Journal of Philosophy
Of
International Law

Volume 7 Issue 2 2016
ISSN 1746-1863

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TAX INCIDENCE AND SCIENTIFIC INQUIRY

Bret N. Bogenschneider*

Abstract

The ‘small open economy’ model is typically given as the analytic framework for corporate tax incidence. Economists have applied the framework to justify tax policies premised on relatively high rates of labor taxation in both the United States and Europe. However, the ‘small open economy’ model is extremely controversial and has been challenged on various grounds. Here, the additional criticism is developed that the ‘small open economy’ model is not based on scientific methods of inquiry. An alternative theory is proposed referred to as the ‘small person economy’ model, where ‘small persons’ are presumed to pay labor taxes out of current earnings thereby reducing economic welfare directly. This also entails a ‘pass-through’ incidence effect via reduced consumer spending in the macroeconomy causing an efficiency loss. The reformulated ‘small person economy’ has significant implications for tax policy design.

INTRODUCTION

The ‘small open economy’ model is typically given as the analytical framework for tax incidence analysis.¹ The model sets out to address the question: Who bears the burden of the corporate income tax?² Notwithstanding it is labeled as a ‘model’ it is actually a leading theory in the field of public economics. Arnold Harberger first derived the model as what he called a ‘revolution’ against an outdated prior theory from the 1940´s and 1950’s.³ Harberger ultimately proposed various “open”- and “closed”-economy iterations which yield wildly different results as to tax incidence.⁴ However, this redux approach to modeling also introduced a great deal of analytical complexity. Harberger claimed that in a ‘closed’ economy labor bears some portion of the incidence of capital taxation depending on the parameters of the

* Senior Lecturer, Finance Law and Ethics, University of Surrey.


model, whereas in the ‘small open economy’ model labor bears the full incidence of capital taxation to a rate of greater than 100 per cent. Such a result is possible because corporate taxes are claimed to reduce aggregate economic output reflecting the effects of a ‘deadweight loss’ of taxation, subsequently referred to as the ‘Harberger triangle’. The results are further given under the condition of ‘general equilibrium’ defined as ‘equalizing real wages and real after-tax rates of return across two sectors’.

The muddiness of the respective models has the effect of obfuscating the results, and only a few intrepid authors have even set out to discuss the ‘numeraire’ or price-level to be applied therein. Notably, the choice of ‘numeraire’ is a fundamental question in the model and changing it can reverse yet again the policy recommendations derived therefrom. The current obfuscated wisdom is thus the ‘closed’ economy result (ie, that labor bears some significant portion of the incidence of capital taxation) first reversed, and then reversed again, yielding a result back to something akin to the original. However, the re-reversal of Harberger’s analysis renders the explanatory theory behind the ‘closed’ economy model essentially void even if the ultimate results are pleasing. Various legal scholars thus cynically conclude the analytics of tax incidence modeling are presented ‘with no weighting as to which is more likely to hold in reality’ and thus lack practical validity.

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5 Ibid, 304 (‘In the interesting case where Cobb-Douglas production functions prevail in both sectors, and where product demands are determined by a Cobb-Douglas utility function, capital ends up bearing precisely the full burden of the tax.’); see also Jane G. Gravelle, The Corporate Income Tax: A Persistent Policy Challenge, (2011) 11 Florida Tax Review 75.
8 Harberger ‘Incidence Revisited’, 304.
9 See e.g. Richard M. Bird & Eric M. Zolt, Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries, (2005) 52 UCLA Law Review 1627, 1640 (‘Serious conceptual issues exist in all exercises that attempt to put quantitative flesh on the skeleton of conventional incidence theory. It is conceptually challenging to measure the incidence of an entire tax system because doing so effectively assumes that all relative prices, technology, and output levels would have remained unchanged’); Bret N. Bogenschneider, The Tax Paradox of Capital Investment, (2015) 33:1 Journal of Taxation of Investments 59, 64-5 (‘The “numeraire” is the underlying price in which other prices are expressed. A price level numeraire is necessary to establish a relative price level in the context of tax incidence...The logical fallacy of excluding a numeraire in the economic model is set forth using symbolic logic’).
10 Ibid, 75-8.
11 See generally Razeen Sappideen, Imputation of the Corporate and Personal Income Tax: Is It Chasing One’s Tail? (1998) 15 American Journal of Tax Policy 167, 193 (‘It is difficult to take seriously Harberger’s estimates of the loss in output resulting from the double-taxation of dividends in the corporate sector....Clearly tax discrimination against particular legal forms of enterprise or particular asset classes must involve a cost in the misallocation of capital. The cost takes the form of a loss in output, but to attempt to quantify that cost, even in the crudest sense, may result in a totally misleading impression.’).
12 Bird & Zolt, 1642 (‘Because no one knows the true incidence of the corporate tax, many studies simply present alternative scenarios, with no weighting as to which is more likely to hold in reality.’).
Other legal scholars and many economists proceed as if the general assumptions of the ‘small open economy’ model are correct.\textsuperscript{14} The non-obfuscated wisdom derived from the ‘small open economy’ model is thus held to be that capital is ‘mobile’, labor is not ‘mobile’, and therefore, labor bears some significant portion of the incidence of capital taxation.\textsuperscript{15} So, taxing capital really hurts workers.\textsuperscript{16} And, not just some workers, but all workers in a given economy.\textsuperscript{17} Harberger is careful to make that broader point of public policy.\textsuperscript{18} However, the actual ratio of the portion of capital taxation borne by labor is the subject of intense empirical debate.\textsuperscript{19} Kimberly Clausing writes:

Some of the results above appear to support the hypothesis that higher corporate tax rates lower wages. But the complete body of evidence casts doubt, and the evidence in support of the main channel of causality in open-economy general equilibrium corporate tax incidence models is not persuasive... At the end of the searching, I find some evidence that suggests that corporate taxation may lower wages, but the preponderance of evidence does not suggest any wage effects from corporate taxation.\textsuperscript{20}

\textsuperscript{13} See David Howarth, Law as Engineering: Thinking about What Lawyers Do (2014) (Cambridge: Cambridge Univ. Press).
\textsuperscript{14} See e.g. Adam H. Rosenzweig, A Corporate Tax for the Next One Hundred Years: A Proposal for a Dynamic, Self-Adjusting Corporate Tax Rate, (2014) 108 Northwestern University Law Review 1029, 1033 (“This Article, relying on these developments in the theoretical and empirical economics literature, will work under the assumption that, under the unique conditions of the modern economy, increasing amounts of the corporate income tax are often borne by labor rather than capital.”).
\textsuperscript{15} See Rosanne Altshuler, Benjamin H. Harris & Eric Toder, Capital Income Taxation and Progressivity in a Global Economy, (2010) 30 Virginia Tax Review 355, 362-3 (“The corporate income tax is modeled as an add-on tax on capital income in the domestic corporate sectors. Randolph assumes that capital is perfectly mobile across countries, labor is immobile, land is used in the agricultural sector only, and markets are perfectly competitive. Worldwide supplies of capital and labor are fixed. The incidence results in Randolph’s model are straightforward. The corporate tax induces a reallocation of capital abroad that increases the productivity of foreign labor and consequently raises wages abroad. The final allocation of burdens between factors of production depends on model parameters.”) citing William Randolph, International Burdens of the Corporate Income Tax 5 (Congressional Budget Office, Working Paper 2006-09, August) <www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf>.
\textsuperscript{16} Ibid, 357 (“This logic suggests there may be both efficiency gains and increases in progressivity from shifting taxes on corporate equity income from the corporate to the shareholder level... This means that the corporate-level tax may raise the cost of corporate capital... more than it lowers after-tax returns to U.S. investors. As a result, some analysts have suggested that the corporate income tax is mostly shifted to U.S. workers through a decline in the capital-labor ratio in the United States, although others dispute this finding.”).
\textsuperscript{17} Harberger ‘Incidence Revisited’, 303 (‘Capital will flee from areas with lowered rates of return and, as it does, so will move the whole capital markets to a new equilibrium rate of return. Thus, all segments of the capital market will tend to share in whatever fate ends up being inflicted on the equilibrium net-of-tax return of corporate shareholders.’).
\textsuperscript{18} Harberger ‘Incidence Revisited’, 305 (‘Thus, whatever tax ends up being paid in that sector has to be reflected as a reduction in the real wage rate paid there. But we cannot have real wages falling in one sector and not in another (except during a transition period). So the fall in real wages that permits manufacturing to stay in business in the taxing country has to apply through-out the labor market of that country.’).
\textsuperscript{20} Ibid, 460, 480.
The incidence of capital taxation no significant empirical study has been commissioned on the question of the incidence of labor taxation or portion of labor taxes borne by capital.\textsuperscript{21} Hence, much of the prior study of tax incidence relates solely to the incidence of the \textit{corporate income tax} rather than the incidence of capital and labor taxes taken in combination. If money is fungible, then a more comprehensive incidence analysis is required including the incidence of labor taxation which is missing from prior empirical studies. The prior methodology is troubling for many reasons; most particularly, the empirical study of tax incidence was premised on the conclusions of Harberger’s ‘model’ which was purportedly also the subject of the test.\textsuperscript{22} Clausing casts further doubt on the implications of the ‘small open economy’ model for several pragmatic reasons. First, Clausing argues that transfer pricing allows firms to shift costs without moving capital;\textsuperscript{23} and second, she points out that large corporate firms behave as if the incidence of capital taxation is borne by capital.\textsuperscript{24}

Apart from the raw economic analysis, the tax policy implications of the ‘small open economy’ model represent something akin to the ‘holy grail’ of normative tax theory. That is, the modern-day ‘classical liberal’ Libertarians led by Richard Epstein, set out to justify by Lockean principles of ‘natural law’ a system of taxation of wealth maximization for the minimization of property (ie, capital) taxation.\textsuperscript{25} The tax-‘holy grail’ in moral terms is hence an economic proof for the normative argument: \textit{When I pay taxes on capital it hurts both you and I, when you pay taxes on your labor it hurts only you. Therefore, in order to maximize wealth you should pay the taxes on your labor and I should not pay tax on my capital.}\textsuperscript{26} And, this justification is to some extent what the “small open economy” model purports to be.\textsuperscript{27}


\textsuperscript{22} Clausing, 444 (‘Studies often consider the effect of corporate tax on wages, controlling for value added or capital-to-labor ratios thereby controlling for the very mechanism they are purporting to study.’).

\textsuperscript{23} \textit{Ibid}, 467 (“Yet, accompanying this globalization, there has been an increased divergence between the location of economic activity (such as, investment, employment and sales) and the location of income for tax purposes.”).

\textsuperscript{24} \textit{Ibid}, 469 ([Lawrence Summers] noted at a Hamilton Project forum in 2007 that it was indeed possible that corporate stockholders and managers who resist the corporate tax are not really acting in their own interests because they do not understand corporate tax incidence, since corporate taxes will ultimately be borne by their workers. But it seems far more plausible that they have calculated their interests correctly.’).


The epistemological problem is that neither Harberger’s comparison of synthetic economic ‘models’, nor Epstein’s restatement of Locke in Posnerian ‘wealth maximizing’ terms, constitutes ‘science’ because the analysis does not purport to relate to the real world. Both arguments posit a hypothetical ‘world’ (ie, the ‘Lockean World’ and ‘small open economy’ model) and set out to derive tax policy by analogy from the hypothetical world. And, this appears to be in part an exercise in rhetoric, which Donald McCloskey famously defended within the field of economics generally. A critique of normative economic ‘modeling’ in these terms will thus entail an encounter with McCloskey and radical subjectivity in economics. Indeed, the acknowledgements to McCloskey’s seminal Article on subjectivism in economic theory indicate Richard Rorty contributed to that piece directly.

The current Article is accordingly organized as follows: First, the prior tax incidence analyses are introduced and critiqued. The subjectivist approach to economic theory as famously given by McCloskey is then discussed in detail. Next, an alternative model of tax incidence, the ‘Small Person Economy Model of Tax Incidence’ is proposed. In conclusion, the tax policy implications of the ‘small open’- versus ‘small person’-economy models are compared in detail.

CRITIQUE OF THE ‘SMALL OPEN ECONOMY’ MODEL OF TAX INCIDENCE

To begin we need to first distinguish a ‘model’ from a ‘theory’. An economic ‘model’ generally describes an economy in a synthetic universe with defined rules. However, the synthetic universe does not truly exist. McCloskey accordingly defined models as metaphors. On the other hand, a ‘theory’ is an idea used to generate a prediction about future events in the real world. Hence, a ‘theory’ is always designed to relate to the real economy. As mentioned above, empirical studies on tax incidence actually turn out to be

("The double tax, as compared to a lower single tax in an unintegrated regime, increases the cost of capital to corporations. This discourages capital intensive means of production by corporations. Similarly, the double tax on corporate taxable income increases the total tax borne by savings, potentially discouraging saving.").

31 Ibid, 482.
32 Ibid, 502 (’Models are Metaphors. The most important example of economic rhetoric, however, falls well outside the border of self-consciousness. It is the language economists use, and in particular, its metaphors. To say that markets can be represented by supply and demand “curves” is no less a metaphor than to say that the west wind is “the breath of autumn’s being.”’).
more consistent with Harberger’s ‘closed’-economy version. The ‘closed’-economy iteration of Harberger’s theory does not seem to realistically relate to any economy anywhere. Although admittedly spurious, the ‘closed’-economy results are nonetheless of more predictive value for tax policymakers than the small ‘open’-economy model. The paradox is then that economists still apply the ‘small open economy’ model in any policy discussion of tax incidence even though the empirical world is set apart from the underlying ‘model’.

Any comparison of synthetic world as part of an economic ‘model’ is an inductive comparison of the relative strengths or merits of each ‘model’ based on the expectations of the reviewing economist. This is true even where models apply deductive reasoning inside the model. Such an inductive comparison of ‘models’ is an illustration of what Karl Popper set out to exclude from the epistemology of science. Deductive reasoning inside an economic model does not automatically yield ‘science’. Hence, the process of comparing synthetic economic ‘models’ which are not purported to reflect the real world is not strictly ‘science’. Modeling would be more aptly used in the physical sciences to test a model and not to derive it. For example, Albert Einstein proposed, and Popper reiterated, that the origin of hypothesis is in ‘creative intuition’.

With regard to the empirical idea of proceeding directly from statistical analysis to theory as science, Thomas Kuhn said the following: ‘[T]he road from scientific law to scientific measurement can rarely be travelled in the reverse direction.’ The origins of scientific discovery are hence theory, and certainly not mathematical models.

Harberger’s approach to tax incidence is an illustration of non-science for yet another reason. By positing first one ‘closed’- model, and then another ‘open’-economy model, the results become nearly tautological. Any attempt to test the framework seems to yield results consistent with either one approach or the other. Popper referred to this as a form of hedgehog defense of ‘conventionalism’ in scientific inquiry. Harberger’s self-proclaimed

34 Karl Popper, The Logic of Scientific Discovery (1935/2002) (Vienna: Springer; reprinted: London: Routledge), 24 (‘[A] subjective experience, or a feeling of conviction, can never justify a scientific statement, and that within science it can play no part except that of an object of an empirical (a psychological) inquiry.’); see also Phoebe Ellsworth, Legal Reasoning and Scientific Reasoning, (2012) 63 Alabama Law Review 895, 898 (‘Scientific and legal reasoning are typically described as involving two distinct methods: deductive and inductive reasoning. In science, deductive reasoning involves the derivation of specific predictions from a general theory or set of axioms.’).

35 Ibid, 8 (‘[M]y view of the matter, for what it is worth, is that there is no such thing as a logical method of having new ideas, or a logical reconstruction of this process. My view may be expressed by saying that every discovery contains “an irrational element”, or “a creative intuition”...Einstein speaks of the “search for those universal laws . . . from which a picture of the world can be obtained by pure deduction. There is no logical path”, he says, “leading to these . . . laws. They can only be reached by the logic of science intuition, based upon something like an intellectual love (“Einfühlung”) of the objects of experience.”’ quoted from A. Einstein, Mein Weltbild, 1934, 168 (A. Harris, tr.) in ‘The World as I see It’, 1935, 125).


37 Popper, 59 (‘Whenever the “classical” system of the day is threatened by the results of new experiments which might be interpreted as falsifications according to my point of view, the
‘revolution’ with the ‘small open’ economy model has thus now become the convention of a prior era. The optimistic case for the ‘small open economy’ model in the field of public economics is that economists-qua-scientists are fully aware the model does not relate to the real world (i.e., that the real world is not the ‘small’ open economy at all) yet, the ‘small open economy’ model is also a theory which economists choose to apply (in a Bayesian sense). To put lipstick-on-a-model then, the best case is that Harberger’s ‘model’ has indirectly morphed into something akin to a scientific ‘theory’ of tax incidence.

The morphing of models to theory is acutely necessary in any field which does not accept a modern version of the scientific method where science is understood as the testing (or augmentation) of theory. In other words, where ‘theory’ is excluded from the scientific method, then all empirical testing is conducted by a trial-and-error method to which any ‘model’ is equally as helpful (or perhaps more helpful) than any ‘theory’. Any ‘model’ that can be imagined by an economist can immediately be proposed as a matter of economic epistemology and subjectively compared to any other ‘model’ by an inductive method. This is of course very convenient for economists operating in the field of taxation, since such a non-scientific approach also excludes ‘clinicians’ of taxpayer behavior, such as tax lawyers and accountants, from the scientific method entirely. In the extraordinarily unlikely case that a model derived by this process is relevant to anything it would be as a result of a trial-and-error (i.e., non-clinical) research methodology.

A trial-and-error research methodology does not apply the ‘scientific method’ not because it cannot reach valid results, but because a trial-and-error method is simply an inefficient means of study, but especially in the social sciences which involve variate human behaviors. A better approach would be to consult clinicians (i.e., tax lawyers and accountants) with practical knowledge of taxation in the first process of deriving a theory of taxation. Econometric methods can then be deployed to test the theory.38

ON THE INCONVENIENCE OF “SCIENCE” TO ECONOMIC THEORY

The positing and systemization of replicable theories on a subject, (i.e., theory testable in the real world) is what is generally referred to as “science”. But, the tedious requirements of science are troubling to rhetoricians operating within the field of economics.39 McCloskey wrote:

Yet even positivists actually behave as though the matters are discussable. In fact, most discussion in most sciences, and especially in economics, arises

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38 See generally David Herring, Legal Scholarship, Humility and the Scientific Method, 25 Quinnipiac Law Review 867 (2007), 871 (“The scientific method lies at the core of this approach to legal scholarship. This method is a process of inquiry used by researchers in the basic sciences and other fields. Researchers initiate the process by developing a theory that recognizes and builds on others’ work in the area of inquiry. In this way, the scientific method is highly collaborative in nature, often generating long lines of inquiry that involve numerous researchers over a considerable period.”).

39 McCloskey, 483 (“Rhetoric is exploring thought by conversation.”).
In respect of scientific inquiry a ‘model’ is helpful to science only if we think the specific rules as posited in the synthetic universe are analogous to the real world as it is. A ‘model’ that does not assist with theory formation is thus worthless as a matter of science. So, when Clausing implies that modern transfer pricing techniques seem to render the analytical framework proposed by Harberger radically unrealistic that critique indicates that the theory is not plausible. Any ostensibly consistent empirical results as derived from such a theory are presumptively spurious. The scientific thing to do with an unrealistic theory is to throw it away, unless the theory is tested and the test results are really, really, good. If the test results are really, really, good, it might be worthwhile to study the unrealistic theory and see if it draws a competing theory into substantial doubt. The empirical results derived from testing of the ‘small open economy’ model are not really good, however. The fact that Harberger’s ‘small open economy’ model has not been discarded indicates that something else is at play in the methodology of economics. In the modern era, that ‘something else’ is an economic version of economic subjectivism.

**BACONIAN EMPIRICISM IN TAX ECONOMETRICS**

With regard to tax incidence and scientific inquiry, the preliminary consideration must be identifying the applicable theory of ‘science’. Econometrics, for example, typically proceeds with an understanding of science as given by Sir Francis Bacon as opposed to that given by Karl Popper. Although a full comparison is beyond the scope of this work, Baconian science hinges on the scientist ‘objectively’ gathering facts in the laboratory from which to formulate scientific knowledge. As McCloskey explains: ‘According to the modernist methodologist the scientist’s job is not to decide whether propositions are useful for understanding and changing the world but to classify them into one or the other half, scientific or nonscientific.’ On the other hand, Popperian science hinges on the scientist testing and evaluating competing theories. In Popperian science, the emphasis is on the evaluation of theory as opposed to the evaluation of ‘objectively’-derived facts.

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40 *Ibid*, 482.
41 Clausing, 467.
42 See Sir Francis Bacon, *Novum Organum* (Joseph Devey, ed., 1902), 50 (‘There are and can be only two ways of searching into and discovering truth. The one flies from the senses and particulars to the most general axioms, and from these principles, the truth of which it takes for settled and immovable, proceeds to judgment and to the discovery of middle axioms. And this way is now in fashion. The other derives axioms from the senses and particulars, rising by gradual and unbroken ascent, so that it arrives at the most general axioms last of all. This is the true way, but as yet untried.’)
43 *Ibid*.
44 McCloskey, 510.
45 *Ibid*, 483 (‘More recently Karl Popper, Thomas Kuhn, and Imre Lakatos among others have undermined the positivist supposition that scientific progress does in fact follow Descartes’ doubting rules of method.’).
Given the theoretical obfuscation of the theory of tax incidence, econometricians in the field of taxation seized the opportunity afforded by the lack of clarity to “prove” the implications of the “small open economy” by statistical analysis alone. Not surprisingly, that effort failed remarkably. In response, Clausing identified the importance of theory to tax incidence analysis, explaining: “One pervasive problem in this work is a failure to consider the underlying theoretical mechanisms of open-economy general equilibrium tax incidence; empirical strategies often do not address these mechanisms.” The critical lesson is that Baconian science is consistent with subjectivism when applied to economic theory whereas Popperian science is absolutely not. This explains why McCloskey’s proposal for subjectivist rhetoric as economic theory was given in opposition to Popperian theory. Accordingly, it is appropriate to re-assert an epistemology of science in the field of taxation against subjectivism such as the small open economy model.

### SUBJECTIVISM AND ECONOMIC THEORY

McCloskey rejected the role of scientific inquiry in economic analysis entirely. The assertion was that, “[s]cientific knowledge is no different from other personal knowledge. Trying to make it different, instead of better, is the death of science.” Popper, of course, argued that scientific knowledge must be subject to falsification by testing. This allows one to separate science from religion, for example. McCloskey, however, welcomes the idea of economics as a form of religion. McCloskey thus adopts Rorty’s conception of scientific knowledge as reflecting acquired wisdom. He writes:

> In Richard Rorty’s words, following Dewey, the search for the foundations of knowledge by Descartes, Locke, Hume, Kant, Russell, and Carnap was “the

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46 C.g. Mihir Desai, C. Fritz Foley & James Hines, Jr., Labor and Capital Shares of the Corporate Tax Burden: International Evidence, NBER working paper series ('Evidence from applying this framework to these data indicates that between 45 and 75 percent of the burden of corporate taxes is borne by labor with the balance borne by capital.') Altshuler, Harris & Toder, 362 ('Given the importance of international trade and capital flows, it seems artificial to work with closed-economy models. Once we allow for international capital mobility, domestic owners of capital may be able to escape the tax by moving capital abroad, turning the original Harberger result on its head.').

47 Clausing, 438-9.

48 McCloskey, 491 ('Anyone would commend the vision of science that Popper and his followers have – of science as a self-correcting exploration verging on the dialectic otherwise so foreign to the analytic tradition in philosophy.').

49 For a discussion of legal doctrine in contrast to either economics or scientific inquiry see Richard Posner, Legal Scholarship Today, (1993) 45 Stanford Law Review 1647, 1651 ('The doctrinalists – the traditionalists in academic law – thus are being crowded by economic analysts of law, by other social scientists of law, by Bayesians, by philosophers of law, by critical legal scholars, by feminist and by gay legal scholars, by the law and literature crowd, and by critical race theorists, all deploying the tools of nonlegal disciplines.').


51 Popper, 10.

52 McCloskey, 486.
triumph of the quest for certainty over the quest for wisdom”. To reinstate rhetoric properly understood is to reinstate wider and wiser reasoning.53

With this subjectivist approach, McCloskey proposes that even mathematics is ultimately subjective in the evaluation of proofs by mathematicians.54 Economic terms are also revealed as metaphors, as he says ‘one might acknowledge the metaphorical element in verbal economics about the ‘entrepreneur’, for instance, or more plainly of the ‘invisible hand’.55 The idea of all language as metaphor represents a form of radical subjectivism.56 Under this view flavored by Rorty, wider and wiser reasoning is applied to generate more persuasive argument to reveal scientific knowledge.

The evaluation of competing subjective claims can be very difficult, however. A major problem in subjectivist economics is that scientists then insert claims of relative belief into argumentation even without cognizance of having done so.57 McCloskey gives the following belief-words emphasized:

We think it unlikely that the high degree of national and international commodity arbitrage that many versions of the monetarist [sic] theory of the balance of payments contemplate is typical in the real world. This is not to deny that the price structures of the advanced industrial countries are not linked together, but it is to suggest that the links are loose rather than rigid.58

Harberger’s argumentation in the tax incidence literature slips into the same form of belief-words style of rhetorical argument. He writes:

First, concerning the corporation income tax rate itself, as it applies to the “normal” rate of return to capital in a developing country, there can be little doubt that it ends up causing wage rates to be lower than they would have been without the tax. The reason, of course, is that the capital stock would be higher without the tax than with it. Thinking about this aspect, it is tempting to focus on foreign direct investment…. This temptation should be resisted, for policymakers should realize that it is quite natural for owners of wealth who reside in developing countries to hold part of that wealth abroad... (emphasis added)59

Each of the italicized ‘belief’-words given by Harberger is indicative of an unstated assumption in the analytical framework. McCloskey thought that the

53 Ibid, 483.
54 Ibid, 492 (‘They assert that “informal mathematics is mathematics. Formalization is only an abstract possibility which no one would want or be able to carry out.” Real proofs “are established by ’consensus of the qualified ’” and are not checkable... by any mathematician not privy to the gestalt.’).
55 McCloskey, 505.
56 For a further example of radical subjectivism in the field of taxation see Anthony Infanti & Bridget Crawford, Critical Tax Theory: An Introduction (2009) (Cambridge: Cambridge Univ. Press).
57 Ibid, 497 (‘No wonder: without a rhetoric of economic significance, and in the face of a modernist rhetoric of statistical significance with the prestige of alleged science behind it, they are unaware they are wielding it.’).
59 Harberger, 310.
unconscious use of rhetorical device in economic argumentation was potentially embarrassing to the field. Subjectivism often also entails indirectly proving who is apparently the ‘smartest’ mathematician (or economist), and thus able to generate the most persuasive argument. As McCloskey writes:

Samuelson’s skill at mathematics in the eyes of his readers, an impression nurtured at every turn, it itself an important and persuasive argument. He presents himself as an authority, with good reason. That the mathematics is often pointless, as here, is beside the point.

The strength of argumentation is then evaluated based on the perceived intelligence or authority of the speaker. A prime example might be Harberger himself who is indeed very persuasive to other economists. Subjectivism starts to break down, however, where persuasive arguments are not given logically or coherently. Several tax scholars have indeed noted that it is logically impossible to abandon the economic concept of the elasticity of labor supply by deeming labor ‘immobile’. Bird and Zolt refer to such contradictions in incidence analysis as ‘having it both ways’. McCloskey likewise pointed out that at times economists tend to make rhetorical points by simply ignoring a countervailing aspect of economic theory in a ‘model’.

One possible means to reconcile Popperian theory with a view of scientific knowledge as ‘wisdom’ is that Popper wrote on the logic of scientific discovery – that is, acquiring new knowledge. Rhetorical argument is based on existing knowledge outside the framework of scientific discovery as opposed to regurgitation. However, in the field of taxation the emphasis is typically on acquiring new knowledge as opposed to applying existing ‘wisdom’ about taxation. Thus, how one inductively appraises the state of existing knowledge in the field of taxation is the deciding factor as to the level of rhetoric (ie, argument from wisdom) allowable in scientific inquiry. As to tax incidence, the goal is to apply the rules of scientific discovery to derive a better model that is workable as a scientific theory in the real world.

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60 McCloskey, 494 (‘Even in the most narrowly technical matters of scientific discussion economists have a shared set of convictions about what makes an argument strong, but a set which they have not examined, which they can communicate to graduate students only tacitly, and which contains many elements embarrassing to the official rhetoric.’).

61 Ibid, 500.

62 Bird & Zolt, 1640.

63 Ibid (‘The incidence of consumption taxes rests on the assumption that all demands are perfectly inelastic (or supplies perfectly elastic), while the incidence of income and wealth taxation often makes exactly the opposite assumption: that supplies are perfectly inelastic (or demands perfectly elastic). One cannot have it both ways. Nevertheless, the usual simple summing of the numbers obtained on the basis of contradictory assumptions in effect does this.’).

64 McCloskey, 501 (‘Another common argument in economics with no status in the official rhetoric is philosophical consistency: “If you assume the firm knows its own cost curve you might as well assume it knows its production function, too: it is no more dubious that it knows one than the other.”').
A ‘SMALL PERSON ECONOMY’ MODEL OF TAX INCIDENCE

Science must relate to the real world. A scientific theory which does not relate to the real world is not replicable, and therefore, does not operate with predictive force and must be rejected. In most areas of scientific endeavor, such as theoretical physics, a new theory would need to operate with better predictive force than an existing theory. The introduction of the theory of general relativity by Einstein in comparison to Newtonian physics is a prime example. However, because of the potential for ergodicity in the social sciences it is potentially more difficult to derive a replicable theory. Where a prior theory is agreed not to function at all, then the bar is very low for the introduction of ‘science’ in the form of a functional theory. Since the ‘small open economy’ model does not operate with predictive force in the real world it renders the situation uniquely ripe for the introduction of a competing theory of tax incidence. The methodological goal is to replace the prior theory of tax incidence with a better theory which might operate with predictive force in the real economy. As was the preferred method of Sir Isaac Newton it is helpful to set forth a theory with a series of propositions followed by one or more hypotheses. Accordingly, each of the propositions of the “small person economy” model supplants a nominally unrealistic aspect of the prior theory of tax incidence. The ‘Small Person Economy’ model is premised on the following series of propositions and given hypotheses relating to tax incidence:

Balance Sheet Propositions:

(i) Large corporations hold stockpiled reserves of cash (in multiples of annual income) and do not pay out earnings to shareholders as dividends.  
(ii) Individual taxpayers (i.e., ‘Small Persons’ subject to wage withholding) pay tax out of current earnings and not savings.  
(iii) Money is fungible. 

Tax Propositions:

(iv) Corporate income taxes are levied on ‘taxable income’, but paid in cash. 
(v) Individual income taxes are levied on wage income, and paid out of income (not savings).

See Jillian Berman, Marketwatch News, More than half of millennials have less than $1,000 <www.marketwatch.com/story/more-than-half-of-millennials-have-less-than-1000-2015-12-14>.  
It is not entirely clear why prior economic models of tax incidence do not presume money is fungible. See Bird & Zolt, 1640; McCloskey, 501.  
For a discussion of cash based decision-making in the real world see Robert Kyosaki & Sharon Lechter, Rich Dad, Poor Dad (2000). The prior economic models presume that corporations make tax decisions based on a ‘return on investment’ theory that tracks taxable income as opposed to ‘cash flow’.
Price Level Propositions:

(vi) The numeraire is given as the price of labor expressed in local currency.
(vii) Labor supply is determined by its elasticity.\(^70\)
(viii) The economy is a ‘service-based’ economy where output is derived entirely from labor where \(\pi = \Delta L\) \((Y = f(L))\).
(ix) Taxation of labor increases the relative cost of labor to capital.\(^71\)

Economic Propositions:

(x) Government spending is fixed by a budget set in advance (ie, spending is not a function of tax revenues collected).
(xi) Marginal incomes of taxpayer firms are determined by ‘small person’ spending in the economy.\(^72\)
(xii) The ‘old’ domestic firms that pay corporate tax extract ‘rents’ from the economy without incremental capital investment.\(^73\)
(xiii) Marginal capital investment is determined by ‘new’ firms purchasing domestic labor with previously undeployed capital.

First Hypothesis: ‘Small persons’ are pass-through from a macroeconomic perspective. The labor taxes paid by consumers directly reduce spending in the economy which reduces corporate profits by an approximately equal amount. With the levy of wage taxation, ‘small persons’ accordingly bear a first burden of tax incidence by reduced consumer spending.

Second Hypothesis: Capital taxes function to reduce the stockpiled reserves of cash held by large corporations; yet labor taxes also reduce indirectly the value of capital reserves by an increase in price levels. If corporations do not pay taxes, the price of labor increases by the amount of offsetting labor taxes, which decreases the purchasing power of capital to use labor to drive production in the economy. This entails a double incidence effect from the taxation of labor earnings.

\(^69\) European Parliament Statistics, Tax Policy in the EU, 10: 51% EU proportion labour tax receipts <www.europarl.europa.eu/RegData/etudes/IDAN/2015/549001/EPRS_IDA%282015%295490 01_EN.pdf>; Internal Revenue Service, Data Book Statistics Line(s) 11, 14 Individual withholding: 38.2% of total; employment taxes: 31.9% of total; net approximately 70.1% of Federal tax receipts from wage withholding.


\(^73\) See Claussing, 436 citing Auerbach. Notably, Auerbach applies a pre-modern definition of scientific inquiry where nothing is known until proven by econometrics. This Baconian approach to “science” is contrary to the modern scientific approach applied here.
Third Hypothesis: The marginal incidence of both labor and capital taxation is borne by the undeployed factors of production in the economy (i.e., the unemployed labor force or undeployed capital). The market price is set by a dynamic bid process, so the party which needs to make the bid is the price taker and can be increased by marginal taxation of labor.

‘Double’ Tax Incidence Effects

The hypotheses set forth above indicate a ‘double’ tax incidence effect of labor taxation. Where ‘small persons’ with insignificant cash holdings or savings are forced to pay taxes out of current earnings this reduces dollar-for-dollar consumer spending in the economy. As such, there are two (i.e., ‘double’) tax incidence effects from labor taxation and only a single incidence effect from capital taxation. The first incidence effect with labor taxation is that the consumer spending of ‘small persons’ is obviously reduced. The second incidence effect of labor taxes is borne by businesses which suffer reduced capital accumulations from the decline in consumer spending. So, the net reduction in savings occurs at the corporate level when ‘rents’ are reduced, which is the only place where a savings reduction can occur in the ‘Small Person’ economy model. Accordingly, the significant aspect of tax incidence is not merely an implied reduction in return on investment by the taxation of income, but the reduction in net income from the taxation of labor income plus the follow-on reduction in consumer spending.

Discussion of Realistic and Unrealistic Assumptions in the Current Model

As was also true in the early-1930’s large corporations now seek first and foremost to accumulate balance-sheet capital without paying dividends to corporate shareholders, and thus, operate their existing business lines as a quasi-annuity. Accordingly, corporate income taxation reduces the stockpile of corporate balance-sheet capital. If the net present value of an annuity is reduced by income taxation that certainly reduces the value of the annuity to the holder of the annuity, but does not require the business to forego the annuity. Clausing refers to this description of corporate business activity as extracting ‘rents’ from an economy. She writes: ‘However, to the extent the corporate tax is really a tax on rents rather than on capital in the corporate sector the implications are different. A tax on pure profits may have an impact on where profits are reported, and perhaps the underlying economic activity, but it will have a lesser effect on relative factor use.’ The idea of corporate ‘rent-seeking’ is a more realistic description of the modern economy than either of Harberger’s ‘open’- versus ‘closed’-economy models.

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74 Ibid.
76 Clausing, 437 (“The firms that pay corporate tax are very large, possibly suggesting a role for economies of scale and considerations of imperfect competition that may generate rents”).
77 Ibid, 445
Money is fungible. This is also a more realistic economic assumption for any model of tax incidence. If money is fungible, then in a given economy price levels are relative and taxes which increase the cost of labor necessarily decreases the purchasing power of capital. In other words, labor taxes are not defined as irrelevant to price levels. In a service based economy, capital is used to purchase labor to generate economic output; hence, labor taxes are influential to price levels.

The ‘small person’ economy theory is also subject to obvious limitations based on unrealistic propositions. For example, some portion of consumer spending is saved, or derived from savings, so in actual fact ‘small persons’ are not entirely pass-through from a macroeconomic perspective. Also, even in a ‘service-based’ economy output is not entirely driven by consumer spending so some capital is deployed as capital investment; and, in many industries a trade-off may be possible as between capital and labor. Furthermore, not all large corporations operate as ‘rent-seekers’ and may deploy capital for marginal investment in the given economy. Nonetheless, since the propositions of the ‘small person’ economy are openly stated it is possible to augment or challenge the hypotheses in a scientific manner. That is the methodological goal irrespective as to whether the results turn out to be acceptable. Tax incidence analysis needs to move from pure rhetoric to a scientific method where hypotheses are first proposed by ‘creative intuition’ as Einstein proposed, and then either challenged by falsification, and/or augmented.

Point-by-Point Comparison of the “Small Open” versus “Small Person” Models

Harberger ultimately gave seven policy recommendations derived from his tax incidence modeling. However, as noted here, several of Harberger’s given tax policy recommendations were seemingly unrelated to the underlying model. The methodological approach of deriving an economic “model” and then positing unrelated conclusions is a fundamental aspect of a subjectivist (ie, rhetorical) approach in economics. Each of the policy points are summarized here with a short explanation of the implied alternative policy result from the “small person economy” model:

(1) Harberger: ‘First, there can be little doubt that it ends up causing wage rates to be lower than they would have been without the tax.’

- ‘Small Person’ Model: No, wage rates would be expected to be relatively higher with incremental corporate taxation. Undeployed capital and unemployed labor would bear the marginal incidence of incremental taxation.

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78 Ibid, 457 (‘Since the corporate tax incidence mechanism is driven by a relationship between corporate taxation and the capital stocks that workers have at their disposal, it is also useful to examine the relationship between corporate tax variables and capital/labor ratios.’).
79 Popper, 35.
80 Ulen, 34.
81 Harberger, 310.
(2) Harberger: ‘Second, when it comes to extractive industries, royalties or separate taxes focused on those particular industries tend to make more sense than allowing “extractive considerations” to govern one’s choice of a corporation income tax rate.’

- ‘Small Person’ Model: No, the design of tax policy for each developing nation would depend at least in part on endogenous factors including capital levels, labor force participation, and many others.

(3) Harberger: ‘Third, the greater is the extent to which corporation income taxes fall on monopoly profits, the stronger is the case for a higher rate of corporation income tax.’

- ‘Small Person’ Model: No, large corporations are ‘rent-seeking’ and set out to extract ‘rents’ in the marketplace without making incremental capital investment to increase profits.

(4) Harberger: ‘Fourth, corporation income taxation is much easier to justify if there is some degree of integration with the personal income tax. I indicated above that full integration seems to have turned out to be impractical, but partial integration based on dividends makes a great deal of sense.’

- ‘Small Person’ Model: No, large corporations generally do not distribute profits to shareholders and this assumption of ‘double’-taxation reflects an unrealistic aspect of economic theory.

(5) Harberger: ‘Fifth, to go beyond integration and have a genuine, separate and additional corporation income tax rate, the best justifications are: a) that such taxation will take on a bigger bite out of monopoly profits (striking them, presumably, at both the corporate and personal levels, and b) that such taxation may be a way to get at some of the mineral rents that accrue to extractive–industry companies operating under old arrangements that are considered to be inviolable.’

- ‘Small Person’ Model: Agreed; however, neither model addresses extractive-industry tax policy.

(6) Harberger: ‘Sixth, no developing country should contemplate its tax policy with respect to corporation (or enterprise) income without giving extensive attention to the problem of tax competition from other developing countries.’

82 Ibid., 310.
83 Ibid., 311.
84 Ibid.
85 Harberger, 312.
86 Ibid.
• ‘Small Person’ Model: No, tax rates influence price levels which is merely one aspect of overall macroeconomic policy. For example, tax policy will typically be reflected in the local currency exchange rate. However, a particular design of the tax system in a developing country could yield microeconomic (i.e., firm-specific) benefits. Accordingly, endogenous factors make an economy more or less attractive to undeployed capital; specific firms might gain advantages (or disadvantages) relative to other firms from the design of a tax system.87

(7) Harberger: ‘Seventh, and finally, the maintenance of the “shell” of a corporation income tax has administrative advantages even if all other considerations are absent.’88

• ‘Small Person’ Model: Agreed; however, neither model addresses administrative costs of a tax system.

CONCLUSION

A subjective economic approach to tax incidence analysis yields three immediate tax policy effects. First, tax policy derived from economic theory is given primarily by rhetorical means based on acquired Rortyan-‘wisdom’; second, where acquired wisdom is insufficient to operate with predictive force then a phenomenology of the ‘one-armed economist’, as U.S. President Harry Truman quipped, becomes highly desirable to tax policymakers;89 and third, professional economists will inevitably aver that only an economist is equipped to advise on matters of tax policy as economic policy, and ‘clinicians’ (e.g., tax lawyers and accountants) are irrelevant to tax policy.90 As a result, it becomes very difficult for tax policymakers to apply any economic ‘model’ of tax incidence to derive tax policy in the real world, particularly where economic theory has little or no relation to the real world, by design.

McCloskey and others express concern with the influence of ‘Philosopher Kings’;91 yet, the real concern is over the use of rhetorical device by economists masquerading as scientific inquiry.92 In the field of taxation a theory of ‘science’ is a theory that operates with predictive force in the real world. The proverbial ‘one-armed economist’ could be more aptly termed a ‘scientist’ of economic

87 If a developing country pegs its exchange rate, then tax policy may operate as a form of tax competition from its macroeconomic effects.
88 Harberger, 312.
90 McCloskey, 491 (‘For an economic scientist to adopt an obdurate refusal to consider objections and to resist offering hostages to evidence, though as common in modernist as in nonmodernist circles, is not merely unscientific; it is cowardly.’).
91 Ibid, 482 (‘Economics, like any field, should get its standard of argument from itself, not from the legislation of philosopher kings.’); Harberger, 310 (‘It is not a good idea to dream up “general solutions” to complex policy problems.’).
92 Ibid, 484 (‘The rejection of econometrics, for instance, would be reasonable only if its more naïve claims were taken seriously. For the rest, economists have let philosophical scribblers of a few years back supply their official thinking about what a good argument is.’).
policy. Truman’s expressed frustration with the advice of economists was actually a frustration with the non-application of a scientific method to economics as a function of tax policy. As Clausing further explains:

In sum, the theoretical work in this area is rich and deep, but it raises as many questions as it answers. In the classic general equilibrium models of Harberger, Gravelle and Smetters, and Randolph, labor bears a share of the corporate tax that depends critically on a number of parameters such as the degree of international capital mobility, the degree of international product substitution, the relative capital intensity of the corporate sector, the size of the country, and the degree of factor substitution.93

A theory of science must be testable, and therefore, be subject to question in the future and even potential falsification. However, an economic ‘model’ that neither tests an existing theory, nor informs the derivation of theory, is worthless to any scientific inquiry. If such an economic ‘model’ is held as truth then it has morphed to a form of religious belief and stands opposed to scientific inquiry.94 McCloskey described the failure of these conditions as a realization that the ‘economic emperor has positively no clothes’.95 As to tax incidence analysis, Clausing has presented what she refers to as additional ‘parameters’ relevant to the conventional ‘model’ of tax incidence, or as a matter of science, the conventional theory of tax incidence. The citation of such obviously relevant factors is not merely an inconvenience with the burden on Clausing to prove by statistics an economic effect from such ‘parameters’. Rather, as a matter of science, if a ‘model’ applied as theory appears to be flawed, then a new theory should be proposed that might be more realistic and potentially operate with predictive force. This might be accomplished by augmenting an existing theory with additional parameters under a Bayesian method, or outright falsification under a Popperian method. Here, given both the ‘small open’-, and also, the ‘closed’-economy iterations given by Harberger are highly unrealistic (and contain logical contradiction) an outright falsification in the Popperian sense is plausible.

The ‘small person economy’ theory is an attempt to then fill the void with an alternative scientific theory of tax incidence. This approach applies more realistic propositions about the economy. For example, where ‘small persons’ pay labor taxes out of current earnings such reduces welfare directly and causes a first incidence effect. However, labor taxation also entails a ‘pass-through’ effect via reduced consumer spending in the macroeconomy which is a second incidence effect. This dual incidence is referred to as ‘double’ incidence effects of labor taxation. The “small person” economy theory suggests that labor taxes also increase the price level in a service economy thereby reducing the purchasing power of stockpiled capital. As to tax policy, marginal tax effects are relevant meaning a change in tax methods from a given status quo that might be relevant to the tax policymaker. Here, the ‘small person’ economy theory

93 Clausing, 438.
94 McCloskey, 491 (‘The problem comes, and the modernist preaching begins, with the word “evidence”. Should it be all “objective,” “experimental,” “positive,” “observable”? Can it be?’).
95 Ibid, 482 (“Economics will not change much in substance, of course, when economists recognize that the economic emperor has positively no clothes…. They claim to be arguing on grounds of certain limited matters of statistical inference, on grounds of positive economics, operationalism, behaviorism, and other positivistic enthusiasms of the 1930s and 1940s.”).
suggests the incidence of both marginal labor and capital taxation is borne by the undeployed or unemployed factors of production in the economy.