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TAX POLICY AS THOUGH PEOPLE REALLY MATTERED

By Kurt Wickman and Christopher Lingle*

Oliver Letwin, the shadow Chancellor of the Exchequer, offered a tax-reform proposal that could provide taxpayers greater control over the public purse. If applied as a matter of principle and applied to all taxpayers, individuals could specify which policy spending they feel their contributions should support.

It seems likely that Mr. Letwin was taking a position that would embarrass the sitting Labour Government. For he did not offer a principled stand that addressed general conditions. Instead, his suggestion was limited to allowing conscientious objectors to stop their tax contributions from being used for military spending.

Nonetheless, Mr. Letwin has stumbled onto a neglected argument over how to construct a tax system based upon a well-defined sense of social justice. The threatening nature of this idea is evident in that it invited widespread condemnation from all quarters of the British Parliament.

It is not surprising that tax-greedy politicians from all parties would denigrate this suggestion and condemn it as a silly idea. Indeed, it is a dangerous idea since it undermines the capacity of governments to fleece the governed. It turns out that these same rapacious public officials seldom spend so much energy defending taxpayers from frivolous or excessive public-sector spending.

One has to ask as a matter of fairness and justice whether anyone should have to pay taxes for services they do not use or do not approve of. Although voters may select representatives to make decisions on tax and spending matters, they do not abandon a claim for accountability for choices made on their behalf.

Mr. Letwin’s proposal reflects the views expressed by a 19th Century Swedish economist, Knut Wicksell, whose “just” system of taxes was based upon the preferences of individuals. In his view, the provision and payment of publicly-provided goods and services should be provided in a way that approximates market transactions.

Wicksell observed how tax policy in Europe during the 1880s and 1890s was “hijacked” by special interest groups. Ruling aristocrats used tax rules to impose high value-added taxes on items consumed by the working class.

But he anticipated that democracy could devolve into competition among groups to shift taxes to those with the least capacity to lobby governments. Once the working class became the dominant force, they could be expected to (mis)behave like the aristocrats of the 1890s.

That is, unless tax policy rules were changed. Wicksell felt that a “just” tax policy had to be kept out of the short-term political arena and acquire the same universal legitimacy as basic democratic institutions, like judicial courts or constitutions.

Wicksell worried about the tax consequences of successive governments seeking the support of different special interests by using new public expenditures to compensate those groups. This would lead to a “ratcheting-up” of public spending whereby tax levels and structures would not actually reflect what most citizens want. As such, democracy would lose a considerable amount of its legitimacy.

An important but widely-neglected aspect of tax policy is that legitimacy and acceptance of governments depend upon how citizens feel they are served relative to their tax contribution. Wicksell saw this clearly and proposed that taxes be implemented to approximate market transactions whereby individuals seek to equate the value of a government-provided service relative to its (tax) price.

Wicksell envisioned constraining tax policy with a strong democratic filter so that no one would be forced to pay taxes for public causes that did not meet their approval. This means each individual should pay exactly the amount of tax corresponding to the amount of public service they consumed. For example, citizens with children in private schools or that have no school-age children should be allowed redirect their payments towards spending that suits their needs.

Thus, taxes would approximate “user fees” instead of being forced payments for services or goods not consumed. Under this “Wicksell criterion”, net contributors would be compensated for any new public spending proposal.

Wicksell also suggested that governments must inform citizens of the full tax consequences of all new expenditures in clear, simple language. Then, citizens could evaluate each new proposal and vote on it. If a small minority rejected a proposal, it would not pass.

Such rules have been applied in Finland where a super-majority requirement of 2/3 of parliament must approve changes in tax policy. Some local governments in US states also follow some variation of Wicksell’s proposal.

Another element of tax law would be to set a five-year limit when it would again be placed before citizens. Such “sunset” requirements reflect the fact that circumstances change continuously so that taxes imposed to solve problems that no longer exist could be eliminated.

Wicksell was **not** proposing a way to avoid all or even most taxes. He sought ways to provide long-term stability for financing a public sector within a democracy.

A conclusion drawn from Wicksell's approach to taxes is that strong social and economic forces are set into motion when opportunistic tax policies. Economists should stop making life easy for politicians and bureaucrats by giving them the least-worst ways to raise taxes. If public officials had to justify new expenditures or explain why current ones must be preserved, they would have less time to dream up schemes to spend more taxpayer monies.

Taxes have such important economic and social impacts that politicians should not be allowed to levy them without greater democratic oversight. Left to their own devices, elected officials and their appointed bureaucrats seek new and endless ways to spend more taxpayers' money. But they are never as imaginative when it comes to finding ways to save money or cut spending.

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