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The tax state, benefit and legitimacy

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Professor Miranda Stewart

Tax and Transfer Policy Institute, Crawford School of Public Policy
Australian National University

Abstract

This Working Paper traces the discursive history of the principles of benefit and legitimacy of taxation from the late eighteenth century to the present day. Drawing on the work of scholars from Adam Smith through Richard Musgrave to public choice theorists, it is observed that successful tax states – especially democratic states – seem to depend on both an acceptance by taxpayers of benefits derived under government and a fiscal constitution that limits taxing power. The benefit theory in the context of legitimate government has strengths that are lost if a purely technocratic, narrow economic analysis of public goods is taken. However, both benefit and legitimacy of government are important concepts in the current era of globalisation and fiscal authority, which pose significant challenges to democratic governments. The author argues for a renewed focus on principles of benefit and legitimacy of taxation to fund successful democratic tax states in the global era.

Keywords: Taxation, Benefit theory, ability to pay, legitimacy, public choice, public goods, Adam Smith, Richard Musgrave, globalisation

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Tax and Transfer Policy Institute
Crawford School of Public Policy
College of Asia and the Pacific
+61 2 6125 9318
tax.policy@anu.edu.au

The Australian National University
Canberra ACT 0200 Australia
www.anu.edu.au

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1. INTRODUCTION

It was Alistair who said, on national television, that being a Tax Officer was the most pleasant work imaginable, like turning on a tap to bring water to parched country. It felt wonderful to bring money flowing out of multinational reservoirs into child-care centres and hospitals and social services ... He sold taxation as a public good.¹

Collectively, we give authority to government to levy taxation so as to provide for the public good. This paper discusses two core principles – *benefit* and *legitimacy*– which underpin taxation to fund government. Levying taxes for public benefit is a coercive exercise of government power. In successful tax states, the coercive taxing power seems always to be constrained by a set of rules or norms which both limit and legitimise taxation. This fiscal constitution has been crucial to the success of the tax state. While democratic limits on taxing power are not the only possibility, the slogan ‘no taxation without representation’ indicates how representative democracy developed in tandem with legitimate taxation and became the dominant form of government that could be successfully funded by substantial taxation. This paper seeks to link core principles of taxation to a view of a ‘good democracy’ (Head 1962, 223).

The paper does a sweeping historical discursive survey which aims to show how concepts of benefit, legitimacy and ‘public goods’ in public finance developed in the context of political, economic and technological change in the tax state over the last two centuries. The narrative focuses on two leading scholars: Adam Smith especially *The Wealth of Nations* (Smith 1776) of the eighteenth century and Richard Musgrave including *The Theory of Public Finance* (Musgrave 1959) of the twentieth century), who each saw government as a joint endeavour that must be maintained, developed and funded by taxes.

The paper then discusses the benefit theory of taxation and the legitimacy of the taxing power of government. The benefit theory calls for a way to identify benefit that generates the obligation to pay tax. Its development led to a concept of ‘public good’ which became increasingly refined in public finance but that was itself tied to a limited view of what government should do, funded by taxation. Taxation was always

¹ Carey (1993), 124.

restricted by national jurisdictional boundaries but as these became more important in the early twentieth century, the benefit theory became important in international tax theory which sought to allocate taxing rights between countries. Finally, the paper turns to discuss the challenges to the democratic state in the context of economic globalisation. It is argued that we need to renew our focus on the benefit and legitimacy of taxation to enable funding government for public benefit in the global era.

2. DEVELOPMENT OF THE 'TAX STATE'

The 'tax state' refers to a government dependent on and defined by its power to tax.² We owe the concept to Joseph Schumpeter, the Austrian economist and sociologist who was briefly Finance Minister of Austria and who later moved to Harvard University in the United States. Schumpeter presented the concept of the 'tax state' in 1918. He argued that fiscal affairs were crucial 'at the turning points of epochs, when old forms die off and new structures emerge, times which always involve a crisis of the old fiscal methods' and proposed -

a special field, fiscal sociology ... the view of the state, of its nature, its forms, its fate, as seen from the fiscal side. The word 'tax state' is a child of this view.³

The early British tax state and Adam Smith

The eighteenth century has been described in recent studies of economic history as the time of the birth of the tax state. For example, Wenkai He (2013) traced developments through which central governments in England, Japan and China sought to raise sufficient revenues to govern effectively. He concludes that in England and Japan, a successful transformation was achieved towards centralised and effective public finance, based largely on indirect consumption taxes. In England, this was achieved in the period from 1642 to 1752 and in Japan, a century later, in the period from 1868 to 1880. In contrast, He argues that China failed to transform its public finances away from decentralised property taxes towards centralised taxes and therefore did not achieve the same level of consolidation of government power and did not become a 'tax state'.

² The term 'tax state' is used with more precision by economic historians to refer to particular stages of development of the tax state. See, eg, Bartolome and O'Brien 2012; Hood 2003.

³ Schumpeter 1918, 1954. Fiscal sociology is enjoying a resurgence, see, eg, Martin, Mehrotra and Prasad 2009.

It was in the context of the newly consolidated British 'tax state', which relied heavily on indirect taxes on goods, that Adam Smith developed his ideas about government, economics and taxation.⁴ Smith was, as is now a cliché, the 'father' of free market economics. A less popularised but vital contribution of Smith is that he envisaged taxation as the core funding for government. His views on the free market and the importance of taxation to fund government are not inconsistent but, rather, are necessarily interdependent. Smith observed that the state has long been financed by a combination of sources: tribute from conquered lands; the king's domain; seignorage derived by sovereign control of currency; borrowing; and taxes extracted by compulsion from citizens. The domain is the land or enterprises which belong to the sovereign, from which he derived rents from lands or agriculture, or profits from the means of production such as a mine, or 'mercantile projects'.⁵

Smith observed that the great European states could no longer defray their expenses from the domain. The domain provided would be most productively used in private hands in the market economy and the only lands that should remain in the hands of the Crown are 'lands for the purposes of pleasure and magnificence – parks, gardens, public walks, etc, possessions which are everywhere considered as causes of expense, not as sources of revenue'.⁶

Smith also rejected government borrowing as an adequate source of revenue. He gives as an example, the borrowing practices of the State of Pennsylvania in the United States but observes-

[T]he unstable and perishable nature of stock and credit, however, render them unfit to be trusted to as the principal funds of that *sure, steady, and permanent revenue* which can alone give security and dignity to government. The government of no great nation that was advanced beyond the shepherd state seems ever to have derived the greater part of its public revenue from such sources.⁷

Smith concluded that government must be funded by taxes, 'the people contributing a part of their own private revenue in order to make up a public revenue to the

⁴ Smith (1776) especially Book V Ch 1 ('Expenses of the Sovereign or Commonwealth'); Ch 2 ('Sources of General or Public Revenue of the Society'); and Ch 3 ('Debt').

⁵ Smith (1776), Book V, Ch 2.1. Smith noted wryly that princes 'have scarce ever succeeded' in mercantile projects (Book V, Ch 2.7), referring to Machiavelli's writing about Lorenzo of Medici's failed business ventures, and to the misadventures of the English East India Company.

⁶ Smith (1776), Book V, Ch 2.22.

⁷ Smith (1776), Book V, Ch 2.13 (emphasis added).

sovereign or the commonwealth'.⁸ It is then understandable that Smith paid attention to the principles on which taxation should be designed to support 'government ... of a great nation' in his famous maxims, extracted here-

I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expence of government to the individuals of a great nation is like the expence of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation. ...

II. The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. ...

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. ...

IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state....⁹

Smith presented the Maxims as general, for the design of taxes to fund the ongoing operation of all governments.¹⁰ Half a century later, John Stuart Mill extracted Smith's principles in his own writings, described them as 'classic' and added his own analysis especially on equality in taxation.¹¹ Today, tax policy makers frequently refer to a triumvirate of 'traditional' tax policy principles: equity, efficiency and simplicity, which are drawn largely from Smith's maxims.

Smith applied his maxims in considering the actual kinds of tax, their impact on business, consumption and work, and modes of collection that might be adopted by the state, to an unprecedented level of detail. He was knowledgeable about the diverse types of tax applied in Great Britain, on the Continent and in the Americas. He recognised that taxation has an impact on the entrepreneurial behaviour and choices of taxpayers in the market economy and argued for the most neutral taxes.

⁸ Smith (1776), Book V, Ch 2.22.

⁹ Smith (1776), Book V, Ch 2.25.

¹⁰ Smith (1776), Book V, Ch 2.29.

¹¹ Mill (1848, 1909) Book V, Ch 2, especially 2.1 ff.

He understood that different taxes called for different mechanisms of measurement and collection and sought to articulate how these could be most effectively designed to be acceptable to taxpayers. He also recognised that these maxims of taxation require balancing in the real world.

Smith's work on taxation is a link from the historical development of taxation laws and methods of collection of the eighteenth century to the successful establishment of an income tax to fund government in the twentieth century. Although he died a decade before the first English income tax of 1799 (generally recognised as the first modern income tax), his work reveals that this concept was well understood by him and others. The concepts of taxation on faculty and on profit or revenues as a flow from assets, labour, or business were already established (Harris 2006, 389-90). Smith discussed taxes falling on 'the private revenue of individuals' from 'rent, profit, and wages', arising from land, stock (movable property) and labour, and emphasised that it was the net revenue after expenses which should be taxed.¹² He was aware of the difficult issues facing tax administrators and law makers concerning how to identify, value and tax the returns to 'active' business, trades and professions as well as commodities and land. Smith turned towards direct taxation as the primary foundation for funding government.¹³

The nineteenth century 'fiscal state': tax, debt and liberalism

Taxation came to be the core funding for government in the tax state. However, governments had for thousands of years borrowed money to govern. Some early forms of taxation operated as a system of borrowing. Margaret Levi explains that in the Roman Empire the sophisticated system of tax farming was 'as much a banking as a taxing system': tax farmers gave rulers 'a loan secured by the revenues they then are authorized to collect from taxpayers' (Levi 1988, 77). The Venetian government 'levied a compulsory loan on its taxpaying citizens, for which it promised each of them five percent annual interest, and allowed the "bonds" or contracts to become negotiable, thus creating a market in government debt'; this innovation spread to other Italian cities and across Europe, generating a sense of 'ownership' of government which was perhaps a precursor to citizenship: 'the commercial classes in those mercantile republics that pioneered these new forms of financing did end up

¹² Smith (1776), Book I, Book V Ch 2.23.

¹³ As discussed by Musgrave 2000, 55.

seeing themselves as owning the government' (Graeber 2011, 338-9). Governments, for their part, acted in 'service and subservience to the merchant interest' in a 'close, even intimate, association between the state authority and the merchant interest' (Galbraith 1987, 36). Smith observed the importance of the 'great mercantile families' in republican Holland and Zeeland, who bore a substantial part of the expense of these countries but were also accorded 'either some direct share or some indirect influence in the administration of that government'.¹⁴

At the end of the eighteenth century, some governments became indebted to an unprecedented level. Following the American war of independence, the ensuing economic crisis, the failure of salt taxes and other taxes on commodities (partly due to smuggling and enforcement difficulties) and the Napoleonic wars, Great Britain owed in excess of 200 per cent of national income – considerably greater than the levels of government debt we see arising from the recent global financial crisis (Daunton 2001, 47). This massive challenge for the state was met by the end of the nineteenth century, by which time Britain had embedded the income tax, ensuring stability of government finances.

The successful establishment of the income tax was, in fact, linked to a *reduction* overall in the size of the British state. Acceptance of the income tax 'rested on creating a belief that it would help to constrain the state rather than provide it with additional resources.' As there was 'a close correlation between paying income tax and possessing a vote in parliamentary elections under the terms of the Reform Act of 1832' this accorded nicely with the principle of 'no taxation without representation' (Daunton 2010, 39). Trust was required from two key stakeholders: lenders and taxpayers. From the capital markets, there needed to be an ability to borrow large sums that would bear interest to be gradually paid down over the long term. This could only be financed with a steady flow of taxation revenues and so the government also needed to gain the trust of taxpayers.

The shift towards a new equilibrium in a taxing and borrowing 'fiscal state' also had distributional consequences. Piketty observes that 'a government bond is nothing more than a claim of one portion of the population (those who receive interest) on another (those who pay taxes)' (2014, 113).¹⁵ The 'rentier' class and the

¹⁴ Smith (1776), Book V, Ch 2.225.

¹⁵ Although that general statement ignores debt owed to creditors outside the country.

'taxpayer' class overlapped considerably during the nineteenth century. In uprisings through much of the century and especially by the end of it, this equilibrium became destabilised, as the mass of workers in the industrialising state, who paid relatively little in income taxes but numerous taxes on commodities, sought increased government expenditures and political representation.

The 'modern liberal state' of Britain, although 'widely appraised by contemporaries', could not be replicated elsewhere (Cardoso and Lains 2010, 22). However, a similar pattern emerged in a number of other European states, revealing the 'complementarity of the modern tax system and the modern method of issuing government debt' (Neal 2010, 299). For example, in Sweden, 'on the one hand there were income taxes and indirect taxes on monetary streams and on the other hand state borrowing was long term with a large funded debt' (Schon 2010, 16). We can also observe a gradual change in the features of tax systems during the nineteenth century. Direct taxes, in particular income tax, land and inheritance taxes, were expanded and to some extent replaced commodity taxes and tariffs. A European pattern developed, 'defined by the execution of forms of financing government activity by taxing the economy efficiently and by servicing political and social consensus' but differences in 'the institutional forms of how tax policies were conducted' remained important (Schon 2010, 22).

The German communal state and *Finanzwissenschaft*

An alternative approach to financing government developed in the German states. It is well recognised that the German states were first to expend substantial public monies on social welfare. By the second half of the century, German public economist Adolph Wagner had noticed an interesting trend in public expenditures. In 1863, he pronounced a theory that became famous as 'Wagner's law', connecting the rise in government spending to growth in national income: 'the wealthier a country becomes, the more the share of public activity (and thus expenditure) will increase' (Wagner 1863, 1954, 2-5).

The economic historian Spoerer has concluded, after a detailed review of German local, provincial and federal taxation data, that Wagner made 'a valid empirical description of the development of the public-sector share during his time' (Spoerer 2010, 112). As Spoerer explains, and Wagner observed, expenditures on education, utilities (water, gas, electricity, sewerage), transport and welfare

payments gradually increased: '[w]elfare cost had always been important items in municipal budgets. But whereas supporting the poor used to be discretionary, welfare support became an entitlement with the much-praised social security legislation of Reich Chancellor Otto von Bismarck'. This included government-provided health insurance in 1883, accident insurance in 1894 and old age insurance in 1889, all of which Bismarck intended 'to take the wind out of the socialists' sails' and 'to make the labourer a dependent of the state, someone who feared that he risked his pension should the socialist overthrow the bourgeois order'.

The German states and subsequently the Reich derived substantial revenues from ownership of public utilities, railways, mines and postal services as monopolies. This development, like the heavy use of debt in the fiscal state, contradicted Adam Smith who had argued that governments usually failed at 'mercantile projects'. As traced in Seligman (1908), taxes increased but implementation of income tax was slower than in Great Britain, although German intellectuals had given significant attention to the concept. In the southern states, taxes were largely indirect or on assets including land. An income tax was established in Saxony in 1878, Baden in 1884 and Prussia in 1891.

The specialist subject of public finance for 'communal wants' became known as *Finanzwissenschaft* and became well known outside Germany. For example, Irish scholar of political economy Charles Bastable discussed the German approach in his 1892 volume, *Public Finance*. Bastable explains how this 'remarkably productive' German scholarship placed public finance in the context of economic history and treated it as having politico-social and not merely financial aims.¹⁶ By the end of the nineteenth century, Wagner argued that taxation 'can become a regulating factor in the distribution of national income and wealth, generally by modifying the distribution brought about by free competition ... this second, regulatory purpose to interference with the uses of individual incomes and wealth ... leads to an extended, or if preferred, a second conception of taxation. This is a 'social welfare' concept beside the 'purely financial' one (Wagner 1893, 1954, 89).

¹⁶ Bastable 1892, Ch II.15.

The twentieth century ‘tax and welfare’ state

We should be careful not to overstate the ability or desire of nineteenth century governments, even Germany, to tax and spend for communal wants. While public expenditures in Great Britain reached 20 per cent of national income during the Napoleonic Wars, this level was brought down during the course of the century. Most governments barely reached a fiscal ratio of 10 per cent of national income. The dawn of the twentieth century saw many governments that were neither democratic nor delivering public goods on any scale for benefit of their people. Schumpeter was concerned about the potential collapse of the tax state in the face of increasing social demands, not war (1918, 116) -

While the tax state has been able to survive rising costs of administration and war, changing attitudes towards property and demands for social expenditures offer a more ominous signal for its future. These may generate a crisis which the tax state cannot survive.

Forty years later, the pattern appeared more in line with Wagner’s law – a growth in public expenditures, funded by taxation, consistent with growth in the size of the economy. The public power to tax and spend became a defining characteristic of democratic government (see, eg Campbell 1993; Gould and Baker 2002). As the franchise expanded, the size of government expenditures and level of taxation increased dramatically.

The scholar who literally embodies twentieth century public finance is Richard Musgrave, who lived from 1910 to 2007. Musgrave’s research career spanned nearly 70 years from the early 1930s to 2000. He learned his public economics from the leading scholars of the previous century, in the tradition of the European social sciences; combined this with public policy experience and advice to governments; and in the last part of his career engaged directly with legal concepts of justice and constitutionalism, in teaching taxation at Harvard Law School with another great American tax policy-maker and lawyer, Stanley Surrey. Musgrave did more than any other theorist in the English language to draw together the traditions of public finance in social and economic context, recognising both the German tradition of *Finanzwissenschaft* and the Anglo-liberal tradition inherited from Smith and Mill.

Musgrave (2000, 101) summarises the ‘tax and welfare’ story as follows-

[T]he western world saw the typical state share in GNP rise from 20 to over 40 percent. In part this reflected rising military budgets, but more importantly the growth of social programs to serve the interests of lower and middle income

groups. The propertied class did not dominate voting rights and, in strategic areas, even sponsored the infusion of social concern into the market system. By and large, the rise in expenditures was matched by rising tax revenue; and where instances of over-indebtedness led to fiscal collapse (typically as the product of war finance), that crisis was soon liquidated by bankruptcy and inflation. Thereafter, the capitalist system with its tax state reemerged none the worse.

While only hinted at by Musgrave, this was hardly a smooth trajectory: it is important to remember the wars, financial depression, poverty and holocausts that accompanied the expansion of the state in general, and tax and welfare systems in particular.

The changes in state and economy led to a rush of new ideas and to an overarching debate about the role of government in the economy, epitomised by the debates between John Maynard Keynes and Friedrich Hayek (see e.g. Wapshott 2011). In the tradition of Germany the previous century, many European countries including Great Britain and also Australia, New Zealand, Canada and to some extent the US, were 'mixed economies'. Governments played an active and interventionist role in market activities and derived significant revenues from enterprises supplying everything from fertilizer and steel to power, rail, postal services, airlines and water facilities. Many scholars considered that high tax and expenditure levels, public ownership of enterprises and full employment were necessary for the survival of capitalist society (e.g. O'Connor 1973). In some countries – Sweden and other Scandinavian countries in particular – the public sector came to dominate more than half of the economy. However, in most countries economic growth meant that the private sector substantially exceeded the public sector and the range of goods and services *privately* consumed also grew at an unprecedented speed and scale.

Marshall (1950) and others were influential in establishing welfare policy with the main goal of social solidarity in the twentieth century. In the 'golden era' of the welfare state and unprecedented economic growth from the 1950s to the 1970s, there was a broadly accepted consensus of universal citizenship and an acceptable minimum standard of living. Different countries established quite different models of welfare state including 'insurance', entitlement and more targeted 'poverty relief' models. However, they all had common goals of redistribution, provision for need and social cohesion, so that 'a large proportion of the population supports the

political system that governs the interaction between state and society' (Gizelis 2010, 27).

The use of progressive income taxation with increasing rates borne by both labour and capital was of central importance in funding this welfare state in many countries. In particular, many former British colonies including the US, and Canada, Australia and New Zealand succeeded in increasing income tax and establishing redistributive welfare states. Although they became self-governing at different times and in different ways, the story of development of the 'tax and welfare' state in each place has similarities, especially in relation to the income tax. Leading US tax scholar Seligman places direct taxes, especially the income tax, as the 'last step in the historical development of public revenues' (1908, 8). The intellectual lineage dating back to Adam Smith is revealed in his use of 'revenue' as interchangeable with 'income'-

Just as a man's ability to support himself or his family is seen in his income or revenue, so, in the same way, it is recognized that the test of a man's ability to support the state is to be found in this same income or revenue. From the modern point of view, it is the duty of the citizen to support the government according to his capacity to support himself (Seligman 1908, 18).

The emphasis given by Seligman and others to income taxation was given renewed vigour by Henry Simons in his influential text, *Personal Income Taxation* (1938). Simons was a liberal economist who saw the progressive income tax as essential for viability of the free market economy. It became and still remains central to funding government and to the political compromises made in the twentieth century, especially in the United States, as recently examined in depth by Mehrotra (2014).

In Australia and New Zealand, progressively structured taxes had already been established before the Australian federation was formed in 1901 (Smith 2004, 22). The Australian colonies came to the federation – which up to the last minute might also have included New Zealand – with significant sovereign debt, in contrast to the Canadian and US federations in earlier times. An Australian land tax was introduced in 1910 and income tax in 1915, both ultimately to fund the 'promise of a national old-age pension' which 'had been an important element of popular support for the Federation' (Smith 2004, 48).

During the 50 year period from 1930 to the 1970s we see the most dramatic transformation of tax and government. After World War II, income taxes were for the

first time in history borne by the mass of the population who earned income from work not capital. The broad taxpayer base of the personal income tax was critical for expansion of the 'tax and welfare' state. At the same time, social security taxes on wages also funded the 'entitlement' or insurance model of welfare in many countries. Unlike income tax, these social security taxes were often flat rate or even regressive. Some countries, especially France, relied less on income tax and more social security tax and the new broad-based consumption tax known as the Value Added Tax, or VAT. This was also borne mostly by labour and was adopted to fund growing welfare states across Europe from the 1960s.

At the same time as the base of income tax was broadened, this period up to the 1970s saw the rise of highly progressive income taxes across the developed world, some with very high marginal rates. Higher income earners, including those earning returns to capital, paid more income tax under these progressive regimes than they ever had before (they also, increasingly, sought to avoid this tax).

Fiscal crisis and tax reform for growth

The rosy state of affairs observed by Musgrave appeared, until the 1970s, to be compatible with continuing economic growth. However, this 'golden' period ended in the 1970s. Indeed, Messere defines an even narrower 20 year period 'between 1955 and around 1975' in which 'there was economic growth and increased standards of living in most industrialised countries and a corresponding readiness of taxpayers to accept more tax burdens to contribute to a better welfare state' (2003, 119). He observes that it took another decade for the 'tax backlash' to manifest itself in most industrialised OECD countries (Messere 2003, 119).

The 1970s saw a first wave of globalisation, the collapse of the gold standard and floating of currencies across many countries. Governments borrowed heavily and this combined with 'oil shocks' and high inflation led to fiscal crises in many countries. It became apparent that tax systems were not as robust as had been believed. Inflation became an important problem for workers, as progressive taxes became increasingly heavy on middle income earners through bracket creep, leading to political opposition. In many countries, income tax avoidance by upper and middle earners increased in response to high marginal rates, often using offshore tax havens as international capital flows became easier.

One reaction in public finance to these developments was an emphasis on supply side economics and the rise of neo-liberalism. A broad consensus developed that inflation must be halted and the goal of low inflation was institutionalised. There were calls for lower tax rates on capital and labour to encourage investment and economic growth and a reduction in tariffs as borders were opened to trade.¹⁷ Daunton (2002) writes of the shift to the 'enterprise' state in Great Britain, which led to an increased focus on incentives to entrepreneurship, savings and an acceptance of inequality as a necessary element in a successful capitalist economy.

Another important theoretical development was optimal tax theory, which built both incentives and distribution into tax analysis and identified biases in the tax system against work, entrepreneurship and saving. James Mirrlees and Peter Diamond 'proved' that high and progressive personal income tax rates on work and capital were inefficient and hence rates should tend to zero at higher incomes to counter economic disincentives for work and saving.¹⁸ These theories made many assumptions that were not tested against empirical evidence until decades later, when methods improved and data became available (and Diamond, at least, has recently presented a view in support of both progressive taxation and some level of taxation on capital: Diamond and Saez 2011). At a time when top marginal rates were as much as ninety per cent, optimal tax theory supported calls for dramatic reductions of taxation on capital (because of the disincentive to save and capital mobility) and on labour income (because of the disincentive to work).

These economic theories and practical developments, including global tax competition led to the 1980s being called an unprecedented era of tax reform (Sandford 2000; Steinmo 1993). The US was globally influential in its 1986 reform under President Ronald Reagan. Significant reductions in tax rates, especially of personal and company income tax (and more generally tax on capital) were enacted. These changes were often accompanied by increases in consumption taxes. There was also a push to reduce the overall level of taxes (and hence the size of the state). However, tax levels remained stable or even increased in many developed countries in this period as tax bases were broadened although rates were lowered, and debt was brought under control with the increased focus on controlling deficit. However,

¹⁷ Swank (2006); I survey these trends in Stewart (2003).

¹⁸ See e.g. Mirrlees (1976); Mirrlees and Diamond (1971).

some have observed that the trend of growth in the size of government came to an end during this time (e.g. Peltzman 2009).

3. THE BENEFIT THEORY OF TAXATION

We now turn to consider in more detail the theory of benefit of taxation. This theory, both as a justification for taxation, and as an explanation of how to allocate the burden of taxation, waxed and waned as the tax state developed over the two hundred years surveyed above.

The early benefit theory

Adam Smith insisted in his first maxim, extracted above, that the subjects 'ought to contribute towards the support of the government ... in proportion to the revenue which they respectively enjoy under the protection of the state.' This had older antecedents. In 1651, Thomas Hobbes defined the philosophical basis for paying taxes as an obligation in exchange for security under the state, in proportion to what they consumed in society.¹⁹ Sir William Petty said in 1692, 'it is generally allowed by all that men should contribute to the public charge but according to the share and interest they have in the public peace; that is, according to their estates and riches'.²⁰ At the time, the benefit theory was applied explicitly to support taxation in the early American colonies, such as New England as explained by Harris (2000, 176)-

[The] duty of every inhabitant to contribute towards the support of the colony was based upon the theory of benefit received by reason of the existence of the government. The amount of the contribution was determined by the ability of the inhabitant to pay, and his ability, by the amount of land and property he possessed, while every able-bodied freeman was required to pay a specified sum as a poll tax.

A later American recognition of the benefits of government and hence of taxation is in the famous saying, 'taxes are what we pay for civilised society'.²¹

¹⁹ T Hobbes, *Leviathan* 'the benefit that every one receiveth ... is the enjoyment of life, which is equally dear to poor, and rich ... when the Impositions, are layd upon those things which men consume, every man payeth Equally for what he useth' (1651, 1968).

²⁰ Petty, 'A Treatise of Taxes and Contributions' in Hull C (ed) *The Economic Writings of Sir William Petty* (Cambridge, Cambridge University Press, 1899), extracted in Musgrave and Peacock (1954), 66.

²¹ *Compania General De Tabacos De Filipinas v. Collector of Internal Revenue*, 275 US 87 (1922), 100 (Holmes J).

Adam Smith defined the tax obligation, as did Hobbes and Petty, on the basis of an *objective* measure of benefit, and hence, ability to pay. Smith measured benefit by the 'revenues' of the taxpayer who prospered. He assumed, apparently without needing much discussion, that those who by observation had more in 'riches' benefited more under the state and should pay more in taxation. This formulation of benefit does not focus on provision of any particular service or good by the state to the individual subject, for which the individual pays. Rather, it required a contribution to taxation in exchange for the general benefit of security or prosperity under government.

Adam Smith also developed a concept of a 'public good' to be funded by taxation, besides the benefit of 'protection' of government. He observed that some goods 'though they may be in the highest degree advantageous to a great society are, however, of such a nature that the profits could never repay the expenses to any individual or small number of individuals and which it therefore cannot be expected that any individual or small number of individuals should erect'.²² Such goods included roads and infrastructure, defence and the administration of justice and more broadly, the necessary institutions 'for facilitating the commerce of the society' and 'for promoting the instruction of the people' – especially, and still relevant today, he called for free public education of youth.²³ Smith saw the need, in his time, for increased public expenditures in all of these areas.

Decline of benefit in the nineteenth century

The benefit theory remained important in the German school to the extent that it referred to taxes to fund communal wants and public expenditures. However, liberal political thinkers in the nineteenth century including Mill and others, in discussing fairness of taxation famously emphasised ability to pay instead of benefit. From the late nineteenth century onward, the benefit theory is frequently described as a limited, thin or out of date theory of tax justice, which is at best inadequate and at worst, false. Seligman considered that the idea that taxes should vary according to the benefits that persons receive from government was 'a principle based on "a false political philosophy" from which follows "a false political economy"' (Duff 2004, 391).

²² Smith (1776), Book V Ch 1.69.

²³ Smith (1776), Book V Ch 1.130 ff.

Henry Simons called it 'a significant element in a reactionary social philosophy, constructed from the gratuitous implications of laissez-faire economics' (1938, 34).

What led to such a change? The first reason for the turn away from the benefit theory by the Anglo-liberal political economists was precisely because they were, unlike the German scholars, not interested in a theory of public expenditures and were sceptical of government. Their focus was on the individual and freedom from state coercion. This individualisation of the relationship of taxpayer and government differed sharply from the 'communal' approach of the German school.

The second reason was the acceptance not only of the individual but of his (or her) *subjective* experience of happiness and exercise of choice. This found the greatest expression in Jeremy Bentham's (1780) utilitarian philosophy, published while Adam Smith was alive. While utilitarianism concerns the collective goal of the 'greatest good for the greatest number', it is premised on the subjective wellbeing of each individual, which became (and still is today) the foundation of welfare economics.

The market can be theorised as consistent with subjective wellbeing, and a utilitarian calculus, as it is assumed that the price signal in the market indicates individual choice and that individuals choose to purchase what will make them happy. In contrast, there is no price signal for government. The objective measures on which taxation must be based – income, consumption, wealth – are mere proxies for accessing subjective wellbeing. The inability to determine each individual's subjective preferences and wellbeing without a price signal is a problem for all theories of taxation including ability to pay. However, it was seen to deal a particular blow to the benefit theory. Bastable said, 'The theory that taxation is the price of the State's services, and finds its measure for each citizen in the amount of benefit received, is, as regards the latter part, quite unsupported by history'.²⁴ Supporters of a 'benefit' approach to public expenditures, such as Wicksell and Lindahl, struggled with this problem. How could it ever be known in what way, and to what extent, each individual subjectively benefits from government? And if this could not be measured, how could this justify the taxation burden?

²⁴ Bastable (1895), Book III Ch III.4.2.

Public goods and Musgrave's Allocation Branch

Some twentieth century theorists remained interested in public benefit and saw a positive general role for government that must be funded by taxation. Richard Musgrave recuperated the benefit theory, drawing on both the Anglo and Germanic traditions of public finance. Musgrave established a normative framework of a government with three branches: Allocation, Distribution and Stability. He used the term 'public' or 'social wants' to be satisfied by expenditures of the 'Allocation' branch of government for the benefit of the public as a whole. Musgrave separated this function from the Distribution Branch, which would address tax and welfare payments to implement the (re)distribution of income or wealth between people in society. Finally, the Stabilisation Branch would address the goals of full employment and monetary stabilisation (inflation). This approach was explicitly a normative and imaginative model of government for analytical purposes; it did not purport to represent what government actually does in any taxing or spending transaction.²⁵

Musgrave's move to shore up the benefit theory has to be understood in the context of the US debate around taxation in the first half of the twentieth century, which focused on the progressivity of the income tax as the government's main gesture towards distributive justice. Musgrave found this to be too limited a view of government. He explains as follows (1959, 21-22)-

I think it useful to maintain a distinction between the problems of the Allocation Branch and those of the Distribution Branch. This, at least, is preferable to the other extreme, inherent in the ability-to-pay approach, of discarding assignment of benefits from public services and of considering the placement of the entire tax bill as a distributional problem ... We may still think of the taxes of the Allocation Branch as allocated on a proportional basis, and of the tax-transfer process of the Distribution Branch as providing for a proper state of distribution, defined now with reference to income left after payment of taxes to the Allocation Branch.

The challenge remains: How can we apply the benefit theory if we do not know the individual's subjective benefit from the state? Musgrave addresses this by assuming equality and assessing taxation for public goods purposes on a 'proportionate' basis. Taxation for redistribution as being progressive 'with reference to income left over' after public goods have been provided. The reliance on a 'proportionate' theory of taxation harks back to the language of Adam Smith who is

²⁵ As is made clear in P Musgrave (2008).

often assumed to argue only for a flat percentage rate of taxation. However, Smith clearly did not always intend 'proportionality' to mean a flat rate as in other contexts especially housing taxation, he supports progressive taxation.²⁶

Public economists sought to refine the definition of 'public good' in an attempt to solve the problem of 'price' for the taxpayer-voter. Samuelson (1954, 1955) established the conditions that a public good be both 'nonrival' and 'nonexcludable' and consumed equally by all. An example is commonly given of national defence, such as a submarine purchased for the nation. Once the benefit (let's assume for the time being) of the submarine is made available to citizen A, it *must* by definition also be made available to citizen B. The non-excludability of public goods distinguishes them from private goods, which are excludable and so can be priced in the market. One consequence of non-excludability is that the market will not supply the optimal level of such goods, to the detriment of all; consequently, there is a role for government to supply them. Where there are large numbers of people, so that the contribution of each individual or consumer is insignificant in relation to the total, Wicksell and subsequent writers argued that each individual would not voluntarily make any contribution to public goods (Head 1962, 86). On the demand side, a public good is nonrival, that is, all individual consumers can access the good once produced. Each person's consumption of the public good (such as a submarine) is identical to the total. Citizen B not only gets the full 'benefit' of the submarine, but cannot reject it, even if B is opposed to this form of military spending.

These conditions make the concept mathematically tractable but they have the effect of confining the concept of a 'public good' to a very narrow compass. As market failure is the only justification for government provision and coercive taxation, and this only occurs in the narrow situation of the 'public good' defined, this narrow compass implies a narrow view of the role of government.

One context in which this narrow benefit theory of public goods seemed to apply was in a fiscal federal context. The benefit theory has been based largely on Tiebout (1956) who developed a theory of local public goods, benefit and exit. Taxes and spending at the local level are linked and taxpayer-voters are assumed to be fully mobile, able to vote or exit until they obtain the mix of tax and public goods that they prefer. Thus, the tax-price can be ascertained and the analogy between

²⁶ For example, on 'house-rents': Smith (1776), V.2.71.

government and market seems plausible as local governments will compete for taxpayer-voters (see explanation in Oates 2005). Many tax theorists conceptualise local taxes, especially property taxes, as a fee for local government goods or services (the redistributive character of local taxes tends to be fudged in this analysis; local property taxes tend to be levied at higher rates on those residents who are richer). Nonetheless, local taxes can be justified on the basis of an obligation to make a minimum contribution to government based on prosperity or capacity, measured by local assets, echoing the early uses of benefit theory to justify taxation as a contribution to government.²⁷

However, even this plausible application of the direct benefit-taxpayer theory depends on many assumptions about competition and exit that may not hold in reality. More broadly, the narrow approach to the concept of public good limits the explanatory power of the concept of 'public good' for understanding the reality of government. Colm (1956) observed that the distinction made by Samuelson between 'public' and 'private' goods does not necessarily match the distinction between government and non-government activity. He explained that the interesting question we want theory to explain is 'why in a given economic system certain activities are conducted through government, others through private agencies?' Many publicly funded goods can be at least partly excludable. For example, the government could quite easily exclude people from use of a bridge – perhaps unless they paid a fee, or were wearing blue – and it could enforce this. Colm observed that there are also activities in the non-government sphere, including philanthropy or research and development which are not able to be priced in the market.

Cooper (1994, 414) observes that-

The image which the economic analysis suggests is that government is to be regarded as if a private enterprise selling to its citizens the benefits it controls. The government, in providing various goods and services, tries to emulate the activity of a market and so, as in a market, the choice and extent of government-provided services as well as their tax 'price' is tied to the expression of a desire for that service through the consumer's willingness to pay for it.

On this basis, the benefit theory can be applied where government 'services' can be charged for like market goods. However, this analogy breaks down once government

²⁷ R Bird, 'Tax Assignment Revisited' in J Head and R Krever (eds) *Tax Reform in the 21st Century: A Volume in Memory of Richard Musgrave* (The Netherlands, Kluwer, 2009) 441.

is accepted to do more things; as there is no market, and so no objective price, *by definition* for government as a whole.

John Head (1992, 77) observed that the utilitarian analysis of the nineteenth century 'manifestly failed to produce meaningful results and had mainly served to divert the attention and energies of leading tax scholars away from the practical challenge of implementing tax fairness ideals in the modern democratic state'. However, it held sway to the extent that even Musgrave conceded that '[u]nless the Allocation Branch succeeds to a significant degree in imputing benefits to individual taxpayers, there is no point in distinguishing between tax distributions by the two Branches' (1959, 99).

Most theorists turned instead to a theory of ability-to-pay based on the objective measure of the taxpayer's measurable income, consumption or wealth. However, as all now recognised the subjective wellbeing of individuals as the foundation of economic theory, a fiction is also required to support ability to pay. This is the theory of declining marginal utility of income, which imputes the objective measure of income as indicating subjective happiness in receipt of the next dollar received by a millionaire compared to a pauper; the assumption is that the marginal dollar is worth less to the millionaire (Lawsky 2011).

The strictly defined economic concept of a 'public good' is limited in other respects. It ignores the role of government in forming consumer or citizen preferences and in constituting the market itself, so as to shape and deliver what people want in response to price signals. More fundamentally, the division of public and private in the interaction of government, society, individual, family and market is socially constructed. Both market and public good preferences of individuals are endogenous to the governmental, societal and economic context.

The economic concept also does not address those goods that people should have but do not necessarily want (and bads that they want but should not necessarily have). Musgrave used the term 'merit goods' for this category of goods which government decides all people should have for their own and collective wellbeing. Arguably, providing people with what is good for them (and preventing them from having or doing what is bad for them) is today one of the key roles of government. It is also, of course, a key reason why people resent, resist and protest against government.

4. LEGITIMACY

This brings us to the other main focus of this paper, the legitimacy of taxation – which is tied to the legitimacy of government more broadly. Taxation must be *legitimate* to be successful in the long term. Margaret Levi (1988) argues persuasively that successful taxation requires negotiation of a stable fiscal bargain between government and key interests. Levi's theory is borne out empirically in the broad statistical analysis of Dincecco (2009) who uses long-run panel data of fiscal statistics to show that the transition to a successful tax state across Europe was successful only if both fiscal centralisation and establishment of relatively stable political limits on taxing and expenditures were achieved.

In the nineteenth century, the overarching liberal narrative of *limiting* government, as epitomised by Great Britain had its philosophical basis in the work of political philosophers such as Mill and Bentham. Both liberal and utilitarian strands of thought addressed the changing role of government and taxation from a point of view of freedom and happiness of the individual. In contrast, the Germanic concept of *Finanzwissenschaft* tended to treat the state as representative of the people as a whole, not as individuals. Even in the German states, however, empirical evidence shows that increases in taxation led to constraints on government. Spoerer (2010, 108) comments that 'while the graduated income tax imposed a much higher tax burden on wealthy taxpayers, it increased their political voice enormously' by the suffrage linking the voting power of taxpayers to the amount of direct taxes paid. Limits on government developed in quite different ways in different states but some kind of increased voice, or control by certain interests or taxpayers, for example through the vote, was the price of success in taxation (Neal 2010, 299).

These political and economic ideas and experiences of taxation and government circulated widely in Europe and into the 'New World' of the United States and Canada, as well as among the Antipodean colonies during the nineteenth century. At a time of expansion of colonial power and the British Empire, after the French Revolution and the birth of the new independent nation of the United States, these ideas provided the principled support for political advocacy or bargaining to ensure 'limited' government in many countries in exchange for taxation.

Legitimacy, benefit and the taxpayer-voter

The benefit theory was connected to the new philosophies of democratic government through an increasingly broadly defined notion of the 'taxpayer-voter'. As a justification for broad-based taxation to fund government in general, the benefit theory of taxation requires a broad acceptance of the legal, institutional and political process of voting and associated decision-making about taxing and spending. More specifically, the benefit theory requires a process of decision-making about what, and how much, of each 'public' good should be provided by government. Musgrave explains this 'preference-revealing' function of voting (1959, 58)-

The crucial role of assigning tax prices in this setting (a term more appropriate than that of distributing tax 'burdens') is to induce preference revelation by voting on tax-expenditure issues. This is essentially the spirit of benefit taxation. Ideally, the voting process would be one where all conceivable cost distributions (tax-prices payable by various individuals) would be matched with all conceivable public service programs, but this is hardly feasible. Selected expenditure and tax programs must be considered and tax programs must be expressed in terms of generally applicable tax formulae, rather than as a set of individual tax-prices.

Governments at different times and for different purposes have gone a long way down the path of disaggregating the 'state' into separate goods and services; the modern practice for hypothecation of revenues to particular expenditures, at least in political rhetoric, continues this process. When benefit can be linked directly to specific services, a tax-price can be ascertained and this is generally accepted as an appropriate use of the benefit theory (Duff 2004).

Yet, it is a fallacy to conceive of government as simply an additive set of separate goods or services. Government is more than the sum of its parts. The benefit theory also underpins development of the big 'tax and welfare' states of the twentieth century, which taxed workers so as to fund insurance and protection for families, disability, unemployment or old age. The analysis holds even in countries, such as Australia or Sweden, where funding for the welfare state came out of consolidated revenue. The broad theory of benefit justified broadening the tax base to the mass of voter-workers who paid income tax, social security tax and value added tax in exchange for government.

Cooper (1994, 407) is therefore persuasive in stating that 'the benefit theory is capable of sustaining a coherent tax policy framework both for taxes based on

marginal benefits (such as fees and charges) and for taxes based on notions of total benefits (such as broad-based income and consumption taxes)'.

Is it possible to analyse tax as funding the benefit of government broadly and also take account of redistributive goals? As well as thinking of taxation as payable on the basis of ability to pay, we have to remember that more than half of government expenditures in developed countries today are on health, education and welfare that have significant redistributive as well as 'public good' features.

Musgrave's distinction between Allocative and Distributive branches of government is a metaphor only, but he saw redistribution as being of the 'remaining' income after public goods were funded, thereby placing it second in importance to the base level of 'proportional' taxation needed to fund public goods. On the other hand, legal philosophers Liam Murphy and Thomas Nagel subordinate public goods to redistribution. They argue that redistribution cannot be set aside in a decision about 'public goods' because 'in determining the level and type and form of financing' of public goods, 'we will also be determining what is left under the private control of each individual' and they conclude that 'the best we can do ... is to set public expenditure at a level financed by unequal contributions from individuals that come as close as possible to equalizing the marginal utility of public and private expenditure for each of them' (2002, 81).

We cannot eliminate the distributional dynamics from either the Allocation or the Distribution branches of government. Redistribution can only be delivered by government and it cannot have a market price – therefore, I suggest that a particular goal of redistribution is itself properly considered as a 'public good'. In contrast to the conclusion of Murphy and Nagel, it makes sense to incorporate redistribution *into* the benefit theory by treating the entire redistributive tax-transfer mechanism as itself a public good; this seems, in later work, to be accepted by Richard Musgrave (eg, Musgrave 1978). The extent of redistribution, or level of inequality, acceptable to a particular society is a political choice which requires decisions to be made by voter-taxpayers.

Public choice and the voter-taxpayer

Decisions about taxation to fund public goods (including redistribution) must be made in a political arena bounded by what public choice theorists called a fiscal constitution. Economists, theorising from the perspective of the market, turn

reluctantly to consider the complexities and weaknesses of non-market, political decision-making systems. The political economic literature is quite pessimistic about the ability of voter-taxpayers to deliver the optimum level of public goods. Head observes that just because the market 'fails' to provide sufficient public goods, 'there is no guarantee that government can do better' (1962, 86). Even Murphy and Nagel suggest in gloomy fashion that 'of course' the optimum values of public and private provision 'simply have to be guessed at by the designers of the system' (2000, 82). They seem not to trust the political or legal process to make the right choices in this regard.

The view that government will fail was especially taken up by public choice theorists. In particular, Geoffrey Brennan and Neil Buchanan wrote against the Musgravian tradition of taxation to finance government, assuming a given level of revenue required. They made specific reference to US developments in the 1970s, an 'era of apparently uncontrollable budgets' (Brennan and Buchanan 1980, xii). They also draw on deeper philosophical roots, insofar as they are concerned lack of consent, freedom from coercion and government as Leviathan which must be constrained.

Brennan and Buchanan sought to design a fiscal constitution that would constrain or limit the governmental power to tax. They contested the baseline public finance assumption that a set level of revenue is required to fund the state and that ideally this would be levied as a lump sum tax, which then serves as an analytical benchmark. They argue that, prior to such a baseline assumption, there must exist the 'constitution' under which it is legitimate for government to raise taxes at all. This has substantive implications for tax policy because 'at the constitutional stage of decision in the Leviathan model, potential taxpayers will recognise that government may be held back in its fiscal appetites only by limits on tax bases and on allowable rate structures' (Brennan and Buchanan 1980, 35).

We can accept the fundamental principles of limited government and taxing power, without rejecting as some more extreme public choice theorists do, the benefit of government in providing public goods and redistribution. The concept of 'constitutionalism' implies a framework of limits on public power (Levi 1988, 49; Wolfram 2002). The 'fiscal constitution' may be established under a written or unwritten Constitution combined with a wide range of written and unwritten legal

rules, institutions, norms and practices. The fiscal constitutions of successful tax states have evolved over time at national, state and local levels (see, e.g. Smith 2004; Webber and Wildavsky 1986; Conti-Brown and Skeel 2012). There are many innovations including some that have been developed in recent times, including independent fiscal councils, parliamentary budget officers, and fiscal rules that are all aimed at constraining government taxing and spending to varying degrees. They reflect a variety of visions of how to achieve and constrain legitimate decisions about taxing and spending.

Indeed, the tax laws and principles of a country can themselves be understood as ‘quasi-constitutional in nature’ (Head 1992, 65). To illustrate, we can return to Adam Smith, who was greatly concerned to prevent tyranny. Smith’s *Maxims* made clear that the tax owed by each taxpayer must be *certain*. He sought to prevent arbitrariness, corruption and abuse of power in the tax system, and he placed certainty above equity and even above efficiency as the most important principle of taxation. Smith also preferred direct taxes to indirect, in part to contribute to certainty. Subsequently, J S Mill argued that the more visible progressive income tax performs a critical political role as ‘a security ... for economy in the public expenditure’.²⁸ Henry Simons also saw a progressive income tax as a necessary accessory of a capitalist market economy and this principle is reiterated by Brennan and Buchanan in 1981.

As the ‘golden age’ of the tax and spending state hit a crisis in the 1970s, it became clear that to be effective, a tax system in a liberal democracy requires a high level of ‘quasi-voluntary’ compliance (Levi 1988; and see Braithwaite and Levi 2003; Braithwaite 2009). Quasi-voluntary compliance ‘rests on reciprocity and trust. It is a contingent strategy in which individual taxpayers are more likely to cooperate if they have reasonable expectation that both the rulers and other taxpayers are also cooperating. The key lies in what rules and other government officials do to create mutual expectations of tax payments’ (Levi 1988, 69). Levi’s approach acknowledges the coercive power of taxation while recognising the dynamic negotiation for limits and voice in exercise of governmental power.

The link between successful tax collection and trust or representation of taxpayers should not be considered simplistically. Today, government itself has

²⁸ Mill (1848), Book V.6.1.

changed to include a much wider set of market and non-market engagement. The fiscal constitution can be conceived as a 'constellation of norms and practices' (Scott 2010, 16) Fiscal legitimacy, like legitimacy of other rules, may be achieved through a variety of governmental processes (Baldwin 1995) including transparency and certainty of laws and the accountability of institutions and agencies tasked with fiscal responsibility to the legislature. That can encompass legitimate processes of consultation with citizens in tax law making; procedurally fair review and appeal rules in administration; recognised expertise in fiscal policy of the Treasury and tax collection agency; or implementation of a fiscal policy that may achieve deficit reduction goals accepted as important by taxpayer-voters or other key stakeholders, such as external creditors or ratings agencies.

In some respects, contemporary tax law techniques seem to run counter to Adam Smith's notion of certainty as fundamental. An example is the discretionary power inherent in a general anti-avoidance rule. However, in today's world, these 'uncertain' rules likely contribute to building trust in the mass of (mostly compliant) taxpayer-voters. Historical experience has shown that governments have often been able to use technology and bureaucratic techniques to overcome problems of tax compliance without directly engaging with trust, consent or representation of taxpayers. Most of these techniques require the co-operation of the legal intermediaries of the capitalist economy. In these techniques, governmental engagement is shifted away from the voter-taxpayer towards one or other form of intermediary or agent such as a corporation, employer or bank, or the tax profession.

In sum, the concept of legitimacy is nuanced and links to the broader conception of taxes paid for the benefit of government in a variety of ways. It cannot be properly reflected in the simple binaries of government/market, public/private, voter/price or Leviathan/benevolent voice of the people. Nonetheless, in democratic tax states, the fundamental concept of legitimacy obtained by support of voter-taxpayers remains critical to success of the tax state.

5. TAX, BENEFIT AND LEGITIMACY IN THE GLOBAL ERA

So far, we have been discussing the benefit and legitimacy of taxation as if the nation-state existed in isolation. We have been used to thinking about tax law within a national 'frame' of analysis. This 'Keynesian-Westphalian frame' (Fraser 2005)

refers both to the national boundaries of the state at international law and to the economic character of the state, especially developed during the twentieth century, which has until recent decades incorporate an expectation that government will – indeed, must - play an active role in the national economy.

Globalisation has caused national boundaries of economies (and, less so, states) to weaken or even disappear, as we become participants in global markets and we come, in some ways, to see ourselves as global citizens (see e.g. Twining 2000). How does this change the way we think about benefit and legitimacy of taxation? I argue that there are two countervailing effects. First, we see a drive towards smaller government and policies of fiscal austerity in a context of a growing global economy. Second, we see governments seeking to engage with each other to secure national taxing power in the context of this global economy.

Austerity, globalization and tax reform

Since the 1990s, we have seen both an intellectual push, and signs of a trend, towards smaller governments after the massive growth of the twentieth century. Tanzi and Schuknecht (2000, 131) observed a reversal of the growth of government from 1980 onwards and they argued that -

there must be considerable scope for redefining the role of the state in industrialised countries so as to decrease public spending without sacrificing much in terms of social and economic objectives.

Tanzi and Schuknecht's goal of 'smaller and more efficient' governments would, they argued, 'provide an appropriate framework for market forces to stimulate both growth and social welfare' (2000, 132). For example, citizens 'should be able to buy, perhaps more cheaply, some of the same goods and services now provided by the government. If the private sector provides these same services more cheaply, as it often does, then society would gain from the change. Obviously in this process the regulatory role of the state will need to become more important, better directed, and more efficient' (2000, 134). The challenge lies in the last two sentences: *if* the service or good is provided more cheaply and *if* the regulatory role of the state can become better, this may leave all better off.

As economic globalisation gained momentum during the 1990s, the tax reform 'decade' that started during the 1980s continued in many countries. The shift in tax policy discourse and the recognition of increasing tax competition between states for

mobile capital investment led to significant changes in tax laws. The trend of lowering tax rates on income and capital continued. Tax reforms were part of a broader set of new policies in which governments began in earnest to deconstruct the old ways of interaction with the economy and to construct and participate in a new global economic order facilitating trade in goods and services, global financial capital and increasing cross-border direct investment as well as increased mobility in information and some labour mobility. These changes have 'constituted a distinctive program of state renovation', aimed not only at 'shrinking the state but also at rebuilding government so that it would complement a liberalized and globalized economy' (Roberts 2010, 4).

However, many have expressed concern that that this 'logic of discipline' is anti-democratic, as the influence of popular sovereignty is constrained in order to build the state so that it could do 'tasks that must be performed properly if a nation is to survive, and thrive, in a globalized economy' and to ensure that governments do not 'lose the confidence of globalized financial markets (Roberts 2010, 12). Since the global financial crisis of 2008, we are now in what has called an 'age of austerity' (e.g. Schui 2014), in which governments seek to constrain their budgets in ways that imply drastic reductions in the size of the welfare state. The move towards fiscal discipline generates hotly contested domestic political disputes regarding the distributional impact of fiscal adjustments.

Citizens have in many countries resisted the goal of reducing the size of government, while ageing populations and associated social trends have continued to drive public expenditures upward. At least to some extent, tax revenues have been maintained, although in some countries the 'tax mix' has shifted towards consumption and labour taxes and corporate tax rates have come down. More countries have enacted indirect taxes such as a value added tax or goods and services tax, and the rates of these taxes were increased to pay for government services.

Benefit theory and relations between governments

The benefit theory may be applied where more than one government exists, levying taxes or providing services. As briefly outlined above, the benefit theory was relied on first, in analysing federalist structures, where taxing and spending is allocated across different local or provincial governments within a country. Applying a similar

logic, the benefit theory may also be applied in an international context, where taxing power must be allocated between nation states. One key difference, of course, is that there is no over-arching world government. Another key difference is that there is no free global mobility of labour.

During the early twentieth century, as the income tax expanded on individuals and companies, attention increasingly turned to the allocation of taxing jurisdiction between countries. In general, taxes were levied on the basis of tax residence or of source of income, and international tax rules were established to prevent double taxation. The concept of benefit from government became an important element in defining these tax boundaries. There was a contest between the state of 'source', which was in the end given priority in respect of active income from business or labour, and the state of residence, which had a residual claim and priority in respect of passive income and gains. Klaus Vogel suggests that during the nineteenth century, Georg von Schanz, an early German scholar of income taxation, had proposed a concept of 'economic allegiance' and 'convincingly showed that both the state of residence and the state where a direct investment is made can legitimate a tax claim on the grounds of services provided, but that the share of services provided by the source state typically is higher than that provided by the state of residence' (Vogel 1988, 395). However, the opposite was adopted by the 'Four Economists' in their statement of international tax principles in 1923, which gave priority to the state of residence of the taxpayer (League of Nations 1923).

Richard and Peggy Musgrave (also a leading economist and Richard's spouse), considered the application of tax policy to inter-nation equity; however, Peggy Musgrave took up this issue most substantially. The Musgraves linked inter-nation equity in taxation especially regarding the company tax base, to a concept of benefit for the investor: 'the idea that the source state should be able to recover from the investor some of the costs of public goods and services from which the investor benefits (a benefit tax) and/or on the idea that the source state should be able to retain the gain associated with pure economic profits' (Brooks 2009, 471; P Musgrave 2008). On this basis, national taxation on foreign direct investment by foreign or multinational companies may be supported by the benefit theory of taxation (see e.g. Avi-Yonah 1997, 2004; Pinto 2002). Companies are legal fictions that do not themselves 'benefit' from any government public goods or services.

However, it is plausible that the owners or beneficiaries of capital invested through companies – in particular non-resident individuals who invest in a jurisdiction – have benefited from that activity in relation to the source country in exchange for services provided by it. The evidence is objective: ‘prosperity’ of the company measured by profits arising under the source country government.

Tax competition and cooperation

This basis of allocating taxing jurisdiction is under increasing pressure. In spite of moves by governments to secure tax systems for public expenditures, global capital mobility (and some labour mobility) continues to grow. Dagan suggests that we are seeing the unfolding of ‘tragic choices’ for national polities in a contest for efficiency, revenues and redistribution (Dagan 2013). We can see this play out in contradictory moves by governments to compete or cooperate with each other in taxation.

During the 1990s, as capital mobility increased, the OECD sought to establish cooperation among its member states to address ‘harmful tax competition’ and counter tax havens (OECD 1998). Early attempts at cooperation failed to achieve their ambitious goals, although national governments slowly began to increase cooperation in tax administration and information exchange with each other. Since the global financial crisis in 2008, governments have taken more significant steps, led by the G20, to address international mobility of economic factors that has pressured governments to engage in global fiscal competition by lowering tax rates, and to counter ‘base erosion and profit shifting’ (BEPS) as multinational companies take advantage of incoherent national tax rules in a global economy (OECD 2013). There has been significant progress in tax administrative cooperation. Yet in spite of these developments, tax law remains stubbornly, jurisdictionally bound to the nation-state and governments continue to compete for capital. There is no world tax organisation, or multilateral tax treaty that regulates tax systems globally or regionally.

Public choice scholars may welcome the increasing constraints imposed by the global economy on governmental ability to collect taxes; indeed, Brennan and Buchanan specifically welcome an open economy and competitive taxation as having potential to constrain Leviathan (1980, 77). However, their theory of governmental tax competition assumes perfect mobility of both capital and labour. That does not currently apply in the global arena. Instead, we have high – but not

complete - mobility of capital and much lower, distorted and uneven mobility of labour. Exit is not an option for most people who do not like their own state's tax and benefit compromise.

We are increasingly aware of the need to secure global public goods, and how to fund them (Kaul et al 2003; Brock 2009). To date, the international debate about equity, development and public goods has focused (just as the domestic debate has) too much on ability to pay and not enough on the benefits of a legitimate government funded by taxation. To return to the OECD BEPS project, it is important to note that this project is premised on a base assumption that there is a 'fair share' of taxation accruing to governments, to be defined by international tax rules.

Conclusion

The benefit principle is a foundational principle which defines the obligation to contribute taxes to government but which also depends on legitimacy of taxation by government. The principles and practice of taxation in successful 'tax states' have evolved interdependently with the benefit and legitimacy of government. For example, the theory of public goods developed at a time when it was clear that the market was *not* delivering what was desired for society. However, there was always a tension concerning what government should or could do, and we can observe renewed philosophical concern to limit coercive governmental taxing power emerging at a time of apparently uncontrollable government spending in the 1970s.

Globalisation poses challenges for all aspects of the benefit and legitimacy of taxation. It requires us to rethink principles about who benefits or should benefit from government; who is owed redistribution; who bears or should bear the tax burden and who makes decisions about taxation and spending. As Fraser observes, we need to change the frame in which we think about these crucial questions. If we take the view that the redistributive element of our tax-transfer system is a public good, then this makes the benefit theory consistent with redistributive taxes and services at the local, national or global level. It is possible on this basis to argue that a minimum level of revenue must be raised and distributed to fund a basic minimum standard of living for all individuals globally. If we ignore the benefits provided by national governments and the relation of governments to each other, we are unable to deal with this global redistributive challenge.

This paper argues that the benefit theory of taxation should be recuperated in the current era, but that this also requires us to develop a new theory of a legitimate fiscal constitution in the global context. 'Tax states' must confront the challenge of sustaining the legitimacy of their respective fiscal constitutions in the context of economic globalisation. To deal with these challenges successfully will likely require significantly increased co-operation by governments in taxation. However, the prospect of increased global tax cooperation, or even revenue sharing where taxes raised in one state are distributed to another, brings into sharp relief the challenge of legitimacy and the dynamic and evolving process of democratic and institutional constraints on taxation.

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