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Coercion, Welfare, and the Study of Public Finance

Jorge Martinez-Vazquez and Stanley L. Winer

1. The Purpose and Outline of This Book

Social interaction necessarily requires limits on the freedom of individual choice. As soon as we are part of a group, different voices must be heard and compromises must be made. Major questions will inevitably arise about whether some people have more to say than others do when acceptable limits to individual actions are specified, how such limits or rights are to be defined and circumscribed, and how they will be enforced once agreement on their nature is achieved.

Coercion is an essential part of this process. Although voluntary agreement may underlie some of the compromises achieved, coercion is a part of all widely used collective decision mechanisms. Coercion will also be involved in the enforcement of group decisions after they are made, to deal with free rider problems and other types of strategic behavior by individuals or groups who attempt to take advantage of their fellow citizens.

Coercion is therefore a fundamental and unavoidable part of our social lives. For this reason, it is not surprising that philosophers and legal experts have examined its nature at length. Economists, however, have not yet offered a fully integrated analysis of its role in either the private or the public economy. Contemporary economic analysis of the public sector usually does not deal with coercion in a direct or formal manner, although a concern with it often lies below the surface, especially when contentious issues such as taxation are involved. The essays in this book are different. Because collective choices on fiscal matters emerge from and have all the essential characteristics of social interaction, including the necessity of coercion, and because there is an older tradition of work on coercion in public finance (introduced later) that we can build on, the essays presented here focus directly on the study of coercion arising through the operation of the fiscal system.

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The initial questions that were put to the contributors to this volume on coercion in public finance are challenging: How does the coercive power of the state evolve, and what are the implications of this history for the structure of public finances? How can we understand the meaning and role of coercion in contemporary societies? Can we measure it? What is its role in modern public-sector economics, which is, after all, concerned with figuring out how governments should interfere with our private and social lives? How does a concern with coercion in public finance conflict with, or mesh with, welfarist objectives? And what are the important issues and problems that may guide contemporary research?

Detailed answers, and more questions, are found in the individual contributions by the group of thoughtful authors and discussants we have brought together here. In this introductory chapter we hope to convince the reader that a deeper understanding of coercion in fiscal affairs is important for the study of the public economy and of public policy generally. We shall also explain the structure of the book and briefly outline what the reader can expect from each contribution.

Our enterprise is both old and new. A concern with coercion was central to an older tradition in public finance that was initiated by Knut Wicksell (1896) and Eric Lindahl (1919), and which is an important part of the equally celebrated work of James Buchanan and Gordon Tullock (1962). We shall have more to say about this tradition shortly. For the moment, however, we shall point out that with the exception of one special type of work that originates with Lindahl, and which is well represented in this book, *explicit* concern with, and analysis of, coercion is not reflected in the mainstream of contemporary research on the public economy. Contemporary public economics is a field that is primarily guided by a social planning approach to welfare analysis, in which a benevolent planner is allowed to coerce anyone to any extent, for example, by taking from the rich to give to the poor, as long as aggregate social well-being is increased.

Two specific and basic sources of coercion in public finance are at play in the essays in this volume. Coercion in public finance arises (1) as a result of external control by the state over one's life and that of the country exercised through threats of violence or sanctions; and (2) as a by-product of the compromises that all citizens must agree to in a democratic society as part of the process by which collective decisions are made. These two situations, while conceptually different, are related, and the issues of how a society progresses from the first to the second, as well as their coexistence, also arise.

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The first source of coercion – external control by the state – is closely connected to what has become one of the most influential theories of the state. In Max Weber's (1919, p. 78) view, "a state is a human community that (successfully) claims the monopoly of the legitimate use of physical force within a given territory." How such a state evolves from anarchy to one in which state sanctions are severely constrained under an impersonal rule of law, and the nature of the public finances that arise at different stages of this development, are key issues in the first part of the book.

In market economies, coercion is pervasive in *private* contracts and can be productive. As Thomas Hobbes put it some time ago in *Leviathan* (1651, part II, chapter XVII): "Covenants, without the Sword, are but Words, and of no strength to secure a man at all." Oliver Williamson (1975) draws on this idea by observing that it is possible to think of most human interactions as undergoing a "fundamental transformation." Before a private contract is signed, there is no coercion in the negotiating process. Each party can exit without harm. After the contract is signed, however, exit from the agreement may be expensive, and failure to meet its terms may trigger punishment. So it is likely that the contract would never have been signed unless there was an *ex ante* expectation that *ex post* sanctions would be imposed. That is, both parties are inviting coercion voluntarily, as a means of making a credible commitment, and without this the contract would not be effective.

Coercion also arises naturally in the *public* life of liberal democracies. This brings us to the second source of coercion in public finance identified earlier – coercion that arises through the operation of a collective choice process. To fix ideas, consider a group of people who have come together in a room for a common purpose and who must collectively set the temperature on a thermostat and then pay for the resulting use of energy. Inevitably, some will be too hot and some too cold, and even those for whom the temperature is just right may be unhappy with the resulting balance between what they pay and what they get. Individual citizens can escape the situation if they move to another room or out of the building that represents the collectivity in this example. If they stay, however, they must cope with the coercion implied by their assent to the collective decision.

Coercion in this situation – that is, not getting what you *think you deserve* at the tax price you have to pay – cannot be avoided whatever collective choice procedure is employed in deciding on the public budget, as we implied earlier. Nor does anyone want to do so if on balance we value the goods and services made possible by collective action, provided (and here we mimic the logic of private contracts) that we can be sure that others will

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also be forced, if necessary, to carry through with *their* tax obligations.[1] On the other hand, it is our understanding that if coercion of the individual by the state or by special interests acting through the state becomes too great, unrest, emigration, and eventually failure of the state may occur.

The two sources of coercion introduced in the preceding discussion are just that – situations that lead to coercion, not measures of the degree of coercion itself. In the second part of the book, we shall see that it is not easy to come up with a practical definition or measure that incorporates the counterfactual, the state of relative freedom from coercion that any careful definition unavoidably must encompass. (What is the precise meaning of what we *think we deserve* in the definition of coercion suggested in the previous paragraph?) Still, we must do so if we want to proceed further, and this leads, as we find out here as well, to reappraisal of aspects of the foundations of welfare analysis.

In the third and longest part of the book, the task of actually doing public economics when coercion is an explicit part of the framework of analysis is tackled, first from the theoretical perspectives of mechanism design and optimal taxation, and then in the somewhat more applied contexts of the study of fiscal incidence and fiscal federalism. Finally in the fourth part of the book, experimental methods are used to investigate the collective action problem citizens face in organizing resistance to coercion, and to explore the productive role of coercion in organizing public life.

In addition, the reader will find short formal discussions of the essays at strategic points in the volume. These discussions are presented to help the reader gain a critical perspective on what has been said, while at the same time provoking a contest of ideas.

Before we introduce the individual contributions in greater detail, it will be both helpful and interesting to go further into the history of thought concerning the role of coercion in public finance.

2. Reflections on Coercion in the History of Public Finance

It is fair to say that the role of coercion in public finance was drawn to our attention by Wicksell in his book *Finanztheoretische Untersuchungen* (1896), part of which was published as the chapter titled “A New Principle of Just Taxation” in the Musgrave-Peacock (1958) collected readings of *Classics in the Theory of Public Finance.*

[1] One should note that such reciprocal coercion is also part of the foundation for one important view of what is, and why people obey the law. See, for example, Hart (1961).

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As we have noted, contemporary public economics remains a field largely guided by utilitarianism and social planning. The state in this approach stands outside the polity and the economy. The tradition initiated by Wicksell, in contrast, views public finance as the study of how people act collectively to achieve their various ends. In this view, as Richard Wagner reminds us, the state does not stand above the economy and its participants, and the fiscal system that emerges through the collective choice process may be, depending on the nature of governance in place, beneficial for a large majority or only for an elite (Wagner 1988, 1997).

Wicksell was especially concerned with the possibility that the fiscal system could be used to coercively redistribute from one group of citizens to another. Indeed, since spending and taxing decisions in the modern legislature are usually not coincident and the decision-making rule departs substantially from unanimity, this is more than a possibility: it is obviously politically tempting to deliver publicly financed benefits to favored groups at the expense of other taxpayers. It is a testimony to the importance of the issue to be able to say that it is one of the key problems addressed by contemporary political economy, which is focused to a considerable extent on the study of why such coercive redistribution happens and on the precise form it takes in various political systems.[2]

Wicksell recognized that the design and operation of fiscal systems is intimately bound up with the way in which they are determined, because fiscal policies are *always* the outcome of a collective choice process in a democratic society. He advocated the adoption of an approximate unanimity rule voting process to consider packages that combined public expenditures with the taxes required to finance them as a way of making decisions about the public finances that he thought would achieve both economic efficiency *and* the absence of coercion. Wicksell's purpose, as James Buchanan (1967, 1986) emphasizes, was to insure that as far as possible, government actions embodied a quid pro quo process of exchange among citizens that was mutually beneficial.[3]

[2] This sort of redistribution is often referred to as rent seeking. See Congleton, Hillman and Konrad (2008) for a comprehensive collection of work on this topic.

[3] We are reminded of this important aspect of the Wicksellian perspective and of Buchanan's discussion of it by Mueller (2003, 5). Readers interested in further reading about the role of coercion on public finance, in addition to what is provided in this Introduction and in the volume as a whole, may wish to look at the work of Buchanan and Tullock cited earlier, as well as later work by Johansen (1963), Buchanan (1968, 1975), Head (1974), and Breton (1996). For textbook discussions, see Mueller (2003, chapters 1 and 4) and Besley (2006, Chapter 2)

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Avoiding coercion while pursuing efficiency by seeking a broad consensus about both spending and the taxes required to support that spending before action is taken was, for Wicksell, a valued end in itself. In later work, for example by Lindahl (1919) and Buchanan (1959), this was also seen as a way of uncovering what people actually want in public-goods situations where market prices that guide an invisible-hand process toward an efficient allocation do not exist.

No doubt on purpose, Wicksell swept many of the difficult issues raised by using coercion as a criterion with which to judge fiscal systems. In particular, he knowingly left aside the problem of injustice in the initial distribution of income, dealing with which may require coercive redistribution from rich to poor, and the problem of how we control a (Weberian) state that has a monopoly on violence while still ensuring that the state has sufficient power to tax.[4]

He must have been aware of the many issues involved in dealing with coercion more deeply, as it has long been an important subject in philosophy. To take one famous example, Jean-Jacques Rousseau, perhaps the most important theorist of the social contract, offered an analysis of coercion more than 130 years before Wicksell's work. In his *Social Contract* (Book IV, 1762) he states in a passage worth quoting at some length:

> When the state is instituted, residence constitutes consent; to dwell within its territory is to submit to the Sovereign. Apart from this primitive contract, the vote of the majority always binds all the rest. This follows from the contract itself. But it is asked how a man can be both free and forced to conform to wills that are not his own. How are the opponents at once free and subject to laws they have not agreed to? I report that the question is wrongly put. The citizen gives his consent to all the laws, including those which are passed in spite of his opposition, and even those which punish him when he dares to break any of them.

Similar reasoning has found its way into thinking about the public sector, though not generally in the public finance literature. For a recent example, we can read William Baumol (2006, 613), who echoes Rousseau in stating

[4] As to the first issue, Wicksell notes (Musgrave and Peacock 1958, 108) that "it is clear that justice in taxation tacitly presupposes justice in the existing distribution of property and income." As Besley (2006, 53) points out, he then goes on to say that society may revise the existing property structure if it is in contradiction to modern concepts of law and equity, although how this was to be done was not then discussed. We are not aware of how he thought about the second issue of controlling the state. For a recent discussion of why the twin issues of controlling state power while still ensuring sufficient power to tax are important, see, for example, Levi's Presidential Address to the American Political Science Association, "Why We Need a New Theory of Government" (2006, 5–19).

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that "the essential feature that defines a democratic government is voluntary agreement by the members of the public to subject themselves to its coercion."

About twenty-five years after Wicksell's seminal contribution, his student Eric Lindahl (1919) presented a dissertation in which he attempted to find a positive solution, or mechanism, to implement the Wicksellian ideal.[5] Lindahl's contribution appeared during the same year in which Weber introduced a monopoly on violence as *the* defining characteristic of the modern state, in his famous Munich lecture titled "Politics as a Vocation." However, we are not aware of any direct connection between Lindahl and the Weberian conception of the state, a view that still is of substantial importance in political science.

The problem of constraining the state aside, Lindahl's attempt to find a mechanism to implement a non-coercive and efficient allocation of public goods set off a quest that has occupied mechanism design theorists for many years. This still-active area of theoretical research, well represented in this volume, is the only one in public-sector economics in which coercion explicitly plays an important role. Coercion – or more precisely, its complete absence – is imposed on the abstract economies explored in this work by requiring that all agents in the economy have the option of withdrawing without cost to some outside alternative, thus ensuring that no one is coerced in any solution of the model.

While a concern with non-coercive implementation in economies with public goods has become an established part of the contemporary mechanism design literature, Wicksell's approach to the study of the public sector more or less disappeared from the mainstream of public finance after being introduced to the English-speaking audience by Richard Musgrave in an early paper (1939) and especially in his *Theory of Public Finance* (1959). This was so despite the rise of the public choice school led by Buchanan and Tullock, who generalized Wicksell's framework in their *Calculus of Consent* (1962) to determine the socially optimal degree of consensus for collective choice.[6] Social planning as an expression of utilitarianism, following the work of Francis Edgeworth (1897), Arthur Pigou (1932), and

[5] This work is also provided in the Musgrave-Peacock volume in a chapter titled "Just Taxation – A Positive Solution."

[6] See Chapter 6 and especially Figure 6.3 where the optimal degree of consensus for a collective choice process is determined. Buchanan's book on the *Demand and Supply of Public Goods* (1967) is also an important contribution, standing between the Wicksellian tradition and post–World War II developments.

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especially Paul Samuelson (1947, 1954), emerged after World War II as the predominant approach in public economics and economic policy research.

In terms of the stylized collective choice scenario introduced earlier, modern social planning leads to the study of how to set the temperature on the thermostat to optimize an objective that combines and allows for trade-offs between aggregate social welfare and equity among heterogeneous citizens. It is implicit in this approach that one accepts, or should accept, the solutions favored by the planner as a matter of social solidarity. Also implicit in this approach are the assumptions that the community is well organized to take advantage of collective action by the state on behalf of its citizens under the rule of law, and without the exercise of violence. In this volume, none of these conditions are taken for granted.

3. A Tour through the Individual Contributions

We turn now to the individual chapters. The emphasis in our introduction to these essays will be on their general thrust and on how they fit together.

3.1. Violence, Structured Anarchy, and the State

We begin in Part I, and appropriately so for a book on coercion in public finance, with two essays that deal with the connection between violence and the public finances in societies in which democracy under the rule of law is not already well entrenched.

Chapter 2 by John Wallis sweeps across the history of human organization. In this work he extends to the study of public finance, his recent book with Douglass North and Barry Weingast on *Violence and Social Orders* (2009). It will not come as a surprise to the reader of this Introduction that Wallis begins with the Weberian conception of the state. He asks how a society capable of limiting a government that has a monopoly on violence must be structured to constrain the government's use of violence, and how an answer to that difficult question bears on the use of unanimity in taxing and spending that was Wicksell's solution to the problem of limiting coercion. Wallis then shows at some length – in part using arguments developed in his book and extended here – how an understanding of the evolution of impersonality in the application of the rule of law bears on the study of public finance. He concludes on the basis of this analysis that Wicksell's idea is too simple; that it is not consistent with a solution to the problem of constraining the state because it leads to too much detail or attention to individual preferences in public finance, which is at odds with

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the requirements of an open access society with limited government under the impersonal application of the rule of law.

In rejecting Wicksell's approach, Wallis is in accord with the *Calculus of Consent*. But the argument here takes a different route, bypassing the problem of how to structure the collective choice mechanism itself. In this respect, his conclusions – though not his precise reasoning – are similar to those of Henry Simons (1938) and of Buchanan and Roger Congleton (1998), all of whom advocated broad tax bases that, to paraphrase Simons, prevent government from dipping deeply into great incomes with a sieve. The idea here, cast in the original language of Wallis's analysis, is that to prevent the breakdown of impersonality in the application of (tax) law, and the higher level of coercion and even violence this leads to as groups then sort themselves out for reasons of self-protection, the state should not be able to use tax discrimination to effectively play favorites.[7]

These nondiscriminatory tax systems are the antithesis of an Optimal Tax system, which is a generally more complex structure proposed by a benevolent planner to maximize social welfare in a world of heterogeneous taxpayers. (For examples, see, among others, Ramsey 1927; and Diamond and Mirrlees 1971a, 1971b.) While reading this chapter, one wonders how far one can go in a democratic, open access society where interest groups must compete openly and vigorously and hence on unfavorable terms for government favors, toward such an Optimal or economically efficient fiscal system without regressing back into the world governed by bargaining among interest groups. That is one of the unpalatable alternatives to a society based on the impersonality Wallis favors, where membership in a group is what matters, and the waste of resources in protecting one's common interest with other members of the clan, tribe, or party, as in much of the world today, reduces social welfare substantially.

In Chapter 3, Stergios Skaperdas investigates at length a world of structured anarchy that is certainly unpleasant by modern democratic standards. The societies Skaperdas describes are the ones where elites compete to provide security for the larger society, and where each rent-maximizing elite uses the fiscal system to exploit the citizens under their control. There is no Weberian state, a type that looks benign by contrast. The proprietary

[7] This idea works reasonably well whatever the tax base chosen, such as with a broad-base consumption tax, as Buchanan and Congleton realize. But it seems that advocates of the broad-base income tax in particular (in the tax expenditure literature) have not generally understood the basic idea, and would not, it seems, be opposed to such deviations from nondiscriminatory treatment if it were instead delivered by explicit discrimination in the provision of public expenditure.

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state – one in which the state is "owned" by a ruler who maximizes revenues net of the cost of governing and which are common in the history of the world (Finer 1997) – emerges here out of anarchy given the state of military technology, but faces difficulties surviving because of the problem of providing effective security. This is a more or less stable world in which the center of power establishes itself at great expense in terms of enforcement and security.

Skaperdas's model includes, as an exceptional case, Mancur Olson's (1993) roving bandits, who arise and survive only when military-scale economies are absent so that there is no surplus that can be captured by an "entrepreneur" who offers to rid the peasants of these bandits in exchange for tax payments that leave them with a subsistence existence.

In his formal discussion of the Wallis and Skaperdas essays, Leonard Dudley characterizes Wallis's chapter as one that deals with bargaining between elites and the associated commitment problems that these elites must cope with as they try to maintain their rents. He thinks of the essay by Skaperdas as an analysis of the role of scale economies in military technology in the outcome of elite competition. Dudley then argues that these two chapters are parts of a bigger picture and that they may be unified by thinking about the first paper as an essay on the demand for governance, and about the second as providing a theory of its supply. Rents play a key role in this unified framework because they provide the incentive for and currency via which elites can make stable agreements. He goes on to argue that coercion in public finance – in the sense of tax prices in excess of willingness to pay – will be a key feature of regimes in the (possibly substantial) period of time following important shocks to the economy or society, especially when the private sector becomes more efficient (after a technological shock), and will be less important in long periods of stability. We leave the "proof" of this assertion, along with the many interesting details of the arguments in the main essays, for the readers to discover.

Before continuing to introduce the other contributions in the book, it is important to note that in the essays in Part I, more than in the following chapters, the emphasis is on the kind of governance in which rulers and elites use fiscal instruments to satisfy private interests without direct concern with the public interest, and in which competition between elites often generates unequal and even destructive outcomes. In the following parts of the book, some constraints such as exist in a democracy on the powers of the government and the bureaucracy are regarded as a normal, albeit still problematic, aspect of society.

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