EAMONN BUTLER

An introduction to TAXATION

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AN INTRODUCTION TO TAXATION

EAMONN BUTLER

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Eamonn's other books include introductions to the pioneering economists Adam Smith, Milton Friedman, F. A. Hayek and Ludwig von Mises. He has also published primers on classical liberalism, public choice, capitalism, democracy, trade, economic inequality, the Austrian School of Economics and great liberal thinkers, as well as *The Condensed Wealth of Nations* and *The Best Book on the Market*. He is co-author of *Forty Centuries of Wage and Price Controls*, and of a series of books on IQ. He is a frequent contributor to print, broadcast and online media.

LIST OF ACRONYMS

EU	European Union
FTT	Financial transaction tax
GDP	Gross domestic product
GST	General sales tax
LTJ	Low-tax jurisdiction
OECD	Organisation for Economic Co-operation and Development
VAT	Value added tax

FIGURES

INTRODUCTION

The role of this book

This book is not specifically about any specific tax system, but is about the general *idea* of taxation. It explains what taxation is, why it exists, its history, its aims and purposes, its impact on individuals and the economy, its social and moral results, who pays it, what benefits it has, what damage it does, and how to make it work better.

The book is jargon-free. It is aimed at lay readers who want to understand the role of taxation in society and the arguments around it, and at school and university students who are looking for a broader view of taxation than they can find in their textbooks.

Why this book is necessary

Economic textbooks are remarkably thin on the concept of taxation. They examine it only as a tool for managing the economy, redistributing resources or changing people's behaviour (e.g. to encourage them to reduce their pollution). But this is far from the whole story.

In his 1776 book *The Wealth of Nations*, the pioneering Scottish economist Adam Smith (1723–90) formulated the principles of good tax policy as fairness, certainty, convenience and efficiency – ideals that are widely accepted today (Butler 2007). But, sadly, today's tax systems often fall short of *fairness*, being skewed for political purposes and often weighing most heavily on the least well-off. *Certainty* should mean that people know clearly how much tax they pay, but the complexity of many tax systems makes that impossible. *Convenience* is about making taxes easy to pay; but again, tax complexity often forces people to hire expensive professionals to guide them. *Efficiency* means that taxes should be easy to collect and should not distort or stifle commerce, though some taxes almost certainly cause more economic damage than they raise in revenue.

Despite these shortcomings, the textbooks take taxation as a given. They see taxes as a necessary source of funds for the provision of essential and beneficial government services. They explore their workings largely in terms of who pays them and who is affected by them. But they do not explain how and why taxes are created or abandoned, nor how politics affects them, nor what they really mean to people. They rarely ask whether some taxes do more harm than good, or which taxes are most useful or most damaging, or whether there are other ways of funding public services. Nor do they raise any questions about the morality of how taxes are raised and what they are spent on.

This book takes a much broader view, asking these and many other questions in order that we might put taxation and its benefits much more into its economic and human context.

It argues that taxation often falls short of its aims. It explores the principles that would define a better and simpler tax system and examines other techniques that might be used to fund public services with less taxation.

1 THE HISTORY OF TAXATION

The US statesman Benjamin Franklin (1706–90) famously wrote that ‘in this world, nothing is certain except death and taxes’ (though modern-day wits complain that the two come in the wrong order). Certainly, taxes have been with us for a long time.

The ancient and medieval world

Governments throughout history have turned to taxation in order to fund their provision of goods and services to the public (or to keep their rulers in a style that reflected and magnified their status). And for most of that history, taxes have centred on the main industry, namely agriculture: the production of the essentials we need to eat and drink.[1]

Egypt. Between two and five thousand years ago, Ancient Egypt’s Pharaohs employed scribes in their thousands to assess harvests for tax purposes. Grains, livestock, beer and other produce were taxed, with harsh penalties for evasion. The Pharaohs had a monopoly on cooking oil and

1 For more on the history of tax systems, see Blankson (2007).

taxed it, too: officials would enter people's homes and punish anyone trying to escape the cost by reusing oil.

China. Imperial China was another largely agrarian economy and was taxed accordingly. Local officials were charged with raising set amounts of revenue – though they had discretion about exactly how. The main revenue sources were land and produce, but at various times there would be taxes on salt, artisan industries, valuable metals, tea, tobacco and other goods. This provided finance for the army, public works (including the Great Wall) and other imperial expenses.

Greece. Much tax collection in Ancient and Classical Greece (700–323 BCE) was contracted out to 'tax farmers', who bid for state contracts to collect taxes. Tax was levied on products, including the all-important olive oil, and on trade (including high tariffs on oil imports, designed to protect domestic producers). There was a poll tax on foreigners living in Greece, and, during emergencies, the richest citizens too were taxed directly (Kolasa-Sikiaridi 2022).

India. Before 300 BCE, ancient India also levied taxes on agriculture and trade, and on various professions. There were charges on land, alcohol, salt, mining and other activities. As in Greece, taxes and loans were raised to deal with emergencies.

Rome. The Roman Republic (509–27 BCE) levied customs duties on foreign trade, and a wealth tax on land and property. Our word *tax* may come from the Roman *taxare*, meaning 'to estimate value'. Tax farmers gathered revenue effectively, but corruptly, which made the system unpopular. Later, the emperor Augustus (63 BCE–14 CE) introduced wealth and poll taxes for all adults. An interesting oddity later in the Empire was a tax on urine collected from public toilets – a valuable source of ammonia to clean and whiten woollen fabric.

England. Another interesting tax was Anglo-Saxon England's Dane-geld (991–1016), a land tax levied to pay protection money to Viking raiders, to stop them pillaging land and property. Sadly, the attacks continued: in the words of a much later poet, Rudyard Kipling, 'once you have paid him the Dane-geld, you never get rid of the Dane'. Nor, it seems, was it easy to get rid of the tax: when the Viking threat was eventually overcome, kings continued to levy it.

Local lords could raise revenue too – there is a legend (certainly untrue or exaggerated) that the eleventh-century Anglo-Saxon countess Lady Godiva rode naked through the streets of Coventry to protest her husband's oppressive taxes on his tenants. But England's new rulers after the Norman invasion of 1066 were much more systematic; they assessed and recorded the country's tax potential in the *Domesday Book* and imposed taxes on fertile land, livestock, townships and much else.

Capitation (or 'poll') taxes were levied in England from 1275 onwards. That of 1381, a minimum four pence tax on everyone, is blamed for the Peasants' Revolt uprising of that year. It was not the first backlash against unfair taxation. After the Norman ruler King John (1166–1216) exploited taxpayers to fund wars abroad, the barons listed their objections to his arbitrary rule in Magna Carta (1215), (Butler 2015). Nor would it be the last such uprising: further arbitrary taxation under Charles I (1600–49) helped precipitate civil wars, and eventually Charles's execution.

The post-industrial world

United Kingdom. The Industrial Revolution, originating around 1760 in Great Britain, also revolutionised how taxes could be raised. The balance of taxation began to tilt from land, livestock and produce towards business, manufactures, employment and income.

From 1789 to 1831, tax on tallow for candles made artificial light expensive, leading to the expression: 'The game's not worth the candle.' And one of the reasons why wigs declined in popularity in the early nineteenth century was the 1795 tax on the aromatic powders that people dusted them with.

Income taxes go back to ancient times, but their modern version dates from 1799, when the British Prime Minister William Pitt (1759–1806) introduced one to finance the war against Napoleon (1769–1821). His new measure taxed annual incomes over £60 on a graduated scale, from 1 per cent up to 10 per cent on incomes of £200 or more. The tax was generally accepted as the price of victory – though the Parliamentary Commissioner did complain about the number of Members of Parliament declaring their incomes at £59 (Phillips 1967)!

In 1816, with the threat from Napoleon over, the income tax was repealed, and the records burned. But in 1842 Prime Minister Robert Peel (1788–1850) resurrected the tax; though it was supposedly a 'temporary' measure, there has been an income tax in Britain ever since. Prime Minister William Gladstone (1809–98) proposed to abolish the tax, but his plans were scuppered by the cost of the Crimean War of 1853–56.

The twentieth century brought higher income tax rates on investment returns, a new 'supertax' on the highest earners (collected directly from employers under a 'Pay As You Earn' scheme), and new sorts of taxes on company profits and capital gains. The early years of the twenty-first century brought 'stealth' taxes on air travel, and on pension funds and other investments.

United States. From the 1660s onward, Britain enacted various measures to stop its American colonists trading with other countries, or to tax their exports if they did. America's molasses, iron, salt, alcohol, sugar, paper, lead, glass, paint and even hats all came to be taxed by the colonial power. The Stamp Act (1765) imposed a duty on legal documents, newspapers, playing cards, dice and other items. Taxes on tea triggered the Boston Tea Party (1773), and within three years, the colonists would declare their independence and (successfully) take up arms against Britain.

The new country's government now had to raise its own revenue. Some 90 per cent would come from tariffs on trade, thanks to James Madison's (1751–1836) 1789 Tariff Act, which put a duty on trade tonnage, and there were taxes on whiskey, carriages, and other luxuries, too. However, the government soon saw tariffs as a way of protecting domestic producers as well as raising revenue, and protectionist duties were imposed on imports of goods such as iron, cotton and hemp.

During the American Civil War (1861–65) the Union government scrambled to raise money, imposing taxes on more items, including luxuries such as gambling, tobacco and alcohol, plus professional services, patents, stamps, manufactures and company earnings. After the war, many tariffs and taxes remained in place. Income tax was ended in 1872, but revived in 1894 – only to be ruled unconstitutional by the Supreme Court a year later. However, it was not yet dead. In the early 1900s, it re-emerged in a different form, and was raised sharply to help pay for World War I (1914–18).

After that war, there was pressure to ease taxes, and in the 1920s, President Calvin Coolidge (1872–1933) slashed the top income tax rate. Surprisingly for some observers, this led to top earners contributing a *larger* share, as the disincentive effects of high taxes faded. In the following decades, World War II (1939–45), the Korean War (1950–53), and the Vietnam War (1955–75) all led to tax increases. By the early 1960s there was again pressure to cut taxes, and when President John F. Kennedy (1917–63) cut top income tax rates, the share of revenue coming from higher earners rose, just as it had under Coolidge. The same effect followed the later top-rate tax cuts of presidents Ronald Reagan (1911–2004) after 1980 and George W. Bush (1946–) in 2001–03 (Grecu 2004: 6–9).

Some lessons from history

The historical record demonstrates the ingenuity of governments in finding new things to tax – land, livestock, salt, olive oil, tea, tobacco, candlewax, wig-powder, soap, incomes, profits, urine, paint, air travel, stamps, playing cards, hats and more. In 1705, the Russian emperor Peter the Great even placed a tax on beards. This, however, was not driven by a need to raise revenue: rather, as part of his plan to turn Russia into a leading European power, he wanted Russian men to emulate the clean-shaven fashion of Western Europe. It was an early example of a tax designed to change people's behaviour.[2]

Also, it seems, taxes can remain in place long after their original justification has disappeared. Dane-geld outlived the Dane threat, income tax outlived Napoleon, and many other 'emergency' taxes have similarly lingered. In 1902, Kaiser Wilhelm II (1859–1941) of Germany imposed a tax on champagne to fund the Imperial Navy. Though the imperial fleet was scuttled in 1919, the champagne tax still exists, generating millions of euros in revenue. Similarly, in 1936 the US state of Pennsylvania placed a tax on alcohol to raise revenue to rebuild Johnstown, which had been devastated by floods. Johnstown was soon rebuilt, but the tax (now 18 per cent) is still in force (Shannon 2017).

2 For a short selection of history's oddest taxes, see Keck (2022).

Taxation today

Increasing size. Today, the most elaborate tax systems are found in the more economically advanced countries. And in those countries, the amount of tax levied has grown significantly over the last hundred years.

That is partly because most of these countries now have large and costly welfare states covering social insurance, healthcare, housing and education. With an ageing population and longer life expectancy, these programmes have become costlier because they must now serve more people, with more complex needs, for longer.

But taxation has many purposes beyond the funding of state services. These include redistributing income, stimulating industries, building infrastructure, and changing people's behaviour. And the more money that governments want to raise for these many purposes, the wider and more ingenious is their search for sources. Unfortunately, this can create complexities that put an additional burden on taxpayers.

A few large taxes. Most governments draw the bulk of their income from a few very large taxes, principally on incomes, sales and social insurance taxes (in the US and UK, for instance, these three taxes produce around three-fifths of all revenue). Taxes on companies, capital and property tend to be the next largest, with other taxes being relatively minor revenue earners (see, for example, Keep 2023).

Opportunities and limits. Economic development, however, increases the opportunities for taxation. It brings a greater diversity of taxable industries, processes, manufactures, buildings, professions, services and transactions compared with agricultural economies. Development also brings more wealth, and in general a more equal distribution of wealth and income (OECD 2011), expanding the scope for taxation (the 'tax base') even wider: simply, there are more people who can afford to be taxed.

By the 1980s, the Internal Revenue Service had become the US's largest single employer, and tax was many households' largest expense. But then taxpayers in the US and other countries started to revolt. In response, several governments in the 1980s and 1990s lowered headline tax rates. Yet even committed tax-cutting leaders such as Ronald Reagan in the US and Margaret Thatcher (1925–2013) in the UK struggled to reduce their governments' need for money.

New taxes. Governments soon found innovative ways to fill the gap, with taxes on the new technologies and 'stealth' taxes that were less obvious to those paying them. They also resorted much more to borrowing – effectively, shifting the cost of government activities onto future generations.

It was an old idea (see Due and Kay n.d.). In medieval times, the governments of Venice and Genoa borrowed from the newly created banks. In 1692, the British government pledged its alcohol tax receipts as security for a loan of £1 million. French finance ministers borrowed in the seventeenth century and onwards. America's government borrowed to finance its revolutionary war against Britain.

Canada's debt began with its confederation in 1867. Japan's government issued bonds in 1870. Nevertheless, government borrowing was generally small, other than in times of war. Then, from the early 2000s, with the rising cost of welfare, pensions and other government services, plus the cost of a financial crash and a pandemic, borrowing rose considerably. That left governments with a big challenge to find more tax revenues to rebalance their books – and to do so without stifling economic recovery.

2 TYPES OF TAXES

Direct taxes

Taxes are broadly categorised into *direct* taxes or *indirect* taxes.

A *direct* tax is one that a person or organisation (such as a company) pays directly to the tax authorities. Examples are taxes on income, dividends, capital gains, land, property, inheritance and wealth. These taxes cannot be passed on to others: payment is the responsibility of the particular person or organisation.

Proportional and progressive income taxes. In general, direct taxes are designed to reflect the taxpayer's ability to pay. Higher earners, for example, will pay more *income tax* than those on lower earnings.

This will be true even under a *proportional* (or 'flat') tax where everyone (or everyone earning above some minimum 'threshold') pays the same *marginal rate* (i.e. the same percentage tax on each additional dollar they earn). So, both low and high earners might pay the same 10 per cent on each additional ('marginal') dollar they earn. But while the *rate* is equal for both, the higher earner will end up contributing a higher *total* in tax, simply because they are paying the 10 per cent tax on *more* dollars.

Many jurisdictions, though, impose *progressive* taxes on incomes. That means the more people earn, the higher the *marginal rate* of tax they pay on each additional dollar they earn. Thus, someone on a low income might be charged 10 per cent on each dollar of earnings above the threshold; someone on average income might be charged 20 per cent; and a high earner might be charged 30 per cent on each extra dollar earned. Under a *progressive* system such as this, the top earners pay very much more in total tax. In the UK and US, for example, the highest-earning 1 per cent of taxpayers contribute over a third of national income tax revenues (Delestre et al. 2022; York 2023).

Basing taxation on the ability to pay is one of the key principles of most tax systems. But critics of progressive tax rates argue that they significantly reduce higher earners' work incentives, which depresses economic activity and therefore general prosperity, and that they encourage unproductive avoidance and evasion.

> Taxation according to income is the most effective instrument yet devised to obtain just contribution from those best able to bear it and to avoid placing onerous burdens upon the mass of our people.
>
> US President Franklin D. Roosevelt (1882–1945)

Among the other direct taxes, a *corporation tax* may be levied on companies' earnings. *Property taxes* may be charged on the value (or rentable value) of land or buildings.

Inheritance taxes are paid (by those who inherit) on the estate of a deceased person. And there may be *gift taxes* on wealth transferred to other people during a person's lifetime.

Flat rate direct taxes. Some direct taxes, however, are *not* based on people's ability to pay. *Vehicle licences*, for example, may be levied at a flat rate, or be based on the size of the vehicle, rather than on the owner's wealth or income.

Another interesting example is *poll tax*, a uniform charge on each individual. Though arguably a logical way to pay for services that people use roughly equally (such as rubbish collection), poll taxes have generally been unpopular (as in the Peasants' Revolt) because of the greater relative burden they impose on the least well off.

Indirect taxes

Indirect taxes are not levied directly on a person or organisation. They are remitted to the authorities by one person or organisation, but then passed on to others who ultimately pay them, usually in the form of higher prices. An example is *excise duties* on fuel, alcohol and tobacco, and *tariffs* on imported goods. These are all remitted to the authorities by producers, merchants and retailers even before the goods reach the customer. But they are passed on to customers, wholly or partly, in the price of the goods they buy. Similarly, a *sales tax* is collected and remitted by the retailer when goods are sold, but it is ultimately paid by customers.

(Although employers sometimes deduct social insurance contributions and income tax from employees' pay, these remain *direct* taxes, since they are taxes on the individual employee, even if, for convenience of collection, they are collected and remitted to the authorities by the employer.)

Varieties. *Consumption taxes* are indirect taxes that may take the form of a general sales tax (GST) on consumer products, or a value added tax (VAT) that taxes the product at each stage of its manufacture. *Sales taxes* are another example. These may be charged at a flat rate on the price of whatever the customer buys, though sometimes 'luxuries' (such as prepared meals consumed in a restaurant) are taxed at higher rates than 'essentials' (such as raw food bought in a supermarket).

Sales taxes are generally *ad valorem* taxes. That is, they are levied at a certain percentage of the *price* of goods and services. The more expensive the product, therefore, the more tax is paid. Another form of consumption tax is *excise duties*. But these are *specific* taxes: i.e. they are levied on *each unit quantity* of the particular goods and services, not on their price. Thus, the same excise duty is payable on a bottle of wine, whether it is the finest Château Mouton-Rothschild or the cheapest supermarket blend.

Purposes. Indirect taxes have many purposes other than raising revenue. *Excise duties*, for example, may be used to raise the price of (and thereby, reduce the demand for) goods that are regarded as harmful – harmful either to the individual (e.g. alcohol, tobacco and gambling, with their possibilities of addiction) or to others (e.g. fossil fuels, with their environmental impact).

Scale. Indirect taxes constitute a large proportion of the total tax revenue raised by the governments of many countries. In the Organisation for Economic Co-operation and Development (OECD) countries, they comprise around a third of the tax take (OECD 2022). That proportion has been rising, partly because economists today regard consumption taxes as less damaging than taxes on incomes and corporations.

Regressive nature. However, critics argue that indirect taxes are regressive. *Specific* taxes such as *excise duties* form a higher proportion of the price of the cheap products bought by poorer families than of the price of the expensive ones bought by the rich. *Tariffs,* likewise, raise the price of imported goods for every end customer, regardless of their means. In addition, some of the main targets for import tariffs are typically essentials such as food and clothing: since these already absorb a larger part of poorer households' budgets, the extra tax falls most heavily on those least able to afford it.

A tax on sales, goods and services or value added again raises the price of food, clothing, fuel, housing, transport and other essentials, hitting poor families hardest. This is why many consumption taxes are levied at different rates (e.g. as mentioned, on 'essentials' or 'luxuries') to offset this regressive effect. Unfortunately, this then increases the complexity of the tax, making it more arbitrary and harder to enforce. In the UK, for example, the zero rate of VAT on children's clothes, determined by their size, means that small adults can buy tax-free clothing while the families of large children have to pay the tax. And the UK government faced ridicule when a cold pie bought in a shop (classed as an 'essential') bore no tax, but a warmed-up one bought from a takeaway (classed as a 'luxury') did (Quinn 2012).

Covert nature. Critics also complain that indirect taxes are hard for taxpayers to see. Someone buying an imported car, for example – and even the retailer it is bought from – is probably unaware of how much tax has been paid on it in the form of tariffs and excise duties. Shops may not even itemise the sales tax on the price tickets of their goods. And, say critics, a key principle of taxation is that taxes should be known and transparent.

Potential politicisation. Both direct and indirect taxes can be used to favour certain industries and activities over others. However, it is more common to use indirect taxes for this purpose because their less visible nature helps conceal the preferential treatment.

Thus, a government that wants to boost employment, say, might levy lower consumption taxes on the products of labour-intensive industries (e.g. agriculture, catering and services), while raising those on capital-intensive products such as cars, telecommunications and energy. But critics point out that this distorts the normal working of the economy, drawing resources into sectors that may deliver less value to consumers. Worse, the tax may be used politically to help a government's own supporters: a government with a strong base in rural areas, for example, may choose to lower taxes on rural industries for the benefit of its voters there.

Transfer taxes

A *transfer tax* is one levied on the transfer of ownership or title to property from one person or organisation to another. In a sense, sales taxes are a sort of transfer tax, because any sale of goods is a transfer of property. But in general, the term is reserved for the transfer of property that must be formally registered or declared in some way, such as land, buildings, shares or bonds. Examples include *stamp duties* on the transfer of land or securities, *inheritance taxes* paid on the transfer of a person's estate after death, or *gift taxes* paid on transfers to friends and family made during life. The rate payable is normally based on the value and type of the property.

Direct or indirect? There has been debate about whether transfer taxes should be regarded as direct or indirect taxes. In *Knowlton v. Moore* (1900), the Supreme Court of the United States heard a case in which a taxpayer argued that Estate Tax was a direct tax on the inheritors, rather than an indirect tax on the estate. (Since the tax was graduated, calculating it as a tax on the total value of the estate would produce a larger tax bill than calculating it as a tax on the smaller amounts inherited by each beneficiary.) The Court ruled that Estate Tax was an indirect tax on the *transfer* of property rather than a tax on *property* itself.

Tobin taxes. Some people advocate transfer taxes not only on the exchange of physical goods but also on financial transactions too – a *financial transactions tax* (FTT). The British economist John Maynard Keynes (1883–1946) thought such a tax would calm speculative bubbles (such as 1920s Wall Street) by making it costlier to buy and sell assets. This, he reasoned, would discourage high-volume buying and selling in the speculative hope of making short-term gains, while sales and purchases that focused on securing long-term value would remain relatively unaffected (Burman et al. 2016).

In a 1972 lecture, the American Nobel Prize economist James Tobin (1918–2002) proposed a similar tax (or 'Tobin Tax' as FTTs have come to be known) on currency conversions, aiming to protect the 1944 Bretton Woods system of fixed exchange rates from speculative runs on weak currencies.[1] This purpose is now redundant, given that today's floating exchange rates adjust automatically to market realities. More recently, in 2011, the European Union (EU) has promoted an EU-wide FTT on all financial transactions as a way of generating revenue for the (supranational) European Commission and reducing its dependency on EU member governments.[2]

1 Tobin's proposal was later published in Tobin (1978).

2 For a critique of the EU's proposals, see Worstall (2011).

Critics. The different forms of transfer tax each have their critics. Some complain that *inheritance tax*, for instance, hits people at the worst possible time – after the death of a close friend or relative. They see it as contrary to the natural human instinct of providing for one's family. They note that people will go to great lengths to avoid it – setting up complicated trusts or switching their fortunes into lower taxed but perhaps less productive assets. They say that if people could invest freely instead of being driven to such measures, it would benefit them and the wider economy much more (see, for example, Bracewell-Milnes 1995b).

Taxes on *land and property transfers*, continue the critics, make moving home more costly. So, older people, whose families have left home, then remain in houses that are too large for them, rather than downsizing and freeing up the space for a family that needs it. Such market inertia also leaves people trapped in homes that are far from their work, increasing travel time, costs and pollution. And the tax encourages evasion – for example, sellers agree a lower price for the taxable property, but an inflated price for fittings, furniture, garden ornaments or other untaxed items.[3]

And FTTs, say critics, ignore the fact that speculation has benefits. Speculators usually have the sharpest knowledge of individual markets and whether prices in them are too high or too low. So, their buying and selling activity speeds up the adjustment to current realities, boosting the efficiency of markets and thus the productivity of the

3 On the damage caused by property taxes, see Southwood (2017).

whole economy. Even if the tax on each transaction is small, imposing it on the millions of financial transactions that occur every day still amounts to a major distortion of economic activity.

Hypothecation

A *hypothecated tax* is one where the revenue raised by the tax is 'earmarked' or 'ring-fenced' for a particular purpose, rather than going into the government's general funds. Some of the *licence fees* already mentioned may count as examples. A historical example is *ship money*, a tax levied on English ports in the seventeenth century, and used to finance Britain's Royal Navy. More modern examples include social insurance taxes, which are used to provide services such as pensions and healthcare; vehicle and fuel taxes that go to the upkeep of the roads; and airport taxes that are used to maintain airport facilities.

The *degree* of hypothecation can be strong or weak. *Strong hypothecation* is where the revenue raised goes *only* to the nominated service, or the service is financed *only* by the tax. This is appropriate for services such as social insurance for healthcare or pensions, where most of the benefit is enjoyed by the paying individual. *Weak hypothecation* is where the revenue does not all go to the nominated service, or where the service is funded additionally in other ways. This might be appropriate where there is a wider public interest, such as education.

Criticism. Hypothecated taxes have obvious benefits. If people know that what they pay will indeed go to the nominated service, and will not be used for other purposes, hypothecated taxes may attract more public support and trust than general taxation.

But can the public really be so sure? For example, social insurance taxes might not be ring-fenced for social insurance purposes but may in reality be no different from income tax, both going into the government's general funds. Yet it may serve politicians to claim they are separate because it makes the tax on income look smaller. There is also the question of what people get for their hypothecated tax. Is it spent *widely* (in the case of education, say, on the whole range of nurseries, schools, colleges and adult education) or *narrowly* (where it funds, say, only schools)?

In general, we would expect people to support *strong and narrow* hypothecation, where the revenue goes *only* to the *specific* service. However, it is not always clear whether or not that is the case.

Another criticism is that public spending on any particular service should be determined by the *need* for it, not the amount of money that can be raised from it. Moreover, many taxes will raise more revenue when commerce is expanding and incomes are rising, but it is during the times of economic recession and rising unemployment that government services such as social insurance are most needed.

And tax revenues might not match need, nor expenditure, more generally. Motoring taxes, for example, may raise many times the amount spent on road maintenance, or can be justified by environmental damage (see, for example, Ebbs 2014). Nor do we expect tobacco taxes to be spent only on treating the associated health problems of smokers. They can and often do raise far more than is needed for those services. While politicians might like to suggest that taxes are largely hypothecated, their real interest is in keeping the revenues as free to spend as possible.

3 PURPOSES AND PROBLEMS

The main purpose of taxation is to raise revenue to finance the services provided by a government, such as defence, the justice system, roads, education, welfare, pensions and healthcare. But it is used for other purposes, too. For example, a government might try to regulate the economy and smooth boom–bust cycles by raising taxes during upturns and cutting them during downturns. Or it might aim to reduce inequality by raising taxes on wealthier people and reducing them for others. And it might hope to reduce the demand for harmful products such as alcohol, tobacco and leaded fuel by putting taxes on them.

Sometimes, though, governments use taxation for less noble purposes. For example, taxes may be skewed on or off particular groups (such as property owners) with the aim of benefiting supporters of the ruling party. Or they might be used to benefit favoured domestic producers by taxing lower-priced imports. They might even be imposed on successful groups out of envy, or on ethnic or religious minorities out of antipathy.

Why taxes?

The prime duty of any government, for which they seek to raise funding from taxation, is to establish peace and security: to protect its citizens against hostility from abroad and criminality at home, making life and liberty feasible (see, for example, *Leviathan* by Thomas Hobbes, 1651). That means standing up against the threat or use of force from foreign powers, and protecting citizens against intimidation, deception, fraud or violence from their fellow citizens. This is not a small task, nor a cheap one, as it requires the building of substantial institutions.

For example, the pursuit of peace and security implies the existence of national defence, security, police and justice systems. It means having a military that can deliver a credibly effective response to any attack. It means having a police service that can provide a deterrent against crime and investigate and prosecute crimes when they occur. And it means having a system of courts and punishments.

It might even imply the existence of a regulatory system to ensure that all these agencies operate in the public interest and are not corrupted. There must also be an institution, such as a parliament, to decide on what actions count as hostile or criminal; how the defence, policing and justice systems should operate; and what punishments are appropriate when crimes are committed. And perhaps a civil service is needed to administer all these functions. All of this needs to be funded, just for government to discharge this one basic function.

The free rider problem. Most people can see the benefit of having defence and security: but would everyone pay towards it voluntarily? As long as enough people paid to ensure that the country and the community was well protected, the others could enjoy the benefits of that protection even if they paid nothing. Under those circumstances, it might be hard to get *anyone* to contribute, knowing that they could 'free ride' on others who do.

The normal solution to this problem is to compel everyone to pay for these services, under threat of punishment for non-compliance. In other words, to levy a tax on citizens.

This is not a wholly comfortable option. The use of force against citizens is precisely what government is there to minimise. And some people may have moral objections against their money being taken to spend on armaments, say, or against the policing of laws they regard as unjust, or against imprisoning people. Yet there remains wide agreement that taxation, at least for these basic protection purposes, is justified.

What range of services?

More controversial is the question of what institutions and services are so necessary, and so impossible to fund in other ways, that they must be paid for through taxation.

No clear boundary. Even Adam Smith, though a critic of big government, believed that the state had a role in the provision of infrastructure such as bridges and harbours. These, he reasoned, are vital to the trade and commerce that enriches society, though they could never deliver a profit to any individual provider. The state had a role in providing schools and adult education, too, he thought, since these are important to culture and the mental health of workers and their families (Butler 2007).

But there seems to be no logical limit to this. *Infrastructure*, for instance, might be stretched to include the state provision of transport and utilities. *Education* might be taken beyond normal schooling to include the state provision of colleges, adult learning programmes and vocational courses, too. *Healthcare* might be used to justify state provision not just of doctors and hospitals but also of health clubs and even dancing classes. Arguably, such goods and services may all help boost a country's economic performance. But, critics ask, do they *all* have to be provided by governments, out of taxation?

Public goods. Governments also provide amenities, such as local and national parks, lighthouses and streetlamps, that are classified as 'public goods' because it is hard to prevent anybody accessing their benefits, and many people can enjoy their benefits at once. Here, the argument is that without taxation these things could never exist, because people could 'free ride' without paying, and no producer would invest in them.

But the standard lists of what constitute 'public goods' seem exaggerated. Often, these goods can indeed be charged for, or otherwise funded, without using taxation. Even lighthouses – long hailed as the purest sort of public good because their warning light is accessible to any passing vessel, even without payment – originated with marine pilots lighting bonfires to advertise their navigation services; for a long time, they were funded by charges on vessels calling into nearby ports (see Geloso 2019).

National parks, too, can be funded by the limited sale of mineral prospecting rights, or by parking and accommodation charges and the sale of food, beverages, souvenirs, garden plants and much else.[1] Shopping malls provide customers with public goods such as light, heating, security, seating and toilets, not by charging them directly for each one but by charging their commercial tenants for the 'bundled' package of facilities. Volunteer groups keep clean parks, beaches and other facilities. And new technologies allow providers to exclude free riders – such as scrambling cable and satellite television signals or identifying and charging motorists who use congested roads.

To conclude, though taxation may well be an obvious way of funding many goods and services, and may be unavoidable, there are many other possibilities that should be considered but are often overlooked.

Taxation for public investment

As Adam Smith noted, it might not be in the interests of private individuals to fund some physical investment (e.g. infrastructure such as communications, transport or buildings) or human investment (e.g. education, skills, knowledge and R&D) – despite the fact that investment

1 For innovative ways of funding supposedly public goods, see Taylor (1992).

in such items would benefit the whole community. Consequently, it seems that government-led investment in these projects is important, necessary and inescapable.

Nevertheless, government-led investment has its problems. Critics argue that it 'crowds out' private investment by absorbing much of the available capital, and that public investment, being driven by politicians and civil servants, is less productive than that driven by value-focused entrepreneurs.

Investment or spending? Another problem is the fluidity of the term 'public investment'. Economists regard *investment* as using resources to buy or create goods that will produce other goods or services quicker, better or cheaper, or that will produce a financial return. Thus, when manufacturers spend money on machinery, or people go to night school to earn qualifications that make them eligible for better-paid jobs, or buy bonds to provide their income in retirement, those are investments.

In the public sector, spending money on a new highway or harbour that will speed the transportation of people and goods, or installing airport passport scanners that process arrivals more quickly, or building new school science blocks are all investments.

Spending, by contrast, is using resources for gratification *today*, not in the hope of *future* gratification. And in reality, the huge bulk of government expenditure in the developed nations is 'day to day' spending on current benefits such as welfare payments, pensions, health and social care, housing, transport and refuse collection. While some of these may have *some* future benefits, they are all aimed primarily at benefiting us today. Politicians might call them 'investment' because that sounds a more worthy use of taxpayers' money, but this does not make it any more legitimate as a justification for taxation.

Macroeconomic management

Most economists maintain that taxation and government spending have a key role in steering a nation's economy to full employment, stable prices, economic growth and the avoidance of boom–bust cycles. They argue that governments should expand their spending or cut taxes to stimulate an ailing economy, or should cut spending or raise taxes to combat rising inflation. This so-called *demand management* approach has played an important role in many nations' economic life since World War II.

Yet this approach has its critics, too. Some – e.g. monetarists such as Milton Friedman (1912–2006) – argue that other factors such as the amount of money brought into existence by the central bank outweigh the effects of tax changes (see Butler 2011). Others – e.g. public choice school economists such as James Buchanan (1919–2013) – observe that government decision-making is often irrational: for example, politicians gladly raise expenditure in bad times but show great reluctance to cut it in good times, and much prefer to cut taxes than to raise them (see Butler 2012a). Thus demand management theory is overwhelmed by practical politics. And some observers – e.g. Austrian School economists such as F. A. Hayek (1899–1992) – believe that these political realities explain why the post-war decades saw so much inflation, unemployment, government expansion and rising debt (see Butler 2012b).

Redistribution

Another common aim of taxation is to *promote economic equality* by shifting more of the burden onto those who can most afford it.[2] Taxing better-off people more than others is seen as fair because money is of less value to someone who has plenty of it than to someone on the breadline (an example of the general principle of 'diminishing marginal utility'), so they will not feel its loss through taxation so keenly. Many countries therefore operate 'progressive' tax systems whereby those on higher earnings pay higher rates of tax than those on lower earnings.

Issues. Yet there are difficulties about using taxes in this way (Butler 2022). First, the inequality statistics on which the redistribution policy is based can be misleading. A snapshot of society may suggest large inequalities of income and wealth, for example, but much of that may be because the older people, with greater experience and skills, earn more than younger ones – even if each may earn identical amounts over their lifetimes. Second, some people, such as footballers or music stars, may have large earnings, but their careers may be short. Over a lifetime, again, they may be little better off than others. Third, some people

2 For a fuller account, see Butler (2021: 63–77).

earn a lot doing dangerous and unpleasant jobs while others earn less but have easy and enjoyable work: there is more to equality than money alone. And there is more equality than might appear, since many public amenities – parks and open spaces, roads, schools, policing and much else – are accessible to everyone.

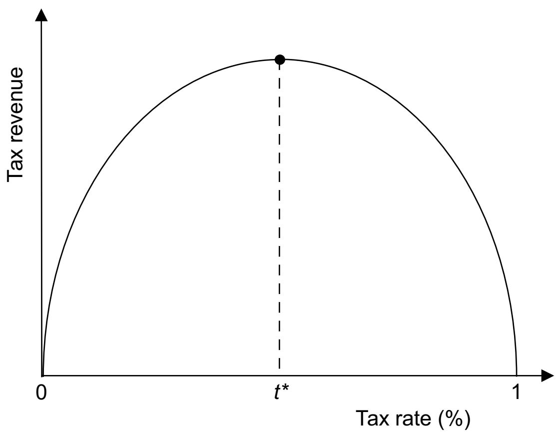
There are also political, moral and practical concerns about using taxation in ways that affect some groups more than others. It opens taxation up to the politics of envy – with higher taxes imposed on successful groups merely because others resent their success. The ruling party may skew taxes onto the opposition's supporters. And powerful interest groups may be able to extract favourable tax treatment, which others cannot. Progressive taxation also treats people differently, contrary to the principle of equality before the law. And in practical terms, progressive taxation soon gets very complicated, as those paying the higher rates lobby for reliefs and exemptions. (Such complexity is one reason why many countries have chosen to replace their progressive taxation with 'flat tax' systems in which everyone pays the same rate.)[3]

Error, or envy? It is a common assumption that the higher a tax rate is set, the more revenue it will bring in for the government. But in 1974 the American economist Arthur Laffer (1940–) created his famous hump-backed 'Laffer Curve', which suggested that receipts rise only up

3 For background on flat taxes, see 'Flat tax', TaxEDU, Tax Foundation, undated (https://taxfoundation.org/taxedu/glossary/flat-tax/).

to a certain point, beyond which they start to fall. There are many reasons for this. Faced with very high tax rates, people may decide to work less and take more leisure, or retire earlier, or move themselves or their business abroad (the 'brain drain'), or employ expensive accountants to find ways around the tax.

Figure 1 The Laffer Curve



Often, though, we find that tax rates, particularly the top income tax rate, are set dangerously close to (and occasionally above) the revenue-maximising point on the Laffer Curve. Higher earners start to contribute a *lower* proportion of the tax revenue than they did before, while *cuts* in the higher rate of tax, as mentioned in chapter 1, lead to them contributing a *larger* share. So, why do legislators set such high rates, given that the main purpose of the tax is to maximise government revenue at minimum cost to economic life?

There are many possibilities. Perhaps policymakers fail to grasp the Laffer argument entirely. Or perhaps they see only the immediate boost to revenues that come from a tax increase, not the gradual decline of revenues as people gradually change their behaviour because of it. Maybe they imagine that the tax will be harder for people to avoid than it really is. Perhaps they understand Laffer's argument but imagine that the revenue-maximising rate is higher than it is. Or perhaps they wish merely to indulge the public's envy of higher earners. Whatever the reason, it is clear that taxes are not always imposed in a rational and evidence-based manner.

Tackling negative externalities

Another aim of taxation may be to combat *negative externalities* such as the effects of air and water pollution on ecosystems, or the delays and frustration caused by road congestion, or the public health costs of excessive alcohol, tobacco and sugar consumption. By taxing such things, we can make those who produce the negative effects pay the whole 'social cost' that their actions impose on others. These taxes are called Pigovian taxes, after the British economist Arthur Pigou (1877–1959). They can take many forms, such as road congestion charges and fuel duties, taxes on emissions, a carbon tax, alcohol and tobacco duties and sugar taxes.

Pigovian taxes are a better way to tackle negative externalities than most alternatives. *Judicial* options, for example, taking polluters to court, are slow and expensive, and happen only after the damage has been done. *Regulation* is often crude; for example, banning certain noxious emissions outright is harsh on those industries that have no other option, or that produce only manageable amounts of pollution. *Limits* on pollution levels give no incentive for those below the limit to cut their emissions even further. A tax on emissions, by contrast, induces everyone, across all industries, to reduce all their emissions wherever they can.

Economists favour Pigovian taxes for two other reasons. First, as already mentioned, if well structured, they raise the cost of a person's or business's externalities (such as airborne pollution from their activities) up to the costs (such as lung disease) that these impose on others. Second, if individuals and businesses have to pay for the pollution they cause, it will discourage them from doing it, resulting in a general improvement in the environment and in social welfare. For governments, too, they can be a useful source of revenue.

However, Pigovian taxes do face both theoretical and practical problems. The British economist Ronald H. Coase (1910–2013) argued that the critical factor in problems such as pollution is *transaction costs* – how hard or easy it is for the polluters and those affected by them to reach a deal on the issue – and taxes may be an inefficient option (Coase 1960). Furthermore, there are the calculation and knowledge problems identified by the Austrian economist Ludwig von Mises (1881–1973) (Butler 2010a). It is very difficult to determine exactly how high the social costs are, and therefore what the right tax level should be. Estimates vary, for example, about how strongly carbon dioxide emissions affect the climate. Setting a Pigovian tax incorrectly might do more harm than good.

Trade management

Another use of taxation is trade policy. Most countries impose taxes – *tariffs* – on imported goods, often to protect their local producers from foreign competitors. Sometimes, their aim is to make their country self-sufficient, or to give their new industries time to grow large enough to compete with cheaper producers abroad (the 'infant industry' argument). They may believe that others are unfairly bringing in goods that are priced cheaply or even below cost ('dumping'), perhaps with the specific intention of undermining the importing country's own producers and strengthening their market dominance. Countries may also object to imports from countries that do not share their own high employment or environmental or food standards. Or they may be worried that they are spending more on buying goods from other countries than those others buy from them (the 'trade gap').

The infant industry argument was a prominent driver of trade policy in the 1960s and 1970s. Developing countries raised tariffs against imports and created their own manufacturing industries, making steel, cars, domestic appliances, even electronics and aircraft. But the results were disappointing. Often, these industries had no comparative advantage over other producers, and being insulated from the effects of world competition, their products were often expensive and of poor quality.

There are other downsides to taxing imports, too. A country's trade barriers make its own population worse off because the imported goods that their consumers want (and which their producers need for their production processes) become more expensive or even totally unavailable. Locally produced alternatives might not exist or might be of poor or insufficient quality. In addition, the possibility of getting protection against foreign imports leads other domestic industries to lobby for it, further restricting competition in other markets. And tariffs require a costly bureaucracy to administer. For all these reasons, economists today generally agree that whatever the temporary benefits for a few producers, tariffs and other trade barriers are a mistake (Butler 2021: 63–77).

Why people disagree on taxation

There is a great deal of disagreement about taxation – in particular, what the overall level of taxation should be and how and from where that should be found. Much of this disagreement is due to the different beliefs people have about the nature and efficiency of government.

To some people, government is a largely benevolent agency, which aims to maximise the welfare of the society, and which largely reflects and represents society's collective preferences. They see taxation, well designed and at the right level, as a potential force for good – a necessary means of funding public services and investment, and having many other useful purposes such as tackling inequality and economic fluctuations. That being so, they maintain that governments should be left free to decide both the overall level of taxation and how it is raised, such as which activities should be taxed more than others.

Other people, though, are less sanguine. They might see government as, at best, both unrepresentative and inept, a bureaucratic leviathan that is riddled with perverse incentives and incapable of delivering what the public wants either cheaply or efficiently. Or at worst, they might regard government as a self-regarding elite of corrupt politicians and lazy officials who claim to serve the public interest but, in reality, pursue only their own. In evidence, they argue that taxation policies are often short-sighted, irrational or counterproductive, and can be a source of considerable economic and social harm.

Not surprisingly, therefore, these critics seek to impose limits on how and how much government may tax us. To see if they are right, it is worth looking at the realities of where taxes fall and what (often unanticipated) economic and social effects they have.

4 IMPACT AND INCIDENCE

The *impact* of a tax is how it affects the person from whom the tax is collected (for example, whether people fly less in response to a tax on airline trips). This is different from the *incidence* of the tax, which is about who ultimately pays the tax (for example, the shop customers who ultimately pay the sales tax that is collected by the retailer, because the retailer adds this cost to the price of the products that customers buy).

The impact of taxes

Let us look first at impact. Some taxes are deliberately intended to have an effect on the behaviour of those who face them. As mentioned, taxes on alcohol, tobacco or vehicle emissions may be intended partly to prompt people to drink, smoke or pollute less by making those activities more expensive.

When something is taxed, it becomes more expensive to produce or consume. So less of it is likely to be produced or consumed. A tax on lead in motor fuel, for example, aimed at reducing pollution in vehicle emissions, raises the price of leaded fuels – which prompts motorists to demand, and producers to supply, less leaded fuel and more unleaded fuel. Since taxes like these impose an economy-wide pressure on everyone to use or produce less of the taxed pollutant, they can be very effective: the tax on ozone-depleting chemicals in the US under President George H. W. Bush (1924–2018), for instance, led to a 38 per cent reduction in their use (Hanson and Sandalow 2006).

Too often, though, the impact of taxes is neither intended nor desirable. A tax may be designed solely to raise revenue, and yet may produce social and economic effects that are no part of its designer's intention. For example, high taxes on imports make smuggling more profitable, requiring the authorities to spend considerable time, effort and money to tackle smuggling in order to protect their revenues. Taxes on tobacco or alcohol, meanwhile, increase the incentive for gangs to produce and supply illicit, untaxed versions of these products – versions that may be far less safe than the legitimate brands – and again drive consumers into the arms of criminals, who may well be prepared to use violence to protect their illegal trade.

Even within the legitimate economy, taxes have unintended and sometimes undesirable impacts. The cost to consumers of a tax on their favourite products, for instance, is not just the sum they pay on the items they consume; it is also the forgone enjoyment of the additional items that they would have consumed in a world without the tax, but now do not because of the higher price.

The work–life balance

But taxes are not restricted to 'bad' things, such as pollution, which we want less of. They are also imposed on 'good' things, such as productive work and business, which, sadly, we might then get less of, too. Exactly whether that is so, and to what extent, will depend on the interaction of two effects.

Substitution effect. The imposition of a new tax on income or a rise in income tax, for example, changes the way people think about work and leisure. The tax leaves workers with less take-home pay for the same effort. This makes work less attractive to them, and leisure more attractive. So (in what is called a *substitution effect*), people may opt to do less work and take more leisure. They might work less overtime or fewer hours, or move into part-time work, or even quit working entirely. If they stay in work, they may be less willing to do more than the minimum expected of them. So, less work goes on in the economy, businesses become less productive, and economic output is depressed.

Moreover, because the tax leaves workers with less take-home pay, they may have to cut back on their spending. And because of that falling demand, businesses produce and supply less. Workers might also save less because their daily expenses now eat up a larger proportion of their earnings, leaving less room for saving. But savings are vital in providing the capital for investment; with fewer savings being banked, lenders have less money available to lend to businesses that want to invest in more productive equipment and processes. All this again depresses the country's output and growth.

Income effect. In some cases, though, there may be a pressure in the opposite direction, known as an *income effect*. Because income tax leaves people with less take-home pay, some (particularly the poorest) might be prompted to work *more* hours to make up for the money they have lost in tax.

Wide impact. It is not always easy to predict whether the substitution or the income effect will be greater, though in general the substitution effect is stronger: when you tax something, you tend to get less of it. Exactly what happens will vary according to the particular tax and people's reactions to it. But the effects can be wide: as already stated, taxes on income from work and on business can affect how much people work, how productive they are at work, how much they save, how much they invest, how much is produced, and how and where it is produced. They can affect how much money governments have available to spend, and the balance of incomes between rich and poor, and more.

How large are the effects? Economists and politicians disagree, however, on just how much people change their behaviour in response to taxes. Some argue that people tend to carry on their own lives without changing anything much merely because taxes go up or down. Others argue that people are very sensitive to tax changes indeed, and that even small changes in tax policy can lead to huge – and not always predictable or desirable – changes in people's activities.

In light of recent debates about the Laffer Curve, tax authorities have gradually shifted their position. In previous decades, many authorities did not factor behavioural changes into their calculations. They assumed that a rise in income tax rates, for example, would, of necessity, bring in increased revenue. Increasingly, however, they have concluded that people do indeed alter their actions in response to higher or lower rates – in the case of income tax rises, perhaps retiring earlier or working less and taking more leisure – and that this in turn might affect economic growth. Such 'dynamic' modelling of tax impact is now a normal part of government budgeting in, for instance, the US, the UK and other developed economies.[1]

Other impacts

Income inequality. Such effects are not always intentional, nor desirable. For instance, progressive income taxes, whereby a higher proportion of the income of higher earners is paid over in tax, may be a deliberate strategy to make take-home pay more equal, and the tax revenue may be used to provide goods and services (e.g. housing, healthcare and education) for the benefit of poorer people, reducing the inequality even further. But then other taxes (particularly those on food, fuel, alcohol and tobacco) are

1 For a review of the debate, see Feldstein (2008). See also Weber et al. (2014).

regressive. They have a much larger impact on poorer families, since the cost of these items, including the tax, absorbs a higher proportion of their household budget than of the much larger budgets of wealthy families. So, this pushes economic inequality up again.

It can be difficult, therefore, for policymakers to balance their various objectives. We want to preserve the incentives on good things such as productive work, yet it is easy to tax work in a way that produces more equality in take-home pay. We want to discourage the 'bads' such as alcohol, tobacco and emissions, but it is hard to tax these things without hurting the poorest more than others. As with all taxes, we have to ask if the damage they do is worth the benefits they might bring.

Cascading problems. Tax may have other unfortunate consequences. Taxes may force the poorest people in the poorest countries, for example, to cut back on necessities such as nutrition, making them less able to work and contribute economically. Likewise, if taxes discourage work, saving and investment, the resulting fall in productivity hurts the poorest most, since they benefit more than others from being able to buy cheaper, better products, and from having more work opportunities.

Further impact problems

Compliance costs. Another impact on taxpayers, beyond what they actually pay in tax, is what it costs them (not only financially, but in time and effort) to comply with the tax rules. This includes individuals' and organisations' time and expense in studying and filling out tax forms, keeping the appropriate records, and preparing and reconciling financial data. It also includes the cost of getting help and advice on these questions, such as the expense of hiring accountants and lawyers.

These costs fall particularly hard on small businesses and self-employed persons, taking up a larger proportion of their time, energy and money. While all businesses have to deal with the various rules on income, payroll, capital and sales taxes, a large company can afford dedicated compliance departments full of knowledgeable tax specialists. But in a very small business, compliance is up to the individual owner, who may not be an expert on tax accounting. By favouring large, established businesses over small, new ones, business taxes can discourage competition and entrepreneurship.[2]

Deadweight losses. Taxes raise revenues for governments to spend on public services, on the provision of infrastructure, pensions and welfare benefits, and the other purposes outlined in chapter 3. Yet, when governments create new taxes or raise existing ones, the results can be counterproductive, creating a net *loss* for society, not a gain.

This phenomenon was explained by the British economist Alfred Marshall (1842–1924) (Marshall 1890). By raising taxes on particular goods or services, a government hopes to collect more revenue – and may well do so. But

2 On the effect of taxation on new business creation, see Butler (2020a: 107–11).

the taxes also raise costs for the producers of those goods or services, causing them to raise their prices. That results in consumers buying less, and producers selling less. Demand and supply are then both lower than everyone's ideal. This gap between the pre-tax and post-tax production volumes is known as the *deadweight loss* of the tax. It is a loss to society in general, and not just a financial loss but a loss in terms of the forgone enjoyment that people would have had, in the untaxed world, from consuming more of the products they desire.

These losses can stretch into the very long term. By reducing producers' returns from their investment, effort and entrepreneurship, the tax lowers people's incentives to invest, work and take entrepreneurial risks, causing productivity and growth to slow. And it encourages producers to try to avoid the tax, perhaps diverting their investments into projects and processes that are less taxed but may be less productive.

So, even if the new tax produces greater revenue for the government and allows it to provide more tax-funded services, there may well still be a net loss to society as a whole, stretching into the future. Moreover, the fact that total tax revenues may *fall* as a result of the reduced economic activity makes the possibility of an overall loss even greater.

Unpredictable losses. Ideally, taxes should be designed to deliver the most benefit for the least cost. But because the effects of different taxes cascade through the economy and down the years, the total reduction in production can be hard to assess.

As outlined above, taxes on earnings may mean people switching from work to leisure, work becoming less productive, and economic growth slowing. Taxes on capital, for instance, may see finance, land and equipment being switched from productive (but taxed) uses into less productive (but untaxed) ones. Taxes on rental homes, meanwhile, may prompt owners to leave the market, making rentals scarcer and more expensive, perhaps forcing people to travel further to their work or else take less productive jobs locally. Taxes on investment may reduce people's willingness to finance new businesses, and taxes on business may increase the (already considerable) risks involved in starting up and growing a business, leading to less job creation, innovation and progress (Butler 2020a: 107–11).

Given how diverse these effects are, and how hard it is to measure them, it should be no surprise if many taxes actually end up producing a net loss to society.

Avoidance and evasion. A special case of deadweight cost is the time, effort and ingenuity that people put into *avoiding* or *evading* taxes.

Avoidance is where people use the tax rules, or loopholes in them, to minimise *legally* the amount of tax they are due to pay – for example, by setting up family trusts to avoid inheritance tax, or taking their income in lower-taxed forms, such as in dividends or benefits in kind, rather than salary. The large size of this deadweight cost is evidenced by the scale of the industries that help people avoid tax – trust lawyers, tax planners and many more.

England's curious history of tax avoidance

England had a long history of tax avoidance. In 1660, there was a tax on fireplaces. The idea was that people in larger homes, with more fireplaces, would be taxed more than those in smaller ones. But people avoided the tax by bricking up their fireplaces. So, the tax collectors' attention turned to chimneys, which were easy to count from the outside.

In 1696, a window tax – another proxy for property size – was introduced. In 1797, Prime Minister William Pitt (1759–1806), keen to tilt the tax burden towards those who could best pay, raised the tax substantially, but this led to people bricking up windows to avoid the tax– the health implications of which led to the tax being repealed in 1851.

Another luxury, printed wallpaper, was taxed from 1712. But builders avoided this tax by hanging plain paper and painting patterns on it. Also in the 1700s, when bricks were taxed, builders simply started using bigger bricks, prompting the government to respond with a larger tax on bigger bricks. The tax lingered until 1850.

To avoid a 1784 tax on hats, hatmakers simply called their products by other names. In 1804, the government responded by extending the tax to any form of headwear, but eventually the tax was abolished in 1811.

In contrast to avoidance, *evasion* is where people *illegally* conceal or understate their earnings or other taxable activities in order to pay less than is due under the law. They may simply lie on their tax forms, say. Or tradespeople and professionals may ask to be paid in cash rather than declare their receipts for payroll and sales taxes. Meanwhile, those in illicit trades – such as (in some countries) sex workers and drug dealers, sellers of fake merchandise, or those smuggling high-duty goods such as cigarettes – are driven to evasion because they cannot declare their earnings openly without revealing their unlawful activities (though curiously, the US Inland Revenue Service demands that they do just that).

> Income tax has made liars of more Americans than golf.
>
> US humourist Will Rogers (1878–1935)

Precisely because these activities are undisclosed, it is impossible to measure the scale of what is called the *hidden* (or *shadow*) economy. By some estimates, its average size across all nations is around 30 per cent of the declared economy – over 60 per cent in counties such as Bolivia or Zimbabwe, though less than 10 per cent in countries with more efficient tax-collection systems such as Austria, Switzerland and the US (Schneider and Williams 2013; Shenfield 1968).

However, an unfortunate consequence of tax avoidance and evasion is that the authorities' response to it is almost always to raise costs on honest taxpayers as well as on ingenious avoiders and dishonest evaders. They might impose stricter rules on reporting – making the tax code longer and more complex but, as a result, more difficult for taxpayers to navigate – or they might instigate intrusive inspections into people's tax affairs, and harsher penalties on those under-reporting, even as an honest mistake.

Conclusion. Taxes, then, can have profound and unexpected effects on the economic *and* social structure. Economists agree that the best tax policy is one that addresses genuine externalities, preserves incentives to work, save and invest, and promotes productivity and prosperity, with minimal distortion to economic life and without running governments into long-term debt. But these ideals are often far from the practical reality.

Tax incidence: who pays?

The person or organisation from which a tax is collected is not necessarily the person or organisation who ultimately pays it. Shopkeepers facing an increase of sales tax on their goods, for example, might try to pass the extra burden on to their customers in the form of higher prices, rather than absorb it themselves. If they succeed, then the tax is ultimately *paid* by the customers, even though it is *collected* by the shop.

Where the burden of taxation ultimately falls (e.g. on shopkeepers or customers) is called the *incidence* of the tax. Just how far the person collecting the tax (e.g. the shopkeeper) will pass it on to others (e.g. customers) depends upon market conditions – on the income and substitution effects described earlier, on the amount of competition from other sellers, and on how people value the particular goods and services involved.

An example

Suppose that the government imposes a tax of ten cents on books. A bookshop may then try to charge an extra ten cents on each book they sell, rather than pay the tax themselves. The ten-cent higher price, however, may deter customers from buying as many books from that supplier. They might instead decide to read more online, or borrow books from libraries, or read magazines, or travel to cheaper bookshops, rather than pay the increased price. So, the bookshop will find it hard to pass the full ten cents on to customers.

If, however, customers prefer books to magazines, do not like reading online, or cannot access a local library or other nearby bookseller, then the bookshop can pass more, perhaps all, of the tax on to the customers in higher prices.

Likewise, if the bookshop is completely unwilling to sell at lower prices – perhaps because there is intense competition in their market and profit margins are already at the bare minimum needed to survive – the more of the tax will it try to pass on to customers. But if it is content to accept lower prices – perhaps it has a local monopoly, and its prices are already high – the more of the tax it will end up bearing itself.

Who ultimately pays how much of the tax, therefore, depends on market factors, on the willingness of customers to pay more – what economists call the *elasticity of demand* – and the willingness of sellers to accept less – the *elasticity of supply*.

Lessons for governments. The important lessons for governments, as they seek to raise revenue from taxes on goods and services, is that the more customers are willing to buy something, even at higher prices (i.e. the more *inelastic* their demand), the more tax can be extracted from them. Tobacco smokers, for example, often find it difficult to quit, so have little option but to pay the higher prices, which competitive retailers can pass on to them in full.

This is why *excise taxes* are mostly levied on goods such as tobacco, alcohol and fuel, where demand is inelastic and customers are more willing to put up with high prices. Duties are not usually placed on goods such as magazines, carpets or chessboards, where demand is elastic, because customers' needs are not critical, and they have easy alternatives.

Incidence of different taxes

Different sorts of taxes on goods and services have different effects on tax incidence – i.e. on who ultimately pays them. *Excise duties*, for instance, are levied on each *unit* of the goods traded, regardless of their cost. Typical *sales taxes*, however, are a percentage of the *price* of the product. So, people pay more tax on the higher-priced goods.

Excise duties are *regressive*, therefore, because they do not reflect people's ability to pay (and perhaps also because dutiable goods such as fuel absorb a larger proportion of the household budgets of poorer families). Sales taxes, by contrast, put more of their burden onto households that can afford to buy more expensive goods (Snowdon 2018a,b).

Analysis of the relationship between impact and incidence reveals other unexpected results. For example, workplace taxes such as social security or national insurance taxes are often described as being paid by employers.

But they also affect workers by making it more costly for employers to hire people, and perhaps forcing them to reduce staff numbers and offer less attractive conditions. Corporation taxes, too, are supposedly paid by company owners, but several studies suggest that workers bear the greater part of the tax, perhaps even more than it raises.[3] One possible reason is that the tax leaves businesses with less money available to invest in productive capital, so workers' productivity does not increase, and neither, therefore, do their wages.

Economists disagree on such effects. But it seems wise for legislators to give proposals for new or increased taxes the most careful analysis and scrutiny.

3 On the costs of corporation taxes on workers and customers, see Southwood (2014). See also Zuluaga (2016).

5 TAXES AND GOVERNMENT

Investment, by individuals and businesses, is essential to future productivity, and therefore to economic growth and progress. Taxes, however, shift resources from individuals and businesses to government, which reduces their scope to invest. But taxation also gives the government more to invest (and spend) on behalf of the community – though in a different way.

Government vs private investment

Some economists think that governments will invest *more* than the private sector because they keep less of their resources in idle savings, and that governments can invest *more efficiently* because they can undertake large infrastructure and other socially useful projects that are beyond the scope of private individuals and groups. And such investment can boost the effectiveness of private investment, too. Businesses may invest in creating innovative products, but if government builds better road and rail networks, private producers can get more of those products to market, faster and more easily. Supporters of this argument point out that many high-tax countries (e.g. Sweden) are highly developed and rich, while many low-tax ones (e.g. Albania and Afghanistan) are considerably poorer.

Supply-side criticisms. Critics, however, challenge this view. In the first place, they argue, there are many reasons why some countries are rich and others are poor. Sweden might be even richer if it lowered its tax burden. There are also trust differences: Swedes are generally prepared to pay higher taxes than Albanians because they trust their government to spend their money well, while Albanians generally do not. That in turn might explain why, despite a very high tax level, Sweden's shadow economy is relatively small.

Government spending, say its critics, is still notoriously inefficient. Much is wasted on politically inspired and prestige projects that are of low value, and usually late and over budget. Much of what politicians call 'investment' is really only current spending. And with public finances always tight, governments tend to give in to public employees' wage demands and put off capital maintenance and renewal, leaving the public infrastructure outdated and crumbling, and public services an inefficient drag on growth.

For these reasons, so-called *supply-side* economists advocate keeping taxes low to encourage private investment and growth. They believe that lower tax rates will boost economic activity by incentivising people to work and invest, while lower tax revenues will prompt governments to invest and spend more efficiently. The result, therefore, is greater productivity and economic growth.[1]

1 For a summary of supply-side economics, see Gwartney (2003).

Supply-siders concede that it may take time for people to adjust their work schedules and plan their new investments, so the higher-growth benefits of supply-side policies may take two or three years to show. In the meantime, the government's finances may be strained, but this temporary strain, they say, is worth the long-term benefits.

Taxes and politics

As already noted, taxation has many purposes other than financing government spending – such as discouraging harmful activities, creating new infrastructure, boosting equality or promoting industries such as tourism. Many economists are comfortable with this, seeing the government as better than the private sector at steering resources in the national interest.

Public choice issues. Critics are less sure. They note that tax policies are always decided in the hothouse of political debate, and party politics may drive tax policy more than evidence does. Perhaps there is an election looming, and the ruling party can improve its chances by cuts to the most visible taxes – possibly shifting the burden onto less visible ones or borrowing to make up the shortfall. Perhaps there are noisy interest groups to be bought off with tax breaks – even though this might complicate the tax system for everyone. Perhaps there are opportunities for politicians to favour their supporters and discomfit their opponents.[2]

2 For an overview of such 'public choice' criticisms, see Butler (2012a).

Jean Baptiste Colbert (1619–83), First Minister of State under Louis IV of France (1638–1715), famously declared: 'The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing.'[3] Such political realities may not promote fair, rational and transparent tax policies, say the critics. On the contrary: politicians commonly strive to conceal the real burden of their tax plans to minimise opposition to them. Thus, while the headline rates of income tax may stay the same, the income thresholds (above which people pay the tax) may become eroded by inflation, or allowances and exemptions may be curbed, resulting in more people paying the tax. Such 'stealth taxes' may not be obvious, but their effects are real.

Misuse of taxation. Tax policy can be very easy for politicians to manipulate. Sometimes, ministers can change tax rules without even asking the legislature, making it easy for them to use taxation for political purposes rather than for public benefit – skewing taxes onto minority groups with little political support, say, such as bankers, speculators, foreigners or 'the rich'.

This political skewing can be very subtle. For instance, a ruling party that derives most of its support from older, wealthier homeowners rather than younger, poorer renters may slant the tax system to favour home ownership over

3 Attributed. A similar phrase appears in a letter from the French economist Anne Robert Jacques Turgot (1727–81) to the Scottish philosopher David Hume (1711–76): 'On cherche, comme on dit, à plumer la poule sans la faire crier…' ('We try, as they say, to pluck the chicken without making it scream.')

other forms of investment. But that brings overinvestment in residential housing and underinvestment in productive business, and therefore lower growth that would benefit younger, poorer people.

> No government can exist without taxation. This money must necessarily be levied on the people; and the grand art consists of levying so as not to oppress.
>
> Frederick the Great of Prussia (1712–86)

World comparisons

According to World Bank and International Monetary Fund data, the highest tax burdens today, measured by tax revenues as a proportion of gross domestic product (GDP), are found in Europe. Taxes are over 30 per cent of GDP in the UK, Spain, Poland, Portugal, Germany, Norway, the Netherlands and Greece – and over 40 per cent of GDP in Austria, Italy, Finland, Sweden, Belgium, Denmark and France (the world's highest). These countries all have extensive and costly welfare states and have developed extensive and complex tax systems to raise the necessary finance from a variety of sources.

The lowest taxes tend to be found in Middle Eastern and other countries that can rely on oil production to provide their revenues. In Iraq, Saudi Arabia, Nigeria, Oman, Qatar, Burma, Bahrain and the United Arab Emirates, tax revenues are under 10 per cent of GDP.

The next lowest taxes are in sub-Saharan Africa, where Guinea, Botswana, Niger, Zambia, Gambia, Malawi, Ghana and Kenya have relatively low tax burdens of under 20 per cent of GDP. This may reflect the relatively small *tax base* (the number of individuals, processes, goods and services that can be taxed) in more agrarian economies.

Tax burdens between 20 and 30 per cent are common in Asia-Pacific countries such as Nepal, Mongolia, Brunei, the Maldives, Tonga, Fiji and South Korea. Countries in the Americas, such as Chile, El Salvador, Honduras, Nicaragua, Costa Rica, Guyana, Jamaica and the US, are also found predominantly in this band.[4]

> There is no art which one government sooner learns of another than that of draining money from the pockets of the people.
>
> Scottish economist Adam Smith (1723–90)

Tax Freedom Day. The Tax Foundation, a US-based think tank, developed a stark way of thinking about the tax burden, expressing it as the number of days that the average taxpayer has to work in order to pay their taxes – not just income taxes but all of the social taxes, sales taxes, excise duties and everything else that governments levy. The idea was later taken up by groups in several other countries.[5]

4 See 'Tax revenue (%GDP)', The World Bank Data. See also International Monetary Fund, Government Finance Statistics Yearbook and World Bank and OECD GDP estimates. See also Rogers and Marques (2021) and OECD (2020).

5 For example, the Centre for Civil Society (India), Lithuanian Free Market Institute (Lithuania), Adam Smith Institute (UK), Liberální Institut (Czech Republic) and Austrian Economics Center (Austria).

Thus, an average person starting work on 1 January would effectively be working solely to pay tax until early March in South Africa; April in the US and Canada; May in the UK, Japan, Australia and Ireland; June in Spain, Portugal, the Netherlands and Sweden; and July in Germany, Italy, France and Austria. Only after those dates would people be working for themselves (see Rogers and Marques 2021).

Cost of Government Day. However, Tax Freedom Day does not take account of the fact that some governments may keep their current tax take low by borrowing to fund current spending – which increases the potential burden on *future* generations. Adding in this burden, the Tax Foundation generates a 'Cost of Government Day', which, given the significant borrowing of most developed countries, comes much later, falling in July for the US, Canada, Germany, the Netherlands, the UK, Spain and Portugal, and as late as the end of August for France and Sweden.

Tax competition

A well-structured tax system is one that does not discourage business and investment, but encourages domestic enterprise and inward investment, thus boosting economic growth. It should raise the revenue necessary for public services with the least distortion to economic decisions. It should be *neutral* – not favouring particular activities (e.g. consumption) over others (e.g. investment). It should be easy to comply with, straightforward, and equal in its application (i.e. without concessions to particular groups).

On the basis of these principles, the Tax Foundation publishes rankings of how attractive different countries' tax codes are to taxpayers and wealth creators – the annual *International Tax Competitiveness Index* (see Bunn and Hogreve 2022; Teather 2005).

One of the most important factors in tax competitiveness, the Foundation discovers, is *capital taxation*. Capital is highly mobile, and if it is highly taxed, investors (both foreign and domestic) look to invest elsewhere. Labour is less mobile than capital, but with cheaper travel it is increasing, and high personal taxes may similarly induce talented individuals to move elsewhere (the 'brain drain'). With countries mindful of this, *tax competition* between them, believes the Foundation, has pushed down capital and income tax rates.

Country ratings. The Tax Foundation bases its analysis on 40 variables, including the taxation on companies (another highly important factor) and on incomes, consumption, property and overseas earnings. It concludes that Estonia has the most tax competitive system, thanks largely to the country's 20 per cent corporate tax being levied on profits only when they are distributed, its 20 per cent tax on income (but not dividend income), its land value tax, and its avoidance of double taxation by exempting the profits companies make abroad.

Behind Estonia in the tax competitiveness ratings come other small countries such as Latvia, New Zealand, Switzerland, the Czech Republic, Luxembourg and Israel. Also in the upper section are Australia, Sweden, Slovakia, the

Netherlands and Germany. The US and the UK are around halfway down the league (Bunn and Hogreve 2022; Teather 2005).

Federal systems

It is possible to have tax competition even within the same country, depending on the level of government at which different taxes are raised. Some countries, such as the UK, have highly centralised tax systems, leaving local or regional authorities with very little power to create or abolish taxes or to change the rates that are levied. Others, such as Switzerland and to some extent the US, have a much less centralised system in which a large proportion of the total tax revenue is raised locally – by cantons in the case of Switzerland and the individual states in the case of the US.

Localised systems allow a measure of what economists call 'Tiebout sorting', named after the American economist Charles M. Tiebout (1924–68). If some regions choose to provide a more generous array of public services than others, the cost being reflected in the local taxes that they levy, then citizens can choose which mixture they prefer. Those who are willing to pay more for wider government services will move to those areas, while those who prefer lower taxes and less generous public services can move elsewhere.

(An interesting aspect of this is that it provides a non-political solution to the free-rider problem. Those who are unwilling to pay for services do not have to be forced to do so. They can simply migrate to an area with lower taxes.)

There may, of course, be barriers to such migration – family members may be content in their jobs, homes and schools and unwilling to move, and in places such as Switzerland, language might be a restraint. But increasingly, there are large numbers of more mobile individuals who can and do move in response to taxes and services – as evidenced in recent migrations out of California and into lower-taxed states such as Texas and Florida (see, for example, Ramaswamy 2023).

Tax havens

Some territories make a point of ensuring that their tax systems are highly competitive. These are the *low-tax jurisdictions* (LTJs) commonly known as *tax havens*.

Image and reality. Mention the phrase 'tax haven' and most people have a mental picture of money-laundering billionaires sipping cocktails on superyachts as the Caribbean sun sinks behind the palm trees. But is there another side to this common view?

An LTJ is merely a place that can determine its own tax policies – even if it is a dependency of another country – and chooses to set some of its taxes (e.g. those on income, investments, corporations and capital) low enough to make it an attractive place for people with wealth or high earnings to live, and for savers to keep their investments. The island of Jersey, for example, is a British Crown Dependency, and is defended by and represented internationally by the UK. But it has a 5 per cent Goods and Services

Tax instead of the UK's 20 per cent VAT, and a top personal income tax rate of 20 per cent, around half of the UK's. And unlike the UK, it has no capital gains or inheritance taxes.

The tax rates and laws in some LTJs, such as the Bahamas, apply to both residents and foreigners. In others, they apply only to foreigners – making the world's biggest tax havens not tropical islands but chilly Manhattan and rainy London. The UK's *non-domicile* ('non-dom') status, for example, allows wealthy foreigners to pay UK tax on their UK income only, so enjoying the benefits of living in the UK while paying little tax because the bulk of their income comes from abroad (see Palan 2022). Sometimes, non-doms can arrange their affairs so as to live in the UK but pay no UK tax at all. Manufacturers that invest in the US, meanwhile, may be given incentives such as lower company tax rates, tax holidays, accelerated depreciation allowances on plant and equipment, exemption from import duties, government grants, subsidised loans, loan guarantees, publicly funded venture capital partnerships and government insurance at preferential rates (for details, see, for example, PWC 2023; see also Dadush 2013).

Criticisms. Tax havens are widely criticised, not least from high-taxing governments. The OECD, for example, wants to abolish LTJs and require all countries to charge agreed minimum rates of tax.

The case against LTJs is, first, that they facilitate tax evasion and aggressive tax avoidance. They enable individuals and companies to shift earnings and profits artificially into LTJs, thereby reducing the tax base and revenue-raising potential of their home countries. A second argument is that LTJs raise inequality because it is generally wealthier individuals and companies that can exploit these arrangements – and that the loss to other countries' tax revenues means that their governments have less money to spend on social welfare programmes. Third, it is argued that LTJs lack transparency and facilitate money laundering by allowing corrupt individuals and organisations to conceal corrupt earnings. Fourth is the concern that the increasing mobility of individuals, earnings and capital, and the practice of shifting profits and earnings to lower-taxed jurisdictions will distort global competition.

Transparency is sometimes an issue, though on those grounds, Manhattan and London (two OECD capitals) would both have to be sanctioned, since they allow foreigners to invest in their markets without reporting it to their home governments. Many of the world's seventy-plus LTJs claim that they are actually more tightly regulated than Manhattan and London – as they must be in order to attract investors away from the bigger markets and stand up to international scrutiny. Money laundering, they say, is less of a problem in LTJs than it is in high-tax ones, and it is worst in low-income countries with weak institutions that allow people to acquire wealth corruptly.

Supporters of LTJs argue that high-tax governments simply fear low-tax competition. It makes them work harder to run their public finances efficiently: they cannot spend extravagantly and pass the cost on to taxpayers, or their citizens' capital would move abroad. But, they say, tax competition does work, and the existence of LTJs has prompted governments to curb their double taxation of savings and to cut inheritance and capital taxes, which are among the most damaging taxes (Whyte 2019; see also Mitchell 2011).

Other economic benefits. Supporters also argue that LTJs encourage saving and investment, since they allow individuals and organisations to keep and save more of their earnings – and to invest that money knowing it will not be taxed away. LTJs also promote the efficient use of those savings. Jersey, for example, has an important role in consolidating capital for large-scale investment in major international markets.

LTJs' policies also promote economic growth – which is partly why they often become wealthy places, despite most having few natural resources. That, say supporters, promotes growth internationally because it shows the importance of policies that encourage saving, investment and entrepreneurship.

The moral case for tax havens. There are moral arguments, too. LTJs provide people with protection against theft, corruption and persecution from their home governments, as well as from untrustworthy banks, hyperinflation and expropriation. A classic illustration is the role that Switzerland played in providing a safe home for the assets of German Jews who were persecuted by their government in the 1930s.

Today, LTJs are vital to people in countries with less democratic governments such as Russia, China and the

Gulf states – not so much to conceal money made corruptly, but to shelter honest earnings from governments that would confiscate them. When people call for LTJs to be made 'more transparent', say their supporters, they may be helping disreputable governments to track down and seize their citizens' money, leaving nowhere safe from corruption or oppression. And LTJs are vital to wealth creators, and to those who manage money (e.g. pension fund managers) in countries that are deeply unfavourable to business, capital, saving and investment.

6 TAX AND ECONOMIC MANAGEMENT

Can tax policies help government achieve their goals of full employment, stable prices and economic growth? Perhaps, but there remains controversy about how.

Aggregate demand management

The mainstream approach rests on Keynes's idea (1936) that the level of *aggregate demand* is crucial to an economy's performance, and that government's taxing and spending policies are a big influence on that (for an outline, see Hansen 1953).

Fiscal policy. In this view, the major components of aggregate demand are *consumer spending*, investment, *government spending* and the *balance of exports and imports* – all of which are affected by tax policies. That makes taxation and spending (*fiscal policy*) a major factor in the management of aggregate demand, and therefore economic stability.

In an economic downturn, this thinking prescribes *expansionary fiscal policy.* Government should reduce taxes and expand public spending. That leaves households with more money to spend, boosting their demand. The extra consumer demand induces firms to expand production and hire more workers. Unemployment falls, and the increased competition for workers bids up prices, and the economy is rebooted.

If individuals and businesses become too optimistic and overconfident, leading to excessive spending and rising prices, *contractionary fiscal policy* is needed. Government should raise taxes and reduce public spending, leaving households with less money to spend, 'cooling' demand and again restabilising things.

Deficits and borrowing

Critics, however, see problems with these policy recommendations.

The expansionary ratchet. For instance, how can governments cut taxes in order to stimulate economic activity, when they so rarely have money to spare? Generally, they do it through *deficit spending* – that is, by taking in less in taxes than they spend, and borrowing to meet the shortfall. But racking up government debt, say the critics, is a dangerous policy.

Also, the expansionary mixture of tax cuts and high spending is, of course, *popular*: people have more money in their pockets *and* enjoy better public services, too. But when higher taxes and lower spending are called for, that part of the policy is very *unpopular*. This difference, say critics, means that real-world politicians are far more likely to reach for *expansionary* fiscal policy (even if it is *not* strictly necessary) than for *contractionary* fiscal policy (even if it *is* necessary). And as people get used to low taxes and high government spending, it becomes even harder to rein in the policy once the need for it has passed. It becomes a one-way ratchet towards 'overheating', rising inflation and public debt – which explains why the decades after World War II, when such policies were widely practised, saw mounting government deficits plus high and enduring inflation.

> We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle.
>
> UK Prime Minister Winston S. Churchill (1874–1965)

Crowding out. Critics further argue that this chronic *deficit spending* does not work, because it *crowds out* private investment in several ways.

First, the large scale of government borrowing absorbs capital and pushes up interest rates, making it harder and more expensive for firms to borrow to invest in long-term commercial projects.

Second, higher government spending on activities such as healthcare or education or housing makes it hard for private providers to compete against the (often free or low-cost) state provision.

Third, critics say that government projects are rarely as well managed, or as productive, as private-sector ones. Typically, they take much longer to plan and to build; they come in late and over budget; their design makes them more labour intensive and costlier to run; and sometimes their main driver is their political benefit rather than their social benefit.

All these crowding-out effects leave the economy and citizens, in general, worse off.

Asset bubbles. Another problem is *asset bubbles*. Expansionary policy makes individuals and businesspeople overconfident, optimistically believing that the 'new normal' rise in spending, wages and growth will continue indefinitely. Assets such as stocks and bonds, land and property become more valuable as people look forward to future gains. And rising asset prices fuel speculation that drives prices up even higher. A classic example is the US stock market in the 1920s, where huge numbers of people scrambled to buy shares that simply kept on rising.

But like that experience, ending in the Wall Street Crash of 1929, asset bubbles cannot last. Eventually, reality asserts itself and the prices of assets are exposed as being far above their true value. People then scramble to sell and get out of the speculative bubble with whatever they can, leaving in their wake a string of losses – failed investments, bankrupt businesses, broken supply chains and worker layoffs.

Other explanations

Other critics of the demand management approach argue that while expansionary fiscal policy might deliver a short-term economic boost, it has little long-term effect beyond setting off a phoney, unsustainable boom that produces only inflation and asset bubbles, followed by a real, destructive bust.

Monetarist critics such as the American Nobel Prize economist Milton Friedman (1912–2006) argue that the main tool for creating stable and sustainable growth is not taxation but the *money supply* – all the currency and other liquid holdings, including bank accounts, that exist in the economy. The money supply varies, because governments may issue greater or smaller amounts of coins and paper currency, and financial regulators adjust how much the commercial banks are allowed to lend to their customers, and therefore how much money is in their accounts.

To Friedman, the best policy is to make the money supply grow at a steady rate, in step with the growth of production. Then, prices will remain stable. But if governments create too much currency, and regulators allow the banks to lend too much to their customers, people will have more money to spend and (without a matching increase in output) prices will be bid up, spiralling into runaway inflation. On the other hand, if money supply growth shrinks below that of output, prices will be squeezed, and the economy will slip into a downward spiral of recession.[1]

Another explanation is given by *Austrian School* economists such as the Anglo-Austrian Nobel Prize economist F. A. Hayek (1899–1992). To them, the key problem is central banks keeping interest rates too low for too long. Low

1 On Milton Friedman's monetarist analysis, see Butler (2012b).

interest rates on loans encourage businesses to borrow to invest in new production, and individuals to borrow to spend. Feeling better off, customers demand more luxury goods, so businesses steer production into more sophisticated products and the more complex processes needed to create them.[2]

Unfortunately, because interest rates are low, savers get lower returns, so begin to save less. That leaves the banks with a problem: individuals and businesses are demanding loans, but there are not enough savings coming in to finance them. The result is that the banks have to curtail credit. Then, many of the new production processes that businesses have invested in can no longer be afforded and have to be written off – again, with real layoffs, closures and other damage.

Inflation: the hidden tax

Different economists have different explanations for inflation (in the sense of generally rising prices). But many agree that it works like a tax, boosting government revenues at the expense of the public.

For example, if a government borrows to cover its budget shortfall in the normal way, i.e. by issuing long-term IOUs (government bonds, or 'gilts'), it knows that by the time it has to repay those debts (in, say, ten years' time), it will be doing so in a currency that by then will have lost its value through inflation. It can repay the same number

2 For the Austrian approach and theory of business cycles, see Butler (2010b).

of dollars or euros that it borrowed, but each dollar or euro will by then purchase less, leaving the investors who have lent money to the government short-changed.

If investors *expected* this, they might insist on getting back more dollars or euros when repayment was due. They might demand that the repayment was *indexed* – i.e. raised to reflect the rising cost of living. But lenders can be caught by surprise: inflation is often unanticipated, and governments usually insist that it will quickly be brought under control. (They also resist indexing unless forced: only a fraction of developed countries' borrowing is pegged to prices.)[3]

Fiscal drag. Governments also benefit from *fiscal drag*. When workers get pay rises to compensate for cost-of-living increases, they find themselves entering higher income brackets where the progressive tax rates are higher. The real value of their income – what it actually buys – might not be any greater, but now a larger portion of it is taken in income and social security taxes. The same sleight of hand occurs with taxes on savings and capital gains. An asset bought for $100 might sell for $150 after a bout of inflation in which prices have risen by 50 per cent, but the investor might be charged tax on the $50 'gain' even though the real value of the asset has not risen and the extra $50 is merely the effect of inflation.

3 In the UK, for example, it is 25 per cent, according to the National Audit Office. Press release: managing government borrowing, 5 July 2023 (https://www.nao.org.uk/press-releases/managing-government-borrowing/).

It is quite reasonable, therefore, to regard inflation as a *tax* on earners, savers and investors, who end up paying more to the government simply because of the falling value of the currency.

Wider effects. Inflation has wider effects beyond these distortions. For example, people facing rising prices might switch to buying cheaper, lower-quality products – adversely affecting the suppliers of higher-quality products, and forcing layoffs or bankruptcies. Rising prices are also bad for people on fixed incomes, such as pensioners, or workers on fixed contracts. Poorer families, too, are badly affected, with the rising cost of essentials hitting their household budgets far more than those of wealthier households. And high inflation may cause people in general to shift their money away from banks and into hard commodities that keep their value: stockpiles of tinned food, perhaps, or even bricks. That may provide safety, but hardly contributes to economic growth.

Alternative views

Mindful of these many criticisms and problems, can there ever be an optimal tax policy? One which stabilises the economy and maximises social welfare with least deadweight loss? Many critics think not.[4]

Social welfare issues. For a start, they say, how can we direct

4 On the difficulty of creating 'optimal' tax policies, see Mankiw et al. (2009).

tax policy at maximising social welfare when people have different opinions of what 'social welfare' means? Does it mean raising the economic position of the poorest, or of everyone? Does it mean making people better off now, or investing to improve their prosperity in the future? Are there other vital parts to social welfare rather than wealth or income, such as access to books, art, education, health-care, open spaces, leisure or work enjoyment? If so, which are most important? Since everyone has different views on these issues, what should designers of tax policies be aiming for?

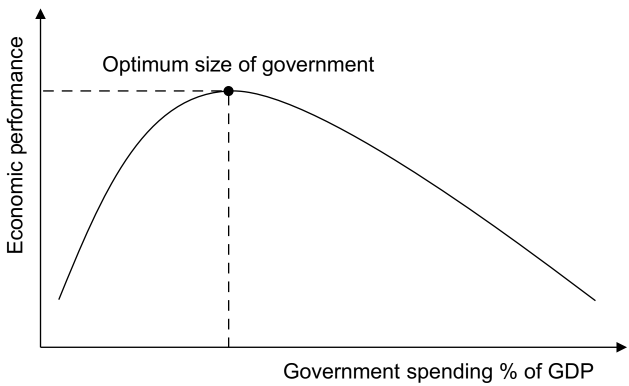
Diverse taxpayers. There are problems, too, in minimising the deadweight loss of taxes because taxpayers have diverse attitudes to work and taxes. People may have the *ability* to pay higher taxes, but are they *willing* to do so? Their different attitudes make the deadweight loss hard to predict.

But then it is hard to even identify people's *ability* to pay. Their wealth may be tied up in long-term investments that cannot be liquidated immediately to pay a tax bill. And their companies may become worthless if key elements have to be sold off to pay taxes.

> Be thankful we're not getting all the government we're paying for.
>
> US humourist Will Rogers (1879–1935)

Supply-side economics. Given these problems for tax designers, supply-side economists argue that, rather than trying to use fiscal policy to stabilise economic activity, we should boost growth by simply keeping taxes low and avoiding deficits. And we should respect the Laffer Curve, and certainly not set tax rates above the revenue-maximising level. Indeed, to keep incentives keen and minimise damage, we should probably set them well below.

Figure 2 The Rahn Curve



Another argument for such fiscal restraint is the Rahn Curve, named after the American economist Richard Rahn (1942–). This suggests that the relationship between economic growth and government spending is also a hump-back curve. Some public spending may be necessary to provide the basic infrastructure and institutions (e.g. defence and justice) that make economic life feasible. But as governments spend a greater proportion of the national income, economic growth slows. An important reason, say supply-siders, is the finding that higher taxes significantly depress innovation – with a 1 per cent rise in top income and corporate tax rates leading to a 4 per cent or more fall in patents and an 8 per cent plus dearth in 'superstar inventors' (Akcigit et al. 2016, 2019a,b).

> The people are hungry: It is because those in authority eat up too much in taxes.
>
> Chinese philosopher Lao Tzu (b. 571 BC)

Conclusion

While some economists, then, believe that taxation has an important role in economic management, others believe that it is much too weak and blunt a tool for that job. Indeed, they argue, it often has the opposite effect of that intended. It creates disincentives that lead to stagnation and unemployment. It prompts deficit spending that fuels inflation, seriously damaging markets. It depresses investment and thus future earnings. And that is all on top of the fact that people do not agree on what the economic and social welfare targets of active tax policy should even be.

Hence the supply-side view that taxation should be kept to the minimum necessary to fund public services and promote prosperity – and that governments should aim to raise what revenue they need through the taxes that do least damage.

7 MORE AND LESS DAMAGING TAXES

Modern governments have to raise considerable amounts of tax revenue to finance their extensive public activities. For that, they commonly rely heavily on income taxes, social insurance contributions, sales taxes and company taxes – and on other taxes to a lesser degree. All have their downsides, but given the need to raise revenue, it is worth exploring which of these taxes are the most damaging, and which the least.[1]

Taxes on business and capital

Though taxes on companies and on capital can be large revenue earners, they are arguably the most harmful of taxes, since they tax the nation's productive capacity and depress the investment that might produce future prosperity.

Corporate taxes. It seems a natural idea that companies which earn large profits or have massive sales should pay tax on them. And there is a suggestion that, in return for

1 For a review of research on the damaging effects of different taxes, see Durante (2021).

their large profits, companies and their owners should 'give something back' to society.

But companies and their owners already contribute to society. Their contribution is the benefit that we all derive from the huge variety of useful products that they create. Also, some researchers believe that around a fifth of the corporation tax is ultimately borne by workers, rather than by company owners (see Nunns 2012). That is because the tax leaves companies with less money to invest in new plant, equipment and processes. This leaves workers less productive than they might have become, and since wages reflect productivity, wages do not rise as fast as they otherwise would.

Moreover, corporate taxes can be costly for companies to account for, since they are not always levied on a company's published sales or profits, but on different measures, specified by the tax authorities. That may be designed to limit companies' scope for evasion, but it requires them to produce yet another set of accounts. Also, the ultimate tax liability depends on how the authorities set those rules – for example, how quickly they permit companies to 'depreciate' the cost of capital equipment in their accounts.

Such rules may be arbitrary, but they are crucial to how damaging (or not) the tax is. In some tax systems, for instance, the rules distort corporate activity by favouring debt finance over shareholder finance, or limited companies over family-owned firms. And since one country's corporate tax regime rarely meshes with that of others, companies operating in more than one jurisdiction face additional accounting costs.

Governments typically rely on corporate taxes for a large part of their revenue, but a 2008 OECD study ranked them as doing the most damage to economic growth (with the other big revenue-earners, income taxes and then consumption taxes, being the next most damaging) (Johansson et al. 2008). Also, as mentioned earlier, capital is highly mobile, and high taxes may prompt companies to move to lower-taxed jurisdictions, shrinking their home countries' tax base, tax revenues and economic growth (Goodspeed 2022).

Capital gains taxes. For similar reasons, taxes on capital gains and on dividends paid by companies are also highly damaging to economic growth. Tax Foundation modellers found that increasing the rates in the US's top capital gains tax brackets would actually *reduce* GDP and so would gain the government no net revenue (see McBride 2012).[2]

One explanation may be that the amount of capital created in an economy is highly elastic – that is, very sensitive to changes in the return that people expect to get from their capital. A small rise in capital gains taxes can make a large difference to whether people decide to build capital goods such as factories and equipment, or instead devote their money to present-day consumption.

2 For the Tax Foundation's calculation of the effect on GDP of capital gains tax in the US, using the Tax Foundation General Equilibrium Model (2021), see Watson and York (2021).

Capital generates *future* income and wealth, and fuels productivity and progress. Taxes on capital, therefore, lower our future consumption because they tax what generates it. And by depressing future incomes, they leave future generations with less to invest towards production in the more distant future, compounding the losses as time goes on.

Furthermore, not only do capital gains taxes discourage the formation of capital, but also they seriously distort people's investment decisions. People persist with old, less productive investments, hesitating to move out of them because of the potential tax bill. And (as explained earlier, in the discussion of inflation) they might even find themselves being taxed on inflationary increases as well as real gains. The resulting suboptimal pattern of investment is a loss for the whole economy (Bracewell-Milnes 1995a).

Such distortions are a good reason to have low – or no – capital taxes. But the authorities derive considerable revenue from capital taxes, and also worry that if capital gains tax rates are set below income tax rates, then some people could avoid tax by taking their earnings as (less-taxed) capital gains instead of (higher-taxed) income. But while a few, mostly wealthy, people might avoid tax by shuffling their affairs, some economists (e.g. Bracewell-Milnes 1992) argue that, set against the large distortions caused by capital taxes, avoidance by a few is of little concern. Moreover, say the critics of rate equalisation, salaried incomes tend to be much more certain than entrepreneurial gains, which are inherently riskier.

Equalising income tax and capital gains rates would discourage people from taking risks, such as setting up new businesses.[3]

Transactions taxes. Taxes on transactions, such as financial or property transfers, are also very damaging. They are not usually major revenue raisers, but they slow down the smooth operation of markets and damage people's plans for saving, investment and trading. The harm can be very significant: one UK economist has argued that the effects of property transfer taxes (e.g. stamp duty on house sales) make property transactions taxes four times as damaging as income tax, and eight times as damaging as consumption taxes (Southwood 2017).

As already mentioned, the EU is proposing a *financial transaction tax* (FTT) to fund its central bureaucracy. Dubbed the 'Robin Hood Tax', the suggestion is that billions of euros can be extracted from wealthy investors and financial institutions without anyone feeling much pain – and the money diverted to more needy groups (European Commission 2013a,b).

But apart from questioning whether the bureaucracy would really spend those billions on needy people rather than on its own favoured projects, we must consider the real *incidence* of such taxes. They may be *collected* from large institutions, but ultimately, they are *paid* by those institutions' customers – ordinary people saving for their pensions, say, or holidaymakers buying foreign currency,

3 For more on the impact of taxation on entrepreneurship, see Butler (2020a).

or the everyday customers of the banks. Far from robbing the rich to support the poor, an FTT falls heavily on ordinary people (Worstal 2011).

Taxes on individuals

Income tax. Next down the list of the most damaging taxes is income tax – in particular, high top rates of income tax. Though it may seem obvious that high earners can afford to pay more tax, the substitution effect is strong in them. They have the financial cushion to work less and take more leisure. They are mobile and can move themselves or their businesses to lower-taxed jurisdictions. They can afford advisers to help them avoid the tax.

Again, the Tax Foundation found that a rise in the top rate of income tax would reduce the US's total GDP by almost three times what it raised in revenue (see Vermeer 2022). Experience confirms this: on the several occasions when top income tax rates have been cut in the US and UK, top earners (as noted in chapter 1) actually contributed a *larger* share of income tax revenues (Grecu 2004).

The 2008 OECD study *Taxation and Economic Growth* suggested that the most GDP-enhancing income tax regime would be one with low rates and few exemptions so that more people pay it. Indeed, 'low rates, wide tax base' seems to be the best policy for many kinds of taxes. Low rates – of taxes in general, not just income tax – are less resented (and less avoided) by taxpayers and cause less economic damage. Also, removing complexities and exemptions from the tax code helps spread the tax burden across more people, while simultaneously reducing taxpayers' accounting costs and rendering unnecessary the enormous 'tax planning' industry that helps people minimise their tax liability.

There is some indication that world governments, perhaps facing up to the increased mobility of top earners, have (to some extent) accepted this wisdom, since income tax rates have become less progressive since the 1960s: few countries now impose rates above 50 per cent (Ortiz-Espina and Roser 2016). The most optimal income tax, however, might be a flat tax – that is, a single tax rate for all income levels – with no exemptions – apart, perhaps, from exempting the lowest earners entirely, and a number of countries have now moved in this direction (see *The Economist* 2005).

Payroll taxes. Taxes on payroll, often presented as contributions for government-run insurance systems such as pensions, unemployment benefit or healthcare, are collected by employers, but are paid ultimately by employees. In consequence, they raise the cost, to employers, of employing workers. Again, this makes these combined taxes worth avoiding, which adds to the distorting effects of income tax.

Inheritance tax. The case for death taxes is that those inheriting large estates, often from their parents, do nothing to earn it. After inheriting, they are still better off, even if part of their windfall is taxed away. And such taxes are another means to transfer wealth from rich to poor.

But there are also moral and economic objections. For a start, inheritance taxes are out of step with human nature: most parents have a strong desire to leave their assets to their children. And, indeed, a vast 'inheritance tax planning' industry has sprung up to help them do so (Bracewell-Milnes 2002).

Not only is the cost of estate planning a drag on the economy, but also the tax induces people to keep their wealth in assets that escape it, or are taxed at a lower rate, but that may not be as productive as other opportunities. In some places, for example, farmland is exempted from inheritance taxes, or qualifies for reliefs, which leads to wealthy people (especially in retirement) buying farmland – though not necessarily farming it very efficiently. As with capital gains tax, the result is that capital (farmland and equipment) is used less productively, and the whole economy suffers. The Tax Foundation calculates that death taxes reduce the US's GDP by more than they raise in revenue (Cole 2015). In the UK, the British economic consultant Barry Bracewell-Milnes (1931–2012) calculated that death taxes there had produced negative revenues every year in their century of existence (Bracewell-Milnes 1995b). The unpopularity of inheritance taxes, and their poor record as revenue earners, has led a number of countries to repeal them (listed in Cole 2015).

Less damaging options

Consumption taxes. Though consumption taxes can be large revenue earners, economists generally believe that they do less damage than other taxes. They do not discourage work, as income taxes do, nor employment, as company and workplace taxes do. Nor do they produce the long-term structural damage to productivity that capital taxes do. Instead, taxes on what people spend encourage them to spend less and save more, leaving more funds available for investment and therefore promoting the productive efficiency of the business sector.

Critics, however, argue that consumption taxes are too often regressive. They have the strongest effect on the poor because poorer households are less able to afford the higher prices that result from taxes on what they buy; the impact on richer households is less. Also, poorer people spend a larger proportion of their household budgets than do wealthier ones, and their capacity to save is already less. And, as we have seen, consumption taxes that come in the form of excise duties form a larger proportion of the price of cheaper products, which poorer households are more likely to buy. Lastly, if consumption taxes lead to people buying less, that reduced demand will have a depressive effect on production and economic growth.

Consumption taxes can cause other distortions, too. Some, such as a General Sales Tax (a tax on goods and services purchased by consumers, calculated as a percentage of the listed retail cost and added to the final purchase price paid by the consumer) may be relatively easy for retailers to calculate, but others, such as VAT, are difficult to compute. That imposes accounting costs on businesses – particularly on small businesses, which may not have specialist in-house accounting skills. But small businesses are responsible for most commerce and employment – making this cost on them a cost burden to the wider economy, too.

Land value tax. The American economist Henry George (1839–97) advocated a single tax on land, which is in (nearly) fixed supply and not created by individual effort. So, such a tax would not discourage production and economic growth. On the contrary, it would incentivise the more efficient use of this key resource and provide governments with a stable and predictable source of revenue.

Moving to such a system, however, seems politically difficult. Landowners are a significant interest group, who might challenge both the tax and the individual land valuations that it would require. The tax would also lead to very significant economic changes, especially in land use, that could strain existing infrastructure and public services. And in any case, politicians prefer to have a variety of taxes, rather than just one, because that makes the real size of the tax burden less obvious and allows them to favour particular activities and groups.

Base broadening. Governments often seek to enhance their revenues by *broadening the base* of their taxation – in other words, by bringing more people or more activities into the scope of the tax. This can have positive effects. For instance, cutting exemptions and deductions (e.g. on income or corporate or consumption taxes) and simplifying the tax rules on investments (e.g. personal pension savings) may have the positive effect of reducing compliance costs for taxpayers and administrative costs for the government.

But by making more individuals and activities liable to tax, base-broadening policies may face great opposition. Tax exemptions, concessions and deductions usually exist because some interest group has campaigned for them, and many people gain from the fact that such reliefs exist. Removing tax-free status from US workplace health insurance plans, for example, or from children's clothing in the UK, or from schools and charities in many other countries, would prompt outrage and political opposition from those who benefit from these various exemptions.

Another base-broadening idea would be to ensure that government employees pay the same taxes as the general public. For example, OECD officials pay no income tax, while US government workers escape taxes on allowances and workplace benefits. Ending these privileges and bringing government employees within the same tax regime as everyone else would seem fair, and free from damaging effects – though again, it would be resisted fiercely, and the revenue gains may not be large enough for politicians to take on that opposition.

Least damaging taxes

Co-payments for services. Among the least damaging taxes are those that are really a *fee* for a specific service, such as payments for passports, which are intended to cover the bureaucratic cost involved. Unlike taxes, though, fees are not always compulsory. There may be an admission fee to enter a museum or a toll to use a bridge, say, but people are not forced to visit museums or use particular routes: other options are open to them.

Some fees, however, *are* compulsory like taxes: the individual or business cannot escape them. They include, for instance, regulatory fees to cover safety inspections of cafés and restaurants. In terms of their potential damage, there are two key questions: whether the fee reflects only the bureaucratic cost involved, and whether it has a substantial economic effect, such as the café owner deciding to give up selling ice cream or alcohol, for which extra licences are needed, or even going out of business entirely. Ideally, such effects should be minimised, and user fees limited to the actual cost of providing the good or service.

Governments can rarely raise significant revenues from user fees. The case for them is more that they impose the cost of public goods onto those who use them and therefore that they avoid damage to others.

Pigovian taxes. Least damaging of all are Pigovian taxes, i.e. taxes on activities that generate negative externalities. These taxes simply align the private cost of an activity with the social cost (such as air or water pollution) that it imposes on others. They are, therefore, more like prices than taxes, applying a price to desirable resources (e.g. clean air or water) that were previously unpriced. This promotes a more economically efficient use of such resources. But if Pigovian taxes are not to be damaging, they should reflect only the actual costs imposed on others. They are therefore never likely to be a source of very significant revenue for governments.

8 MORAL ISSUES IN TAXATION

The moral case for taxation

The moral case for taxation is well known. For a start, taxes are needed to fund the core purpose for which governments are created: to defend citizens from outside aggression and domestic crime. They fund defence, police and the judicial system, providing the security within which citizens can live in peace to pursue the life that they deem best for themselves and their families. Only then is moral life possible. Taxes may even fund universal access to legal services so that everyone has access to personal justice, regardless of their means.

Taxation benefits people's lives in other ways, too. It pays for infrastructure such as roads and harbours, which facilitate trade and commerce, making the private economy more efficient, thus saving human effort and helping to spread prosperity through the community. Tax policy may help to manage the economy towards long-term stability and growth, providing a more predictable basis for everyday life and making work more productive and rewarding.

Taxes enable the provision of other public goods and services such as parks, museums, orchestras, galleries and exhibitions, which are important to human culture and flourishing. They can help correct market failure – situations where the incentives for individual action do not produce socially beneficial outcomes – tipping the incentives away from, for example, indiscriminate air and water pollution or the depletion of natural resources. They can foster research and development that will provide long-term benefits for the whole community.

Taxation (continues this case) can encourage us to make lifestyle choices that would benefit us but might not come naturally to us. For example, it can spur us to provide for our income in retirement and other forms of security such as provision for unemployment or disability, or avoid potentially damaging lifestyle choices such as smoking. It can help ensure that children receive adequate education, preparing them for future life, and provide social services to protect children suffering abuse or neglect. It can fund welfare services, such as income support and social housing, so that even the poorest can have a decent standard of living; for only then can they make choices and act in ways that realise their fundamental needs and aspirations. Taxation can be used to provide social insurance for disability, unemployment and healthcare, ensuring that nobody need suffer deprivation and hardship through no fault of their own. Going further, taxation can also be used to create a more equal and more just society by redistributing income and wealth from the rich to the poor.

At its deepest level, taxation embodies the idea of the social contract. It allows collective decisions on public priorities to be taken and put into effect, ensuring that the needs and preferences of everyone are considered. And it reminds people of their obligations to others who may be less fortunate, and that personal success depends in large part on the collective support of the community and not individual effort and luck alone.

> Taxes are simply contributions demanded of citizens as their share of the expenses of government.
>
> French economist Paul Leroy Beaulieu (1843–1916)

Such is the moral case for taxation. The moral arguments *against* taxation are heard much more rarely, though they are surprisingly numerous and strong.[1]

Force and morality

First, taxation might be necessary, but it still relies on the use of *force*. Taxation at today's historically high levels is possible only because non-payers face fines or imprisonment. To prevent a greater evil (such as invasion or terrorism), such coercion might be justified. But force is a moral evil: can it be justified for facilitating *everything* that elected officials do?

Moreover, taxation forces people to pay for things they may have fundamental moral objections to, e.g. state-funded abortion, foreign wars or mixed-sex schools. Yet we force them to live with the dismal thought they are funding things they believe are wicked, even murderous.

1 This chapter draws from Butler (2020b).

And how do we know that society actually benefits from tax-funded activities? The gain to those who benefit and the loss to those who pay are *subjective* personal feelings. We cannot measure them *objectively*, so how do we know the balance is worth the compulsion?

Even if people accept that their tax contribution does do some good, they may still believe that too much of it is wasted by bureaucracy, politics or corruption. Can we justify *forcing* them to pay into a system they think fails them?

> To compel a man to furnish funds for the propagation of ideas he disbelieves and abhors is sinful and tyrannical.
>
> US President Thomas Jefferson (1742–1826)

The state and the individual

Taxes reduce people's ability to use their own resources as they believe is right and proper for themselves and their families. That makes them incomplete moral beings, less able to take responsibility for their own actions. People can be considered moral or immoral only if they are in control of what they do. Taxation denies them much of that personal control.

> There is no worse tyranny than to force a man to pay for what he does not want merely because you think it would be good for him.
>
> US author Robert A. Heinlein (1907–88)

There may be a case for elected governments taking *some* decisions on behalf of citizens, but that is a slippery slope. If we grant the state moral authority over some of people's choices, where does that end? There seems no logical limit. And remember, only *individuals* have values; *institutions* such as the state do not have values. People might associate for collective projects such as defence, but their association is not some superhuman entity with its own values that can override those of the *individuals* who make it up. Only *they* have values and morals. Taxation, however, tries to put some supposedly 'collective' morality above them.

Personal responsibility. Taxation (continues the criticism) undermines personal responsibility. People may wish to take care of elderly relatives, say, or provide a better education for their children. But tax-funded services replace those choices with someone else's priorities.

Furthermore, paying taxes may convince people that they have no further social obligations. People are told that their taxes pay for vital services such as education, welfare and policing. So, they may feel no moral compulsion to intervene when they see children neglected or vandalism committed, believing these are the responsibility of the various authorities they pay taxes for.

Taxation crowds out private giving

Charitable giving is important to good causes such as schools, hospitals, libraries, art galleries, orchestras, medical research and care homes, but high taxes leave potential donors with less money to support these activities. And when people believe that the state will provide, they see less reason to contribute themselves: why support education, medical research or social care when the government has taken on these responsibilities? What difference can one person make compared with the government's vast resources?[2]

Americans have a long tradition of philanthropy. The Scottish-born Andrew Carnegie, for instance, sold his steel company in 1901 for $480 million and used most of that money to fund scientific research, schools, libraries and colleges.[3] And today, Bill and Melinda Gates are giving away almost their entire software fortune on education, health care and the eradication of malaria.[4] Part of the reason why US citizens give so much more to charitable causes than other countries do is that the US takes far less of its citizens' money in taxation and incentivises private giving.[5] In higher-taxed countries, people's charitable giving is sapped by the imposition of higher taxes.

2 A classic example is Britain's Royal National Lifeboat Institution (RNLI), which was created independently in 1824, but then fell on hard times. So, in 1854 it accepted £2,000 in government grants. But for every £1 the government put in, the RNLI lost £1.50 in voluntary donations. In 1869, it cut loose again and has flourished on private donations ever since.

3 See Andrew Carnegie: Pioneer. Visionary. Innovator. Carnegie Corporation of New York (https://www.carnegie.org/interactives/foundersstory/#!/).

4 Bill Gates pledges to donate 'virtually all' of $113bn fortune to his foundation. *The Guardian*, 15 July 2022 (https://www.theguardian.com/us-news/2022/jul/15/bill-gates-billions-fotune-donate-foundation).

5 International comparisons of charitable giving. Charities Aid Foundation, 2006.

Conflicts of interest

Another problem is that taxpayers get very little say in where their money goes. Elections are years apart. When they do come, people are asked to vote, not on individual spending programmes, but on a whole package of spending – as diverse as education, welfare, transport and defence. It gives legislators a poor idea of taxpayers' priorities, and electors end up voting for items in the package that they object to morally.

Furthermore, as economists of the Public Choice School point out, taxation is supposed to be spent in the public interest. But public policy decisions are rife with personal interests – such as the party interests of politicians and the personal interests of officials. It is hardly a moral basis for taxation (Butler 2012a).

Interest-group politics. The bigger the public sector grows, the larger the number of people (e.g. government workers and those on state pensions and benefits) who potentially gain by voting to keep it expanding. So, the state grows, not through necessity, nor public interest, nor moral justification, but through plain self-interest. And the bigger the state becomes, the less people think about the public good and the more they think that a greater share of state spending should come to them.

And the more money that flows through the political process, the more opportunities there are for politicians, officials and lobbyists to promote their own self-interest at the expense of taxpayers. There is more opportunity for vote-buying, with grants and subsidies being steered to supporters, and industries lobbying for special treatment, sometimes in return for party funding or even bribes. The higher the tax take, the more it will be fought over by interest groups and diverted away from more morally deserving causes.

> Elections are advance auctions for stolen goods.
>
> US satirist H. L. Mencken (1880–1956)

As F. A. Hayek (1976) noted, this promotes conflict between social groups.[6] In the marketplace, different people can choose different products: you buying an iPhone does not stop me buying an Android. In politics, however, the legislature decides for *everyone* – say, how much should be spent on defence rather than the arts, or whether the wages of doctors should be higher than those of teachers. So, different groups, with different values, become pitted against each other in the fight to secure government funding for themselves. Such factional rivalry undermines the morality of society.

Inefficiency of tax spending

Most people believe they can spend their own money better than the government. They could well be right. As Milton Friedman (2004) put it, when you buy something for your own use, you seek to get good quality at a good price.

6 For a summary, see Butler (2012b: ch. 8, The social justice myth).

When you buy something for someone else (e.g. a birthday present), your focus is more on price than quality. When you spend someone else's money on yourself (e.g. an expense-account lunch), your focus is more on quality than price. When you spend someone else's money on someone else (e.g. the public sector), you have less focus on either price or quality.

Charities and voluntary groups can spend other people's money better than governments (say the critics) because they are better able to treat people as individuals and tailor support innovatively around their needs, while civil servants have to follow rigid rules. Thus, a charity may help an unemployed person most effectively with a course in interview technique, while a civil servant might be able to do no more than pay them cash benefits.

> The politicians say 'we' can't afford a tax cut. Maybe we can't afford the politicians.
>
> US publisher and activist Steve Forbes (1947–)

Scepticism and moral corrosion

The higher that taxes rise, the more people may regard them as unjust confiscation rather than payments for services, and to see themselves as being exploited by elites, not willing contributors to essential public functions. And the more they may believe their money is being spent on marginal, pointless or even undesirable activities.

The authorities typically respond to such taxpayer resistance in two ways. First, they may tighten the rules and increase the penalties on non-compliance – i.e. *increase* the coercion. But this breeds more resentment and accelerates the downward ethical spiral.

Second, they may try to raise the same revenues in ways that are less obvious – the 'stealth taxes' mentioned earlier. This, however, amounts to deception. A commercial company that concealed its charges in the same way as governments do would soon be facing criminal prosecution. And on a moral level, it is simply dishonest.

Tax and human nature

There is a strong moral argument that people who create things and achieve success should enjoy the fruits of their creativity and hard work. That encourages productive activity that ultimately benefits the whole community.

But taxes on income, saving and gifts, say critics, conflict with our essential human nature. The powerful human drive to provide for one's own children, for instance, is thwarted by inheritance tax – a tax that hits families at the worst time of their lives (after bereavement) and is so widely resented that great effort goes into avoiding it (Bracewell-Milnes 1994).

> When tax assessments and imposts upon the subjects are low, the latter have the energy and desire to do things. Cultural enterprises grow and increase, because the low taxes bring satisfaction.
>
> Arab sociologist, philosopher and historian
> Ibn Khaldun (1332–1406)

Is taxation theft? Is taxation then akin to theft? The term is loaded, so perhaps inappropriate to a moral discussion. Unlike theft, taxation has the justification that it is (at least in principle) imposed only by the decision of a majority, after public debate, and for public rather than private purposes.

Yet, say critics, if two strong people took money from a third by force and spent it on themselves, we would certainly call it theft. If 51 per cent take money by judicial force from the other 49 per cent and spend it as they think fit, is there really such a big difference?

> Collecting more taxes than is absolutely necessary is legalized robbery.
>
> US President Calvin Coolidge (1872–1933)

Conclusion

Taxation, then, should not be seen as the hallmark of a generous moral society. It rests on coercion, undermines personal responsibility, crowds out charity, sows division, rewards power and discourages work, saving and creativity. Some taxation may be a necessity for the smooth and secure operation of society, but that should not exempt it from moral scrutiny.

9 BETTER, SIMPLER TAXES?

Falling short

Taxes play an important role in how the world's economies operate. In most developed economies, after all, they account for between a third and a half of national income. How such huge sums are raised and spent is of enormous consequence for fairness, incentives, production, efficiency and prosperity.

As such, one might expect tax systems to be carefully designed, based on vision and principle, and on minimising any distortions and disincentives. But that is far from the reality. Frequently, perhaps usually, they are not the coherent product of rational minds but the very incoherent result of thousands of unrelated and unreflective political initiatives, pulling in one direction then another, over years and decades. They become over-complicated and often out of date. They may struggle to deliver the (sometimes competing) goals of full employment, stable prices, growth and trade. In many cases, tax systems even fall short of Adam Smith's basic principles of fairness, certainty, convenience and efficiency.

Fairness. Unfairness in tax systems is not uncommon. But then the goal of fairness often conflicts with other goals.

For instance, fairness may suggest that higher earners should pay higher tax rates, but that means treating people differently, which is unjust. Or it may seem unfair that some children inherit great wealth, yet laudable that people save to provide for their families.

Certainty. Tax codes are often opaque, too. The multiplicity of taxes makes it hard for people to see how much they really pay. Numerous deductions and exemptions mean that people have to hire accountants to navigate their tax forms. And there is the huge cost and uncertainty of legal contests over the interpretation of complex rules.

Convenience. Governments do try to make it easy for people to pay taxes. Income tax and social taxes are deducted at source, sales taxes are added into purchase prices, and so on. But again, this conceals the true burden of taxes, conflicting with honesty and justice.

Efficiency. Efficient taxes would be cheap to collect and cause minimal distortion to economic activity. But most countries' taxes are costly to collect (as their large tax bureaucracies attest) and do distort markets – e.g. favouring particular investments or industries.

Employment, prices, growth, trade. Active tax policy has not spared us from large fluctuations in unemployment or inflation. Many large economies struggle with low growth rates. Trade tariffs are lower than they were, but other sorts of barriers remain (Butler 2021: 111–22).

Revenue sufficiency. Nor has tax policy stopped governments lurching into deficits. Instead, the cost of today's spending is passed on to future generations as debt, which again conflicts with fairness.

Simplicity. Tax codes are rarely simple. The UK's code comprises more than ten million words: it would take around 50 days (and nights) just to read it. The US tax statutes and regulations comprise 'only' four million words, but there are many volumes of court rulings to consider, too. Roughly 99 per cent of the total has been added since 1935, and half since 1990 (Bishop-Henchman 2014). Yet the lengthier a tax code is, the less simple it becomes and the more it is likely to conflict with certainty, efficiency and fairness.

> Tax complexity itself is a kind of tax.
>
> US politician Max Baucus (1941–)

Modernity. Tax codes have trouble keeping up with the dynamism of markets. The authorities may try to tax different sorts of products or activities, only for markets to create new ones that do not fit neatly into the definitions of what is taxable. Authorities generally respond by adding new regulations, which adds greater complexity.

Meeting the targets

Many people would like tax to be simpler and fairer. But again, these principles conflict with other aims. Simpler taxes would reduce people's time, money and stress in dealing with tax forms, and might well be fairer than a complex system that only those with costly expert help can navigate to advantage. But simplification might conflict with the idea of placing more of the burden onto those who can most afford it or of encouraging useful activities such as investment and discouraging harmful ones such as pollution.

Rational tax policy would make taxes as simple as they can be, given their conflicting purposes, and ensure that the costs of any complexity are outweighed by its benefits. But tax policy is not driven by reason alone: politics inevitably intervenes. Politicians might even welcome complexity, as it conceals the true burden of taxes and so reduces public opposition to it. To win votes, they may also build in complex exemptions for favoured groups. Any plan to reform taxes must be aware of such obstacles.

A thoughtful blueprint for what might constitute a good tax system is found in the Mirrlees Review, led by the British Nobel economist Sir James Mirrlees (1936–2018), which in the early 2000s brought together a group of international experts to consider the question.[1] It concluded, first, that such a system should be coherently structured to meet the overall funding needs of government. It should be transparent and should not earmark revenues for particular purposes. It should not try to force every tax to serve every objective, as long as the overall system meets its general objectives. Second, it should seek neutrality, and any

1 The conclusions of the Mirrlees Review are encapsulated in Adam et al. (2011).

departures from this (for example, taxes on environmentally damaging activities, or tax concessions to promote research and development) must be thoroughly justified. Third, the overall system should be generally progressive, taxing those who can afford it most – but on the basis of their lifetime resources, not just what they have at any one time (Adam et al. 2011: ch. 20).

Principles of reform

Taxes cause harm. The first principle for successful tax reform is to acknowledge that some (or even most) taxation will inevitably cause harm. People enter into voluntary transactions, exchanging goods or services for money, because both sides benefit. But taxes diminish the value created because they impede and distort those transactions. Moreover, taxes take value from individuals and transfer it into a bureaucratic process that may well use resources less efficiently than individuals themselves.

> When more of the people's sustenance is exacted through the form of taxation than is necessary to meet the just obligations of government and expenses of its economical administration, such exaction becomes ruthless extortion and a violation of the fundamental principles of free government.
>
> US President Grover Cleveland (1837–1908)

An exception is Pigovian taxes, which aim to prevent value being eroded by activities such as pollution or overfishing.

Indeed, they aim to promote value by giving traders a more rational indication of each resource's worth. But Pigovian taxes may mistakenly be set at levels that undershoot or overshoot that value, and politicians might pad them out to raise revenue. So, if not well structured, even these can sap value.

Minimising taxes. Perhaps the easiest way to reduce the harm done by taxes is to keep them to a minimum. And the best way to do that, say supply-siders, is to minimise the need for them – that is, to minimise public expenditure. Then, taxes can become simpler; fewer anti-avoidance measures are needed, and enforcement costs (e.g. against smuggling or evasion) fall, too.

> High taxes, sometimes by diminishing the consumption of the taxed commodities and sometimes by encouraging smuggling, frequently afford a smaller revenue to government than what might be drawn from more moderate taxes.
>
> Scottish economist Adam Smith (1723–90)

Restraining government expenditure

Restraining public spending is not easy: there is constant pressure from interest groups and the public to expand it. But over the centuries, various strategies have been suggested.

Borrowing restraint. In the eighteenth century, there were arguments in both Britain and the US about the hazards of a 'national debt'.

Banning governments from borrowing would mean that they would have to live within the means of today's tax revenues and could not shift the burden to future generations. But governments might need to borrow to fight wars, pandemics and other emergencies. Even in normal times, it could be rational for governments to borrow to fund long-term infrastructure projects such as roads and bridges – just as families borrow to buy homes and cars – and have the benefit of them now rather than in decades' time.

> Nothing is so well calculated to produce a death-like torpor in the country as an extended system of taxation and a great national debt.
>
> English pamphleteer William Cobbett (1763–1835)

Given that, the need to control borrowing has led to calls for *balanced budgets*, i.e. that over some defined period – say, over the seven- or ten-year up-and-down period of *business cycles* – the government's books have to balance. Thus, if it has borrowed in the downward half of the cycle, it must generate corresponding surpluses in the upward half.

But business cycles are by no means regular and predictable. Governments that borrow to smooth things over hard times may find that the hard times go on longer than predicted, dashing any prospect of returning to balance. And unexpected shocks, such as bad harvests or disrupted supply chains, again make a balanced budget rule hard to meet.

A more flexible rule might be for governments to keep borrowing to a manageable fraction of GDP – say, 3 per cent. But the problems are similar: long-term borrowing commitments may be made, only for GDP to falter because of some shock (such as oil and gas embargoes), or some emergency (such as war or pandemic) might intervene. And the suggestion that governments should borrow only to invest hits the problem of politicians' tendency to call almost any sort of spending 'investment'.

Another proposal is that governments should not announce new expenditures without simultaneously explaining how taxes must rise in order to fund them. For long-term expenditures, such as state pension plans, they should identify both the current and future costs to show that the spending is affordable. But this again seems a forlorn hope: even if spending and taxation are announced together, voters are likely to welcome the immediate expenditure and not worry too much about having accurate future funding predictions.

Next, governments might adopt *zero-based budgeting* in which all expenditures would have to be fully justified each year, instead of budgets simply carrying on unquestioned from one year to the next. This, it is suggested, would allow low-value government activities to be axed, and would pressure public servants to deliver maximum value for money. But this rational approach to expenditure policy also comes up against political realities. It is not easy to define the 'value' of many public expenditures – such as welfare spending, or research, or social care. And each programme will have its adherents – including those who work in it or benefit from it – who will defend it and its budget fiercely.

A related proposal is *sunset legislation*, whereby government programmes and agencies are given a fixed term of life, whereupon they must be voted back to life, or will expire. While some countries have managed to remove less-effective programmes and agencies through this method, it still faces interest-group opposition. And given the sheer number of government agencies and programmes that abound, legislators often find it easier to simply vote them a new term rather than spend time researching whether they are good value for money.

Tax constitution. Turning from spending to taxation, the American economists Geoffrey Brennan (1924–2022) and James M. Buchanan (1919–2013) proposed a *tax constitution*, designed to restrain the scale and politicisation of the tax system (Brennan and Buchanan 1980). Like other constitutions, this would be a broadly permanent set of rules, requiring overwhelming agreement on what taxes could be levied, and how. That would bring greater predictability than current systems, in which tax rules change at each annual budget. It would allow people to make better future plans and thereby boost productivity. It would keep taxation simpler because there would be no annual budget opportunity to add new taxes or embellish old ones. It would protect taxpayers from the costly demands of lobbyists because nearly everyone would have to agree before taxes could be imposed.

Yet it is hard to see why politicians should accept any such arrangement, given the flexibility over taxation that they enjoy today. And again, there may be emergencies where higher revenues are needed urgently, before any amendment to a tax constitution could be agreed.

Alternatives to taxation

More simply, governments could minimise taxation, and the damage it does, by asking a few questions about their spending.

First, does each government activity really *need to be done at all*? (For example, do we really need public libraries?) Second, if an activity is necessary, does it *require government to do it*? (Could private philanthropy provide libraries instead?) Third, if the government must take responsibility for a function, need it provide that function *itself*? (Could it contract out library management to others?) Fourth, if government must undertake the activity itself, can it still do it *better*? (Are there cheaper ways of getting books to the public?)

On this last point, there are several ways to minimise taxation by making essential government activities more cost-effective, or funded other than by taxes, including the following.

Competition. Government services may be made significantly cheaper by exposing them to competition.[2] State

2 There are numerous international examples of this in Poole (1980).

enterprises may simply be privatised, and turned into independent providers that have to compete in the marketplace. That competition will bid down costs and bid up quality – something state monopolies are poor at. Quite possibly the whole of the government expenditure that was previously required to sustain these activities can be saved. They might even become net tax revenue producers (for examples, see Pirie 1988).

Services may also be contracted out. Central or local government may still take responsibility for refuse collection, road maintenance, schooling, firefighting or water and sanitation, for example, but hire private companies or non-profit groups to provide them. At the same time, competition can be introduced, with several different groups competing for the contract to provide the service, or with the services divided between several providers. Again, the expectation is that costs fall, quality rises and taxpayers are saved money (see Savas 2000).[3]

User fees. Services that governments continue to provide do not necessarily have to be funded out of taxation. For example, many bridges, tunnels and highway systems are financed from tolls – i.e. charges imposed on users. Tolls may rise at peak periods in order to discourage congestion, something for which general taxation is too blunt a tool.

New technologies have made such alternatives easier. For instance, vehicles may be fitted with a payment tag

3 Savas suggests that contracting out routinely brings savings of around 15 per cent, though savings can be many times that.

that is automatically billed as they drive through a tollgate or over a congested road. Similar developments make it possible for user fees to be charged on waterways or in government-provided parks, museums and recreational facilities.

Bundling. Another method to allow fees to be charged is *bundling*. As mentioned earlier, lighthouses originated when maritime pilots lit bonfires to advertise their services. Ships would pay the pilots to be guided into port, with the warning bonfire bundled in. Later, ports themselves charged docking fees that bundled in the cost of the lighthouses that would guide ships safely into harbour (Geloso 2019).

A modern example of bundling might be national parks, where it may be difficult to restrict access. But car parking charges, motels, cafés, shops and other facilities can be used to generate at least some of the revenue needed to keep up the property.

Using and selling assets. Governments often own large tracts of land and buildings but do not necessarily get the best value out of them. Possible solutions might be to contract out government property management to professionals, or simply to sell the land and buildings that the government is not using, or not using well. Obliging governments to keep a balance sheet of their assets and liabilities would help expose where costly assets were being underused and should be disposed of.

Crowdfunding and philanthropy. Experience with crowdfunding suggests we should not underestimate the willingness of the general public to pay voluntarily for something they believe important. Large numbers of public-service broadcast channels, museums and theatres are maintained, not by government tax revenues, but by private subscriptions. Philanthropists, too, support orchestras, libraries, art galleries and other cultural bodies on a large scale. Might other public services – particularly those that are not genuine 'public goods' – be funded in this way, instead of through taxation?

Conclusion

However numerous these alternative options, taxes seem likely to remain both a necessary and an inevitable way of maintaining public activities and services on the scale that they exist today. Perhaps it should be a duty of every government to explore all the options before they reach, lazily, for new and higher taxes.

'Taxes,' wrote the American judge Oliver Wendell Holmes (1841–1935), 'are what we pay for civilized society.' But there may be many other ways to at least contribute to the cost of that civilisation, and less damaging ways, too.

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