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# Introduction

How much of your hard-earned money is it fair for the state to collect through taxation? What public services should the state use that money for? Economics, politics, and moral philosophy are inextricably intertwined. Nowhere is this more apparent than in public finance—the study and practice of the interactions between the state and individuals through taxes and public expenditures. Questions on the appropriate role of the state in our lives require us to consider moral perspectives.

This book analyzes the economic driving forces behind the evolving role of the state globally and the rising gap between actual practice and what citizens perceive to be fair in the areas of taxation and provision of public services. Fiscal measures taken during the COVID-19 pandemic and the global financial crisis a decade earlier have rekindled debates on what policies are fair. They have also reshaped our understanding of how fiscal policy (such as tax and government expenditure measures) can and should support people and their livelihoods during emergencies.

Government choices regarding public expenditures or taxation reflect—implicitly or explicitly—moral points of view. Does everyone have a right to education, health care, food, and shelter?

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How much redistribution is justified from the well-off to those less fortunate or less talented? Should the state collect taxes on the current generation or issue debt, shifting the burden to unborn generations? Should taxes be levied on inherited wealth rather than current income? Should consumption taxes be higher for alcohol, cigarettes, sugary drinks, or fossil fuels, than other goods? More generally, how can public policies give everyone a fair shot at gaining prosperity, or at least earning a decent standard of living?

Likewise, political battles on the appropriate role of the state in society reflect differing values or opinions on individuals' freedoms, rights, and abilities to control their own destinies. In many countries, emotions run high not only because of the divide between the haves and the have-nots, but perhaps even more because of perceptions that the system is rigged, or that not everyone is given a chance to be successful. Just to take a couple of examples familiar to those based in the United States, consider (on the left) the "Occupy Wall Street" movement in the aftermath of bailouts of financial institutions in 2008–9, or (on the right) slogans such as "Drain the Swamp" during the 2015 presidential campaign. In recent years, major street protests around the world were triggered by relatively small changes in taxes (France, 2018) or fees for public services such as transportation (Chile, 2019). A common thread tying these episodes in such diverse countries was the perception that their elites were not paying their fair share.

Economists, political scientists, and philosophers have long sought to make sense of such developments and to inform public policies to address these concerns. Many of the great economists of the past, such as David Hume and Adam Smith, were also moral philosophers.<sup>1</sup> As economics became more math-based during the second half of the twentieth century, moral perspectives became less central to the discipline, notwithstanding important contributions by giants of the profession such as Kenneth Arrow, Tony Atkinson, James Mirrlees, and Amartya Sen. The explosion of statistical and econometric analysis also led to focus on hard data—facts, not feelings were deemed the object of interest. Most

economists sought to position themselves as impartial social scientists and generally focused on economic efficiency. Yet, people also care deeply about fairness in the distribution of income, wealth, and opportunities.

Apprehension about inequality ebbs and flows historically. For several years now we have experienced a rising tide. A resurgence of academic work on the topic has attracted interest among general educated audiences—witness the success of Thomas Piketty’s 2014 book *Capital in the Twenty-First Century*, for example. But measuring inequality of incomes or wealth, or even the redistributive role of tax and transfer policies, is only part of the story. The broader concern seems to relate to inequality of opportunities rather than outcomes. Indeed, the COVID-19 pandemic laid bare inequities in access to basic services—health care, education, or digital infrastructure. In turn, these differing opportunities may cause income gaps to persist generation after generation, as documented by important recent studies by economists including Raj Chetty and collaborators under the Opportunity Insights project.

Moreover, advances in evolutionary moral philosophy (popularized by books such as *The Righteous Mind*, by Jonathan Haidt, or *Moral Tribes*, by Joshua Greene) have opened new avenues for understanding how people’s emotions respond to inequalities in incomes and opportunities, and how their reactions ultimately shape public policies. These studies suggest that our moral choices depend on a combination of instincts or feelings and reason. Our feelings evolved to promote cooperation within groups, which facilitated our species’ endurance.<sup>2</sup> We are usually sensitive to signs of suffering and disposed to care for those in need. We despise cruelty. We value and reward collaboration and reciprocal altruism, whereas we want to shun or punish cheaters. Sometimes we value loyalty to a group and respect for authority—crucial for the survival of our ancestors’ roving bands of hunters. We also experience disgust when observing something that looks polluted (whether physically or figuratively). We sometimes long for purity in nature or relationships, and we may view certain objects, places, people, or principles

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as sacred—feelings that likely originated from the need to avoid pathogens. We all experience these feelings, although their intensity or importance seems to vary across individuals and cultures.

Considering that these feelings underlie many people’s moral perspectives makes it easier to understand their policy preferences. Morality grounded in reason alone would make us “universalists” who apply the so-called golden rule (treat others the way you would want to be treated) equally to all humans, regardless of family ties, nationality, or religion. But sensitivity to feelings of loyalty, authority, or purity may lead many people to “communitarian” preferences that call on them to take care of those in their own community first, and thus make them less favorable to immigration, international aid, or welfare payments that might accrue to those from other groups. (In reality, pure universalists may not exist. Almost all of us are communitarian but to varying degrees and with respect to different groups—some caring mostly about family or friends, others feeling strong affinity to neighbors, co-nationals, co-religionists, etc.)

This book takes a global perspective to consider fiscal policy issues through the prism of what people consider to be fair, or what is morally right or wrong. Its goal is to connect developments in fiscal trends and measures with what we are learning from different disciplines, to inform public discourse on future policies.

Recently published evidence from rigorous studies corroborates the view that people care more about fairness than efficiency when considering fiscal measures, although notions of fairness may differ, as discussed in subsequent chapters.<sup>3</sup> Social scientists are indeed returning to moral questions and making progress by analyzing newly available data. In the past few years, pioneering researchers have analyzed large surveys to explore respondents’ attitudes toward tax and expenditure policy choices. As more data become available about people’s feelings and perceptions, the economics profession is going back to its origins, armed with state-of-the-art statistical tools. This line of work deserves attention outside specialized academic circles.

Beyond different moral perspectives, we are also learning more about behavior that looks squarely immoral from a distance but may seem justifiable to those who facilitate it. Investigative journalists and academic economists have recently shed new light on how corruption or other illicit or near-illicit behavior undermines revenue collection or the pursuit of value for money in public spending. Curbing corruption is crucial for the state's ability to fulfill its mandates and to preserve its legitimacy when asking people for their hard-earned money.

Criminals and corrupt individuals have always existed and it may be no surprise that they are upping their game. But more intriguingly, illicit financial flows increasingly depend on the cooperation of enablers in otherwise fully legitimate professions (accountants, lawyers, and so on) who may in some cases push the boundaries of what is legally and morally acceptable. Perhaps these professionals consider that helping clients to pass their wealth on to their children is a worthy cause, and that investigating the source of the wealth is someone else's responsibility. Understanding these enablers' perspectives may reveal potential avenues for reform.

More generally, where corruption or its facilitation are widespread, their persistence often reflects individuals' incentives to conform to existing practices by those already engaged in such systems. Occasionally, politicians are persuaded to introduce new tax deductions for special interests or to pass reforms that make it easier to hide illicit gains in opaque trusts. In some cases, the local gains are minimal, but the burden on other countries can be massive. Those undertaking such actions may justify them by arguing that other countries (or regions, or cities) would do the same—thus engaging in races to the bottom that lend themselves to economic analysis. Society's discontent arguably comes from the fact that legal avoidance often stretches the limits of the law and is available only to those for whom the tricks of trade are known or affordable.

If we are not able to reverse recent trends, will people feel even more strongly that the state is unfairly taking, and perhaps wasting,

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their hard-earned money? What will the political consequences be? In an analysis of the record over the past millennia, historian Walter Scheidel (2017) found that only warfare, revolution, state collapse, and epidemics rectified economic inequality. In recent decades, modern welfare states have sought to ameliorate inequality somewhat and to maintain a reasonable, if fragile, degree of social peace. Addressing people's concerns and restoring a sense of fairness is central to preserving democracy.<sup>4</sup>

Informed by the interplay between moral perspectives and policy decisions, it becomes easier to analyze why the level and composition of taxes and expenditures have evolved during the past century or so. Similarly, measures taken during the most recent global crises have been importantly shaped by, and have had an impact on, views on how the state should support people's lives and livelihoods, and who should ultimately cover the fiscal cost of these actions. The time is ripe for an overview of important analytical and policy developments, distilling their early findings, and pointing to new directions in the examination, design, and conduct of public policies at the domestic and international levels.

### **What You Will Find in This Book**

The book's storyline is arranged in five chapters. A preview goes as follows.

#### **1. WHAT IS THE RIGHT THING TO DO? MORAL PERSPECTIVES ON PUBLIC FINANCE**

This chapter begins with a whirlwind overview of moral philosophy pertinent to fiscal issues. Although the book's coverage is global for economic policies and attitudes toward them, the scope of this chapter is confined to the Western tradition.

Considering the role of the state, long-dead philosophers confronted moral dilemmas akin to those we face today, and many of their insights remain relevant. But principles outlined centuries

ago can acquire new meaning or gain importance as societal situations evolve. Moreover, even in fields as ancient as moral philosophy, new approaches emerge as each generation of thinkers reflects on previous writings or as progress is made in related disciplines. In that regard, the chapter considers potentially valuable lessons from recent findings by psychologists who study how natural evolution has shaped our feelings and our moral perspectives.

Public finance has traditionally focused on economic efficiency, sometimes considering tradeoffs with equality of income or wealth. When addressing such distributional issues, economists have generally sought to steer clear of moral considerations that could be seen as subjective. For the most part, redistribution has been analyzed by requiring users to input their own preferences regarding inequality: tell economists how much you care about inequality, and they can tell you how much redistribution is appropriate through the tax-and-benefit system. People (or, in some cases, families or households) have usually been considered as individuals, differing only in income, wealth, or spending potential. Most economic analysis has taken a universalist perspective, treating all humans equally.

However, many heated public policy debates can only be fully understood by analyzing communitarian perspectives too. Consider, for example, the debate on the appropriate policy response to job losses attributable to automation and globalization. Until recently, economic analyses of long-term unemployment emphasized the need to liberalize the markets for labor and housing; if jobs were lost in a region, economists recommended the removal of barriers preventing the migration of workers to locations where new jobs were emerging. This approach emphasized individuals' ability to move, paying less attention to the role of communities in people's lives. Helping individuals, however, may not be enough if they identify with, and care for, a community that is no longer thriving. Having witnessed pushback against policies that failed to support the localities that lost jobs, economists and policymakers have become more conscious of the need to support communities left behind (Rajan 2019, Sandbu 2020).

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Equally, understanding the debate on whether immigrants should have access to publicly funded services requires considering cultural identity (for both native and immigrant communities), not just calculations of economic costs and benefits. Similarly, disturbing societal trends such as the rising death rate for white, non-Hispanic Americans without a four-year college degree in the United States since the 1990s cannot be explained by economic developments alone. As shown by economists Anne Case and Angus Deaton (2020), these are deaths of despair—from drugs, suicide, and alcohol—which the authors attribute, in part, to weakening community and support systems in the workplace and at home, a seeming loss of social standing, and a perception by some that the deck is now stacked against them.

The chapter then turns to recent developments in evolutionary moral philosophy, including a new understanding by researchers in that field of how evolution led us to have favorable emotions toward those belonging to our group. This helps trace how some moral perspectives are not grounded in reason alone, and favor those close to us. Under this new approach, social scientists should devote greater analytical focus to perspectives such as loyalty (to one's family, tribe, region, or country), community, purity, or authority. The chapter illustrates how such approach can be related to public finance. It also reviews rapidly growing research by social scientists who draw on large surveys to explore the relationship between people's moral perspectives and their preferences regarding tax policies and the allocation of government spending.

## 2. WHY SO MUCH INTEREST IN FAIRNESS AND DISTRIBUTION?

Interest in fairness and distribution has risen in recent years. To understand, it is helpful to review the facts on inequalities of incomes and wealth. But one must also delve into how people perceive inequalities and how gaps between the haves and the have-nots impact people's mental and physical health.

As shown in the chapter, if one were to measure inequality by lining up all living individuals in the world by personal income, ignoring national borders, one would find that global inequality has gone down during the past two or three decades. Considering inequality within countries, it has fallen in about half of the world's countries, and risen in the other half. But it has risen in most advanced economies, notably the United States and the United Kingdom, countries with an outsized role in determining the zeitgeist reflected in the media.

Many people and sometimes entire communities are suffering as their job options shrink, their living standards stagnate, and their relative position in society declines. Anxiety, depression, and stress often occur when people perceive they are falling off the income or power ladder—especially when comparing themselves to those they consider as peers by virtue of similar education, geographic proximity, or similar background. Meanwhile, as the income gap between the professional classes and the uber-rich widens, intellectuals and journalists become more sensitive to inequality and raise the issue's profile in public discourse.

Besides developments in income distribution, concerns about lack of fairness also stem from perceptions that the system is rigged. Beyond episodes of outright corruption, rich individuals or corporations can often avoid or evade taxation, whereas basic public services fall short of expectations for large swaths of the poor and the middle class.

### 3. HOW THE STATE HAS EVOLVED

This chapter focuses on how both the practice and the notion of what the state should do evolved as countries became richer, life expectancy grew, democracies became more prevalent, and societies confronted morally relevant challenges, such as changes in inequality, the need to compensate war veterans, and the need to support those harmed by major economic and health crises. To that end, the chapter steps back even further in history to

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document developments in spending, taxation, and their composition since the early 1900s.

Governments were small until the beginning of the twentieth century. Their main expenditure item was defense. Spending (and public borrowing) would occasionally spike when countries waged wars, and taxation would subsequently rise to a higher level for several years to pay back the debt. Throughout the twentieth century, the state gradually took on more and more roles, including provider of basic services and promoter of economic development (education, infrastructure), insurer (health care, unemployment benefits), issuer of safe assets that allow transferring savings into the future (government bonds, pensions), entrepreneur (state-owned enterprises, basic research), and financier of last resort (emergency financial backing to private firms and financial institutions through loans, guarantees, or equity injections during times of crisis). Support for these functions depends on moral perspectives: for example, universalists tend to favor the insurer role more than do communitarians, who instead prefer spending on defense, and law and order.

Taxation has also risen to finance these growing functions of the state. But the form of taxation and its incidence on different taxpayers has changed in recent decades, owing to a combination of technological and political factors. With globalization, for example, it has become more difficult to tax multinational firms or high-net-worth individuals, who can now more easily eschew national borders. As a result, income taxes on corporations and on individuals at the top of the income distribution have fallen in most countries. Meanwhile, a tug-of-war in the realm of ideas on progressivity and in the practice of tax administration led to changes in revenues collected from multinationals and the rich.

Although slow-moving factors such as globalization or population aging have influenced tax and spending patterns, the role of the state was expanded quickly and profoundly reshaped during major crises, beginning with the two world wars and the intervening Great Depression. The state has a special responsibility

to support people in need during emergencies. This role of government has again been tested, improved, and expanded during the two most recent global crises—the global financial crisis that began in 2008 and the COVID-19 pandemic of 2020–22.

As documented in the chapter, the experience gained in those episodes is informative for possible future crises. Two lessons are worth mentioning from the outset. First, fiscal measures can be quick and impactful. Traditionally, fiscal policy had been viewed as a large ship that takes a long time to steer, leaving monetary policy (measures undertaken by central banks affecting, for example, interest rates) as the quicker and nimbler tool to respond to changes in the economic cycle. During the global financial crisis and, especially, the COVID-19 pandemic, however, strong political consensus allowed governments to deliver support to people and firms shortly after the start of the crisis. Together with the provision of liquidity by central banks, swift fiscal support allowed people to survive during lockdowns and medical emergencies, avoided personal and corporate bankruptcies, and reduced the scale of global economic implosion. Support reached people and firms quickly—in some cases, even in rural areas in low-income countries, leveraging digital means.

Second, the state can serve as a powerful financier of last resort. In major crises, and for countries with sufficient credibility, the state can be even more swift and impactful through large financial support measures such as public sector guarantees, loans, and equity injections, which can be deployed upfront and act faster than traditional spending measures. Together with ample liquidity from central banks, such measures ruled out a self-fulfilling pessimistic scenario and averted economic collapse.

The COVID-19 pandemic also focused attention on the government's mandate to help people and firms during emergencies. Many dropped out of school (especially in developing economies), suffered irreparable health damage, or experienced personal financial bankruptcy. During times of adversity, meeting the rising demand for basic public services is crucial to help

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people bounce back from unemployment, sickness, or poverty, thus avoiding scars that would otherwise contribute to prolonged hardship. Swift support can strengthen public trust and support social cohesion.

The chapter also explores people's attitudes toward social protection and basic public services such as education and health care, and taxation options to finance them, both before the pandemic and during its most intense period.

### 4. CHEATING THE STATE: HOW DOES CORRUPTION PERSIST?

The rise in the size of the state and the range of public services it provides has improved the quality of life for many people, but it has also created opportunities and incentives for malfeasance. Corrupt civil servants can abuse their positions to solicit bribes, by capitalizing on overregulation, opacity, and bureaucratic discretion. People and firms can evade taxation through various stratagems. This chapter shifts the analysis to squarely immoral behaviors—corruption, tax evasion, and illicit international financial flows—all of which remain, of course, rampant. It then explores the gray areas where professionals use legally acceptable means to facilitate illegal behavior on the part of their clients. Indeed, it is exactly near the blurred lines between what is legal and illegal, or between what is socially tolerated and condemned, that moral perspectives may differ and the discussion becomes interesting.

A central theme of the chapter is that corruption—the abuse of public power for private gain—generally occurs because people are unable to coordinate their actions on a better path. Imagine that you are hired into the civil service and find that everyone there is corrupt. It will be difficult for you to behave in a clean manner, because your colleagues and supervisors will punish you if you do not extract bribes and share them. Thus, corruption persists. Conversely, imagine that you enter the civil service and everyone there is honest. You will have to resist temptation

to solicit bribes because you would likely be caught and punished. In this case, honesty persists. Intriguingly, as developed in the chapter, the interaction between individual choices and the behavior of broader groups is reminiscent of the very foundations of morality.

The chapter brings this theme to life using documented examples from around the world (including a classic account of long-lasting corruption in India's irrigation system in the 1970s, and a reminder that corruption was reduced quickly in Georgia and Rwanda in the early 1990s, in the aftermath of different political upheavals).

Within the broad framework of challenges in coordination, the more intriguing part is how enablers in perfectly legitimate professions—lawyers, accountants, investment or tax advisors—justify their role in facilitating corruption or other financial crimes. A lot more is now known about these enablers at the interface between legality and illegality, thanks to the brave and painstaking work of investigative journalists. Enablers may help clients meet (or redesign) the letter of the law to push the boundaries between tax avoidance (legal) and tax evasion (illegal). They may also help corrupt bureaucrats move their illicit gains to foreign jurisdictions. Their self-justifications are often along the lines of “if I don't do it, someone else will,” which again fits the theme of coordination failure. The same applies to the behavior of entire countries or states, regions, or provinces within countries, which gain financial advantage by cutting their tax rates or allowing the use of opaque trusts by tax evaders or money launderers.

## 5. THE WAY FORWARD

If we are not able to reverse recent trends, will people feel even more strongly that the state is unfairly taking, and perhaps wasting, their hard-earned money? Is there a risk that inequality will be reduced through violence, as historically has been the case according to Scheidel (2017)? Can governments muster consensus for

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policies to gradually reduce the gap between the haves and the have-nots, as in post–World War II Europe, as argued by Atkinson (2015)?

This chapter sketches a few broad policy directions at the domestic and international level in the fiscal area, selecting those that present more linkages to moral questions. For some policies, I merely summarize the main pros and cons. Attempting to be comprehensive would require a book for each topic. My hope is that presenting this material together will reinforce the case for the general direction of travel and encourage more cross-fertilization of ideas across topics.

I provide some considerations for domestic policymakers (at least those that base their policy design on analysis) and for social scientists who conduct research and distill its results for policymakers. I include some suggestions on how to apply a wider range of moral perspectives in that work. I also make a case for more international cooperation on tax policy and tax administration matters—a thorny task given the strong tradition for countries’ sovereignty over tax matters. Paradoxically, even staunch communitarians will need to warm up to international cooperation. Giving communities the tools to pursue a better future will require resources, and nobody can afford further revenue losses in an international race to the bottom.

### **About This Book**

The book is accessible to the educated general reader. Students may find it helpful to see economics, politics, and moral philosophy presented together. Scholars of one of these disciplines may come across developments in the others that may benefit their own research. If you are a professional in government, an institution, a think tank, or a civil society organization with an interest in public finance, reducing inequality, or fighting corruption, I hope this book can widen your toolkit to help you shape public debate and public policies.

For full transparency, I should mention those aspects of my upbringing and professional background that are relevant to the topics addressed in the book. The values I absorbed from my family and community from early childhood probably place me at the universalist end of the human spectrum. These were reinforced by my personal history studying, living, and working in several countries, as well as more than three decades dedicating my professional life to international cooperation on economic matters. I have been fortunate to visit dozens of countries in a professional capacity, to interact with officials from more than a hundred countries, and to have friends and colleagues pretty much from every country in the world. Nevertheless, an intrinsic aspect of being human is to have relationships and thus special bonds to one or more groups such as family, neighborhood, workplace, city, country, ethnicity, or religion. Even inveterate universalists retain a communitarian side in some way, which makes me hopeful that everyone can empathize and engage constructively with other communities' perspectives.

My goal is to share my best understanding of the latest thinking about what governments can and should do to collect necessary revenues, provide public services, and support people in a manner that is both efficient and fair. Many of the arguments are based on a review of high-quality, often cutting-edge work by academics or economists at the interface between policymaking and academia. This is a fast-moving area of research, where several scholars are producing top-quality studies faster than I can read them. But the questions are timeless and long-dead philosophers still teach us something useful.

The book's approach—based on moral reasoning and economic arguments—might come across as naive or quaint, given that policies and societies are often shaped by realpolitik, power and coercion, driving a hard bargain, or mobilizing groups with common interests. Those are crucial topics covered elsewhere.<sup>5</sup> Even so, I am still hopeful that these approaches can be complementary and, in many situations, much can be accomplished through

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persuasion grounded in facts, reason, and understanding of others' moral perspectives.

I will not delve into issues related to the sustainability of public debts or fiscal deficits. Those issues are important and well covered in many reputable publications, including those by international financial institutions, national independent fiscal institutions around the world that provide non-partisan analysis, or the financial press. Suffice it to say that, in most countries, fiscal resources are scarce, the needs for public investment and services are great, and this is why debates on the fairness of taxation and spending choices provide strong motivation for this book.

To help the reader focus on the arguments, I have deliberately not included data tables or charts. As quantities matter, however, I mention a few key numbers in the text. All statements regarding estimates are backed up by references to datasets or studies that are publicly available and listed in the footnotes or bibliography.

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