

Friedrich Hayek on Taxation and Income Redistribution

PREDRAG BEJAKOVIĆ*
Independent researcher
Zagreb, Croatia

GORAN LUBURIĆ
Zagreb School of Business
Zagreb, Croatia

Review paper
UDK: 336.22
doi: 10.3935/rsp.v30i1.1845
Received: May 2021

A proper care for the poor is the true test of civilisation -
Samuel Johnson, English writer and lexicographer, 1709-1784

Friedrich Hayek was a staunch advocate of the free market principle. He was convinced that progressive taxation was a great threat to individual liberty and social fairness, particularly because there is no limit how high a progressive rate can be in it. The only explanation by which a progressive taxation can be defended is a wish to alter the income distribution, but this approach cannot be explained by any scientific argument. Progressive taxation is unjust and short-sighted while, according to Hayek, a proportional tax system satisfies a standard of fairness and justice because it applies the same general rule to all and prevents discrimination against the well-off taxpayers.

Key words: redistribution, fiscal system, tax policy, Friedrich Hayek.

INTRODUCTION

Scientific spears on the fiscal and social policy have been broken for a long time about the need and justification of tax progressiveness, i.e. the existence of higher tax rates for higher income levels. Conclusions on progressivity were based on the assumptions (1) that utility could be compared among individuals and measured in general terms; (2) that there is a known marginal income utility curve; (3) that this curve shows how marginal utility decreases with income; and (4) that it is the same for all people (Musgrave, 1985). Doubts regarding assumptions (3, 4) were

raised by Edgeworth (1897), and Pigou (1920), but a fundamental break with the assumption (1) did not occur until the 1930s. The main reason is the general acceptance of the conditions of Pareto-optimality. According to it, welfare gains can only be deemed positive if the position of person A improves without deteriorating person B or, which is less demanding, if the gain of person A is sufficient to allow the possible compensation to person B.

In 2022 the world commemorated the 30 years of death of Friedrich Hayek (1899-1992), widely regarded as the best-known member of the so-called Austrian

*Predrag Bejaković, Independent Researcher / Nezavisni istraživač, Zagreb, Croatia / Hrvatska predrag.bejakovic@ijf.hr

School of Economics and the most sophisticated and articulate representative of the movement that consistently opposed economic planning. Throughout his extensive writing and discussion on political economy he was an unswerving advocate of the free market principle. Hayek had a strong belief in the role and importance of the individual in the economy and society, rather than any collective group or government.

Hayek's most important argument against planned economies is based on an estimation that a small group of individuals would be utterly in charge of determining the allocation and distribution of resources. According to his view, for them it would be completely impossible to ever have enough information to do this and adequately meet people's needs. Hayek thought that market forces alone would have the information needed to make these decisions, because markets coordinate opinions and information held by all stakeholders in the society in a *spontaneous* way.

While Keynes supported substantial government intervention in the economy to stimulate growth and employment, Hayek had an opposite opinion believing that the only possible role for a government was to maintain law and order. However, later in life, he did suggest that the state could establish a small 'safety net' for those who found themselves unable to work.

The aim of this article is to shed light on Hayek's ideas about the taxation and redistribution. After this short introduction, the Section dedicated to Hayek's view on free market economy follows. The next Section deals with his opinion on taxation as a mean for income redistribution. The third Section presents his views on proportional versus progressive taxation. The fourth Section analyses his opinions on Welfare State. The article finishes

with Hayek's thoughts on taxation in the modern world.

HAYEK'S VIEW ON LIBERTY AND FREE MARKET ECONOMY

Hayek firmly believed that a free market economy would let the market, consumers and producers to decide how resources should be used without intervention from the state. Hayek categorises liberty as a consisting part of the Western civilisation. The terms *liberty* or *freedom* which he uses interchangeably are the product of the Western experience, and the West thrived by adhering to them. However, approximately by the mid-19th century, the West commenced to lose faith in the ethics of liberty, and henceforth there have been no firm beliefs on which the West could oppose intimidating ideologies. In various texts Hayek underlines multiple threats to Western liberty, like demands for social justice, central planning, the extremes of majority rule, but the biggest danger is this loss of self-confidence and a lack of faith in human capabilities. Hayek is particularly strict in his accusation of Western intellectuals, who have for long period been disenchanted with their own civilization and its accomplishment. According to Hayek, they departed from Western ideas, just as other people around the world were looking up to the Western principles for guidance. The West should renew its thoughtful attitude towards liberty and liberty's value as a desired goal, both to society and to individuals.

Hayek is fully aware that in clarifying the danger of planned economy, he must go beyond economics and historical analysis. The present-day situation entails attention to the principles which require universal validity and therefore demands a vindication of basic principles. Economics and historical analysis can without doubt

explain the issue of liberty, but no single discipline has the needed comprehensiveness and normative strength required to put liberty on a sound footing. Regarding the governmental activities to redistribute wealth, Hayek believes that the progressive income tax is a great threat to individual liberty and social fairness, as explained in the following text.

HAYEK'S OPINION ABOUT TAXATION AS A MEAN FOR INCOME REDISTRIBUTION

Whether combined with the welfare state or not, according to Hayek's opinion, progressive taxation is the main measure of redistributing income, but it is also the most important source of governmental arbitrariness and democratic irresponsibility (Miller, 2010). Therefore, he advocated strongly against redistributive legislation because:

Formal equality before the law is in conflict and in fact incompatible, with any activity of the government deliberately aiming at material or substantive equality of different people, and ... any policy aimed at a substantive ideal of redistributive justice must lead to the destruction of the Rule of Law (Hayek, 1944: 76).

In the same way he was against Karl Marx's dogma of "from each according to his ability", pointing out the fallacy of this thinking;

Unlike proportionality, progression provides no principle which tells us what the relative burden of different persons ought to be... the argument based on the presumed justice of progression provides no limitation, as has often been admitted by its supporters, before all incomes above a certain figure are confiscated, and that below left untaxed (Hayek, 1960: 272).

Although in his time, redistribution by progressive taxation has come to be almost universally accepted as just, Hayek is consistently against it arguing that:

Individual taxes, and especially the income tax, may be graduated for a good reason - that is, so as to compensate for the tendency of many indirect taxes to place a proportionally heavier burden on the smaller incomes. This is the only valid argument in favour of progression. It applies, however, only to particular taxes as part of a given tax structure and cannot be extended to the tax system as a whole (Hayek, 1993: 127).

In a proportional and progressive system, citizens with higher wages pay more, but in the progressive system they do so at an escalating rate. Hayek reminds that in the progressive taxation, in principle, there is no limit how high a progressive rate can be. A high progressive rate is often accepted under false pretenses and all arguments in support of it can be applied to justify any degree of progression.

Hayek fully refutes the possibility to apply utility as a possible explanation of progressive taxation. It has lost its legitimacy because it is impossible to compare the utilities to different persons. Furthermore, Hayek doubts whether the theory of decreasing marginal utility (taxing the wealthy at a high marginal rate will have little effect on the wellbeing of rich) can be legitimately used at all to income as a whole. Finally, if one speaks of utility (and a possibility of decreasing marginal utility with income increase), this might lead to propose not progressive but regressive taxation.

Once the tax rate begins to increase, there are no obstacles for its endless growth. For example, when a progressive income tax system was introduced in the USA in 1913, the upper rate was 7%,

but very soon it increased further. A very similar history happened earlier in Prussia, and at the same time in Great Britain. Therefore, Hayek reminds on the almost forgotten words of Rudolf von Geist, that the progressive taxation means the abandonment of the basic sacred principle of equality before the law, which is the only barricade against infringement on private property. The only explanation by which a progressive taxation can be defended is the desire to change the income distribution, but this defence cannot be explained by any scientific argument. It has to be accepted as an open political postulate of imposing a type of distribution accepted by a majority decision. Hayek does not object to the majority determining tax policy, as it does not levy a discriminatory tax burden on a minority or try to define what is an appropriate income. The problem is that numerous voters with average incomes have significant voting strength and they try to shift the tax burden to the wealthier classes by often pushing tax rates to confiscatory levels.

Such self-interested strategy of progressive taxation is both wrong and short sighted. The strategy is wrong, because the majority, instead of applying a general rule, releases itself from a policy that it applies to other. Such strategy is short-sighted and economically inefficient, because in such way relatively small public revenues are collected, and inflation gradually pushes the middle classes under the higher rates, without raising their real income. Such approach is also inefficient because it prevents necessary capital formation and therefore causes limited competition on the market and burdens the economic growth. In this work it is deemed primarily on progressivity in the context of personal income tax.

While the steeply progressive tax system is inefficient and unjust, Hayek con-

ceives one that fully respects a principle or rule which applies to all as the efficient and just tax system. Progressive taxation is not inhibited by any such principle and it does not apply diverse rules to different people, according to their income or assets. On the other side, a proportional tax system satisfied Hayek's standard of fairness and justice because it applies the same general rule to all, prevents discrimination against the well-off and, demands that political majorities respect the rules they enact, and prevents high rates of taxation. The unjust tax system also causes inefficiency in lessening the issue of poverty and a suboptimal welfare state.

HAYEK AND WELFARE STATE

The difficulties of social democracy in the 1970s and 1980s gave the arguments of neo-liberals a renewed authority. At the heart of their position lied the belief that the spontaneously arising market economy, or what Hayek had called "catallaxy", offered the best means of securing both optimum individuals and social welfare and the surest guarantee individual liberty. To the extent that social democracy and the Keynesian Welfare State superseded this "natural" order, they had always, even in the period of their greatest successes, offended against justice and economic rationality.

Very often there is a general delusion that all social problems could be solved by government institutionalized necessity to control "everything" and the widely accepted notion that the bureaucrat knows what is best, so that never for a moment is there a doubt in the validity of bureaucratic solution. It is also slightly insane, or at least indicative of mankind's incapacity to order priorities with any common sense, to spend huge money for the sole purpose of bureaucratic neatness (Hall, 1976). The

majority of government today is too large and too intrusive. It has a say in matters that should be entirely out of its domain, and in the domain of personal moral judgment: drug use, race relations, abortion, and various moral initiatives (such as volunteerism and censorship). Surprisingly, this seems to suit most people splendidly; if ever there are complaints about the government's involvement in any of these issues, they will most likely be that the government is taking the wrong side or that it's not doing enough. The much more important question, whether the government should have any involvement at all, is ignored or taken for granted.

But indeed, on both a practical and a theoretical level, the government isn't at all suited to deal with many issues (for example *moral*), that is, to control individual moral decisions. This is a lot to ask of any political system, and too much to ask of one that founds itself on respect for individuals' rights and particularly the right to dissent. The reason the government repeatedly fails here is that dealing with moral matters was never meant to be its charge. A democratic political system as such is designed with a lot of freedoms implying a lot of responsibilities. But if the responsibilities are abnegated, then so are the freedoms. The government, now enforcing specific personal moral decisions, becomes large, powerful and top-heavy. It creates a rift between the government and the governed. As in the many modern societies today, it unhappily approximates between democracy and dictatorship.

We are assuming for now that democracy is a feasible and sustainable political system. If the current state of modern politics is just a slump, then what can we do to get out of it? Any aspects of the public that embrace or resign themselves to the large size and great power of the current government believe two things. Firstly, they

hold that it's the government's place or obligation to deal with delicate (moral or poverty) issues. Furthermore, and perhaps more importantly, they feel instinctively that the government is the only institution competent to deal with or solve those issues; because of this, they are willing to accept the government growing as large and powerful as necessary.

It is striking to note the interplay in this context between legal and economic thought. Laws are a major product of the state activity and this itself makes them a natural target of free market radicals who believe in a minimal state sector. They tend to be suspicious, in particular, of redistribution legislation and state welfare, which are seen as encouraging welfare dependency and discouraging self-help, and they condemn excessive commercial regulation, which is seen as an impediment to commercial freedom and as a stifling economic enterprise. It has been suggested that the "stock" of laws in existence at any given time effectively binds government to honour many open ended entitlements to social benefits and obliges them to carry out a multiplicity of inherited spending programmes: something that in an era of big government laws may be seen as having a positive inertia, carrying forward the binding commitment of government to provide costly program benefits to citizens, whether or not the government of the day would have initially chosen to do so (Rose, 1986). Yet there is an element of ambivalence in the "free market" that is suspicious of law. Some aspects of law and regulation may be seen as undesirable by-products of an over-large and over-active state, but the task of rolling back the state by privatizing, contracting out and deregulating often cause a substantial resistance by various interest groups which lose their monopolies or privileges. As law is one of the building blocks of the state,

the reconstruction of the state - or demolition of some of its functions - must have significant legal consequences. It is a paradox that the very process of deregulation can generate more regulation rather than fewer, particularly in the short term.

No doubt that in many instances in which the legislator would like to restate the law, he would not be able to make whatever rules he likes, but would be bound by the requirements of the part of the given system. Hayek put this differently:

It will be the whole complex of rules which in fact are observed in a given society that will determine what particular rule it will be rational to enforce or which ought to be enforced. Though two sets of rules may in part be the same, yet the first set of rules may include some which need not be enforced because they are universally obeyed, while the second set of rules will contain some which would not voluntarily be obeyed but whose observance is important for the same reason as the observance of the first, so that those who observe the first have good reason for demanding that the second be also obeyed (Hayek, 1993: 51).

How could one estimate Hayek's attitude regarding current welfare and social protection in modern society, specially having in mind the complex situation in transition countries? As a persistent enemy of too high redistribution policy that necessarily incorporates oppression, he stressed:

As is becoming clear in ever increasing fields of welfare policy, an authority instructed to achieve particular results for the individuals must be given arbitrary powers to make the individuals do what seems necessary to achieve the required results. Full equality for most cannot but meant the equal submission of the great

masses under the command of some élite who manages their affairs (Hayek, 1993: 97).

If state authority is too powerful and responsible for almost every part of society, there is increasing evidence of considerable discretionary decision-making, rent seeking and other forms of political influence on important public policy decisions. Furthermore, in many cases public money has been used for private interest and unproductive expenditure. Hayek was fully aware that it could not be denied that in the existing market not only the results, but also the initial chances of different individuals are often very different. These chances are affected by the circumstances of their physical and social environment which is beyond their control, but in many particular respects might be altered by some governmental action. So, Hayek wrote:

There is no reason why in a free society government should not assure to all protection against severe deprivation in the form of an assured minimum income, or a floor below which nobody needs to descend. To enter into such an insurance against extreme misfortune may well be in the interest of all; or it may be felt to be a clear moral duty of all to assist, within the organized community, those who cannot help themselves. So long as such a uniform minimum income is provided outside the market to all those who, for any reason, are unable to earn in the market an adequate maintenance, this need not lead to a restriction of freedom of conflict with the Rule of Law (Hayek, 1993: 87).

Problems could arise only when the remuneration for services rendered is determined by the authority that defers impersonal mechanism of the market. Very often this is done in the name of "social justice" and is not only unjust, but also

very unsocial in the true sense of the word: it is only protection of entrenched interest.

CONCLUSION

Modern society, Hayek (1993) mentioned capitalism, as it exists today in consequence undeniably has many remediable defects that an intelligent policy of freedom ought to correct. A system which relies on the spontaneous ordering market forces, once it has reached a certain level of wealth, is also by no means incompatible with government providing, and outside the market, some security against severe deprivation. But the attempt to provide to each what he is thought to deserve, by imposing upon all a system of common concrete ends towards which their efforts are directed by authority, as was a habit in socialism, would be a retrograde step that would deprive mankind of knowledge and advantages of free society.

Rather than being an inaccessible and independent monolith, the government, at the least in a democracy, is a manifestation of some prevailing desire of the governed public. That is part of the essential quality of democracy: a form of government that is representative of the people, and not dependent on the whims and capacities of an elite ruling class. If it is interfering where it really should not, then the people must want it to.

When Hayek originally wrote these words on taxation and redistribution at the end of 1950s, it was thought impossible by many that progressive taxation could have a profound adverse effect on incentives and on the total production of wealth in society. Reading these chapters sixty years later, we are the beneficiaries of several of Hayek's insights into the dangers that follow the erosion of market forces, including the menacing effects of too progressive taxation.

Although there are no general and always applicable rules that correspond to all tax systems and times, there are some characteristics and rules that are almost universal and which are applied in almost all modern tax systems: 1) there is no generally optimal tax system, and in particular there is no optimal profit tax system; 2) modern tax systems should in principle be based on the broadest possible tax base (with as few non-taxable exceptions as possible), and tax rates should be as uniform and low as possible in order to mitigate the negative impacts on the behaviour and work activity of taxpayers; 3) over the next 20 years or so, there is likely to be a slight shift towards consumption taxes (especially VAT) and property taxes, and away from income tax and social security contributions; 4) over the next 20 years, the total tax revenue in GDP is likely to continue to rise slightly – mainly due to increased allocations for pensions and health insurance, although this share will continue to move in different directions in various countries; 5) the impact of globalization and other international factors (including EU conclusions) on the decisions on tax rates, bases and systems, both in the past and in the future, is less significant than domestic goals and pressures; and 6) there is no reason to believe that in the next 20 years there will be a greater international tax convergence than is the case now, where many things also depend on the initial state, tradition, taxation habits and the like. All issues, such as the characteristics of existing properties, the acceptability of market-based determination of income distribution, forms of social welfare, maintenance of full utilization of resources, phenomena of taxation and economic growth, have great significance in determining the appropriate size and operation of public finances. Thus, it can be assessed that Hayek's thoughts on taxation are mostly accepted.

Although excessive progressive taxation has been abandoned almost everywhere in the world, given that Hayek is an opponent of progressive taxation, and many countries have precisely progressive models at least in some parts of their tax system, it is necessary to mention that the proportional compared to the progressive tax system reduces the income inequalities that are present today less, while citizens are more sensitive than they were in the past. But on the other hand, the remark highlighted by Hayek himself points that in a progressive system, the rates for those with higher incomes can be arbitrarily or unduly high and too high progressivity can negatively affect the economy and investments due to the possible flight of capital or the emigration of skilled labour force from such countries. Therefore, there are also examples today of reducing progressivity. For example, in Croatia this happened regarding the personal income tax, while one of the explanations was to reduce the higher tax rate in order to keep professional experts in the country, for example in the IT sector, etc.

It is difficult to give an unequivocal assessment of how much modern social policy systems respect Hayek's statements. It is certain that there are multiple complex links between different parts of social insurance and policies. Large allocations for social protection and care are likely to hinder investments in education and technological development, which could in the long-term cause adverse consequences for economic growth and development. A successful employment policy greatly reduces the risk of poverty and social exclusion, and contributes to easier financing of pension and healthcare insurance systems. Enhancing the effectiveness of social policy has a number of side effects in the overall economy. For example, employment promotion measures have no effect on

employment alone, but they also affect an increasing number of active insurers and contributors, thus reducing welfare expenditures. Poor health status prevents and/or discourages education, training and the search for employment, thus increasing the risk of poverty. Through different types of interventions, or through the actions of well-meaning but largely incompetent politicians or because of the narrow and short-term interests of individual groups, the state could be an obstacle for social development and social policy. Consequently, the expectations of citizens and the tax burden have also increased, which had undesirable consequences and contributed to the economic growth slowdown.

Social policy in the wider sense (pension and health insurance, employment and unemployment protection and social welfare) has without doubt been successful in lessening the vulnerability of a significant part of the population, but at the same time it has created an enormous pressure on the expenditure side of the national budgets in many countries. However, a noteworthy share of the population has been still exposed to a risk of poverty and/or unsatisfactory access to appropriate public services. Thus, it could be assessed that current social policies in the broader sense are largely far from executing their primary tasks - reducing social inequalities and mitigating conflicts between social groups - and in reality, they reinforce existing social differences.

Since the bulk of transfers are pensions, the weaknesses of the welfare system in the EU Member States in helping the poor can be linked to problems of the pension system. One can argue that this is not a failure of the pension system *per se* because this social insurance system has other objectives, primarily the intertemporal transfers or saving during the working age for future revenues for retire-

ment. However, expenditures for public pensions were constant in almost all EU Member States. The existing deficits in the public pension systems have been mostly covered from the central budget, reducing the financial resources that could be otherwise redirected towards the poor.

REFERENCES

- Edgeworth, F. Y. (1897). The Pure Theory of Taxation. *The Economic Journal*, 7, 46-70. <https://doi.org/10.2307/2956958>
- Hall, T. E. (1976). *Beyond Culture*. Doubleday, New York: Anchor Books.
- Hayek, F. A. (1944). *The Road to Serfdom*. London: Routledge.
- Hayek, F. A. (1960). *The Constitution of Liberty*. London: Routledge.
- Hayek, F. A. (1993). *Law, Legislation and Liberty, Vol. 2: The Mirage of Social Justice*. London: Routledge.
- Miller, E.F. (2010). *Hayek's The Constitution of Liberty: An Account of Its Argument*. London: The Institute of Economic Affairs.
- Musgrave, R. A. (1985). *A Brief History of Fiscal Doctrine, Handbook of Public Economics Vol. I, Auerbach A. J. & Feldstein M. (Eds.)*. Amsterdam: Elsevier Science Publishers B.V.
- Pigou, A.C. (1920). *The Economics of Welfare*. London: Macmillan.
- Rose, R. (1986). Law as a Resource of Public Policy. *Parliamentary Affairs*, 39(3), 297-314. <https://doi.org/10.1093/oxfordjournals.pa.a052047>

Sažetak

FRIEDRICH HAYEK O OPOREZIVANJU I PRERASPODJELI DOHOTKA

Predrag Bejaković

Nezavisni istraživač

Zagreb, Hrvatska

Goran Luburić

Poslovno veleučilište Zagreb

Zagreb, Hrvatska

Friedrich Hayek bio je odlučni zagovornik načela slobodnog tržišta. Smatrao je kako je progresivno oporezivanje velika prijetnja osobnim slobodama i društvenoj pravdi, pogotovo zato što u njemu nema ograničenja koliko može iznositi progresivna stopa. Jedino objašnjenje na temelju kojeg se može braniti progresivno oporezivanje jest želja za promjenom raspodjele dohotka, ali ovaj pristup ne može se objasniti niti jednim znanstvenim argumentom. Progresivno oporezivanje je nepravedno i kratkovidno, dok prema Hayekovom viđenju proporcionalni porezni sustav zadovoljava načela pravednosti jer primjenjuje isto opće pravilo na sve porezne obveznike i sprječava diskriminaciju dobrostojećih poreznih obveznika.

Ključne riječi: preraspodjela, fiskalni sustav, porezna politika, Friedrich Hayek.