

## SECTION 4

### PUBLIC FINANCES

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## Chapter 13 The History of the Theory of Public Finance

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The earliest democratic thinkers held that that government was best that governed least, and present-day Marxists foretell the eventual "withering away of the state". Both hypotheses have been proven false. The certainty of "death and taxes" appears to hold true. There has always, even in the most primitive society, been some ruling group or organizing body. The role and limitations of such a body was an integral part of the economic thinking of the day. This may appear to be an odd statement, since 'economics' as a body of knowledge is scarcely two hundred years old, and the first specific work on public finance appeared less than a century and a half ago. However, every society has had to feed and clothe itself and so each one has attempted to find a practical solution to the fundamental problem of scarcity. Within this solution is a role, however small, for a ruling group. This role depends upon cultural norms, the degree of organization and communication, and the degree of advanced, systematic thought; I shall term this role 'public finance theory'. This is a very narrow term as financial matters are only one facet of governmental activity.

I shall treat of the dominant works on social organization and shall point out what part 'government' played in those works.

Since our religion and the moral law sprung from the Hebraic heritage, what the Bible has to say on economic organization has influenced ethical codes to this day. Biblical social legislation enshrined the concepts of the Sabbath (the day of rest), the Sabbatical year in which land was to be left fallow for the poor, the fair treatment of slaves (who were to be set free in their seventh year), the banning of usury to fellow Israelites, the exhortation of compassion for the poor, and the elevation of industrious labour to high virtue. These have become traditions or have been legislated for or have been extolled by governments at particular times (e.g. controversy over Sunday trading).

Greek philosophy saw two primary roles for public finance. The first was to provide for public consumption; every town had its own theatre, great works of art were scattered throughout the countryside, and annual festivals were held. The second role for government was to raise and train soldiers and provide finance for war, which would bring both slaves and glory upon the city-state. It is notable that there is no word for 'unemployment' in Greek; economic ruin meant slavery. The aims of government, therefore, could be identified as only one of the recognized three modern aims of full employment, equity and growth; that of growth (although such growth was more often achieved through war than industry).

Roman civilization spread the idea of a systematic body of law; this law would guarantee property and uphold freedom of contract. Following from Stoic philosophy it would define 'reasonableness' - reasonable price, reasonable value, reasonable man. The development of an advanced system of roads and the tight control of its colonies led to one of the first effective systems of taxation.

After the decline of the Roman Empire, the feudal system suffered from weakness due to poor communications and general insecurity. All land was

proportion than quantity". (2). He noted, however, that other objectives for tax policy could interfere with the proportionality of tax. Petty approved taxation "according to what men spend" (3) in order to encourage saving and investment. The responsibility of government was, he held, to take care of those who would otherwise live by charity or crime by endowment with "a regular and competent allowance by public tax". (4). This approaches the modern idea of the negative income tax. His belief that "*res nolunt male administrari*" (the world refuses to be governed badly) foreshadowed the rise of liberal thought which held that the power of government was limited not so much by the rights of citizens as by laws of nature which impose restraints on the effectiveness of the exercise of statecraft.

Charles Davenant (1656-1714) was an early advocate of *laissez-faire* when he held that "trade is in its nature free, finds its own channel and best directs its own course, and all laws to give it rules and directions, and to limit and circumscribe it, may serve the particular ends of private man, but are seldom advantageous to the public". (5).

The eighteenth century saw the rise of two schools; the Physiocrats in France and the classical school in Scotland and England.

The Physiocrats criticized vehemently the fundamental Mercantilist doctrines; foreign trade is not a primary aim of a nation but is a "means of last resort" which carries with it the danger of ill-feeling and war. Gold and silver are not wealth but "effects of real production which has changed its form". Physiocratic thought was based upon the "rule of nature". Alongside the natural order was the positive order which reflects the inadequacy of human legislation. They postulated "*laissez-faire, laisser-passer*" but felt that only in the natural order could harmonious individualism reach full flowering; in the real world the free play of individual forces may be frustrated. Quesnay, the father of the school, derided the idea of everybody having a right to everything and the concept of private property was central to them. Thus the Physiocratic role for government was to guarantee private property and the levy of a single tax, that on the "*produit net*", i.e. the farmers' surplus, which they held supported the two other classes (landlords and artisans) and was the only surplus in society. Apart from that free trade was to be allowed, "*on laissez-faire la nature*".

In 1776 Adam Smith published his five volume work on "The Nature and Causes of the Wealth of Nations". He dealt with labour, capital, economic development, the history of economics, and public finance.

His central claim was that self-interest can lead to the common good. In pursuit of self-interest man is not necessarily perfectly rational, but is rather over-optimistic. Consumption is the "sole end and purpose of production", but it is a theory of production rather than of consumption which Smith develops.

He advocated *laissez-faire* but recognized a role for government in protection, justice, and public works. His was the first formal recognition of a good which provides value to society as a whole far exceeding its value to one individual, i.e. a public good. Government was to regulate paper money banking, patents and copyrights, enact usury laws, provide public education and public enterprise in transport, and could grant a temporary monopoly. The central criterion for a public project was, in the final analysis, its ability to yield profit.

His "Canons of Taxation" held that the four criteria of a good tax were equality (based upon ability to pay), certainty, convenience, and economy. He recognized that these goals may clash with each other or may prove incompatible with other goals of policy.

Malthus, a radical economist, devoted his life work to a transformation of Smith. Unlike his peers he questioned the adequacy of total output and advocated self-restraint as the solution to economic scarcity. He foreshadowed Keynes in his belief that a tax-financed public work would be more effective than tax reductions if it created greater and more certain demand for labour and commodities.

David Ricardo also studied Smith's works and his work was more widely accepted than that of Malthus. As an exponent of laissez-faire he conceded only a few legitimate exercises of statecraft - mainly taxation in moderation. His theory of taxation was integrated with his theory of distribution by his work on the shifting and incidence of taxation. He held that "taxes which are levied on a country for the purpose of supporting war, or for the ordinary expenses of the state, and which are chiefly devoted to the support of unproductive labourers, are taken from the productive industry of the country, and every saving which can be made from such expenses will be generally added to the income, if not the capital of the contributors". (6).

In 1845 McCulloch, a disciple of Ricardo, produced the first separate treatment of public finance.

Karl Marx held that the state, instrument of coercion of the ruling class, would lose its function and disappear. However, in Marxist states, the government has tended to yield brutal and dictatorial power; whereas in Western democracies the extension of the suffrage and the development of labour laws has meant that Marx's description of the state as instrument of the bourgeoisie no longer applies.

The 'Kathedersozialisten' (or socialists of the professorial chair), were part of the Schmoller school of socialism. They espoused "state socialism" entailing public ownership, redistributive tax policies and the taxation of unearned income. Adolph Wagner of Berlin, postulated a "law of increasing fiscal requirements". Their programme of social justice, concessions to labour and levelling of wealth was attacked both by Rosa Luxembourg on the left, and by social Darwinists on the right.

The idea of a "public good" was further developed because of the work of Marshall and Pigou, both leading members of the Cambridge school. Marshall's "externalities" and Pigou's recognition that social and private returns are not necessarily equalized led to the concept that a public good was one for which the benefits were diffused, the enjoyment of which was not confined and the price of which was often not feasible for an individual to pay. The marginal revolution provided a link between the consumer and public good provision. A demand curve was postulated for which prices were vertically summed. Cost-benefit analysis was developed and was drawn into the wider perspective of public policies - the quality of the environment, health, education, renewal of cities, unemployment, price stability and economic growth.

Knut Wicksell (1851-1926) criticized the classical view that competitive prices ensure a social optimum. Rather he held that total utility may be increased by an exchange between rich and poor. This exchange may come about by setting prices at other than competitive levels, and as an example he adduces minimum wage or maximum hours legislation, which would be a function for government. Wicksell advocated government intervention and proposed marginal rather than full cost pricing for public utilities and sowed the seeds of the idea of nationalization. He introduced marginal utility into public finance theory and he went beyond the conventional treatment of the shifting and incidence of taxation by considering the question of income distribution and justice in taxation.

The modern theory of public finance really blossomed after the Second World War. It owes much to the work of J.M. Keynes who questioned the adequacy of demand in the classical system and saw a role for government in maintaining aggregate demand at its full employment level. The development of Keynesian economics coincided with an expansion of government intervention in the economy and practical Keynesianism was summarized in the "three ways to full employment". These were an increase in government spending and an associated deficit, a tax reduction with an even bigger deficit or a balanced budget increase in government spending. Keynesians also argued that contradictory policies of tax increases or decreases in government expenditure would restrain inflation.

The subject of public finance is now so greatly expanded as to hold its own place in economic theory. Within the framework of general economic analysis the competitive economy is being examined, a questioning of the nature of government is taking place, and an analysis of the mechanism of public choice is being carried out. Within these broad areas there are thousands of smaller theoretical and empirical studies going on; general equilibrium incidence of tax, econometric study of the response to tax and social security benefits, optimum design of fiscal policy, debt policy and capital accumulation, provision of public goods, stabilization, growth and curtailment of government, and the real effects of inflation. It is too early yet to decide which of the prevailing theories will last and which will be consigned to a historical footnote.

Public finance will always provide ample food for thought on the central problem of scarcity and the associated issues of growth and distribution.

#### *Footnotes*

1. Spiegel, p.121.
2. Quoted in Spiegel, p.132.
3. Spiegel, p.133
4. Spiegel, p.134.
5. Spiegel, p.139.
6. Spiegel, p.334.

#### *Bibliography*

- H.W. Spiegel, "The Growth of Economic Thought".  
Musgrave and Musgrave, "Public Finance in Theory and Practice".  
Buchanan and Flowers, "The Public Finances, An Introductory Textbook".  
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