

Lithuanian Free Market Institute
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Taxation and its Justification

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There is a number of different ways to define taxes. Probably the most precise one is given by the “Britannica Encyclopaedia”, which describes taxation as an *imposition of compulsory levies on individuals or entities by governments*. However, no definition can be exhaustive for revealing all the aspects of a matter. Hence, any kind of definition leaves too much room for unavoidably contradictory interpretations. The most distinctive of them for taxes and taxation in general are given below.

Tax is the price we pay for a civilised society. – Oliver Wendell Holmes

Taxation is robbery. – Frank Chodorov

Taxes are the sinews of the state. – Marcus Tullius Cicero

A fine is a tax for doing something wrong. A tax is a fine for doing something right. - Author Unknown

As the cardinal differences in perceptions of the issue reveal, no final conclusion about the importance and benefits of taxation has yet been made – the question still is and probably will long be open for discussions and analysis.

After having investigated the matter thoroughly we decided that the best way to organize our argument is through a comprehensive cost – benefit analysis. Thus, in the first part of the work we are to deal with the aims and desirable benefits of taxation. After that, we will present the drawbacks that the taxes create. Finally, we will conclude our analysis with our own interpretation of the moral foundations of taxes and suggestions for the case of Lithuania. The whole argument is to be grounded on the ideas of the Austrian School economist Murray N. Rothbard and examples from the Lithuanian tax system.

Purposes of taxation

The first known tax system was found in Ancient Egypt. The main purpose of the Egyptian taxes was to collect funds from the poor for the luxurious life of the pharaohs and the nobility. Even though the redistributive effect of taxation is still relevant, nowadays the redistribution is somewhat different. Many countries now aim at taxing the rich and the successful in order to help the unfortunate make the ends meet. In order to understand the purpose of taxation in the broader sense, we may remember one of the ideas presented above – taxation is needed to keep the state alive.

The key idea arises from the fact that people tend to live in communities. As there are issues relevant to all the members of a community, they agree that some administrative institution is required to solve such common problems in a more efficient way. Hence, government is elected. For the purpose of serving the collective problems, government raises resources by taxing the public. Here the primary goal of taxation emerges – taxation provides governments with funds needed to serve the public needs.

Above all, the major common needs include economic infrastructure, i.e. the environment which is essential for any sophisticated economic activities to take place. The creation of economic infrastructure involves ensuring the property rights and enforcement of contracts as well as building roads and creation of a widely accepted legal tender. Governments ensure the protection of property rights by publishing laws, hiring and maintaining police, army and judiciary. Besides, some governments are also responsible for providing education, healthcare and social security. The tax collection provides the means for all of these ends.

In addition to the primary goal of taxing discussed above, modern governments use taxes as a tool for dealing with the so – called market failures. According to Begg et al (2003)¹, the term “market failure” describes all the situations in which free market equilibrium is inefficient. Such situations emerge in 1) industries where, due to various reasons, *imperfect competition* settles in the market – one or more agents in the market are able to exert some market power; 2) markets where producers of a good fail to incorporate all the costs (or to appreciate all the benefits) of their production borne by the society – *externalities*; 3) circumstances where due to the nature of a good or other causes (like information asymmetry or moral hazard) market for that particular good simply fails to emerge – *missing markets*. Some economists consider government intervention as the best remedy against the problem in all of these described situations.

There is a number of ways to deal with the described problems. Governments impose anti-trust laws and create institutions to control the bad practices of the agents in markets (e.g. the Competition Council of the Republic of Lithuania). Even though taxation plays no direct role in this case, the tax revenue is used to fund the relevant institutions. The problem of externalities is addressed by imposing excises or quotas on the goods produced or the by – products that emerge in affected markets. For instance, many countries impose excises on fuel to make fuel price incorporate the additional costs that pollution, originating in the process of the fuel production and consumption, creates to the whole society. This causes the prices to rise and, in theory, should make the consumers aware of the “true” higher cost borne by society and reduce the consumption of the

given good. At the moment, the excise on the unleaded petrol in Lithuania is 1484 Lt per 1t (given the current price of petrol, the excise constitutes approximately one third of the retail price).

Another important issue is the role of government in providing the society with *public goods* – goods that are non-rival and non-excludable in consumption. A public good may be perceived as a special case of externality – a positive one. One of the often used examples is the case of national defence: once an army is established for protecting a particular territory, it is extremely hard (some people argue, even impossible) to exclude anyone within the territory from benefiting from the service, even if he refuses to pay for it. Hence, it is often believed that in cases like this, the state should take care of the problem, by taxing every citizen and providing the service.

Income disparity is the third issue often addressed by governments while using taxation. It is common to perceive that large differences in income of different members of a society constitute a problem. Some argue that differences in earnings create a tension and lessen social cohesion within society. In addition, egalitarians and their proponents believe that equality between all people is the true objective. Moreover, income equalization is trumpeted as the straight way to achieve the main goal. Hence, it is believed that the rich should be taxed while the poor should be supported financially. That is why modern governments usually set proportional taxes instead of lump sum ones, thus causing income redistribution within the society.¹ An even stricter case of redistribution occurs when progressive taxation is adopted – the higher the income a person earns, the higher the tax rate is imposed on his earnings. It causes an even greater equalization of the after - tax income of people having different competences. The aim of income redistribution adopted by government unavoidably involves an ethical/moral judgment. It shows that in some sense the poor and the unfortunate are the privileged few in society.

Finally, a great deal of money raised through taxation is dedicated to supporting bureaucratic apparatus. The size of bureaucracy depends on the number and importance of functions assigned to it. It is important to note that, given the usual structure of government², the size of the whole apparatus and the funds needed to maintain it rise exponentially while expanding its functionality.

¹ The amount and quality of services provided by government to any citizen rarely depends on the amount of taxes the person has paid (It is not important how much money a person has paid to the tax collectors when police officers investigate his house after a robbery. However, people having different income are (indirectly) priced differently for the same service.). Thus, any proportional tax may be considered as a redistributive one – rich citizens pay for themselves and partly for the poor.

² The importance of the principles of accountability and control for successful operation of governmental institutions creates a need for hierarchical structure of bureaucracy (when one new institution is established, either the powers of an already functioning one have to be extended or a second new institution has to be created to incorporate the need for control of the new institution).

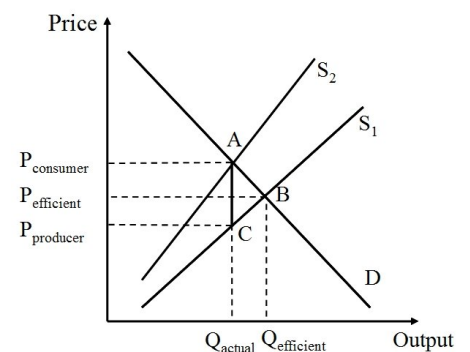
Consequently, the tax burden has to increase in proportion to expenses. Besides, whenever the size of government increases, fewer and fewer people are left working in the private sector, where domestic product is actually created, while the number of dependant public workers, whose role is too often just administrative or supervisory, rises.

Critique of the system

As we have already discussed, the aims of government and the theoretical uses of taxation money seem to be kind and noble. However, what looks nice in theory too often does not look the same in practice. We are now going to argue that the drawbacks such system creates are far greater than the benefits it brings, and that the free market with its *invisible hand* should be allowed to do its job.

The taxation is criticized most for creating market distortions. According to Burda and Wyplosz (2005) tax distortions are the “effects on real behaviour

arising from the wedge that taxes introduce between the price received by the provider of a good or service and the price paid by its consumers”^{II}. The negative effect of a tax on overall welfare is easiest to demonstrate by employing a usual demand – supply diagram. Consider a general case for a good which is sold in a perfectly competitive market. In this case, the supply and demand curves intersect at the point



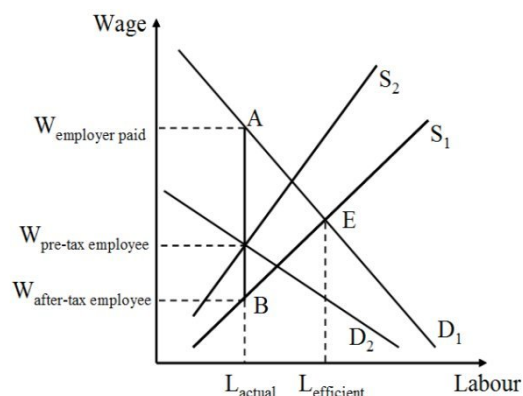
where social welfare is maximized.³ Now suppose that some ad valorem tax is imposed on the good and for each litas that a consumer pays for it, the producer receives only 75 cents. Hence, for any given price the producer is now eager to supply less output (causing the leftward shift of the supply curve). This causes the total output to fall and the price of the good to rise, even though producer receives even less than it was paid before. Parts of consumer and producer surpluses are now dedicated to the payment of taxes, while the triangle ABC in the figure constitutes a deadweight loss to society.

By adopting similar analysis we may show how taxation distorts one of the most important markets in economy – labour market. Consider the case of Lithuania. A Lithuanian worker has to dedicate 3% of his income to social insurance and 24% of his income above the untaxable minimum income level for paying the income tax. In addition, an employer wishing to remunerate a worker with

³ For a detailed proof of the efficiency of perfect competition please refer to any beginner or intermediate level Microeconomics textbook (e.g. W.Morgan, M.L.Katz and H.Rosen *Microeconomics*).

2000 Lt monthly salary, has to bear in mind the 620 Lt (31%) that it will need to pay on behalf of the worker as his social insurance contribution. The changes that taxation induces in demand and supply of labour are shown in the figure. If there was no taxation, the labour market would clear at the point E, which is socially most desirable –

involuntary unemployment would be absent and social welfare would be maximized. However, taxes levied on both types of agents (employers and employees) operating in the market cause leftward shifts of both supply and demand curves. The tax wedge causes employers to pay much more than employees actually receive, hence, the level of employment falls and



unavoidably productive activity of society decreases. Moreover, as fewer people are employed, unemployment emerges. Given the current preferences of government and society, the unemployed are perceived as in need of financial support and unemployment benefits are issued. How is the government supposed to fund the benefits? Rather unsurprisingly – through an even heavier taxation. What is the effect of higher taxes? Well, we are forced to take another look to the top of the page.

Such tax distortions in labour as well as in the other markets result in a fall in production. Drop in production, in turn, means fallen consumption and the standard of living enjoyed by the citizens of a country. As we have just proved, distortionary taxation reduces real GDP and prosperity of a nation.

After having considered this, another important question should emerge in your mind: What about the non – distortionary taxes? Is there such a thing as neutral taxation? By definition, neutral taxation is such “that would not divert the operation of the market from the lines in which it would develop in the absence of any taxation“(Mises, 1996)^{III}. In other words, neutral taxation is the one that allows the market to function as if there were no taxes at all and *free market* would set the equilibrium. The aim of the government, in this case, is to simulate the free market perfectly. There is no way to explain the matter better than L.Mises did:

The neutral tax would affect the conditions of the citizens only to the extent required by the fact that a part of the labour and material goods available is absorbed by the government apparatus. In the imaginary construction of the evenly rotating economy the treasury continually levies taxes and spends the whole amount raised, neither more nor less, for defraying the costs incurred by the activities of the government's officers. <...> If we assume that in such an evenly rotating economy there prevails perfect income equality in such a way

that every household's income is proportional to the number of its members, both a head tax and a proportional income tax would be neutral taxes. <...> A part of each citizen's income would be absorbed by public expenditure, and no secondary effects of taxation would emerge.^{IV}

However, the reality we observe is much different from the assumptions presented above. Actually, there hardly is any society where income and wealth are distributed evenly among its members and do not change over the time. People, by nature, are changeable, impulsive and impermanent. Hence, the economy they live in must also be very dynamic. Because of this, L.Mises argues, no tax can be neutral. This statement is also supported by M.N.Rothbard: “The idea that taxation, and therefore government’s operation, should be neutral to the market <...> is a noble but impossible one. <...> Taxation can never be neutral to the market, and the impossibility of this dream is rooted in the very nature of taxation and government.”^V M.N.Rothbard goes even further in criticizing the modern system by saying that “it is perhaps because of this impossibility that this concept, in the hands of the modern public-choice theorists and others, has so quickly become yet another device for ratifying the status quo of State power”^{VI}.

As M.N.Rothbard correctly pointed out, the proponents of the large State power quite often use rather artificial arguments to support their views. It is so because there is not much one can use to rebut the arguments of free market activists. *Laissez faire* supporters argue that one of the major drawbacks of large government powers is the inefficiency of the State. Whenever governmental institutions are made responsible for providing a service to the public, there is a strong tendency for a governmental monopoly to emerge. Furthermore, as there is no one subject to reap the profits, the incentives to innovate and minimize the costs are rather weak. In addition, due to inexistence of *invisible hand*, which normally signals the quantities of goods required through adjusting the price, governments often fail to choose the optimal amount of public service, thus inducing misallocation of resources. Besides, the absence of competition within the industry keeps productivity, its growth and efficiency in general rather low and far away from the optimal level which would be reached if the industry was operating under free market conditions.

Government, in need to solve the mentioned problems, finds establishing various supervisory institutions, which control the state monopolies and public institutions, as the best mean to at least partly fight the inefficiencies. The most remarkable example is the National Audit Office of Lithuania. It is a public institution which, among its other duties, is responsible for auditing the implementation of the budget of the State Social Insurance Fund and Compulsory Health Insurance Fund. According to the website of the institution, it employs around 330 staff members in its offices

spread all over the country. Under free market conditions, there would be no need for supervision as competition would ensure the efficient operation of the agents. Thus, society could enjoy the possibly more tangible fruits of the labour of these 330 people. Basically, most of the public institutions take the resources away from the private sector and do not make them contribute to the welfare of the nation as much as they could possibly add if they were employed in producing goods and services actually required by the public. The more labour is involved in performing administrative and supervisory tasks in the governmental institutions, the less of it is available for enlarging the domestic product, the more resources are required to pay for such labour and the heavier the tax burden becomes.

The aim of any economic activity is to maximize the utility available to an agent. Whenever a person consumes a good, it generates him some utility and increases his welfare. As consumption is valuable, people choose to give up some leisure and exert labour, in order to earn resources which, in turn, are exchanged for the desired consumer goods. As we see, the key element of all economic activity is the freedom of choice. A person is free to choose how much of any good to consume and how much time to spend at work, given the prevailing conditions in the market. Irrespective of these conditions, the freedom allows an agent to act in the way that maximizes his welfare. As opposed to this, by imposing taxes government leaves no room for personal choice. All agents in the market are treated in the same way according to some benchmark of an average citizen. Personal needs and desires are ignored: there is no choice of quality, price or quantity of a service provided by a government monopoly. People are paying price for the service (taxes) according to the command of the State rather than their personal preferences. In this case, given the natural diversity of mankind, inefficiency is unavoidable.

Voluntariness is another related issue. In the description of the primary purposes of a government, the idea of a voluntarily elected administration for self-regulation of the community was mentioned. Here arises the common belief that, viewed in this way, taxation is a voluntary act of the society members in order to fund and maintain the publicly beneficial government. However, as M.N.Rothbard once accurately pointed out, “if these payments to government were voluntary, we can be sure that they would be substantially less than present total tax revenue. Why? Because if people were willing to pay voluntarily, then there would be no need for the apparatus of coercion so intimately wrapped up in taxation.”^{VII} Yet, if taxes are collected despite of the involuntariness, it is then high time we started speaking about the property rights.

In a very narrow sense, the modern system is based upon two key ideas of property rights: 1) a person has the property of his own body and himself; 2) a person has the property of his own labour and anything that is created by it. After having designed something by mixing up natural resources and his personal efforts (labour), he can then *choose* to exchange his creation for the goods produced and services provided by other people. (M.N.Rothbard, 2000)^{VIII} By imposing taxes, government collects the fruits of one's labour. However, as it was proved that citizens interact with government mostly involuntarily, any taxes of this kind may be perceived as violation of property rights. As the government is involved in an exchange that takes places with an agreement of only one part of the contract, we are left with the unhappiest conclusion – *Taxation is robbery* (F.Chodorov). As M.N.Rothbard puts it, "Everyone <...> in society acquires income *either* through voluntary gift (lodge, charitable society, chess club) *or* through the sale of goods or services voluntarily purchased by consumers. If anyone *but* the government proceeded to "tax", this would be clearly considered and thinly disguised banditry. Yet the mystical trappings of "sovereignty" have so veiled the process that only libertarians are prepared to call taxation what it is: legalized and organized theft on a grand scale."^{IX}

By imposing taxation government not only raises funds for providing public services, it also performs the role of justice by addressing income disparity within the society. As mentioned before, it aims at taxing the rich and supporting the poor in pursuit of the common belief that complex equality of people is an objective of society. Even though the idea of equality is perceived as a very kind one, what are the ethical, moral and economic arguments for and against it? There can hardly be found any objective arguments supporting egalitarianism. Rather, it is accepted as a moral norm which does not need scientific grounding. Only a few people dare to question it and, quite surprisingly, the arguments they find do not support the idea. The straightest way to understand the matter is again provided by M.N.Rothbard: "The species, mankind, is uniquely characterized by a high degree of variety, diversity, differentiation; in short, inequality. An egalitarian society can only hope to achieve its goals by totalitarian methods of coercion."^X Hence, because of the inherent differences among the people, no two of them can be equal with respect to each and every aspect. One may argue that the State does not aim at complete equalization of people – rather it taxes to equalize the income among different members of society. But this goal, as well, lacks moral foundations – taxation in general violates the property rights and, thus, is immoral. Moreover, as people are inherently different, all of them have different talents, attitudes to work and struggle unequally. Why, then, should they be remunerated equally? Finally, "if equality is an absurd (and therefore *irrational*) goal, then any effort to approach equality is correspondingly absurd. If a goal

is pointless, then any attempt to attain it is similarly pointless.”^{XI} The same holds for taxation as a mean of generating equality within the society.

Last but not least, taxation aims at correcting market failures. By imposing taxes government seeks to bring the “failing market” to its equilibrium. Even if we assumed that the government succeeds, the costs of such practice are not negligible: a whole range of institutions need to be established for collection and administration of taxes. However, the problem could be solved without making the society incur these costs, if instead of imposing taxes government allocated the property rights of an externality to one of the affected agents⁴. As public goods are kind of positive externalities, the same methods based on free market principles should be applied in dealing with them.

Conclusions

The sole existence of taxation contradicts the main idea of the presence of government. While government is a result of *free choice* of community members to have an institution which would deal with common problems, taxation is a *compulsory* and *coercive* duty of society for its government. It conflicts the key idea of liberty which the modern society is built on. Although one of the major functions of government is the protection of property rights, it violates its purpose completely by performing this “theft on a grand scale”^{XII} called taxation.

As our analysis has demonstrated, the employment of taxation in order to deal with market failures, redistribute income and provide public services is either inefficient or unjustified. The only purpose that the government should dedicate to is the protection of property rights and enforcement of contracts. It should deal with these tasks in the way that would minimize the costs borne by society, i.e. act according to the rule set by J.B.Say: “The best scheme of finance is to spend as little as possible; and the best tax is always the lightest.”^{XIII}

With reference to these conclusions, we have to admit that both governmental apparatus and taxation in Lithuania are far too large. Instead of searching for new methods to exert money from its citizens, Lithuanian government should, in turn, retreat from entire industries which are now ruled by public institutions. For instance, there is a common agreement between local experts that Lithuanian healthcare system would benefit from deregulation of government and allowing free market to perform its role in the sector. In addition, the failure of the government to provide education of proper quality signals the need for liberalization of the educational system. We could

⁴ For a detailed description, please refer to Coase theorem.

continue this list almost indefinitely and in all of these cases injection of free market principles would only benefit the wealth of society.

^I Begg, D, Fischer, S and Dornbusch, R., 2003, *Economics*, McGraw-Hill, pp. 218

^{II} Burda, M.C. & Wyplosz, C., 2005, *Macroeconomics: A European Text*, Oxford University Press, pp. 416

^{III} Mises, L., 1996 (edited by Greaves, B. B.), *Human action*, Foundation for economic education, pp. 737

^{IV} Mises, L., 1996 (edited by Greaves, B. B.), *Human action*, Foundation for economic education, pp. 737

^V Rothbard, M.N., 1981, 'The myth of neutral taxation', *The Cato Journal*, Fall, 1981, pp. 564

^{VI} Rothbard, M.N., 1981, 'The myth of neutral taxation', *The Cato Journal*, Fall, 1981, pp. 564

^{VII} Rothbard, M.N., 1981, 'The myth of neutral taxation', *The Cato Journal*, Fall, 1981, pp. 525

^{VIII} Rothbard, M.N., 2000, *Egalitarianism as a revolt against nature*, pp. 96

^{IX} Rothbard, M.N., 1973, *For a new liberty*, Macmillan

^X Rothbard, M.N., 2000, *Egalitarianism as a revolt against nature*, pp. 8

^{XI} Rothbard, M.N., 1972, *Man, Economy & State*, Chapter 6 'Antimarket Ethics: A Praxeological Critique'

^{XII} Rothbard, M.N., 1973, *For a new liberty*, Macmillan

^{XIII} Say, J.B., 1803, *A Treatise on Political Economy; or the Production, Distribution, and Consumption of Wealth*, Lippincott, Grambo & Co.