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# 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]<sup>1</sup>. 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 respected<sup>2</sup> 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

<sup>1</sup> Unless otherwise noted, all unmarked page references refer to these four texts.

<sup>2</sup> 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 sand<sup>3</sup>.

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 incarceration<sup>4</sup>. 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

<sup>3</sup> 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).

<sup>4</sup> 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 services<sup>5</sup>.

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 uncriticized<sup>6</sup>. 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

<sup>5</sup> 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.

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

entirely arbitrary<sup>7</sup>. 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 arms<sup>8</sup>, 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

<sup>7</sup> 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].

<sup>8</sup> 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-MSB 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 else<sup>9</sup>. Pareto

<sup>9</sup> 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 rights<sup>10</sup>.

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].

<sup>10</sup> 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 Musgrave<sup>11</sup>. 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

<sup>11</sup> 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 regard<sup>12</sup>.

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 me<sup>13</sup>. 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

<sup>12</sup> 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.

<sup>13</sup> 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»<sup>14</sup>. 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

<sup>14</sup> 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?

The public finance writers cannot both have their cake and eat it. Their merit want concept makes a mockery of their allocation concerns. The two are contradictory. At least one set of arguments must go by the board.

#### 6. – *Income Redistribution*

At first glance, it might be thought difficult for avowedly value-free economists to prove that income redistribution follows from the basic premises of their discipline. But such niceties do not for a moment dissuade the public finance theorists from this task. What are their arguments?

Atkinson and Stiglitz announce (p. 6) that «Pareto efficiency does not ensure that the distribution that emerges from the competitive process is in accord with the prevailing concepts of equity (whatever these may be). One of the primary activities of the government is indeed redistribution». Indeed? Surely, before we accept any such conclusion we must be shown that there are certain specific concepts of equity<sup>15</sup> which alone follow from economic principles. Needless to say, this has not even been attempted, let alone accomplished. And why bring up Pareto efficiency? This is completely dependent upon the vantage point of consumer sovereignty, which has been rejected in the merit want analysis.

Musgrave's defence does not fare any better. He declares (p. 17) that «there was a time when the provision of public services was considered its [government's] only legitimate function, and it was argued that "the fiscal problem pure and simple" should not be confused with "alien considerations of social and economic policy". Subsequently, *however, most people came to recognize* that the revenue-expenditure process of government is bound to have social and economic effects, and that these may be aimed usefully at purposes not directly connected with the immediate objective of satisfying public wants. Adjustments in the state of distribution are one such purpose» (emphasis added). This defence consists of a semi-reasonable opening statement, coupled with a gigantic "however", followed by no more than a bald assertion that «most people» in effect have changed their minds about this matter. No reasons are given for supposing that this change of heart was preferable to the opinions which originally prevailed<sup>16</sup>.

<sup>15</sup> Whatever concepts of equity there may be floating around in society will hardly do. For it is doubtless true that the income distribution which emerges as a result for market place activity will not be in accord with many concepts of equity.

<sup>16</sup> DUE (p. 12) argues along similar lines: «The market economy, even with relatively free competition, has resulted in a pattern of income distribution among families which opinion in society has typically regarded as inequitable, because of the high degree of inequality». But is "opinion in society" correct? How much inequality is too high? Why should only money incomes be subject to forced egalitarianism? Suppose we had the ability to redistribute intelligence, or serenity, or health: is there anything in the axioms of economics that would force us to recognize the validity of coercive transfers of these characteristics? These are among the questions avoided by the public finance advocates of wealth transfers.

Shoup, in contrast, does attempt to base the normative standard of equity in the positive realm. He opines (p. 23) that «there is a generally accepted standard of equity, or fairness, with respect to public finance measures: equal treatment of those equally circumstanced. It is a principle predominantly founded in analogy with equal treatment before the law». But this analogy is only tenuously connected with present considerations. Justice would indeed be outraged if of two parties guilty of the same crime, one were hanged and the other set free. But is this sufficient ground for in effect robbing Peter to pay Paul?<sup>17</sup>

Due's analysis of this question is lengthy (pp. 9-10), but very informative, and worthy of quotation in full. He starts out in a quite reasonable manner, a vast improvement on the treatment accorded to this subject by many of his public finance colleagues, but then he takes it all back. He does so with a howler of a "however", which is probably the largest and most dramatic "however" in the entire history of economic thought.

«(A) generally accepted goal is that of a distribution of income which is regarded as equitable by the consensus of opinion in society. Since equity in income distribution, as in all matters, is based upon value judgements, economics can be of no real assistance in defining it. It is sometimes argued that economic welfare requires a distribution of income such that the marginal satisfactions of all persons are equal, since otherwise a shifting of income from some persons to others would increase total satisfaction. Actually, this statement has no significant meaning, because of the impossibility of making interpersonal utility comparisons, that is, of comparing relative satisfactions obtained by different persons. There is no way in which the satisfaction received by one person from the consumption of a particular good can be compared with that received by another person from the consumption of the same good. It is not possible to say that two persons with the same income, accumulated wealth, number of dependents, and other external circumstances receive the same satisfaction and thus are "equally well off" in any subjective sense. It is impossible to show that a person with a million-dollar income receives less satisfaction from the expenditures of an additional dollar that does a person with an income of one thousand dollars».

So far, so good. Due has brilliantly closed the door on all sorts of government interventionism, in the name of unsubstantiated value judgments, and illicit interpersonal comparisons of utility. But now comes that infamous "however".

<sup>17</sup> There is also the religious analogy. In the bible [MATTHEW, chapter 20, verses 1-16] there is a story of workers who begin their (equally productive) labors at different times of the day, and all end at the same time. Nevertheless, they are all paid the same amount of money at the end of the day. The moral of the story drawn by some left wing commentators is that this is unfair, because unequals are being treated equally. But the employment contract is an agreement between consenting adults. The employer, surely, can in effect make a free gift of money to those laborers who began later in the day, without being accused of anything untoward. This, as it happens, is in accord with the biblical interpretation.

«However,» Due continues, «persons make judgements about equity in the distribution of income, on the basis of which they evaluate the actual patterns which occurs with a market economy. Furthermore, in any particular society, there is a substantial consensus of opinion about an optimum pattern; while there are extremists at both ends of the scale, the differences in opinion would typically appear to extend over a relatively narrow range. There is widespread acceptance of the view that the actual distribution of income which develops in a market economy is excessively unequal, and thus that equity requires a closing-together of the extremes, the incomes of the very poor being increased and those of persons at the highest levels being reduced».

Although these passages follow directly one from the other in Due's text, it is as if they were written by two very different people. The first paragraph quoted above wields the basic tools of economic analysis into a coherent refutation of the case for redistribution; but the second is filled with every cliché which mars the usual public finance treatment of this subject. His earlier insights disappear in a welter of consideration for public opinion, and "widespread acceptance"; he seems to feel that truth consist of a sort of "golden mean" between extreme views; he swallows whole the view that incomes can be shown to be "excessively unequal", based solely on considerations of positive economics. All in all, a most disappointing discussion.

### 7. – Obstacles to Charging a Price

At one time virtually all economists at least theoretically conceded the preferability of the market over the government bureaucracy on straight efficiency grounds. They did so, or were presumed to have done so, because of the profit and loss weeding out process which operates in the former case, but not the latter [MISES, 1969]. But this, unfortunately, is far from true in the public finance literature.

Contends Due (p. 16): «It is generally presumed that private enterprise can produce more efficiently than governments, because of the effective stimulus provided by the profit motive. *However*, there are certain situations in which governmental production may be more efficient, in the broad sense of that term. In the first place, certain real costs to society may be avoided if the services are produced by the governments and provided free of charge to the users. The savings are due primarily to elimination of the costs of collecting the charges from the users; the administrative expenses of the taxes used to finance the activities may be much less. For example, if sidewalks were provided by private enterprise, the cost of collection of tolls would far exceed the present costs of collection of property taxes and special assessments to finance sidewalks. This is an extreme example, but the same considerations apply to the financing of highways, since the costs of

collection of tolls on all roads must greatly exceed the costs of administering the gas tax» (emphasis added).

When Due uses the word "however", we have learned that we must tread carefully. The problem here is that he has in mind a very unsophisticated version of the free enterprise system. In sidewalk provision, for example, he seems to picture pedestrians stopping to pay at a toll booth set up near each home or store they pass. In actual point of fact many miles of private sidewalks now exist – in shopping malls, condominium developments – and there are no costs of collection; rather, the service is given away for free, as a package deal offered to shoppers, guests, owners and tenants. In the event, these private sidewalks are far more safer, cleaner and in better repair than their public counterparts; and this is because of the usual profit and loss considerations.

A similar analysis applies to the case of private highways [BLOCK, 1983; ROTHBARD, 1973]. Under free enterprise, motorists would not have to stop every few feet at a toll booth, as Due implies. Rather, sophisticated electronic monitoring devices could be utilized as a low-cost collection technique. Alternatively, a leaf could be borrowed from the Singapore experience. That system utilizes differentially colored windshield display permits to indicate time of day and geographical area where travel is allowed. This works on a principle similar to the one used in coin-operated private parking lots.

It is undoubtedly true that *government* toll booth systems are vastly inefficient. As presently operated, limited access highway motorists are forced to stop their high speed travel every few miles in order to pay a few pennies. This system is as galling as it is costly. It is even likely that a gas or property tax may be a more efficient collection device<sup>18</sup>. But it by no means follows as Due seems to think it does that *private* collection costs would therefore be more expensive than either a tax or the present toll booth system. We cannot conclude that absence of collection costs can render public operation of commercial ventures more efficient than private.

### 8. – Stabilization

A recurring claim all throughout the public finance literature is that the unencumbered market is subject to sudden bouts of depression, and that government intervention is thus needed to keep the economy on an even keel. Musgrave's statement (p. 22) is symptomatic of the genre: «A free economy, if uncontrolled, tends towards more or less drastic fluctuations in

<sup>18</sup> The gas tax has the disadvantage that it cannot be used for peak-load pricing. The statist toll booth system now in operation *could* be used in this manner, but given bureaucratic arteriosclerosis, it is not.



prices and employment; and apart from relatively short-term swings, maladjustments of a secular sort may arise towards unemployment or inflation. Public policy must assume a stabilizing function in order to hold within tolerable limits departures from high employment and price stability».

This view amounts to the reiteration of the old familiar standby, "market failure". But here, as in all other cases where this charge is made, it is "government failure" which is really responsible for the flaw mistakenly seen in the market.

Unemployment, for example, is not intrinsic to the capitalist order. On the contrary, it is brought about through all sorts of unwise and mischievous government interventions: minimum wage legislation; legal support for unions to raise wage rates above productivity levels; the Davis-Bacon Act; "fair" labor standards; occupational licensure; excessive taxation [WILLIAMS, 1982].

Similarly, Musgrave to the contrary notwithstanding, inflation is always and ever a strictly governmental phenomenon [FRIEDMAN and SCHWARTZ, 1963; WALKER, 1976]. Price inflation depends crucially upon excessive monetary creation, and in the modern era of central banking this is solely a prerogative of the state. It can only be alleged that the market is responsible for inflation from a perspective that is innocent of basic economics.

The 1929 depression is commonly though to be a product of the unhampered market place. This is perhaps "exhibit A" of the public finance point of view on this matter. But even here, despite widely accepted man-in-the-street opinion, there is strong evidence which indicates that far from being a result of the working of the free economy, the great depression, too, came about because of unwise government policy: the Smoot-Hawley tariff; artificial controls on wages and prices, keeping them inflexible in a downward direction. Most important, Friedman and Schwartz (1963) lay a large part of the blame for this débâcle at the door of the Federal Reserve System, which presided over the reduction of the money supply by one third in the short space of a few months<sup>19</sup>.

## 9. - Conclusion

We are forced to conclude that the main task set for themselves by the public finance writers has not been met: they have failed to justify - without resorting to unsupported value judgments - the institution of taxation. We cannot infer, based on this examination, that taxes are *not* justified. We can only maintain that their self-imposed task has not been

<sup>19</sup> As well, in the Austrian analysis, the previous bout of inflation during the 1920s artificially encouraged and overstimulated basic industries and round about methods of production; this, in their view, led to the débâcle of the thirties [see ROTHBARD, 1975; MISES, 1966, 1971; HAYEK, 1932, 1933; for a critique of this view, see TULLOCK, 1988].

accomplished, and that the whole question of how and whether taxes may be justified is still unresolved<sup>20</sup>.

This is an unsatisfactory state of affairs for textbook writers in a sub-discipline of economics. After all, a text is supposed to be an amalgamation of well established doctrine in the field. Either this task should be acquitted with far greater success, or it is advisable that it be left off entirely from the table of contents. Then, public finance could address its proper task: a positive economic evaluation of the effects of taxation, and not a deeply flawed normative justification of the tax system.

<sup>20</sup> Are there any public finance texts which conclude from their initial examination of these matters that taxes are not justified? Not to the knowledge of the present writer. The writers in this field act almost as if it would be awkward were any such conclusion to be drawn; that is such a case it would be exceedingly difficult for the remainder of the book to be written. But this is to conflate the normative and the positive. Surely one can engage in a positive analysis of the effect of a policy without concerning oneself with the moral justification of that policy.

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