debt problems in present-day Europe.

In addition to these substantive conclusions, the paper has two methodological implications. First, the recent literature concerned with political constraints on economic policymaking and political determinants of the business cycle (Alesina, 1988b) has even broader applicability than sometimes supposed. Second, it can be seriously misleading to draw conclusions about the feasibility of a policy purely on the basis of theory. As Comstock (1928, p.18) put the point, "The attempt to judge the practicability or the effects of an untried fiscal device, such as the capital levy . . . , is fantastic if it is based on abstract reasoning alone. The experience of other countries, unlike as they are and must remain, is a better guide."

FOOTNOTES

1. Following Chou (1945), I refer to a nonrecurrent tax on all wealth as a capital levy, and to an involuntary reduction of interest or principal on government debt as a forced conversion. In this paper, I do not consider taxes on individual assets, including levies on money balances that accompanied inflation stabilization.
2. See for example Prescott (1977), Alesina (1988a), Chari (1988), Chari and Kehoe (1988), Eichengreen (1988a) and Grossman (1988).
3. The effects of the LDC debt overhang have been analyzed theoretically and empirically by Sachs (1989), while the implications for future creditworthiness are the subject of Eichengreen (1988b), Jorgenson and Sachs (1989) and Lindert (1989). The seminal article on time consistency is of course Kydland and Prescott (1977).
4. Different ways in which this might be accomplished, in addition to outright repudiation, include a forced conversion and inflating away the real value of obligations bearing fixed nominal interest rates.
5. In general, savings and investment will be lower than in a regime in which there is no possibility of the imposition of a levy, however. See Section II below.
6. I am far from the first to stress the political dimension of the capital levy. See for example Keynes (1923) and, more recently, Dornbusch (1986).
7. The statement that this is the only 20th century example of a successful capital levy is meant to provoke and is surely overstrong. Belgium, followed by Czechoslovakia, Austria, and Germany, blocked bank accounts and converted them into new currency notes at disadvantageous rates following World War II. But these measures were generally limited to bank accounts and were designed to remove excess liquidity which threatened to ignite inflation rather than to fund government expenditures or eliminate a debt overhang. See Maier (1984). Another candidate is the Italian rearmament levy of 1937-38. Since its success can be attributed to the capacity of an authoritarian government to discuss the policy in secret and impose it unilaterally, this example also supports the point of the exceptional difficulty of utilizing the levy in a democratic society. Moreover, since the levy was imposed in a period when Italy was concluding a war in Ethiopia and preparing for the coming European conflict, it is difficult to regard it as a peacetime measure.
8. More generally, the capital stock would increase at the rate of interest, assuming no consumption out of principal or interest.
9. A more general formulation would specify r as a declining function of the domestic capital stock.
10. Abreu (1988) shows that it is a perfect equilibrium in a variety of

noncooperative games.

11. This device introduces the possibility that the inequality in (6) need not hold. Other assumptions that deliver the same result are discounting of future expenditures by the government (a further advantage of which is that it insures $u(j)$ is bounded), or the assumption that the government has a non-negligible probability of losing office in each period and attaches no utility to expenditure by its successors. These are more elegant and more rigorously defensible, but they add complexity and change none of the substantive implications.

12. Hobson (1920), p.210.

13. Hobson (1920), p.214.

14. Committee on National Debt and Taxation (1927a), p.259.

15. It is worth noting another reputational argument that figured in the debate. Edgeworth (1919) and Scott (1918) argued that a debt burden is a form of discipline on the government. It limits the government's ability to indulge in deficit finance. If it is levied away or repudiated, governments will not lower taxes; rather they will fritter away revenues on other forms of spending and increase their deficit finance.

16. There are a number of other interesting theoretical issues in the debate over the capital levy that cannot be pursued here. These include (i) the precise yield of the levy, especially when the reduction in future estate taxes and death duties are netted out from levy revenues (see for example Stamp, 1924), (ii) the appropriate tax base for the levy, and specifically whether there should be an attempt to tax human as well as financial capital (Pigou, 1918), (iii) the effect of a levy on security prices in particular and financial markets in general (Pethick-Lawrence, 1918), and (iv) difficulties of implementation and administration (Arnold, 1918).

17. It is on grounds such as these that we can understand Keynes's volte face from advocacy of a levy immediately following World War I to deep skepticism by the time of the 1923 General Election. Keynes's views in 1927 are recounted in his Colwyn Committee evidence (1927b, p.534). See also Keynes (1923) and footnote 39 below.

18. A survey of the relevant history is provided by Soward and Willan (1919), chapter 11.

19. See Asso and Barucci (1988) for a detailed analysis of Ricardo's views and Gottlieb (1953) on the surrounding debate.

20. Einaudi (1921), p.108. Economist (May 15, 1920, pp.1004-1005).

21. Hicks, Hicks and Rostas (1941), p.235; Einaudi (1921), p.111.

22. Rostas (1940), p.24.

23. Hicks, Hicks and Rostas (1941), p.199.

24. Rostas (1940), p.25; Economist (January 31, 1920, pp.196-197).
25. Van Sickle (1931), p.138.
26. Hicks, Hicks and Rostas (1941), p.221.
27. Van Sickle (1931), p.160.
28. Rostas (1940), p.28.
29. See Diehl (1918).
30. Silverman (1982), pp.71-73.
31. Under the provisions of this scheme, all income tax payers who failed to subscribe to the forced loan bearing three per cent interest in amounts equal to one tenth of their total wealth would be levied an exceptional tax equal to the shortfall. Peel (1926), p.243.
32. Rogers (1929), pp.252-253.
33. Haig (1929), pp.124-125.
34. Sauvy (1984), vol. III, p.82.,
35. Comstock (1928), p.10.
36. Comstock (1928), p.12.
37. Labour's vision for postwar society is described by Cole (1948).
38. Gottlieb (1952), p.373.
39. Keynes's speeches on the issue made in connection with the General Election are recounted by Harrod (1951), pp.338. On Stamp's views, see Stamp (1924), p.228.
40. They continued, "We have no hesitation in saying that a capital levy at that time (1919-1920) could have been carried out comparatively easily, and that it is a matter of great regret that no levy was then imposed." Committee on National Debt and Taxation (1927a), pp.410-411.
41. Committee on National Debt and Taxation (1927a), p.296.
42. Committee on National Debt and Taxation (1927a), p.248.
43. See Section III above.
44. Hicks, Hicks and Rostas (1941), p.262.
45. The account that follows relies on Shavell (1948).
46. These figures understate the debt/income ratio because they divide end-of-fiscal year debt figures by national income for the fiscal year as a whole. Data are from Shavell (1948), Tables 1 and 2.

47. Cited in Shavell (1948), p.131.

48. While the levy to reduce the great estates of the families that controlled the combines was adopted, early Occupation initiatives intended to break up the combines themselves were not pressed once the Cold War increased the importance the U.S. attached to speedy Japanese economic recovery. Instead, the decision was made to permit Japanese reconstruction to proceed along traditional lines.

49. Borton (1970), pp.461-462.

50. The first draft of the constitution was written in English in February 1946, translated into Japanese in March, passed by both Houses of the Diet in October, promulgated by the Emperor in November, and made effective in May 1947, coinciding almost exactly with the period from adoption to implementation of the capital levy.

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