1 The Political Economy of Public Finance since the 1970s: Questioning the Leviathan

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> When government takes on an independent life of its own, when Leviathan lives and breathes, a whole set of additional control issues comes into being … Institutions evolve, but those that survive and prosper need not be those which are 'best', as evaluated by the men who live under them … General escape may be possible only through genuine revolution in constitutional structure, through generalized rewriting of social contract. To expect such a revolution to take place may seem visionary.
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> (James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan*, Chicago: University of Chicago Press, 1975, pp. ix–x)

Thomas Hobbes' image of the state as Leviathan was shaped by his pessimistic view of humanity. Unhindered by strict regulation, people would resort to murdering each other – or at least that was the philosopher's impression after witnessing the turmoil of the English Civil War. Man is wolf to man and his survival is only possible under strong leadership, which was why Hobbes argued that the state is entitled to wield limitless power. Over the following centuries, Hobbes' notion of the state was subject to massive criticism from the great thinkers of the Enlightenment and liberal theoreticians. They championed the rights of the individual and accordingly endeavoured to limit the power of the state and distribute its authority among various institutions. Since then, Hobbes' Leviathan has rarely been seen in a positive light and has almost universally symbolised a threatening, all too powerful state. This has led to widespread criticism of Leviathan, particularly since the eighteenth century.[1] States that combined democracy and capitalism generally withstood such liberal criticism and, until the early twentieth century, were hardly seen as Leviathan. By contrast, it was primarily dictatorships that were perceived as Leviathan.

[1] Thomas Hobbes, *Leviathan or the Matter, Forme and Power of a Commonwealth Ecclesiastical and Civil* (first English edition, 1651); Quentin Skinner, *Hobbes and Republican Liberty* (Cambridge: Cambridge University Press, 2008), and *Die drei Körper des Staates* (Göttingen: Wallstein, 2012).

It was not until the late 1960s that broad and influential movements emerged which saw the democratic state also as Leviathan. One of the most radical proponents of this view was James M. Buchanan (1919–2013), Nobel laureate in economics (1986) and co-developer of the public choice approach of the Virginia School.[2] The introductory quotation to this chapter shows that the self-styled revolutionary proposed a radical change in the current state and its institutions. Buchanan dispelled the notion of selfless politicians and civil servants who were concerned only with the 'public interest'. In his view, politicians and bureaucrats wish to maximise tax revenues and spend more, whereas the electorate and taxpayers wish to minimise taxation. He warned that the democratic state had become increasingly powerful and was absorbing an increasing percentage of social resources, which he perceived as a deleterious influence on society. His assessment was based on a significant rise in tax and expenditure ratios in the wealthiest countries between 1900 and the late 1960s. Buchanan's main objective was to reduce tax revenues and government expenditure, particularly social spending. To achieve this, he urged greater tax competition, both between nation states and within federal states, limiting the power of the central state and reducing public spending by bolstering fiscal federalism so that competition between levels of jurisdiction would restrict Leviathan.[3]

Buchanan was by no means alone by the 1970s, and it was no longer only representatives of liberalism who were questioning how the democratic state was evolving. Indeed, criticism of the state was emerging on the radical left of the political spectrum. The democratic state now appeared less as a bulwark against the unruly forces of the market and more as an authoritarian state, the capitalists' sheriff, an information-devouring monster, a repressive socialisation machine. By now, a barrage of attacks had put the democratic Leviathan clearly on the defensive. Even among a number of European labour parties there was a growing sense that certain state interventions designed to allow people to make their own choices were engendering monolithic and bureaucratic systems that tended to limit personal freedom.[4]

[2] Although state intervention had been harshly rejected by earlier liberal economists, such as Friedrich Hayek, they rarely referred to the metaphor of the Leviathan.

[3] Geoffrey Brennan and James M. Buchanan, *The Power to Tax. Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980); and 'Towards a Tax Constitution for Leviathan', *Journal of Public Economics* 8/3 (1977), 255–73.

[4] For an overview of the range of criticism of the state, see Dominik Geppert and Jens Hacke (eds.), *Streit um den Staat. Intellektuelle Debatten in der Bundesrepublik 1960–1980* (Göttingen: Vandenhoek & Ruprecht, 2008); Daniel Rodgers, *Age of Fracture* (Cambridge, MA, and London: Harvard University Press, 2011), ch. 3. Important for the contemporary debate on a state crisis is Michel Crozier, Samuel P. Huntington and Joji Watanuki, *The Crisis of Democracy. Report on the Governability of Democracy to the Trilateral Commission* (New York: New York University Press, 1975).

In the United States in particular this criticism has continued to gain momentum in both conservative and liberal circles. Among Tea Party supporters it is no longer a matter of 'questioning Leviathan' but rather becoming a 'Leviathan slayer', a boast now found on websites associated with this political movement.[5] It is often no longer a question of pragmatically deciding which revenues should be used to finance particular expenditures. Instead, segments of the political spectrum now reject any increase in taxes or social spending, and the debate on public financing has been transformed into a highly charged dispute over fundamental principles.

After the Boom: The 1970s as a Starting Point

In most western European and North American countries, the 1960s was a period of grand dreams.[6] People looked to the future full of confidence that they would enjoy an era of boundless prosperity, where the capitalist economic system and the democratic state appeared to be a perfect match. Indeed, they seemed inseparable. Just as it seemed that the economic system would continuously improve thanks to planning and predictability, many felt that it was also possible to spur democracy on to ever greater heights. 'Let's dare more democracy', the acclaimed and popular slogan coined by Willy Brandt, post-war Germany's first Social Democratic chancellor, in 1969, was the most poignant expression of this sentiment, and was repeated in many Western countries at the time.[7]

However, these aspirations suffered a serious setback in 1973. That year's oil shock was triggered by a political crisis, but it quickly became an economic crisis when members of the Organization of Petroleum Exporting Countries (OPEC) voted to restrict the supply of oil, leading to drastic increases in the price of crude. Cheap oil had served as one of the main motors of the impressive growth rates in Western countries. Now, the petrol price increases severely exacerbated the incipient

[5] leviathanslayer.blogspot.de, last accessed 1 September, 2015.

[6] David R. Faber, *The Age of Great Dreams. America in the 1960s* (New York: Hill and Wang, 1994); Gabriele Metzler, 'Geborgenheit im gesicherten Fortschritt. Das Jahrzehnt von Planbarkeit und Machbarkeit', in Matthias Frese, Julia Paulus and Karl Teppe (eds.), *Demokratisierung und gesellschaftlicher Aufbruch. Die sechziger Jahre als Wendezeit der Bundesrepublik* (Paderborn: Schöningh, 2003), pp. 777–97. The main exception here was the United Kingdom, where matters were less optimistic amid a seemingly endless series of balance-of-payments crises and the progressive dismantling of the British Empire.

[7] Bernd Faulenbach, *Das sozialdemokratische Jahrzehnt. Von der Reformeuphorie zur Neuen Unübersichtlichkeit. Die SPD 1969–1982* (Bonn: Dietz, 2011), pp. 39–79.

economic crisis already felt in many Western countries.[8] Most leading Organisation for Economic Cooperation and Development (OECD) countries slipped into recession for the first time in years.[9] The rise in oil prices led to a dramatic increase in production costs for industry and also in the energy costs of private households, contributing to a fall in consumption outside the energy sector. In most Western countries the crisis consisted of high inflation rates, falling production, rising unemployment and balance-of-payments deficits. Most at the time hoped that this would be a brief reversal, but today we know that the first oil crisis marked the end of the boom and that over the following years the West would never again achieve the high growth rates of the 1950s and 1960s. In western Europe, growth in gross domestic product (GDP) per capita was 4.05 per cent from 1950 to 1973, but only 1.75 per cent from 1973 to 1997.[10] We also now know that this slowdown was more of a restoration of the norm, as the growth rates of the boom were unprecedented and many of the economic and institutional factors that had made the 'European miracle' possible – from technology transfers to working conditions and labour relations – began to peter out.[11] But for the actors in the early 1970s these had become the norm and they responded as if a return to growth could be expected and this new norm could be restored through state action.

[8] Karen R. Merrill, *The Oil Crisis of 1973–1974* (Boston, MA: Bedford Books, 2007); Mahmoud A. El-Gamal and Amy Myers Jaffe, *Oil, Dollars, Debt and Crises. The Global Curse of Black Gold* (Cambridge: Cambridge University Press, 2010); Jens Hohensee, *Der erste Ölpreisschock 1973–74: Die politischen und gesellschaftlichen Auswirkungen der arabischen Erdölpolitik auf die Bundesrepublik und Westeuropa* (Stuttgart: Steiner, 1996); Stefan Göbel, *Die Ölpreiskrisen der 1970er Jahre. Auswirkungen auf die Wirtschaft von Industriestaaten am Beispiel der Bundesrepublik Deutschland, der Vereinigten Staaten, Japan, Großbritanniens und Frankreichs* (Berlin: Logos, 2013).

[9] In some countries the economic slowdown began before the oil shock. And there is no doubt that the factors that fuelled the crisis were far more complex than merely a hike in the price of oil. In fact, the oil crisis also gave rise to an acute awareness of an economic crisis in the world's leading industrialised nations.

[10] Angus Maddison, *Economic Progress: The Last Half Century in Historical Perspective*, 1999, table 3a, at www.ggdc.net/MADDISON/ARTICLES/madpaper.pdf. See also Niall Ferguson, 'Introduction: Crisis, What Crisis? The 1970s and the Shock of the Global', in Niall Ferguson, Charles Maier, Erez Manela and Daniel J. Sargent (eds.), *The Shock of the Global. The 1970s in Perspective* (Cambridge, MA, and London: Harvard University Press, 2010), p. 9.

[11] Nicholas Crafts and Gianni Toniolo, 'Postwar Growth: An Overview', in Nicholas Crafts and Gianni Toniolo (eds.), *Economic Growth in Europe since 1945* (Cambridge: Cambridge University Press, 1996), pp. 1–37; Barry Eichengreen, *The European Economy since 1945: Coordinated Capitalism and Beyond* (Princeton, NJ: Princeton University Press, 2007), chs. 7 and 9. See also Werner Plumpe, *Wirtschaftskrisen. Geschichte und Gegenwart* (Munich: Beck, 2010), p. 99.

The end of the Bretton Woods system constituted another major challenge, albeit one that was paid far less attention at the time, although its long-term impact was just as significant. On 15 August 1971, President Richard Nixon suspended the convertibility of the US dollar into gold, and the subsequent attempts to return to a system of pegged exchange rates failed, leading to a new exchange rate system.[12] When they met on 11–14 March 1973, representatives of the countries of the European Community agreed to abandon the system of fixed foreign exchange rates and let their currencies float. This spelled the end of the worldwide currency exchange system of the boom era. The Bretton Woods regime was based on a desire to stabilise exchange rates and at the same time allow individual countries to pursue an active domestic monetary policy. These two aims could be reconciled only by limiting the movement of capital in response to different interest rates, which would otherwise put pressure on the fixed exchange rate – the so-called trilemma or 'impossible trinity'. This trade-off came under pressure from the growing freedom of capital movement after the currencies became convertible in 1958, the emergence of the Eurodollar market and the relaxing of capital controls in the 1970s. These changes gave rise to tensions within the Bretton Woods system and, alongside the failure to clear trade imbalances, contributed to its demise. As a result, the central banks now gained a considerable degree of autonomy and influence. At the same time, the greater scope for movement of capital between countries constrained independence in taxation policy, for if a country adopted policies that were too redistributive or costly for the markets to tolerate, it would be punished by capital flight.[13] The inflow of oil money from the OPEC countries and the rise of the Eurodollar market laid the foundations for the modern system of finance capitalism. The rise of the Eurodollar market also expanded the possibilities of evading taxation and contributed to the growth of tax havens.[14] Furthermore, the new phenomenon of stagflation – economic stagnation despite high inflation rates – gave renewed strength and

[12] Francis J. Gavin, *Gold, Dollars, and Power. The Politics of International Monetary Relations, 1958–1971* (Chapel Hill, NC: University Press of North Carolina, 2004).

[13] Harold James, *International Monetary Cooperation since Bretton Woods* (New York and Oxford: Oxford University Press, 1996); Barry Eichengreen, *Globalizing Capital. A History of the International Monetary System* (Princeton, NJ: Princeton University Press, 1996).

[14] See this volume, Chapter 6; Gabriel Zucman, *The Hidden Wealth of Nations. The Scourge of Tax Havens* (Chicago: University of Chicago Press, 2015); Ronen Palan, *The Offshore World. Sovereign Markets, Virtual Places, and Nomad Millionaires* (Ithaca, NY: Cornell University Press, 2003).

persuasiveness to (neo-)liberal criticism of Keynesian government policies.[15]

Due to lower growth rates, increases in tax revenue were negligible compared with the boom period. With expenditures continuing to grow at the same rate in nearly all areas, governments increasingly relied on borrowing to meet their financial obligations. This was helped by a refloating of oil money in the Western banking systems, especially the Eurodollar markets, which made credit very cheap in the mid-1970s. The formerly low level of government debt in the wealthy OECD countries steadily rose – and rose even more in many developing countries – and inflation rates reached levels not seen in decades.[16] All hopes of a return to rapid growth ended abruptly with the second oil crisis in 1979. This sparked loud demands in political circles for a reform of state finances.[17]

This is the story that can be told, with some national variation, for western Europe, North America and Japan. But for southern Europe, the story was different. In Spain, Portugal and Greece the 1960s was dominated by dictatorships that did not foster high expectations among the majority of the population. All three countries participated in the high growth rates of western Europe, but on average at a much lower level. Their tax rates were low and the welfare state was in its infancy. In contrast, the 1970s in these countries became an era of high expectations with the overthrow of the dictatorships and the introduction of democracy. All three countries were now governed by more or less social democratic parties, which led to greater expectations among the population. Their aim was to raise their countries to western European standards within a short period, but they faced doing so while western Europe was in the midst of an economic crisis.

How Politics Discovered Public Finances

James Buchanan's and others' criticism of the state as a rapacious and dangerous Leviathan was, of course, intensely political. To use their

[15] Charles Maier, '"Malaise". The Crisis of Capitalism in the 1970s', in Ferguson, Marer, Manda and Sargent (eds.), *The Shock of the Global*, pp. 27–32; Michael Bruno and Jeffrey D. Sachs, *Economics of Worldwide Stagflation* (Cambridge, MA: Harvard University Press 1995); Alan S. Blinder, *Economic Policy and the Great Stagflation* (New York: Academic Press, 1979).

[16] Wolfgang Streeck, *Buying Time. The Delayed Crisis of Democratic Capitalism* (London and New York: Verso, 2014).

[17] Göbel, *Ölpreiskrisen*; Frank Bösch, 'Umbrüche in die Gegenwart. Globale Ereignisse und Krisenreaktionen um 1979', *Zeithistorische Forschungen*, 9/1 (2012), 8–32.

own analytical categories, what they were proposing amounted to a shift in the fiscal constitution and thus differed from the more limited debates of the 1950s and 1960s. Any constitutional change is deeply contentious until the codes and rules of the new parameters are accepted as 'natural' and self-evident. The 1970s and 1980s were therefore characterised by deep political and ideological divisions as the new constitution took shape, on a par with the debates of the early twentieth century that led to the acceptance of a progressive and redistributive income tax, and to a related shift from market or charitable to collective, public provision. As a result, a more technical approach to taxation and public finance, with relatively low public engagement, gave way to a much more ideological and public debate as the critics of Leviathan moved from the periphery to the centre of politics. Fundamental assumptions about politics, society and economics were at stake.

Criticism of this nature had been voiced in some quarters in the 1950s and 1960s, but was marginal and had no clear sense of where it might lead. One example was the Union de Defense Commercants et Artisans (UDCA), founded in 1953 by the French right-wing politician Pierre Poujade. This was an anti-tax party, mobilising small shopkeepers, artisans and peasants against the government. However, the Poujade movement collapsed after the election of Charles de Gaulle and the establishment of the Fifth Republic in 1958.[18] In the United States, tax protest also mounted with the People's Initiative to Limit Property Taxation, which succeeded in enacting an amendment of the Constitution of California in 1978 to limit property tax to 1 per cent of the assessed value of real estate. Proposition 13 triggered a series of similar initiatives in other US states. The taxpayer revolt at the local and state levels had a strong impact on the presidential campaign and led to the election of the Republican candidate, Ronald Reagan, in 1980.[19] By 1985, Reagan could portray himself as a tax rebel in a long and honourable American tradition going back to the Boston Tea Party of 1773. As he expressed it in colonial Williamsburg, 'The tax system has earned a rebellion – and it is time we rebelled.' It was a clever piece of rhetoric, placing the President alongside the people against Leviathan. It was, of course, a partial account of American history, which was in reality in continuous tension between two approaches. On the one hand, taxation was theft, an attack on states' rights and family

[18] Stanley Hoffmann, *Le Mouvement Poujade* (Paris: Armand Colin, 1956). For a new tax resistance movement in the 1970s in France, see Alexis Spire, 'The Spread of Tax Resistance: The Antitax Movement in France in the 1970s', *Journal of Policy History* 25/3 (2013), 444–60.

[19] See this volume, Chapters 3 and 5.

responsibilities. Low taxes would lead to incentives and prosperity. On the other hand, taxation would rein in the power of big business, protect opportunities by constraining rent-seeking behaviour and create social solidarity. The progressive agenda sometimes was to the fore, as it was under President Franklin Roosevelt; at other times, hostility to taxation was in the ascendant.[20] Why did the second approach dominate in the 1970s and 1980s, moving from the periphery to the centre of debate? The shift occurred not only in the United States, for taxation lost its legitimacy to a greater or lesser extent in many OECD countries. There was a decline in acceptance that income and wealth were generated by society as whole, and a growing belief that income and wealth belonged to the individual, with anything taken by the state seen as expropriation. Political support for taxation weakened and was linked to a shift from direct to indirect taxes, from taxation to borrowing, from a tax state to a debt state.

Public choice theory offers one way to explain the change, in terms of the self-interest of voters seeking to maximise their utility and deciding whether paying taxes for the collective provision of public services was beneficial. There are two ways of explaining the change in their perception of the costs and benefits of taxation. The first is to look at the relationship between the franchise and taxation. Between 1945 and around 1970 most voters fell below the income tax threshold, and certainly below the higher-rate threshold. Thus they were likely to benefit from public spending without contributing to it, and so would vote for it. As wages rose and tax thresholds did not increase in line with inflation, more voters began to pay tax or were liable at a higher-rate – indeed, they could experience a very high marginal rate by losing benefits and coming into the purview of direct taxes. The politics of direct taxation had changed: after the war, the median voter earned a modest income, falling below the threshold for income tax. This gave rise to strong electoral support for direct taxation. However, by the 1970s the median voter was paying income tax at a high rate and this eroded support for direct taxation.

A second way of looking at the changing assumptions of taxpayers and the electorate is to consider the relationship between the incidence of taxation and the receipt of benefits. In some countries, such as Britain, social benefits were funded by direct taxes largely paid by

[20] Romain D. Huret, *American Tax Resisters* (Cambridge, MA: Harvard University Press, 2014); Isaac William Martin, *Rich People's Movements. Grassroots Campaigns to Untax the One Percent* (Oxford: Oxford University Press, 2013). For a comparative approach, see 'Tax Resistance: A Global History?', special issue of the *Journal of Policy History* 25/3 (2013), eds. Romain D. Huret and Nicolas Delalande.

middle-class voters. Initially, the middle class might have felt that they were getting a reasonable deal, for they might disproportionately benefit from greater access to healthcare and secondary and higher education; and at a time of high employment, there was less concern that benefits were being used to support the 'undeserving' poor. A public choice analysis might suggest that the attitude of middle-class taxpayers would change by the 1970s. The somewhat generalised pattern of welfare provision after the war seemed more attractive at the time, but rising incomes and advances in healthcare created a demand for more individualised and targeted provision. Pressure for increased social spending would lead to higher income taxes and a resentment of 'scroungers'. According to Avner Offer, affluence led to myopic choice rather than rational choice: a search for instant gratification and a loss of self-control.[21] There is a more general point that greater disposable income and paying higher taxes for a basic level of provision seemed less attractive to a generation with different assumptions about consumer choice created in the decades of affluence in the 1950s and 1960s. Why not opt out of the state system and purchase what they wanted? By contrast, in some countries direct taxes were much less important and the costs tended to fall on consumption: thus whereas in the United Kingdom consumption taxes comprised 27.6 per cent of total taxation in 1970, they accounted for 50.5 per cent in Ireland, 38.3 per cent in Italy and 36.5 per cent in France.[22] This different tax structure modified the assumptions of the electorate, for the middle class was less inclined to pay high-income tax rates to fund benefits for less well-off members of society. Could it be that a less progressive tax regime mitigated the hostility of voters with incomes above the median to providing redistributive welfare benefits? Marc Buggeln highlights some of the dynamics created by these different tax regimes. In Britain, high levels of taxation of average incomes created demands for tax reform, leading to a shift to consumption taxes after 1979. However, he also shows that in France, the Socialist government of President François Mitterrand moved in the opposite direction, reversing the trend towards higher sales taxes and introducing a 'solidarity tax' in 1981, which required the wealthy to

[21] Avner Offer, *The Challenge of Affluence: Self-Control and Well-Being in the United States and Britain since 1950* (Oxford: Oxford University Press, 2006). For a comparison between the United States and Japan, see Sheldon Garon, *Beyond Our Means: Why America Spends While the World Saves* (Princeton, NJ: Princeton University Press, 2012).

[22] Eurostat (ed.), *Structures of the Taxation Systems in the European Union 1970–1997* (Luxembourg: Office for Official Publications of the European Communities, 2000), p. 148.

fund employment and welfare benefits. The electoral response of voters and the calculations of politicians were shaped by the incidence of taxation and the receipt of benefits at different income levels.[23]

Of course, these arguments are open to the criticism that they incorporate the assumptions of the critics of Leviathan: individual utility-maximising voters or taxpayers decide what is in their own interests. Although there is some merit in the public choice approach, it does not tell the whole story. Society is not made up of individuals, but of groups, and their identity is shaped not only by the prevailing material conditions, but also by language and rhetoric. We need to ask what was considered to be fair, just and equitable, and one of the major changes from the 1970s was precisely the sense that any assessment rested with the individual. In his analysis of American society, Dan Rodgers has termed this the 'age of fracture' – a movement away from concepts of national consensus, managed markets and citizen responsibility to a more fluid sense of gender and racial identities, narrower definitions of collective responsibility and the replacement of solidarity in terms of class or race by fluid, multiple identities. Keynesian macroeconomics was overtaken by flexible, instantly acting markets and by the individual interest of public choice theory. As Rodgers puts it, solidarity and collective institutions gave way to a more individualised sense of human nature based on choice, agency, performance and desire. 'Strong metaphors of society were supplanted by weaker ones. Imagined collectivities shrank; notions of structure and power thinned out.' He argues that social assumptions shifted through a 'contagion of metaphors', as central features of game theory such as the prisoners' dilemma and free riders moved from economics departments into law and the social sciences, and out into the wider public discourse. The notion of 'choice' was employed more frequently and became an inherent claim on both the progressive left – for example, a woman's right to abortion – and the conservative right – the freedom to choose how to spend one's own money. Both used the rhetoric of choice, though for different ends.[24]

Historians have grappled with the reasons for this change. In broad terms, it is often said that it amounts to a rise of neo-liberal ideas which

[23] See this volume, Chapter 5.

[24] Rodgers, *Age of Fracture*, pp. 3–12. See also Pierre Rosanvallon, *The Society of Equals* (Cambridge, MA, and London: Harvard University Press, 2013), ch. 4; Edward D. Berkowitz, *Something Happened. A Political and Cultural Overview of the Seventies* (New York: Columbia University Press, 2005); Bruce J. Schulman, *The Seventies. The Great Shift in American Culture, Society, and Politics* (New York: The Free Press, 2001); Konrad H. Jarausch (ed.), *Das Ende der Zuversicht? Die siebziger Jahre als Geschichte* (Göttingen: Vandenhoeck & Ruprecht, 2008).