# The Economic Philosophy of Taxation

By

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## Chapter 1
# Introduction

Governmental or legislative decision making – at any point in time and in any nation in the world – involves normative considerations. Normative, as opposed to positive notions, are subjective and not necessarily based on facts. They are born of beliefs or values that help one conclude 'what ought to be'. This is but a characteristic of humankind, whose members are participants of a social life, whose ancestors have experienced various colours of history and whose future socio-political realities are given forethought.

In the case of a nation's economy, there is also much consideration given to the understanding and knowledge produced in the field of economics. Theories, models, methods of predictions and other scientific calculations act as tools or guidelines in the process of formulating economic policies.

However, a quick look at a popular media presents to us the vast non-economic challenges to policy making with regard to social justice and 'fairness'. At various points, one may also observe the influence of political parties and other social groups on the content of the decision-making process by the government. This certainly suggests that economic policies are not made with theoretic concerns that arise from economists alone, but pass through heavy discussions and real conversations between the representatives of the State as well as the public. Rejoice! For this is the blessing of a democratic society.

The purpose of this thesis concerns the study of economic philosophy – to enquire about the role of ethical or normative values, such as human welfare, freedom and social justice, in economic reasoning, particularly that which precedes an economic policy decision. This aspect of economic philosophy challenges what we call as 'rational', especially in the context of a democracy supported by a capitalistic economy, featured by pluralism in both social and economic aspects.

For such an objective of the study, the process of taxation is chosen as a subject through which I may explore the combinations of normative and economic ideas that determine the structure as well as the continuation of fiscal policies in a nation-state.

The research will thus explore important philosophical questions in the context of taxation such as: What is the role of the State in ensuring social justice through taxation and provision of public goods? What normative values determine how much an individual should pay? To what extent ought a government expand the size of the public sector in an economy? To gain understanding regarding these concerns, the research will survey a range of secondary texts in order to collect and organize various ideas and arguments by scholars from different standpoints in economic literature.

The dissertation will be divided into three main chapters. First, 1. An Enquiry Through Normative Values – a review of thoughts regarding the role of the State, redistributive justice as well as various normative statements regarding criteria upon which an individual's tax liability ought to be determined by. 2. An Enquiry Through Economic Concepts – an analysis of the various economic effects of taxations, measured or evaluated by neoclassical economic concepts such as efficiency and tax incidence which present the effects of a tax system in an economy and lastly 3. Views on Public Finance – a study of some important arguments regarding the extent of a government's control over a nation's wealth and the nature of public expenditure.

## Chapter 2

# An Enquiry Through Normative Values

### 2.1 Taxation as the collection of surplus

There are multiple ways through which one can view the economic process of taxation: a collection of funds for the administration of society, a method to systematically reallocate the wealth present in nations or a democratic means of redistributing income, given that Robin Hood and his Merry Men[1] are no longer around. Whichever the perception, none are complete without the concept of surplus.

The term surplus was described fundamentally by Quesnay[2] as the part of the social product (or total produce) of a society that remains after deducting the 'necessary consumption' and can be disposed of without compromising that society's survival. Here we may identify three known values: (1) the social product or aggregate of commodities present in a given period, (2) real wages, or distribution to workers for their subsistence and the replacement to the means of production, and (3) the total number of workers employed. The product of the (2) and (3) represents the 'necessary consumption' which, when deducted from (1) gives us the surplus of that society. Surplus is produced when the labour process(es)[3] in a society is able to generate more than is required to maintain the workers at the standard of living that is context appropriate (time and space) as well as to replace the capital used up in production. This surplus, say in a household, may be saved and used for consumption of goods/services or paid as tax to the government. On a larger scale, surplus can be recognized as that part of a nation's total product which is at its free disposal.

The use of the surplus that is collected by a sovereign government often allows us to evaluate the structure and evolution of that society. If it is reinvested in labour saving

1 Robin Hood is a fictional character found in English folklore dating back to the 15th century, a heroic outlaw, who with the help of his group of bandits "Merry Men", would fight to rob the rich and give to the poor.

2 As elaborated by Garegnani, P.. (1984)

3 Labour processes can be identified using two elements – technology and social organization of production. While the former defines the relation between inputs and outputs, the latter describes the relation between people and the process of production itself; as understood from Bowles, S., Edwards, R., & Roosevelt, F. (1993). *Understanding capitalism*. Harper Collins College.

technology, we may predict that the society will incur some increase in living standards. If it is put to use in a specific sector, such as that of defence and nuclear weapons, it may alter its global political position. But prior to discussing the use of the surplus itself, it is worthwhile to inquire about both the manner and motive behind the *collection* of surplus from the people in a society. Surely, the central administrative units of any nation-state (defined in the subsequent section) must defend their rates of taxation, proposed tax structures, budgeted tax revenues and other related measures. An inquiry of this nature warrants an understanding of the nation-state or government as an institution, as well as its role as the coordinater of our socio-economic reality.

## 2.2 Role of the State

The concept of a 'state' is so abstract that there are parties that dismiss its very existence. According to Jessop (2006), there are different considerations that are made in the attempt to characterize a 'state' – its legal nature, coercive abilities, aims and functions or its role and place in an international context. The State is sometimes referred to as a subject, when addressing what it does or should do, and it is also perceived as a thing, an object used by different economic classes or political parties to pursue their own interests. Another method to try defining a State may be to list the various institutions that the state is comprised of, or manages, say, legislature, judiciary, defence, etc. Jessop refers to the German sociologist, Max Weber to observe that there is no activity which a state always performs and none that it never performs; a state may undertake a range of endeavours, from building national highways to family planning – it is known to have provided for it all.

Theorists, however, have more or less identified the crux of a state to be the territorialization of political authority. Jessop further quotes Weber to define the modern state as the "… human community that successfully claims legitimate monopoly over the means of coercion in a given territorial area" (p. 112) Such an exposition fails to encompass the most fundamental role of a State or government – that of coordinating human life – and excludes the pillar upon which societies rely on –

cooperation. While definitions that come close to Weber's – emphasizing on the 'power' element of a nation-state – are more popular, I wish to borrow Richard Musgrave's definition (1999, p. 31), "… the state as an association of individuals, engaged in a cooperative venture, formed to resolve problems of social coexistence and to do so in a democratic and fair fashion. The state, in short, is a contractarian venture, based on and reflecting the shared concerns of its individual members."

My choice of Musgrave's quote intends to defeat the popular view of the government as the people's competitor and narrow its functions to provision of public goods, redistribution of wealth and establish social justice and also to stabilize an inherently unstable capitalist economy. By an extrapolation of the quote, I further oppose the idea of the process of taxation as a form of abuse, but what we "… pay for civilized society."[4] Here I also wish to acknowledge that different societies might find themselves in entirely different socio-economic conditions and urgencies at various points in time, thereby calling for a diverse set of policies based on what laws suit best the the social, political and economic circumstance of that point in time. Taking the case of a developing nation with a particularly unique socio-economic structure such as India, "problems of social coexistence" go as far as the eye can see and demand an intricate web of decisions by its center of coordination.

To illustrate, I take the example of three points in India's economic history to evaluate the state's fiscal intervention – 1951, 1993 and 2010. In 1951, the main aim of the First Five Year Plan's fiscal policy was to "raise, to the extent possible, through taxation, through loans and through surpluses earned on state enterprises, a considerable portion of the savings needed. The financing of investments through public savings would help to ensure a pattern of development in consonance with accepted social criteria." (Purohit, M. & Purohit, V. 2014. p. 2) To accomplish this aim, the Government of India raised larger resources from richer sects of society to provide massive funds towards the public sector, especially in infrastructure development. Much farther down the timeline, the proposed reforms to the tax structure in 1993 were largely to combat the "complicated and irrational tax system"[5] including various

4 Quote by Justice Holmes in 1927 regarding a US tax case in the Supreme Court.

5 As described by Chelliah, the Chairman of the Tax Reforms Committee set up in 1991, in his K R Narayanan oration at the Australia South Asia Research Centre in 1994. Sourced from Chelliah, R. (2006). Reforming India's Tax Base for

cascading taxes and unjustified concessions. Government expenditure reforms along with disinvestments of public sector undertakings were also carried out with the aim of increasing operational efficiency through transfer of ownership to private hands. Relatively recently, the 2010-11 Union Budget proposed an upward revision of tax slabs as well as a multitude of tax incentives and exemptions in order to revive consumer demand due to the economic slowdown. Evidently, policy or fiscal policy in specific is managed given the economic context of a region. Each introduction or modification of a policy is backed by the intention to bring about a certain change, based on some logic or normative evaluation that the legislating group believes to be fit. This desired 'change' needs to be discussed, debated and concluded upon using ideas of 'what ought to be', again, pertaining to the context of the socio-economic stage at that point in time.

Given the function of the state mentioned earlier, that of provision of public goods, redistribution of wealth and establishing social justice, we may understand the process of tax policy-making with regard to performing them. Musgrave (1999, p. 32) insists that a vital dimension of social coexistence is "… distributive justice and the balance of individual rights and obligations upon which a meaningful concept of liberty has to be built." The role of the State that this study will connect with the process of taxation is that of ensuring social justice through the redistribution/reallocation of wealth and income in the form of public goods and other services. In this context, as Piketty (2014, p. 493) rightly asserts, "Taxation is not a technical matter. It is preeminently a political and philosophical issue, perhaps the most important of all political issues." Therefore, the fundamental question becomes, *how ought the people of a society manage their surplus in order to reduce economic inequality?* Narrower questions of concern might be: Who should pay, and how much? What are the individual characteristics of a citizen that a state and its people would choose to base the answers to these questions? The various decisions or conclusions that may be taken with respect to these concerns are all certainly endorsed by normative claims that I will attempt to engage with in the following section.

Economic Development. In Jha R. (Ed.), *The First Ten K R Narayanan Orations: Essays by Eminent Persons on the Rapidly Transforming Indian Economy* (pp. 5-16). ANU Press.

## 2.3 The reality of inequality

The connect between social justice and redistribution lies in the fact that economic inequality (in the form of wealth and personal distribution of income) exists. *Why* exactly it is desirable to do away with inequality is outside the scope of this dissertation, but I will nevertheless briefly touch upon why citizens, and specifically policy makers, would be interested in prioritizing equality along with other basis of economic reasoning. The proposition of equality is relevant to the question of social justice in any society supported by a capitalistic economy. In such economies, the owners of the means of production have a disproportionate access to the produce of industry, in the form of rents and profits. In order to address controversies regarding whether the economic inequality prevalent in the economy is 'fair' and whether the rich truly deserve their wealth, owing to 'risk-taking, hard work and skill', I look to Marx's critique of capitalism.

Karl Marx (1867) reserves an part of *Capital* to the concept of “primitive accumulation” in *Capital* as one of the main concerns of classical political economy. Marx describes primitive accumulation as the mass of capital that exists in the hands of capitalists that is not obtained as a result of surplus/profit. The capitalist system of production exhibits a pattern for the producers: first, the manufacture of commodities earn a profit or surplus, which allows further capital accumulation followed by more production, which again results in a surplus or profit. This cycle could *not* have started without the possession of some initial capital in the hands of the producers. Marx draws a parallel between primitive accumulation and the theological notion of original sin – just as Adam's biting of the apple called sin upon the entire human race, the capitalists' control over the initial round of capital brought poverty upon majority of the population (workers). In this sense, Marx (1867, p. 508) states that primitive accumulation is “the historical process of divorcing the producer from the means of production,” since it totally separates the means of production from the workers who produce the output. According to him, workers experience continued hardships despite their labour, while capitalists' wealth increased even without having to spend a day of effort. In the Indian context, one may hypothesize that the historical social structure of the caste system has inherently provided certain sections of our society with much larger endowments than the rest. If one were to justify capital accumulation with the risk-taking and hard-working attributes of capitalists, they cannot extend the argument for the socio-economic injustice in the form of unequal initial endowments, engraved by the caste system into the Indian society. Given the above contention, one may still wish to ask, why ought the group of *homo-economicus*[6] and their government be concerned about this inequality?

Bowles (2016) argues that the widely held assumption of homo-economicus is both self-defeating as well as inaccurate. This same assumption, in circles of jurists and economists, that the average human is totally self-interested and void of any morals, is what drives the massive system of incentives in today's economies. Policy makers now introduce material incentives for worker effectiveness, environment-friendly consumption, etc. that could otherwise have been motivated by ethical or noneconomic reasons. Bowles states two reasons why it is not wise to assume a homo-economicus personality of people – one, that the assumption of "universal amoral selfishness" might be self-fulfilling as it is the presence of systems of material incentives (that are based on this assumption) that lead people to act in more self-interested manners than in their absence. Two, that material incentives are not the appropriate tool to control selfish behaviour since it might cause the "crowding out" of ethical motivations. It is entirely possible that a general civic-mindedness or desire to uphold social norms (such as equity) may be lost as a result the introduction of policies that are based on material incentives. This means that a person's intrinsic ethical considerations, or their eagerness to cooperate with fellow citizens may be eroded if selfish behaviour is in fact met with policies that induce more selfish behaviour. Using the above logic, Bowles suggests that decision makers should be encouraged to limit the role of economic incentives in public policy as well as increase the role of government or informal nonmarket organizations in the allocation of resources.

6 Or 'economic man' in Latin, referring to a person who tries to maximise utility as a consumer and profit as a producer, using rational evaluations to make decisions.

## 2.4 Criteria for distinct treatment in collection of taxes

Having introduced and established the rationale of state intervention in ensuring social justice by commenting on the role of the State as a third-party coordinator, 'primitive accumulation' and inequality, let us now explore the combined influence of the State and norms in introducing fiscal policies, particularly, the reasoning used to decide how much to tax whom. Various authors and economic thinkers, ranging from Adam Smith to Piketty, have offered their conclusions on this matter.

For example, Smith's first maxim of taxation states that rates of tax must be based on one's ability to contribute to the common costs of promoting collective interests of a society. If it is intuitive that an individual with a higher income is also better able to pay an amount of tax than someone with a lower income, there also exists numerous differences in opinion, often philosophical, regarding such a proposition. The economist Sismondi argued[7] for progressive taxation (a tax structure in which those with higher income are taxed at higher rates than those with lower income) claiming that since it is the state's job to prevent the poor from robbing from the rich, the rich are but only paying for this service. On the other hand, John Stuart Mill criticizes[8] such a tax design, insisting that it "... is to lay a tax on industry and economy : to impose a penalty on people for having worked harder and saved more than their neighbours". One could also argue for regressive taxes by stating that the state protects life and liberty which are equally valuable to the rich and poor. Justice or fairness, with regard to fiscal policy, can and must be adjusted as per the acknowledgment of contemporary political, economic and social conditions. Thereby, it is required that matters of taxation be justified using tools of ethics rather than economics alone.

### 2.4.1 The Ability to Pay principle

It is an accepted claim that equal treatment or political equality of its citizens by a

7 As quoted in Myrdal, G.. (1969). *The Political Element in the Development of Economic Theory*. New York : Simon and Schuster.

8 Also quoted in Myrdal, G.. (1969). p. 167. *The Political Element in the Development of Economic Theory*. New York : Simon and Schuster.

government is the principle feature of a democratic state; the Right to Equality is guaranteed to every Indian citizen, stated in Articles 14-18 of the Indian constitution. Such a norm can be followed through in fiscal matters, but there exists multiple perspectives behind a policy decision because, though equality may be sought by all, what it means to have a 'just' tax system has not been unanimously concluded upon. 'Equal treatment' could mean a lump-sum tax is paid by all and it could also imply a progressive rate of taxation where the rich pay a higher rate than other citizens. Two approaches to debate tax fairness are: (1) equal treatment and (2) the ability to pay. The equal treatment concept suggests that everybody should be taxed the same amount and so, that both the rich and poor should pay a “flat tax” which amounts to the same measure of payment. The ability to pay argument, as stated by (Scheve, K., & Stasavage, D. 2016. p. 5) considers that “a dollar in taxes for someone earning a million dollars a year represents less of a sacrifice than it does for someone earning a more average salary,” thereby implying that progressive taxation is the fair choice. However, since we have established that economic inequality exists and the state may use fiscal policy as a means through which they may redistribute this skewd dispersion of income, I will examine the ways in which debates with regard to taxing the rich have evolved.

Scheve and Stasavage (2016) present the beginning of such arguments that can be formally dated back to the 16th century where Francesco Guicciardini produced a text (*La Decima Scelata)* displaying both arguments for and against the city's government in 1500, introducing a progressive tax on land income known as *decima scalata.* His writings presented his arguments, “… the payment should be of a kind that one and the other are inconvenienced to the same degree.” (p. 27) He also claimed that not only did the rich need to spend more than the poor to maintain themselves but they also deserved the higher income that they received because they had earned it. The latter argument had already been furthered by another Florentine a century ago, Matteo Palmieri, pressing that those who advanced beyond others not only practiced their “craft or profession honestly and well,” (pg. 27) but also increased the common good and therefore their privilege should be preserved and encouraged owing to their being the most useful and worthy citizens of all.

The concept of 'luxury', what it meant and whether it held any significant value at all has also been discussed through the centuries developing along alongside the expansion of commerce. That these 'luxuries' should be particularly taxed found an ardent proponent in Jean-Jacques Rousseau in the 18th century – he proposed that items such as carriages, chandeliers and mirrors may be taxed squarely since they were not objects of necessity, that goods should accounted for in terms of how superfluous they were. Those opposing such an idea were found to follow the arguments of Palmieri who claimed that the ability to pay criteria did not address the source of the wealth/income of the rich, the same case was put forward by Jean-Francois de Saint Lambert in the 18th century who thought that the point was not whether luxury items were 'good or bad' but how it those items were generated. If luxuries were procured as a result of some initial advantage provided by the state then it is fair to remove such an advantage, otherwise it should be allowed to thrive. These are clear examples of ability to pay being used and denied as a criteria for a 'fair' system of taxation.

Later, the 19th century saw what we now refer to as the “marginal revolution”, lead by the works of economists such as Jevons, Menger and Walras. Theoretical frameworks, based on the measurement of marginal utility[9] and diminishing marginal utility[10], was employed to answer the question of what the rate of tax ought to be. Using this school of thought, a handful of ideas emerged, eventually leading to a shift of thought from considering equal sacrifice as a criteria for fairness to minimizing the total loss from taxation to the whole of society. Thus, assessment of “equal absolute sacrifice” or “equal proportional sacrifice” was left behind to pursue “equal marginal sacrifice”. As Edgeworth proposes, this essentially meant that the utility lost from the last dollar of taxation for each individual was identical, thereby maximizing aggregate social welfare, or the effect of distribution of income, resources or commodities influence the economic well-being of a society as a whole. Another important development was the increase in focus on the question of whether wealth had been initially generated unfairly in the first place: Walter Blum and Harry Kalven's 1952

9 A measurement of the gain in benefit from consuming an additional unit of a commodity.
10 A law which states that the utility gained from every additional unity of a commodity consumed will start diminishing, or, increase at a diminishing rate.

critique called “The Uneasy Case for Progressive Taxation” insisted that arguments for progressive taxation were 'intellectually weak' since there was no reference to whether the income/wealth was justly or unjustly earned, a condition they felt was important to make decisions regarding the possibility of progressive taxation. Scheve and Stasavage (2016, p. 32) write of another critique for the ability to pay doctrine, by Lionel Robbins in 1932: he argued that it was impossible to compare the utility functions of all citizens, thereby impossible to apply any equal sacrifice standard for taxation. In other words, the phenomenon of diminishing marginal utility for each individual alone is not sufficient to believe that the transfer of wealth from the rich to the poor will increase total utility[11].

Finally, the quest for equity in terms of fiscal policy, might also include questions regarding *what* of the rich ought to be taxed. Piketty (2014) suggests a tax on capital. His reasons are clearly presented in *Capital in the 21$^{st}$ Century:* to keep an eye on, or control in whatever little way, the levels of capital accumulation by the capitalists/super-wealthy, to stay clear from the path leading to an inegalitarian economy and to unmask the concentration of wealth to the public eye. Piketty suggests that the most appropriate tool to go about these motives would be to introduce a progressive tax on capital. Here, a tax on capital will include levies on the flow of income from capital, such as corporate income tax, as well as tax on the value of the stock of capital, such as estates and wealth. This device would accomplish democratic financial transparency (expose the true location/concentration of wealth that is otherwise not really known) as well as regulate capitalism and block the indefinite increase in inequality of wealth. The tax on capital will include all assets of the individual – real estate, financial, non financial, business assets, etc. and not just the income of that individual, which may only be a fraction of their fortune. Another justification to tax capital is that it would act as an incentive to encourage investors to seek the best possible return on capital stock, or sell assets (in order to reduce tax payments) so that better users of the wealth may invest better.

11 Total utility refers to the sum of all individuals' utilities.

## Chapter 3

# Enquiry through Economic Concepts

The study of Economics, in its various sub-fields makes conclusions, suggestions and predictions about society and the activities it undertakes for its sustenance. Classical economics, popular from the 18th century to the mid 19th century, explored the political economy and theorized the variability of value in terms of profit, rent and wages in the context of the rise of capitalism. Neoclassical economics, on the other hand with the help of a novel framework featured by perfect competition, with a focus on individual's preferences and endowments enquired upon prices and quantities of commodities and factors of production in a market. For the purpose of explaining social phenomena, while classical economics adopts the doctrine of methodological holism, attending to social institutions and existing power dynamics, neoclassical economics follows methodological individualism, fixating on individuals' preferences and actions.

This chapter will survey the various observations, ideas and theories concerning the effects of taxation; section 3.1 will briefly address the effects of taxation in a classical economics framework by studying the writings of four note-worthy scholars – Smith, Ricardo, Malthus and J.S. Mill. This will be followed by section 3.2, which attempts to enquire about the effects of taxation in the economy using neoclassical concepts. This section will also include an elaboration on the history and relevance of Pareto optimality as the popular measurement of efficiency, one of the desired characteristics of a tax system, as well as the concept of tax incidence and the challenge it poses to the State's political responsibility in introducing tax designs that are transparent, a second desired characteristic of a tax system.

### 3.1 Taxation in classical economics

Kurz and Salvadori (1998) illustrates on the many analyses of the effects of taxes by classical economists in the 18th and 19th centuries: Smith, in chapter 2 of book V in *Wealth of Nations,* writes extensively on taxation. Using his assumptions of natural price, natural rates of wages, profits and rents, he concludes the following: (1) Tax on raw produce decreases rent, leaving prices of raw produce, necessities and luxuries unaltered; (2) Taxes on necessities, wages, and profits reduce rent, raising the prices of necessities and luxuries; (3) A tax on luxuries increases their price, but keeps nominal rent and the price of necessities unchanged; and (4) A tax on rent reduces rent, maintaining the prices of raw produce, necessities and luxuries. Through these conclusions we arrive at the point that all taxes, except those on luxuries, reduce nominal rent. A further judgement made by Smith is that the 'main' taxpayers in a country are its landlords, since tax on luxuries (as opposed to on necessities and raw produce) increase the prices of luxuries which are largely purchased by these landlords. While Smith did not suggest what type of taxation to impose, we infer that he preferred taxes on luxuries, rather than on other commodities that would decrease rent, thereby interfering with the improvement of land.

Ricardo, in his *Principles of Political Economy and Taxation* concludes that taxes on raw produce, necessities, wages and (direct tax on) profit, will reduce the rate of profit and increase the price of these commodities, as opposed to the tax falling on rent, as per Smith's theory (this is because rent is not included in the cost and price calculation of raw produce). Since profit was known to be the main source of capital accumulation, he was against any tax that meddled with or reduced these profits. We understand that Smith was of the opinion that taxation would transfer private consumption into public consumption, while Ricardo was in opposition of high taxes because he believed that it was private savings that would be transferred to public consumption.

Malthus did not elaborate on his ideas about taxation, halted by two contradictions – one, the inability of owners of marginal land to pay taxes due to the law of diminishing returns which disallowed the owner to receive rents. Malthus would either have to develop a theory of rent such that marginal land received positive rent, or, dismiss Smith's conclusion that taxes on raw produce ultimately fell on rent. Second, Malthus, as a rival of the Poor Law, also claimed that minimal taxes were more preferable but he also felt that unproductive consumption from taxes acted as incentive for production, or in other words, he acknowledged the demand creating effect of taxes.

Lastly, J.S.Mill also commented on the issue of taxation in his *Principles of Political Economy*. Mill's observations on taxes was in the context of a more dynamic process by which the economy moves towards a 'stationary state'[12]. Prescribing to Ricardo's opinion that taxes on raw produce or profit ate up rates of profit, Mill additionally believed that taxes would also fall on rent and wages, suggesting that Ricardo's analysis was only applicable to the stationary state.

### 3.2 Taxation in neoclassical economics

Neoclassical microeconomic theory, developed in the 19th century, offered a paradigm shift in studying the economy. Using concepts such as budget constraints and utility, the theory captures the interactions between individual decision makers such as the consumer and firm. It also relies on assumptions such as rationality and perfect competition to present profit or utility maximizing decisions/outcomes in a free market. Through the above mentioned components, it also offers ways of evaluating what the “efficient” allocations of resources may be, a topic we will ponder on later in this chapter. Another characteristic of neoclassical theory is the extensive use of quantitative methods of enquiry or prediction. Policy makers, therefore, rely not only on normative evaluations but largely borrow from microeconomic theory to ensure desired results. Similarly in the context of taxation, there will be some criteria, which borrows the microeconomic theoretical framework to determine what a favourable tax system would be like; two important criteria that evaluates whether a tax system is favourable are: that it imposes minimal interference in the 'efficient' allocation of resources and that it satisfies political transparency, that is, any individual must know how much tax they are paying and whether the current system satisfies their preferences. Both these criteria will be elaborated in length in the coming sections 3.2.1 and 3.2.2.

12 Stationary state here refers to a situation of economic stagnation where the economy will have reached the limits of economic growth and reproduce wealth by “replacing worn- out goods, maintaining capital stocks, and carefully husbanding nonrenewable resources”, as sourced from Buckley M. (2011) John Stuart Mill and the Idea of a Stationary State Economy. In: Dierksmeier C., Amann W., von Kimakowitz E., Spitzeck H., Pirson M. (eds) Humanistic Ethics in the Age of Globality. Humanism in Business Series. Palgrave Macmillan, London

### 3.2.1 Effects of taxation

Given the desirable characteristics mentioned above, one may want to begin observing the consequences of taxation, or a system of taxation in particular. It is important to note that the neoclassical perspective assumes a perfectly competitive market for the purpose of its theorizing. This perfect competition is characterized by: perfect knowledge and flow of information, rational consumers and producers who make rational decisions in order to maximize their utility and are also too many in number to individually influence market prices. In such a market, taxation enters the picture as an interference that has numerous impacts on the operations of this perfectly competitive market. Stiglitz and Rosengard (2015) elaborate on this efficient allocation of resources – in a free market without the imposition of taxes, market prices would express information about the product that would lead to production, exchange and product mix efficiency[13]. Once that product is taxed, it alters relative prices leading to inefficiency. Efficiency, here, implies that the marginal benefit attained by producing one more unit of any commodity should equal its marginal cost. If the marginal benefit exceeds the marginal cost, society would gain more from producing more of the good; if the marginal benefit was less than the marginal cost, society would gain from reducing production of the good. In other words, the market is equilibrium when market demand equals market supply, where marginal benefit is equivalent to marginal costprice. Thus, conditions for efficiency are defeated if taxes modify relative prices as it will no longer reflect and signal for efficient levels of production and exchange of commodities.

This inefficient allocation of resources may occur due to various effects of taxation on the interlinked activities of an economy. Stiglitz and Rosengard (2015) present some of these effects in *Economics of the Public* Sector. A popularly debated upon consequence of taxes is that it might also discourage people to work as well as distort

13 Production, exchange and product mix efficiency are basic conditions for pareto efficiency. Production efficiency is the point at which the marginal rate of technical substitution between any two inputs is equal; exchange efficiency is the point at which the marginal rate of substitution between any two commodities is equal for all individuals; and product mix efficiency is the point at which the marginal rate of transformation is equal to the marginal rate of substitution. Perfectly competitive markets satisfy all four conditions. (Stiglitz & Rosengard, 2015. pg. 78)

decisions (as opposed to the 'pure' rational decisions that a economic agent may otherwise have resorted to) relating to consumption and production. Some peculiar examples for this claim is the window tax that was introduced in Britain in the 1600s, inducing the construction of many windowless homes in those times. Taxes may also result in some far-reaching behavioural changes. The decision-making processes of individuals affected by different types of taxes are plentiful: the levels and forms of investments, that is, what portion of national savings are allocated to housing and equipment, etc., the rate at which natural resources may be extracted – either at a judicious or unsustainable rate and risk-taking. Through such allocations, taxes may affect macro variables in an economy such as consumption, savings and levels of work.

Another effect of taxation pointed out by Stiglitz and Rosengard (2015) are financial in nature. This is not only in terms of amount spent/saved but also its 'form'. For example, there is no practical difference in whether an employer provides their employee the income to purchase health insurance or purchases it for them (in the form of “benefits) instead, other than that the former transaction will be taxed and the latter will not. In the same manner, saving directly for one's retirement or having one's employer take part of your income to invest in a fully funded pension plan has no practical difference, except for the tax implications. Such differences in the form of transactions has a direct influence on one's behaviour, for instance, investment or consumption might be different in individuals under the different conditions mentioned above. It is possible that some individuals may be “forced” to save through their pension plan more than they would have voluntarily done otherwise.

A third important implication of taxes in the market is organizational in nature. Whether the current system of taxes favours corporations or companies can encourage or discourage economic activity of that form, thereby influencing the degree and nature of risk taking in the economy. Different tax systems can also impact the choice of financial institutions or arrangement (banks as opposed to stock or bond markets) which again, decide the organization of the credit or finance in the economy. A gender economist would identify that taxes also alter the consumption patterns within households. For example, some taxes may encourage “inside firm consumption” (similar to what was mentioned regarding the forms of financial transactions), and only tax the payments from firms to household (income). This implies that employees (largely men, owing to prevalent occupational segregation) will be discriminated in favour of, as opposed to their partners who worked within home (largely women).

Finally, a more indirect effect of taxation is that on announcements and capitalization – if the future details of a tax on a particular asset is announced, there is an immediate impact on its current value. For example, say, taxes on housing is about to be increased, the price of this category may experience a fall – subjecting the current owners of these assets to bear the major burden of the tax. It is also possible that the very anticipation of taxes, and not even its announcement, can affect the value of assets.

### 3.2.2 Efficiency: a critical examination

Given the above mentioned effects of taxation on the efficient allocation of resources in an economy, it is also true that efficiency is a major consideration in the process of fiscal policy deliberation. Through the neoclassical lens, no matter the manner in which an individual or firm responds to a tax, the collection of a fraction of their assets (in whatever form) will make that party worse off. Taking the simple case of a tax on a commodity, borne fully by a consumer, an individual will be able to purchase less of the commodity that is being taxed, owing to their budget constraint. This decrease in consumption of the taxed commodity could be due to two reasons: the income effect, because the tax has made the individual worse off, and also the substitution effect, the tax has made the commodity relatively more expensive than others, encouraging consumers to purchase other products instead. Essentially, taxes are a transfer of purchasing power from an individual to the State and for the reasons mentioned above, create distortions that are considered to be a loss of efficiency. This loss is measured in the form of a concept called 'deadweight loss', which is the extra loss in welfare or output as a result of a distortion to the equilibrium between the supply and demand for a commodity. In other words, it is the sum of both consumer and producer surplus that is lost when, say, the quantity supply of a particular commodity has decreased due to the increase in cost of production that a tax on that commodity may impose.

For example, an extra loss in welfare can be measured in the comparison of the effect of a tax on a single commodity with that of a lumpsum tax. This comparison is essentially an evaluation – for the same impact on an individual's welfare, how much extra revenue would a lumpsum tax have raised instead, or, how much less revenue a tax on a single commodity is able to raise. The difference in revenue will be a measure of the deadweight loss of the tax. Another example that is often used in the battle against progressive taxes is that the more progressive a tax, the larger the deadweight loss or inefficiencies that arise from it. Progressivity implies that the average tax ratio (or the ratio of total tax payments to the individual's income) increases with income; this means that the more progressive a tax, higher the marginal rate, thereby leading to a larger deadweight loss. This directly suggests a tradeoff between efficiency and equity (since we have already concluded in chapter 2 that progressive taxes are more equitable).

Following the exploration of various concepts and matters that may be of concern to policy makers, it is important that we further critically evaluate the concept that is given the lion's share of attention – the high and mighty “efficiency”. Theoretically, given the perfectly competitive market whose features we have discussed in section 2.2.1, the economy in this state is said to be efficient, in that it allows the production, distribution and consumption of commodities by the allocation of resources with the help of prices. Such an ideal situation would thus have no need for any intervention. While justifications *for* government intervention, such as market failure, will be elaborated on in chapter 4, here I will attempt to define what an efficient market has been theorized to be, or what the popular notion of economic efficiency is.

One of the earliest and most popular concepts about the free market is 'the invisible hand' as in Adam Smith's *Wealth of Nations,* in 1776. Stiglitz and Rosengard (2015) contrasts the notion of the invisible hand with the belief that was previously carried, that fulfilling the best interests of the public required government action or participation (the mercantilist view of 17$^{th}$ and 18$^{th}$ centuries that government should promote industry and trade). At this time, some countries greatly benefited from government action while others prospered even without. However, some did not flourish; on the contrary had had their resources squandered in the name of wars or unsuccessful public ventures. In such a situation, when leaders or government may not always be trusted with the fulfillment of public interest, Smith spoke of how the public interest could be served if individuals acted upon their self-interest, since such a characteristic of human nature was much more persistent than “a concern to do good” (p. 62), thus providing a reliable basis for the organization of society/economy. It is also easier for an individual to determine what is in their own self interest than to decide for the public's interest.

Further, the competition between firms for profits (where a consumer's value for an item is higher than the cost of producing it) leads to two beneficial outcomes in public interest – efficient ways of production (those adopting inefficient methods will exit the market once they incur losses) and new commodities (if individuals are willing to pay more than the cost of production). There seems to be no need of government government intervention in such a situation. This is the underlying basis for the popular consensus (among economists and otherwise) that competitive markets in the absence of State intervention lead to higher levels of efficiency and encourages innovation. In the context of taxation, efficiency loss due to a tax is “the excess of the reduction in the consumer's welfare above and beyond that which can be accounted for by the income loss due to payment of the tax” (Bagchi, 2005, p. 180) Thus, this efficiency loss is referred to as the excess burden of the tax, as it arises from the tax induced distortion only, when comparing taxed and non taxed commodities.

Free markets, in this way, are celebrated for their efficiency. However, contemporary policy makers and economists, in an attempt to recommend the optimal 'mix' of government intervention and market mechanisms to run the economy, begin the quest for Pareto optimality. A Pareto optimal or efficient allocation of resources is one which, when adopted, does not have an alternative allocation by one can be made better off without making someone else worse off. Policy makers find themselves opting for policies with the belief that any Pareto improvements (changes that make some better off without making anyone else worse off) should be instituted. The field of Welfare

Economics, one that is motivated by normative issues of ensuring the welfare of all members of society, borrows and makes heavy use of the Pareto principle. The first fundamental theorem of the same, as a description of the relations between competitive markets and Pareto efficiency state that: any competitive equilibrium leads to a Pareto optimal allocation of resources, or in other words, a social optimum; this theorem directly acts as a strong justification for the reliability of market mechanisms.

Pareto optimality is therefore widely used and trusted amongst economists and policy makers. Berthonnet (2016) reviews the journey from Vilfredo Pareto himself in the 19th century to its use and relevance in contemporary economics. With regard to explaining social phenomena, Pareto thought that the socioeconomic truth needed both economics and sociology and described a specific method: first pure economics as a first basis of the analysis for an abstract level of explanation, followed by sociology which included both pure and applied economics. According to him, pure economics studied logical actions and sociology, non-logical actions; they differed in the object of study and not necessarily their methodology of empirical observations. Pure economics as defined by Pareto, was an evaluation of the means to reach some goal. Berthonnet considers this a narrow definition in that it limits the role of economics to study the means alone, leaving the concern of what the goal may be outside its scope. In her paper, she quotes Raymond Aron, “Isn’t it a result of the definition provided for logical actions that the choice of goals cannot be logical?” (p. 168) Thus, the goals for a society becomes necessarily decided outside the study of economics. Due to such a description, the economics that Pareto thought himself to be an author of was a purely positive science, based on empirical observations, void of any value or political judgements. In this context, the “maximum of ophelimity” introduced by Pareto as:

> The maximum of ophelimity is defined as follows: We will say that the members of a community enjoy, in a certain position, the maximum of ophelimity, when it is impossible to slightly move away from this position, so that the ophelimity of each individual of this community rises or goes down. This is to say that every little move from this position has the necessary effect of rising some individuals’

> ophelimity, and of diminishing that of others: to be pleasant to some, unpleasant to others.
>
> Pareto, 1963; as quoted by Berthonnet, 2015: 169

This position is purely scientific, according to Pareto, and names it the "P-point", an objective feature of a particular type of market equilibrium, without any normative suggestion. While Pareto claims this position to be purely scientific, a sharp definition with no relation to social utility, it inherently expresses a desirable state, hinting at some normative judgement. This contradicts the method and scope of pure economics that he had initially set.

Such a "hesitation" (as Berthonnet calls it) between pure and normative economics left Pareto's ophelimity up for grabs by economists in 20th century normative welfare economics, as Pareto 'optimality', later also increasingly replaced as Pareto 'efficiency'. The use of Pareto's ophemility as an evaluation for social justice, given Pareto's attitude towards ethics and justice (he claimed that such considerations were unscientific) is contradictory. Quoting Berthonnet's words:

> Therefore, the first economic theories that have built upon the Paretian maximum of ophelimity belonged to a field of research which had nothing to do with the original methodological framework in which it was introduced… Pareto's proposition has lost the status of descriptive characteristic of competitive equilibrium that he had attributed to it, and has become a minimal desired norm.
>
> Berthonnet, 2016: 173

In any case, another obvious inadequacy that we may identify in this Pareto approach, particularly since it is extensively referred to in policy making (in the context of the discussions in the previous chapter) is that it is very individualistic. In other words, it is not concerned with relative inequality: making a rich person better off without changing anything for a poor person would still be considered Pareto efficient. For example, when developing countries undergo rapid growth of their economies, income on an average may rise but rises much more rapidly for the richer section of society than the poor, which Pareto efficiency does not acknowledge.

### 3.2.3 Tax burden and tax incidence

The imposition of a tax in an economy inevitably has some effect on an individual's disposable income. A tax burden can be defined as the true economic weight of a tax, or, "the difference between the individual's real income before and after the tax has been imposed, taking full account of how wages and prices may have adjusted." (Stiglitz and Rosengard, 2015)

The identification of two broad *types* of taxes will help us to further scrutinize the effects of a taxation on the welfare of individuals – distortionary and non-distortionary forms of taxes. Stiglitz and Rosengard (2015) state that non distortionary does not imply that the individual will not react to the change, but that "there is nothing an individual or firm can do to alter the tax liability." (p. 516) These can also be referred to as "lump-sum taxes" (for example, a head tax, which one has to pay regardless of income or wealth). Individuals and firms cannot avoid them, and so, they do not lead to changes in behaviour or the reallocation of resources, other than the income effect of after-tax income. In contrast, distortions occur when an individual/firm can and attempts to lower their tax liability. In the case of taxes on commodities, by simply purchasing less of that commodity. Tax on income can also be distortionary because an individual can reduce her tax liability by working less.

Thus, the possibility of distortion due to the shifting of burden poses a challenge to the political responsibility of transparency that policy makers bear – the proposed tax system must be one that is aware and makes public of who *really* bears the "burden" of the tax. If a state legislature is in the process of passing some tax policy, there is discussion regarding whom they want to levy the said tax on, on the basis of some economic or normative rationale (as we have discussed in chapter 2). The nature of distortionary taxes, thus, also calls for a distinction between whom a tax is imposed on and who finally 'pays it'. A measure of the *actual* incidence of tax from the *intended* incidence of tax is known as 'tax incidence': for example, as a result of some tax imposed on firms, wages might fall or prices might rise. If the wages fall, it means that the tax has “shifted backward” to a factor of production (labour) and if prices rise, it means that the tax has “shifted forward” to the consumers. This shift can be measured in terms of the amount of the tax that has been relocated (as part of the wage/price) – if the wage or price has increased or decreased by the full amount of tax levied, we can say that it has fully shifted and if by less than the amount, we say that it has partially shifted.

For example, in the US case of Social Security tax having (by law) levied half from the employer and half from the worker, it could be that that the employer-paid part of the Social Security tax is shifted backward and that the employees bear the full burden of the tax that is actually imposed on the employers, in the form of lower wages.

The discussion around the incidence of corporate tax is inconclusive: while part of the burden of corporate tax is on capital as a whole, the intended target of the tax, it may be that a large portion of the tax is shifted to and borne by consumers if the firms raise their prices as a consequence of being taxed. Similarly, if wages fall due to the fall of demand of labour, the workers bear the tax.

Studying the incidence of tax is both a very important and difficult field of public sector economics[14] since it may suggest what is fair and unfair; it also almost never easy to accurately work out who finally carries its burden. Given the desirable characteristic of transparency, a tax policy should be both, one with a clear indication of the nature of incidence as well as one that “makes the apparent incidence of a tax correspond to the actual incidence” (Stiglitz and Rosengard, 2015. p. 539).

The incidence of tax depends on many factors – on whether the economy is perfectly competitive, and if it is, on the shapes of the demand and supply curves (the elasticities of demand and supply). In the case of a tax on firms, firms produce or supply their goods when their marginal cost is equal to their marginal revenue, or, when their marginal cost is equal to the price of their products. Thus, a tax on the production of

14 A field of economics that is concerned with the effects of government intervention of markets in the form of government revenue, expenditure and investment decisions.

the commodity will have some effect on the firm's production decision as this tax is an addition to its cost of production. As a result, the amount that the firm is willing to supply for the current price will be less, post tax. This also implies that post-tax, the price at which the the market (addition of supply of all firms producing that commodity) is willing to supply a certain level of output has increased. This shift in market supply can be determined almost directly from the amount of tax that has been imposed on the production of that commodity. In this manner, though the tax was “nominally” imposed on producers, consumers end up being forced to pay part (or whole) of the increased cost, thereby distorting the current market equilibrium to produce a new market equilibrium. In such a scenario it does not matter whether the tax is levied on consumers or on producers: if the same tax that had been previously levied on producers is now imposed on consumers, they would still pay the old price plus the tax and the producer would still receive the same revenue as they would not need to pay direct attention to the tax that the consumer is paying to the government, since they only care about what they receive.

However, the amount by which the prices rise, or the extent to which consumers bear a tax will depend on the shape of the demand and supply curves, or their price elasticities (measure of response to changes in price). It is important to note that price elasticity is determined by characteristics of the commodity – whether they are necessary goods such as medicines, which have very low elasticity because no matter the change in prices, consumers will continue to purchase the items; or whether they are luxury goods such as a TV, which have high elasticity since consumers decision to purchase is no longer based on necessity and so is highly dependant on the price of the commodity. If the demand is perfectly inelastic, or supply is perfectly elastic, the entire burden of tax is bourne by the consumers. On the other hand, if the demand curve is perfectly horizontal or supply curve is perfectly vertical (in a graphical presentation), prices paid by the consumers do not rise at all and the producers bear the complete burden instead. Generally, the steepness can determine whether the tax will be borne more by the consumer or the producer (steeper demand, flatter supply, borne by consumer and vice versa).

### 3.2.4 Further considerations for tax design

We have explored in detail regarding the two desirable characteristics of a tax system – that it will have minimal influence on the efficient allocation of resources in an economy (Pareto efficiency) and that the structure and incidence of the taxes is transparent and known to everyone. We can now briefly review what frameworks a government may adopt in the process of choosing one tax policy/design over another. Again, keeping in mind the State's role in ensuring some contemporary idea of social justice, we know that it may opt to test a tax system for both its efficiency *and* equity potential. Both yardsticks are just as important as each other in the larger picture of socioeconomic coexistence – efficiency ensures that we coordinate activities in such a way that a society's resources usefully and equity ensure that a tax structure is not regressive in nature. The very process of decision making is outside the scope of this paper, however, we can speculate (in the absence of both technical and political detail) that the respective policy makers may want to choose, among the available Pareto efficient tax structures, one that represents its normative attitude towards the welfare of all, but different, individuals in a society. This step can be made possibly by choosing a social welfare function, that will "... separate efficiency considerations from value judgements." (Stiglitz and Rosengard, 2015. p. 532)

Two such social welfare functions used by economists, as presented by Stiglitz and Rosengard (2015) are the utilitarian and Rawlsian approaches. In the utilitarian approach social welfare equals "the sum of all individuals' utilities" (p. 533); in the Rawlsian approach, social welfare equals "the utility of the worst-off individual" (p. 534) . Both functions can be used to determine by how much taxes should increase with income, consumption or other bases that are used for taxation. With the utilitarian approach, a tax design will be chosen to match the principle that the marginal utility of income, or the loss in utility from taking a rupee away from an individual, must be the same for all individuals. In this manner, utilitarianism is found to provide a rationale for progressive taxation, or, the taxation of rich individuals at higher rates than poor individuals, using the assumption that the poor have higher marginal utility of income than the rich, thus causing them more loss of welfare than the rich when same amounts of tax is collected from both individuals. However, this rationale does not take into consideration that if an individual's income depends on their work or effort, raising taxes on higher earning individuals may very well discourage this effort and reduce their work. An implication of this consideration is that “… raising the tax rate actually reduces the government's tax revenue, or that the marginal utility loss to the individual per dollar raised by the government may be very large.” (Stiglitz and Rosengard, 2015. p. 533)

Such an idea describes the famous Laffer curve, a graphical presentation showing the decrease in tax revenue with the increase in tax rates beyond some threshold. Many arguments particularly note that this may not be applicable to poor because when their taxe are increased they need to work harder to meet basic needs. Lower tax rate means more money collected, and so high tax rate is pareto inefficient. Utilitarianism also implies horizontal equity – if everyone with similar utility functions also had the same income, they should be taxed the same. Speaking in utility terms, if an individual A was taxed at a higher rate than another B, both of whom have the same income, A's marginal utility for income would be higher. Raising a tax on B would cause them less loss in utility than the gain in utility that would be caused by lowering the tax on A (But this argument only holds if income is believed to be unaffected). However, it is important to note that the concept of utility or individual utility functions cannot be easily determinable in reality, as this measure is subjective to every individual.

Given that some philosophers and economists believe that the utilitarian approach may not necessarily be equality or equity ensuring, there is a second social welfare function that subscribes to the work of John Rawls. This approach states that society should be concerned with the welfare of the worst off individual and ought to design economic or social policies so that the welfare of this individual is maximised. The direct implication for tax policies would be to increase tax rates on everyone excluding the worst off individual until tax revenues are maximised. (But this does not necessarily mean that the richest individuals be taxed at the highest rates or progressivity in the tax rates). There are still, criticisms that even the Rawlsian approach may not be egalitarian – if a policy change makes the worst off individual slightly better off, while making the richest section of the population much better off, this cannot be called equitable and yet is desirable under the Rawlsian framework.

Thus, given the two social welfare options (out of many), it is evident that even with a neoclassical analysis of the consequences or technicalities of taxation, there are still normative requirements from the part of policy makers to choose whether they ought to introduce policies that are beneficial to everybody, or give those who are the least economically well off.

# Chapter 4
# Views on Public Finance

Every State in the world has adopted some form of administration of economic policy, regulations, provision of public goods and/or other coordinative activities. However, it is not the case that all government opt for similar approaches or projects concerning economic intervention; on the contrary, the distinction(s) between countries and their public sector is vast on numerous accounts. A difference one may easily observe is that of the scale of size of the public sector. This variable alone determines many economic and social features of a society, thereby calling for different perspectives and opinions regarding its value by economists, policy makers as well as the public. The following chapter attempts to present the various arguments for and against greater extents of government intervention, or the size of the public sector in a nation. Following a brief introduction and description of the role of the State in terms of public finance, I will elaborate on some arguments for public finance, including the importance of public goods as well as philosophical ideas by authors such as Piketty , Bagchi and Musgrave. This will be followed some arguments against a generous approach to public finance, such as economic destabilization and government failure. Finally, the equity vs. efficiency debate will be commented on, using the content of the previous two chapters.

## 4.1 Public finance and the role of the state

According to Bagchi (2005), the terrain of public finance strives to settle "… the finances of the government, how much of a country's resources the government should acquire for its own use, how and what makes for their efficient spending…" (p. 1) According to him, two areas of concern in public finance are: (1) The raising of funds for the working of the public sector through taxes or borrowing – its implication for the equity in and efficiency of the economy. (2) The decision of what the appropriate roles and size of the public sector should be. Of the two areas, we have already covered the first by enquiring into multiple normative analyses and Pareto considerations that assists policy makers in the choice of tax systems. The second area of interest first requires an introduction to what consists of the public sector are as well as the measurement of its 'size'.

The public sector is that part of the economy which comprises of State owned enterprises that provide public goods and services, such as transportation, education and health facilities, among the many. This includes industries that are funded by the revenue collected through taxation, user-charges from public services offered by government operations as well as fines and concessions. Some of the key differences of the public sector from the private sector, apart from the capital/resources that are collected and utilized to fund its administration is that it is fundamentally not driven by profit. It is also the case that the public sector produces and maintains many essential commodities that are non-excludable and non-rivalrous[15]. Non-excludable implies that the consumption of a public good cannot be exclusive to taxpayers alone. The most quoted example is that of defence. The performance of defense personnel benefits all within the borders of a nation, regardless of whether they are members of the income tax bracket or not. Non-rivalrous indicates that the consumption of the public good by person B is not reduced by its consumption by person A. That public goods are not profit-driven, combined with its features of non-excludable and non-rivalrous indicate its importance in the economy and its expression of the role of the State in "… ensuring social justice through the redistribution/reallocation of wealth or income in the form of public goods and other services" as mentioned in chapter 2. The relevance of public goods will be further elaborated in section 4.2.

The 'size' of the public sector refers to the proportion of the entire economy that it composes of, relative to the private sector. This 'size' can be measured in different ways: one way, as proposed by Piketty (2014) is to measure the total amount of tax relative to the national income. If we were to take a global look at this evaluation, an increase in this proportion will be observed; total tax revenues were less than 10

15 There are various commodities produced by the public sector that are both rivalrous (such as a road, which if fully congested excludes other individuals from using it) and excludable (such as airlines, which as a function of its prices may exclude those who do not/cannot pay its price). However, for the purpose of this study, we think of public goods in its modified sense – merit goods – that may be non-excludable, but not necessarily non-rivalrous, such as education and health facilities, both of which may be exhausted when used at point above its carrying capacity.

percent of national income in rich countries until 1900– 1910; they make up between 30% and 55% of national income in 2000– 2010. A stabilization of tax revenue observed between 1980-2000, with not much scope for an increment. A similar method, as mentioned by Bagchi (2005) is to measure the proportion of government expenditure to the GDP. The average measure for 'advanced' countries was not more than 10% during early 1900s and only 18% even at the time of World War 2 and but increased to 40% by 1980s. The Indian figure was about 9% at the time of independence and doubled during the 70s and reached 25% in 80s. According to Bagchi, such an increase raised questions about whether it was sustainable since such a trend was observed even when revenue receipts failed to grow proportionately, resulting in a large government budget deficit. Thus, the size of the public sector becomes of economic concern, due to purely financial matters as well as a social interest owing to the role the public sector plays.

Some questions that arise from such matters are: what would be the most optimal allocation of resources between the public and private sectors to serve best the welfare of the society? Since public goods are provided outside of the free market that would otherwise have had to signal, through prices (thus leading to an absence of incentive for consumers to reveal their preferences, or the "free-rider problem[16]), how does a government or society decide upon the amount of goods to be provided by the public sector? This implies that the expenditure of the State (to provide public goods) as well as the tax to be collected must be jointly settled. These questions, as well as that of an optimal tax rate/system were systematically addressed with the coming of the 'marginal analysis' towards the end of the 19$^{th}$ century through the matching of consumer preferences and the cost of production of particular goods. Even a more precise formulation for optimal government expenditure by Samuelson in his 'Pure Theory of Public Expenditure' in 1954, followed by the entry of 'Pareto optimality', still could not take into account the problem of unrevealed consumer preferences. For this, Wicksell introduced an approach (which was to become the start of the theory of social choice) which perceived the process of voting as a dummy for the bidding that takes

16 The free-rider problem is a phrase used to describe when an individual is able to take advantage of using a common/public good without having to pay for it. In the case of public goods, individuals that do not pay taxes are able to 'free-ride' by using public provisions such as national highways or defence without paying for its maintenance.

place in the free market. In this model, subsequent rounds of voting ensure that members of society 'reveal' their tax and expenditure preferences by voting for the 'package' (political party or delegate that represents it). Later, Samuelson also proposed an approach by introducing a 'referee' who would know the preferences of consumers and thereby able to meet efficiency requirements. The similarity between the last two approaches mentioned above is that it tends to individual self-interests and the choices that are expressed thereof. Both mechanisms merely combine all the declared choices to provide way for decision making. The fundamental unit remains to be the individual and their choice.

A contrasting approach that is briefly discussed by Bagchi (2005) is imperative to this dissertation and its underlying rhetoric: the Communitarian tradition of German origin. This tradition is characterized by its focus on community and a notion of a collective concern, as opposed to one that is individual preference oriented. A perception of society as an organic whole with shared and unified goal allows one to make a judgement on the provision and need of public goods from an entirely distinct view point. Examples of such a consciousness is, for example, the wish for clean and hygienic neighbourhoods in general, or the upkeep of a national monument – both of which are not directly needed by an individual alone but rather, a concern of the society as a whole. Musgrave (1999) offers a similar insight to the question of individual choice, “The state, as a cooperative venture among individuals, must reflect their interests and concerns. Its foundation in that basic sense has to be individualistic. At the same time, individuals do not live in isolation but are members of a group and thereby have common concerns. Social choices, though individually based are conditioned by group association” (p. 32). This implies that provision of public services will require some level of politics in order to determine policy.

Bagchi thus concludes that there exists a concept of group choice that arises in a democracy as a result of voting and consensus; similar to Marx's ideas of group interests arising in social interaction (focusing on the capital-labour dichotomy) and Schumpeter's ideas of social development as a result of changes in social structure, fiscal economic decisions cannot be viewed in the absence of an acknowledgment of social structure, and solely as individuals attempting to maximise their self interest in a market. Membership of an individual in a group/community is valued even though individuals are basically the acting agents. “Self interest is not all that matters, nor can the good society be based on it alone. Liberty, as I see it, is not to be defined as absence of restraint and self-centered interest only. Rather, a meaningful concept of liberty calls for limitations imposed by mutual concern for others.” (pg. 32)

**4.2 Why public finance?**

Given the presence of the individualistic and communitarian traditions, Bagchi (2005) states, “A bridge between the two approaches is sought to be provided by Richard Musgrave… with the idea of 'merit goods'.” (p.7) Such goods are characterized in a way that they are not non-rival (and so share a feature of private goods) but for many reasons whose demand by society is not fully met through the market. The reality of such a type of goods, according to Musgrave, grants the rationale for the redistributive function of the State. The reasons for which a society will depend on its government for the provision of public (or merit) goods are many. The role of redistribution through public goods is necessary and required to satisfy a society's notion of economic justice because *Laissez-faire,* or free market operations rid of government interventions does not always ensure efficient or Pareto optimal outcomes. Six of such instances, as listed by Stiglitz and Rosengard (2015) are: the absence of the prerequisite of perfect competition in realistic economies, does not allow for the satisfaction first theorem of welfare economies, that free market economies produce Pareto optimal outcomes. This directly implies non-Pareto optimal results. A second matter that does the same is the appearance of 'externalities'. The imposition of costs by one firm on another, or other members of the society beyond or without scope for compensation poses as an obstruction to the efficient allocation of resources because individuals that do not bear the full cost of the negative externalities they have created will continue to be occupied in those activities, thereby still causing costs to others. Similarly, incomplete markets and information failures, two common features of the market in reality, also lead to Pareto inefficient results. The macroeconomic phenomena such as unemployment, inflation and conditions of disequilibrium, featured by recessions or depressions often require government intervention to help the economy get back on its feet. Finally, the sixth instance in which the government intervenes is that of public goods. As we have already discussed, these are the goods that enjoy the features of being non excludable and non rivalrous, produced by the State due to its unmet demand in the market. The characteristics mentioned above hint that the free market is not as ideal as it is cheered out to be. Such an acknowledgement provides rationale for government regulations and other interventions in the economy.

Moreover, the government may also enforce its powers to organize functions of the market through laws of contract and right to property. The construction and increase in size of the social State, through increased tax shares, may provide the government with the opportunity to undertake broader social functions that what is conventional (defense and infrastructure), such as old age security, higher education and housing insurance. One would also see the possibility of a kind of modern redistribution of wealth, as framed by Piketty (2014), which in place of explicitly reallocating income from the rich to poor, arranges public services or goods that should ideally (according to the logic of justice we explored in chapter 2 be equally accessible to all citizens. Furthermore, the State may operate as an institution to direct action to meet collective wants in the absence of cooperative effort from the part of individual. Since there is no incentive for preference revelation, individuals take up the dominant self-interest strategy and fail to cooperate in that their actions will be in favour of their own interest, rather than an explicit effort for the good of society as a whole.[17]

Thus, given the various considerations of State intervention in the form of provision of public goods or coordinating economic production, the choice of size of the public sector is dependant on one's outlook on the extent of impact of these roles in the lives of the people the State governs.

### 4.3 Against public finance

If we have so far attended to the arguments in support of public finance and its

17 One cannot generalize this claim, as there are numerous examples, in the form of social experiments (such as Fehr and Gächter (2002) and Bowles and Gintis (2002)) that show that cooperation can be expected when faced with common resources and a possibility of punishment.

growth, there are just as many opposing arguments to it. One such claim is that excessive government expenditure will prove to be damaging to its own functioning, elaborated in *The Elgar Companion to Classical Economics* by Kurz and Salvadori (1998). Since any mode of government expenditure is funded through taxes (and borrowing), a rise in expenditure will require and push for the expansion and increase in taxes. Such a development is believed to both destroy the finances of producers as well as discourage productivity of businesses, since firms that are increasingly taxed on their production and revenue will bottle their operations.

The sequence of "destruction" (pg 345) had been observed as early as 1377 by the Arab historian Ibn Khaldun. In his *The Muqaddimah: An Introduction to History,* Ibn Khaldun goes on to elaborate his observations regarding the shrinking tax base. First, the proposition that government expenditure has a tendency to grow faster than the tax base and no benefit to the tax base is put forward. To match this expenditure, the State will need to levy increased taxes on commerce. This will have a negative impact on the incentive to produce, or decline in business effort, which consequently results in the slump of commercial or taxable activity. To escape this situation, citizens move out of the region, leaving it in ruins. Thus, a government's increase in expenditure or the increase in its taxing of citizens has both direct and indirect effects on the future of the nation's prosperity.

Kurz and Salvadori (1998) also Quesnay also saw danger in increased public expenditure if it was financed from any other source other than the economy's surplus:

> The tax should not be destructive or disproportionate to the mass of the nation's revenue; that their increase should follow the increase in revenue; and that they should be laid directly on the net product of landed property, and not on men's wages, or on produce, where they would increase the costs of collection, operate to the detriment of trade, and destroy every year a portion of the nation's wealth…

Kurz & Salvadori, 1998*:* 346

It is claimed that taxes on the income of farmers would lead to deterioration of land, and that on labourers as well as commodities would result in a cost of collection of tax that exceeds the tax revenue itself. Quesnay also believed that some pubic expenditure was indeed productive, but if financed inappropriately would not be worth the decline of the state that would be a consequent outcome. Adam Smith, like Quesnay made the distinction between productive and unproductive labour (productive being that which produced economic surplus), but only considered agricultural activity as productive labour, whose surplus can be added to the capital stock to support both productive and unproductive workers for the coming year.

Kurz and Salvadori (1998) write that in Smith's understanding, a cause of economic decline could be if an economy is dominated by unproductive labour. Smith claims that it is rarely the private units that impoverish a nation but public actions/expenditure that maintain unproductive workers. If this maintenance encourages the reproduction of such members, increasing the number that is dependant on productive labour, it is likely that a greater share of the produce would be consumed by them, leaving insufficient produce for the maintenance of the productive labour force. Smith further explains that while public expenditure might be able to push a nation into trouble, the activities of the private firms or families (through the accumulation of capital) will continue to support and increase the wealth of the nation. However, Smith does admit the productivity of some govt expenditure such as that on ports and other components of a nation's infrastructure as well as education.

Smith's Scottish predecessor, Steuart, further claimed that taxes were generally too low to bring forth a country's productive potential. In fact, he also suggests that taxes discourage idleness and that taxing in order to spend was a way by which economic welfare could be increased - ‘Taxes and impositions in their hands, are the wealth of the father of the family; who therewith feeds, clothes, provides for, and defends everyone within his house’ (Kurz and Salvadori, 1998, pg. 349) Steuart also particularly felt that public expenditure funded by taxing would improve the infrastructure in the long term.

Another argument against increased government expenditure stems from the popular belief that politicians and bureaucrats are untrustworthy and self-interested – that national resources in the public sector is, "… inherently wasteful, and detrimental to economic growth and social welfare." (Bagchi, 2005. p. 491) There is also a question of the authenticity or ability of a government to ensure a representation of preferences such that the policies chosen will produce the highest levels of welfare possible. This not only implies an apprehension towards majoritarianism in public policy making but also the very nature of politics at the decision making levels.

Poterba (1998) offers some insight on the political factors that influence the choice of tax systems. Stigler and others from the 'Chicago school' in the year 1971 introduced models that presented instances where self-interested 'regulators' chose policy on the basis of the transfer of rent offered by special interest groups. In other words, it was argued that well organized or well financed industry groups could persuade regulators away from efficient policies to ones that generated rents for these groups. In this way, the importance of policy formation itself is considered, in order to move from the analysis of efficiency costs to evaluating political factors that drove regulatory policy.

Poterba presents a model by Winer and Hettich (1998) that evaluate the effect of political considerations on tax systems in representative democracies by modifying the neoclassical optimal tax model with the introduction of a self interested politician in place of the benevolent social planner. This politician will effectively attempt to equate the marginal political cost per dollar of revenue raised from different methods of policy instead of the marginal efficiency cost, in other words, some kind of political calculation will take place prior to decision making in policy, considering variables like vote banks, interest groups and election funds. Such a model suggests a move away from economically efficient tax systems. Poterba further claims that this, "…expands the traditional public finance dialogue regarding tax efficiency to allow for the possibility that "political market failures" result in politically inefficient policies." (pg 393)

### 4.4 Equity vs. efficiency – a tradeoff?

Various instances in both chapters 3 and 4 have hinted upon an apparent bargain that policy makers must make between equity and efficiency prior to a decision regarding State schemes or policies. The standard objection to progressive rates of corporate or income tax is that it will lead to the lowering of economic output and hindering economic growth, owing to the 'misallocation' of resources, leading to an impact on efficiency. A response to this objection has been put forward by Atkinson (2015): Firstly, it need not be that we as a society, prefer the proverbial cake to be larger than to be justly shared. Given some rationale of redistributive justice (as elaborated in chapter 2), we may indeed prioritize equity over any idea of economic efficiency or growth. Moreover, it is not true that all proposals involving an increase in public finance will lessen the size of the cake. It is entirely possible that various interventions by the government, fiscal or production and organizational in nature (provisions of the public sector) enhance economic conduct. Some basic examples are: provision of free or subsidized health and education act as improvements to the nation's human capital, compared to the cases that the lower income brackets of society are unable to afford these facilities. Musgrave (1999) refers to ideal of distributive justice and rightly insists that:

> A view of fiscal economics which holds that all is well if only Pareto optimality prevails, bypasses these essential components of social coexistence and fails on both normative and positive grounds. Without allowing for a sense of social justice the good society cannot be defined, and without it democratic society cannot function.

Musgrave, 1999: 32

Finally, it is worth noting that the theory that guarantees Pareto optimal outcomes – the first theorem of welfare economics – is based on the unrealistic assumption of perfect competition. The assumptions of perfect competition, or sets of markets equalizing the supply and demand curves on its graph, and perfect information does not hold in markets outside of Varian textbooks, as was elaborated in the section on market failures. Therefore, even if we were to prioritize efficiency over equity, we still do not have an assured alternative of pareto or socially optimal outcomes in the case that public finance is limited.

Thus, we require a modification of our current tradeoff between equity and efficiency. This can be done by reassigning appropriates weights to each after considering relevant ideas such as the spirit of redistributive justice, the implication and probability of genuine Pareto efficient outcomes as well as a fine reflection upon what it means to coexist as human beings striving towards the greater good.

## Chapter 5

# Conclusion

As mentioned in the introduction of this study, economic philosophy attempts to conceptualize and explain the relations between economic theories and the reality of norms or ethical values in society, thereby studying the dynamic between the two in the process of economic reasoning. This research has attempted to explore this dynamic in the context of public finance, particularly regarding matters concerning fiscal policies.

Chapter 1 presented ideas regarding the role of the State, the reality of inequality and other ethical considerations regarding who to tax how much; a conclusion was reached that an important role of the State is to correct historical social injustice by the means of redistributive measures through taxation, the design of which ought to be progressive in nature alongside the with provision of public goods that are accessible to all. Chapter 2 surveyed various concepts from the neoclassical microeconomic framework to analyse the effects of taxation in a perfectly competitive market, and contained an elaborate review of the critique of efficiency and Pareto optimality used as a yardstick for whether a tax system is desirable. I conclude that the heavy reliance on Pareto optimality is problematic; the absence of perfect competition, a requirement for the fulfilment of the first fundamental theorem of welfare economics, thereby is unable to guarantee pareto optimal outcomes in the real world. Moreover, another practical deficiency of the concept of Pareto optimality is its inability to account for concerns regarding equity. Thus, this calls for third party intervention (in the form of the State), with the use of fiscal policies and public expenditure to fill the gaps in an economy in order to ensure welfare to all people. Finally, chapter 3 surveyed arguments for and against State intervention, regarding the role and size of the public sector, as well as thoughts on public financing in a nation. I conclude that the public provision of goods and services serve various purposes; in the context of unequal socio-economic opportunities of a society, it responds to the necessity of commodities that are accessible to all.

With the content of the three chapters, I string together pieces of the reasoning that takes place prior to a fiscal policy decision. Public expenditure, together with progressive types of taxation, behaves as a modern-day method of redistributing income and wealth in a society. By doing this, the State thereby fulfils its duty in a contractarian venture by acting upon shared concerns of a society, one of which in this case is economic justice. However, with the consideration of economic concepts such as deadweight loss and Pareto optimality as a measure of welfare of the members of a society, there seems to be a tug of war between equity and efficiency, both ideas crucial to any economy. Here, I challenge the application of Pareto optimality as the golden rule for decision making in public finance owing to its various deficiencies. This is not to say that Pareto efficiency *should not be aimed for,* but, that arguments against government intervention in the form of progressive taxation and increased levels of public expenditure based on the desire for Pareto optimality are disadvantageous to society. Some of these deficiencies are: the benefits of Pareto optimal outcomes, as per the first fundamental theorem of welfare, lie in an assumed perfectly competitive state of the market. Such an assumption discounts various components of economic reality such as unemployment, externalities, monopolies, oligopolies and information asymmetries; thus, even in the case that Pareto optimality is the priority, it would still not be guaranteed in the economies that we are part of in reality. Additionally, there is a stark difference between the context in which Pareto's optimality was introduced and its application today – Pareto's conceptualization of ophelimity describes a condition of competitive equilibrium, a measure that is divorced from normative claims of any kind; on the other hand, the measure is now being used as a desired norm. This means that the concept and its use fails on both positive and normative grounds. Moreover, the quest for Pareto optimality lacks any consideration of the relative inequality between individuals, or the structural socio-economic discrimination that may hinder equal accessibility to various commodities, had they not been publicly provided (such as rationed grain, education, health facilities, etc). In other words, there seems to be a disconnect between the socio-political reality of society and the narrow 'economic' modelling of it. Borrowing from the works of McCloskey (1985), a scholar's (or, in this case, a policy maker's) intuition and consideration of social norms is a move towards the direction of rationally arguing like human beings and away from the narrow (by the neoclassical methodology of explaining social phenomena) range of criteria that claim economic truth.

To illustrate the issues with policy makers relying on the Pareto optimality as the benchmark for good policy, I present the infamous internal memo written by Lawrence Summers in 1991, the then chief economist of the World Bank:

> I think the economic logic behind dumping a load of toxic waste in the lowest-wage country is impeccable and we should face up to that… The costs of pollution are likely to be non-linear as the initial increments of pollution probably have very low cost… I've always thought that under-populated countries in Africa are vastly under polluted; their air quality is probably vastly in efficiently low compared to Los Angeles or Mexico City. Only the lamentable facts that so much pollution is generated by non-tradable industries (transport, electrical generation) and that the unit transport costs of solid waste are so high prevent world-welfare-enhancing trade in air pollution and waste.
>
> Hausman, McPherson & Satz, 2016: 13

While it is claimed (Hausman, D., McPherson, M., & Satz, D. 2016) that Summers had written this memorandum as a "provocative exploration of the implications of "economic logic" rather than as a serious proposal for a World Bank program to export pollution to the LDCs" (p. 13), in 1992, Brazil's Secretary of Environment, Jose Lutzenberger wrote to Summers, "Your reasoning is perfectly logical but totally insane… Your thoughts [provide] a concrete example of the unbelievable alienation, reductionist thinking, social ruthlessness and the arrogant ignorance of many conventional 'economists' concerning the nature of the world we live in" (Adler, M. 2013. p. 44)

Thus, due consideration is to be given to observations of the social world, inclusive of ethics and normative notions, in order to achieve the closest truth that one may confidently depend on for the purposes of policy making.

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