1. The destructive nature of taxes

Taxes obviously have a role to finance public expenditures, those of the state as well as those of all public organizations, for instance local government agencies or what are called "social organizations", the financing of which is made thanks to compulsory contributions.[1] Analyzing taxes thus leads back to an analysis of the state, or more precisely of the acts and the choices of statesmen for whom taxes constitute the major part of their resources. To have a complete knowledge of the role played by taxation, it is thus necessary to take into account the use of the resources taken by the state, i.e. public expenditures. We will have the opportunity to consider this whole set of problems at the end of the current book. But, for the time being, it is preferable to focus only on taxation and its economic consequences. We will have the opportunity, in the following chapters, to examine the role played by each type of tax or the operation of the whole tax system. But all taxes share certain characteristics of which any serious analysis of a tax system should absolutely take into account.

THE DESTRUCTION OF PRODUCTIVE INCENTIVES BY TAXES

One could consider that taxes that are used to finance public expenditures quite simply constitute the price of the goods and services provided by the state, what are sometimes called "public goods". One would thus establish a parallel with the voluntary exchange between two private individuals (or organizations). But there are two essential differences between a public exchange and a private exchange. First of all, whereas in a private exchange one chooses the nature and the quantity of the goods which one wishes to acquire, the state offers a considerable set of goods without it being possible for the purchasers – the taxpayers – to decide which public goods they wish to purchase and in what quantity. But, above all, the resources of the state are obtained in a way absolutely different from the one which prevails in a private exchange: A tax is imposed; it is confiscated by the use of constraint and not earnt via the voluntary exchange between two free people.

We are all very sensitive, in our personal life, to the differences which exist between an act decided and carried out freely and an act carried out under constraint. But, rather strangely, this essential dimension of human action is generally forgotten when one is caring about economic problems. Politicians, bureaucrats, professional journalists, but also, very often, economists, consider that there are collective total quantities – for example the gross domestic product – and that one can transfer a more or less large part of it from some individuals to others without the quantities in question being modified. This means that one forgets that economic phenomena are necessarily the result of individual decisions and that these decisions are not unconcerned with the compulsory or free character of human relations.

Any human being has this double inescapable characteristic according to which he uses his reason to act and his action takes place over time. Thus, he accepts an effort in the present time with the aim of increasing his future satisfaction. However, not being a simple automaton, he will decide his present actions according to what he hopes to obtain in the future, i.e. the output of his actions. In addition, insofar as the future is always uncertain, he will take account of the risk attached to each of his possible actions. It is an obvious truth that an individual will make all the more effort – for instance as regards working, innovating, or saving – the greater will be the return from his effort and the weaker will be the risk. But this obvious truth is unfortunately and generally forgotten, in particular by all those who debate taxation. A tax is necessarily taken from the resources created by individual efforts. If it is proportional to the amount of these resources – or more than proportional (which is the case with the progressive income tax) – it decreases the return on the efforts which were at the origin of the creation of these resources. As an obvious consequence there is less incentive to act. Thus, a tax proportional to income decreases the incentive to produce an income, a tax taken from the amount of savings or from the amount of capital (accumulated savings) decreases the incentive to make saving efforts in order to increase one's future income, etc. Obviously these incentives are also decreased if there exists a risk that the rate of these taxes be increased.

In order to clearly appreciate the role of most taxes in the destruction of productive incentives, let us carry out two comparisons.

First, let us compare a "poll tax" and a tax proportional to income. A poll tax is a tax which is fixed and identical for all taxpayers, whatever their characteristics, whether their incomes are low or high. Thus, let us imagine that a state suddenly decides to impose this type of tax on its citizens. What would be the reaction of a taxpayer to the creation of this tax? This tax represents a (compulsory) levy on his resources. To be able to pay it he will necessarily be obliged to increase his productive efforts and/or to decrease his consumption of goods and services. In both cases, his level of satisfaction is decreased since he must give up the consumption of certain goods and services or give up part of his leisure time to work more. The choices made by the various members of a society will most probably be different, but one can think that on average there will simultaneously be an increase in production and a reduction in consumption.

A tax proportional to income has completely different consequences. If one assumes that a state suddenly creates a proportional tax on income, it will modify the arbitration made by an individual between work and leisure, since the return gained from working is decreased by this tax. Thus, there will be, normally, a reduction of the productive efforts of a taxpayer and therefore a reduction of his income. But it will also have an effect on savings. Indeed, saving means giving up a present consumption and therefore a present satisfaction. One would be all the more inclined to accept this sacrifice the larger his future output. But if he knows that an income tax will reduce the return on his savings, the incentive to save will be decreased. The results from this tax are a lower accumulation of capital and a smaller rate of economic growth. The proportional tax on income thus decreases the incentive to produce an income in the present and in the future.

The second example consists in comparing two systems of health insurance and it is rather similar to the previous example. Let us take the case of the French system called "social security" (which it would be more accurate to call "socialized individual insurance"). In this system – as in similar systems which exist in many countries – the contribution to the system paid by an individual is proportional to his income. As mentioned previously, there is thus a destruction of productive incentives (incentives to work, to innovate, to develop a business, to save, or to invest) and this destruction of productive incentives is obviously all the more important now that the rates of contribution are higher. This situation is the consequence of the fact that the social security system is a public monopoly – which implies that citizens do not have the freedom to choose another health insurance system – and that the state has decided on this particular and compulsory way of financing. But the working of the health insurance system is completely different if it is a purely private insurance system, in which there is competition between different providers of insurance services, as is the case in some countries.

The contributions are not proportional to income but to risks. In such cases – as in the case of the poll tax – the (voluntary) holder of an insurance has the incentive to make more productive effort in order to be able to pay his insurance and he is all the more encouraged to act that he wishes to have a greater insurance coverage. Moreover, it is his own responsibility to choose the type of insurance which he wishes to have and the means of financing it.

There is thus a considerable difference between the financing of a service by taxation and the financing by voluntary exchange. Financing by taxation necessarily destroys productive incentives, whereas voluntary financing encourages people, on the contrary, to increase their productive efforts. We must always keep in mind this inescapable consequence of taxation, and no debate about taxation, no policy proposal about a tax reform, should overlook this major fact. This is also why one should always wonder whether it is not possible to replace the public supply of a good or service and its financing via taxes by a private supply and a voluntary payment. To be convinced, it may be useful to push the reasoning to its extreme limit. Let us imagine that a tax takes 100 percent of the income of taxpayers. In such a case, nobody would believe any more that it is rewarding to make any productive effort. There would be no more production, no more incomes, but also no more taxes and, therefore, no more state … It would lead to total destruction of the concerned society.

The destructive effect of taxes is thus obvious. It is however necessary to go further and to realize that actually there is even a *double destruction of productive efforts by taxes*. Indeed, taxation makes it possible for the state to provide goods and services. Now, even if we have decided not to examine the "public expenditure" part of state activities for the time being (thus shifting this analysis to the end of the present book), it is essential to evoke it here briefly. Indeed, if an individual can obtain free – or almost free – goods or services which he wants from the state, he is less encouraged to try hard to make productive effort in order to get them. Taxation thus destroys the productive incentive of taxpayers, but it also destroys the productive incentive of the recipients of public goods. Let us take the example of housing. Normally an individual is inclined to make productive effort to be able to pay rent or to buy a house. But if the state levies taxes to offer free housing to certain people, the taxpayers who pay the taxes reduce their productive effort and the recipients of housing offered by the state are also inclined to make less productive effort. There is thus a double destruction of wealth compared to what would occur in an economy based on the free decisions of individuals. It is normal to assume that individuals are rational so that the logic of their behavior necessarily leads us to the following conclusion: *If the creation of wealth is smaller, the burden of taxation is heavier*. From this point of view, one can put forward an inconsistency in public policy. Politicians, indeed, very often claim that their goal consists in improving the fate of those who have limited resources. But, by following a redistributive policy, the state slows down the creation of wealth and thus prevents the improvement of the fate of everyone and, in particular, the fate of those whom it claims to help.

Thus it is not surprising that the economic growth rate is very low and unemployment is high in countries with high taxation, such as France. In this country, since the beginning of the 1970s, the amount of taxes and social security contributions has constantly increased (in particular as a consequence of the election of the socialist president François Mitterrand in 1981). It increased from less than 35 percent of the gross national product in the 1970s to more than 45 percent in recent years. The gross national product growth rate has been slightly higher than 3 percent only five times since 1980 (whereas, during the 1970s, it had constantly been higher than 3 percent – except in 1975 – and it had even reached 6.2 percent in 1970 and 6.6 percent in 1973). The unemployment rate has always been higher than 7 percent since 1982 and even close to 10 percent, while it was lower than 5 percent until 1979. If there is a persistent "economic crisis", it is not because there is a "lack of total demand", as Keynesianism wants us to believe and as the majority of public opinion does believe. In fact, how could one speak of a lack of total demand for "national production", when the worldwide market is practically unlimited and thus constitutes a potential demand for any national production?

Actually, if the growth rate is weak, if there is unemployment and unemployed factors of production, it is because producers are discouraged from producing more, since the additional remuneration which they would withdraw from an increase in production would be too weak. One has to take care of a problem of supply and not a problem of demand. Such is partly the message transmitted by what is called "supply-side economics", which in fact is mainly a rediscovery of the classical tradition which was almost completely forgotten because of the long Keynesian night.[2]

Supply-side economics – which it would be more correct to call the "economics of incentives" – precisely recalled that it was incorrect to study the alleged macro-economic effects of a change in the amount of taxes, for example with the fallacious aim to modify total demand, and meanwhile to be unaware of the micro-economic aspects of this change, namely the reactions of individuals to present or forecast changes in taxation. The higher the tax rate which strikes an activity, the more taxpayers are encouraged to escape the tax by shifting towards another less taxed activity, by devoting more time to leisure and less to work, by devoting more effort to finding ways of evading taxes, rather than being productive, or even by trying to benefit more from official redistributions, etc. All these effects of taxation correspond to concrete experiments that everyone knows, and it is precisely an error of the macro-economic and mechanistic approach not to be aware of this reality. This is why, if one wishes to evaluate the impact of taxation on the working of a society, it is not sufficient to know, for instance, the share of taxes and social security contributions in the national product. It is at least as important to know to what extent taxation affects more specifically certain activities. Supply-side economics insists rightly on the importance of the marginal rates of taxation: Thus, a tax or a set of taxes the average rate of which would be moderate, but which would very strongly hurt a part of the taxpayer's income, would be very destructive of incentives. This is the case – among other possible examples – of the progressive income tax (analyzed in Chapter 2). We will see in detail later on that the excessive taxation of savings induces individuals to consume more and to save less. The future economic growth is thus reduced. We will show why it is extremely important to react against the wrong but fashionable idea which consists of claiming that capital is less taxed than work.

LOWERING TAXES, THE BEST PUBLIC INVESTMENT

Supply-side economics has rediscovered and improved the old precept according to which "taxation kills taxation". The famous Laffer curve – which is inspired by the idea that taxation destroys production incentives – has given a striking illustration of this precept. It would not seem necessary for us to do more than just mention it, if there had not been a certain number of bad interpretations of it.

The Laffer curve depicts the evolution of public revenues from taxes according to the rate of a tax (for instance the income tax). These revenues are obviously equal to the product of the tax rate by the amount of the tax base, i.e. the value of the resources on which this tax is levied (the tax base being, for example, the value of income in the case of the income tax; it is the value of capital in the case of a capital tax, etc.). The traditional macro-economic approach consists in supposing implicitly that the tax base is constant (or, at least, independent of the tax), so that an increase in a tax rate results in a proportional increase in tax revenues. But if one admits, as it appears fully legitimate, that the tax base is reduced as the tax rate increases, there exists a contrary influence. The combination of these two effects – the increase in the tax rate and the decrease in the tax base – gives the Laffer curve. It expresses an obvious idea: If the tax rate is zero, the public revenues from taxes are also zero (one is at point 0 on Figure 1.1). If the tax rate is equal to 100 percent, the tax base becomes zero since nobody may find it beneficial to maintain an activity the return of which is completely confiscated. The public revenues from taxes are then also zero (one is at point B). Between these two points – i.e. between a rate equal to zero and a rate equal to 100 percent – there exists a series of rates for which the revenues from taxes are not zero. Starting from point 0, the increase in the tax rate increases initially the revenues from taxes without the decrease in the tax base being sufficient to compensate for this effect. But one reaches necessarily a certain point A, which is at the top of the curve, where the revenues from taxes reach their maximum value. Beyond this point the increase in the tax rate decreases the tax revenues because the tax base decreases more rapidly than the tax rate increases.

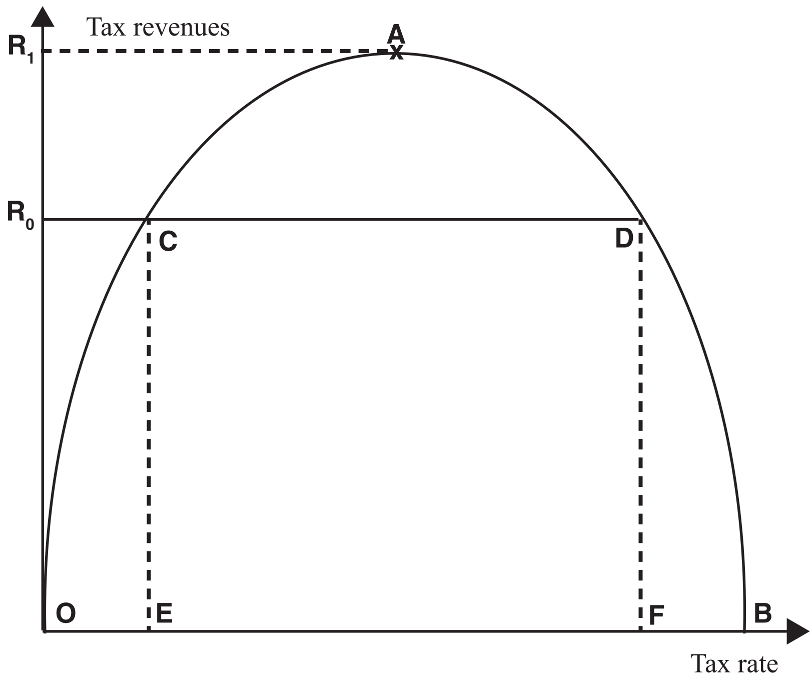

Figure 1.1 Laffer curve

This curve makes clear that the same amount of tax revenue can be obtained with two different tax rates. Thus, the R_0 revenues (on Figure 1.1) can be obtained with a rate equal to OE as with a rate equal to OF. The rate OE is preferable for everyone since taxpayers take advantage of a lower rate, which encourages them to be more devoted to the activity thus taxed. Thus, if one is, in a country at a given time, at a point such as point D, a reduction in the tax rate – leading for example to point C – does not imply any loss for the state, but allows a development of the concerned activities. As an example, a reduction in the progressiveness of the income tax makes possible a faster growth of incomes, without the state losing tax revenues; in the same way, a reduction in the rate of the taxes on savings induces a higher accumulation of capital. Of course, the expected effects are not obtained immediately and there probably exists a period during which the revenues from taxes decrease initially after a reduction in a tax rate, because the tax base has not yet had time to increase. The government must then either decrease public expenditure correspondingly, or finance a temporary budget deficit by borrowing money.

One frequently draws an incorrect conclusion from the Laffer curve, namely that the point A, at the top of the curve, would be an "optimum" point. It is at this point that tax revenues, amounting to R_1, are the most important, but there is no reason to say that a situation in which public revenues are maximum is an optimal situation. This point may be an optimal point for statesmen, but it is surely not for citizens. Anyhow, one may add that, generally speaking, it is impossible to define a "social optimum".

Let us take for instance the assumption according to which the "public services" produced by statesmen and "supplied" to each taxpayer would be less appreciated by each of them than the services which they would have wished to get if they had not had to pay taxes. In this case, the optimal tax for taxpayers – but not for statesmen – is obviously a zero tax. This assumption can be considered as excessive and one frequently assumes that there are "public goods", desired by all citizens, although we can never really know the preferences of individuals, and the electoral procedures, which are supposed to allow the expression of choices concerning these goods, are in fact completely imperfect.[3]

One can however learn a lesson from the Laffer curve, namely that it is always justified to decrease the rate of taxes when one has good reasons for thinking that one is at a point located beyond the top of the curve (for example a point such as D). It is in fact this pragmatic rule which partially inspired the American economic policy during the first mandate of President Reagan. The reduction in the rate of the corporate income tax increased the profitability of capital, the reduction in the highest rates of the income tax increased incentives to make work effort of the most productive persons. It is this tax policy which allowed the economic "recovery". It is striking to note that the high real interest rates of this period have not affected investments; investments are indeed determined by the prospects of net future returns and the reduction in the marginal tax rates increased these returns, thus compensating for the negative effect of high interest rates.

Moreover, the Laffer curve provides the only means of understanding the terrible vicious circles in which many countries are trapped. Let us suppose that one is at a point such as D on Figure 1.1 and that one wishes to decrease a budget deficit. A purely accounting approach – which governments tend to use – suggests increasing the rate of one or several taxes. But tax revenues, instead of increasing, decrease (one moves towards point B) and the public deficit is increased instead of being reduced. Moreover, a consequence of such a tax policy is an increase in unemployment and a lower economic growth rate because the economic activity is reduced by this attack on productive incentives. More important transfer expenditures are then decided to help unemployed persons or "to boost economic activity" by stimulating total demand, according to the Keynesian prejudice. Thus, in order to avoid too great an increase in the public deficit, one then decides a new increase in taxes. The vicious circle remains indefinitely until a clear-sighted government understands that it is advisable to adopt the exact opposite strategy, to break the vicious circle and to create a virtuous circle by decreasing taxes.

Unhappily, this strategy is often not discovered and there is a steady growth in taxes and social security contributions, and one is obliged to note that the "economic crisis" remains. But if the vicious circle perpetuates, it is because governments do not understand that the productive behaviors are strongly influenced by taxation. It is also because of an institutional bias. Indeed, contrary to what one generally says, political leaders have an extremely short perspective – focusing on the horizon of the next election. They fear, consequently, that a fall in taxes leads to a fall in tax revenues and thus to an increase in the public deficit which could be criticized. However, as we saw, it is true that it is necessary to wait for some time for the tax base to increase after a reduction of taxes, so that the public deficit can increase during a period of about two to three years. But beyond this period of adjustment, the tax base increases and tax revenues also increase (as was the case when President Reagan strongly decreased the highest rates of income tax). But it is necessary that statesmen have strong convictions and that they are persuaded that the decrease of taxes probably constitutes one of the most profitable investments that the state can make. Just as a firm can legitimately get into debt to finance a profitable investment, the state should accept an increase of its debt during a period of two to three years to finance this remarkable public investment which would be the reduction in the rates of the most destroying taxes. This means besides that there are "good" and "bad" public deficits. A deficit which results from economic stagnation and/or the incapacity of governments to monitor efficiently public expenditures is a "bad" deficit. A deficit which makes it possible to obtain an important future return for the population as well as for the state is a "good" deficit.

THE IMPOSSIBLE TRANSPARENCY OF TAXATION

One of the important characteristics of taxes which must be stressed at the beginning of our analysis of taxation is the impossible transparency of taxes. An example will make it possible to understand the phenomenon in question. Let us imagine an initial situation in which taxes do not exist (for example because the state is financed by the returns of a public domain) and let us take the case of a working contract by which an employer promises to an employee a wage equal to 100 per work day. Let us suppose now that the state suddenly decides to impose on the employer a tax equal to 20 percent of daily wages. Initially the profit of the employer will be decreased by the same amount since he promised 100 to his employee and he must pay moreover, in an unforeseen way, 20 to the state. Given the fact that in the private sector one is respectful of his contracts, it is consequently not possible for the employer to lower the wage of his employee. But over time he will find various ways to shift, at least partially, the burden of this new tax onto the employee. Thus, he can wait for the end of the work contract – or even cause it – in order to hire another employee to whom he will promise, for example, a wage equal to 90 (so that the employer will actually pay 10 in taxes and the employee will pay 10 indirectly). Or he will make productivity gains but, instead of increasing correspondingly the wage of his employee – as would have been the case in the absence of this new tax – he will maintain the wage at its level of 100 until there is a profitability of his activity which he considers satisfactory for him. Generally speaking, one can think that the net burden of the tax will be, more or less quickly, borne both by the employer and the employee in proportions which depend on the circumstances and which an external observer is absolutely unable to know. This knowledge is impossible since it would imply comparing the existing wage to the one which would have existed in the absence of tax, information which nobody could have.

From this point of view, we may note that most existing taxes are characterized by this lack of transparency. One tax would certainly escape from this criticism – the poll tax, which we already met, but which is unfortunately often disparaged because it is considered obsolete (and perhaps also unable to bring to states the considerable sums which they are absorbing in our time!). Indeed, if each citizen had to pay a fixed sum independent of his activities, each would bear the burden of the tax which he pays, without any possibility of transferring it to others. This is not the case with other taxes, as they are generally taken on the occasion of the fulfilment of contracts, i.e. of activities which concern several people simultaneously. Such is the case, for example, of a tax on the income of labor or social security contributions levied on the occasion of labor contracts. But it is also the case, for instance, of a lending contract the interests of which are subjected to the income tax. We will have many occasions in the current book to meet situations of this kind, for instance the taxation of savings or value-added tax.

This means that the one who pays a tax to a tax administration is not necessarily the one who completely bears its weight. In other words, we do not know by whom existing taxes are being paid. This situation is more worrying the higher the level of taxation in a country. This lack of transparency makes taxation the most undemocratic system one can imagine, since democracy is supposed to be founded on the idea that citizens are consenting to what the state is doing; but they do not know what the state costs them. There is, from this point of view, an essential additional difference between a public activity and a private activity: In the private sphere if I buy a product, I bear completely and definitively the weight of the price which is required from me and the system is thus perfectly transparent. In the field of public goods and public choices, one does not know who pays what. This would be a very strong reason to significantly decrease the public sphere and to allow the maximum widening of the private sphere. Contrary to what one very often believes, the system of private contracts is the most respectful of people, while the system of public obligations rests on dissimulation and trickery.

NOTES

1. For convenience reasons, we will use the term "tax" to indicate all compulsory levies imposed by public authorities. In a similar way, we will generally use the term "state" to indicate any public authority, whether it is national or local (or, possibly, international).

2. The contemporary so-called Austrian School – developed particularly by Ludwig von Mises, Friedrich Hayek, and Murray Rothbard – kept the best aspects of this classical tradition, while being the only one to draw all the logical consequences of the revolution in the theory of value at the end of the nineteenth century.
3. This problem is analyzed in Chapter 11.