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TAXATION

A Very Short Introduction

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Chapter 1
Why do we have taxes?

Revenues: the sinews of the state

Cicero

Taxation is a theme that crops up with surprising frequency in popular music. It rarely figures positively. In their 1966 song, 'Taxman', the Beatles sang of a world in which they felt taxed at every turn. In the very same year, the Beatles' contemporaries, the Kinks, had a hit single, 'Sunny Afternoon', in which the singer laments that the taxman has made him penniless; all that he has left is the consolation of a lazy afternoon in the summer sunshine.

Why taxes should figure so strongly in popular music is not clear. Maybe successful popular musicians spend their career writing songs about the things that are most immediate and vital in their lives. When they were young and poor it was love, angst, and, perhaps, drugs. Once they find themselves on the escalator of fame, wealth, and endless touring, it is the misery of life on the road, divorce, venal managers . . . and their tax bill.

Away from popular music, taxation appears to figure little in our written or visual culture. True, there are plenty of cartoons, many of them, like most of the pop music lyrics, with more venom than humour. The celebrated cartoonist H.M. Bateman, a tart observer of English society in the first half of the 20th century, spent much of his later years embroiled in bitter warfare with the Inland Revenue, and encapsulated his vitriol in some brilliant, scathing, cartoons. But taxes figure little in literature, and—cartoons apart—are barely to be seen in the visual arts.

This absence contrasts with the enormous role that taxes play in our lives, and in the organization of society. In the UK, as in most countries in western Europe, more than one pound in every three earned is taken in taxation. Our lives and our society are closely engaged in activities that depend on taxation—public safety, defence, the courts, roads, schools, health care—not to mention public funding for the arts and culture. Taxes are at one and the same time hugely prominent in public debate, in political controversy, in the conversations we have in pubs, with taxi drivers, and with colleagues and friends—yet they are curiously invisible too. It is as if we don't want to admit—or don't fully comprehend—the fundamental role that they play in our society, our lives, and our living standards.

What is taxation?

So, what are taxes? Yes, we know. They are the money that is taken from us by the government. But taxes differ from the money that we spend in other ways in two distinctive respects.

To attempt a formal definition, taxes are compulsory payments, exacted by the state, that do not confer any direct individual entitlement to specific goods or services in return.

The second part of this definition is crucial, distinguishing taxes from the prices, fees, or charges that could be levied on the sale of goods and services by the state or state enterprises. While these, too, can generate public revenue, the fact that something is supplied directly in return for the payment means that they can be voluntary. As with things bought from the private sector, people pay if they want to buy the good or service in question, and if they would rather use their money for other purposes they can choose to do so. By contrast, taxation involves compulsion—which crucially distinguishes taxation from most other activities in modern democracies. The compulsory nature of taxation doubtless accounts for much public hostility.

A key characteristic of taxation in modern tax systems is that taxation is 'parametric': in other words, it is governed by legislation which defines in advance the basis of individual tax liability. Typically, such legislation will define the tax base—in other words, the aspects of economic activity on which the tax will be charged, such as income, spending, or the value of property—and will specify how an individual's tax liability will be calculated, in a clear and predictable way. This has not always been a characteristic of taxation. At many times in the past taxes have been levied which have been arbitrary, and not based on clear and stable principles. If undertaken once only, economic confiscation of this sort may cause little economic harm, apart from the loss that taxpayers suffer through the resources which are confiscated. But regular confiscation can exert a chilling effect on economic activity—once people begin to believe that there is little point in doing anything if the fruits of their enterprise will merely provoke further confiscation. And arbitrary taxation—taxation which is not precisely governed by a legal framework specifying how liability to tax should be calculated—can offer undesirable scope for corruption to take hold.

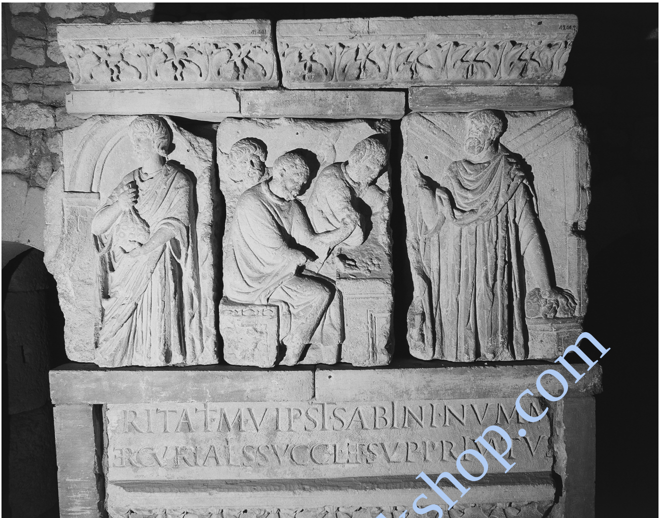
Taxation in history

Taxation is by no means a modern phenomenon. Taxes, it would seem, were present at the dawn of recorded history. Some of the earliest written documents in existence, cuneiform clay tablets from Sumeria in southern Mesopotamia (modern-day Iraq) dating from around 3300 BCE, take the form of tax records: lists of gold, animals, and slaves received by the temples which formed the core of social organization in the Sumerian city-states. The need to record tax payments was, perhaps, one of the earliest reasons to develop some form of written record-keeping—and so it might be argued that taxation played a part in the development of writing itself.

The earliest taxes, in Mesopotamia, ancient Egypt, and elsewhere, take the form of shares or tithes of crops or other items of production, and also obligations to provide labour services, in the form of military service or work on construction projects. Money—currency—did not develop until considerably later, and so taxes were paid in kind. Tax collection became a major activity of government, requiring a significant bureaucracy to assess and enforce the payment of taxes due. In ancient Mesopotamia, according to a contemporary proverb, the person you should fear the most is the tax collector.

In ancient Greece and Rome, too, a large part of taxation took the form of levies in kind, but taxes of a more recognizably modern form started to appear, in the form of cash levies triggered by certain kinds of transaction, such as the importing of goods, or the sale of land and slaves. During the time of the Roman Republic, extensive use was made of tax farmers, *publicani*, to whom the right to collect taxes for a fixed period of years would be auctioned, giving the Republic a guaranteed steady revenue, while leaving the dirty work of tax collection in the hands of contractors. The writings from this period give plenty of evidence that this was a corrupt and arbitrary system which allowed many *publicani* to enrich themselves greatly, while placing harsh pressures on ordinary taxpayers (Figure 1).

Towards the end of the 1st century BCE, the Roman Emperor Augustus implemented a radical overhaul of the system of taxation, replacing the existing taxes by a fixed property levy, together with a head tax (poll tax) to be levied on the provinces. The censuses that were undertaken to initiate these taxes are familiar from the start of St Luke's Gospel: 'And it came to pass in those days, that



1. Gallo-Roman relief from the 1st century CE showing taxes being paid, from Saintes (France).

there went out a decree from Caesar Augustus, that all the world should be taxed…And all went to be taxed, every one into his own city'. Luke 2:1, 3 (Authorized Version). Likewise, detailed land registers were instituted, recording the ownership of land and its potential productivity. City councils, rather than the *publicani*, now played the primary role in tax collection, and the more predictable and rule-based tax regime catalysed a period of growth and prosperity.

The role of taxation in the subsequent decline and fall of the Roman Empire is heavily disputed. Over many years the fiscal viability of the Roman Empire began to be eroded, caught between the twin blades of rising military costs and a declining yield from taxation, as the provinces that were the main revenue contributors (Figure 1) proved unable—or unwilling—to maintain their massive fiscal transfers to the centre of the Empire. By the

3rd century CE, it had become necessary to restrict individual mobility, both geographical and social, to ensure that people did not escape the tax obligations they owed by virtue of their occupation or the land that they farmed. The measures which were taken to extract additional revenues almost certainly hastened the economic decline of the Empire, weakening still further its revenue-raising capacity.

Taxes have waxed and waned over the centuries. In western Europe, the centuries that followed the end of the Roman Empire were marked by a reversion to more rudimentary systems of revenue generation—tithes and the supply of forced labour under the feudal system—that inhibited both economic development and effective government. Taxes of a modern sort—stable and regular levies based on transactions or property—gradually began to reappear, although monarchs frequently resorted to heavy and arbitrary levies when in need of revenue to finance wars or other undertakings. In the early modern period in Europe, social and economic changes began to generate pressures to end arbitrary taxation, and rebellions in a number of European countries started to constrain the power of monarchs to impose taxation at will. Democratic legitimacy in tax policy began to take shape.

Rapid industrialization and democratization in the 19th and 20th centuries have, however, been associated with a dramatic growth in the sophistication of taxation and in the scale of tax revenues in all industrialized countries. At the end of the 19th century tax revenue was less than 10 per cent of national income in both the UK and France, and only about 7 per cent of national income in the United States. During the course of the 20th century, each of these countries then saw substantial growth in the size of the public sector and the burden of taxation, with the share of taxation in overall economic activity increasing roughly by a factor of four. Both world wars appear to have provided significant impetus to the growth of government and the scale of taxation. In the UK, for example, the two world wars were accompanied by a permanent upward jump in the level of taxation, each time of the order of 10 per cent of national income or so.

Figure 2 shows the growth in the level of overall taxation as a percentage of gross domestic product (GDP) (i.e. as a share in the

2. International comparison of the level of taxation, selected countries (total tax revenues as a percentage of GDP).

***Note*: Countries are shown here in descending order of tax as a percentage of GDP in 1965.**

value of overall production) in a number of industrialized countries in 1965 and 2012. Over this period of almost fifty years, different countries have experienced rather different amounts of growth in government spending and taxation. Over the OECD area as a whole, taxation accounted for 25 per cent of GDP in 1965, and 34 per cent in 2012, a growth of nine percentage points. In the UK, growth was only around half this, and the overall burden of taxation in the UK in 2012 was, at 35 per cent of GDP, very close to the OECD average, despite having been substantially higher than the average fifty years earlier. The United States experienced no growth at all in taxation as a percentage of GDP over this period, and by 2012 had the lowest level of taxation, as a percentage of GDP, in any of the countries shown. By contrast, public spending and taxation continued to grow rapidly in some European countries. The level of taxation in France reached 45 per cent of GDP in 2012, a rise of 11 percentage points, and there was an increase of almost twenty points in Italy and Spain. The highest levels of public spending and taxation are almost all in European countries; taxation takes less than 30 per cent of GDP in Japan, Korea, and Australia as well as in the USA.

Taxation and the growth of government

Readers may well differ in their views about the desirability of government spending and taxation on this scale. The proper role of government is, after all, an issue that lies at the heart of political debate and controversy. This short book is not the place to debate this fundamental and complex issue. To a very large extent it should be possible to consider the efficient and equitable design and effective functioning of the tax system, independently of the scale of the revenue-raising task which it is assigned. The features of individual taxes, their economic consequences, the distribution of payments, and their efficient operation are all matters which can be discussed objectively in the light of analysis and evidence of real world operation. In the author's view, much can be learned from the experience of different countries, even where differences in the scale of government demonstrate very different political pressures and underlying philosophies of the role of state action.

However, this is not necessarily a view which is shared by all. Certainly there is a wide measure of agreement across the political spectrum that there are a range of government functions that require tax financing—collective or 'public' goods such as defence and street lighting for which individual charging cannot work. Governments are needed to provide these goods and services, and taxes are required in order to finance them. On the other hand, much of the expansion of government in recent decades has reflected a substantial expansion in the redistributive functions of government. In many countries, especially in Europe, 'welfare state' spending has grown, providing services and income to the poor, the disabled, the sick, and the elderly. Some might argue that the buoyancy of tax revenues at a time of rapid economic growth has made possible growth of government even where there is no pressing need to expand provision of public goods that can be financed only through taxation—that government has become a 'Leviathan', expanding to absorb the resources available.

If this view is taken, it can obviously lead to a very different philosophy of taxation and tax policy. Advocates of efficient revenue-raising might want to reform taxation, to ensure that public revenues can be raised on a fair and efficient basis, with the least disturbance to economic activity and the least possible resistance from taxpayers. To those concerned that efficient taxation invites the excessive growth of government, however, such tax reforms might be seen as unwelcome—as an invitation to government to open its jaw still wider. The latter view—represented, for example, in the economic literature by Brennan and Buchanan amongst others—implies very different priorities in tax policy, with less emphasis on efficiency, and more interest in reforms which would enhance political and constitutional restraints on the taxing powers of government.