

CHAPTER 4 — BINARY INTERVENTION: TAXATION

CHAPTER SUMMARY

Society is composed of taxpayers and tax consumers. The tax consumers benefit from taxation while the taxpayers foot the bill. All taxation distorts resource allocation and severs “distribution” from production. The *total level* of taxation is far more significant than the specific *forms* of the tax.

Tax *incidence* refers to the actual long-run burden of taxation, which may differ from the immediate target. *No tax can be shifted forward*. (If retailers had this power, why wait for the tax?) All sales taxes are ultimately *income* taxes.

An income tax reduces the utility of the taxpayers, and generally provides a disincentive to earn income. Income taxes may *indirectly* raise time preference rates by reducing overall income. It is no more odious to impair savings than consumption.

Taxes on wages cannot be shifted to the employer. Corporate taxes are examples of “double” taxation. This encourages stockholders to leave the net income as “undistributed” earnings and hence distorts the flow of funds. A capital gain is a form of income, just as other types of profit. If we desire the (unattainable) goal of uniform taxation, one would need to correct capital gains for inflation.

Proposals to directly tax consumption merely translate to an income tax. Such a tax does *not* favor savings, because the point of savings is to consume in the future (when the tax will also operate).

In contrast to a tax on *current* savings, the charge of “double taxation” is coherent when it comes to taxes on accumulated capital. These destroy the inherited tools, equipment, etc. from the past, and thus a twenty percent tax on capital is far more destructive than a twenty percent tax on income.

The typical arguments against the progressive tax are that (1) it reduces the incentive to work, (2) it reduces savings, and (3) it is robbery of the rich by the poor. The first argument is correct, but this is also true of a proportional tax. The second argument is also correct, but those making it usually imply (with no justification) that it is somehow worse to reduce saving than to reduce consumption. The third argument is wrong: Under progressive taxation, the *government* robs both the rich and the poor.

The Georgist proposal to tax ground rent ignores the owners' role in allocating land to the most value-productive users. There would indeed be no incentive to charge rents *at all*; this would eliminate the Georgist tax base and cause severe distortions in the allocation of scarce land.

The only objectively “just price” is the market price. Economists have generally abandoned the medieval quest for the just price, yet they cling to the notion of a just tax.

It is impossible to tax everyone uniformly. First there is the distinction between taxpayers and tax consumers; since the latter pay *no taxes*, clearly “uniformity” is only possible if no one pays any taxes. Second, there is the problem of defining *income*. For example, should it include services in kind? Should it be calculated as a yearly average?

If each taxpayer were truly taxed according to how much he or she benefited from government services, then it would be pointless to provide the services in the first place. Moreover, all bureaucrats would have to work for free.

CHAPTER OUTLINE

1. *Introduction: Government Revenues and Expenditures*

Government derives its revenue (income) from taxation and inflation. This chapter assumes that all revenue is spent.

2. *The Burdens and Benefits of Taxation and Expenditures*

Society is composed of taxpayers and tax consumers. The tax consumers (politicians, bureaucrats, and subsidized citizens) benefit from taxation while the taxpayers foot the bill, though the exact effects are difficult to trace. All government spending is *consumption* (not investment). All taxation distorts resource allocation and severs “distribution” from production (whereas there is no such distinction in a market). The *total level* of taxation is far more significant than the specific *forms* of the tax.

3. *The Incidence and Effects of Taxation*

Part I: Taxes on Incomes

A. THE GENERAL SALES TAX AND THE LAWS OF INCIDENCE

Tax *incidence* refers to the actual long-run burden of taxation, which may differ from the immediate target. Contrary to popular and even mainstream economics belief, *no tax can be shifted forward*. Even in the “obvious” case of a general sales tax, it is not true that the retailers can “pass on” the tax in the form of higher prices. (If they had this power, why wait for the tax?) They stay in business by shifting the tax *backward* to the factor owners. Thus all sales taxes are ultimately *income* taxes.

B. PARTIAL EXCISE TAXES; OTHER PRODUCTION TAXES

An excise tax distorts resource allocation (as all taxes do) by shifting demand from consumers to politicians, but also because it only applies to particular goods. Excise taxes too are ultimately taxes on income, not just consumption.

C. GENERAL EFFECTS OF INCOME TAXATION

Because sales and other taxes are ultimately taxes on income, this section is not confined to the “official” income tax. An income tax naturally reduces the utility of the taxpayers, and generally provides a disincentive to earn income. (Even if someone ends up working *greater hours* to offset the tax, this still represents a loss of utility.) Income taxes may *indirectly* raise time preference rates by reducing overall income. They also encourage unofficial work, e.g. “do it yourself” projects, and hence impair the division of labor. Contrary to many “right wing” economists, it is no more odious to impair savings than consumption.

D. PARTICULAR FORMS OF INCOME TAXATION

(1) *Taxes on Wages*

Taxes on wages cannot be shifted to the employer. In fact, the opposite is true. The employer contribution for Social Security is ultimately deducted from the employee's wage.

(2) *Corporate Income Taxation*

Corporate taxes are examples of "double" taxation. This encourages stockholders to leave the net income as "undistributed" earnings and hence distorts the flow of funds.

(3) *"Excess" Profit Taxation*

This is a direct penalty on successful entrepreneurship.

(4) *The Capital Gains Problem*

A capital gain is a form of income, just as other types of profit. If we desire the (unattainable) goal of uniform taxation, one would need to correct capital gains for inflation.

(5) *Is a Tax on Consumption Possible?*

Proposals (such as Irving Fisher's) to directly tax consumption merely translate to an income tax (albeit at a lower rate). Such a tax does *not* favor savings, because the point of savings is to consume in the future (when the tax will also operate). (This conclusion only holds if we rule out dishoarding or dissaving.)

4. *The Incidence and Effects of Taxation*

Part II: Taxes on Accumulated Capital

In contrast to a tax on *current* savings, the charge of "double taxation" is coherent when it comes to taxes on accumulated capital. These destroy the inherited tools, equipment, etc. from the past, and thus a twenty percent tax on capital is far more destructive than a twenty percent tax on income.

A. TAXATION ON GRATUITOUS TRANSFERS: BEQUESTS AND GIFTS

Gifts are transfers, rather than payment for production. Consequently taxes on gifts are taxes on capital. These taxes weaken private charity and family ties.

B. PROPERTY TAXATION

Property taxes must rely on assessed values which can't be known outside of market sales. They also penalize property under debt because of "double taxation." Taxes on rents are capitalized in the sale price of assets and do not fall on future buyers.

C. A TAX ON INDIVIDUAL WEALTH

Although no one proposes it, we can analyze the effects of a hypothetical tax on individual wealth. Like an income tax, it could not be shifted. Unlike a tax on property, it could not be capitalized and hence the market could not "contain" its harmful effects after the initial shock.

5. *The Incidence and Effects of Taxation*

Part III: The Progressive Tax

The typical arguments against the progressive tax are that (1) it reduces the incentive to work, (2) it reduces savings, and (3) it is robbery of the rich by the poor. The first argument is correct, but this is also true of a proportional tax. The second argument is also correct, but those making it usually imply (with no justification) that it is somehow worse to reduce saving than to reduce consumption. The third argument is wrong: Under progressive taxation, the *government* robs both the rich and the poor.

6. *The Incidence and Effects of Taxation*

Part IV: The "Single Tax" on Ground Rent

The Georgist proposal to tax ground rent is severely flawed. The taxing agency must make estimates of ground rent, and moreover determine how much of gross rent is really the return to the land, and how much reflects interest and wages. (These returns are jumbled in the real world whenever original land has been augmented.) The Georgist theory ignores the role of time, and hence misunderstands cases of idle land with a positive capital value. If ground rents were fully taxed, then owners would cease performing their vital role of allocating land to the most value-productive users. There would indeed be no incentive to charge rents *at all*; this would eliminate the Georgist tax base and cause severe distortions in the allocation of scarce land.

7. *Canons of "Justice" in Taxation*

A. THE JUST TAX AND THE JUST PRICE

The only objectively "just price" is the market price. Economists have generally abandoned the medieval quest for the just price, yet they cling to the notion of a just tax. Adam Smith advanced four criteria of justice in taxation that are analyzed below.

B. COSTS OF COLLECTION, CONVENIENCE, AND CERTAINTY

It is not at all obvious that a given tax should be administered with the least possible cost; a costly tax may be implemented less vigorously. It is also possible that an *inconvenient* tax may be beneficial by encouraging the taxpayers to protest. It is also arguable that if a tax is *uncertain* that the taxpayer benefits, because now he or she has “wobble room” when it comes to assessing total tax liability.

C. DISTRIBUTION OF THE TAX BURDEN

There are various proposals for “justice” in distributing the tax burden:

(1) *Uniformity of Treatment*

(a) *Equality before the law: tax exemption*

Equality of treatment is not a virtue if the “treatment” is itself unjust! For example, if someone proposes to enslave others, it is much better that he ensnares only a few rather than enslaving everyone equally. Exemptions are not at all subsidies, because the government is not the rightful owner of one’s money. They are not really “loopholes” but rather just the law.

(b) *The impossibility of uniformity*

It is impossible to tax everyone uniformly. First there is the distinction between taxpayers and tax consumers; since the latter pay *no taxes*, clearly “uniformity” is only possible if no one pays any taxes. Second, there is the problem of defining *income*. For example, should it include services in kind? Should it be calculated as a yearly average?

(2) *The “Ability-to-Pay” Principle*

(a) *The ambiguity of the concept*

There are many plausible approaches to defining one’s “ability to pay” a tax; this underscores the arbitrariness of the concept.

(b) *The justice of the standard*

It is impossible to justify the “ability to pay” principle; it has been taken as self-evident. On the market, such a principle would lead to disaster.

(3) *Sacrifice Theory*

Some economists have attempted to justify progressive taxation on the basis of declining marginal utility of money, but this relies on nonsensical interpersonal utility comparisons.

(4) *The Benefit Principle*

Some economists conflate the benefit and cost principle when they justify proportional taxation on the grounds that the rich benefit more from government protection than the poor. Yet this assumes that the government somehow helped them earn their incomes. On its own terms, the benefit principle is nonsense: If each taxpayer were truly taxed according to how much he or she benefited from government services, then it would be pointless to provide the services in the first place. Moreover, all bureaucrats would have to work for free.

(5) *The Equal Tax and the Cost Principle*

In many respects a uniform head tax on all citizens would be more neutral than other proposals, but it too would require bureaucrats to work for free. It would deviate from a market price in that some people use more government services than others, yet would pay the same “price.” The cost principle is flawed because government costs are higher than private analogs and there is no guarantee that a government agency’s budget correlates to the benefits received by citizens.

(6) *Taxation “For Revenue Only”*

This slogan is silly since all taxes are “for revenue.” The government can implement all sorts of “social engineering” through the *expenditure* side.

(7) *The Neutral Tax: A Summary*

The quest for a *neutral tax*, i.e. one that does not distort the outcomes that would occur in a free market, is hopeless.

D. VOLUNTARY CONTRIBUTIONS TO GOVERNMENT

Even if taxpayers made voluntary contributions to pay for government activities, there would still be no direct link between payment and service. Such a system would not be truly voluntary because of government prohibition on competitors. If competing legal and defense firms *were* permitted, then we would have a free market.

NOTABLE CONTRIBUTIONS

- As Rothbard notes (p. 1160), his analysis of tax incidence—and in particular the conclusion that taxes can't be shifted forward—follows from the Austrian understanding of causality in market prices. Both the neoclassical and Austrian would agree that the equilibrium price of a radio could be higher after the imposition of a tax on sellers, and that (in a sense) consumers are bearing some of the tax burden. However, Rothbard emphasizes that the price rise is not “caused” by the tax, but rather the tax puts marginal sellers out of business, and then the marginal utility of the smaller supply of radios allows sellers to charge a higher price. The typical treatment of tax incidence subtly relies on a cost theory of prices.

TECHNICAL MATTERS

- The issue of “double taxation” can be confusing. Many economists argue that the income tax favors consumption and penalizes saving, because (say) if there is a ten percent income tax and Smith buys a savings bond, then Smith is first taxed on the income which he uses to buy the bond, and then Smith is taxed a second time when the bond matures and he is paid its face value. Reading Rothbard's critique (p. 1169) of Fisher and others—“There is therefore no reason here to say that an income tax especially penalizes savings-investment...”—one might conclude that Rothbard *rejects* such an analysis. However, Rothbard later on (pp. 1169-1170) does indeed admit that an income tax reduces the net interest rate earned on an investment, and to that extent it penalizes saving. The (suggested) resolution to this apparent contradiction is that Rothbard is taking Fisher et al. to be arguing (in our example) that a ten percent income tax penalizes present consumption of \$100 by \$10, while it penalizes present *savings* of \$100 by *more than* \$10, since the \$100 investment will yield more than \$100 of income in the future. It is *this particular type of argument* that Rothbard rejects. (If this is indeed their argument, then a slightly different way to expose the fallacy is to point out that the “higher” absolute amount of taxation in the future must be converted to *present dollars* when deciding whether to consume or invest the \$100 today. Thus the rate of return completely drops out of the analysis when assessing the tax's impact on present versus future consumption in this respect.)
- In footnote 11 (p. 1157), Rothbard erroneously says that a tax on income causes a “rise in the opportunity cost of leisure,” but it actually causes a *fall*, i.e. leisure becomes cheaper and thus people consume more of it. In footnote 36 (p. 1187), the final equation should be $C=R/(i+t)$. (In other words, Rothbard should have added parentheses for clarity.)

STUDY QUESTIONS

- (1) If tax consumers don't really pay taxes, is it also true that (say) Ford executives don't really pay for pickup trucks? (p. 1151, fn 3)
- (2) Why don't politicians keep all tax revenues for themselves? (p. 1152)
- (3) Rothbard says (p. 1158) that a sales tax can't be shifted forward because businesses don't need a tax to raise prices (if that were really more profitable). But doesn't this also prove that a sales tax can't be shifted backward? (p. 1159) If businesses could get away with cutting wages, why wait for the sales tax?
- (4) If government officials happen to have lower time preferences than the society at large, couldn't an income tax increase savings? (pp. 1166-1168)
- (5) Rothbard argues that taxes on *current* saving and investment aren't really cases of "double taxation," whereas matters are different with taxes on capital accumulated in the past. Does this only apply to unanticipated, new taxes on capital? I.e. what if our forefathers knew their bequeathed capital stock would be taxed? Would this then constitute "single taxation"? (p. 1184)
- (6) Would a reduction in property taxes be a subsidy to landowners? (pp. 1188-1189)
- (7) What is the *tax illusion* of the Chicago economists? (p. 1196)
- (8) What is the "land question," and how does the free market solve it? (p. 1209)
- (9) When are land speculators truly the bad guys? (pp. 1210-1211)
- (10) Following the argument of footnote 58 (p. 1213), could someone legally get away with murder in a libertarian world, so long as he took care to wipe out his victims' entire family?