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The Great Schism in the Theory of Public Finance. A Treatise in the Theory of Economic Thought

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The Great Schism in the Theory of Public Finance

A Treatise in the Theory of Economic Thought

by

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28 February 2014

Abstract:

In 1870 Menger, Jevons and Walras succeeded in explaining prices in a market economy. While most economists welcomed their achievement, economists of the theory of public finance split in a **Great Schism**. The dissent is on the two Gossen Laws on which the neoclassical revolution relies. Continental Europeans insist in the relevance of choice and therefore adopt both Gossen laws, meaning that of declining marginal utility and that of utility equalization at the margin. The Anglo-Saxons adopt only declining marginal utility because they found that individual choice does not work for public goods. The former became choice individualists, the latter utilitarians. The Schism was revitalized with the Mirrlees Review of 2010/2011, a monumental work by 63 renowned economists over 1880 pages on what a good tax system ought to be. The author argues that without choice, nothing can be said on a good tax system. Therefore the Mirrlees Review is rejected in favour of a choice alternative which is developed in this paper.

Key words:

Dissent on economic theories
History of economic thought
Competing approaches to economics
Methodology: individual choice versus utilitarianism

JEL Classifications:

B1/B2: History of economic thought;
B5: Heterodox approaches
B13: Neoclassical history of economic thought
H2: Taxation, subsidies, revenues

28 February 2014.
*In Wicksell's view the fundamental principle
of taxation was that of equivalence between the
contribution made to the government and benefit
received from government ...
The developments which had caused
the benefit principle to be placed in the background
and the correspondent ascendancy of
the ability-to-pay principle represented
to him a step backward in fiscal thinking."*
James M. Buchanan (1952)

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A. The Great Schism in Public Finance

This paper is a treatise on two approaches in public finance. It explains why Anglo Saxon and Continental European Public Finance have gone along two different methodological ways for more than 140 years. The point of departure is the neoclassical revolution by Carl Menger, Stanley William Jevons and Léon Walras on the explanation of prices in a market economy of about 1870. The message of this revolution has been adopted with enthusiasm in all fields of economics. Only public finance is different. A utilitarian approach is followed by the Anglo Saxon School and an individualistic approach in Continental Europe leading to a deep Schism between the economists here and there. That the Schism still exists is documented in the "Mirrlees Review" of 2010, 2011, a monumental work demonstrating the methodological standpoint of the Anglo Saxon School of public finance under the

¹ The author is indebted to Knut Borchardt, Jan Schnellenbach and Carl Christian von Weizsäcker for helpful comments and to Mats Geiden von Schwarzenburg for editorial support.

Laureate James Mirrlees and the London based Institute of Fiscal Studies which is in contrast to the Continental European approach.

Descendants of both Schools can be found today all over the world. Nevertheless it is useful to locate the Schism where it has started: In Anglo-Saxon countries and on the European Continent.

The purpose of this paper is to explain the Schism. Sections B to E explain the Mirrlees Review within the broader framework of the Anglo Saxon School of public finance. Section F presents the Continental European alternative. In section G it is asked which approach is more open minded towards new questions. Public debt will serve as an example The conclusions will follow in section H.

B. The Mirrlees Review

The Mirrlees Review is an encyclopedic work published in two volumes “Dimensions of tax reform” and “Tax by design” in 2010 and 2011 by the London based Institute of Fiscal Studies under the direction of the Nobel Laureate James Mirrlees. It consists of 33 in depth studies by 63 of the most renowned authors of the Anglo-Saxon public finance tradition. The Mirrlees Review wants “to identify the characteristics that would make for a good tax system in an open economy in the twenty-first century” (IfS Homepage).

The reader of this paper will learn what is written in the Mirrlees Review. But this is not the main purpose of this paper. The paper is a treatise in the theory of economic thought in public finance. The author wants to explain the reader the Mirrlees review as a result of the Anglo Saxon School of Public Finance under the Nobel Laureate James Mirrlees. The reader should understand why it has been possible that such a monumental work which has absorbed such an enormous amount of scholarly resources over many years which should become the flagship of British Public finance ended in our view in the tragedy of a stillborn child. The reason of this tragedy is a combination of “Pride and Prejudice”, of self-confidence to be in possession of the right theory plus the endeavor of the editors to demonstrate that their theory is able to master the fiscal problems of the coming century. A great monument should resort out of a rock. But the monument did not resort. The rock has only got a new colour. Nevertheless, the rock as it stands allows the reader to carve out many useful smaller pieces which might help to better understand particular problems of public finance.

C. Interpreting the Mirrlees Review

In order to understand the Mirrlees Review one has to go back to the great neoclassical revolution of 1870. Around this year the three economists Carl Menger (1871), William Stanley Jevons (1871) and Léon Walras (1874) succeeded in explaining prices in a market economy. Their intuition is based on two laws found by

the German statistician Hermann Heinrich Gossen (1854) to whom Jevons refers as follows in his Theory of Political Economy (1871):

"We now come to a truly remarkable discovery in the history of this branch of literature ... [the] theory of pleasure and pain, written by a German author named Hermann Heinrich Gossen." As regards to Gossen's First Law Jevons writes: "Increase of the same kind of consumption yields pleasure continuously diminishing up to the point of satiety." (p. xxxiv). As regards to Gossen's Second Law Jevons writes: "Hence he [Gossen] draws the practical conclusion that each person should so distribute his resources as to render the final increments of each pleasure-giving commodity of equal utility for him:" ... From this statement it is quite apparent that Gossen has completely anticipated me as regards the general principles and method of the theory of Economics. So far as I can gather, his treatment of the fundamental theory is even more general and thorough than what I was able to scheme out. (Jevons 1871 preface to the second edition 1879 p. xxxiv, xxxv)

Jevons openly concedes that his and Gossen's findings coincide. Therefore it is correct to use the two theories symmetrically in this paper. The First Gossen Law says that the marginal utility of a good declines with increasing consumption and Gossen's Second Law posits that in equilibrium an agent allocates expenditures so that the ratio of marginal utility to price is equal across all goods and services and hence the consumer is indifferent on the use of the last euro leading to a consistent set of prices in the economy as a whole, in fact the law of one price.

The neoclassical revolution was a great success in economics. All over the world economists were eager to integrate these new insights in their theories. Micro and macroeconomics cannot have been sustained without the results of the neoclassical revolution.

Only public finance differs. The Anglo-Saxon economists believe that Gossen's Second Law cannot be applied to the public goods and that it is therefore useless as a rule for organizing the State and for the economist as a consultant of the State. Only the first Gossen Law can help if not to organize the State, so at least to structure taxation. For with declining marginal utility of all goods or of income, an income tax schedule can be constructed justifying taxation at increasing or progressive rates.

Eliminating the Second Law of Gossen and applying only the First changes fundamentally the conception of economics. Under the Second Law of Gossen individuals are choosers on their own account. They are self-responsible for their utility and are therefore said to live under "**choice individualism**" (Vanberg, 2005). The economist participates as an intermediary facilitating choices.

If, however, the Second Law of Gossen is eliminated, the individual ends to be a free chooser. She stands aside while a referee makes the political choices. The referee may also care of individual's utility. But the individual becomes an object of the referee's perception of individual utility. The individual lives in a regime of "**utility individualism**" (as compared to choice individualism). The referee maximizes the

individual's utility. The referee chooses the taxes which are good for the individual. The economist is not any more involved in these decisions. He stands aside, gives comments, dreams of a social welfare function, but the decisions are made in politics in which he does not participate. Therefore it can be concluded that Anglo Saxon Economics is not with it.

This is the point where Continental European economists and the Anglo Saxon economists of public finance split in the **Great Schism** with the choice individualists on the one side and the utility individualists on the other.

At this point it is important to understand that the Mirrlees Review is a child of the Anglo Saxon School of public finance starting with the neoclassical revolution. The heritage between fathers and children is fairly clear. It is true that the Anglo-Saxon economists have always had a soft spot for utilitarianism. They were always utility individualists. Bentham and John Stuart Mill argued for a just distribution of the tax burden. Mill invented the sacrifice principle of taxation. But then the neoclassical revolution of 1870 arrived with its twofold message that one has to consider not only the declining marginal utility, but also the utility equalization at the margin. Some time in these years the British branch of public finance seems to have left the common European ground and to have withdrawn to the British Isles, generating the Great Schism. In 1897, some 17 years later the point of no return is passed. This is the year when Francis Isidro Edgeworth publishes his article on just taxation. Although this is considerably after the great neoclassical revolution Edgeworth quotes only Bentham and Mill, but consistently leaves out the neoclassical trias of Menger, Jevons and Walras.² Apparently he puts Gossen's Second Law aside and argues only with Gossen's First Law. He uses the first half of the neoclassical revolution and drops the second half, and so do Edgeworth's descendants mainly Frank Ramsey (1927) and Peter A. Diamond und James Mirrlees (1971) and the other optimal taxation theorists. That the Mirrlees Review is a child of Anglo-Saxon theory of public finance is also documented, in the Review's article "The Economic Approach to Tax design" in the volume "Tax By Design" (2011, pp. 38-39) where extensive emphasis is made of Mirrlees' optimal taxation.

D. The subsequent history of the Great Schism

It is wrong to say that a Schism such as the Great Schism of public finance is an accident or even worse a "mistake". A schism is an opportunity for the scholars to engage in a vivid debate. Therefore the Great Schism in public finance is a gain, not a loss. But a schism requires a constructive spirit. The combatants have to feel provoked to attack the positions of their opponents and to defend their own positions and to put both positions on test. Such an atmosphere prevailed in the first years

² It is true that Edgeworth incidentally refers as "the Jevonian 'law of dinishing utility'" of Jevons (1871), but misperceives that Jevons has only one good of an indeterminate amount of goods in mind when he refers to the law of diminishing utility, whereas Edgeworth writes about about the diminishing utility of a well defined convex amount of all available "means" (Edgeworth 1897, 1958, p. 132).

after the Great Schism of 1870, when Adolph Wagner proposed his provocative law of a relatively increasing state activity in 1876. Suddenly the expenditure side showed up in a theory which was uniquely concerned with taxation. But this lasted only for a short period. Then the discussion between two approaches to public finance retreated into the history of economic thought, where no one wants to hurt his colleague

Under the protection of history, the Schism continued to bubble moderately like the bubbles of a gradually extinguishing volcano. Then and when attention is attracted, e.g. when Richard A. Musgrave and Alan T. Peacock flash the two sides of the Great Schism in their *Classics in the Theory of Public Finance* (1958). A Liberty Fund Conference organized by the author of this paper in Potsdam with Richard A. Musgrave und James M. Buchanan as participants celebrating the 100th birthday of Knut Wicksell's "New Principle of Public Finance" (1896) ends with a consensual dissent between Buchanan and Musgrave. A greater echo is generated when Hans-Werner Sinn invites Richard A. Musgrave und James M. Buchanan in 1998 to a Conference in Munich on their respective views on Knut Wicksell which then results in the authors' book on *Public Finance and Public Choice* (2000). But there is still little scientific dispute. On the whole public finance is comparable to a cartel establishing a live and let live arrangement. Each side is convinced of its theory and anxious of not to put it on test. So time goes on.

The appearance of the Mirrlees Review put an end to the atmosphere of mutual benign neglect though this was not at all intended by the Review's editors. The Mirrlees Review contains the essence of Anglo-Saxon public finance as defined by Edgeworth, Ramsey and Diamond and Mirrlees. The purpose of the Review is not at all to activate the debate between Anglo-Saxon and Continental European economists. The name of Knut Wicksell, probably the most important author of the Continental European side, does not even appear in the Index of the Mirrlees Review. The editors of the Review rather think that Anglo-Saxon public finance is the right star on the firmament of economics that helps economists who got lost to find the right way-

The remainder of this paper is organized as follows.

Section E is entitled with Problems of the Anglo Saxon School of Public Finance

Subsection E.1 illustrates historically that public finance was always a complement to the state. It is only after the great Schism that Anglo-Saxon public finance lost touch with politics therefore became responsible for the actual separation between itself and the political economy.

Subsection E.2 illustrates the consequences of a regime which delegates taxation to a referee.

Subsection E.3 criticizes particular aspects of the Mirrlees Review item by

item.

Section F contrasts the Continental European approach to public finance.

Section G is on the relative open mindedness of the two schools

Conclusions will follow in section H.

E. Problems of the Anglo Saxon School of Public Finance

E.1 What should public finance economists do? A historical review

This section illustrates a historical development between state and public finance. In history the state has come and is gone. Whenever the state exists, public finance is with it. In periods without the state there is no public finance. But public finance invariably reemerges when the State reappears. Only Anglo-Saxon public finance of the last 140 years is different. It judges the State according its principles of utilitarianism, but stands aside of politics. History, however, shows that public finance was always with the State.

(i.) Public finance as a companion of the state

Following Thomas Hobbes (1651) and Max Weber (1922) the state is established by its monopoly of power. The first monopoly of state power appears in Mid-Western Europe with the establishment of the Roman Empire at around 50 B.C.³ The first duty of the new subjects is to pay taxes. Roman taxation takes different forms over the centuries. It starts with tax farming by private contractors who are liable to the state for a contracted sum. As the contractors are also local grain traders, tax farming is full of corruption and hated by the local population.

In order to stabilize the Roman administration in the provinces, Emperor Augustus assumed personnel control of the outer provinces, the so called imperial provinces, while leaving the less problematic inner or “senatorial” provinces under control of the senate. He put an end to tax farming and established a system of moderate general taxation consisting of a wealth tax of about 1% of the property value and a flat poll tax on each adult to be collected and delivered by the provinces. The taxes of this time are akin to the benefit principle of taxation. The local population pays taxes in exchange of being released of the duty to provide personal military service. In this way the benefit principle of taxation generates mutual dependence between Rome and the local population and hence stabilizes State power in particular in the outer

³ The Roman political philosopher Marcus Tullius Cicero has written a book *De re publica* “On the state” from 54 to 51 B.C. The book is, however, more philosophical than practical with a heavy weight on Plato’s *Discourse*. Among the three forms of government – monarchy, aristocracy and democracy – Cicero prefers a mixed form of government §§ 38-71 1.

provinces which are far away from the government in Rome.

With the third century, however, public finances apparently lose influence as a moderator. The Augustean tax system is being increasingly eroded by inflation. Moreover higher and new taxes are levied in order to meet the increased expenditures for defense against the Germanic invasion. Simultaneously the benefit principle of taxation is eroded. Eventually the benefits of adhering to the Roman Empire vanish. The price of Rome becomes too high so that the local population does no longer see the advantage of the Roman State. They resign to the Roman State and its public finances (Demandt, 2007).

(ii.) The medieval system: No State, no public finances

The medieval system is fundamentally different. Without State power there are no public finances, no taxes, no public expenditures, and no protection of the inhabitants. Moreover literacy is abandoned while money comes out of use. Without State's administration, protection becomes a private marketable good. Early 20th century historians hesitate to consider the Middle Ages as an era without state power. They try to extrapolate the pride on their own state structure back into the Middle Ages and erroneously consider the medieval order as a state in the sense of a holder of a monopoly of power (Mitteis 1974). Oliver Volckart (2002), however, shows that a State monopoly does not exist in the Middle Ages because none of the players is strong enough to assume a monopoly of power. What has been public ordering under the Roman monopoly of power is replaced by private ordering in the Middle Ages.

- a. *The private competitive organization of power.* Under medieval private ordering the relevant power holders form a *triangle of power*. Security is provided as a private good according to demand and supply for protection. Demand for protection comes from peasants whose lands are constantly devastated by robbing hords of bandits. A peasant is therefore willing to provide labour services to his vassal in exchange for protection. The vassals are in competition with each other for providing protection. They are reinsured to receive protection from their seigneur, the King or the Emperor in case of war, but simultaneously promise the seigneur to provide him protection if he is in an emergency situation. The triangle of power subsists because none of the players is indispensable neither on the demand nor on the supply side. The seigneur can look for other vassals, the vassals for another seigneur. Even the peasants have choices. On the one hand they can withdraw their labour services to the vassals and switch to another vassal or they can simply emigrate Eastwards where land is abundant. On the other hand the peasants know that labour is scarce in a territory which has lost one third of its inhabitants since the collapse of the Roman Empire. The triangle of power is

stable. For on the one hand every participant can exit and none can be exploited. On the other hand none of actors is irreplaceable when he decides to exit. In this system there is no state monopoly and hence there are no public finances.

- b. *Coalitions and the re-emergence of the state:* In a situation without literacy, money and contract trust rests only bilateral credibility face to face. Collusion among more than two parties is difficult. When, later on, literacy, money and contract come in, contracts among more than two participants become feasible. Coalitions emerge which become the nucleus of power monopolies and the state. But which of the three partners – seigneurs, vassals or peasants – will make the game? At this point it is helpful to return to Oliver Volckart (2002) who shows how political and economic factors unite to favour the seigneurs and the vassals at the costs of the peasants. On the one hand the peasants gain because their returns of farming increase due to three-field crop rotation and wheel fitted plough. On the other hand the progress of productivity in farming reduces peasants' mobility, and all in an area which is increasingly populated and migration of one is at the costs of another. The peasants react to these changes by syndicalitization. With the assurance of no outmigration of the peasantry, vassals and seigneurs are now in a position to unite in a cartel at the costs of the peasantry.
- c. *Public finances:* Under the new coalition and the reappearance of money the seigneurs and the vassals are able to tax and to replace former labour services by money payments. Public finance reappears. Seigneurs and vassals share the tax resources among themselves. The seigneurs receive the "camerale" consisting of public properties, the mining rights and customs revenues to finance their own expenditures. The "contribuale" relates to additional resources the seigneur may obtain in case of war (Thomas Mayer 1926, p. 216). These are the first institutions of public finance, and quite naturally the state and public finance form a unity. Note the state needs public finance, and public finance without the state does not make sense.

(iii.) *The Cameralists: A formal unity between the state and public finance*

The merits of establishing orderly public finances in German principalities is owed to the cameralists of the 17th and 18th centuries.⁴ The cameralists are the first well established economists of public finance in history. They convince the princes of the advantages not to spend all their revenues immediately, but rather to save them partially for investments and state infrastructure. The princes have been made aware that population growth and maintenance of state properties are important variables in the political power play. (Jürgen Backhaus and Richard E. Wagner 1987, Schefold 2014). The cameralists often succeed in establishing an ordered record of revenues and expenditures. Cameralistic book keeping is a method of public planning which has survived until present. Careful budget management allows the princes to survive in time of war. The larger the budget reserves of a prince, the longer he can survive.

⁴ K. Klock (1651). Johan Heinrich Gottlob von Justi (1782) and Joseph Sonnenfels (1787)

The cameralists work in mutual interest with their princes.

(iv.) The rise and fall of mercantilist public finance in France

It is often said that the counterpart of the cameralists in Germany are the mercantilists in France. It is true that cameralists in Germany and mercantilists in France both want to increase the power of their sovereign. But the conditions are different. In the small scale German territories the cameralists do not have the same taxing power as the mercantilists in large scale France. For the costs of outmigration are much larger in France than in Germany. Therefore the mercantilists can proceed in taxation much farther than the cameralists. But the audaciousness of the mercantilists in pursuing their goals has its own political costs. Higher taxes do not always generate more revenues. It seems that the peak of the Laffer curve of taxation is reached in France towards the end of the 18th century. Further tax increases bring barely more revenues but rather more tax resistance. When the King nominates the physiocrat Jacques Turgot as controller-general of the public finances it is already too late for reforms to overcome the doctrine and policy of mercantilism. Turgot's ordinance for a deregulation of corn trade was contested, the famine of 1774 leads to the flour war of 1774 which can best be seen as heralding and as a test of the great Revolution that starts with the capture of "La Bastille" in 1789.

(v.) Public finance as seen by the physiocrats and Adam Smith in the UK

Britain catches just the right moment for a policy shift towards the new doctrine of physiocracy. At least domestically the mercantilist customs policy is abandoned in the 1750ies whereas it is upheld in the American colonies where it contributes to the outbreak of the American War of Independence. In 1776 Adam Smith makes the right point in his book "The Wealth of Nations" (1776). The pursuit of self-interest increases the welfare of the Society as a whole. Adam Smith's famous quotation of the Second Chapter of Book I is: "It is not from benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard of their own interest." Apparently Smith's theory of human self-interest fits well with the economic perceptions of the politically rising bourgeoisie aiming at free markets. Smith differs from the traditional mercantilist theories in that he no longer starts with the state, but with the market. The state appears in his Vth Book on "Public Works", but "Public Works" remain alien and disintegrated part of his main theory.

Smith sees himself as a private choice economist, as an intermediary in markets far away from the later Anglo Saxon utilitarianism.

(vi.) Summary: What should economists do?

Public Finance has a history of many hundred years. Always its economists have understood themselves a partners and as a part of the state, its emperors, princes and governments, using their professional knowledge to negotiate improvements of public finances in the interest of the sovereigns. This attitude has been lost in Anglo

Saxon Public Finance after 1870 and is still missing in the Mirrlees Review of 2010 and 2011. It is not clear in whose interest the whole Review has been written. The absenteeism of Anglo Saxon Public Finance from the state and its institutions is a direct consequence of the Great Schism of public finance.

This section illustrates a historical regularity between State and public finance. Whenever the state existed, public finance was with it. In periods without the State there was no public finance. But public finance reemerged when the State reemerged. Only Anglo-Saxon public finance of the last 140 years is different. It studies public finance, but stands outside of the state.

But today the state is growing as a regulator and relatively to GDP. Economists should increasingly study how the State works. This is, however, not the path which Anglo-Saxon Public finance takes. It publishes the Mirrlees Review, but remains an outside observer of the State. It does not intermediate between parties in order to reduce conflicts and to come to mutually beneficial arrangements. Mirrlees economists only say how to tax. Politics have to be done by others. Who wonders that politicians go their own way and do not listen to what the Mirrlees Review says (see E.3.1)

E.2 The consequences of a regime which delegates taxation to a referee

According to Anglo-Saxon public finance taxes are not a political issue. They are set by a referee at level “T” and are then distributed among individuals in such a way that welfare is maximized. Edgeworth (1897) assumes a Benthamite social welfare function, later authors simply assume economic efficiency as a goal. Two main problems make this approach questionable: The definition of “T” and the definition of the individual utility functions.

(i.) Taxation under the ability to pay principle

Assume first that “T” is given. The distribution of the tax burden then follows along the postulated individual utility functions. Under the usual assumptions of an equal and declining marginal utility function for all, a progressive taxation results. But in reality nobody knows his fellow citizen’s utility function. Therefore there is no reason to assume any form of a utility functions. If marginal utility functions of income are equal and constant with income, the ability to pay principle requires a head tax if the absolute utility loss counts. Other assumptions on the individuals’ utility functions of income may lead to progressive, proportional or regressive taxes. The ability to pay principle does allow arbitrary taxation.

If not only individual utility functions of income are malleable, but “T” is also flexible, the referee can continuously increase “T” and eventually end up at tax revenue maximization “T”_{max}. Tax payers are fully exploited, but within the rules of the ability to pay principle. For as long as taxes are paid nobody is charged beyond his ability to pay. Leviathan’s triumph.

(ii.) Optimal commodity taxation

Consider an optimal commodity tax of the Ramsey type: Under constant marginal costs, competition and vanishing cross elasticities the optimal relative commodity tax is $(p_i - MC_i)/p_i = \alpha/\eta_i$. The tax rate $(p_i - MC_i)/p_i$ is inversely proportional to the price elasticity of demand η_i inflated by a common proportionality factor α . The structure of this optimal tax is exactly the same as that of a profit maximizing monopoly $(p_i - MC_i)/p_i = 1/\eta_i$. Observers of the Anglo Saxon School of public finance who should control the referee will not find any misbehavior as long as there is no theory explaining “T”. The actual commodity tax can always be interpreted as an optimal tax as long as the tax structure is the same independent of the amount of exploitation. A welfare maximizing optimal tax regulator cannot be distinguished from Leviathan.

E.3 Particular aspects of the Mirrlees Review.

Subsequently the reader may find some critical remarks on the Mirrlees Review proper.

(i.) Is the Review with it?

That the editors prize their Review is not surprising. But how do other specialists evaluate the Mirrlees Review? According to the IfS homepage Mervyn King, Lawrence Summers, Tim Harford and Daniel Coyle find the Review good and useful. But the evaluation of the distinguished journalist Peter Wilby makes the reader perplex. Wilby concedes: „The report was compiled by some of the world's finest economic brains”. And then adds: “[B]ut no government is likely to act on it.” (The New Statesman 7 April 2011. p. 1). Note that only the first part of the quote shows up on the Institute's homepage. The second part of Wilby's evaluation has been carefully eliminated by the IfS. Apparently the reader should share the good news, but not the bad news. He should not learn that the Review is not with it. But by eliminating the bad news the product does not become better. Censorship rather corroborates our view that the Review has lost contact with political economy.

The remainder of this section some of the Review's problems are discussed more in detail:

(ii.) Taxing commodities instead of income

A well known argument found in textbooks is that the government should tax goods which are complementary to leisure if leisure itself cannot be taxed. This logic is further developed to redistribution in chapter 6 of Tax by Design (p.157). Suppose there are two individuals who are income taxed. One is able but lazy, the other is less able, works hard, but earns less. If the government would like to redistribute from the

more able to the less able, the high-wage individual can always work less and benefit from the redistribution. To avoid this reaction the government can tax goods that are complementary to leisure discouraging the high-income individual from taking too much leisure.

At a first glance it seems that this example involves only an efficiency problem. But who knows that the income transferred to the less able involves at least as much utility as the one taken from the able. The economist takes a political position, but will the government share it?⁵

(iii.) Government expenditures are a white spot

The Review intends “to take a 'big picture' view of tax design” (IfS Homepage). This intention inevitably leads to the question: Taxes for what? Every private household evaluates carefully between its revenues and its expenditures. Every government justifies higher taxes with particular expenditures the government intends to undertake. All these delicate valuations are condensed in the Review’s blunt statement: „[I]f we are to have public spending, we must also have taxation.“ (Tax by Design p. 21). If a student makes such a crude remark in an essay he would receive a dark red mark in the margin. Governments cannot simply define public expenditures without justifying them. They have to explain the purpose of public expenditures What are possible savings, expenditure shifts and expenditure cuts? It is true that in textbooks one can find occasionally a capital “T” for the aggregate revenues. But the student is reminded that “T” is a simplification for didactical reasons. In a treatise with policy relevance this seems hardly legitimate (see E.2)

(iii.) More efficiency with equal revenue and equal redistribution

The editors of the Mirrlees review envisage tax reforms under the traditional *ceteris paribus* constraint: “The primary task we have set ourselves is to identify reforms that would make the tax system more efficient, while raising roughly the same amount of revenue as the current system and while redistributing resources to those with high needs or low incomes to roughly the same degree.” (Tax by Design, 2011, Introduction p.2). The intention looks attractive: More efficiency with constant revenue and constant redistribution. No one is made worse off. Therefore the referee can decide and impose the reform. Political economy is not needed. Looking closer, however, the proposed reform is not so straightforward. A tax becomes more efficient if it comes closer to a lumpsum tax. But more of a lumpsum tax requires a modification of the tax base and of the tax rate. It follows that whoever wants to change efficiency will inevitably change revenue and or redistribution too. The editors seem to misunderstand the economic function of a tax base. A tax base is not simply an instrument. It is part of the rule of law in which the individual trusts. Whether a

⁵ “The economic Approach to Tax design” in the volume *Tax by Design* makes the point explicit: “The resulting changes in tax liabilities will redistribute income from some points in the distribution to others and this will be welfare enhancing only if we weight welfare gains to the recipients more strongly than we weight welfare losses from the losers. If we care more about the welfare of the poor than the rich, then, other things equal, we will prefer a world in which the rich pay more tax. How much more will depend on how much we care about inequality.” p. 36.

reform is worthwhile cannot therefore be simply calculated “from above”. The test is whether it is approved under the rules of the Constitution.

(v.) For increasing taxes, efficiency is a relevant criterion.

In their treatise on Value Added Tax (VAT) Crawford, Keen, and Smith conclude with careful optimism: „What does seem clear, nevertheless, is the potential for building on the inherent strengths of the VAT” (Value Added Tax and Excises, Tax by design, 2011 p. 349). A future tax system could rely on a reasonably designed VAT. No disagreement. The problem is, however, that reasonableness is not a necessary criterion for tax or a tax increase. An “unreasonable” VAT may have an even larger potential for tax increases. Under the EU Tax ordinance of 2007 EU member states may increase their VAT taxes as much as they want. But they are not allowed to cut them. This asymmetry contributes to VAT as a “Money machine” for ambitious politicians as emphasized by Gary S. Becker and Casey B. Mulligan (2003).

(vi.) A bias towards centralism

The renowned public finance economist Sir Anthony B. Atkinson reminds us in his book review of the Mirrlees Review of 2013 that the authors of the Review discuss the UK tax system only under the assumption of a unitary tax system. They do not consider the possibility that Scotland and Wales might have differing taxes somewhere in the future. Why not? It would have been easy to accommodate fiscal federalism in the volume „Dimensions of Tax Design” as can be seen in the contribution by Chr. Wales (Dimensions of Tax Design, 2010, p. 1310).

(vii.) Political economy

The final chapter of the Mirrlees Review is written by James Alt, Ian Preston and Luke Sibieta. It has the title „The Political Economy of Tax Policy”. The editors of the Mirrlees Review want “The final report [to take] explicit account of the political economy of tax reform in setting out a possible path to a better system” (IfS Homepage). Apparently the editors want that with this final paper the whole Review is put on railroad tracks which make sure that it arrives at the intended destination. But unfortunately the tracks used by Alt, Preston and Sibieta lead to quite another destination.

The real world of UK tax policy not only disregards the optimality conceptions of the Review, it also deviates therefrom and makes a significant move to the political right. The reasons seem to rest in the British institutions, such as the agenda setting power of the treasury, deficits in auditing and the fiscal illusion of the voters. Therefore better controls are recommended. But would better controls help within the old institutional incentive structure? That UK governments shift to the right is certainly an important observation. But why did governments conduct a left policy in years preceding the authors’ selected period of time? Why was Churchill out and Attlee in in 1945, and what happened then? An outside observer is inclined to separate the

pre-Thatcher years from the post-Thatcher years. How can Thatcher be explained? Was she exogenous or endogenous?

The Alt, Preston and Sibietta paper is a good start for future research. The authors show the market niches and the constraints of institutional change. Therefore this chapter should stand at the beginning of the Mirrlees Review and not at the end when all authors have already made up their minds.

F. The Continental European Approach to Public Finance

In this section the author looks at the constructive side of the neoclassical revolution. The section explains how the neoclassical revolution has given an early impetus to the Continental European school of public finance to reform its theoretical approach towards a political economy of public finance.

The economists of the Italian School of public finance are the first who understand the message of the neoclassical revolution of 1870. Antonio de Viti de Marco studies the problem how to extend the individual choice calculus from the market to the public goods of the state (1888).

Quite contra-intuitively he starts with the ensemble of individuals and intends to proceed from there to the single individual. As public goods are consumed collectively the sum of the individuals' willingness to pay compared to the price of the public good has to equal the marginal utility of the private goods per price. It is remarkable that this first step by De Viti de Marco antecedes Paul A. Samuelson's seminal paper of 1954 by 66 years.

De Viti de Marco, however, does not yet succeed to apportion the contributions of the entity to the individuals in order to find out how much each individual has to contribute to finance the whole the public good. While this discovery still needs some time of thought, two important contributions towards this goal have been made already earlier. The Italian economist Francesco Ferrara (1849/50) and the Austrian economist Emil Sax (1889), already understood, that an individual's contribution was not a sacrifice for something imaginary (in the sense of Edgeworth, 1897) and others, but a contributory price for the collective good^{6,7}. Taxes take the character of prices. The problem is not to postulate some arbitrary tax schedules (in the Anglo-Saxon sense), but to organize the taxes as prices. De Viti de Marco writes in a presentiment of the necessary institutions that not a state by privileges, but only a cooperative

⁶ "The tax in its pure significance, would represent neither a sacrifice nor a violence exercised on the contributor by some superior; it would represent a price... for all the great advantages which the state provides for us." *Trattato speciale delle imposte* [1849-1850] contained in: *Lezioni di economia politica*, Bologna 1934, II p.551, quoted from Buchanan (1960, p. 28-29).

⁷ The view that taxes are to be apportioned according to the individual evaluation on the tax payers has also been emphasized by the Austrian economist Emil Sax. Otherwise „either the resulting satisfaction by collective goods is deficient or, if full satisfaction is reached, the apportionment is unilaterally excessive for some." (Sax 1889 § 82 p. 520).

state may succeed in solving this problem.

The Swedish economist Knut Wicksell (1896) reads the works of the Italian economists considering the different individual satisfactions of one and the same public good and hence different individual prices. But Wicksell is skeptical. Prices according to each individual's satisfaction, according to his "godimento" as suggested by Ugo Mazzola (1890. p. 80-81.) will not work. Wicksell understands the Law of one price of the neoclassical revolution and concludes:

"If the individual is to spend his money for private and public uses so that his satisfaction is maximized, he will obviously pay nothing⁸ whatsoever for public purposes (at least if we disregard fees and similar charges)... Of course, if everyone were to do the same, the State would soon cease to function." (Wicksell 1896, 1958, p. 81)

What to do? Instead of giving up and escaping to utilitarianism Wicksell investigates how to organize the state to elicit individuals to reveal their true willingness to pay. His idea is to ask individuals under the condition that the public good will only be provided if and as far as unanimity is reached:

There is a whole range from the simple head tax or the (least comparable) levies on flour, salt, spirits etc., to the progressive income, property or inheritance tax and the indirect tax on luxury goods. Provided the expenditure in question holds out any prospect at all of creating utility exceeding costs, it will always be theoretically possible, and approximately so in practice, to find a distribution of costs such as all parties regard the expenditure as beneficial and may therefore approve it unanimously. Should this prove altogether impossible, I would consider such a failure as an a posteriori, and the sole possible, proof that the state activity under consideration would not provide the community with utility corresponding to the necessary sacrifice and should hence be rejected on rational grounds. (Wicksell 1896, 1958, pp. 89-90)

Wicksell's approach is often mistakenly seen as a purely theoretical model.⁹ This is only one half of the story. Wicksell's approach has to be evaluated in the institutional framework of 19th century Sweden.

Sweden had an extremely conservative political system in the years after the French revolution (Blankart and Fasten 2011). Three quarters of all male citizens had no franchise. Thus the distribution of representatives in the Riksdag was extremely skewed towards the rich. The rich decided on taxes, which had to be paid by both, the rich and the dis-enfranchised poor. Given the issue was on financing a new vessel for the Swedish navy, the enfranchised rich were in a position to vote yes in their interest by simultaneously shifting the burden of taxation on the disenfranchised

⁸ In literal translation from German: „not a brass farthing”

⁹ As the model by Erik Lindahl (1919)

poor via regressive taxes on alcohol, flour and salt.¹⁰ Thus taxation of 19th century Sweden can be seen as a result of the restrictive suffrage.

As Wicksell is a political activist, his political aims are clear. For ending the practice of shifting the tax burden from the enfranchised rich to the disenfranchised poor not words but deeds are necessary. Universal suffrage has to be introduced. So both, the rich and the poor will have representatives in the Riksdag.

But Wicksell is also a theoretical political economist. He realizes that general franchise (giving suffrage to the poor) is not enough to guarantee that the rich and the poor can throw their political weights into the process in an equitable way. A simple extension of the franchise would only reverse the distribution of power compared to the status quo. The majority of the poor would be in a position to exploit the minority of the rich. Wicksell reminds us:

"It is not the purpose of this movement and indeed it would be contradictory to its guiding spirit, to have wholly or partially shaken off the yoke of reactionary and obscurantist oligarchies only to replace it by the scarcely less oppressive tyranny of accidental parliamentary majorities." (1896, 1958 p. 88).

In Wicksell's mind, the only possibility to bring the interests of the rich in balance with those of the poor is the unanimity rule which gives the poor veto power against the dictate of the rich and vice versa. It is only through unanimity that all citizens or their representatives are forced to reveal their preferences. No group is able to exploit the other by an octroy of majority decisions. Taxes are voluntary and individually differentiated according to individual interests, but after given approval, all are obliged to pay the price on which they or their representatives have agreed. Should one try to cheat or to get a free ride, the total sum cannot be raised, and the project cannot be accomplished. Hence it is conceptually in everybody's interest that the collective decision is enforced

What Wicksell proposes is basically a multilateral contract enforced by law. The contract justifies the public good. In the economy as a whole the contract can be seen as part of a general exchange equilibrium resulting from a particular distribution of the initial endowments. Another initial endowment will lead to another pareto optimum etc. Musgrave argues at several instances that the Wicksell process only works if it starts from a just initial endowment of resources (Musgrave 1958, 1996). But this is not correct. For a pareto optimum will always result if property rights are allocated and negotiations are possible. Only an optimum optimorum (if there is any) requires a just distribution at the outset. Notwithstanding, piecemeal improvements are always possible whatever is the distribution of endowments.

¹⁰ The politician Wicksell is against any rearmament and against prolonging the mandatory military service. He also doubts on Sweden's ability to defend itself in case of a Russian assault. He proposes therefore to search for an arrangement with Russia and to erode Russia by democratic reforms from inside. (Gardlund, 1958 ch. VI; Uhr 1987).

Deviations from Wicksell's unanimity principle, such as decisions with simple or qualified majority can be justified if they result out of a superimposed constitutional contract. The individuals consider the benefits of less than unanimity voting in general against the costs of being outvoted when the collectivity reduces the threshold of approval. This is the essence of the "Calculus of Consent" by James Buchanan and Gordon Tullock (1962). In fact, Wicksell's unanimity principle is preserved on a higher level of the political debate.

G. Market Preserving Federalism and Public Debt

Wicksell was a member of the national parliament in Sweden.¹¹ In this capacity he was primarily interested in the financing of national public goods. The rich and the poor should find themselves in a consensus for national laws. Collective decision making in the provinces was not his immediate problem. But obviously the unanimity principle can be applied on any federal level. Applied to the provincial level the individual has more choice. She can choose to live in province A, B or C with different public goods that are then determined internally according to the unanimity principle. According to Tiebout (1956) an individual votes with her feet between provinces and, according to Wicksell with the unanimity principle within provinces. Gossen's Second Law is fulfilled between provinces and within provinces. Choice between jurisdictions is preferable to choice within jurisdictions (under unanimity) because individuals can adjust in the preferred quantities of public goods between provinces whereas a quantity choice within a jurisdiction is restricted by the unanimity rule.

Fiscal federalism as described here is, however, not yet self-sustainable. Wickell's provinces may have an incentive to run into deficits and bankruptcy if they can expect to be bailed out by the national government. Therefore Yingyi Qian and Barry R. Weingast (1997) propose a federalism which is "market preserving". The charters of subcentral governments should unambiguously exclude any bailout. This would stabilize the expectations and the federalism.

An effective no-bailout does not rule any demand for public debt by the subcentral governments, nor would creditors be reluctant to supply any loans because of no-bailout. Both sides of the market will find each other at a positive public debt depending of the general market conditions and the market conditions specific to the particular province.

Disregarding public debt over the business cycle, a province will raise debt if the real rate of interest (the nominal rate of interest minus the rate of inflation) is below the real rate of growth of the province $i < g$. On that base it can always pay back the debt. Ponzi is feasible. A province will abstain from (long term) public debt if the real rate of interest is above the real rate of growth $i > g$. For in the long run an ever increasing debt cannot be paid back, and will lead to insolvency. Ponzi is not possible.

¹¹ Wicksell is an elected member of the city of Stockholm to the Second Chamber of the Riksdag in 1893.

There would be no cause for a dispute within the model of market preserving federalism were there not two opposing macro-economic theories. The theory of the EU Fiscal Compact on the one hand says: governments should abstain from any public debt because given $i > g$ public debt is not sustainable and debt brakes should be enforced with $\Delta D \neq 0$. The modern capital theory argues in contrast that there is a long run disequilibrium between supply and demand on the capital market (Carl Christian von Weizsäcker 2014). Savings get larger and larger because individuals save more (even at negative real interest rates) to survive in old age. On the other hand the demand for capital does not grow faster than GNP because investment goods do not live longer and the capital output ratio has remained constant over more than a hundred years. Von Weizsäcker concludes that there is a savings glut keeping long run interest rates down with $i < g$ or even $i < 0$ if, in the latter case, the central bank pursues an inflationary policy. In order to allow individuals to provide for old age under stable prices the government should raise more public debt.

The struggle between the two theories of interest has direct relevance for the Great Schism in public finance discussed in the paper. The argument of the Continental type theory is that market preserving federalism provides the solution between the two macro-economic theories of public debt. The fiscal compact theory requires government intervention to prevent excessive debt. Modern capital theory requires government intervention to increase public debt to contain the savings glut. Market preserving federalism finds the efficient mean with competition among decentralized governments under strict no-bailout. Governments as demanders and creditors as suppliers of public debt will find each other at a sustainable rate of public debt. The problem is not whether governments should actively brake or promote public debt, but to find market preserving federalism as a framework which generates sustainable public debt.¹²

It is true that our actual fiscal institutions are miles away from market preserving federalism, and economists are therefore tempted to take the short cut of macro-economic intervention for or against public debt. Both ways can be predicted to fail because the incentives of the federal decision makers are disregarded. Market preserving federalism, in contrast, is designed in a way that the resulting budget policy is sustainable.

The author of this paper has desperately looked for harmonious end between the Anglo-Saxon and the Continental European approaches to public finance. He has hoped that the two schools could find themselves in a common field such as public debt. It is true that the Mirrlees Review is about taxes and not about public debt. But we know since Ricardo that tax and public debt finance are equivalent for a given government expenditure. Even if the Mirrlees Review does not discuss public debt, one would expect that its theory is open minded if it leaves at least an open door for problems such as public debt. But even here the end is sad: The expression of “public debt” does not even appear in the Indexes of the Mirrlees Review.

H. Conclusions

¹² Concerning taxation see Brueckner (1982) and Blankart (2013)

It was around 1870 that Menger, Jevons and Walras have succeeded to explain prices in a market economy. This was the neoclassical revolution. The intuition of the three scholars is based on two the Laws of Hermann Heinrich Gossen (1854): the law on declining marginal utility of a particular good or service and the law of utility equalization at the margin between goods. Economists all over the world welcomed the new insights provided. Only public finance was different. It resulted in a **Great Schism** between the Anglo-Saxon and the Continental European public finance economists that remains through this day:

- The economists of the Anglo Saxon School claim that Gossen's Second Law cannot be applied to public finance because of the free rider problem inherent in public goods. Individuals would disguise their true preferences. Public finance must therefore restrict itself to the first Gossen Law and focus on utilitarian tax schedules.
- The economists of the Continental European School claim that individual choice is indispensable and that not only the first, but also the second Law of Gossen must enter the theory of public finance. Public finance cannot be separated from choice and public financing rules which are not linked to political choice are useless. The problem of public finance is to find choice rules which are consistent with preference revelation.

The Anglo Saxon School studiously avoids the problem of politics. The Mirrlees Review masterfully explains the trade-off between different taxes and juxtaposes them. But the juxtaposed trade-offs are not enough as long as they are not evaluated. It is the task of the public finance economists therefore to consider and to evaluate these trade-offs under the second Gossen Law and to arrange trades among the politically relevant groups so that politics gets from here to there. A public finance economist who is only an observer along the first Gossen Law is not with it.

History over many hundred years shows that public finance economists were wise enough to understand themselves as participants of the State. The cameralists are the most lucid example. Only after the neoclassical revolution and after the Great Schism of 1870 did the Anglo-Saxon public finance economists stand aside of politics. This happened not by accident, but because they have chosen the particular methodological approach of utilitarianism which placed them aside of political choice. So choice was excluded.

Anglo Saxon public finance must remain silent on important issues because of its self-restriction. With so many excellent public finance economists in the Country, this self-restriction is a waste of scholarly resources. Due to this restriction Anglo Saxon public finance is not as open minded as it could be, and it passes opportunities of problems to which it could contribute. The Mirrlees Review e.g. restricts itself to taxation while it remains silent when the public discussion comes to public debt even though it has been known since Ricardo that public debt and taxes are equivalent.

Continental European public finance is more open minded. In a practical application it is shown in this paper that Continental European Public Finance can intermediate between two actually competing conceptions of public debt: the EU Fiscal Compact on the one hand and modern capital theory on the other. Adherents of the Fiscal Compact are for strict budget balancing over the cycle. Adherents of modern capital theory plead for public debt as far as required to cope with the long run demographic savings glut. It has been shown in the paper that a solution accommodating both of these problems can be found in *market preserving* federalism an institution in which subcentral jurisdictions attain and maintain a sustainable amount of public debt out of self-interest.

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