



Deepak Lal

**Taxing Matters:**

*Moving the UK from Predator State to Global Economy*

**POLITEIA**

A FORUM FOR SOCIAL AND ECONOMIC THINKING

*Deepak Lal*

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## Introduction

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Gordon Brown has set a trap on public spending and higher taxation: and all three political parties have fallen into it. They have no desire to challenge the Chancellor on health and education spending. Even the Conservatives have ruled out immediate tax cuts. All the political parties have embraced the *status quo* of a large, unreformed, welfare state with high levels of tax and spending. The position is like that of Butskellism. This post-war economic ideology dominated until questioned by Keith Joseph in the 1970s and repudiated by the Thatcher Governments in the 1980s. Since then the parties have been changing their clothes: Tony Blair stole the Conservatives' clothes and David Cameron is stealing New Labour's. All three parties seem prepared to spend over 40 per cent of our money on a range of activities including 'public services'. Neither opposition party questions whether health and education should in the main continue to be publicly provided and/or financed services, as at present; or indeed, why public funds are spent on a local and central government bureaucracy designed to address 'social exclusion'. The fiscal reforms which dramatically reduced public spending from 45 per cent of GDP in 1983 to 37.5 per cent in 1989 leaving it at 39.2 per cent when New Labour came to power have no current appeal in the party which pioneered them. The upshot is that there is now little to choose between the three parties when it comes to tax and spending.

The Tories, like their Swedish counterparts, appear to suggest they should be elected because the (overgrown) welfare state is safe in their hands; and they can run it more efficiently than their competitors. They have been intimidated by their 'progressive' opponents. They are mindful of the fact that nearly 50 per cent of the electorate have been made direct or indirect wards of the state. Any attack on the welfare state will, therefore, be opposed by a majority of dependants when they vote. As a result power will depend on accepting the new political reality and joining the 'progressive' social democratic tide.

Though the Swedish model is offered to prove that high levels of social security can be paid for from the cradle to the grave without damaging economic performance, the claim is false (see Figure 1). The Swedish economy, between 1870 and 1950, grew faster on average than any other industrialised economy, and the country became technologically one of the most advanced and richest in the world. From the 1950s Swedish economic growth slowed relative to other industrialised countries. This was due to the expansion of the welfare state and the growth of public – at the expense of private – employment.<sup>1</sup> After the Second World War the working population increased by about 2 million: public employment accounted for c. 770,000, private accounted for only 155,000. The crowding out by an inefficient public sector of the efficient private sector has characterised Sweden for nearly half a century.<sup>2</sup> From being the fourth richest

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<sup>1</sup> O. Krantz, *Economic Growth and Economic Policy in Sweden in the 20<sup>th</sup> Century: A Comparative Perspective*, Ratio Work Paper No.32, 2004.

<sup>2</sup> Bacon and Eltis have shown this to be the central cause of the UK's economic decline in the 1960s and 1970s, though stalled and partially reversed by the Thatcher reforms of the 1980s. See R. Bacon and W. Eltis, *Britain's Economic Problem: Too Few Producers*, London, 1976.

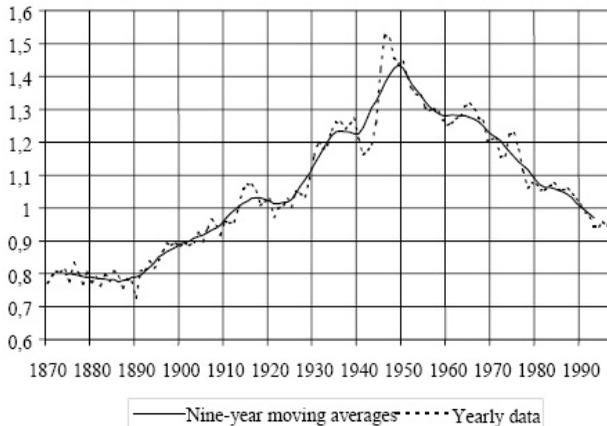
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country in the OECD in 1970 it has fallen to 14th place. Only in France and New Zealand has there been a larger fall in relative wealth. By contrast, Ireland, with economic reform and a low tax regime, improved its ranking from 21st place to 4th. Yet all the political parties in Britain now want to emulate the fabled Swedish model. David Hume and Adam Smith would not have been surprised.

This pamphlet will consider why this has happened. Why, on tax and spending, has political paralysis set in? What has happened to the classical liberal principles and how has the collectivist impulse been channelled into a 'new dirigisme'? The new dirigisme must be countered by classical liberals as the first, essential, step towards the lower taxes and better public services the electorate as a whole wants.

**Figure 1.** GDP per capita, Sweden in relation to the average for sixteen industrialised countries 1870-1997. Constant prices. Index 1913=1.

Source: See Table 1.



Source: O. Krantz, *Economic Growth and Economic Policy in Sweden in the 20<sup>th</sup> Century: A Comparative Perspective*, 2004

## I

### The Predatory State: From Monarch to Middle Classes

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The power to tax is the ‘power to take’. The State has this monopoly of coercion over its citizens. When absolute monarchs ruled, the interests of the people required that the ‘power to take’ should be restricted (as happened in the tax revolt which cost Charles I his head). Those who controlled the State were recognised, both in their origin and actions, to be self-interested predators. The monopoly of coercion provided the controllers of the State with the means to extract revenue from their prey. The State was in effect the equivalent of a Mafiosi protection racket. It is always inherently predatory and the interests of predators and their prey are not wholly divorced from each other. Predators to some extent are interested in the welfare of the prey which provides their own food supply. Similarly, self-interested predatory controllers of States have an interest in the welfare of their prey.

The prey needs the State for protection against external and internal aggression and to settle disputes between individuals. These ends – the classical public goods – prompt them to give the State the monopoly power of coercion and to finance itself from their earnings. But, once transferred to the sovereign, this power should not be used to extract more than necessary to finance public goods.

For the predatory State the ‘power to take’ allows it to extract from its prey when it can; or it allows a rival (external or internal) to provide the public goods at lower cost and contest its monopoly of coercion within the State. This is the dilemma of politics. How can the prey tie down an inherently predatory State to take only what is needed to provide the classical public goods?

When the State consisted of monarchs who took for themselves – for mistresses, palaces, armies and other paraphernalia of power – more than was needed to provide protection or other public goods, the dilemma was clear. At first the absolute monarch’s ‘power to take’ was restricted by representative legislatures. But with the rise of majoritarian democracies, ‘we’ become the State if not the predator; and democratic governments also seek to maximise public revenue exercising discretionary power over its disposal.

Political parties, in two-party democratic systems, tend to serve the interest of the median voter, the ‘power to take’ having passed from absolute monarchs to the ‘middle classes’. Why? Both parties in a two-party system will appeal to the interests of the median voter by occupying the middle ground. As much of democratic politics is redistributive, politicians serve the median voter by taking from those who are both richer and poorer through the welfare state tax-benefit systems of today’s democracies. This is a form of transfer State. The US failure – by any party – to tackle middle class entitlements to social security, or the UK’s to get the middle classes to pay for their children’s higher education illustrate the phenomenon. Gordon Brown’s success in making the ‘median’ voter a ward of the State has now been embraced by David Cameron who recognizes the reluctance of such voters to allow state hand-outs to be taken away.

Politicians do not just promote the interests of the median voter: they resemble the monopolistic revenue-maximising absolute monarchs of yore. Suppose, two parties announce their platforms successively.<sup>3</sup> The party to announce policy last can, by taxing some minority and transferring some of the revenue to a new majority, keep the rest for discretionary use and win. (One illustration of this is Gordon Brown's pledge to find savings from the current 'waste' in public services, to use it for his own purposes of 'investing' it – as he puts it – in public services).

Contemporary ethics do not, in most Western democracies, permit the direct transfer of the discretionary 'surplus' to politicians themselves. Instead it buys future votes, provides favours to 'friendly' interest groups, or – where close 'social' links exist between the politicians and bureaucrats – allows for an expanding bureaucracy. (For example, between the former polytechnic lecturers who now crowd the New Labour benches and social workers in local councils). There is then a continued interest in expanding the size of their 'bureaux' and budgets: to establish, maintain or expand monopoly of public provision of goods and services (including those which competitive private producers could provide more efficiently). Expanding the public sector leads to lucrative tenured jobs at the base of the bureaucratic pyramid and improves the future 'life chances' of bureaucrats in income, perquisites and power.

Though direct income transfers to government ministers are not now permitted in Western democracies, they are advocated for alleviating poverty. However, public servants do not favour direct non-discretionary monetary transfers to the 'poor', which give them little advantage. They prefer indirect and discretionary transfers which require the larger 'welfare bureaucracy', characteristic of the welfare state. With declining poverty in most industrial countries, new 'welfare' needs are discovered, for example that of 'social exclusion' (discussed below). This in turn leads to a further expansion of the welfare bureaucracy.<sup>4</sup>

Just as the interventions of self-interested politicians and bureaucrats affect public finances, so too do the pressure groups into which individuals organize themselves. Election results will therefore reflect the interests of the most successful interest groups. Public policy will, as a result, be determined by competition among pressure groups, the most successful of which will be small and concentrated. As the income taken from the majority is spread over their members, the per capita costs to the 'losers' will be small and will rarely lead to the majority forming an opposing pressure group. Foreign trade protection advocated by producer interests, though contrary to consumer interests, can be explained in this way. One example is that of the protection offered to agricultural producers in the EU through CAP.

A further difficulty in checking the inherent predation of the State is the move from representative to participatory democracy. The increasing use of opinion polling in the political

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<sup>3</sup> This is not an essential assumption; the platforms could be announced simultaneously. See G. Brennan and J. Buchanan *The Power to Tax*, Cambridge, 1980, pp. 20-23 for a fuller discussion. They also derive the set of taxes based on classical liberal principles which would limit predation by the State.

<sup>4</sup> In any given week there are advertisements for the myriad of local authority jobs advertised weekly in *The Guardian*, so that one group or other of welfare workers can deal with perceived social exclusion.

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process in the UK and US has led to this. With the median voters now seen as holding the key to electoral success, politicians need to know their opinions and interests to design the ‘bribes’ to be offered for votes; and they also need to train the spin doctors to win the rest of the electorate (through the altruistic rhetoric in which such self-seeking can be clothed).

The slide to participatory democracy is contrary to the Western notion of liberal democracy based on the representative principle. From the founding fathers of the American Republic to liberal thinkers like Immanuel Kant, direct or participatory democracy on the model of the Greek city States has been held to be deeply illiberal. Subject to populist pressures and the changing passions of the majority, it can oppress minorities. By contrast, in a representative democracy, people choose their representatives for a legislature which legislates. The people do not themselves write or pass legislation. The representatives judge legislation on the merits of the case, moved ideally by reason. Edmund Burke’s summary is as apt today as it was in 1774: ‘Your representative owes you, not his industry only, but his judgment: and he betrays it instead of serving you if he sacrifices it to your opinion. You choose a member indeed; but when you choose him, he is not a member of Bristol, but he is a Member of Parliament’.<sup>5</sup>

The move towards direct participatory democracy has nonetheless taken place gradually in the US and UK. With the rise of the pollsters, and the weakening of party loyalties, politicians – particularly those of the ‘third way’ – have come to rely increasingly upon ‘focus groups’ to discover and pander to public opinion, the practice decried by Burke. By opening up the legislative process to greater scrutiny and accountability the system paradoxically becomes more open to influence by pressure groups and the phenomenon of *Demosclerosis*<sup>6</sup>, where well-funded interest groups hijack domestic politics. Changes designed to democratise the system or to make it easier ‘to listen to the people’ have too often led to well-organized interest groups forcing governments to bend to their will. It is, as Zakaria put it, now clear that reforms ‘designed to produce majority rule have produced minority rule’,<sup>7</sup> as the people have neither the time nor the inclination to monitor the legislators’ laws on a daily basis. As a result instead of rational consideration of alternative policies by the people’s representatives, referenda determine the outcomes, often the consequence of ‘spin’ and emotion.

It might therefore seem quixotic to champion classical liberal principles for public finance. But even predatory political processes around the world have at various times *provided* liberal reform.<sup>8</sup> The solution may lie in the theory of ‘crisis and reform’.<sup>9</sup> A serious economic crisis,

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<sup>5</sup> E. Burke, ‘Speech to the electors of Bristol’ in J. Payne, *Select Works of Edmund Burke*, vol. 4, Indianapolis, 1774/1999.

<sup>6</sup> J. Rauch, *Demosclerosis: The Silent Killer of American Government*, New York, 1994.

<sup>7</sup> F. Zakaria, *The Future of Freedom*, New York, 2003.

<sup>8</sup> The Thatcher reforms which curbed the power of trade unions and dismantled the vast panoply of nationalised industries illustrate the point.

<sup>9</sup> This cycle of economic repression, crisis and reform was observed during the mercantilist period as documented in Eli Hecksher’s magisterial book “Mercantilism”. See D. Lal, *The Political Economy of Economic Liberalization*, World Bank Economic Review, vol.1, no.2, 1987, pp.273-99. D. Lal and H. Myint, *The Political Economy of Poverty, Equity and Growth - a comparative study*, Oxford, 1996.

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caused by the prey seeking through evasion, avoidance or flight to escape predation must occur so as to force the State to disgorge. Ideas help, but ultimately it is the interest of the State in overcoming the disorder its predation has bred that leads it to reverse direction.

Has the UK reached such a crisis in its social policies, with the NHS, schools and universities increasingly in disarray? Only time will tell. But when the crisis does arise and the median voter sees that with the prey fleeing, predation on this scale can no longer continue, the nature of reform must be clear. As numerous examples from around the world attest, the window of opportunity for reform is likely to be very small.

## II

### What Kind of State Are We In?

#### Classical Liberalism in the March from Freedom to Social Exclusion

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The aim of political economy is to find how the State can provide the essential public goods at the least cost in terms of taxation. The classical liberals recognized the aim and laissez-faire economics provided a realistic approach where predatory governments were seen to put revenue maximisation above the social welfare maximisation of Platonic guardians. The classical policy prescriptions have been misrepresented.<sup>10</sup> The classical liberals were neither hostile to the State nor of the view that the role of governments in economic life was minor. Their view of the State was positive; and indeed<sup>11</sup> Adam Smith's view is almost identical to that of Keynes' who argued that 'the important thing for government is not to do things which individuals are doing already, but to do those things which at present are not done at all'.<sup>12</sup>

The State's three functions were recognised as (i) to protect society from foreign invaders, (ii) to protect each member from oppression and injustice by others and (iii) to provide and maintain the public works and institutions which provided public goods.<sup>13</sup> The principles of economic liberalism were set out in Mill's *Principles*, and their clearest modern reformulation is to be found in Hayek's *The Constitution of Liberty*. In fact, the current 'Washington Consensus' on economic policy is essentially a classical liberal policy package.<sup>14</sup>

Classical liberals from Smith to Hayek to Friedman, have agreed that equality may be in conflict with liberty, and the liberal is not an egalitarian.<sup>15</sup> Classical liberals advocate public transfers,

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<sup>10</sup> Caricatured by Carlisle's 'phrase anarchy plus the constable, or by Lasalles's simile of the night watchman'

<sup>11</sup> L. Robbins, *The Theory of Economic Policy in English Classical Political Economy*, London, 1952.

<sup>12</sup> J. M. Keynes, *The End of Laissez-Faire*, London, 1926, pp 46-47.

<sup>13</sup> A. Smith, *The Theory of Moral Sentiments*, Indianapolis, 1982/1759, .pp.184-5.

<sup>14</sup> The "Washington Consensus" was the term coined by Williamson to describe the policy package which had emerged as best able to promote efficient poverty alleviating growth as a result of the experience of developing countries in the 1970s and 1980s. It is close to that advocated by A.C. Harberger, as constituting the best technocratic advice based on experience. It is also the one emerging from the Lal-Myint study of 25 developing countries. Recently Williamson has sought to disown it partly as the anti-globalization backlash has used it, particularly in Latin America, as the whipping horse in its denouncement of what it calls the 'neo-liberal' policies adopted in Latin America. But, as Mario Vargas Llosa has argued, there are hardly any countries in Latin America, apart from Chile, who have in fact adopted the full package, and hence to announce its failure on the half-baked liberalization attempts in many countries is rather premature. T. N. Srinivasan rightly takes Williamson to task for his partial recantation.

J. Williamson, 'What Washington means by Policy Reform' in J. Williamson (ed): *Latin American Adjustment: How much has happened?*, Washington., 1990.

A.C. Harberger, *World Economic Growth*, San Francisco, 1984.

M. Vargas Llosa, 'Liberalism in the new millennium', in I.Vasquez (ed): *Global Fortune*, Washington, 2000.

T. N. Srinivasan, *The Washington Consensus a decade later: ideology and the art and science of policy advice*, World Bank research Observer, vol.15, no.2, 2000, pp. 265-70

<sup>15</sup> F. Hayek, *The Constitution of Liberty*, Chicago, 1960, p.402.

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when private transfers are not available or sufficient to help the ‘deserving poor’<sup>16</sup> and, since Mill, they have also advocated the public *financing* but not *provision* of merit goods such as health and education for those unable to afford them.<sup>17</sup> Though the programme promoted by social democrats increasingly resembles the classical liberal prescriptions, the exception is merit goods. In eschewing egalitarianism in taxation and by welfare state reform designed to concentrate the benefits to the ‘deserving poor’, both the New Democrats under Clinton in the US and New Labour under Blair in the UK are closer to the classical liberal viewpoint than they imagine. The main difference is over the merit goods of health and education for which they believe that planned public provision should replace the operation of the market and that bureaucracy should be expanded to enforce various forms of political correctness. This is an enterprise view of the State as distinct from the State viewed as a civil association by classical liberals. These two views of the State – that of civil association with no purposes of its own and that of an enterprise seeking to legislate some vision of perfectibility – have been the two dominant voices in Western political thought and action: one going back to the Greeks, the other being part of the Judaeo-Christian tradition.

## The “New Dirigisme”

The rise of the ‘enterprise’ voice of socialism towards the end of the 19<sup>th</sup> century led to ‘the end of laissez-faire’.<sup>18</sup> The erosion of the classical liberal ‘civil association’ view of the State had begun in Europe with Bismarck’s social insurance scheme in Germany and the liberal welfare reforms in Britain of 1906-14. It spread to the US during the Great Depression and Roosevelt’s New Deal. The dominant ideology which was to follow – ‘embedded liberalism’ or ‘social democracy’<sup>19</sup> – was encouraged by the economists; and by the Second World War the 19<sup>th</sup> century classical liberalism had been replaced by the dirigiste dogma, especially pronounced in the Communist countries. With their demise after the Berlin Wall fell, the socialist impulse has been transformed. Rather than seeking to replace capitalism, it wishes to create ‘capitalism with a human face’. Moreover, the notion of freedom has been used to promote the ‘enterprise’ views of the State under cover of an implied view of the State as a ‘civil’ association by using the distinction between negative and positive freedom, and by arguing that the promotion of ‘positive freedoms’ is no different from the promotion of negative freedom, which classical liberals value.<sup>20</sup>

### (a) ‘Freedom’ and ‘Liberty’

The economist-philosopher Anthony de Jasay has provided classical liberals with an escape from

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<sup>16</sup> See the discussion in Lal and Myint, *The Political Economy of Poverty, Equity and Growth*, 1996.

<sup>17</sup> In D. Lal, *Nationalised Universities - paradox of the privatisation age*, London, 1989, I have outlined how this can be done for higher education in the UK and in D. Lal, *A Premium on health: A National Health Insurance Scheme*, London, 2001, how the NHS can be reformed in line with these principles.

<sup>18</sup> J. M. Keynes, *The End of Laissez-Faire*, 1926

<sup>19</sup> B. Eichengreen, *Globalizing Capital*, Princeton, 1996.

<sup>20</sup> As discussed by I. Berlin, *Two concepts of Liberty*, in his *Four Essays on Liberty*, Oxford, 1969.

this dirigiste trap. Jasay jettisons the notion of freedom as being central to classical liberalism. The most basic reason for not relying on the concept of freedom to justify a classical liberal society and polity is that freedom in ordinary speech involves ensuring that deliberate obstacles are not being placed in the way of individuals' actions. This immediately leads to the slippery slope, where 'being *free* to do something and being *able* to do it' are elided. The discourse of freedom then degenerates into one in which freedom means the general availability to all of the good things of life. This allows various policies forming part of the socialist enterprise view of the world to be smuggled in as being part of freedom.<sup>21</sup>

Instead Jasay, relying on the English common law tradition, defines the rules which the State as a civil association should uphold. These are Mill's principles of liberty: a person can undertake any *feasible* action which does not harm others or break an obligation.<sup>22</sup> The burden of proof lies on someone who wants to prohibit an individual's actions. This process is equivalent to the presumed innocence of the accused unless found guilty by due process. In contrast to this common law tradition of justice there is an alternative which may be called the continental system of justice, or 'public law' as Jasay calls it. Under this, individuals are forbidden from feasible actions unless they are expressly *permitted* by various 'rights' granted under constitutional provisions.

Of the two alternative legal traditions, the common law based on a list of *prohibited* actions is more readily verifiable than the public law tradition based on a list of *permitted* actions. For feasible actions are limitless, and listing what we must not do is less onerous than listing what we are permitted to do.<sup>23</sup> If the 'liberty' norm of the common law tradition based on prohibitions of feasible actions is more sound (being verifiable) than the continental tradition based on permissions, what of 'property rights' and 'human rights'?<sup>24</sup>

### (b) Property Rights

Property rights are mistakenly called rights. If an individual is free to do something which is not wrong, this liberty must include the freedom to do what he likes with his property. *Liberties are different from rights*. While the property owner has the *liberty* to use his property, the non-owner

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<sup>21</sup> See A. K. Sen, *Development as Freedom*, Oxford, 1999, R. Sugden, "A review of 'Inequality reexamined'" by Amartya Sen, *Journal of Economic Literature*, vol.31, no.4, 1993, pp.1947-86.

<sup>22</sup> A. De Jasay, *Before Resorting to Politics*, Aldershot, 1996, p.23.

<sup>23</sup> If, as is usually the case, there is no clear boundary to the possible harms a particular action could cause, it will be impossible to prove that a feasible action is harmless. Similarly with obligations (which confer corresponding rights), it will be impossible to prove that some right has not been violated. In the common law tradition the *prosecutor* has to prove that, in pursuing a particular action, the defendant has violated obligations or caused harm to others. In the continental law tradition it is for the *defendant* to prove that he has not violated *any* right or caused *any* possible harm.

<sup>24</sup> R. Nozick, *Anarchy, State and Utopia*, Oxford, 1974, p.92. Jasay's position on rights is different from R. Nozick. One of the senses in which Nozick uses rights: 'rights that is permissions to do something and obligations on others not to interfere' Jasay rightly notes 'rights are not permissions but claims for performance by another. Yet liberties are not permissions either; if they were they would be most confusingly misnamed. Who would be competent to grant permissions and on what authority?'. He also contests Nozick's position on property rights.

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has to get the *right* to use it which is provided by the lease. Thus, whereas liberties are not conferred by anyone, rights require someone else to have agreed to fulfil some obligation.

Ownership is often acquired through the proceeds of work, through exchange (e.g. like that of assets) or from gifts and inheritance. These means of acquiring property meet the requirements of justice; they involve exercising a liberty without transgressing any obligation or causing harm to others.

Conquest and seizure have been equally important in acquiring land. The means are morally unjust and calls for restitution would be justified. This is at the heart of the controversy about the Palestinians' 'right to return' in the Arab-Israeli dispute. But, though the claim may be morally just, it is not expedient. For most societies throughout history have recognised the chaos that would be caused by seeking to redress every fault in the historical descent of every current title to property, no matter how far back the chain of transfers stretches. They have, therefore, (correctly) applied some form of statute of limitations – if for no other reason than recognising that the sins of the fathers should not be visited upon their grandchildren and great-grandchildren.

### (c) Human Rights

What of 'human rights?' Rights (as already mentioned) arise from contracts – actual or implicit – which give rise to obligations that have been accepted by someone else. Thus 'every right of one person has the *agreement* of another as its source, cause and evidence'.<sup>25</sup> Agreement is crucial in generating rights and the corresponding obligations. Thus social rights are not rights but *entitlements*. The right of the unemployed to unemployment insurance or the poor to welfare are not rights, but entitlements created by the State, which can be changed or repudiated because they are not based on contract. By contrast a genuine right arising from a contract cannot be limited or withdrawn without the right holder giving his consent. These rights are sometimes called *specific* rights.

In addition the claim is made for 'human rights' – a *general* right – which arise from the assumption that being *human* justifies certain rights which go beyond specific rights. They are the descendants of 'natural rights'.<sup>26</sup> They arise from the general right, namely 'the equal right of all men to be free'<sup>27</sup>, including the right to free speech, free worship, to walk about, to breathe. However such a 'right' is redundant in the Common Law tradition where one is free to act provided it does not infringe one's obligations (the specific rights of others) or cause others

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<sup>25</sup> De Jasay, *Before Resorting to Politics*, p.30.

<sup>26</sup> K. Minogue, 'The history of the idea of Human Rights', in W.Laquer and R. Rubin (eds): *The Human Rights Reader*, New York, 1979.

<sup>27</sup> H. Hart, 'Are there any Natural Rights?' *Philosophical Review*, 64, reprinted in A. Quinton (ed) *Political Philosophy*, Oxford, 1967, p.53.

harm.<sup>28</sup> Only in the Public Law tradition do these ‘rights’ need to be specified where all feasible actions require *permission*, including these ‘human rights’ to breathe, to be able to speak freely, to walk around etc.<sup>29</sup> Individual freedom of action is much better protected by the common law tradition where one is free to take any feasible action subject to the constraints of harm and specific obligations (rights).

(d) Capitalism with a Human Face

Many of capitalism’s opponents use the concept of freedom to imply an ‘enterprise’ view of the state, yet appear also to subscribe to the classical liberal view of the State as a ‘civil’ association. They aim to justify redistributive measures. Their position is one of denying that distribution of property based on contract, transfers, and first possession can be just. Instead they view property as arising from the mutual gains provided by social co-operation.

The claim is that much existing wealth is the result of social co-operation going back to Adam and Eve. It is a social inheritance and belongs to the whole of society. But, largely for reasons of efficiency, it is inexpedient to rule out some private appropriation of this social wealth. Hence, some social wealth can be converted into private property, on the terms and conditions specified by the co-owner society. This can be done provided social exclusion from this social wealth – of those disadvantaged by lack of talent, luck or who are unable to share in the benefits of social co-operation – is prevented. The State as the co-owner of this social wealth should use its powers to coerce some to give up part of their property or income to the disadvantaged.

The false premise is that individual contributions to past and present social co-operation and wealth are impossible to trace and all wealth is seen as that generated by society as a whole.

But, though social co-operation has generated the wealth in the world, it is false to claim that no trace of the individual contributions is available. Everyone who has contributed through work has been paid in voluntary exchanges. Some payments were consumed, some saved and invested and the resulting assets have the contributors’ title to them. To coerce them to give away what is theirs – and which they are at liberty to use as they see fit would – be unjust. Though over the millennia everyone has contributed to the generation and accumulation of a society’s wealth, this does not mean that everything is owed to society. ‘*Nothing is owed*’ Jasay rightly notes, ‘everything has been paid for, one way or another, in a manner and to an extent sufficient to call forth the contribution. There is no further common-pool claim overhanging the lot, for no payment must be made twice. He who sees an overhanging claim in favour of ‘society’ is seeing a mirage, or the wishful image of one’.<sup>30</sup>

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<sup>28</sup> Isaiah Berlin refers to human rights as ‘a frontier of freedom’ which no one is allowed to cross (p.165). But as Little rightly notes: ‘an infinite list of rights is not convincing as a frontier. The frontier is properly constituted by the quite limited list of things that one may not do to human beings’.

<sup>29</sup> But as there are infinite number of such ‘rights’, it will be impossible to delineate them all, which would give rise to endless legalistic disputes.

<sup>30</sup> De Jasay, *Before Resorting to Politics*, p.51.

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In the same way it is false to claim that because social co-operation is needed for gains in a business or corporation, everyone is a *stakeholder*, to be consulted and if necessary assuaged. A corporation consists of a series of voluntary exchanges based on a contract where the worker is obliged to perform certain tasks in payment for the agreed remuneration. The obligation to consult may be given by the employer to the worker, as part of the contract and in this way a specific right is granted matching the voluntarily agreed obligation.<sup>31</sup> But there can be no general right to consult 'stake-holders', unless one believes that the sharing of the fruits of co-operation cannot be assigned by voluntary contract, and hence this social product has to be shared by continual negotiation or mediation by the co-owner of society's capital – the State. For the dirigistes the employer's capital has been leased to him from society's capital owned by the State on its behalf. The claim is false. The employer has justly acquired capital from past savings and can do with them what he pleases. There is nothing which belongs to society which has been leased out to the employer.

Another illegitimate claim is that the economic power wielded by employers and corporations is coercive and forces the weak to give into the demands of the strong. That confuses the *actual options* open to the weaker party (where they can act freely on the offer of the employer) with their *hopes* for a better deal.<sup>32</sup> However, it would be unjust to use the coercive power of the state to enforce this hope of the weak and violate the stronger party's liberty to use their endowments as they wish.

In the same way other State coercion to take a person's justly acquired property to give it to anyone else would also be ruled out where the State is seen as a civil association. Inheritance taxes would be ruled out; other redistributive taxes would be unjust. Would public transfers to the destitute be ruled out? Most societies have made provision for the destitute: those incapable of making any living. The safety net has usually been provided through private transfers from other family members or public charity. With the fraying of families in the West these private social safety nets have also become frayed. Public charity remains the only alternative. Therefore where private charity can no longer be relied on to alleviate destitution, some form of public transfers may be forthcoming.<sup>33</sup>

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<sup>31</sup> R. H. Coase: 'The Nature of the Firm' *Economica*, n.s., 4, reprinted in his *The Firm, The Market and the Law*, Chicago 1937/1988. The existence of corporations depends upon there being various contracts which cannot be specified at arms length. Because workers acquire various skills which are specific to the firm through on the job training, this form of firm-specific capital is of value to the firm but not the the worker who cannot cash them by moving to another firm. These firm specific skills are to be distinguished from the general skills acquired from on the job training which can be marketed outside the firm. Because of the importance of firm level skills there will have to be a more permanent relationship between employer and employee than the arm's length transactions of a spot market for labour. This means that the employer will now have to incur the policing type of transactions costs in monitoring workers to see that they are not shirking. This would require the hierarchical organization of firms. As part of this task the employer may choose various forms of contracts with the workers which could include 'co-determination' like having workers on boards of companies. But given the diversity of conditions faced by different firms, in a free market, the types of contracts will be varied, including the types advocated by promoters of 'stakeholder capitalism'. What would go against the functioning of the free market was if a particular type of contract, viz. the stakeholder type, was forced on all employers by legislative fiat.

<sup>32</sup> This can be seen as part of the set of feasible actions they can take, based on the offer made by the strong, which does not infringe the rules of justice that the owner is free to dispose of his endowment as long as he does not violate the constraints of harm and obligation.

<sup>33</sup> See Lal-Myint, *The Political Economy of Poverty, Equity and Growth*, 1996 for a fuller discussion.

### III What Kind of Tax for the Global Economy?

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How then can the fiscal exactions of democratic, predatory states be controlled? How can the fiscal privileges inherent in the government's power to take and give to whom it chooses be limited? Two different answers are given, both from Nobel Prize winners. The first is that of the 'optimum tax theory', for which James Mirlees won the Nobel Prize, but which goes back to the Cambridge mathematician Frank Ramsey in the 1920s. The idea is that the optimum pattern of taxation to raise a given revenue is higher taxes levied on goods for which the price elasticity of demand (which measures the sensitivity of the quantity of the good consumed to its price) is low (e.g. cigarettes and alcohol). It assumes (falsely) a benevolent government.<sup>34</sup>

But, suppose if instead of a benevolent government seeking to raise a *given* revenue we have a predatory government which wants to raise the *maximum* revenue it can, what set of taxes will it choose? These are Ramsey's optimal taxes which a consumer (e.g. an addicted smoker facing a tax on cigarettes) finds inescapable.<sup>35</sup>

The only taxes which citizens should grant to a predatory state, says the other Nobel Prize winner, James Buchanan and others, are those from which people can escape – those for goods with elastic demand. In the same way for providing local public goods there should be local sales taxes in a decentralized fiscal system, with tax competition between localities limiting their predation, not taxes on property or wealth. All sides agree, however, that the base of the tax system, should, ideally be consumption and not income.

Recent proposals for flat taxes to limit the fiscal predation of governments should be considered in this context. A flat tax, in its pure version, replaces multiple marginal rates with a single marginal rate; it also abolishes the complex systems of allowances and reliefs used by governments to buy votes or for social engineering. A high personal tax-free allowance allows

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<sup>34</sup> These set of optimum taxes were derived by Frank Ramsey, a Cambridge mathematician, as the formal answer to a puzzle set him in the 1920's by A. C. Pigou. What set of taxes would minimize loss of welfare to raise a *given* revenue? Ramsey's answer was that the optimum pattern of taxation was to impose higher taxes on goods for which (in economists' jargon) the price elasticity of demand was low – like cigarettes and alcohol. Imposing such taxes would reduce the excess burden (in terms of loss of consumers surplus) associated with raising a given revenue. The explanation: suppose that there are two goods: cigarettes, for which price elasticity is low, so that when their price rises, consumption does not drop substantially; and restaurant meals, for which the price elasticity is high, so that an equivalent percentage increase in their price reduces their consumption substantially. As a welfare measure of the loss of satisfaction to consumers depends on the reduction in the quantity of good consumed induced by the price rise, the tax on cigarettes will involve a lower loss of consumer satisfaction than a tax yielding equivalent revenue on restaurant meals.

<sup>35</sup> It is Ramsey's optimal tax, because the tax yield from any given ad valorem tax on cigarettes in inelastic demand will be greater than an equivalent tax on restaurant meals with an elastic demand. Because of their addiction smokers will find the tax on cigarettes inescapable, whilst consumers of restaurant meals being more easily able to reduce their consumption can escape the tax.

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the poor to be taken out of the tax net and imparts progressivity to the system. All taxes – corporate, personal income, and commodity taxes (eg. VAT) – are set at the same rate, amounting in effect to a consumption tax which abolishes any double taxation (such as that of dividends). The flat tax has the advantage of simplicity and transparency (which lead to greater tax compliance and increased tax revenues), faster economic growth (due to greater incentives to work) and the removal of disincentives and distortions in existing tax systems. The main costs in the short run could be a loss of revenue with the reduction in rates and the increased income tax threshold to help low earners. The UK Treasury in its uncensored version of the flat tax found support for many of these beneficial effects to the UK economy from a flat tax<sup>36</sup>.

The major advantage from a classical liberal viewpoint is that the flat tax prevents governments from carrying out politically inspired redistribution. But whereas the East European countries which adopted the flat tax were replacing defunct tax regimes, in developed countries mature tax systems are based on such a redistribution game over many generations. The likely losers would be the middle classes, the former beneficiaries who would resist the flat tax. So, even though a number of developed countries, including the UK, Germany, Spain Greece and Italy are considering a flat tax, it is unlikely to be of the pure form. According to George Osborne, the Shadow Chancellor and a British supporter, that also would probably be the case in the UK. If, however, a flat-tax could be implemented, it would, on account of its transparency and simplicity, make it more difficult for governments to increase predatory public expenditure. *All* taxpayers would know it implied a rise in the flat tax they would have to pay. This should aid the tax resistance of all the prey who can no longer be played off one against another by the predatory state.

The signs are that developed countries like the UK may adopt the classical liberal principles on tax and spending on account of the growing tax competition from the new economies of Asia and Eastern Europe. Many of the emerging economies are, because of their own economic reforms, low tax and spend economies. Based on classical liberal principles China has undertaken the largest unilateral trade liberalization since the UK's repeal of the Corn Laws in the 19th century. If they can resist the siren pressures for the European 'social model', they will increasingly provide a more congenial environment for footloose capital from around the world. As their per capita incomes rise and they attract home their 'best and the brightest', the US and UK will find it increasingly difficult to use the present 'brain drain' from Asia to reverse the damage done to their indigenous human capital formation by failed public education systems. Perhaps this will lead to the crisis of the welfare state which alone will persuade the median voter in these countries to abandon continuing *dirigisme* and adopt the classical liberal principles they still, at least rhetorically, espouse.

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<sup>36</sup> See [http://www.hm-treasury.gov.uk/media/CFA/92/foi\\_flattax010805.pdf](http://www.hm-treasury.gov.uk/media/CFA/92/foi_flattax010805.pdf)

## IV

### Brain Drain, Capital Flight and Public Service Collapse: The catalyst for change

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As the global economic picture changes, new and successful economies are poised to challenge the survival of older high tax and spending countries. Western politicians must therefore grapple anew with one of the oldest economic problems: How can lower taxes and better public services become the natural order? How can the State, by nature predatory and with monopoly power of coercion, be forced only to extract what is needed for the basic classical public goods - defense, law and order – financing merit goods (for those unable to afford them) and alleviating destitution? Today the problem has come full circle, as the concept of ‘freedom’ which provided a basis for controlling the predator, is used to justify the predatory state.

Whereas the classical liberals recommended laissez-faire as the best way of tying down the state, their socialist successors promoted the dogma of state enterprise, central control and dirigisme. Even after socialism’s demise, the dirigisme – the way in which the State fulfills its inherently predatory instincts – was not reversed. Rather the socialist impulse found a new voice advocating a ‘new dirigisme’. It appropriated the (classical liberal) ideal of freedom and championed predatory dirigiste policies in the name of ‘positive’ freedom. New Labour’s legacy is a burgeoning nanny state based on moral and social paternalism, and an intricate web of stealth taxes which has considerably raised the State’s ‘take’ to finance unreformed public services. The upshot is that in the UK today, New Labour and the Opposition parties all seem to want to imitate Sweden’s tax and spend policies. But just as Sweden has slipped in the growth league because of its over-extended welfare state, the UK’s current economic boom – largely due to the Thatcher reforms – may also be stifled by this new dirigisme.

What then does the future hold? How can the UK ensure economic prosperity with a fiercely competitive global market? At a theoretical level, the new dirigisme (in the name of ‘positive freedom’) can be curbed by distinguishing ‘freedom’ from ‘liberty’ as enshrined in the Common Law tradition. If economic as well as social policy is once again based on classical liberal principles it will serve the interests of the prey who want lower taxes and better public services. In particular the UK must address two developments.

First, the growing economic competition from the emerging economies of Asia and Europe with its potentially serious implications for the UK’s economic future, must be understood and met. These new and successful economies have relatively low spending and tax, where as the UK’s by contrast is high. As a result these new economies may attract both footloose capital and (given time) their bright and able nationals who currently work abroad. That would lead to the flight of much needed capital for investment from the UK and it would reverse the brain drain, now seen as helping to sustain an increasingly unsustainable dirigiste economy in the UK. So the UK must change course if it is to maintain its prosperity.

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Second the ever increasing appetite by the state for funds to feed un-reformable public health and educational systems could lead to a crisis. Just as in the 1970s nationalized industries eventually compelled reform, so now these nationalized public services may do likewise. When that happens, the – classical liberal – principles which have already shaped reform, that of tax and spending reform and that of moribund industries, may once again provide the solution to the crisis. The state must then denationalize and allow the winds of competition and freedom to blow.

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If the UK is to prosper in today's global economy, it must change. The problem, Deepak Lal suggests, is two fold. The state by nature is predatory and politicians have a vested interest in keeping voters on the public payroll. At the same time public services are inefficient and fail to reach the standards expected, and paid for, by taxpayers. But the predatory state must change; otherwise its taxpaying victims will flee with their money and invest elsewhere. If the UK is to survive, classical liberal thinking must govern the economy. Tax and public spending levels must be curbed. The winds of competition which blew through nationalized industries in the 1980s, must now create the same beneficial changes in the public services.