

Walter Block

The Fraser Institute - Vancouver, B.C., Canada

The Justification for Taxation in the Public Finance Literature: an Unorthodox View

1. - *Introduction*

Public finance is the sub-discipline of economics that deals with taxes, fiscal policy and government enterprise in general. In order to assess the case in behalf of taxation commonly made in this field, I shall analyze the public finance textbooks of ATKINSON and STIGLITZ [1980], DUE [1963], MUSGRAVE [1959] and SHOUP [1969]¹. I have chosen textbooks because they are a distillation of knowledge, methodology and perspective of an entire profession; they are the amalgamation of what is considered correct and important. I have chosen these four because they are a representative sample, and highly respected² amongst the practitioners of economic orthodoxy in this domain.

The category of economic study we shall consider is sometimes called government finance, sometimes public economics, and sometimes government economics. But whatever the name, this field is very different from all other sub-disciplines of economics in one important respect. In every other case, whether it is micro or macro, trade or labor, business cycles or money, resources or growth, development or industrial organization, managerial or accounting, the practitioner plunges right into the subject matter.

In public finance, in contrast, and only in public finance, there is first an attempt to justify the very existence of the topic. In every textbook on this theme I have examined, plus the four to be scrutinized here in detail, there is always an introductory chapter, and in some cases two or three, where

¹ Unless otherwise noted, all unmarked page references refer to these four texts.

² According to Due (p. 13), Musgrave's text «is the modern classic in the field of government finance».

the author feels compelled to defend against the charge that the whole enterprise rests upon a foundation of sand³.

How can we account for this felt need to vindicate the very subject matter? Although this can only be speculative, one possibility is that public finance is the only economic field studying activities to which the use of force is intrinsic.

Shoup, however, attempts to deny this. Or, rather, to mitigate this claim, by asserting that other institutions beside government also avail themselves of the use of force. He states (p. 4): «The government's system operates with the aid of a legal power of compulsion. But in many countries one or more members of a family or of a religious or charitable organization have possessed or still do possess legal power of compulsion over other members. The chief difference between the government's allocating system and that of the family, church, or other nonprofit institution lies in the degree of impersonality of the rules under which the government distributes its services and allocates the burden of covering the costs».

But this is unconvincing. For one thing, there is surely a great difference between the way a private charity engages in fund raising, and the government's tax system. In the former case, this is accomplished through purely voluntary means; in the latter, there is a resort to threats of incarceration⁴. Shoup, perhaps, could attempt to defend his position by claiming that families do exercise coercion over children. But this would not be definitive in the case of adults, where families, religious and charitable organizations treat their members on a voluntary basis. For another, while there is indeed an important difference between government and these charitable institutions with regard to impersonality, this doesn't begin to account for the distinction between the public and private sectors, to which the latter belongs.

If not impersonality, of what, then, does the justification for the tax system consist? Although each of our four authors places a different emphasis on the matter, a definite pattern emerges. On the whole, they all subscribe to the view that government action (i.e., taxation) is justified because of market failure. In what is to follow I shall consider the charge of market

³ For example, at the conclusion of his introductory chapter in this regard, DUE (p. 17) states: «These considerations account for the undertaking of the great bulk of present-day government activities. Likewise, they provide a *justification* for replacement of the market mechanism by central decision making on the part of the government» (emphasis added).

⁴ This point can be interpreted in both a value-free (positive economic) and value-laden (normative economic) manner. From the latter perspective, it is usually stipulated as immoral for one person to demand funds from another against his will – for whatever purpose. Exceptions, however, are commonly made for state tax collections, but for an alternative view, see SPOONER, [1870, 1973]. This distinction is also based on a positive economic category, our main focus of interest in the present paper. For there is all the difference in welfare economics between a forced interaction and a voluntary one. In the latter case we are entitled to deduce, at least *ex ante*, that both parties gain from the exchange. In the former, no such conclusion is ever warranted.

failure under seven different rubrics: 1. Perfect competition; 2. Externalities; 3. Growth and economic development; 4. Merit goods; 5. Equity; 6. Obstacles to charging a price and 7. Stability.

2. – Perfect Competition

It is charged by the public finance community that the real world lacks the conditions which together comprise perfect competition: perfect, costless and full information; demand curves of infinite elasticity; numerous sellers and buyers in all markets; homogeneous products; equilibrium; futures markets and insurance for all conceivable goods and services⁵.

This absence of perfect competition is very important in the view of the public finance economists. Due, for example, goes so far as to assert that «freedom of choice is interfered with... when competition ceases to be entirely perfect» (p. 11). But there is a serious objection with such a stance. It fails to distinguish between lack of free choice, and lack of numerous alternatives. An otherwise free man who has the unfortunate luck to live on a desert island, or to have been born thousand of years ago, has very few options, compared to most people in modern western industrialized countries. But unless he is under some sort of compulsion (i.e., in prison), he does not lack free choice. Rather, he merely has fewer alternatives than might be available to him under other situations.

Perfect competition, moreover, is unlikely to increase the number of options. To the extent that is meaningful to even discuss this model as a possible description of reality, the requirement that all goods be homogeneous would on the face of it practically guarantee fewer choices than at present. For the heterogeneity of foods and services is surely one of the greatest sources of variety.

Nor has the perfectly competitive model itself gone uncriticized⁶. Among the basic fallacies is that perfect competition, paradoxically, misconstrues competition. It is usually operationally defined in terms of four-firm concentration ratios: the percentage of an industry's sales, profits, output, employment, etc., is accounted for by the largest four firms. If this ratio is "low", perfect competition is said to be approximated, but if it is "high", the market is said to be "imperfect". But all such measurements are

⁵ This latter condition is especially stressed by ATKINSON and STIGLITZ (pp. 7 and 349). But the lack of any specific market (say, that for mud pies) is no indication of inefficiency. Rather, it may be evidence that market actors contemplate receiving insufficient returns for setting up such markets. In any case, all academic critics of the non-existence of a given market are free to set up one on their own. That they do not do so, and instead cavil at the inactivity of *others*, is evidence not of market inefficiency, but of their own timidity.

⁶ See ARMENTANO [1972, 1982, 1986]; BLOCK [1982]; ROTHBARD [1970, chapter 10]; DI LORENZO [1988]; BROZEN [1982].

entirely arbitrary⁷. No one has ever shown where "low" leaves off and where "high" begins. Equally arbitrary is the very definition of an industry. If narrowly conceived (i.e., colas) the ratio will be "high", but if broadly determined (i.e., all beverages) the ratio will be "low". But again we are vouchsafed no non-capricious delineation. And this is because no proper definition of an industry exists, despite the crucial need for it on the part of those who believe in the coherence of the perfectly competitive scheme. If anything in this murky field is certain, it is that were "perfect competition" ever attained, it would be the very opposite of rivalry. With zero profit, no innovations and product definition, no continuing struggle to woo customers away from one another, "perfect competition" is no competition at all.

There is also the difficulty that the absolutely crucial concept of entry restrictions is all but ignored, despite protestations to the contrary. During the years that I.B.M. and ALCOA were the only sellers of computer services and aluminium, respectively, there was complete free entry; that is, no laws existed which prohibited or even discouraged competition. As a result, both companies acted competitively, that is, rivalrously, fending off *potential* competition by innovating, cost cutting, reducing prices, etc. In contrast, the organization of taxicabs in most cities resembles the perfectly competitive model: there are numerous buyers and sellers, and only one price is charged. But new entry is strictly prohibited. Paradoxically, then, advocates of "perfect competition" must see the highly regulated taxi industry as closer to their ideal than the almost completely free computer and aluminium industries.

In a sense, the lack of perfect competition justification for government action is almost too good. For it proves far too much. It argues, in effect, that

- 1) reality does not resemble an arbitrarily contrived model of the world;
- 2) reality should resemble this model; and therefore
- 3) the government should step in, to bring the world into closer conformity with the model.

But almost anything can be "proven" with this line of reasoning. Substitute for perfect competition objects moving faster than the speed of light, or people having more than two arms⁸, and further government intervention can easily be justified.

Even were it true, however, that the market is somehow deficient because the pinnacle of perfect competition has not been attained, it by no means follows that further state encroachments on the economy would improve

⁷ The two-firm concentration ratio in a boxing ring is 100%. Yet anyone who has ever entered this milieu knows just how competitive it is. See ARMSTRONG [1982].

⁸ If one arm is useful, and two are even better, then do not three, four or even eight constitute a further improvement?

matters. It is entirely possible that the governmental "cure" might be worse than the free enterprise "disease". In reality, the so-called efforts to improve competition through anti-trust activity have soon degenerated into rent-seeking, i.e., attacks on private property. Indeed, many have started off with that very intent [KOLKO, 1963].

The most potent charge of the perfect competitionists is not that monopolistic firms earn excessive profits, but rather that they misallocate resources. But as ROTHBARD [1970] shows, this thesis depends entirely on the existence of an independent and objective measure of optimal production under perfect competition. There are curves and diagrams aplenty which illustrate such points, but nowhere is there a criterion for determining the exact price and quantity for each product in a perfectly competitive world.

In any case, there can be no optimal allocation of goods and services under government control. This, even the public finance writers concede. According to Due, for example, the only objective criterion for resource allocation would be the marginal social benefits equal to marginal social costs rule. However, he states (p. 21): «The comparison cannot be made on any meaningful basis. As a *practical matter*, there is no way in which the marginal social costs and benefits of activities which benefit the community as a whole can be measured; the MSB-MSC rule offers no *actual guidance* for policy determination (emphasis added)». In his view, the whole process of government production is reduced to arbitrariness: «In other words, the optimum levels of each activity are determined by the collective estimates of the community regarding relative desirability of particular degrees of attainment of various specific goals» (p. 22). In case you missed it, this means allocating resources by ballot-box voting.

Another aspect of the lack of perfect competition is the lumpiness of factors, or decreasing cost industries. Unused capacity, or conditions where marginal costs are lower than average costs, is a particularly irritating situation for the public finance theorists (MUSGRAVE, p. 7; DUE, p. 21), on the grounds, again, of resource misallocation. But there are several difficulties here. Costs are essentially a subjective phenomenon [BUCHANAN and THIRLBY, 1981]. The most basic elemental concept of cost is alternative cost, the next best alternative foregone by the economic actor when he makes a choice. But these costs can only be known to the chooser himself, not to outside observers, such as public finance economists who wring their hands at the prospect of a wrong decision being made.

Moreover, the proponents of this doctrine are lead into a *reductio ad absurdum*. Consider the additional seats in a movie theater which are left unoccupied when there is less than a full house. The objective costs of seating these people, goes the argument, are zero. Allowing in additional people would add to their welfare, without reducing that of anyone else⁹. Pareto

⁹ Presumably we should ignore the welfare of the proprietor. After all, he is only in business to earn a profit, a most despicable motive; so anything done to him need not be too carefully factored into our calculations.

conditions are thus not met under real world conditions, because a positive price, any positive price, precludes movie attendance by at least some people.

But this is a recipe for nationalizing all industries which have high set-up or fixed costs, and low marginal costs. If positive prices are not allowed to be charged in the case of newspapers, books, theatres, automobiles, air travel, etc., these industries cannot possibly continue to exist in the private sector. Actually, however, the *reductio* is even more serious. It extends to *all* goods and services, whatever the concatenation of fixed and variable costs. For once a product is manufactured, and is just sitting there in the warehouse, or on the retailer's shelf, for all intents and purposes it has virtually no alternative costs at all. Thus, according to the perfectly competitive doctrine we are here considering, it should not be sold for any positive price. Rather, it should all be given away for free.

3. - Externalities

Yet another source of private market resource misallocation are externalities, variously called: "neighborhood effects", "public goods", "non-excludability" and the "free rider" problem. These phenomena, too, justify taxation and the government regulatory activity, at least in the view of the public finance economists.

Consider first external economies. Musgrave states (p. 7): «Establishment of an expensive store may increase real estate values in the neighborhood, even though the store cannot collect for the services thus rendered. A railroad into new territory may lead to gains in economic development that greatly exceed the profits to the particular railroad. Since the market permits a price to be charged for only a part of the services rendered, the development may be unprofitable from the private, but profitable from the public, point of view».

However, the owner of the new expensive store is the only one who knows for sure its future location. He is therefore in a position to buy up large swatches of the surrounding real estate *before* its value rises, due to his own investment. (And the same reasoning, of course, applies to the railroad). Another way of internalising this sort of externality is with the self-enclosed shopping center. There, virtually all of the supposed spillover benefits of retail commerce are captured by the owner of the mall.

Now consider the case of external diseconomies. According to Musgrave (p. 7): «Similarly, private operations may involve social costs that are not reflected in private cost calculations and, hence, are not accounted for by the market. A factory may pollute the air and damage an adjoining resort. The smoke nuisance is a cost to the particular community, yet it is not a private cost to the firm. The resort owners cannot collect from the firm since they cannot prevent its use of the common air. Thus, what is profitable to the private firm may be unprofitable from a social point of view».

These difficulties do abound, but they are not at all the fault of the marketplace, as the critics contend. The problem with this analysis is that it fails to take into account the institution of private property rights¹⁰.

In the early part of the 19th century, there were a spate of law suits which established the precedents which now inform pollution law [HORWITZ, 1977]. Before that time private property rights were all but sacrosanct. Plaintiffs were commonly granted injunctions against railroads, manufacturers, and other polluters. But then arose a doctrine according to which the private property right not to be invaded by smoke particles had to be "balanced" against the "public good". In effect, the courts began deciding that the public interest consisted of allowing polluters almost *carte blanche*. As a result industrial technology began switching from non-pollution intensive methodologies to pollution intensive ones. Even a particularly ecologically-minded manufacturer would be powerless to stop this oncoming tide. For if he refrained from unleashing pollutants, perhaps by investing in smoke prevention devices, he would be imposing a cost disadvantage upon himself. Other things equal, he would tend to drive himself toward bankruptcy.

The point is, despite the views of the public finance theorists, that market cannot exist in a vacuum. It rests on a foundation of law. If jurists will not protect property rights, "external diseconomies" will indeed abound. But this is an instance of government failure, not market failure [ROTHBARD, 1982].

The creed of externalities and public goods is also responsible for a frontal attack on the concept of methodological individualism. Due tells us (p. 12) that «there are various services, such as national defense, which yield substantial benefits to society over and above those which may accrue directly and separately to individuals». But it is difficult to envision what may exist «over and above... individuals». On the contrary, one is tempted to reply, there are only individuals in society; there is nothing that can accrue to any "society" which exists over and above the individuals who comprise it. There is certainly no such thing as a group mind or conscience which can experience benefits which somehow go unappreciated by mere individual citizens [BLOCK, 1980].

¹⁰ Perhaps this is why ATKINSON and STIGLITZ go so far afield in their comprehension of the problem: they have made a decision to eschew consideration of property. In their view (pp. 7-8) «Even if the economy is well described by the competitive equilibrium model, the outcome may not be efficient because of externalities. There are innumerable examples where the actions of an individual or firm affect others directly (not through the price system). Because economic agents take into account only the direct effects upon themselves, not the effects on others, the decisions they make are likely not to be 'efficient'. Air and water pollution are perhaps the most notable examples». However, they also state (p. 4) that their «coverage is selective. Some readers will no doubt be horrified or disappointed by the omissions, which include... the economics of property rights».

Further, it is not true that all members of society benefit equally from government defense expenditures, as claimed by Musgrave¹¹. On the contrary, some people are "hawks", who presumably demand ever-increasing military budgets; some are "doves", who call for cut backs. And others are pacifists, who don't benefit at all from armaments. For them weaponry – even limited to defensive purpose – is actually a harm.

We turn now to the claim of non-excludability. According to Musgrave (p. 8), «People who do not pay for the (social) services cannot be excluded from the benefits that result; and since they cannot be excluded from the benefits, they will not engage in voluntary payments. Hence, the market cannot satisfy such wants. (Government) budgetary provision is needed if they are to be satisfied at all». But excludability is just an example of internalising externalities. It is merely a matter of common sense, and sometimes of research and investment into new "fence-building" technology. If the will is there, the job can usually be done. Of course, if it is legally prohibited, it usually cannot occur. In such a case, however, the fault does not lie with the market, but rather with the statist prohibitions on the functioning of the market.

Consider the case of the old-fashioned baseball stadiums. In days of yore, fans would congregate on the roofs of surrounding buildings to watch an important game, such as the world series. The baseball companies were thus unable to exclude these non-paying viewers, and, according to the theory, not only should not have been able to continue operations, but never should have been able to set up a business in the first place. In the event, however, the solution was simple: building higher fences; and ultimately, domed stadiums.

How could this work in the case of defense? One possibility might be a geographical in-gathering of like-minded people within the U.S. on grounds of compatibility on defense matters. For example, the hawks might more closely congregate in Orange Country, California, or in Texas; the doves might assemble in Greenwich Village, and on the upper west side of New York City; in Cambridge, Massachusetts, in Ann Arbor, Michigan, and in the People's Republic of Santa Monica. This tendency might be aided by legislation easing restrictive covenants, so that landlords and property owners would not rent or sell unless the tenant or purchaser agreed to contribute to a private defense agency (or not, as the case may be). Further, such private enterprise protection firms might issue buttons, stickers or signs to their clients, in this way better enabling the exclusion of all non participants from the benefits [BLOCK, 1983; FRIEDMAN, 1973].

Excludability is not inherent in goods – the public finance error, any more than value is inherent in goods – the Marxist error. The fashioning of better fences, jamming devices, and other ways to discriminate between

¹¹ He states (p. 12): «Social wants are those wants satisfied by services which must be consumed in equal amounts by all».

payers and non-payers, is an entrepreneurial task. To be sure, it is sometimes hard to conceive of what business could accomplish in these areas, but this is only because markets are currently not allowed to operate in this regard¹².

Sometimes the externalities argument is couched in terms of social wants and public goods. The complaint, here, is that the tie between payment and benefit is broken; the advantages of a would-be commercial enterprise are not (cannot be!) limited to customers, so no one is willing to pay. The contention is that we all benefit from national defense, courts, public health measures, etc., whether we contribute to their financing or not. As a result, a "Let George do it" attitude develops. Force, therefore, brutal naked force, must be resorted to if these services are to be produced.

In this regard Musgrave (p. 10) tells us: «The government must step in, and compulsion is called for». And again (pp. 10-11): «A political process must be substituted for the market mechanism, and individuals must be made to adhere to the group decision».

On this theory, however, it would be difficult to account for the existence of any charitable or civic organizations. Consider such groups as the NAACP, ASPCA, ACLU, Salvation Army, United Way, March of Dimes, Red Cross, MS Foundation, Public Radio and Television. In each case, all ties between benefit and payment are cut. None of these public benefactors is able to exclude non-payers from receiving benefits [HUGHES, 1989]. Further, this view of the public finance ideologues is inconsistent with the creation of the very government they are so anxious to justify. For the state, on their view, is a public good. We are all free riders. If I start a government, it will benefit you too; so I won't do it. Nor will you, for such activity will benefit me¹³. But this only points to a very flawed logic in the public finance lexicon. It is surely erroneous to defend government and its tax collections on a theory which implies that no such institution can be created in the first place.

4. – Economic Growth

The market is also said to misallocate resources between present and future consumption. I.e., it is charged that the rate of growth is not optimal

¹² Note that we are not advocating that any such new industries be allowed to operate. Indeed, we are not advocating anything, for such would be the task of normative economics. To engage in such matters would take us away from our agenda, which is a positive economic criticism of the public finance case for taxation.

¹³ We are here discussing the *creation* of the government, not its continued *existence*. It is important to distinguish between these two situations because only the former, not the latter, is incompatible with the philosophy underlying the public finance literature. For once the state exists, it can force all people to pay taxes; thus there need not be any "spillover benefits". But this argument cannot apply to its very creation, *before* it is able to extract payments from all and sundry.

under free enterprise, and that this, too, is a justification for government taxation and expenditure policy. In the view of Musgrave (p. 7), «other discrepancies may arise from differences between public and private... time preferences»¹⁴. And Shoup maintains (pp. 38-39) that «the rate at which income per head will grow under full employment can be increased by public finance measures that restrain certain types of consumption, thus freeing resources for investment in the broadest sense, including education, medical care, and improvements in the pattern and level of nutrition for children and working age adults that increase their productive capacity, present or future, by more than the cost of these improvements (all discounted to a given date). Some of those whose consumption is restricted for this purpose will object, not agreeing that the present sacrifice is worth the gain, present and future, even if that gain materializes in time to be enjoyed by them rather than only by a future generation».

Surprisingly, all such public finance attempts to show non optimal growth patterns assert that standards of living will increase too slowly. This is in sharp contrast to the view that growth is too *fast*, which is espoused equally firmly in the "limits to growth" literature [EHRlich, GALBRAITH]. Which is correct? The point is that neither one is; that the only firm basis upon which to judge whether or not economic growth is optimal is the time preference rates of the individual economic actors. But this is precisely the point rejected by both sets of critics of the marketplace! Neither, unfortunately, wrestles with this basic question. Neither proves that the saving consumption decisions made by the individual are «inefficient».

Let us focus on the public finance claim that growth is too slow in the capitalist system. Even granting this dubious proposition, it by no means follows that government, fiscal and other such policies are a good means toward attaining a higher growth rate. For as the best research in this area shows [BAUER, 1971, 1981, 1985], in reality the state actually retards economic development. If the public finance theorists really favor enhanced rates of progress, the last thing they should advocate is an expanded government sector.

5. - Merit Goods

Let us review for a moment. So far, we have examined the public finance writer's treatment of perfect competition, externalities and growth. We have

¹⁴ The following sentence reads: «Indeed, if we assume that any one person's welfare depends on that of all others - a case of keeping up with the Joneses - we must conclude that the satisfaction of all private wants involves gains and losses that are not accounted for in the market». But surely this involves a *reductio ad absurdum*, for this is a justification for a government takeover of *all* commercial activity. It proves far too much, and in doing so, exhibits yet again the fallacy of the argument.

noted their attempt to justify taxes on the ground that the market, if left to its own devices, would misallocate resources in these three respects. It was contended that the *laissez-faire* system could not maximize welfare from the point of view of the average person, or consumer. That is to say, the vantage point of consumer sovereignty took center stage. It was made the core of the analysis.

And now, we arrive at their investigation of merit goods. Here, we shall see, there is a complete reversal of field. Instead of arguing that the market is deficient in that it misallocates resources, these writers now maintain that although the free enterprise system does *not* misallocate resources from the vantage point of consumer sovereignty, government should still be brought in, precisely for that purpose!

What are merit wants? According to Shoup (p. 43), «Certain private-sector outlays are deemed so laden with a public purpose that they are stimulated by tax laws or subsidies; philanthropic and religious outlays are examples». Musgrave (p. 13) holds that merit wants are «considered so meritorious that their satisfaction is provided for through the public budget, over and above what is provided for through the market and paid for by private buyers... Public services aimed at the satisfaction of merit wants include such items as publicly furnished school luncheons, subsidized low-cost housing, and free education. Alternatively, certain wants may be stamped as undesirable, and their satisfaction may be discouraged through penalty taxation, as in the case of liquor... *The satisfaction of merit wants, by its very nature, involves interference with consumer preferences.* In view of this, does the satisfaction of merit wants have a place in a normative theory of public economy, based upon the premise of individual preference in a democratic society? A position of extreme individualism could demand that all merit wants be disallowed, but this is not a sensible view». Atkinson and Stiglitz (p. 8) describe merit wants as «a category of goods where the state makes a judgement that certain goods are "good" or "bad", and attempts to encourage the former (e.g., education) and discourage the latter (e.g., alcohol). *This is different from the arguments concerning externalities and public goods, in that with merit wants, the "public" judgement differs from the private evaluation, rejecting a purely individualistic view of society*» (emphasis added).

But this will not do at all. The public finance economists cannot have it both ways. If it was so important not to misallocate resources from the perspective of consumer sovereignty before (e.g., their analysis of perfect competition, externalities, growth) how can the very opposite now be required, namely a setting aside of the sovereign consumer's desire for alcohol, and wish to neglect education?

Alternatively, if resource allocation in service of the sovereign consumer is so unimportant that it can be set aside in favour of these paternalistic merit wants, why should anyone pay attention to arguments purporting to show that the market misallocates resources by being imperfectly competitive and subject to externalities and growth problems?

