

Consumption Tax, Liberty, and Democracy: Financing the Minimalist State

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Classical liberalism allowed for a minimalist state, one limited to maintaining an environment where liberty thrives (Narveson 2009). However, the role of the state has grown in the last 200 years as it took on more redistributive functions (Jasay 1998). For classical liberals, democracy was considered to be the most complementary form of government for capitalism (Hayek 1960). Unfortunately, it also has the ability to provide for unlimited government (Hayek 1960, 116). Democracy is based on the rule of the majority and the majority will be inclined naturally to use the political process to attain what they cannot or have not attained through the economic process (Jasay 1998, 188). Income tax has become the predominant means used by the state to finance its agenda. Because income tax rates can be increased as the state takes on more redistributive functions, it is the perfect tool for a democratically-elected government to carry out the desires of the electorate for more state services. For the libertarian who would tolerate a minimalist state, the need is to find an alternative revenue source to income tax. It is proposed that consumption tax be reconsidered as the alternative. It has the potential to finance the state in its role of defending liberty, while keeping its growth in check.

The Terms of the Debate

For purposes of this discussion, democracy is defined as rule by the people following the majority principle. The majority must maintain adherence to the rule of law and the equal status of all individuals before the law. There must be freedom to discuss, dissent, challenge and exchange information, which in turn provides for a free exchange of goods and services. Ideally, these provisions of freedom must be protected in a constitution. This definition does not assume democracy is limited to the political sphere but recognizes its significant application to economic activity.

Liberty is economic freedom, something not possible without the rule of law. The role of the state is to ensure the rule of law is adhered to. Upholding agreements, promises and commitments is implied when there is adherence to the rule of law (Narveson 2009, viii).

Consumption tax is a broad term that has a number of manifestations. This paper will use a retail sales tax (RST) applied at all points of transaction, including business-to-business and business-to-retail, as the working example of a consumption tax.

Starting with these definitions, the task here is to demonstrate how consumption tax - particularly RST - meets various libertarian and democratic conditions better than income tax.

The Libertarian Position on Taxation

Minimalist state libertarians have said little about alternatives to income tax for financing the state. Each of Hayek's major works offers some insight into the discussion of liberty, democracy, taxation and their interrelatedness. He observed that successful democracies manage to restrain the abuse of majority rule by placing other values in a constitution (Nishiyama and Leube 1984). Machan (2010) specified that the right to life, liberty and the pursuit of happiness are inalienable rights that provide the basis for liberty. Their inclusion in a constitution seemingly provide a check for societies that value liberty and small government. Machan went a step further than Hayek by recognizing the need to constitutionally restrain the resources of the state, noting the U.S constitution was flawed by entrenching both liberty and the right of the government to taxation, particularly income tax. Hayek (1960, 1988, 1994) and Jasay (1998) talked about democracy as seemingly complementary to a liberal economy, but also having the propensity to erode liberty by facilitating redistribution of wealth. Machan (2010) was well aware of this paradox of democracy, that it can complement liberty but also erode it by facilitating the redistribution of wealth. He also recognized that the fault is not in democracy but in the decision to entrench in a constitution the right of government to tax income. A burgeoning state results when the majority is able to sanction an increase in government services, coupled with the power to tax income. The people unwittingly give the government more than they would do so consensually (Nishiyama and Leube 1984, 403-4). The myriad types of tax which are imposed at all levels of government support this claim, as well as the complicated nature of tax codes in most jurisdictions. In Canada, The Income War Tax Act of 1917 was 11 pages long; today's

Income Tax Act is over 2800 pages long (Clark 2013, 213). Hayek (1960) wrote specifically about how progressive taxation robs from the successful. He did not venture into what would be a better form of taxation.

Consumption Tax as the Solution

The imposition of a consumption tax in lieu of income tax would check the inevitable growth of the state. As individual income grows, a growth in tax revenues does not necessarily follow in a consumption tax regime. Individuals may choose to save rather than consume more. The state still has the ability to raise the consumption tax rate. The difference is that the choice to actually pay higher taxes by continuing to purchase non-essential goods is now in the hands of the consumer. If the increased rate of consumption tax is deemed to be excessive, or for purposes that the taxpayer does not agree with, they have the choice of curtailing consumption until a future date, particularly for items which are not essential. By doing so they rob the state of the increased revenue it sought through the tax increase. The consumer can exercise control over the otherwise unlimited taxing authority of the state and the majority it represents. In the sense that democracy is control by the people, the people in their role as consumers can exercise immediate and effective control over the state. It can happen without recourse to violence. At the same time, the state is unable to use its monopoly over coercion to enforce the tax increase. It cannot force people to spend their money. In contrast, in the income tax regime, it has the potential to garnish wages and seize assets to ensure its revenue demands are met.

The public exchange argument clarifies the differences in two relationships: that of the taxpayer and the state, and that of two traders in a regular market. With corporations, you may take or leave their offers, whereas, as Higgs (1997, 325) noted, the government can use force against you if you resist entering into its deal. The impact of this dynamic, which characterizes an income tax regime, is lessened in a consumption tax regime. In the latter, the consumer has the choice to withhold purchases or seek substitutes, denying the state its revenue without violating any law. Control passes from the state to individuals.

Central to the libertarian disdain for taxation is the concept of self-ownership (Feser 2000, 225). Feser refers to the eyeball anecdote to explain how the self-ownership concept works (226). If everyone is forced to give up an eyeball so that those without sight might be able to see, it would be considered morally repugnant. However, there is nothing immoral about volunteering to do it. In the same vein, it is morally repugnant to force someone to pay taxes. In a consumption tax regime, consumers can respond to increases in the tax rate by consuming less. The self-ownership concept of libertarianism is less threatened in the consumption tax regime than it is in an income tax regime.

In an income tax regime, it might be argued that individuals can deny the government tax revenue by earning less. However, this also means the individual has less property for his own enjoyment. In a consumption tax regime, the property is earned and retained in the form of cash or investments. Control reverts to the individual as to whether he uses this property to buy goods

or services. Many consumers opting to defer purchases could force an immediate reversal of high taxes, or at least deny the government an increase in revenue. Even without the assistance of others, an individual could choose to do this by consuming less, deferring spending on non-essentials entirely, or opting to buy second-hand goods that are not subject to consumption tax. They could exercise discretion and decision-making, as is the expectation in a praxeological view of the world.

The politicized democracy as practiced in most liberal democracies has problems. Minorities, and occasionally majorities, are often disenfranchised between elections. The shortcomings of democratic institutions in the first-past-the-post electoral systems are particularly notorious in this regard. Parties may win majority governments after having received much less than half of the popular vote.

In the current version of legislative democracy practiced by most Western nations, the majority can use the political system to get what the economic system does not allow for (Jasay 1998, 188). If the state serves to provide people with what they want, it must have resources to do so. If the state were restricted to using RST it would have to raise this tax to provide the expanded revenue necessary to satisfy the wishes of the electorate. In turn, prices would rise consistent with the increase in RST. Voters could not elect a party that promised to redistribute wealth in the interests of the majority, then sit back and let it happen with no repercussion to their own wealth. This would be possible in an income tax environment where the tax burden could be more heavily shifted to those with wealth. Instead, in a universally-applied RST environment, all voters would have to back up their votes with their wallets. The state can only provide services to the extent that people are willing to consume beyond a necessary threshold of goods and services. The ability of government to provide increasing services would no longer be possible based on the ability of the majority to take from the wealth of one group to satisfy the wants of another. Democracy as practiced at the electoral polls and in the market would be linked, with the latter determining what actually transpires in terms of government spending. Both the political process and the market involve one individual and one vote. The difference is that in the market individual consumers can exercise their vote as frequently or infrequently as they desire and have it count.

Mises recognized the ability of the market rather than politics to serve as the ultimate platform for democracy. He compared the market to a democracy by noting that each successful businessman was successful because of a market plebiscite that had been decided in his favor (Long 2008, 138). A product or service was deemed useful when enough consumers purchased it to make its production profitable. At the same time, those who did not purchase were not without a voice. They could choose a substitute product or not purchase at all. Consumers were not forced to buy, nor were rivals kept from entering the market to compete at any time. Using arguments constructed by Mises and others, the case can be made for the market rather than politics to serve as the forum for democracy (Long 2008, 138). Democracy is enhanced when individuals have a continuous ability to exercise a vote, this time with their pocketbook rather than their ballot.

In its simplest form, democracy means rule by the people (Birch 2007, 109). In their distrust of direct democracy, the drafters of the U.S. constitution institutionalized representative government (112). Democracy became representative and politicized rather than direct. It need not be. Diamond (2003) observed that liberty was protected by limited government and the rule of law long before the modern versions of representative government were in vogue. In the same way that a large state is not necessary for liberty, neither is the presence of democracy dependent solely on political institutions. Economic activity in a free market provides for direct democracy outside of politics. Liberalism depends on a coexistence of freedom in both economic and political venues, a trait that was noted by Mises (1963). He also noted the need for government to be restricted if the freedom equation between economics and politics was to work. Government would ensure the rule of law, the key ingredient for liberty (281). Popper (1966, 329) shared this view that government must be present to protect freedom, but should be given no more power than necessary to fulfill this basic function.

Conclusion

Liberty and democracy are compatible, but characteristics of democracy, particularly the premise of majority rule, can harm liberty by allowing the state to take on a greater role than the administration of justice. Income tax is an accessory to democracy in providing the means for the growth of the redistributive functions of the state. The substitution of a RST for income tax can change this dynamic significantly.

Hayek was well aware of the fact that liberty was derailed by the growth of the state and the interventionist policies that accompanied it. Rather than give in and admit defeat, he advocated assessing the causes for the derailment and trying again to establish a truly liberal economic and political order (Hayek 1994). To get back on track requires keeping a policy of freedom for individuals as the only guiding philosophy for any decisions that are made for change (262). The Friedmans recognized the intimate connection between politics and economics. In their estimation, the market allows for unanimity without conformity, a system of effective proportional representation (Friedman and Friedman 1962, 23). Capitalism and democracy were once deemed complementary, but liberalism has been eroded over time by the match. Substituting consumption tax as the means of financing the state can unite economics and politics once again in their promotion of liberty.

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