7 Knut Wicksell’s principle of just taxation revisited

Charles B. Blankart and Erik R. Fasten

1 Introduction

Among the three main works by Knut Wicksell – *Value, Capital and Rent* (1893, 1954), *Finanztheoretische Untersuchungen* (1896) and *Interest and Prices* (1898, 1936) – the second one is often regarded as a step-child of the great economist. Only the second chapter of his book entitled *A New Principle of Just Taxation* is available in English, due to James Buchanan who translated it and to Richard A. Musgrave and Alan T. Peacock who edited it in their *Classics of the Theory of Public Finance* (1958). The relative neglect of the *Finanztheoretische Untersuchungen* (Inquiries in Public Finance) is not accidental. While *Value, Capital and Rent* and *Interest and Prices* deal with the functioning of markets, in particular capital markets, *Finanztheoretische Untersuchungen* focuses on the organization and the functioning of the state.¹

In mainstream economics the state is most often regarded as an exogenous authority assessing the policy instruments to attain socially desired outcomes. The motivations of the authority and the constraints it faces remain concealed in a black box. For Wicksell (1851–1926), this methodological separation was untenable. For him the object of inquiry, markets and politics, were one and the same. This insight has often been forgotten in subsequent generations. Therefore Richard Musgrave reminds us that Wickell’s *Inquiries in the Theory of Public Finance* is “the most creative book in public finance ever written” (Musgrave, 1983: 6).

The present chapter on Wicksell is in honour of Bertram Schefold, outstanding researcher and the editor of “Klassiker der Nationalökonomie” (Classics of Economics) for his sixty-fifth birthday. Of the two “Vademecums” on Knut Wick- sell, the one edited by Hansson et al. (1997) and complemented with an introduction by Bertram Schefold is mainly on *Interest and Prices*, while the one edited by Samuelson et al. (1988) on *Knut Wicksell’s [entire] Opus* dates back more than 20 years and may therefore be worthwhile to be reconsidered due to the new insights that recent research and debate in public choice and public finance have contributed.

We shall start our chapter with the organization of the government in Sweden in Wicksell’s time around 1890, and proceed to Wicksell’s “New Principle of Just Taxation”. Thereafter we shall explain the methodological advantages of
Wicksell’s principle. Some very core problems of Wicksell’s principle were raised and fervently discussed between Buchanan and Musgrave in the 1990s up to recent years, before the death of Musgrave in 2007. The pros and cons of unanimity rule versus majority rule are then discussed, followed by a summary to conclude.

2 A glance at Sweden’s political system in the end of the nineteenth century

Wicksell’s “New Principle of Just Taxation” has to be viewed in light of the political system of Sweden at the end of the nineteenth century. Based on the constitution of 1809, Sweden was a constitutional monarchy ruled by the House of Bernadotte, who became hereditary kings in 1810. Power was shared between the king and the Riksdag of the Estates consisting of the nobility, the clergy, bourgeoisie and the peasantry. In 1865 this system has been given up in favour of a two-chamber system where the members were selected by the enfranchised population. The first chamber, consisting of 150 members of the upper class, was elected indirectly by those whose total wealth was above 80,000 crowns or who received a personal income of above 4,000 crowns a year. The second chamber of 230 members was elected directly and less restrictively by citizens with an income of above 800 crowns or with an estate valued more than 1,000 crowns. Acts of legislation had to pass both chambers to become valid.

If the majorities of the two chambers differed, e.g. if the majorities of the upper and the lower chamber disagreed, the votes were summed up. The winner was the proposal that unified more votes. As the aggregated mean was 190 votes, a coalition of 190 up to 230 members of the second chamber could always outvote the first chamber. The first chamber had a disproportionate weight in the decision process, but not an absolute veto power even when all its representatives agreed. But they could try to collect an additional 40 votes in the second chamber in order to outvote a majority there. Thus the Swedish parliamentary system had a conservative bias with an open window towards progress. The constitution provided a built-in evolutionary reform mechanism, generating a slow (maybe too slow) retreat of the hereditary rights of the aristocracy. The most important ground of conservatism in Sweden, however, resulted from the fact that three-quarters of all male citizens were not enfranchised. Thus the distribution of representatives was markedly skewed towards the rich and very rich. They decided on the taxes which had to be paid by both the rich and the disenfranchised poor. Wicksell criticized the fact that when, for example, the issue was on financing a new vessel for the navy, the enfranchised rich were in a position to vote “yes” in their interest by simultaneously shifting the burden of taxation on the disenfranchised poor. Thus taxation of nineteenth-century Sweden can be seen as a result of the restrictiveness of the suffrage. In our modern vocabulary we would say that the principle of institutional congruency was violated, that the circles of the decision makers were not coincident with the circles of the beneficiaries and the tax payers. Hence some political groups carried a
higher burden compared to their benefits and their collective decision power, and some carried a lower burden compared to their benefits and their political sway.

3 Wicksell’s “new principle”

For Wicksell the consequences were clear: to end the practice of shifting the tax burden from the enfranchised rich to the disenfranchised poor not words but deeds were necessary. Only if the poor could be elected into the federal diet, an equitable taxation could be imposed. Thus, general franchise was a necessary condition for both the rich and the poor, in order to bring their opinions into the political process.

At this point Wicksell was a full-blown homo politicus. As an elected member of the city of Stockholm to the second chamber of the Riksdag in 1893, he fought without compromise for general franchise. He had become known for his radical views as one who rejected any compromise even when some moderate progress had to be forsaken and thereby often embarrassed his party friends (Gårdlund, 1996: 139; Blankart, 1998).

At this stage in his career, Wicksell was a political economic scholar whose theoretical insights always originated from his practical experience as a politician. He saw that general franchise (giving suffrage to the poor) was not enough to guarantee that the rich and the poor could throw their political weights into the process in an equitable way. An extension of the franchise would only reverse the distribution of power compared to the status quo. The majority of the poor would be in a position to exploit the minority of the rich who would become a de facto minority without effective voting power under majority rule. Wicksell pointed out:

It is not the purpose of this movement and indeed it would be contradictory to its guiding spirit, to have wholly or partially shaken off the yoke of reactionary and obscurantist oligarchies only to replace it by the scarcely less oppressive tyranny of accidental parliamentary majorities.

(1896/1958: 88)

In his mind, the only possibility to bring the interests of the rich in balance with those of the poor was the unanimity rule or by giving the poor veto power against the dictate of the rich and vice versa. Only through unanimity rule were all citizens or their representatives forced to reveal their preferences by voting and to openly declare, after discussion and debate, their interests in terms of taxes for a particular project. No group would be able to exploit the other by an octroy of majority decisions. Taxes were to be voluntary and individually differentiated according to individual interests, but after given approval, all were to be obliged to pay the price for which they or their representatives have agreed on. Should one try to cheat or to free-ride, the total sum could not be raised, and the project not accomplished. Hence it would be in everybody’s interest to fulfil the collective decision.
It is true, however, that while free-riding is eliminated, strategic behaviour now might become a new problem under the Wicksellian rule. On the one hand, participants could refrain from approving up to the very last moment through which they may unduly delay the process. On the other hand, strategic behaviour depends on the decision group size and the relative advantages of free-riding or cooperation. Hoffman and Spitzer have found that Pareto outcomes resulted in structured games of small groups in 90 per cent of their experiments (Hoffman and Spitzer, 1982). More recent studies emphasize the relevance of private information in these processes (McKelvey and Page, 2000).

4 The methodological advantages of the benefit principle

Astonishingly, Wicksell’s approach did not disseminate quickly in the community of scholars of economics. It is true that Wicksell’s contemporary economists of the Italian School of public finance were willing to think in terms of Wicksell’s neoclassical approach. They were ready to transfer neoclassical marginal utility theory from private to public goods and recognized that the evaluation of these goods must be elicited from individual consumers. But they overlooked the free-rider problem. Mazzola (1890, 1958) believed that individuals would reveal their preferences voluntarily without a contract. Wicksell replied: “If the individual is to spend his money for private and public uses so that his satisfaction is maximized, he will obviously pay not a brass farthing for public purposes” (1896: 100; authors’ translation).

Similarly, German public finance scholars such as A. Wagner (1893), A. E. F. Schäffle (1867) and E. Sax (1887) adopted the new insights of neoclassical marginal utility theory. But they were too sceptical on the possibility to elicit the evaluation of public goods from individuals. Without the market, recourse must be made to the state which, as an authority, determines the utility to the society and hence the required amount of public goods.

Whereas the Italian and German scholars of public finance were willing to apply at least conceptually the neoclassical theory on public goods, the Anglo-American schools of public finance ignored Wicksell’s principle for almost 50 years more or less. Marginal utility theory though pioneered by the British economist W. S. Jevons (1871) was not found to be useful for the evaluation of public goods. In fact public goods have not been given closer attention. Instead the theory of marginal utility of income and wealth has been developed from neoclassical economics. This sideline of the neoclassical marginal utility theory is, in our view, a blind alley as it forsakes the road towards a voluntary evaluation of goods and services based on the substitution principle of Jevons’s, Menger’s and Walras’s works. Under the “ability to pay principle” there is no exchange and hence no equalization of evaluations at the margin. Therefore, marginal utility of income and wealth as a rod for taxation has to be assessed by a dictatorial authority. As arbitrary as the authority are the results of this theory. Even under restrictive assumptions of equal and declining marginal utility functions of income and wealth, a tax under the ability to pay principle can be
progressive, proportional or regressive. Eventually, every tax which can be effectively collected trivially satisfies the ability to pay principle. From the point of view of the rule of law such an approach is rather problematic. What is even more astonishing is that this theory could persist for so long. Its early sources lie in J. S. Mill’s sacrifice theory, then it was adopted by F. Y. Edgeworth (1897) who integrated the notion of marginal utility of income, then led to Pigou and in more sophisticated versions to the optimal taxation approach by F. Ramsey (1927) up to P. A. Diamond and J. A. Mirrlees (1971). Expenditures play only a small role in the ability to pay principle, which has already been criticized by Wicksell. In fact, Wicksell summarizes the ability to pay or sacrifice theory in the following way:

In this respect the sacrifice theory appears far weaker. It determines and indeed can determine only the distribution of taxes but has nothing whatever to say on the absolute amount of the total tax bill (and hence of the individual’s tax bill).

(p. 75 in the translation; p. 79 in the original)

5 Just taxation and the initial distribution of endowments: Buchanan versus Musgrave

Musgrave and Buchanan have both interpreted Wicksell. But they came to quite different conclusions. Musgrave criticized (in personal conversations) Buchanan from his more social democratic political standpoint for having interpreted “his Wicksell” according to his own ideological standpoint. Indeed, Buchanan sees his Wicksell more closely from his own non-conformist conservative point of view. Right or wrong, the dispute sparked on the following quote of Wicksell: “It is clear that justice in taxation tacitly presupposes justice in the existing distribution of property and income” (p. 108 in the translation; p. 143 in the original). For Musgrave this quotation anticipates the 1954 model by Paul A. Samuelson on the optimal allocation of means to private and public goods (Samuelson, 1954). He argues:

Distribution … enters when closing Samuelson’s model. The referee first derives a utility frontier, showing Pareto-optimal combinations of mixes of public and private goods, together with distributions of private goods, among consumers. As a second step, the optimal point on that frontier has to be chosen, and here a social welfare function is … needed so as to determine what society views as a just state of distribution.


While this standpoint is defensible, it makes Wicksell’s choice mechanism dependent on a precedent judgement of an outside referee who imposes the relevant social welfare function. If justice according to the social welfare function is not established, there is no way to apply the Wicksell rule. In our view there are two reasons why Musgrave’s view is overly restrictive:
First, starting from Wicksell’s quote and Samuelson’s interpretation four situations have to be distinguished:

a the status quo is just and efficient;
b the status quo is just and inefficient;
c the status quo is unjust, but efficient;
d the status quo is unjust and inefficient.

It is true that Wicksell’s principle cannot contribute to an improvement in case (a) since all potential efficiency gains are already exploited and in case (c) since Wicksell’s criterion cannot improve justice. The classical case for Wicksell’s principle and also the one intended in Wicksell’s quote above is (b). Justice has been established, and more efficiency is feasible. In this case one can be optimistic about Wicksell’s unanimity principle as the status quo is characterized by social harmony. But this is obviously a very rare case. Before this background case (d) becomes interesting where the status quo is unjust and cannot possibly be improved, but where more private and public goods can be made available through efficiency gains. In such cases a unanimous “yes” to a Wicksellian proposal is not unreasonable.

Second, Musgrave does not consider that justice itself can become an issue of individual choice so that the need of a social welfare function can be avoided. Here enters the important contribution by Buchanan and Tullock (1962) who argue that principles such as justice are typically long-run issues which are set by individuals beyond their narrow horizon of self interest. Constitutional justice is typically not defined in issues, but in rules adopted unanimously by individuals. Procedural justice is obtained when subsequent decisions are made within these rules (Brennan and Buchanan, 1985).

6 When deviate from unanimity rule? Should Aristides be exiled?

The debate between Musgrave and Buchanan has shown that the Wicksellian unanimity principle is not something rigid leading to deadlock when the first difficulties arise, especially in the case of heterogeneous preferences. It is rather a challenge for policy makers and their economic advisers to ask the right questions, to reformulate them into debatable packages, to place them on the right level of constitutional or ongoing decision making and so on. It is also not necessary that the polity sticks together forever. When preferences differ too much, separation or secession should not be prevented, and a new consensus can be found.

Alternatively, one could also deliberate to replace absolute by relative unanimity of, say, 80 or 90 per cent of the constituents, as suggested by Wicksell, when strategic behaviour blocks the collective decision-making process. Buchanan and Tullock (1962), however, argue that the departure from unanimity is not costless. Individuals have to offset the expected external costs of being outvoted
and the costs of increasing probability of cycling from the advantages of eased decision making.

To summarize: unanimity remains the norm in this framework even if full unanimity is not attained. Other rules such as simple majority rule have no normative grounds per se and should be dismissed. It is particularly useless to use simple majority rule to decide on distributive issues as suggested by Wicksell for the case of public debt service. As these issues are zero-sum games, simple majority rule will lead to cycling, leaving it open as to who will eventually bear the burden.

Alternatively we could ask: what characteristics are required to generate decisive results by a collective decision-making rule? May (1952) proposed tagging the ballots by +1 for yes, −1 for no and 0 for abstention and then to add them (without weights) to generate a simple majority outcome. He found that a collective decision rule is the simple majority rule if and only if it satisfies the following four conditions:

1. decisiveness;
2. positive responsiveness (to increasing number of votes for or against);
3. neutrality (of intensities of preferences on particular issues);

These conditions are very strong. Therefore, we should use simple majority rule only where we share the values behind. (1) We want a decisive result; (2) we want that, as the number of individual pros increases, the probability of a collective pro increases; (3) that the same weights count for all issues and all voters. If so, the simple majority rule is the right rule. There are many cases, however, in which we do not share these values. For redistributive issues the equal intensity assumptions are generally not fulfilled. Unequal intensities promote coalition formation and hence cycling. Another example is human rights. It is usually easier to support another person’s free speech than to give up one’s own free speech. Therefore, the equal intensity of preferences assumption is again violated or could only be fulfilled under barely acceptable value judgements.

To give an example: the ostracism held in Athens in 482 BC on whether to withdraw Aristides the Just (commander and statesman) the right of settlement was a binary issue which resulted in an unambiguous decision: Aristides had to leave for exile. The issue was defined in such a way that May’s (1952) conditions were fulfilled. But did the Athenians really share the value judgements behind? Why should Aristides’ vote be given the same weight as that of all other citizens/voters? This is certainly a case where simple majority rule is barely appropriate.

It is possible that a closer consideration would reveal that the issue of how to treat Aristides was not a simple binary one. As a sort of compromise, Aristides could have been prohibited, for example, from participating in political debates in Athens for a certain time. Given this new alternative, the question of transitivity of majority voting arises, and as one can see, “transitivity” is not among May’s
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(1952) four conditions. Hence we cannot expect decisiveness from majority voting and have therefore to discuss the issue more intensively until a consensual decision will be found. Or we have to decompose the issue and return to bilateral market contracting. Simple majority rule is apparently not the panacea able to solve all collective issues. It rather seems that political bargaining and searching for compromise are indispensible tools of political processes to succeed.

7 Summary: applying the right collective decision rule to the right issues

Knut Wicksell had a challenging agenda when he entered Swedish politics in the second half of the nineteenth century. The tax system was highly loaded by indirect taxes falling mainly on the poor who had to finance armament and other public expenditures that often benefited the rich. He was aware that the traditional tools of public finance such as the ability to pay principle were ambiguous in their conclusions and therefore of little help in inducing a policy change.

Wicksell’s analysis led him to three conclusions to which we can add two more in the light of today’s level of knowledge:

1. Wicksell made the important point that just taxation is less a problem of norms, as could be derived from the ability to pay principle, but a problem of the organization of the collective decision process.
2. Just taxation cannot be achieved by simply extending the franchise from the rich to the poor as that would simply reverse the majorities. Instead of the poor being exploited by the rich, the minority of the rich would be exploited by the poor.
3. General franchise combined with unanimity rule would, however, balance the two sides by giving each of them a veto power against proposals of the other. In balance, each side would pay taxes according to its interests.
4. Later scholars have criticized Wicksell’s principle because it leaves the status quo of the distribution of income and wealth untouched. This is, however, only half of the truth. If the state is progressive in developing new fields and innovative services, the rich will be ready to bear the costs of these public innovations due to their high income elasticity of demand, while the poor obtain the benefits of the innovations for free. Hence, contrary to intuition, Wicksell’s principle can lead to progressive taxes. If, on the other hand, the government lags in innovative activity and the rich individuals prefer private instead of public provision of progressive services, taxes are more likely to be regressive.
5. It has also to be acknowledged that redistribution which cannot be obtained through Wicksell’s principle cannot be enforced by simple majority rule either. In this point, Wicksell was too optimistic. In general, simple majority rule will not generate decisive results – it fails in particular for redistribution – and where it does lead to decisive outcomes, the underlying value judgements are often barely acceptable in free society.
Notes

1 See Wagner (1988) for a comparative analysis.
2 An extensive discussion by the two authors on their views on public finance and Wick-sell in particular can be found in Buchanan and Musgrave (1999). As a postscript, see Sinn (2009).
3 As we have noted on more than one occasion, the above reasoning rests on the assumption that the legislature is completely free to accept or reject the public expenditure item under consideration. When the expenditure is a necessary result of a previously existing obligation and cannot, therefore, be refused, an entirely different procedure is in order. One cannot speak of taxation according to benefit when the expenditure is not made for the sake of the utility it is expected to yield to the country but rather to meet a recognized obligation. The expenditure must always be approved and if this has to be done by vote at all, a simple majority is the obvious procedure.

While it is highly desirable that the majority be inspired by motives of justice and equity in the distribution of this particular burden, it is difficult to make any generally valid observations of detail on this distribution. It is hard to say out of hand what public expenditures belong to this category.

In the first place interest and amortization payments on the public debt come to mind.

References


