

The Social Contract Revisited

Plucking the Goose:
The Role of Taxation in
the Modern Social Contract

REPORT AND ANALYSIS OF THE THIRD WORKSHOP OF
THE SOCIAL CONTRACT REVISITED, OXFORD
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Introduction

The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest amount of hissing.

– **Jean Baptiste Colbert**, *Finance Minister to Louis XIV*

This report is intended to provide both a record and a critical assessment of the third workshop of the Foundation for Law, Justice and Society's programme on *The Social Contract Revisited*. The workshop was held in Oxford on 23rd to 25th April 2008.

The third workshop of the programme dealt with questions of taxation and distributive justice. Though many writers on welfare focus exclusively on spending, surprisingly few have written on just takings, that being left to tax scholars and libertarian constitutional law scholars. A complete account of the social contract demands attention not only to what the state must provide, but also to the financial burden these provisions entail and the way they will be funded. This is one good reason for investigating taxation within the scope of the analysis.

Taxation is not only a means for government to acquire resources. It has a potentially important role in achieving equality and distributive justice. What constitutes justice and how it is achieved is

a matter of debate. Here the concept of the social contract may be helpful: while people reject taxes that are unfair or excessive, fair taxes are generally viewed as a responsibility which we all should share and accept. If they are based on consent (a central, albeit evasive, concept in social contract theory), then taxes are viewed as a social good, not a necessary evil.

The workshop demonstrated how closely taxation discourse is related to social contract concepts and methodology. The papers repeatedly referred to the need to identify the relevant rights and obligations that a modern society should recognize; to the relevance of certain moral principles in the design of a tax system; and to the effect that such a system may have on social and economic incentives.

The purpose of the workshop, then, is to arrive at principles that should govern fair taxes, to address some current ideas on the matter, and to suggest some solutions to prevailing problems in the tax systems of many Western countries.

Taxing Away Poverty: the Promise and Perils of the Contemporary Welfare State

Keynote lecture by **Professor Douglas Besharov**

Chair: **John W. Adams**

Professor Besharov's lecture questioned the adaptability of the tax system to eradicate poverty. He addressed three distinct issues: poverty, spending, and taxation. Poverty is the most elusive because of the lack of a consensus regarding its definition. A minimal definition would be: deprivation of tangible things necessary for survival, such as food, clothing, shelter, water, etc. These are, most commonly, problems that afflict developing nations, and thus are best dealt with by international instruments rather than domestic taxation.

Within developed nations, there are two approaches to measuring poverty: absolute and relative. An absolute measure of poverty was established in the United States in 1963, based on the dollar costs of the US Department of Agriculture's 'economy food plan' multiplied by a factor of three. In contrast, the main poverty line used by the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU) is a relative poverty measure based on 'economic distance', a level of income set at 60% of the median disposable household income. As may be expected, measures to alleviate poverty differ according to the definition of poverty. Thus, based on absolute measures of poverty, the poverty rates in the United States are slightly lower than those in the EU (about 12%), whereas, based on relative measures of poverty, the United States has significantly higher rates than the EU (24% versus 16%).¹

1. Forster, M. and d'Ercole, M. M. (2005) 'Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s', OECD Social, Employment and Migration Working papers No. 22, p 22. Available at: <<http://www.oecd.org/dataoecd/48/9/34483698.pdf>> Last accessed 24 July 2008.

Early on we find that different definitions of a social problem (e.g. poverty) affect the way certain policies (e.g. taxation) are assessed. It is clear that, when assessing the situation in developed countries, 'we are not', in Besharov's words, 'in the terrain of subsistence poverty'. And yet, *relative* poverty has proven to have serious consequences for the well-being of children and adults, bearing as it does on their cognitive capabilities, educational attainments, on their probability of being a victim of crime or its perpetrator, as well as on other aspects of social inclusion. Relative poverty, in other words, is more relevant to an analysis taking a social contract paradigm as its reference point, since the latter takes into account the risk of excluding certain groups from its terms. Many governments view tackling relative poverty and large disparities in wealth as a means towards social inclusion.²

The second matter addressed is social spending. The important factor to consider is not the level of social spending, but its source. While the average *total* level of spending in the OECD is comparable to that of the United States, for example, differentiating public and private spending reveals that the rate of private spending in the United States is about five times that of the average OECD country. The data does not include benefits that derive from the recognition of certain expenses (mortgage, health, pensions) as tax expenditures. Tax expenditures for

2. See, for example, the Irish government's statement regarding poverty and social inclusion, as highlighted by the Irish Office for Social Inclusion <<http://www.socialinclusion.ie/poverty.html>> Last accessed 24 July 2008.

People are living in poverty if their income and resources (material, cultural and social) are so inadequate as to preclude them from having a standard of living which is regarded as acceptable by Irish society generally. As a result of inadequate income and resources people may be excluded and marginalised from participating in activities which are considered the norm for other people in society.

social needs benefit richer citizens more than poorer citizens, resulting in the state subsidizing the social needs of richer citizens several times more than it provides for those in most need.³

Tax expenditures for social needs benefit richer citizens more than poorer citizens, resulting in the state subsidizing the social needs of richer citizens several times more than it provides for those in most need.

Focusing on spending intended to raise children above poverty levels, Besharov points out that, after spending £11 billion, the United Kingdom has managed to remove 'only' 600,000 children from poverty, leaving 3.8 million children behind. His claim is that spending should be directed to channels other than direct transfers. The state should encourage education, 'strong families' (i.e. marriage), and work, since they are much more effective in alleviating poverty than income transfers.

This assertion would not appear to be borne out by the experience of the United States, however, which, especially since the introduction of welfare-to-work legislation in 1996,⁴ stands apart in its low tax rates and the incentives it creates towards work in the labour market, marriage, and education, and yet it is still the country with the highest poverty rates for children. In contrast, the United Kingdom is commended in a 2005 UNICEF report as showing 'particular progress in reducing its child poverty rate'.⁵

It is true that education and work are both important in eradicating poverty. Yet proper, free education and decent jobs at fair wages cost money as well. Generous tax credits for poor families provide incentives to work, while promising a decent livelihood. In contrast, under current policies, even where education is formally free at the point of delivery, costs of school activities are passed on to parents, creating particular barriers for children from poor families.⁶ Far from being cost-neutral, if the policies suggested are to be effective in alleviating poverty, governments must raise taxes and ensure better implementation.

3. See Hacker, J. (2002) *The Divided Welfare State*. Cambridge: Cambridge University Press, pp. 29–40.

4. Personal Responsibility and Work Orientation Reconciliation Act 1996.

5. UNICEF (2005) *Child Poverty in Rich Countries* (Report Card No. 6)

6. Ridge, T. (2002) *Childhood Poverty and Social Exclusion*. Bristol: Policy Press.

SESSION ONE:

Taxation and the Modern Social Contract

Professor Avner Offer, *Oxford University*:
'The Role of the State – a Contracting Perspective'

Professor Wim Van Oorschot, *Tilburg University*:
'Social Legitimacy of the European Welfare State'

Chair: **Paul Dodyk**, *Chairman of the Advisory Board for The Social Contract Revisited*

Professor Offer began with a very broad question: 'what does the state do?' In posing the question in this way, Offer continues the tradition of the early social contract theorists, who sought justification for the existence and power of government. By delineating the normative role of the state – what it *should* do – we can decide if its powers are *justified*. The state power most relevant to our purposes here is the power to tax earned income or profits. This power, Offer shows, has increased several times across countries from the mid-nineteenth to the mid-twentieth century, and where welfare transfers are concerned, has continued to increase since then. While classic 'public goods' such as defence, law enforcement, public order, and local administration have remained at about 30% of the United Kingdom's gross domestic product (GDP), for example, the bulk of expenditure has been used to fund social security and housing (33%), health (17%), and education (15%).

So what is the justification for the state acting in this way? Offer explains and defends the generous, social-democratic state on economic grounds. Neither compassion nor fairness are relevant foundations for social policy or taxation. Instead, just as the state should intervene in the economic markets only when serious market failures are detected, here the state has a role because of psychological and social 'failures'. With respect to psychological biases, people are understood to be

myopic. In David Hume's words: 'There is no quality in human nature, which causes more fatal errors in our conduct, than that which leads us to prefer whatever is present to the distant and remote'.⁷ People tend to make bad choices for immediate rewards. The reasons for this are now well known: cognitive biases are grounded in the intractable nature of the calculations required to assess present sacrifices and future rewards.⁸

If such psychological biases are aggregated, we encounter a serious problem of social commitment. People have difficulties when required to construct complete, long-term contracts, which will inevitably have to account for immeasurable contingencies, to encompass an impossible level of detail, and be administered through costly management and regulation.

Enter the state, which acts as a *commitment agent*. It permits and provides for commitment solutions that members of society can fall back upon. For example, since there is no way children can commit themselves to twelve years of education, although beneficial for their future and for society's progress, the state creates a school system, funds it, and makes attendance compulsory. It forces its citizens to commit. This is an important explanation, and one that can easily fit the early social contract tradition. Unlike contemporary theories, it does not claim to detect the principles of justice that underlie the modern state, and does not employ the contract in strictly hypothetical form.

7. Hume, D. (1739) *A Treatise of Human Nature* [Book III, Part II, Section VII].

8. Kahneman, D. and Tversky, A. (1974) 'Judgment Under Uncertainty', *Science*, 185: 1124.

Instead, the contractual element is significant. To paraphrase Rousseau, people are forced to contract so they can be free. The unique role and power of the state are also addressed directly. The state is not simply a derivative of the theoretical conceptualization of justice; rather, it is expected to use its power to enforce an equilibrium, to renegotiate the terms of the long-term, pay-as-you-go contract, if the need arises. And by way of the democratic process, the state reflects society's priorities and balance of powers.

When the state relaxes its obligation as a commitment agent, the downside becomes apparent. Privatization of goods and services that were previously owned and/or managed by the state has led to an increase in corporate fraud, to a dramatic reduction in savings (e.g. pensions), to an increase in costs for reduced services (e.g. health care), and to private finance initiatives that are renegotiated to the benefit of the financial industry, instead of the state. Government's loss of its role as a commitment agent is, essentially, a loss of its ability to govern.

While Offer, in his reply, focuses on the state, Professor van Oorschot begins with society and the idea of solidarity. His argument identifies the social determinants that are necessary for state institutions to remain intact. Van Oorschot questions what is required for such institutions to retain social legitimacy, and in so doing, identifies the breadth and extent of welfare programmes as related to patterns of solidarity.

Solidarity has long been used in sociological literature to refer to the tendency of individuals to contribute to collective interests, even when this would negatively affect their personal interests. Patterns of mutual affection and identification between donors and receivers are often referred to when describing trends in taxation and distribution. Frank Field, former Minister of Welfare Reform, found 'the breakdown of a contract' to necessitate welfare reform, since 'all societies require a shared ideology, containing an agreed moral framework'.⁹ And the

9. Field, F. (1995) *Making Welfare Work*. London: Institute of Community Studies, p. 26.

House of Commons Employment Committee describes the Jobseeker's Agreement as a 'formalised contract [between the claimant and] the taxpayer'.¹⁰ In that respect van Oorschot follows a familiar path.

But he goes beyond accepted interpretations of solidarity, viewing the idea of solidarity as more than people contributing to a collective goal against their own interest simply because they identify with the goal or with those who will benefit from it. Instead, solidarity may emanate from calculated, long-term self-interest and from institutional role obligations. Both these interpretations seem to stand in direct opposition to the original definition, just noted. This expansion of the notion of solidarity is refreshing. Why should we confine the complexity of human behaviour to a dichotomy of motivations, either for yourself (egoistic) or for the common good (solidaristic)? Indeed, Thomas Hobbes viewed civil order (a result of the social contract) itself to be in our enlightened self-interest.

Relying on this expanded version of solidarity, and assuming solidarity to be indicative of support for generous welfare provisions, surveys conducted in Europe find stable levels of support for the welfare state. This assessment is heartening, especially in light of dire warnings of increased retrenchment and worries that the era of the welfare state and social justice is drawing to a close.¹¹

But a second look at the data reveals that there is still cause for concern. First, as Professor Gilbert remarked, the survey itself suffers from a significant flaw. Respondents living in countries where contribution to the welfare state is mandatory were asked whether their motivation to pay derives from self-interest, from a moral duty towards others, or from a feeling of affection and pity towards others.

10. House of Commons Sessions 1995–6, Employment Committee Second Report *The Right to Work/Workfare* (HMSO London 13 Feb 1996) xxiv cited in King, D. (1998) *In the Name of Liberalism*. Oxford: Oxford University Press, p. 248.

11. Miller, D. (1999) *Principles of Social Justice*. Cambridge MA: Harvard University Press, p. 2.

In this context, many respondents naturally answer that they are moral people. This does not mean, necessarily, that in the abstract (i.e. with no legal obligation to contribute) the answers would have been similar. Moreover, Gilbert continues, why is 'voluntary willingness to pay' an indication of the legitimacy of the welfare state in a given country? Such a criterion would rank the residual American welfare state at the top, based on the high level of voluntary contributions. We find, then, that the concept of solidarity remains evasive. While strong solidarity probably does coincide with generous welfare provisions, and weak solidarity threatens welfare state legitimacy, more work needs to be done before we truly understand what solidarity really means, and how to assess it.

Turning to the analysis of respondents' assessment of justice in the welfare state, a different concern arises from the data. The age-old distinction of 'deserving' versus 'undeserving' poor holds strong. But who are the 'deserving'? The survey reveals that not much has changed throughout history, and that we tend to view others as more deserving if they lack control over their own deprivation. For this reason, the elderly and the unemployed remain the constituency paradigmatically 'deserving' of state assistance. Alexis de Tocqueville's warning against the futile effort to distinguish between 'nuances that separate unmerited misfortune from an adversity produced by vice' remains unheeded.¹²

Respondents in twenty-three European countries judge immigrants as least deserving of assistance ... In social contract terminology, it seems that immigrants are relegated to the fringes of the contract, or perhaps even excluded from it altogether.

But of more concern is the importance that respondents accorded to 'identity' (second only to 'control') in the formation of their concept of deservingness, and thus of justice. This ranking leads respondents in twenty-three European countries to judge immigrants as least deserving of assistance, and by a wide margin from other segments of the population. In social contract terminology, it seems that immigrants are relegated to the fringes of the contract, or perhaps even excluded from it altogether. This conclusion is ironic, in light of the contractarian insistence on consent as a central aspect for the formation of the contract, since for those born and raised in a given country, consent is a fictitious construction ('implied consent'), whereas immigrants clearly express willingness to participate in the civil and economic life of the receiving country. Given that they accept dirty, dangerous, and demeaning jobs that few others would take, and ask the least in return, it is difficult to contend that immigrants are the least deserving of assistance, if one is to hold the principle of reciprocity as central to the formation of the social contract and the construction of rights and duties.

12. de Tocqueville, A. (1997) *Memoir on Pauperism*. Chicago: Ivan R. Dee, p. 56.

SESSION TWO:

Taxation and Fairness

Professor David Duff: *University of Toronto Law School*: 'Tax Fairness, Distributive Justice, and the Tax Mix'

Professor Linda Sugin: *Fordham University Law School*: 'Let the Beachcomber Drown: Why Taxing Endowment is Unjust'

Chair: **Professor Neil Gilbert,** *University of California, Berkeley*

David Duff's ambitious paper proposes a structure through which to assess the fairness of particular tax systems. He explains that it is necessary to look to the broader context of the interpretations of fairness and justice we hold, and to the specific purposes and details of the tax system. This pursuit raises background questions that are as fascinating as the main object of the paper. One needs to ask whether moral principles should apply in matters of tax policy, or whether efficiency should be the only determinant. And if moral principles should apply, can there be different principles for different sections of the tax code? Lastly, and highly related to matters discussed in the previous workshop of this programme: to what extent are these principles that govern taxation similar or distinct from moral principles that govern spending, distribution, and allocation of benefits?

Three such purposes are identified: first, the tax system should collect revenue; second, it regulates certain social and economic behaviour; and third, it leads to distribution of economic resources.¹³

The first purpose, of collecting revenue, is governed by two principles of justice: one is the benefit accruing from the tax, and the other is the ability to pay the tax.

13. See, e.g., Avi-Yonah, R. (2006) 'The Three Goals of Taxation', *Tax Law Review*, 60: 1–28.

These approaches could be phrased in social contract terminology, where the benefit approach would reflect a narrow understanding of the contract, while the ability to pay would reflect a broader conceptualization of the contract. The benefit approach requires people to pay only for those goods that they themselves enjoy. An immediate, practical objection to this approach relates to the financing of pure public goods. A public good is a good that is not affected, in quality or quantity, regardless of the number of individuals who consume it. Examples would include clean air or public order. But pragmatic objections lead to pragmatic solutions, and we can simply agree on a mechanism for the allocation of the burden. For example, we may agree that all residents benefit similarly from public goods or that richer people benefit more from public order, because they have more to lose.¹⁴

A more fundamental objection concerns the idea of justice underlying the benefit approach. It is a 'strict contractarian' approach, where people are expected to give (and receive) 'something for something'. Reciprocity is indeed central to modern contractarian thinking. It is reflected in the idea that 'those who willingly share in the social product have a corresponding obligation to make a reasonable (albeit proportional) productive contribution to the community in return'.¹⁵ But how strictly should we insist on the relationship between the 'share' and the 'contribution'?

T. H. Marshall argued in favour of a notion of reciprocity consisting of a wide array of rights in return for the most general obligations.¹⁶ This has the advantage of

14. Murphy, L. and Nagel, T. (2002) *The Myth of Ownership*. New York: Oxford University Press, p. 15–16.

15. White, S. (2000) 'Social Rights and the Social Contract', *British Journal of Political Science*, 30: 507, 513.

16. Marshall, T. H. (1992) 'Citizenship and Social Class'. In: T. H. Marshall and T. Bottomore *Citizenship and Social Class*. London: Pluto; Dahrendorf, R. (1994) 'The Changing Quality of Citizenship'. In: B. van Steenberg (ed) *The Condition of Citizenship*. London: Sage, p. 10.

creating a sense of solidarity, of a mutual endeavour. 'Earmarked' taxes, on the other hand, break down society, reducing it to a sophisticated mechanism for market coordination, where individuals purchase certain goods as distinct groups. This mechanism would be more acceptable against a background of just distribution of economic resources. Otherwise, poorer individuals may be excluded from certain goods due to lack of ability to pay. On the other hand, as Duff notes, the benefit principle may be a fair and legitimate way to provide for publicly provided goods, such as higher education, highways, and public service pensions. Arguably, if such services are financed by the public fisc, the real effect would be to subsidize services that those with the highest ability to pay benefit from the most.

And so, perhaps fair taxes should be apportioned according to an individual's ability to pay. Duff cites John Stuart Mill's contention that 'equality of taxation, therefore, as a maxim of politics, means equality of sacrifice', to suggest that fair taxes should be apportioned according to an individual's ability to pay.¹⁷ But what does 'equality of sacrifice' mean? The problem here combines normative and empirical assessments. Relying solely on earnings seems arbitrarily to exempt from contributing those individuals who derive property-based income. Personal wealth, then, could be a measure of ability to pay; even easier to administer would be a sophisticated consumption tax. Such a tax, Duff concludes: 'might be the most appropriate way to implement a scheme of fair taxation for the collection of revenues to finance publicly provided goods and services that cannot reasonably be financed according to the benefit principle of tax fairness'.

The second purpose of income tax, regulation of social and economic behaviour, is clearer in theory than in practice. Duff suggests that assessing the fairness of a tax that seeks to regulate behaviour requires examining the justice of the regulatory goal (reducing smoking, pollution, etc.), the relationship between the tax and the goal, and the distributional effects.

But while the first two are straightforward (e.g. in order to reduce pollution, regulation should make polluting more expensive), a large part of the conclusion will turn on the 'distributional effects', perhaps better termed the 'law of unintended consequences'. Thus, an environmental tax may aim to make business less profitable for major oil companies by forcing them to internalize the pollution they create. But such industries impose the burden of the tax (as well as the burden of pollution) on drivers, who are often low-income earners.

The third and final purpose of taxation, according to Duff's typology, is that of distribution. This purpose may be difficult to realize, in light of the widely different approaches to distributive justice (including the position that no such concept exists).¹⁸ Even within the modern social contract tradition, some argue that justice is served when measures are taken to limit the occurrence and consequences of social and economic inequalities and when the circumstances of the least well-off are elevated.¹⁹ In contrast, others embrace the Hobbesian strand of the social contract, arguing that the market is a moral-free zone of self-interest and rational choice. Memorably (and controversially), David Gauthier argues that:

*The rich man may feast on caviar and champagne, while the poor woman starves at his gate. And she may not even take the crumbs from his table, if that would deprive him of his pleasure in feeding them to his birds. Distressing as this situation may seem, we must not be misled by it. We think of rich and poor in a social context, and we think that his wealth and her poverty are in some way related.*²⁰

18. von Hayek, F. 'The Meaning of the Welfare State'. In: C. Pierson and F. G. Castles (eds) *The Constitution of Liberty*, pp. 257–262, reprinted in *The Welfare State Reader* (2000), pp. 90–94.

19. Rawls, J. (1999) *A Theory of Justice* (Revised Edition) Cambridge MA: Harvard University Press, p. 55; Scanlon, T. (1973) 'Rawls's Theory of Justice', *University of Pennsylvania Law Review*, 121: 1020, 1064; Scanlon, T. (1998) *What We Owe to Each Other*. Cambridge MA: Harvard University Press, p. 228.

20. Gauthier, D. (1984) *Morals by Agreement*. Oxford: Clarendon, p. 218.

17. Mill, J. S. (1970) *Principles of Political Economy*. London: Penguin Books, p. 155 [Book V, chap. II, sec. 2].

Disparate as even social contract theories of distributive justice are, it is implausible that an agreement may be reached in a manner that could be transferable to the tax code. And yet, all tax policies affect distribution and redistribution. Distributive justice paradigms, including those rooted in the social contract tradition, are helpful to inform the debate on the intended and unintended consequences of particular tax policies, to critique them against a background of broader notions of fairness, and perhaps to have an effect on the nature and details of some tax measures.

Regulation of social and economic behaviour seems a legitimate role of tax policy, not to mention law in general ... the extent of interference with autonomy is troubling, not the fact that any such interference exists.

Linda Sugin's paper examines the highly controversial idea of endowment taxation, a model that suggests taxing people for what they *could* earn, as opposed to what they actually earn. The policy was attractive to economists because it is more likely to encourage individuals to maximize their earnings. However, its implementation borders on the absurd, since it is impossible to measure personal endowments and ability to earn in the abstract. Sidestepping the pragmatic aspects of the idea, Sugin convincingly argues against an endowment tax on liberal-egalitarian grounds, stating that an endowment tax forces individuals to enter or change occupations, thus having an undue effect on one of the most significant choices an individual makes for themselves. The burden on individual autonomy, she concludes, cannot be justified.

While Sugin's conclusion is thoroughly convincing, in the end, 'no one defends endowment taxation'.²¹

21. Murphy and Nagel *supra* note 14, p. 122.

But by examining the argument itself, one finds that the concept of endowment taxation raises issues that have broader significance in general, and for the articulation of rights and duties under the social contract in particular.

Take, for example, the importance of choice and autonomy that endowment tax so blatantly restricts. As noted above, regulation of social and economic behaviour seems a legitimate role of tax policy, not to mention law in general. Tax policy often changes incentives and disincentives to work, invest, save, or rest. So perhaps the problem with endowment taxation is only a matter of degree. The *extent* of interference with autonomy is troubling, not the fact that any such interference exists. Forcing people to work, even if they do not want to, and at designated jobs, ('you cannot work as a social worker – become a corporate lawyer') seems unjustifiable.

But if this is so, why is it not the case with individuals at the other end of the pay (or capabilities) spectrum? The previous workshop in this programme hosted an array of different perspectives on welfare-to-work programmes, but only a small number of them objected *on the whole* to the idea that people should be forced to work, or even to accept particular job offers. One may object that the analogy breaks down because welfare claimants demand something from the state, whereas potential payers of endowment tax may simply want to live simple lives as teachers, artists, or beachcombers. The problem with this response, however, is that it takes a very narrow view of the relationship between citizen, state, and society. As already noted, high-end earners benefit a great deal from the state through tax expenditures, and many subsidies (e.g. to farmers) are not constructed as 'welfare benefits'. Moreover, van Parijs makes the argument that those who opt out of the labour market (surfers) should be 'fed', because they relax the pressure on an already strained labour market: that is *their* contribution.²²

22. van Parijs, P. (1998) 'Why Surfers Should be Fed', *Philosophy and Public Affairs*, 20: 101, 122ff; van Parijs, P. (1997) *Real Freedom for All*. Oxford: Clarendon, p. 92–130.

The moral objection that stands in the way of forcing well-endowed individuals to work in one instance should, arguably, hold the same appeal when the less fortunate are concerned. The imperative of the social contract, to treat each individual with equal concern and respect, would require that much.

Even from a collectivist point of view, there is a troubling aspect to endowment taxation. The idea

that each person must work in a manner that maximizes his or her *market* worth assumes that no other kind of work may compete, to the benefit of society. It may well be the case that there is no shortage of good corporate lawyers or high-end doctors. On the other hand, highly capable social workers and doctors working at inner city clinics for low pay are more of a rarity.

SESSION THREE:

Taxation, Avoidance, and What Can Be Done about it?

Professor Edward McCaffery, *University of Southern California Law School*: 'The New New Property'

Professor Jens Beckert, *Max Planck Institute*: 'Estate Taxation and Social Justice'

Dr Doreen McBarnet, *Oxford Centre for Socio-Legal Studies*: 'Tax and Corporate Responsibility'

Chair: **Professor Matthew Diller**, *Fordham University Law Faculty*

This panel brought taxation into the broader context of the social contract, investigating both the ways it is informed by and affects the family and the democratic process in general. The panel shows how empirical and normative arguments both contribute to the formation of a nation's social contract, a matter uniquely relevant in the context of the debate over consumption tax, inheritance tax, and corporate social responsibility.

Applying the social contract to the tax structure, Professor McCaffery finds that the current structure differs from an ideal type, which would have been chosen under a Rawlsian veil of ignorance. He finds two central bones of contention: firstly, the current tax system is largely a wage tax, with little tax on financial capital and no tax on wealth. Secondly, the estate tax, which is supposedly the most progressive, is largely ineffective, since it encourages high-end consumption by the wealthiest section of society.

His response to these matters follows Rawls, who concludes, in a rare prescription for concrete policy, that, 'a proportional expenditure tax may be part of the best tax scheme'.²³ Both Rawls and McCaffery

advance a progressive agenda that seeks to limit inequality and its consequences by revoking what is commonly seen as the most progressive tax (estate tax) and advocating what is often viewed as the most regressive tax (consumption tax).

The axis for the argument in favour of a consumption tax is the Haig-Simons definition, which is essentially: $Income = Consumption + Savings$. A simple rearrangement of this equation would result in: $Consumption = Income - Savings$. Therefore, by taxing consumption, the state *does*, in fact, tax income. It does so however, while excusing savings from the tax base. The advantage of this suggestion was brought out in the previous workshop: most individuals do not save enough in general, and for their pensions in particular. Preempting objections to the dramatic change in the tax base, McCaffery argues that, because most individuals do not save, the current income tax is, in effect, a consumption tax. If savings are excused from taxation, it may well provide incentives for much-needed savings. It also smoothes out labour market earnings for those whose earnings are uneven throughout their lifetime, a common phenomenon in contemporary societies, as noted in the previous workshop.

The regulation of a consumption tax is managed, in this proposal, via the creation of 'Trust Accounts'. These accounts do not confine themselves to the traditional private-public divide. When the individual withdraws money for private consumption, the state takes its share. And because the tax is progressive, the greater the private consumption, the greater the public share. While not necessarily creating an incentive against consumption, this structure creates a strong incentive against waste. Positing it against the current state of affairs, we find that the estate

23. Rawls, J. (1999) *A Theory of Justice* (Revised Edition) Oxford: Oxford University Press, p. 246.

tax creates an *incentive* to waste, because the more a wealthy individual leaves behind, the more is taxed by the state.

McCaffery's idea is attractive not only because he manages to turn old assumptions on their head, but also because, in doing so, he brings together Adam Smith and John Locke, who sought to align the incentives of self and society, with J. J. Rousseau, whose social contract approach had a strong collectivist appeal. People are free to earn as they please; they are not free to waste resources, because society has a stake in them. McCaffery cites Theodore Roosevelt's Second State of Union Address from 2 December 1902: 'We draw the line against misconduct, not against wealth'.

Professor Beckert explores the controversies over the implementation of estate tax, which were waged over several moral territories, or 'value principles', in his terminology. Recalling David Duff's typology, some arguments in favour of an estate tax were made on the grounds of it being the best way to finance the state; some were based on the moral preference for equality of opportunity, or meritocracy over dynastic wealth that could lead to political power; and some were based on a perception that the estate tax could be a vehicle for distributive justice, transferring money from the rich to improve the living conditions of the lower classes. In addition to these categories, the estate tax raises particular questions concerning the protection of family integrity and an understanding of property rights.

While the dominant argument against the estate tax in the United States is grounded in the individualistic defence of private property, opposition to the tax in Germany stems from a corporatist, familial ideal, according to which the estate belongs to the family, and therefore there is no occasion for tax on the death of a family member. The strong individualistic tradition in the United States has led to higher tax rates and lower exemptions of the estate tax when compared to European countries.

These characteristics of the estate tax in the United States may also explain the stronger opposition to the tax in that country.

Returning to the three value principles noted above, we find that, as is typical of the nature of such charged principles, they can be used to support arguments on both sides of the controversy.

Moreover, each of the principles stems from a different aspect of a country's social contract, and so the effect (or lack thereof) of the contract on the nature of the inheritance tax is indicative of the character of a particular country's contractual foundations.

The estate tax creates an incentive to waste, because the more a wealthy individual leaves behind, the more is taxed by the state.

Taking as a starting point the economic argument, the view that an estate tax is vital to generate income gained prominence during times of war and fiscal crises in the United States. In the countries under investigation here (the United States, France, and Germany), estate tax never generated revenue exceeding 2% of the total tax revenue. This suggests that, while the public was presumably more willing to finance the state through the estate tax at times of security and fiscal crises, the revenue generation from the tax was minimal. If that is the case, what are the underlying justifications for an estate tax?

One common justification is the liberal concept of equality of opportunity, which is closely related to the preference for meritocracy, as expressed by Warren Buffett in a statement before the US Senate Finance Committee: 'Dynastic wealth, the enemy of meritocracy, is on the rise. Equality of opportunity has been on the decline. A progressive and meaningful estate tax is needed to curb the movement of a democracy toward a plutocracy'.²⁴

24. Opening Statement before the Senate Finance Committee Holding a Hearing on Estate Taxes (14 November 2007). Available from <<http://www.cnbc.com/id/21791804/>> Last accessed 24 July 2008.

Further evidence in support of this view is provided by the American Internal Revenue Service, whose data shows that in 2004 only 19,000 American estates, or less than 1% of annual deaths, were subject to estate tax payments. Moreover, more than half of the revenue from estate tax came from only 7%, or 1366, of these estates, with the 510 largest taxable estates paying just under US\$8 billion. The greater portion of the estate tax, in other words, is paid by the super rich. This would suggest that equality of opportunity cannot be derived from a tax that captures such a small portion of families. Conversely, it may be the case that justification for the tax rests on the supposition that tax should be levied on those who can pay (recall Duff's mention of the 'equality of sacrifice').

While this may or may not be a legitimate moral principle, Rawls's reflective equilibrium demands that we consider the practical implications of the model. If the tax leads to increased consumption, because the testator prefers to spend it rather than to give it as tax, the case against waste becomes quite relevant. A dynastic concentration of wealth could indeed result in dynastic political power. As McCaffrey notes, Ross Perot, Mitt Romney, and Michael Bloomberg could all be cited as examples of the super-rich who prefer to spend their money and gain political power rather than be subject to the estate tax, though these examples in themselves do not necessarily indicate a wide-ranging, troubling phenomenon. Lastly, an estate tax could provide incentives, not for increased consumption, but rather for very generous contributions. In most cases (hospitals, universities, cultural centres) this is probably a positive outcome, though contributions may equally be made to less favourable causes, making the comprehensive moral argument contingent on the testator's individual preferences.

Doreen McBarnet's study of taxation and corporate social responsibility (CSR) provides an opportunity to focus on the role of the business sector, on the one hand, and of civil society, on the other. She demonstrated how CSR serves to create a more complex matrix of corporate objectives, whereby, in

place of one bottom line – profits – we see three related considerations: profits, people, and planet.

While the corporate obligation to take others into consideration when making business decisions is beyond the call of *legal* duty, civil society has managed to exert a great deal of pressure to force companies like Shell and Nike to revisit their practices in Nigeria and Indonesia, respectively. Corporations were forced to end harmful practices when civil actors attacked the company reputation and lodged consumer campaigns. Civil society includes not only private consumers, but major financial actors, such as employee pension scheme funds, which have been known to divest themselves from business in certain countries, and from certain companies, on human rights and environmental grounds.

Even before we bring tax evasion into the discussion of CSR, two problems are already evident. First, companies have accepted what is known as the 'business case' for CSR. Companies generally prefer to avoid blatant violations of human rights or environmental concerns, because the long-term losses may exceed the short-term gains. But what happens when the two do not align in such a clean fashion? What happens, in other words, where there is no long-term price to pay? Second, CSR has grown into a business of its own right, and is sometimes used, in quite sophisticated ways, as an argument against regulation of business practices. These insights lead us to the matter of tax evasion.

Blatant practices of tax avoidance, such as creating off-shore accounts and fictitious corporations, may lead to public outrage, as seen recently in at least one case in Britain.²⁵ But when the distinction between tax evasion and tax avoidance is often one that tax specialists and the courts have much difficulty in drawing, how can the public be expected

25. See Leigh, D. 'Tesco: New Claims of Tax Avoidance' *The Guardian*, 31 May 2008. Available at: <<http://www.guardian.co.uk/business/2008/may/31/tesco.supermarkets?gusrc=rss&feed=networkfront>> Last accessed 24 July 2008.

to do so? It may be that when the public finds that a company has engaged in illegitimate (though legal) tax practices, the truth is more complex. Professor Freedman noted in her comment on the paper that two-thirds of tax avoidance in Britain is 'spent' on employees, raising the question of the potential benefits of tax avoidance. In similar fashion, a company's decision to donate very large sums of money to child care centres or research foundations, leaving no money for taxation, may be laudable to some, and objectionable to others.

It could be argued that within the social contract, the government's role is to define legal obligations, and that companies should be free to use their

Within the social contract, the government's role is to define legal obligations, and companies should be free to use their money in ways that avoid tax, as long as they are both legal and beneficial to society.

money in ways that avoid tax, as long as they are both legal and beneficial to society. Unlike matters that concern the environment or human rights, taxation is not about *how* a company engages in practice, but rather about *how much* money it pays.

SESSION FOUR:

Taxation, Distributive Justice, and Helping the Poor

Professor Yoram Margaliot, *Tel Aviv University Law School*: 'Taxation, Welfare, and Stigma'

Professor Shlomo Yitzhaki, *Hebrew University*: 'Does Growth Lead to Higher Deprivation?'

Chair: **Professor Carole Pateman**, *UCLA and Cardiff University*

Professor Margaliot's paper takes up McBarnet's extra-legal approach to 'reputation harm', but in this case, the object of the harm lies on the other extreme of the socio-economic continuum: the focus here is not on powerful multinational corporations but on poor individuals who rely on 'negative tax', or welfare payments. Assuming a selective, or targeted, benefit system, Margaliot is acutely aware of government's inability to distinguish between deserving and undeserving poor. Using economic analysis, he offers a formalized account of a social, non-administrative tool: stigma.

For better or worse, stigma has been a part of social assistance since the early days of the poor laws. This notion dates back to the late seventeenth century, when under the Poor Relief Act of 1696, a person receiving alms was to wear a badge on their right shoulder bearing the letter 'P', joined with the initial of his or her parish.²⁶ Publicly exposing the undeserving poor, so the argument goes, will reduce their tendency to claim benefits, resulting, it is assumed, in a predominance of only the deserving poor on the welfare rolls, thus increasing the legitimacy of the system. Note that Margaliot focuses on one possible explanation for stigma, that which results not from a public perception that claimants are not really living up to their civil

obligations and seeking work, but rather claiming unwarranted benefits. Margaliot is aware that stigma is often attributed to claimants simply *because* they apply for benefits, but chooses to focus on the first attribution of stigma. The attribution of stigma to all welfare dependents derives from the inability to distinguish between deserving and undeserving poor. Exposure to family, friends, and neighbours will inflict a high level of social stigma upon 'chiselers', in a manner that will not affect the deserving claimants, thereby serving to realize the goal of governments with respect to welfare claims since the age of the poor laws.

Two problems confront the argument: goal and method. As to goal, the counter argument would be that the problem in distinguishing between deserving and undeserving poor is not technical but ideological. Thus, the American programme of Aid to Families with Dependent Children (AFDC) was underpinned by a belief that held single (white, widowed) mothers to be 'deserving', and so was meant to assist them to remain at home and care for their children. By contrast, the 1996 American welfare reform viewed single mothers as patently undeserving, and so abolished AFDC and constructed a Temporary Assistance for Needy Families (TANF) programme that forces single mothers to accept any job offer available to them.

More significantly, the choice of method is questionable. Even if the distinction between deserving and undeserving poor is established on a normative level, it is far from clear that stigma will be helpful in differentiating between the two groups of claimants. In Professor Diller's words in commenting on the paper, 'stigma is a bludgeon, not

26. Poor Relief Act 1696 (UK) 8 & 9 Will III c 3 s 2.

a scalpel'. There is a serious danger that legitimating the use of stigma will unleash a 'Frankenstein's mob' on claimants, in a way that will affect deserving as well as undeserving poor. There is some evidence of this already, as take-up rates (i.e., rates of *eligible* individuals who apply for benefits) for means-tested benefits in the United States are as low as 20%, at least partially a result of the stigma attributed to claimants. Furthermore, at the other extreme, there could well be claimants who are not susceptible to stigma, and whose social group does not share mainstream values that drive the distinction between deserving and undeserving poor.

Shlomo Yitzhaki's paper brings a core economic concept, that of growth, into social contract discourse, by reviewing the effect it has on deprivation. The novelty of the argument stems from the fact that economists traditionally focus on what a person has, and not what they do not have. For this reason, growth that leads to a rise in the standard of living for all the population is seen as an uncontestable good, even when it also leads to an increase in inequality. Contesting this notion, Yitzhaki follows Walter Runciman²⁷ and investigates the concept of *relative* deprivation. He accepts the idea that because our desires and pleasures stem from society, they are relative in nature. Therefore, an individual's satisfaction may decrease even when his material situation remains unchanged, simply because the situation of others has improved dramatically. The relevance to taxation, insofar as it affects distributive justice, should be apparent: if growth is not accompanied by a just allocation of its fruits, it may worsen the situation of those at the bottom rungs of the social structure.

This idea encapsulates themes that appeared throughout the workshop. Absolute and relative measures of deprivation are not categorically different from absolute and relative measures of

poverty, introduced in the opening lecture.

The historical perspective, prominent in the first panel, also lends support to Yitzhaki's argument: women and racial minorities began to experience feelings of increased deprivation the more they perceived themselves, and were perceived by others, to be equal participants in society. Their social reference group was significant to the way they felt about their own situation, even when it did not change in absolute terms. Only when women entered the labour market on equal terms did they start feeling (justifiably) deprived when studies showed that their wages did not compare with men's wages, even when they were doing identical jobs.

There is a serious danger that legitimating the use of stigma will unleash a 'Frankenstein's mob' on claimants, in a way that will affect deserving as well as undeserving poor.

The argument, in other words, requires us once again to identify the boundaries of the social contract. Are such feelings of deprivation understandable only within certain geographical boundaries – a community, a city, a nation? When does an immigrant cease to compare herself to people in the 'old country', and begin to aspire to the lives held by her current peers? One may argue that the reference group must contain members who reasonably see each other as mutually related, by profession, social status, or family structure, rather than by accident of geographical proximity. Feelings of envy, in other words, are embedded into a sense of deprivation but are not unrelated to feelings of connectedness and relatedness.

27. Runciman, W. (1966) *Relative Deprivation and Social Justice*. London: Routledge.

Conclusion

That taxation is a crucial aspect of the social contract has been reinforced by the discussion in this workshop. The construction and balance of rights and obligations, a matter that lies at the heart of social contract theory and practice, has been a recurring theme. First, taxation sets the mechanism that provides the funds for the role of the state as designated by the social contract. Understanding the principles of a particular tax system grants insight into the notions of fairness and justice that drive the social contract, much beyond economic capabilities.

A series of interesting questions, then, derive from the attempt to identify the relations between two distinct institutions: a particular tax structure, with its rates of income tax, consumption tax, and estate tax; and a particular social structure, encompassing concepts of solidarity, heterogeneity, gender relations, and so forth. Papers in the workshop expressed differing understandings of cause and effect, questioning, for instance, whether the tax structure affects solidarity, or if the reverse is true.

The workshop also raised the question of the different principles that *should* be relevant to the formation of tax policy, and the breadth of these principles. Should taxation take into account only matters of economic

efficiency, or should it also seek to create incentives to advance social goods, such as environmental matters? In between the two, to what degree is a 'patterned idea of justice', to use Robert Nozick's phrase, a legitimate one to hold for a tax system?

Assuming certain incentives may be legitimately advanced by the tax system, to what extent should we expect them to be consistent? This issue was most pertinent in contrasting the unacceptable idea of forcing certain people to work by implementing an endowment tax, with the idea of forcing other people to work (and even stigmatizing them for refusing to work) through the benefit system.

Indeed, this workshop underscored the fact that the need to address the justice and fairness of funds received (or not) is at least as urgent as the importance of investigating the justification for the distribution of funds. While the latter is routinely dealt with in welfare state expositions, the former is far too important to remain at the fringes of the analysis. As this workshop has shown, and as this report has tried to convey, social contract theory offers a useful means by which taxation can be considered in the wider context of distributive justice, where it belongs.

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