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Taxation in the Liberal Tradition

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Abstract In this essay, we argue that liberal economists should take more seriously the problems of public goods and externalities as well as the capacity of taxation and state action to improve human welfare. While taking seriously the public choice concerns about how the political process works as well as Austrian concerns about the limits of our knowledge in the absence of market price signals, we should also acknowledge that public goods and externalities do exist and taxation can provide a means to improve human welfare.

Keywords Taxation · Classical Liberalism · Public Goods · Externalities · Austrian Economics

1 Who Hates the State?

Murray Rothbard (2012[1977]: 4030) once famously asked the question, "Do you hate the state?" in an effort to contrast the brand of liberalism that he advocated (anarcho-capitalism) with the more utilitarian-flavored ideas espoused by the likes of David Friedman (1973). Rothbard wrote,

> There runs through *For a New Liberty* (and most of the rest of my work as well) a deep and pervasive hatred of the State and all of its works, based on the conviction that the State is the enemy of mankind. In contrast, it is evident that

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David [Friedman] does not hate the State at all; that he has merely arrived at the conviction that anarchism and competing private police forces are a better social and economic system than any other alternative.

In this essay, within the specific context of a discussion of taxation, we argue that hatred of the state is in fact a unifying attitude among liberals.[1] We believe, the utilitarian-oriented anarchism advocated by David Friedman (1973), Bruce Benson (1990), and others (see Powell and Stringham, 2009) as well as the more mainstream minarchism found within Adam Smith (1776), Milton Friedman (1962), and F. A. Hayek (1960) among many others do share a common hatred for the state.

Adam Smith wrote that tariffs are "a *curse* equal to the barrenness of the earth and the inclemency of the heavens," (emphasis added, 1776: IV.2.36) and society prospers "in spite both of the extravagance of government and of the greatest errors of administration," (1776: II.3.31). We think this sounds like someone who hates the state.

Milton Friedman, like Smith, was no anarchist, but he too had no love for the state. To be sure, Milton Friedman saw a role for government as a "rule maker and umpire" and explicitly criticized anarchism for being "not feasible" (1962:25). Rose Friedman once recounted about a time when Milton was pulled over by a police officer for speeding and was additionally cited because he had added a home-made equals sign to his personalized "MV PQ" license plate. Surely a moderate liberal like Milton Friedman would approve of the laws against speeding and the minor requirement to have a license plate? No! According to Rose, he was absolutely furious and the very first thing he did upon returning home was to restore the equals sign on his car's plate using some electrical tape.

The differences among liberals are not so much about love or hatred of the state. The difference is that Rothbard's brand of classical liberalism elevates individual freedom and unanimous agreement in human affairs to the highest level of importance to the exclusion of other concerns. This is of course most prominently seen in the non-aggression principle that denies the appropriateness of initiating force. To Rothbard, freedom itself is the end and the only end.

In contrast, most other liberals place human welfare as the ultimate goal. Such liberals do believe that individual freedom and unanimity work most of the time to enhance human well-being, but there are nevertheless situations where the state can enhance welfare. Freedom is seen as a means to the end of human flourishing.

We might think of the state as an abusive husband, who cheats, drinks, and abuses his wife and children. A wife in this situation can easily grow to hate her husband, and in reality many do. But should she leave him?

Murray Rothbard says the wife who hates her husband must leave him! He is evil and is violating her rights. But human experience, sad though it may be, teaches us that many wives in such situations do not leave their husbands. And this is not just because the wife is afraid of the husband. The wife frequently understands that as vile as the husband may be, she would likely be even worse off without him for he brings home money and protects her and her children from others who might do her even more harm. This is not false consciousness either. The world is a harsh place, and a mean,

[1] Here we use the term liberal in the correct sense, not the corrupted American sense.

drunk husband can in fact be a preferred alternative to having no husband at all.[2] Likewise, an extravagant and error-prone state may be preferable to anarchy.

If you are a disciple of Murray Rothbard on this question, you need read no further. To Rothbard, the state is *ipso facto* evil and no utilitarian justifications are even possible to redeem it. To the rest of us however, the state is an evil yes, but perhaps a necessary evil. The remainder of this short essay will reflect on a few well-known situations in which the state's hated power to tax can nevertheless enhance human welfare.

2 Taxation

Taxes are ultimately the means through which governments supply goods and services to citizens. Taxes are costs, but the things produced with tax revenue are goods. Though to clarify, the things produced by government are perceived as goods only by the relevant political decision makers, which may be a ruling majority in the case of a democracy. Government-produced items need not be seen as goods in the eyes of a minority interest or with the benefit of hindsight. The internment of Japanese Americans during World War II and the Tuskegee Experiment are but two memorable examples of U.S. government "goods" that were financed with taxes. No defense of taxation can be made in these cases.

In spite of this caveat, more generally, it is conceptually possible that the value of the goods produced by government will be greater than the tax costs, and thus human welfare can be improved with tax-financed goods. But which goods and services should the government supply and how will we know if they create value in excess of costs?

Adam Smith's list of acceptable items for government to produce included only three items (1) military for the defense of the nation (2) courts and police for the administration of justice and (3) and certain public works. In the last instance, Smith (1776: 681) expressed a surprisingly early understanding of what we today call public goods:

> The third and last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expence 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 or maintain.

The problem Smith identifies is that some collectively consumed goods, which would include military defense, the justice system, and some public works, may generate more benefits to the community than costs, but no one would have any individual incentive to provide the goods. Privately-consumed goods, say hamburgers, would not present a problem as hamburger sellers have strong incentives to satisfy hamburger buyers' demand because they can charge a price for the hamburgers while still denying service to anyone who doesn't pay.

[2] This metaphor could easily be reversed to be about a husband who hates his indifferent or scornful wife, but the drunk, abusive husband seems more politically correct.

Suppose a community of 1 million persons would like to build a massive central park, where the essential value of the park hinges on it being open and freely available to everyone. For simplicity, suppose each person is equally willing to pay $20 to construct the park—thus since the park is collectively consumed, it is valued by the inhabitants at $20 million in total. If the construction of the park costs only $10 million, then building the park at a cost of $10 per person would literally benefit every single person in the community.

Even if some people value the project not at all (or others value it more), so long as the total willingness to pay by the community exceeds the cost of construction, it is possible to design a system of taxes in which every single person is better off (Lindahl, 1919). If human welfare is our primary objective, then forgoing the opportunity to build a park costing $10 million but valued at $20 million is a $10 million blunder.

In reality, it is hard to imagine such a park being built by the private sector. A private park builder would need to raise $10 million dollars from among the 1 million inhabitants of the city. How can he collect voluntary payments for the park when the inhabitants know they can enjoy the park, assuming it is built, even if they don't pay? People may decline to pay hoping that enough other people do pay. It is easy to predict that large numbers of the population will attempt to free ride on the contributions of others, and if enough do so, there will not be sufficient funds to complete the project.

The advantage, and we do hesitate to call it that, of having government provide such products is that it can compel the $10 payment from all the inhabitants through its power to tax. To be sure, taxes are costly to collect and deadweight losses exist with all taxes, but it is easy to construct examples of the type above illustrating the welfare-enhancing potential of tax-financed public goods. Simply put, tax-financed public goods can make us all, literally each and every one of us, better off.

Externalities or spillovers, both positive and negative, present similar collective action problems and can effectively be included in the same discussion. To the extent individuals do not fully benefit from (or bear the costs of) the provision of a good, the product will be underproduced (or overproduced) from the standpoint of the welfare of the community.

This is elementary economics that is usually taught using simple supply and demand curves, but here a simple example will suffice. Suppose 10,000 amateur astronomers are annoyed by the city lights that make it harder to see the stars and planets and each is willing to pay $1000 to have the city lights turned down (or redirected downward instead of skyward). Collectively, they are willing to pay $10 million. Suppose that the city's 1 million inhabitants would be willing to accommodate the wishes of the stargazers for just $5 each ($5 million in total). If the astronomers could somehow buy off the city's inhabitants, we could have a win-win trade. But how are we going to coordinate the 10,000 astronomers to get the money to the $1 million people in the city? The transactions costs are likely to be insurmountable. Also, as before, the free rider problem arises as some of the stargazers might not want to pay – hoping others do pay.

As Coase (1960) illustrated, if the numbers of participants are small enough, then bargaining amongst the group can be sufficient to handle these situations reasonably well. In the stargazing example, if there were only 3 people involved, perhaps only one stargazer and two neighbors with annoying house floodlights, then we can easily imagine them privately bargaining. But public goods/externalities associated with air and water pollution, global warming, or communicable diseases, to say nothing of city parks or the problem of light pollution, can involve literally millions or even billions of people. Private bargaining is simply not a likely solution because of the high transactions costs and risks of strategic free riding behavior.

If classical liberals seriously care about human welfare, then these public goods and externality problems should likewise be taken seriously. Taxes, as much as we might hate them, are a way to increase human welfare in these cases (see Pigou, 1920).

3 Yeah, but…

There are many important and perfectly valid "yeah buts" to the argument that government should always provide public goods and mitigate externalities. How do we actually know that people are willing to pay $20 apiece for the park? It is easy to *assert* that people want the park, but talk is cheap. In economics, we measure value by people's willingness to pay. In these public goods/externality examples, we do not have any way to accurately gauge this willingness to pay. The bottom line is that in the absence of market prices and an actual market exchange, we simply cannot know what people are willing to pay. Hayek's (1945) insight is central to this criticism.

In addition, governments are notoriously and hopelessly inept and wasteful in using resources given the absence of competition and profit/loss. What can be built by private sector for $10 million could easily cost the government $30 million! We do need to heed the warnings of public choice economists such as Tullock (1967) and Niskanen (1975) among others and not just assume government will do the right thing.

Thus, it is certainly *possible* that the government can improve community's well being by charging $10 each in taxes to provide the park, which is valued at $20 per person. The classical liberal understands that it is also *possible* that the government could charge $30 each for this park, and thereby make us all worse off!

Another common liberal "yeah but" is the (completely correct) claim that public goods, even those with large numbers of affected parties, are in fact sometimes produced privately. Lighthouses, financed by port fees, and radio/TV entertainment, financed by advertising, are two common examples, and more sophisticated examples can exist as well (Tabarrok, 1998). But just because there are *some* public goods produced privately, this does not mean *all* public goods can be produced privately. The problem remains.

The economics profession has been teaching students about the concepts of externalities and public goods as justifications for government taxation for generations, but it has done an exceptionally poor job of addressing the practical difficulties of having the government actually implement a program of public good provision and externality mitigation.

Classical liberals are right to criticize the blasé invocation of public goods and externalities as justifications for taxation. It is indeed all too common to encounter supporters of government action who have merely memorized the terms "market failure," "public goods," and "externalities" from their college classes, essentially using them to mean just those things they want governments to do (Sekera, 2014). Any criticism, however, will be muted unless scholars actually engage the public good and externality debate on its own terms. Coyne (2015), for example, effectively challenges the common claim that national defense is a public good without making a broadside attack on the concept of a public good itself.

4 Market Failure Denial and Conclusions

With that said, and here is the major point of this essay, it is all too common to see classical liberals scoff even at the notion of public goods—we might even call them "public goods deniers". Rothbard (1961: 7) wrote,

> Most economists have two basic arguments on behalf of the public sector, which we may only consider very briefly here. One is the problem of "external benefits." A and B often benefit, it is held, if they can force C into doing something. Much can be said in criticism of this doctrine; but suffice it to say here that any argument proclaiming the right and goodness of, say, three neighbors, who yearn to form a string quartet, forcing a fourth neighbor at bayonet point to learn and play the viola, is hardly deserving of sober comment. The second argument is more substantial; stripped of technical jargon, it states that some essential services simply cannot be supplied by the private sphere, and that therefore government supply of these services is necessary. And yet, every single one of the services supplied by government has been, in the past, successfully furnished by private enterprise. This is a serious mistake if our goal is the improvement of human welfare.

Here Rothbard firstly and disingenuously accuses externality theory as being merely about redistribution – it is just a way for A and B to gang up on C. While is it possible that externality theory could be misused as described, this does not mean externality theory is always and everywhere used in this way. The gains to the stargazers from taxing light emissions may *in fact* exceed the costs to the owners of the lights. Secondly, he ridicules the idea of public goods because private firms have produced all the things governments have produced. This is true, but the argument is that private firms will underproduce public goods and goods with positive externalities (or will overproduce goods with negative externalities), not that private firms never produce these things in some quantities.

If classical liberalism and its various complaints about government action are to be taken seriously, we must engage the ideas of public goods and externalities. Disregarding, or worse yet ridiculing, these concepts as if they are just made-up notions invented by socialists intent on centrally planning our lives is intellectually sloppy and more importantly cedes the battleground to the opponents.

Let us turn our attention to a specific public good/externality issue, namely global warming. We understand that many people firmly believe that the idea of man-made global warming is a socialist conspiracy invented to take over our economies and thwart human progress. We confess that when we see avowed socialists like Naomi Klein (2014) using the issue to advance their anti-human and anti-liberty agenda, we are tempted to join the chorus of skeptics. Alas, carbon dioxide and methane are potent greenhouse gasses and human industrial activity is clearly increasing these gasses to the point that global temperatures are rising as a result. The scientific theory, evidence and, yes, the consensus are simply overwhelming, even if beyond the scope of this paper to discuss in greater detail.[3]

[3] If you are willing to argue in favor of free trade by invoking the consensus of economists, then you really have no basis to complain about people invoking the global warming science consensus.

There are indeed massive benefits associated with burning fossil fuels, benefits that are often ignored by the global warming scientific community (Epstein, 2014). However, these benefits are mostly internalized benefits accruing to consumers. That is, the benefits are already factored into the prices we pay for goods and for the resources used to produce those goods. In contrast, the external costs of global warming in terms of weather changes, rising sea levels, flooding, and so on are not factored into market prices. Basic economic theory tells us that markets will overproduce as a result. Taxation, which would reduce this overproduction, has the potential to improve human welfare by aligning market prices with the true costs of the economic activity.

Of course, we should take seriously the public choice concerns about how the political process works as well as Misesian and Hayekian concerns about the limits of knowledge in the absence of market price signals. Effective criticisms of actual public goods and externalities and any suggested solutions to these problems in practice can be made without denying the theoretical validity of the concepts themselves. Classical liberal scholars should acknowledge that public goods and externalities do exist and taxation can provide a means to improve human welfare. Admitting this does not mean you love the state.

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