

INTRODUCTION

THE PRINCIPLES AND POLITICS OF TAX REFORM

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When Congress gets into the business of figuring out \$370 billion of tax breaks a year, the House Ways and Means Committee and the Senate Finance Committee really are put in the business of trying, at least partially, to plan the American economy. . . . I confess that I am not qualified to act as a central planner and I do not know anybody on either committee who is. They are all wonderful people, great Americans. They all mean well. But the fact of the matter is that when the details are all put together, I am convinced that we do not have the foggiest notion of what we are doing in terms of the total economic outcome.

—Rep. Richard Gephardt¹

Effective tax reform requires both sound principles of public finance and political acceptability. Supply-side tax policy is characterized by the proposition that lower marginal tax rates stimulate economic growth and that this may increase real tax revenues over time. To the extent that this proposition is empirically validated, supply-side tax policy will be more likely to command political support, making it *feasible to adopt a flat rate tax*. Public choice theory cautions, however, that sound tax principles and pragmatic politics seldom go together—unless reform includes *constitutional* change that limits the taxing and spending powers of government.

The 1985 tax reform debate is evidence of the disparity between sound tax principles and the democratic political process. The major tax reform proposals emphasize the need for tax simplification, lower marginal tax rates and a broader base to increase efficiency, and a

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¹Gephardt (1985, p. 458).

fairer treatment of equally situated individuals to improve equity.² These objectives, however, have become entangled in the political process as special interest groups vie for taxpayers' wealth. The prospect of meaningful tax reform in the near term, therefore, is questionable. Even so, the tax reform debate has raised important issues regarding the principles and politics of tax reform, issues that deserve serious consideration if long-run reform is to be achieved.

The papers in this volume—originally presented at a conference on flat rate taxation sponsored by the Florida State University Policy Sciences Program (14–15 March 1985)—discuss the major tax reform proposals from both a positive and a normative viewpoint. Efficiency is treated within the framework of the traditional theory of optimal taxation as well as within a public choice setting, and matters of equity are considered from a property rights perspective. An idea running throughout this volume is that there is a close link between the tax regime, individual incentives to work, save, and invest, and the allocation of resources. Whether supply-side tax policy can bring about meaningful reform, however, is seen to be conditioned by the constitutional limitations on the state's taxing and spending powers, as shaped by the political process in a democratic setting.

Although the authors differ on what constitutes a "good" tax system, they agree that the current Brobdingnagian tax regime merits reform. Emphasis is placed, therefore, on evaluating the flat rate tax as an alternative to the progressive income tax. In order to provide the broader perspective necessary to understand and evaluate the flat rate tax issue, the remainder of this introduction will consider the rationale for tax reform, the principles underlying tax reform, the political difficulty of achieving permanent tax reform, and the case for constitutional tax reform. The current status of the tax debate as treated by the authors in this volume will then be summarized.

Rationale for Tax Reform

The complexity of the current tax code, the heavy burden of taxation on all income classes, the inefficiency of the high marginal tax rates on labor and capital income, and the uncertainty and inequity caused by the loophole-plagued progressive income tax system are all important reasons for tax reform.

²See Thorning (1985) for a discussion of the tax reform proposals before the 99th Congress.

Complexity of the Tax Code

In 1913, when the Sixteenth Amendment to the U.S. Constitution became effective, the federal income tax code filled less than 20 pages; today it fills many volumes and along with numerous rules and regulations occupies thousands of pages.³ The growing complexity of the tax code has led to a profitable tax-service industry as bewildered taxpayers seek the advice of countless tax attorneys and accountants. Indeed, one of the political hurdles that any sensible tax reform must surmount is the hungry tax-service lobby, which has little reason to promote tax simplification.

Social engineering has become the essence of the federal tax system. Instead of directly financing public services that are socially beneficial, the tax code has become an instrument by which legislators seek to influence social policy, whether it is to promote reindustrialization or to encourage home ownership. The numerous "tax expenditures" attest to the influence of special interest groups and have unduly complicated the tax system.⁴ In such a system, it often becomes more profitable to lobby for tax loopholes than to engage in socially productive activities.

The complexity of the tax system is aptly illustrated by the Deficit Reduction Act of 1984. According to Gephardt (1985, pp. 461, 464):

[This law] was 1,300 pages long. It was a so-called loophole closing bill designed to raise revenue. When the regulations are completed, if they ever are—five or ten years from now—they will be another three or four or five thousand pages. It looks like what we are really trying to do is write a code for each person in the country. . . . The whole idea of trying to run this country in part by a committee of 535 people is audacious when you really step back and look at it. With a population of 250 million people, we have a committee of 535 people trying to decide how something as complicated as a tax system should work. I really think it works only if, from time to time, we arrive at a consensus in our democracy that says, "What

³The federal income tax was enacted 3 October 1913, as part of "An Act to Reduce Tariff Duties and to Provide Revenue for the Government, and for Other Purposes" (H.R. 3321, enacted as P.L. No. 16). Section II of that act, known as the *Tariff of 1913*, was devoted to the income tax. Its total length was 15 pages. See *U.S. Statutes at Large* (1915, pp. 166–81).

⁴Tax expenditures are special provisions of the tax law designed to encourage various activities by providing tax relief. They include the Accelerated Cost Recovery System (ACRS), the Investment Tax Credit (ITC), the lower tax rates on capital gains, and the deductibility of mortgage interest payments. Although tax expenditures add complexity and often lead to horizontal inequity, they may offset existing biases in the tax code. Thus, Egger (1985, p. 5) argues that the ACRS and ITC help offset the "inefficient tax-induced bias against capital investment."

we have got here is not working. We need to return to something that will be more effective.”

One of the basic reasons, then, for reforming the current tax system is its overwhelming complexity. A movement away from using the tax code for social engineering and toward a simple tax system designed to raise revenue for the provision of genuine public services would help create a more rational tax code.

Excessive Taxation

In 1984 the federal government drained off 19.2 percent of the gross national product (GNP) in taxes compared to 20.4 percent in 1979 and 20.9 percent in 1969. Over the last 15 years, therefore, the federal tax burden has remained roughly the same. But when compared to an earlier period, say 1929, in which federal tax receipts were 3.7 percent of GNP, the enormous growth in the federal tax burden is evident.

A more accurate measure of the federal burden is the size of federal spending as a percent of GNP. This ratio was 24 percent in 1984, 21.1 percent in 1979, 20 percent in 1969, and 2.5 percent in 1929. From this perspective, the burden of the federal government has increased in the last 15 years, and increased dramatically since 1929.⁵

Ideally, taxes should reflect the marginal benefits received from government spending programs. If a new expenditure program cannot generate sufficient benefits to cover its costs, it should not be enacted. The linking of marginal benefits and costs is essential for a sound fiscal regime. Under the existing congressional budget process, however, the two sides of the federal budget largely are divorced. Together with strong political incentives to hide the cost of government (either by deficit financing or moving items “off-budget”) and to concentrate benefits, the separation of spending and taxing decisions invariably leads toward excessive federal spending and, hence, eventually to excessive taxation.

If the full burden of government spending programs—including the high cost of regulation—were placed squarely on the shoulders of present taxpayers, it is highly probable they would rebel, just as colonial taxpayers rebelled against the burden of British taxes and regulations. More pointedly, President Reagan’s landslide victories in 1980 and 1984 were based in large part on his promises to reduce the size of government and the oppressive tax burden—neither of which has been achieved.

⁵The figures for federal taxing and spending were obtained from the *Economic Report of the President* (1985, p. 66).

As the debt burden grows to \$2 trillion and the deficit approaches 5 percent of GNP—it was 4.8 percent in 1984 versus 0.7 percent in 1979, -0.9 percent in 1969, and -1.2 percent in 1929⁶—it will become increasingly difficult to rely on deficit financing to hide the high cost of government. Popular pressure is likely to build for fiscal conservatism, but reducing spending and/or increasing taxes will not necessarily limit the future growth of government. Without constitutional limits on the size of government, it seems unlikely that the greed of legislators and special interest groups for power and privilege will be effectively curtailed. Indeed, the hidden agenda of “tax reform” often appears to be the *increase* of government revenue, not the reduction in the scope of government power.

Therefore, while government spending continues to climb, taxes remain relatively constant as a share of GNP. In the meantime, federal deficits push tax liabilities into the future, allowing myopic politicians to postpone the day of reckoning. Rather than risk political suicide by attempting to balance the budget by cutting spending or increasing taxes, politicians much prefer to ignore hard realities and make believe there is a free lunch, perhaps in the form of the more naive supply-side theory. But taxpayers are restless, as evidenced by the grassroots drive for a balanced budget amendment, and the stage is being set for meaningful tax reform combining genuine supply-side principles with constitutional economics.⁷

Inefficiency of the Federal Income Tax

The preferential tax treatment of various types of capital assets, the high marginal tax rates under the progressive income tax, the differential treatment of corporate and noncorporate income, and numerous other facets of the federal tax code distort the relative price structure, alter incentives to work, save, and invest, and politicize the allocation of resources. The non-neutrality of the current tax regime, therefore, disturbs the normal flow of resources: human and nonhuman capital as well as entrepreneurial ability are not allocated in accordance with consumers' preferences and, thus, do not attain their highest-valued uses. Under the current tax regime, resources also are wasted lobbying for tax expenditures and complying with the bewildering tax code. A less complex tax code integrating the personal income tax and the corporate income tax and lowering

⁶*Economic Report* (1985, p. 66).

⁷Perhaps it is the fear of real tax reform—limiting the size and power of government—that created congressional support for the Gramm-Rudman-Hollings “Balanced Budget and Emergency Deficit Control Act of 1985” (H.J. Res. 372).

marginal tax rates on income from all sources would allow a more efficient allocation of resources than the present system.

Tax efficiency also requires that individuals pay taxes in line with their marginal evaluations of the services provided by government. Insofar as taxes exceed what individuals voluntarily would consent to pay for the public services, government spending and taxes will be excessive—too many resources will be forced into the public sector, diverting them from higher-valued private uses.⁸ In principle, then, an efficient tax system should resemble a voluntary exchange economy in which prices reflect consumer's willingness to pay, that is, their marginal evaluations of the private goods.

The existing tax regime significantly deviates from the marginal benefit principle of taxation, fails to link taxes to expenditures, and relies almost wholly on the ability to pay principle of taxation. In particular, without any constraint on the government's power to tax, the ability to pay principle has allowed the state to devour taxpayers' wealth without rendering reciprocal services. The modern redistributive state attenuates private property rights and leads to a tax burden whose size and distribution would not emerge from a consensual process. And as Brennan and Buchanan (1980) have emphasized, once it is recognized that the modern democratic state may be a revenue maximizer, more citizens will come to understand why the tax regime will be continuously altered to increase revenues beyond the point of taxpayer consensus, leading to an inefficient allocation of resources and excessive government.

Although the democratic political process cannot duplicate the competitive market process, instituting the following measures would help generate a fiscal regime that is more consistent with the principle of voluntary consent and corresponds more closely with taxpayers' preferences for a simpler, more efficient, more equitable tax system: (1) limit the size of government by fixing the federal tax share as a percent of GNP; (2) replace the progressive income tax with a flat rate tax on either consumption or income; and (3) require a balanced federal budget. With these reform measures, individual tax shares more nearly would reflect both the marginal benefits received from public services. The closer link between taxing and spending would tend to generate a more acceptable tax burden than presently

⁸Wicksell (1896) developed the principle of voluntary consent to guide tax policy and Lindahl (1919) further developed this principle in the context of a voluntary exchange model of taxation, showing that efficient taxation requires that marginal tax prices be equal to the marginal benefits received from the public expenditures; the sum of the marginal benefits will then cover the marginal cost of the public good. See Wagner (1983) for a modern treatment of these ideas.

exists. Constitutional tax reform in the context of supply-side tax policy is likely, therefore, to improve efficiency in the sense of promoting a fiscal regime that is more consistent with private sovereignty.⁹

Uncertainty and Inequity of the Existing Tax Regime

The non-neutrality of the existing tax regime, its inefficiency, and its complexity have increased greatly the uncertainty about future tax shares. The tax code and its administrative rules and regulations can change at any time, making it very costly to predict one's future tax share. Not only are future tax rates uncertain, so are the activities that will be subject to these rates. This is especially true in the corporate sector where tax rules are changed almost on a yearly basis.¹⁰ In such a climate, investment becomes even riskier and an entrepreneur's long-range decisions will be conditioned strongly by his perception of the future tax structure. Those entrepreneurs who are politically astute will survive compared to those who are market-oriented but politically naive. Investment resources will tend to flow more often to those companies whose executives are successful lobbyists rather than to entrepreneurs who anticipate consumers' demands and who ordinarily could undersell their rivals. The inequity that arises from this politically induced uncertainty surrounding the fiscal regime is a significant justification for tax reform.

Currently, individuals with similar incomes can pay widely different taxes depending on their knowledge of the tax code and their success in exploiting tax loopholes. Those who are unable to influence tax policy will lose out to those who successfully gain tax preferences. In this environment, rent-seeking and wealth redistribution will be rewarded rather than profit-seeking and wealth creation.

When the tax system primarily becomes an instrument for redistributing income and wealth rather than for collecting revenues to supply genuine public services (such as the safeguarding of private property rights), incentives to work, save, and invest will be weakened, slowing the wealth-creating market process. Under the progressive income tax, the government has become a redistributive agent for special interest groups rather than a referee who enforces

⁹See Pilon (1985) for a discussion of private sovereignty within a rights-based approach to government activity. Essentially, private sovereignty requires a regime of private property rights and freedom of contract, limiting coercion to the protection of these rights.

¹⁰For example, the ITC was "instituted in 1962," but "modified in 1964, suspended in 1966, restored in 1967, repealed in 1969, reenacted in 1971, liberalized in 1975 (first temporarily), and slightly changed in 1981. In 1982, the ITC was changed again" (CBO 1984, p. 21).

the rules of the game so that everyone is treated equally under the law. The principle of end-state (or distributive) justice has replaced the liberal rule of law tradition with its emphasis on procedural (or process) justice and private property rights.¹¹ Thus, the ability to pay principle of taxation has come to dominate the benefit principle, attenuating private property rights in the process.¹²

The progressivity of the federal income tax is “justified” by an appeal to end-state principles of justice and an invalid interpersonal utility comparison between high- and low-income taxpayers. When the veil of technical jargon is lifted, however, it is clear that progressive taxation cannot be justified from a property rights perspective because it would permit a majority to exploit a minority without the latter’s consent. As Hayek (1960, p. 322) points out:

That a majority should be free to impose a discriminatory tax burden on a minority; that, in consequence, equal services should be remunerated differently; and that for a whole class, merely because its incomes are not in line with those of the rest, the normal incentives should be practically made ineffective—all these are principles which cannot be defended on grounds of justice.

When tax policy is used as a form of social engineering or industrial policy to reward those individuals and firms with the greatest political influence, it cannot help but be inequitable as well as inefficient. Indeed, if justice and efficiency are viewed in terms of voluntary consent, it could be argued that the current tax system is neither efficient nor just.

The effects of a fiscal regime that gives primary attention to redistribution rather than to protection of person and property was recognized clearly by Bastiat (1964 [1848], pp. 128–29):

[When] the state is responsible for establishing fraternity [distributive justice] on behalf of its citizens, we shall see the entire people transformed into petitioners. Landed property, agriculture, industry, commerce, shipping, industrial companies, all will bestir themselves to claim favors from the state. The public treasury will be literally pillaged. Everyone will have good reasons to prove that legal fraternity should be interpreted in this sense: “Let me have the benefits, and let others pay the costs.” Everyone’s effort will be directed toward snatching a scrap of *fraternal* privilege from the legislature. The suffering classes, although having the greatest claim, will not always have the greatest success. . . .

¹¹See Brunner (1983) on the difference between end-state justice and procedural justice and on the implications of each for political institutions.

¹²See Wagner’s paper in this volume.

It is widely agreed that the current tax system is unfair in the sense of treating equally situated individuals differently and creating great uncertainty about future tax shares. What is not agreed on, however, is what the best distribution of the tax burden ought to be. Indeed, no consensus is likely to be reached on this question as long as an end-state approach is taken to determining the “just” distribution of the tax burden and as long as taxing and spending decisions are dichotomized. When taxpayer wealth is viewed by legislators as common property to be preyed on by special interest groups, the budget process is bound to become dominated by political factors rather than grounded in sound principles of finance and justice.

Returning to a more fundamental view of tax equity—a view that considers justice from a procedural perspective rather than from an end-state perspective—would require taxpayers to reconsider their choice of fiscal regimes from a constitutional or property rights perspective. The debate over tax reform then becomes a constitutional debate about the role and size of government. It is this type of “constitutional tax reform” that is the real route to a just system of taxation and meaningful tax reform.¹³ The constitutional route, however, is the route that Congress and special interest groups have little incentive to take.

Principles of Tax Reform

Meaningful tax reform requires an analytical framework based on the following four principles: (1) taxes should be simple so that they are widely understood; (2) taxes should reflect the marginal benefits received from public services so that taxes will not be excessive; (3) taxes should be as neutral as possible in order not to distort the structure of prices and production and as efficient as possible in order not to violate the principle of voluntary consent; (4) taxes should be foreseeable and equitable to ensure a stable fiscal regime, equal treatment of equally situated taxpayers, and consensus in the choice of fiscal regimes.

A Simple Tax Regime

A tax regime should be simple enough to allow taxpayers to understand it and comply with the law. They should be able to calculate their own taxes and prepare their tax returns without an army of tax attorneys and accountants and without a large Internal Revenue

¹³See Brennan and Buchanan (1980, ch. 10) for a discussion of the importance of constitutional tax reform.

Service (IRS) administering the tax code. A flat rate tax on consumption or income would be less costly to comply with and to administer than the existing graduated income tax. From the viewpoint of simplicity, then, a single, proportionate tax on consumption or income would be preferable to the current multi-rate, progressive income tax with its numerous loopholes. For example, a broad-based flat tax would allow both individuals and corporations to simplify their tax accounting by using the postcard-sized tax forms devised by Hall and Rabushka.¹⁴

Under a simplified tax system, Congress would not have to continuously alter the tax code and the resources now tied up in the tax-service industry could be released for more productive uses. If there were a flat rate tax with a uniform rate, Congress need only decide in advance on the tax rate for the coming year. Moreover, if a *permanent* tax rate (expressed as a percentage of GNP) were incorporated into the Constitution along with a balanced-budget amendment, there would be little for Congress to do except to decide how the resulting revenue would be apportioned among competing demands. The present social-engineering approach to taxation would no longer survive under constitutional tax reform, as rent-seeking for tax preferences would become unprofitable.¹⁵ Constitutional tax reform, which would make it relatively easy for individuals to determine their future tax shares, is therefore the most lasting route to tax simplification.¹⁶

It is doubtful if the adoption of a flat rate tax, either on consumption or income, would be accompanied by a balanced-budget amendment. Nevertheless, adopting a flat rate tax now might help pave the way for constitutional tax reform as some future date.

An Acceptable Tax Burden

In the market exchange process there is a direct relationship between the price paid for a good and the individual's marginal evaluation of

¹⁴See the paper by Hall and Rabushka in this volume.

¹⁵It is assumed that a constitutional tax reform would generate a consensus for a flat tax with a significantly lower marginal tax rate, thus minimizing incentives to create new tax loopholes.

¹⁶Perhaps the first American economist to recommend a flat rate tax to achieve tax simplification was Erick Bollmann who in 1812 advocated a 1 percent tax on "net revenue," which he referred to as the "Union Tax." Bollmann argued that such a tax—levied at a "*uniform per centage on the net revenue of every individual, enjoying an income in his own right*"—would reduce significantly the "financial labours of [C]ongress" because Congress would only have to fix the rate of tax each year. He thought that his Union Tax should eventually be incorporated into the Constitution (Bollmann 1812a, pp. 250–51, 255, 257, 259). [Although Bollmann's 1812a essay is unsigned, he is the most probable author given the fact that there are cross references between this article and a successive article in the same journal, which has been attributed to Bollmann (1812b).]

it, that is, between price and marginal benefit. The consensual market process assures this correspondence. Insofar as the fiscal exchange process is characterized by voluntary consent, individual tax shares will reflect the marginal benefits received from publicly provided services. Determining an *acceptable* tax burden, therefore, ultimately requires a correspondence between taxes paid and benefits received, just as in the private-goods case. Thus, taxes should reflect the marginal benefit principle of taxation if the tax regime is to avoid excessive taxation. From this perspective, tax reform should aim at achieving a greater consensus regarding tax shares by linking tax shares to spending decisions.

A flat rate tax on income or consumption and a constitutional limitation on taxes as a share of GNP, together with a balanced-budget amendment, would provide a closer link between government spending and tax shares. Until government's power to tax is limited and the full cost of government is reflected in individual tax shares, which also reflect the marginal benefits received from public services, tax reform is unlikely to reduce the true burden of taxation, that is, the percent of GNP devoted to government spending.

Tax Neutrality and Efficiency

The government should attempt to minimize the substitution effects of the tax regime, so that in raising revenue private activities and decisions are distorted as little as possible. This neutrality ideal will be approached as the tax regime approximates a voluntary exchange process. The difficulty of achieving unanimity in the fiscal exchange process is well known; thus, in discussing neutrality and efficiency, it is more appropriate to compare existing tax regimes than to compare the existing regime to some ideally neutral system. In evaluating alternative fiscal regimes, therefore, one must consider the effect of alternative tax arrangements on private property rights, incentives to work, save, and invest, and on the allocation of resources in line with consumers' and taxpayers' preferences.

The orthodox theory of optimal taxation presents broadly based taxes as being less distorting (more neutral) than narrowly based taxes designed to raise the same revenue. But this theory suffers from an inability to have an actual lump-sum tax that could be used as a benchmark against which to evaluate alternative tax regimes. More important, the equi-revenue assumption implicitly accepts government as operating in the public interest when, in fact, government may more correctly be viewed as a revenue maximizer. As Brennan and Buchanan (1980) have shown, once government is viewed as a revenue maximizer, the conclusions of optimal tax theory must be

modified. A public-choice approach then leads one to conclude that broadly based taxes not bounded by the equi-revenue constraint will have a greater excess burden than narrowly based taxes.¹⁷

Nevertheless, it still holds as a general rule that in raising a *constant* tax revenue, lower marginal tax rates on a comprehensive measure of income or on consumption are preferable to a progressive tax system with numerous loopholes. The present tax system artificially changes the prices of many activities and encourages tax evasion. A simpler, flat tax system would help improve economic efficiency by treating income more uniformly and by allowing resources to be allocated more nearly in line with consumers' and taxpayers' preferences. The danger is that without constitutional limitations on the power to tax, a flat tax with a relatively low initial rate may be increased to its revenue-maximizing level. Under a tax regime with a broadly based flat tax, politicians would have a strong incentive to take advantage of their increased power to tax and the concomitant reduced ability of citizens to escape taxation. In turn, this would increase the excess burden of taxation compared to the present system. Rational taxpayers, therefore, might well prefer a narrower consumption-based tax to a comprehensive, flat-rate income tax.¹⁸

Certainty and Just Taxation

A tax regime should be characterized by certainty and justice. Certainty can be achieved by a principled approach to tax reform, that is, by constitutional tax reform establishing permanent rules for setting tax rates and for selecting a tax base. Under a constitutional tax regime, tax decisions would be taken out of the day-to-day polit-

¹⁷According to Brennan and Buchanan (1980, p. 35):

[O]rthodox normative evaluation of the characteristics of tax structures depends critically on the equi-revenue postulate, one that is untenable when we substitute a revenue-maximizing government for the passively benevolent politics implicitly assumed in the standard treatment. At the constitutional stage of decision in the Leviathan model, potential taxpayers will recognize that government may be held back in its fiscal appetites only by limits on tax bases and on allowable rate structures. Even the analytical benchmark, the idealized and abstract lump-sum tax, loses its "efficiency" features in constitutional perspective.

See Hettich and Winer (1985) for a useful discussion of alternative approaches to tax reform as embodied in the theories of equitable taxation, optimal taxation, and fiscal exchange.

¹⁸The Brennan-Buchanan (1980) analysis "does not necessarily suggest that the consumption tax will dominate the income tax in the rational constitutional calculus of the potential taxpayer." However, the authors do point out that "restriction of the tax base to consumption outlays will reduce the revenue potential of Leviathan, an objective that may in itself be desirable if the income tax is predicted to generate an overly large sum under revenue maximization" (pp. 107-8).

ical process and incorporated into the rule of law superstructure that helps shape individual incentives and behavior in a market order. Constitutional tax reform, therefore, would avoid the need for fine-tuning the tax code, which is characteristic of the current tax regime dominated by partisan politics rather than by sound tax principles.

Just taxation requires that the tax regime be in accordance with the principle of voluntary consent: taxes should raise revenue for those public services that taxpayers are willing to finance. Tax policy should not be used to plan the economy and to reward special interest groups. As Andrew Mellon (1924, p. 11) emphasized:

I have never viewed taxation as a means of rewarding one class of taxpayers or punishing another. If such a point of view ever controls our public policy, the traditions of freedom, justice and equality of opportunity, which are the distinguishing characteristics of our American civilization, will have disappeared and in their place we shall have class legislation with all its attendant evils.

Equity, therefore, requires not only that equally situated individuals be treated equally but that taxes reflect benefits received from public services. Since it is difficult to measure benefits received in a nonmarket setting, it is all the more important to limit government to the provision of those goods (such as the defense of private property rights) whose benefits correlate well with ability to pay. A flat rate tax on consumption or income then could be used to finance the generally accepted level of expenditures.

If taxes attenuate private property rights so that the services received from government are valued less than the alternative private services forgone, or if no services are received for the taxes paid, the tax regime will violate the voluntary consent principle and cannot be justified, at least from the classical liberal's perspective. On the other hand, if one accepts the modern liberal's notion of social or distributive justice, almost any level and distribution of the tax burden can be "justified"—depending on the subjective values of the benevolent despot, the legislators, or the special interest groups who dominate the fiscal process in a democracy.

In choosing between the redistributive state and the minimal state, public choice theory can help indicate the likely consequences of each tax regime for economic incentives and behavior—normative considerations of equity will be influenced by one's perception of the likely consequences of alternative property rights structures. If consumer-taxpayer sovereignty is accepted as the basis for constitutional tax reform, one would expect private property rights to be strengthened. Individuals then would have stronger incentives to

work, save, and invest compared to the present tax regime in which the power to tax is virtually unlimited.

The Politics of Tax Reform

Since any change in the tax regime will alter the distribution of the tax burden, politicians do not have a very strong incentive to take a principled approach to tax reform. Indeed, tax reform seldom reaches the constitutional stage where serious attention is given to linking government spending to taxes and limiting taxes as a percent of GNP. The pursuit of distributive justice, in other words, has a higher political payoff than the pursuit of consensual justice in the modern democratic/liberal state.

As long as politicians do not bear the full costs of their decisions, the political process will lead them to take a narrow, short-run viewpoint, reducing the likelihood of fundamental tax reform. To be sure, politicians have a strong incentive to hide the costs of government, to increase spending, and to disperse the costs of government while concentrating the benefits. Consequently, real tax burdens are likely to increase over time. As Lee (1983/84, p. 802) notes in this regard:

There are strong reasons for believing . . . that the democratic process exerts constant pressure toward excessive tax burdens. . . . [T]ax increases are spread widely over a politically unorganized public and can be made to appear largely independent of political decisions . . . while tax proceeds can be directed rather precisely to those coalitions and constituencies that have the greatest political influence. Therefore, the political costs of tax increases will be heavily discounted relative to the political gains from the additional tax revenue. This bias alone exerts tremendous pressure for an excessive tax burden.

Although a relatively low flat rate tax on either income or consumption would be more efficient (in the sense of generating the same revenue at lower cost and with fewer distortions) than the present tax regime, equity considerations (in the sense of social or distributive justice) have come to dominate the 1985 tax debate. According to Rahn (1985): "Nothing less than a national tragedy is unfolding in the House Ways and Means Committee, as its members transmute the laudable goals of tax reform into a complex, anti-growth orgy of redistributive 'justice.'" Authentic tax reform, therefore, has been derailed by special interest groups who want to impose social justice rather than to defend procedural justice. Instead of safeguarding private property rights, these groups would use government to redistribute property to themselves at the expense of other taxpayers.

When end-state principles of justice are substituted for procedural justice, there can be no hope for consensus on tax reform. It is this lack of consensus that makes tax reform so difficult and that illustrates why meaningful tax reform is impossible without constitutional change. The difficulty, of course, is how to achieve constitutional tax reform in the presence of federal, state, and local legislators who are influenced by special interests. However, without limits on the taxing and spending powers of government, the pursuit of distributive justice is bound to interfere with the goals of simplicity, efficiency, and growth advocated by proponents of tax reform.

The political constraints blocking fundamental tax reform in 1985 or 1986 are formidable. In particular, any reform must achieve (1) revenue neutrality, that is, neither increase nor decrease total federal tax liabilities, and (2) distributive neutrality, that is, not change the distribution of tax burdens by income class. Given the inertia of the federal tax bureaucracy and the entrenched special interests seeking to maintain their tax preferences, these two constraints and the large projected federal deficits imply that political considerations are likely to be the determining factor in shaping tax reform. The principles of sound tax reform—and even constitutional tax reform—will often be referred to by politicians, but they are unlikely to persist in the logrolling process.

The agreement about the need for tax simplification, base-broadening, and lower marginal tax rates to encourage economic growth has been overshadowed by the diversity of opinion about what constitutes a “good” tax system, as illustrated by the number of tax bills now before the 99th Congress. Moreover, the instinct of politicians is to increase their power to tax, not to limit themselves to revenue neutrality. As Lee (1985) observes: “Talk of revenue neutrality notwithstanding, eliminating the escape hatches in the existing tax system appeals to the revenue-enhancing impulses of Congress.” If a modified flat tax were enacted, it is likely that tax rates would be increased over time, unless constitutional constraints were placed on taxing and spending. And if rates were increased, the rent-seeking process for tax preferences would begin anew. Citing Lee (1985): “[O]nce rising tax rates increase the profit politicians can realize by merchandizing tax breaks, the ‘reformed’ tax system will soon be as loaded with loopholes as the present one.”

Unless tax reform takes the form of constitutional limitations on the government’s taxing and spending powers, therefore, supply-side tax policy aimed at base-broadening and lower marginal tax rates is unlikely to stem the tide of big government. In the longer run, politicians are apt to produce further distortions by increasing

marginal tax rates and accelerating spending.¹⁹ The excessive taxes of 1985 may then look mild by comparison.

Constitutional Tax Reform

The traditional theory of optimal taxation ignores the public-choice aspects of tax reform. As such, its recommendation for broadly based taxes designed to raise the same revenue as narrowly based taxes is misleading. That is, a move to a flat rate tax will not necessarily increase efficiency if the tax rate is not limited by constitutional law.

The rise of the redistributive state, the focus on the ability to pay principle of taxation rather than on the benefit principle, and the open-endedness of the tax-spending process in a democratic setting have led to the currently chaotic tax code. In this vein, Buchanan (1967, p. 300) has argued that what is needed to stem the tide of government and achieve authentic tax reform is a "constitutional attitude":

In fiscal theory, as in politics generally, scholars need to pay more attention to the working out of rules or institutions through which final outcomes emerge and less attention to the shape of these outcomes themselves although these must, of course, be relevant to an evaluation of the institutions. Improved allocations, or outcomes, can be achieved only through improvements in the institutions that generate them, and improvements in such institutions, in turn, can be achieved only if their proper role in the whole structure of democratic process is appreciated and understood. Perhaps more than their fellows, scholars themselves need to acquire a "constitutional attitude."

The tax regime, in other words, must be treated as part of the rules of the economic game. The more stable the rules and the more compatible they are with private property rights, the greater will be the incentive to employ resources where they have their highest return to consumers and taxpayers. It is in this light that the late Jan Tumlir (1984, pp. 22–23) called for "constitutional reconstruction" to protect "against the arbitrary exercise of governmental power," and thereby stem the tide of the redistributive state.

In 1985, the legislature's power to tax is still unlimited and the courts continue to defer to the will of the legislative body, even if tax burdens become destructive of private property rights. As Norton (1985, pp. 624–25) points out:

¹⁹In this regard, Lee (1983/84, p. 810) notes: "Recognizing the need for constitutional reform is an essential first step if such reform is to be successful and if the political post-mortem on supply-side economics is to prove premature."

[T]he judiciary will uphold almost any tax classification or unequal placement of tax burdens. The constitutional requirements of uniform and apportioned taxation have been narrowed until they have minimal impact. Furthermore, the fact that a tax is unwisely or destructively high is not grounds for invalidation under current constitutional standards.

Norton calls for a reexamination by the judiciary of the power to tax but concludes (p. 625):

[E]xisting constitutional doctrines present no easy avenues for the courts to follow in evaluating the constitutionality of taxes. None of the theories discussed . . . may provide sufficient guidance for judicial enforcement. Amending the Constitution to provide more clearly drawn safeguards may ultimately be the only way to guard against abuses of the taxing power.

Norton's conclusion is therefore in accordance with the Buchanan-Tumlir recommendation for constitutional tax reform.

At the heart of constitutional tax reform is the notion brought out by Norton (1985, p. 624), namely: "At some point, tax burdens become so heavy that they begin to undermine the free society they were intended to support. When that occurs, the nation must determine whether the balance between protecting individual rights and ensuring necessary government revenues has been disrupted." Constitutional analysis, therefore, points in the same direction as public choice theory and property rights theory, that is, to the need for changing the tax regime in the direction of limited government. Only then will the goals of tax simplification, consensus about tax shares, efficiency, and justice begin to be achieved.

The recent advances in public choice theory and property rights theory have directed attention to government failure and the benefits of constitutional limitations on the powers of government. Unless the current tax reform encompasses constitutional limits on government spending and taxes, it most likely will follow the route of earlier tax reforms and end up producing numerous new loopholes and adding thousands of pages to the tax code. Authentic tax reform requires that we agree on the appropriate size of government; sound tax principles can then be followed to raise the necessary revenue. Unlike the present fiscal process in which spending decisions are separated from decisions about taxes and in which the government has an unlimited power to tax, a constitutional approach to tax reform would force individuals to consider the true costs of government and, hence, to decide if government is excessive.²⁰ Tax shares and expen-

²⁰Hayek (1984 [1979], pp. 403-4) has argued:

diture shares can then be modified to conform with taxpayers' sovereignty in the choice of fiscal institutions.

Current Status of the Tax Debate

The papers in this volume develop many of the ideas discussed up to this point. They also provide a useful reference for analyzing the current tax debate. Wagner criticizes the traditional approach to analyzing tax reform on both positive and normative grounds. He argues that the "optimum tax" approach to tax reform ignores public choice theory and operates in an institutional vacuum. The tax reformer/legislator is self-interested and operates within a common property framework, thus one must begin any positive analysis of tax reform within the given institutional arrangement rather than compare the current regime with some ideally neutral system. If tax reform does not change the existing institutional-incentive structure in which government officials have an unlimited power to tax and an incentive to maximize revenue, moving to a flat tax regime is unlikely to produce results that compare favorably with the current regime.

From a normative viewpoint, Wagner shows that traditional tax theory has taken an end-state approach to justice and used the ability to pay principle to "justify" the redistributive state. As such, those who adopt the traditional normative theory of tax reform act as if tax reform can be considered apart from the subjective interests of taxpayers. The benevolent despot (qua tax reformer/legislator) is then placed above individual property rights and the consensus of fiscal exchange is replaced by the arbitrary force of legislators acting in the

Nothing would probably provide a more salutary discipline of expenditure than such a condition in which everybody voting for a particular outlay would know that the costs would have to be borne by him and his constituents in accordance with a predetermined rule which he could not alter. . . . It is probable that the whole complexity of the tax structure we have built up is largely the result of the efforts to persuade citizens to give the government more than they would knowingly consent to do. . . . [N]othing short of . . . a complete reconsideration of the institutional setting of financial legislation can probably stop that trend towards a continuing and progressive rise of that share of the income of society which is controlled by government.

According to Hayek (1960, p. 323):

The most reasonable rule . . . would seem to be one that fixed the maximum admissible (marginal) rate of direct taxation at that percentage of the total national income which the government takes in taxation. . . . Adherence to this principle would have the salutary consequence that every budget would have to be prefaced by an estimate of the share of national income which the government proposed to take as taxes.

Compare Wicksell (1964 [1896], pp. 87-97).

“public interest.” Wagner suggests abandoning the public interest model in favor of Wicksell’s contractarian model, in which tax decisions are linked to expenditure decisions and the fiscal regime is judged on the basis of its conformity with the principle of voluntary consent. In this model, therefore, the emphasis is placed on the marginal benefit principle of taxation and the safeguarding of private property rights. While reconsidering the normative theory of taxation, Wagner reminds us that a sound, positive theory of public choice can help guide our choice of the fiscal regime by deriving the implications of our normative predispositions. Public choice theory warns us to be wary of self-interested public officials seeking to do good with other people’s money.

McCaleb also takes a positive, public-choice approach to analyzing the current tax reform proposals and reaches conclusions about the efficiency of the current tax regime that are similar to Wagner’s. In examining the efficiency of the current system, McCaleb discusses three public choice models: the private exchange model, the fiscal exchange model, and the Leviathan model. From his analysis, he concludes that the present tax system may be more efficient than moving to a flat tax regime where the power to tax is still unchecked. Like Wagner, therefore, McCaleb basically agrees with the Brennan-Buchanan argument that a flat tax by itself is not sufficient to improve the situation of individual taxpayers or to stop future rent-seeking. Instead, the flat tax must be combined with constitutional limitations on the government’s taxing and spending powers if meaningful tax reform is to occur.

Gwartney and Long, Reynolds, and Vedder all accept the supply-side arguments for tax reform. *Gwartney and Long* review the history of the U.S. federal income tax and reexamine the arguments for a progressive income tax. They argue that the progressive tax has decreased economic efficiency and increased tax avoidance. Thus, switching to a flat rate tax (or a modified flat rate tax) would stimulate economic growth, just as occurred during earlier tax reforms when marginal tax rates were significantly lowered. Reynolds draws on the experience of other countries to provide abundant evidence of the success of supply-side tax policy. He illustrates that countries with lower marginal tax rates on individual income have experienced higher real growth rates than countries with relatively higher tax rates. Consequently, low-tax countries typically experience faster growth in real tax receipts relative to high-tax countries. Vedder draws a similar lesson from his comparison of high-tax and low-tax states. Using regression analysis, he finds a statistically significant

(positive) relationship between the flatness of a state's income tax rate and the growth of its real per capita income.

Minarik's paper points to the confusion surrounding the use of the terms "flat rate tax" and "tax reform." Almost all of the flat tax proposals are for modified flat rate taxes that exhibit some progressivity. Moreover, there is little consensus about the shape actual tax reform should take, except that it should promote "fairness," that is, "treat all tax payers in roughly the same way." According to Minarik, supply-siders have exaggerated the beneficial effects of lowering marginal income tax rates. Thus, he is concerned about the distributional impact flat tax reform might have on lower- and middle-income households and its effect on the deficit.

The papers by Gephardt, Kemp, and Johnson provide a detailed analysis of the three major tax reform proposals: the Bradley-Gephardt proposal for a "Fair Tax"; the Kemp-Kasten proposal for a "Fair and Simple Tax"; and President Reagan's proposal for a modified flat tax, Treasury II. The papers by Gephardt and Kemp also present an interesting discussion of the politics of the current tax reform movement, especially the rent-seeking that accompanies changes in the tax code. All three of these papers agree that what is needed is a supply-side tax policy that will simplify the tax code, broaden the tax base, reduce marginal tax rates, stimulate economic growth, and lead to a more equitable tax system.

The papers by Hall and Rabushka, and Canterbury, Cook, and Schmitt offer additional proposals for tax reform. Hall and Rabushka propose a flat rate tax on consumption, which would be progressive at lower- and middle-income levels by including a sizeable exemption. They argue that a consumption-based tax would be superior to the present income tax because it would encourage saving and investment and increase economic growth. Canterbury, Cook, and Schmitt prefer a combination of a modified flat tax, a negative income tax, and a consumption-style VAT, which they call FLANVAT.

Dye examines the impact of federal tax reform on state and local finances. He analyzes the arguments for deductibility of state and local taxes from federal tax liabilities and for the favorable tax treatment of state and local government bonds. According to Dye, it would be advisable to eliminate state-local tax deductibility and the tax exemption for private-purpose municipal bonds, even if there were no comprehensive tax reform.

In the final paper, Browning and Browning argue that a *true* flat rate tax would increase economic efficiency and stimulate economic growth. These efficiency gains could then be used to help offset any adverse distributional effects the flat tax regime has on lower income

households. Indeed, the authors think that the long-run efficiency gains from a low, flat rate tax could more than offset any adverse, short-run distributional effects. As such, moving to a true flat rate tax actually could benefit lower income families. The equity arguments directed against a true flat rate tax, therefore, are misplaced. *Browning and Browning* also point out that even though the *modified* flat tax will decrease statutory tax rates, it will not change effective rates. Hence, it is incorrect to expect any significant effects on labor supply, saving, or investment under the three major tax reform proposals, all of which seek to maintain revenue neutrality and a constant tax liability by income class.

The present tax reform debate no doubt will continue beyond 1985, for tax reform in a democracy is an ongoing process. Whether the rent-seeking nature of this process will be changed by replacing the current tax regime with a set of fiscal institutions that limit the government's taxing and spending powers will depend on whether the public understands the importance of constitutional tax reform.

Supply-side tax policy and constitutional tax reform would provide a stable institutional framework for individuals to pursue their own goals without the threat of excessive tax burdens and without the uncertainty of the social engineering that now occurs under the tax code. Constitutional tax reform, therefore, would improve the coordination function of the market price and profit system and encourage economic growth.

The merging of supply-side economics and constitutional tax reform will be slow in coming. Much research still has to be done concerning ways of implementing and maintaining a constitutional tax regime. A return to the "constitutional attitude," however, is a necessary step toward a sounder fiscal regime—one that protects property rights and does not subject individuals to the chaos of a tax-distorted economy.

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