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Neo-Classical Arguments

The imposition of taxation ensures that a community as a whole is forced to pay for whatever public goods and services its government in its wisdom may decide to provide. At the macroeconomic level it may be argued that taxation is a justifiable imposition. At the microeconomic level, however, the sum exacted from the individual taxpayer is unrelated to the public benefits received by that taxpayer. Thus, given the principle of private property, taxation can be justified only as a macroeconomic solution to the need for public revenue. It lacks microeconomic foundations: an individual taxpayer does not receive the public benefits paid for through taxation by that individual. The basis of the argument in favour of redistributive taxation is that it ensures some members of the community pay more while others pay less or nothing for public benefits. Redistributive taxation is a crude attempt to rectify the distribution of wealth that results inevitably from government's failure to conform to the principle of private property. Results cannot be mitigated while causes are allowed to remain.

Reality is obscured further by the operation of a tax system which is intended, in accordance with the 'ability to pay principle', to introduce a measure of so-called 'fairness' between individual taxpayers. Within the limits of practicality governments try to establish a positive relationship between the amount of taxation exacted from an individual taxpayer or corporate body and their pre-tax net private income. Such good intentions of governments are thwarted

at the outset. It is apparent that individually taxpayers are not amenable to the imposition of taxation; all react to the impact of a tax and where possible shift the incidence (Chapter 5); some take steps to avoid the tax legally while others attempt illegal evasion. A primal cause of the so-called 'black economy' is the reaction of individuals to taxation. Yet the imposition of taxation is now universal and, lacking knowledge of any alternative source of public revenue, is accepted by taxpayers as a necessary evil. The macroeconomic solution of funding public spending out of tax revenue is accepted by the contemporary economic orthodoxy as a self-evident truth. The possibility of an alternative solution has vanished from orthodox economic thought and its literature.

The Macroeconomic Case

The macroeconomic solution to the question of public finance was put explicitly by Enrico Barone writing during the early part of this century.[1] First, he defined what he called 'public needs' as being whatever a government happened to provide 'in any country at any time'. Thus according to his definition the extent and content of 'public needs' is not determined necessarily by economic factors; in certain countries at certain times the determining factor might be, for example, the prevailing political ideology. Barone then proceeded to distinguish two categegories of 'public needs' which he defined as 'those which are, and those which are not, susceptible to individual and specific demand and divisible supply'.

'Public needs' of Barone's first category being 'those which are susceptible to individual and specific demand and divisible supply' are not, he argued, of necessity to be supplied by government for they can be supplied by the private sector at 'economic prices'. An economic price, according to Barone, may be an open market price or a monopoly price or

a price agreed in some other way. In today's terms 'economic prices', however agreed, may be taken to be current selling prices at a level a producer expects will yield a net income sufficient to cover the full supply price including a minimum profit. While Barone accepted that goods and services included within his first category of 'public needs' could be provided by private enterprise, he admitted that some might with advantage be supplied by government.

The second category of 'public needs' which Barone defined as being 'those which are not susceptable to individual and specific demand and divisible supply' may be interpreted as covering those goods and services which Adam Smith referred to to as the 'necessary expenses of government'. Such goods and services are necessary for the efficient working of a trading economy but, as Barone highlights, it would seem that the ordinary mechanisms of the market cannot automatically translate this 'public need' into an effective demand to which private sector firms can respond. From the view of a private sector producer not only is the supply indivisible but there is no indentifiable buyer with whom a bargain may be struck in the expectation of covering the full supply price, including a minimum profit. In these cases, Barone stated, government initiative is required. If government is to take this initiative then clearly it must command a sufficient public revenue to cover the necessary expense involved.

To Barone, as with most other writers on public finance, public revenue meant tax revenue. Following the orthodox line he assumed the imposition of taxation to be justified by economic necessity. As it is impossible by his definition to finance the second category of 'public needs' by individual pricing ('economic prices'), then they must be financed by taxation ('political prices'). To provide for the second category of 'public needs' he asserted that government have no alternative but by means of taxation to distribute coercively the total cost throughout the community according to an

individual's income. On this assertion of 'no alternative' rests the macroeconomic case for the imposition of taxation.

Barone went on to assert that 'private persons do not demand public goods' — an assertion that does not follow from his definitions. There may be no 'individual and specific demand' for armed nuclear submarines, but this is not to say that collectively private persons do not demand such weapons as a way of providing the community with an adequate means of defence. This assertion led him to argue that the size of the supply of public goods is determined by a majority making decisions through some form of voting. In turn, the size of the supply of public goods and services decided upon by a majority vote determines the amount of tax to be imposed and distributed between taxpayers 'according to established principles'. This line of reasoning led Barone to conclude that ultimately the size of what today is called the public sector is determined by the majority, only within the limits set by the amount of taxation individual taxpayers are prepared to accept as tolerable. More recently Professor Prest writing on the same subject echoed Barone by stating, 'the very bareness of the economic principles set forth will make it clear that we are on the borderland where economic and political considerations meet and mingle inextricably with one another'.[2] This 'bareness of economic principles', Professor Prest concluded, leads modern economists to seek a political solution by devising appropriate principles of voting. Thus, by assuming public revenue is always and inevitably tax revenue, writers on public finance have been led to pose questions that their science is not equipped to answer.

Although the drift of Barone's arguments has led economists into realms outside the scope of economic analysis, this should not be allowed to obscure his significant contribution to the understanding of public finance. Arguing exclusively from economic grounds, he shows that the private sector and market forces cannot provide in every

case all that is necessary for the efficient working of a trading economy. If the goods and services included within his second category of 'public needs' are to be provided, then government initiative is necessary. By isolating on the basis of economic criteria a category of 'public needs' that can be provided only as a result of government initiative, Barone comes up against the question of public revenue. He answers this question with an unsubstantiated assumption which orthodox economics accepts as a self-evident truth. Drop the assumption and one is led to a clear statement of the important issue to be investigated: How is government to command the public revenue required to fund these necessary initiatives?

Writing a little earlier than Barone, the French economist Paul Leroy-Beaulieu also argued that there are 'many cases where private initiative cannot take the place of governments'.[3] He used this argument not only to justify taxation as being necessary, but also as an argument against the reduction of taxes in certain circumstances. 'Let no one say', he wrote,'that citizens would take care of these matters if government, instead of imposing excess taxation upon them, left them with the money of which this excess taxation deprives them.' From this statement Leroy-Beaulieu may seem to be heralding the post World War II demand-side school, but it has to be remembered that he considered a tax take in excess of 12 per cent of private incomes to be exorbitant. Nonetheless his view is topical to the extent that it conflicts with the policy prescriptions of the now dominant supply-side school. Supply-siders would seem to have reverted for inspiration to the 'golden maxim' of Jean-Baptiste Say, 'the very best of all taxes is that which is least in amount': a maxim of immediate appeal to taxpayers and therefore to politicians in their attempts to attract votes.

The Railway Example

By way of an example of the necessity for government initiative, Leroy-Beaulieu took the then topical case of a new branch railway which exerts a beneficial influence over a very wide area. The difficulty facing a privately-owned railway company is, he pointed out, that many of the beneficiaries from the enterprise will not use the railway and so will not contribute to its supply price. Some traders will use the branch line to carry their goods to other less congested markets and so will contribute through the cost of carriage. The net financial benefit they receive is measured by the higher selling prices obtained less the cost of carriage to the new market. Other traders, however, would continue to use their local market which, being less congested than before the new branch line was constructed, would be also now yielding better prices. For these traders the gross financial benefits bestowed by the branch railway accrue as a free gift from the owners of the line. 'This is why', concluded Leroy-Beaulieu, 'many public works cannot be carried out for private account; they would ruin private entrepreneurs, while being highly remunerative for society as a whole'. However, in the tradition of orthodox economics, he used the argument that private enterprise cannot in every case replace government enterprise to support the imposition of taxation. He did not consider the possibility of an alternative source of public revenue that in practice would charge all the beneficiaries the current market price for the financial benefits each received from the very existence of the branch line, apart from whether any particular individual beneficiary actually used the branch line or not.

The example of a new branch railway used by Leroy-Beaulieu provides a better illustration, and is brought into sharper focus when a distinction is made between the fixed or capital costs of constructing and maintaining a railway

system and the variable or running costs of providing the actual services over that system. Running costs may be attributed to those who actually use the services provided, and for this user element of the total supply price the supply is, to some extent, divisible. For this element also there is an identifiable buyer with a specific demand and an identifiable seller. The two parties, the buyer and the seller of railway services, can in the ordinary way strike a bargain from which each expects to gain an advantage (p. 21). The top limit, determined by the buyer, is the benefit the buyer expects to receive from using the service; in Leroy-Beaulieu's example the higher selling prices prevailing in less congested markets. The bottom limit, determined by the seller, is the additional supply price of actually providing the service demanded. The running costs of providing railway services over an existing system fall, therefore, into Barone's first category of 'public needs' (p. 83). They are not a necessary government expense to be covered by what Barone called a 'political price' (taxation) for they can be covered by 'economic' or market prices. Admittedly in certain circumstances, as Barone argued, a case may be made that it is advantageous for railway services to be supplied by the public sector and then charged to users at the current market price of those services.

The capital cost of building and maintaining a railway system, on the other hand, creates no more than the *potential* for providing a railway service. The benefits, positive or negative, arising from this potential will accrue to those who live, work and trade within the catchment area of the services provided over the system. The more the system is used and the better the service provided throughout the system, the more its potential will be realised with advantage to the whole community. Yet while a community may demand a railway system, there is an individual and specific demand only for the services, not for the system as such: hence the supply of a railway system is not divisible. The

system creates a potential that may be realised through the provision of services, but a railway system without any services is worth little more than its scrap value. Thus, in the case of the cost of constructing and maintaining a railway system, market forces cannot work in the ordinary way to ensure a sufficient financial return directly through the process of individual bargains. Where there exists an effective demand for railway services, then the capital cost of the system falls into Barone's second category of 'public needs' to be met out of public revenue. Interestingly, the United States of America attempt to run their passenger railway services in complete contradiction to the implications of Barone's categories. The railway passenger services are a government service, supported by public revenue, being run over privately-owned systems! When compared to British Rail the result is a disaster.

A railway company or similar enterprise, whether private or government owned, basing its charges to customers on the expectation of covering its *total* supply price, including both fixed and variable costs, will find itself locked onto a descending spiral, leading to the need for a substantial subsidy from public funds in order to avoid bankruptcy. The high charges will deter potential customers and thus necessitate further price increases. As prices rise and usage declines the capital investment will become grossly underused and apparently uneconomic. Everybody loses. To maintain such an enterprise out of tax revenue, either directly or through some form of subsidy to a privately-owned company, is akin to cutting off the head of a hydra. By its very nature a tax, properly so-called (p.39), does not equate the amount paid by an individual taxpayer to the public benefits received by that taxpayer. Some members of the community are forced to contribute more than they receive while others receive more than they contribute. When any government-owned enterprise is wholly or partly financed from tax revenue, it is inevitable that some are

forced to pay in excess for external economies (public benefits) which may or may not be available or required by them, while to others they accrue as a free gift. These circumstances must result in an ever increasing maldistribution of income and wealth within that community, plus all the distortions, injustices and tensions concommitant with such a condition. In certain cases the market, unaided, cannot ensure that the private sector provides all the goods and services necessary for the efficient working of a trading economy. Nonetheless, to rely on tax revenue as a source of finance in those cases requiring government initiative, multiplies the problems to be resolved.

The market is a distinguishing characteristic of a trading economy and the basic mechanism of a market is the process of bargaining. Trade may flow between countries, markets may be international, but the process of bargaining takes place between an individual buyer and an individual seller. The outcome of the bargaining process determines the market price. When there appears to be no individual buyer with a specific demand and when the supply is indivisible, then a direct process of bargaining is precluded and the market cannot give the necessary price signals to producers in the ordinary way. When this applies to goods and/or services necessary for the efficient working of a trading economy, then public initiative must act in place of private initiative. It is self-evident that as private initiative incurs a private expense to be met out of private income, so public initiative incurs a public expense to be met out of public revenue. Thus far Barone, Leroy-Beaulieu and other writers at the turn of the century made the case clearly and contributed much to the advancement of public finance theory. However, they assumed that the expenses of public initiatives leave government with no alternative but to impose taxation. This assumption obscured their contributions. As later writers on public finance have taken their assumption as an axiom, the issue remains unresolved.

Alfred Marshall's Contribution

In his major work *Principles of Economics* Alfred Marshall did not treat issues relating to public finance as a separate subject for discussion. Local rates are given an appendix to themselves (appendix G) but, while taxes are considered in a number of places, it is mostly by way of illustrating the particular subject matter being investigated. This has tended to obscure Marshall's most important contribution to the understanding of public finance and contributed to it being ignored by later specialist writers. In chapters X and XI of Book V, in particular, he provides evidence of a link between public outlay and effort and the current market price of land. These two chapters shed much light in those cases which Barone argued, for example, needed 'public initiative' charged at a 'political price'. Marshall argues that public work and outlay creates external economies which become manifested in the enhanced value of land.

In two chapters on marginal costs[4] Marshall, by implication, rejects the applicability of the Ricardian theory of rent for determining the market price of land in a trading economy. He argues that in a trading economy what makes land in general rich or valuable is determined by the extent of the opportunities which the occupation of a given site is expected to grant to its occupier for the time being. When dealing with agricultural land,[5] Marshall states these external economies to be largely the 'product of growing *public* prosperity' (italics in the original). This led him to distinguish between the 'private value' and the 'public value' of land. What he calls 'private value' is that part of the net annual value of land which is the result of the landowner's and/or occupiers work and outlay. The net annual value of land after the deduction of 'private value' he calls 'public value'. Thus, according to Marshall, the annual value of land, 'private value' plus 'public value', is produced wholly or largely by human work and outlays and, therefore, cannot

be determined by the Ricardian theory of the rent of land. (In the Ricardian sense 'rent' arises from 'the original and indestructible powers of the soil'[6] and that, which is both original and indestructible, cannot be produced by human endeavour.) However, having distinguished between the 'public value' and 'private value' of land, Marshall did not use his newly defined terms exclusively. He went on to state that the 'annual value of land' could be called 'true rent', so obfuscating the issue by reintroducing Ricardian associations.

It would seem that Marshall himself was confused by the Ricardian associations of the term 'true rent' when considering the effects of 'a special tax on the annual public value of land'.[7] He argued that the 'special tax' levied on 'true rent' would deter landowners from making outlays to improve the methods of cultivating their land, which developed the latent resources of the soil in the expectation of a net return in excess of normal profits. The excess return would be, concluded Marshall, a 'true rent' and subject therefore to the 'special tax'. While a return on the latent resources of the soil might be classed as a 'rent' in the Ricardian sense, it cannot form part of the 'annual public value' or 'true rent' as defined by Marshall. The excess returns expected by the landowner are the direct result of an outlay by that landowner on improvements in the methods of cultivating his land. That these improved methods developed the latent resources of the soil is immaterial. Thus, according to Marshall's first definitions, the supposed outlays cannot increase the 'annual public value of land' but only its 'private value'. This being so the expected excess return over normal profits would not be subject to the 'special tax'. In fact the outcome is likely to be precisely opposite to that forecast by Marshall. A 'special tax' when levied on the 'annual public value of land' will encourage rather than deter landowners to make outlays on direct improvements to their land. For a time the innovator, having a monopoly of the improvement,

would expect to enjoy as a private income a net return on the outlay in excess of normal profits. This provides the carrot for such innovation. Market forces would provide a stick for competitors. They would be driven to follow suit or risk becoming uncompetitive and, as a result, lose market share, or even go out of business. As the improvement became general usage then competition in a free market would erode the excess net return and, in the longer run, lead to the benefits flowing to consumers in the form of lower prices, or better quality, or some combination of the two.

In the chapter on 'marginal costs in relation to urban values'[8] Marshall provides further evidence of a link between public effort and outlay and the current market price of land. Unfortunately he again obfuscates his contribution by multiplying terms. He uses the term 'situation value' to cover the money value of the net advantage, enjoyed by the occupier of a particular site, resulting from the external economies and diseconomies created by the 'general progress of the industrial environment'. The extra annual income that can be earned by the occupier of land having a 'situation value' he called 'situation rent'. The 'situation value' of a particular site to any industry, including agriculture, is, he argued, the excess money value of the site over its 'agricultural value'. The 'agricultural value' of land he took as being the value of the free gifts of nature to be enjoyed by the occupier of that land. This led Marshall to define 'aggregate site value' as 'situation value' plus 'agricultural value'. He took 'aggregate site value' to be the current market price of land after allowing for any direct improvements made on that land — in the case of building land the current market price of a cleared site. That the greater part of 'situation value' is 'public value' Marshall considered to be obvious, although his various definitions and multiplicity of terms caused him to admit to a number of exceptional cases. The exceptional cases arise where 'situation value' has been produced by private outlay

and effort and is, therefore, to be considered as 'private value'.

When dealing with the exceptional cases of 'situation value', Alfred Marshall, like Leroy-Beaulieu, also considered the effects of contructing a new railway, at the time very much a topical issue. Marshall's purpose was not related to public finance but to whether any resulting increase in 'situation value' should be classed as private profit or 'public value'. He argued that when a group of landowners used their own combined funds to finance the construction of a new railway which was not expected to yield any great return directly, then any income from the increase in the value of their lands should be regarded as private profit — an exceptional case where an increase in 'situation value' enhanced 'private value' and not the 'public value' of land. From this example he concluded that all cases where the owners of land invested their capital, not in direct improvements to their land, but to fund enterprises which they expected would make external economies available to the occupiers of their land and thereby increase its value, should be regarded as exceptional.

What Marshall did not consider was the case of an owner of land within the catchment area of a new railway, or similar enterprise, who decides not to contribute funds to that enterprise. Economic forces cannot discriminate between the land owned by a contributor of funds to some new enterprise and the land owned by a non-contributor of funds. If the values of some parcels of land falling within the influence of a new enterprise are affected, then the values of all parcels of land within that sphere will be affected — an aspect of indivisible supply determining Barone's second category of 'public needs'. Thus, in the case of a non-contributing landowner the increase in the value of his land, resulting from the availability of external economies created by some new enterprise, must accrue to that landowner, not as profits on capital invested or 'private value', but as a free

gift from those who have invested their capital in the new enterprise — as 'public value' not 'private value'. As Marshall did not consider the case of non-contributors, he did not consider, as did Leroy-Beaulieu, the possibility of such enterprises, although advantageous to the community as a whole, proving ruinous to private entrepreneurs due to their inability to charge all those benefitting from their outlay and enterprise. Had he considered all the possibilities, he may have seen the need to redefine 'public value' and 'private value' relative to what he now called 'situation value' of land, thereby contributing even more to the advancement of economic science.

In the same chapter Marshall wrote, 'any increase in the net income derived from the free gifts of nature which was not brought about by, and did not supply the direct motive to, any special outlay on the part of the landowners is to be regarded as rent for all purposes'.[9] Again Marshall confuses the issue by substituting terms with Ricardian associations; but even so this qualification does not cover the case of the non-contributing landowner mentioned above. The non-contributing landowner is the recipient of an increase in net income derived, not from a free gift of nature, but from a free gift of external economies made available by the work and outlay of other members of the community. What Marshall had stated in the preceeding chapter is applicable to the immediate issue. 'Barren heath land', he wrote, 'may suddenly acquire a high value from the growth of an industrial population near it: though its owners have left it untouched as it was made by nature'.[10] In this instance he stated explicitly that this increase in the value of land is produced by 'the actions of men, though not of its individual owners'. Since this value of land is produced by the actions of men it cannot give rise to a 'rent' in the Ricardian sense and so Marshall classed it as 'public value'. From the barren heath land example it must follow that any increase in the value of land, resulting from some enterprise to which the

owner of that land is a non-contributor of funds, must be classed as 'public value'.

From the aspect of public finance Marshall's work on marginal value is confusing and tends to obscure his important contribution to the subject. Nonetheless, he does show that in those cases where, apparently, supply is indivisible, the money value of that supply, or its supply price, is manifested in the enhanced value of land. This comes about as the actual supply produces external economies, or benefits, to the occupiers for the time being of particular sites. In the first instance these accrue to the occupier for the time being as a free gift, but, given private property rights over land, upon the sale of those rights or the renegotiation of the rent the money value of the advantages pass to the landowner. Thus the second category of Enrico Barone's 'public needs' which he stated as being 'not susceptible to individual and specific demand' is shown by Marshall to be susceptible, albeit in a roundabout way. At the time a particular site is sold or the rent renegotiated, there is an individual seller and the otherwise indivisible supply is, in effect, divided. At the same time there is an individual buyer, purchaser or tenant, with a specific demand for the advantages that accrue to an occupier of that particular site. These two parties, the buyer and the seller, or landlord and tenant, in the normal way strike a bargain which determines its current market price. At this price both parties to the bargain expect to gain an advantage. Marshall's contribution thus advances the work of Henry George and, in terms of neo-classical economics, shows how market forces operate to cause the value of public work and outlay to be reflected in the current market price of land.

1. Enrico Barone, *Giornale degli Economisti*, April/May 1912.
2. A.R. Prest, *Public Finance*, 1960.
3. Paul Leroy-Beaulieu, *Traite de la science des finances*, Vol.II, Bk.II, 1906.
4. Alfred Marshall, *Principles of Economics*, Bk.V, Ch.X & XI.
5. *Ibid.*, Bk.V, Ch.X.
6. David Ricardo, *The Principles of Political Economy*, Ch. II.
7. Alfred Marshall, *Principles of Economics*, BkV, X, 4.
8. *Ibid.*, Bk.V, XI.
9. *Ibid.*, Bk.V, X, 1.
10. *Ibid.*, Bk.V, X, 4.