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Austrians and their Precursors on Taxation

“the power to tax is the power to destroy”
Chief Justice John Marshall

Introduction

The Austrian school of economics is noted for its work in areas such as capital theory, monetary theory, business cycle theory, the economic calculation debate, and its critiques Marxism and Keynesianism. The school is not particularly recognized for its theory of taxation. The purpose of this paper is to outline some of the major themes of Austrian tax analysis and to make the case that the Austrian work in this area is different from and superior to the standard (neoclassical) textbook analysis.

The Austrian Tradition

For the purposes of this paper, the “Austrian” position on taxation is taken to be that of the mainline of Austrian thought.¹ Early Austrians, and economists of the 19th century in general, had little to say about taxes.² Mises explains that this is due to the fact that economists in this time period were generally discussing a liberal state. Under a liberal regime, the tax burden is

¹Salerno, 1999 explains the main development of Austrian price theory. This is the line of thought examined in this paper.

²Weiser provided contributions in this area, but his analysis is outside the mainstream of Austrian thought.

light and there is little need for economists to examine the effects of heavy taxation on an economy. Given the rise of the authoritarian state, the need for an understanding of tax issues has increased. Therefore, the analysis of taxation has become more important to more recent generations of economists, including Austrians.

For the purposes of this paper, the Austrian tradition will include the work of Ludwig von Mises, Murray N. Rothbard, and Hans-Hermann Hoppe. Mises did not provide us with a single systematic treatment of tax issues. Instead, his work on taxation is scattered throughout his various works.³ Rothbard extensively discussed taxation. His *Power and Market* is largely about tax issues, *Ethics and Liberty* contains his ethical argument against taxation, and he wrote a multitude of articles dealing with the tax issues of his time. Hoppe, in “The Economics and Sociology of Taxation,” provides us with his fundamental examination of taxation. I mention Hoppe’s work because his economics of taxation is firmly in the Austrian tradition and his sociology of taxation provides us with a valuable addition to the Austrian literature.

Jean Baptiste Say, particularly his price theory and his tax analysis, is also in this (pre)Austrian tradition. In his great *Treatise on Political Economy*, he provides us with his views on taxation. I include Say as part of the Austrian tradition and focus on these authors in the present paper.

³For instance Mises discusses taxes briefly in his *Socialism* and expands upon this in *Human Action*. His central opposition to taxes can be found in his essay “Profits and Losses.”

Austrian Class Analysis

A comparison of Austrian and neoclassical tax analysis immediately shows that the two schools differ in their views of the state. The Austrian view is illuminated in Austrian class analysis. Here, there are two classes of people, taxpayers and tax consumers. Tax consumers benefit themselves and exploit taxpayers by burdening the productive sectors of an economy with taxes. For this reason, Rothbard equates taxation with theft, calling the state a “vast engine of institutionalized crime and aggression.” Say compares taxation to robbery, extortion, suicide, and gunpowder. Mises tends to be less strident, stating that in the liberal regime, “every tax is an evil - though up to a point an unavoidable one.” Say essentially agrees with Mises’ position, arguing that there is a need for some minimal level of taxation. However, Rothbard and Hoppe have a more extreme view, considering taxation unnecessarily.⁴

This Austrian view is strikingly opposed to the standard neoclassical view,⁵ which regards tax payments as analogous to a voluntary payment to a private firm or simply as a cost of production. In this view, the state collects taxes and in return provides public services. This view

⁴This view of the state is not shared by Austrians such as Friedrich Weiser or Friedrich Hayek. Weiser defends the state’s right to tax (the state is analogous, in some respects, to a firm or a club). In a sense, taxes are voluntary, similar to club dues. Weiser also argues in favor of progressive taxation on the basis that this is essentially what a private firm does when it price discriminates. Therefore, it is an appropriate policy for the state. Beginning from this premise, Weiser draws much different conclusions than, say, Rothbard or Say.

Hayek’s analysis focuses on the tax type, not the level of taxation. High levels of taxation are not necessarily a problem, as long as the tax system is not progressive. Hayek proposes the principle that the highest marginal tax rate should be “fixed at the proportion of the national income that the government takes in taxation.” (1994, 283) Such a principle does not provide much of a limit on the level of taxation.

⁵There are non-Austrian class analyses regarding taxation. For instance, proponents and critics of progressive taxation both divide taxpayers into classes, arguing that their proposed tax system will prevent one set of taxpayers from taking advantage of another set of taxpayers.

The Austrian view of the state is also the antithesis of, say, Richard Gephardt’s view that legislators who want to reduce tax rates are “terrorists,” or Bill Clinton’s label that those who want to have lower tax rates are “selfish.” Such statements imply a class distinction much different than the Austrian one.

is summed up in a popular public finance textbook, that cites Henry Clay: the government is “a trust, and the officers of the government are trustees; and both the trust and trustees are created for the benefit of the people.”⁶ The opposing views, between Austrian and neoclassical economists, of the state contribute to the differences in their conclusions about the effects of taxation. To that topic I now turn.

Neoclassical Tax Analysis

Neoclassical tax analysis begins with the common partial equilibrium explanation of the tax effects on a specific market. Beginning with an initial, no tax, situation, the equilibrium price and quantity in the market is P^* and Q^* (see Figure 1), respectively. Given the imposition of an excise tax, the buyers’ price would increase to P_d and the equilibrium quantity decreases to Q_t . Since the tax drives a wedge between the buyers’ and sellers’ prices, the sellers’ price with a tax in place would be P_s . The government collects tax revenue represented by the shaded rectangle, and the tax generates an excess burden. The analysis is then generally extended by examining issues such as demonstrating that the legal incidence of the tax is irrelevant, showing how varying the price elasticities of demand and supply will change the effects of a tax, and describing the differences between an excise tax and an ad valorem tax.

Austrians are essentially in agreement with this basic comparative statics conclusion. A tax on a market will tend to increase the price that buyers pay, decrease the amount of the good being produced and sold, and harm the sellers in the sense that the tax will decrease their profits

⁶Rosen, 1995. In addition, I would argue that Browning and Browning (1994), Hyman (1993), and Musgrave and Musgrave (1989) have essentially the same view of the state.

Figure 1

by decreasing the price net of taxes received by the sellers.⁷ However, this is a rather minor point to Austrians.⁸ Neoclassical analysis is primarily based on comparative statics. However, this type of analysis overlooks the most damaging effects of taxation, namely that taxation harms the functioning of a market economy. Austrian price theory goes beyond the comparisons of comparative statics, and this leads to a more complete understanding of the nature of taxation.

Tax Incidence

The analysis of tax incidence is tangential to the comparison of neoclassical and Austrian tax analyses. However, it does illustrate an interesting difference between the schools of thought. Neoclassical analysis concludes that the burden of a particular tax is dependent on the price

⁷However, Austrians tend to not rely upon a graphical analysis of the tax effects on a market. Say avoided graphical analysis and criticized David Ricardo for introducing into political economy the “unbending maxims of geometrical demonstration; In the science of political economy, there is no method less worthy of reliance.” (1880)

⁸Mises describes these effects in one paragraph in *Human Action*.

elasticities of supply and demand in a particular market. The greater the price elasticity of supply, the greater the share of the consumers' tax burden. The burden of a tax can be shifted forward, from sellers to buyers, according to this argument.

While Austrians realize that taxation increases the price of goods, they are reluctant to call this tax shifting. In their judgment, no tax can be shifted forward in this manner. In fact, the Austrian theory of imputation implies that any tax burden is shifted backwards, from consumers to producers, and then shifted further back onto the original factors of production.

Consumers' valuation of a good generates a monetary price for that good. The price for each factor of production is imputed to it by entrepreneurial demands to rent that factor, according to the objective value of the amount of the consumer good the factor produces at the margin, i.e., its discounted marginal value product. A tax decreases the sellers' net tax price (P_s), and this sellers' price is a determinant of the discounted marginal value product of the factor of production. Reducing the sellers price, through taxation, decreases the discounted marginal value product and reduces the prices paid to the factors of production. Therefore, the original factors of production bear the burden of the tax.

However, Rothbard points out that "it is true that a tax can be shifted forward, in a sense, if the tax causes the supply of the good to decrease, and therefore the price to rise on the market." This price increase is termed tax shifting, according to neoclassical theory. Rothbard argues that this is not shifting in the sense that Austrians are using the term, but is willing to call this increase in the buyers' price "indirect shifting."⁹

⁹Interestingly, Say's view of tax incidence presages the neoclassical view. Say implicitly defines tax burdens as the product of the difference in the price due to the tax and the amount of the good purchased. And, in modern terms, Say argues that relative tax burdens do not depend on the legal incidence of the tax (1880, 471).

Taxation and the Social Function of the Market

The fundamental difference between Austrian and neoclassical analysis is not their views of tax incidence, however, but their views of how markets function. An understanding of price theory requires more than examining the comparative statics of a tax situation. It requires a recognition of how markets adjust to ever changing conditions, and how taxation affects this adjustment process.

A reliance on mathematical and graphical techniques will tend to lead to conclusions that overlook the market process. For this reason, neoclassical price theory and therefore neoclassical tax analysis understates the negative effects of taxation.

Markets allocate resources towards consumer wants. Prime actors in this process are the capitalists and entrepreneurs. Capitalists provide capital and allocate it in a manner that will benefit consumers. Entrepreneurs bear the risk of making these allocation decisions. Both of these functions are necessary in a well functioning economy. The heart of the Austrian case against taxation is that taxes destroy a capitalist economy by punishing capitalists and entrepreneurs for providing these services to consumers. Therefore, taxation necessarily interferes with the social function of the market and decreases the standard of living within the taxed economy.¹⁰

Say also links the relative tax burdens to a concept very close to the idea of price elasticities. According to Say, buyers and sellers try to evade the tax by moving out of the market. Say's description of tax evasion is very similar to the neoclassical argument that tax burdens depend on the price elasticities of supply and demand.

¹⁰Mises credits Karl Marx with understanding that taxes destroy a capitalist economy. Marx aimed to destroy the capitalist economy and progressive taxation was one "despotic inroad on private property" that would further this cause. Mises contrasts this with economists who profess to want to save capitalism through taxation.

Taxation and Capitalists

Austrian macroeconomic theory is recognized as a capital based theory. Similarly, Austrian price theory is capital based. Austrians understand and appreciate the role of capitalists in a market economy, and this understanding leads to a recognition of the effects of taxation on the capital structure of an economy.

Consider the effects of taxation on capital accumulation. Direct taxation of capital reduces the capital stock, since capitalists, when taxed, will tend to produce less capital and consume their existing capital.¹¹ The reduced capital stock leads to decreases in productivity, diminishing the standard of living.

A tax on consumption will also affect capital accumulation. The tax will decrease consumption increasing in the marginal utility of consumption. This will tend to lower savings rates which will also lead to a diminished capital stock. In this sense, all taxes are taxes on capital.

However, the amount of capital is not the only important consideration here. The type of capital created is also critical. The capital must be allocated appropriately to various possible investment opportunities. One function of markets is to apportion capital to those projects that will serve consumers. Taxing capitalists penalizes them for determining an appropriate structure of production. This penalty reduces the incentive to perform this function, negatively affecting the type of capital available. Taxation not only reduce the capital stock, but also reduce the

¹¹The inheritance tax is particularly damaging to capital accumulation. Rothbard calls inheritance taxes “perhaps the most devastating example of a pure tax on capital. It destroys the incentive to build up large accumulations of wealth and generally large sums are involved.” In this same vein, see also Tabarrok’s arguments against “Death Taxes.” (1997)

effectiveness of the existing capital stock.

What about the argument that some taxes, i.e., corporate double taxation and capital gains taxes, may increase investment? Such taxes do not encourage investment but do encourage “frozen investment,” since corporate earnings tend to be undistributed and capital gains are less likely to be realized. This greatly hampers the adjustment of the economy to dynamic changes in market conditions. Tax policies that freeze investment decisions do not aid, but hamper, capitalists in performing their role in a market economy.

What if government spending creates capital, offsetting the capital destroyed by taxation? The standard view is that government spending is much like private sector spending, in the sense that the state decides whether to consume or invest its resources. Its investment decisions are similar to private sector investment decisions.

Mises concedes that government spending could be termed “investment” in the sense that the spending may generate a return on the investment. However, Mises points out that even if state spending is investment in this sense, the state would still have the problem of not being able to calculate in a rational manner. The state will not be able to calculate which investments are economically viable. It will not tend to produce capital that serves consumer wants and the state will not be able to make the correct decisions to maintain its capital structure.¹²

Rothbard makes a slightly different claim, namely that all government spending is necessarily consumption. Government spending decisions are in no manner similar to the decisions made by private sector capitalists. Government spending is, in essence, tax consumption. No one in the government is foregoing his own consumption in order to make a

¹²This point is simply a corollary of Mises’ demonstration of the impossibility of socialism.

particular investment decision. Such spending may create goods generally thought to be capital (e.g., schools, roads), but the government is not fulfilling the capitalists role in the economy when making these spending decisions. Therefore, the state cannot make up for its destruction of private capital by producing capital itself.

Taxation and Entrepreneurs

In addition to the Austrian focus on capital allocation, Austrian price theory also emphasizes the role of the entrepreneur in a well functioning economy.

Economies are dynamic. Consumer preferences, technologies, and resource availabilities and characteristics are constantly changing, and markets must adjust to these changes. Entrepreneurs speed these adjustments. Entrepreneurs anticipate consumer demand for goods and risk assets by allocating resources towards those consumer wants. Entrepreneurs who successfully perform this social function of serving the consumer are rewarded with profits. Markets generate losses for entrepreneurs who cannot allocate resources in a manner that benefits consumers. Taxing profits punishes those entrepreneurs who are most successful in satisfying consumers. Punishing successful entrepreneurs reduces the level of entrepreneurship¹³ and harms the ability of the economy to adjust to consumer wants.

In addition, profits are a signal that the economy is in disequilibrium. Profits indicate that markets need to adjust resource allocations towards the industries with high profits. Taxation

¹³Pasour (1986) points out that entrepreneurial skills follow the law of supply. Taxing away profits implies a lower price being paid for entrepreneurial skills, and therefore, markets will have the benefits of fewer entrepreneurial skills. This may be a convincing way to present this argument to economists and students.

distorts this critical profit signal interfering with the market adjustment process. As Mises points out, “in fighting profits governments deliberately sabotage the operation of the market economy.”¹⁴

Neoclassical theory tends to understate the importance and the function of entrepreneurs and the role of profits as an incentive for successful entrepreneurship. The Austrian appreciation of the entrepreneurial role in resource allocation leads to an understanding of how taxation impairs this function.

Conclusion

Austrian tax analysis is based on Austrian price theory, just as neoclassical tax analysis is founded on neoclassical price theory. Since Austrian and neoclassical price theory differ, the tax analyses in these two schools of thought are naturally different.

Austrian price theory emphasizes the role of the capitalist and the entrepreneur. Taxation necessarily punishes successful capital accumulation and entrepreneurship. Reducing the effectiveness of these vital economic agents harms the market economy. The failure to understand the function of the capitalist and the entrepreneur leads to understating the damage of taxation.

Taxation necessarily harms a market economy. High taxes do more damage than lower

¹⁴Mises (1998, 805). In addition to interfering with the entrepreneurial function of an economy, tax policies often interfere with sound principles of accounting. Tax laws may induce firms to make earnings appear higher in order to increase tax revenues, e.g., laws that decrease deductions without changing tax rates. Also, firms may keep two sets accounting records, one for tax purposes and one for other business decisions. (1998, 214)

levels of taxation. Therefore, in the Austrian view, taxes should be low, or nonexistent. The type of tax is less important than the level of taxation.¹⁵ The Austrian view can be summed up by Say: the “best scheme of public finance is to spend as little as possible; and the best tax is always the lightest.”

¹⁵Austrians do not ignore the discussions over the preferred tax type. For instance, Say (1880), Weiser (1958), Hayek (1960, 1994), Rothbard (1988), and Vedder (1986) all weigh in with their views on progressive and proportional tax systems. However, the primary emphasis is on the level of taxation, not the tax type.

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