The Psychopathology of Taxation

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ECONOMISTS are coy about revealing the extent of the damage inflicted by governments on the people who elect the politicians to power. Financial think-tanks such as the International Monetary Fund certainly attack taxation as damaging, when it suits their strategic aims; but they are guarded in their calculations of the deadweight losses generated by the tax policies employed to raise revenue.

A notable exception by his willingness to speak the plain man's language is David B. Smith. He has published one estimate of the magnitude of the losses. Taking as the starting point the calculations produced in IMF working papers and scholarly studies of economic growth, Smith compiled the estimates shown in Table 1.

Smith asked this question. If governments had not raised their tax-take above the 1960 level, what would the effect have been on economic growth? The

Table 1
Estimated effects on economic growth of increases in public spending since 1960

	Change in Public Spending Burden 1960-1998 (%)	Estimated Impact on Annual Economic Growth (%)	How much higher output would have been in 2000 with 1960 spending levels (%)
Australia	11.7	-1.6	88
Austria	16.0	-2.2	137
Belgium	19.1	-2.6	179
Canada	16.1	-2.2	138
France	19.7	-2.7	188
Germany	14.5	-2.0	118
Italy	19.0	-2.6	178
Ireland	9.6	-1.3	68
Japan	19.4	-2.6	183
New Zealand	20.2	-2.7	196
Netherlands	13.5	-1.8	107
Norway	17.0	-2.3	150
Spain	24.5	-3.3	271
Sweden	27.5	-3.7	334
Switzerland	20.4	-2.8	199
United Kingdom	8.0	-1.1	54
United States	5.8	-0.8	37

Source: David B. Smith, *Public Rags or Private Riches?*, London: Politeia, 2001, p.17.

results are shocking. From column three we see that Britain's output in 2000 would have been more than half as much again. Given that the output was £793 billion, the chief economist of a leading firm of stock brokers in the City of London says that the people of Britain lost something of the order of £428 billion in output last year.

Given the rate of increase of taxation in the last 40 years, Germany's economy is less than half what it otherwise would have been. France's output would have been higher by almost 200%. The same applies to New Zealand. Sweden would have had an economy larger by 334%. The country that comes out best is the US, which has under-performed by 37%.

These are truly awful findings. In Britain's case, the trend is for a further deterioration because Chancellor of the Exchequer Gordon Brown has not only increased the tax burden, he has done so by what Smith calls "capricious and unpredictable taxation". In other words, Mr Brown is an exponent of "stealth" taxation. Pessimistically, Smith concludes: "It would not be at all surprising if the ultimate supply-side costs of his psychopathic meddling are extremely high".[1]

WITH OFFICIALLY sanctioned losses of these proportions, no democratically-elected politician should be allowed to get away with the claim that there are insufficient resources available to spend on the health and education of the nation.

But how much ought a government to spend? In David Smith's view, a tax-take of about 30% is sufficient. He relies on two IMF tax experts, who claim that 30% of GDP was sufficient "to achieve most of the important social and political objectives that justify governmental interventions".[2]

These economists agree that a certain level of government spending is good for society. Education, for example, increases people's capacity to produce wealth. But economists, locked into the neo-classical tradition, still continue to characterise all taxes as bad. As Smith puts it:

> All taxes expropriate the fruits of capital, labour or enterprise. They transfer real resources from the people who created the wealth in the first place to those who did not.[3]

This is a representative statement of the views of conventional economists, but it is misleading.

Some revenue-raising instruments do not expropriate the fruits of capital or labour. Classical economists pointed out that the rent of land and natural resources is a surplus over and above the incomes of labour and capital. Therefore, it would not be correct to claim, as Smith does, that "all taxes ... drive a wedge between the price signals perceived by consumers, and those received by producers, giving rise to dead weight losses of utility".[4] A public charge on economic rent does not raise consumer prices, and it does not reduce utility – for the good reasons that economists will tell you about, if you specifically ask them.

Most of the real resources captured by government are actually transferred back to the people who created the wealth in the first place. It is this kind of wasteful exercise which expands bureaucratic costs for little good reason.

But why, given that taxes on labour and capital are a dead weight on the economy, have governments increased the burden since 1960? Were they being frivolous? Are politicians malevolent? On the whole, such views are false. Most politicians genuinely want to improve the lot of their societies. Thus, we need a theory of political history that explains why it was necessary for the Welfare State to grow to enormous proportions, accounting for between 40% (UK) to 54% (France) of GDP in 1998.

THE SMITH study can be criticised on several further grounds. One is: why take the 1960 figure of 30% as an acceptable point? More importantly, why accept the deadweight losses imposed by the composition of the taxes which took up to 30% of GDP? The key issue, which economists fail to make explicit, is that they measure deadweight losses against the benchmark revenue-raiser which has a negative impact of zero. Governments would impose no disincentives if they raised revenue from the rent of land and natural resources. If that rent constituted (say) 45% of an economy's total annual revenue flow, government could capture the whole lot and still not damage people's incentives to work and invest. Instead, we would have explosive growth – or, the potential of explosive growth, with the option of choosing alternative lifestyles in which people could consciously downgrade the pursuit of material wealth in favour of fulfilling their other needs.

WHAT WOULD HAPPEN if governments treated rent as the revenue base? We have an idea of the magnitude of the gains from a study by two American economists who examined the G7 countries for 1993.

Dr. Nicolaus Tideman and his then doctoral student, Florenz Plassmann, built the Mark I model of the economy to assess the loss of income that could be attributed to the tax policies favoured by democratic governments. Their estimates are shown in Table 2. They calculated that the USA was under-performing by nearly $1.6 trillion. In that year, Britain was losing goods and services – value that people *could* have produced – to the tune of about £440 billion. For all seven countries, the loss was not far short of $7 trillion.

Table 2
G7: Tax-Sponsored gain in Net Domestic Product by switching from old (O) to new (N) revenue policy: $ Billion

	1993 (O)	1993 (N)	Gain
USA	5494	7045	1551
Canada	490	769	279
France	937	1847	910
Germany	1178	2220	1042
Italy	892	1741	849
Japan	2134	3758	1624
UK	883	1594	711

SOURCE: T. Nicolaus Tideman & Florenz Plassmann, in Harrison (ed.), *The Losses of Nations*, pp.146-174.

Economists may argue about the detail of this model and the order-of-magnitude of its estimates, but nit-picking would not impress the public. Even if some of the assumptions made by Professor Tideman exaggerated his calculations by a substantial factor, the remaining aggregate losses would still far exceed the value needed to raise the standards of private and public services that people desire. Notice, however, that his estimate of UK losses is comparable to the losses revealed by the Smith study.

The tax-induced implosion of the economy is equivalent to the detonation of a thermonuclear bomb. But instead of relaxing the tax torque, what do the politicians do? They devise "rescue packages". But cash subsidies and regulatory protection, far from reversing the imposition of avoidable losses, are disincentives that clamp down further on the economy. For the financial "incentives" are financed out of increases in the taxes that were responsible for killing jobs and holding down people's wages in the first place.

MOST PEOPLE would rather pay less out of their earned incomes. At the same time, however, most of them are sensible enough to know that public services are not an optional extra. They have to be financed. The one certain reality is that governments are uniformly unsuccessful at ordering their fiscal affairs in a manner that delivers satisfaction to their electorates. The quest for votes ensures that politicians drive themselves ever deeper into revenue-raising arrangements designed to conceal their actions. And concealment guarantees deeper dissatisfaction in people's relationship with the public sector.

Attempts at reforming the tax system have so far proved futile. The conventional mind-set ensures that the recommendations for change are limited to a narrow range of options. In the Western democracies, the socialist notion of income redistribution continues to be the guiding principle. So there was little prospect of a fresh approach emerging from the deliberations of the Fabian Society's Commission on Taxation and Citizenship.

To understand the Fabian perspective, we need to go back 100 years to its origins under the influence of the Webbs. They were instrumental in formulating Clause IV of the new Labour Party's constitution, which advocated the nationalisation of the means of production – both land and capital.

The emerging political consciousness of the factory-based workers of the late 19th century was much stimulated from a surprising source – an American journalist, Henry George, whose *Progress and Poverty* became the subject of heated discussion and popular support in the pubs and factory canteens of the 1880s. George's thesis, grounded in classical economics, was that the wealth creators would continue to suffer from poverty for so long as they were excluded from their equal share of the net income to which they contributed. That net income is measured by, and captured through, the land market. It is called economic rent. The powerful insights that are studded throughout *Progress and Poverty* aroused the imagination of the public and the moral sensitivities of the intelligentsia. But many of the latter then went on to absorb the socialist doctrine and coalesce within the Fabian Society, which survives to this day as Britain's "senior think-tank".

The Liberal party attempted to turn the Georgist thesis into practical politics at the beginning of the 20th century. But despite the eloquence of Winston Churchill, the weight of history was against this stream of reforms. The socialists emerged as the alternative to the Conservatives, and the Georgist paradigm was forced into the philosophical backwaters.

It took 90 years, but eventually the socialist alternative exhausted itself in the various experiments in social engineering. Nonetheless, the Fabian Society was not able to stand outside the values and tenets that it had helped to embed in the Welfare State model.

IS THERE a viable alternative to the socialist model of income redistribution? The Fabian's Tax Commission, under the Chairmanship of Raymond Plant (a Lord of the Realm and Professor of European Political Thought at the University of Southampton), might have addressed itself to the ideological questions in reviewing the subject of land taxation in Ch. 14 of what is a data-packed survey of fiscal policy in Britain.[5] But the panel of distinguished economists and social theorists was unable to unshackle the investigation from the conventional nostrums of 20th century tax prejudices. This was a missed opportunity to influence not just the fiscal philosophy of the Treasury; but the worldview of the millions of socially concerned people who, having had to abandon the socialist doctrine, are now adrift.

The Fabian Commission accurately summarised the economic virtues of charges imposed on the rent of land and natural resources.

> Since land rental levels are determined by the market, the landowner cannot generally pass the tax on to the user of the land. So the tax has no effect on rents, and no effect on the prices charged by firms or others using the land. It simply reduces the land's value [i.e. selling price]. In this way the entire burden of a tax on land falls on the landowner, reducing his or her wealth.

The "non-distortionary" quality of land rent charges has been acknowledged by economists of all political persuasions ever since Adam Smith and up to and including Milton Friedman.

Having read this far, one might have concluded that the Fabian commission was on the verge of shifting its paradigm to what is now known in the economic literature as the Georgist model. But, alas, the Fabians are as cautiously conservative as the Conservatives. Henry George they characterise as "radical", and therefore not fit to feature in their politics.

> George and his followers propose that land taxation could actually replace all other taxes, financing the entire public spending budget without recourse to taxes on income or labour. Since the latter inevitably reduce economic activity, whereas a land tax was non-distortionary, George argued that such a shift in the burden of taxation would increase production, employment and wealth.

One might have expected a tax commission that included distinguished representatives from the universities and the government, to have explored the issue of the deadweight losses inflicted by conventional taxes, taking as the benchmark the admission in their report that public charges on the rent of land does "not reduce the economic output that takes place on it at all".

Surprisingly, however, the Commission failed to consult the Tideman and Plassmann study. Weren't the quantifiable losses a legitimate starting point for a new evaluation of fiscal philosophy? Most folk, relying on common sense, would have thought so. But the Fabians were deflected, in part because they characterise George's policy as "radical and impractical". They could not resist the repetition of the glib characterisation of the Georgist analysis "as somehow a panacea for all economic ills".

Given the gigantic losses inflicted by conventional taxes, one would have thought that the Fabians could have visualised how some of the social and economic defects of our poverty-making policies could be remedied by relieving people of the burdens inflicted by government. Instead, they chose to circumscribe the benefits of the Adam Smith/Henry George fiscal philosophy by arguing that it could be "much more sensibly viewed as a form of environmental taxation". Thus redefined, it can be accommodated as one among a range of taxes available to the state. By this means, the non-distortionary benefits that would accrue as other taxes were eliminated, were abandoned. The Fabians excluded themselves from a discourse about the substitution of rent charges for income and other taxes because they simply take it for granted that insufficient revenue would be generated to permit such a beneficial reform. Again, surprisingly, they failed to undertake the fundamental research that would have provided them with the order of magnitudes of rent in the economy that would have encouraged them to dig deeper into the economics of land and natural resources.[6]

THE FABIANS, having rejected the Georgist approach to tax reform, are led to an alternative fiscal philosophy which, in their view, does not suffer the problems that flow from the radical demands of Henry George. This is the locally administered property tax now associated with some towns in Pennsylvania where the tax rate on land is raised above the rate levied on the assessed value of buildings.

The Fabians like this model, because they seek a "revenue-neutral framework". A two-tier property tax of the kind which they favour would yield a fractional improvement, as a result of the reduction in the deadweight losses imposed by the tax on buildings. But since the property tax, in Pennsylvania and elsewhere, raises such a small fraction of the total revenue of local government, substantive improvements in people's lifestyles would not be forthcoming.

THE POVERTY of the Fabian fiscal philosophy was illustrated when its general secretary, Michael Jacobs, advised the Blair government to increase the tax burden. Jacobs served as the Tax Commission's Secretary, and therefore was influential in shaping the terms of the report.

On what basis can higher taxes be commended to Britain's burdened wealth-producers? Jacobs pointed to the higher tax-take in Europe, and argued that if UK public spending was raised closer to the European average – "the shortfall is currently around £45bn a year" – world class public services would be possible. This exposes the way in which language is appropriated to stand reality on its head.

- If the UK had German levels of tax-take, the annual loss of output would be at least twice as much as David Smith computed. Germany is now engaged in a tax-cutting programme, because its rates are unsustainable.
- If the UK had a French-like tax-take, the loss of output would quadruple. In January, France was crippled by a nationwide strike as employees sought to resist the plan of employers to postpone the age of retirement, because they could not afford to finance the pensions scheme.

Mr Jacobs has his heart in the right place. The state, he says, could "help protect the quality of our personal lives against the growing time demands of the economy ... public spaces and the sense of community can be enhanced" ... and other good things, which he catalogued in *The Guardian* (Jan. 29). But the reason why we are denied these good things is that, along with all the political parties, throughout the 20th century – and now into the 21st century – the Fabian Society promoted damaging forms of taxation.

There is, evidently, the need for a new fiscal Tax Commission; but one that can step outside the conventional paradigm to define issues that are relevant to people's needs.

THE STARTING point for a scientific reappraisal is the deprivation of freedom. The monetary loss is easy to compute. In Britain, it runs to £7,500 for every man, woman and child, or about £30,000 a year for a family of parents and two children. That's the measure of the increased output of goods and services that could be delivered under current conditions, if government did not distort production through taxation.

To secure a democratic mandate for change, however, a public debate that anticipated objections will be necessary.

Some environmentalists, for example, will claim that increased production will further damage the environment. In fact, the instrument of reform – shifting public finance onto the rent of natural resources – would diminish eco-damage. Besides, not everyone would opt for an increase in material goods. Many would prefer the increased leisure and earlier retirement that they would be able to afford.

The political Right (citing the David Smith study, which relies on a short-cut methodology), would cause problems by demanding a reduction in the tax-take. In many countries (such as the US) this would not be possible: returning to 1960 levels of public spending, if this increased land-rent income in the private domain, would further destabilise the markets. More intensive booms and busts based on inflated land prices would be the result, and the outcome would be the need for increased public spending to pay for the failures of public policy!

The important lesson that has to be learnt, if we want justice and sustainable growth, is this: what matters is not *how much* revenue is raised by government, but *how* it is raised. Once the principles determining this issue are identified and enshrined in law, all the good things in life become accessible to everyone.

References

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