

## NORMATIVE AND POSITIVE FOUNDATIONS OF TAX REFORM

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Many of the papers in this volume examine flat rate taxation as an alternative to the federal government's existing system of income taxation. My concern, however, is with some of the normative and positive foundations that must underpin *any* consideration of tax reform. Normatively, it is necessary to have a vision of what constitutes a good tax system, for otherwise there is no basis for claiming that flat rate taxation or any other proposed change truly represents a reform. But it is not sufficient simply to show that the actual system deviates from the ideal, however this ideal is defined. It is also necessary to show that the proposed reform will *truly* represent an improvement, as assessed against the postulated norm. This latter task is one of positive analysis that entails predictions about the consequences of the proposed reform, predictions that in turn require an understanding not just of economic phenomena, but of political phenomena as well.

In this essay, I seek briefly to reconsider the economic analysis of tax reform in general, and flat rate taxation in particular, with respect to both normative and positive foundations. In doing this, I am more interested in exploring what might be called the grammar of tax reform discussion than in trying to support or oppose flat rate taxation *per se*. I have two main theses to advance, one normative and one positive. The normative thesis is that almost all such discussion confounds two incompatible principles of evaluation. The positive thesis is that most tax reform analysis is deficient because it fails to treat collective choices as endogenous, and therefore misrepresents the probable consequences of proposed tax reforms.<sup>1</sup>

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<sup>1</sup>For a careful survey of what they characterize as the "equitable taxation," "optimal taxation," and "fiscal exchange" approaches to the analysis of tax reform, see Hettich and Winer (1985).

## Normative Principles for Tax Analysis

In discussions of flat rate taxation, or of any other proposal for tax reform, it is common to support or oppose the proposal with reference to predictions about its probable impact on such things as saving and capital formation, patterns of investment, and the distribution of income. One person might argue for flat rate taxation on the ground that it will reduce the welfare loss from distortions in patterns of investment that arise because there are different marginal tax rates attached to different types of investment. Someone else might argue against flat rate taxation on the ground that it will shift tax liability from those with relatively high incomes to those with relatively low incomes.

The various dimensions against which proposed tax reforms are assessed are commonly collapsed into two: efficiency and equity.<sup>2</sup> From this point of departure, it is but a short step to conceptualize some trade-off between equity and efficiency, in which principles of efficiency are abridged or amended by principles of equity or justice. In earlier literature, this principle of equity was expressed by two ideas: (1) the taxes that government collects should be related to some notion of ability to pay and (2) equally situated people should pay equal taxes. The more recent literature on optimal taxation operates from within the same utilitarian framework, and solution of the problem of optimal taxation becomes, metaphorically speaking, a problem of how equally to slice a pie when the size of the pie varies inversely with the equality of the slices. For instance, under an assumption of identical income-utility schedules with diminishing marginal utility, in conjunction with an assumption of zero-elastic factor supplies, optimal taxation is that which promotes full income equality. This is true with even what is referred to in this literature as the "individualistic" norm, that is, the Benthamite social welfare function, in which the maximand is the sum of the utilities of the individuals who constitute the nation.

Yet it is surely a curious piece of vocabulary that affixes the designation "individualistic" to an analytical construction in which people are manipulated as objects at the disposal of some type of despot, who is presumed to be benevolent by virtue of being named "Social Welfare Function." It is an equally curious piece of vocabulary that speaks of a trade-off between efficiency and equity, for to speak of such a trade-off is to confound two contradictory norms regarding the proper relation between citizen and state. Efficiency, as expressed

<sup>2</sup>See the discussion in Musgrave (1959, pp. 61–115), along with the further development in Atkinson and Stiglitz (1980, pp. 333–65).

in its benefit principle incarnation, is a derivation from the general normative vision expressed by contract theories of the state. The fundamental axiom of the benefit principle is one of individual self-ownership: people and their rights are treated as normatively prior to government. Efficiency is defined by consensual action within the framework of those prior rights of person and property, and is not something that can be assessed with reference to some objective, external criterion. Efficiency, in other words, represents an *immanent* standard of evaluation.

In contrast, in both the older discussions of ability to pay and in the newer discussions of optimal taxation, the fundamental axiom is one of collective ownership of individuals. Government is prior to people and their rights of person and property, and evaluation proceeds according to some external or *transcendent* criterion of goodness: public outcomes are evaluated in terms of some transcendent criterion that expressly denies the normative status of consent. Individual rights either represent grants from government or reflect the inability of government fully to control its own domain. A tax system is judged good not because it allows people to further their common interests, as judged by consent among them, but because it accomplishes particular, externally imposed objectives. Again, the so-called individualistic norm represented by the Benthamite social welfare function is transcendental and not immanent: it expresses external authority over people rather than allowing people to work out their own arrangements within the framework of the rules of property and contract.

One can, of course, adopt whatever set of normative axioms one chooses. The axiom of individual self-ownership, along with its corequisite immanent approach to evaluation, is surely more consistent with a democratic polity within a liberal society than is the axiom of collective ownership of individuals, with its corequisite transcendent approach to evaluation. Moreover, and regardless of how one might assess this question of normative perspective, it is still impossible to assess proposals for tax reform without a theory of public choice, as I shall try to explain later in this essay.<sup>3</sup>

All transcendent norms are, of course, despotic, in that they represent authority over people. Some of these are benevolently or

<sup>3</sup>While one might normatively adopt Lockean norms of individual self-ownership, a growing body of literature on public choice suggests that the Hobbesian vision might be more congruent with positive analysis. See Ostrom (1984) for a comparison of these alternative visions. Ostrom seems perhaps to be more optimistic about Locke's approach to incentive compatibility than much of the public choice literature might seem to suggest is warranted.

paternalistically so, while others are more fearsome. But in terms of central principle, there is little difference between contemporary norms of equity and optimal taxation and, say, Machiavellian-like norms for the guidance of actual rulers. Indeed, much of the theory of fiscal illusion that developed in Italian scholarship construed the problem of fiscal conduct as one of how a ruling despot could use his position to maximize his wealth.<sup>4</sup> Even much earlier in Italy the same frame of reference could be found. Suetonius (1957, p. 126), for instance, reports that a relatively early expression of such a guiding principle was articulated by the Emperor Tiberius, who replied to some of his governors who wanted him to impose higher taxes: "A good shepherd should shear his flock, not skin it."

As various forms of constitutional monarchies, republics, and democracies emerged in Europe, real despots disappeared, and norms now came to be directed to some fictional person who often was named "Public Interest." In the last years of the 19th century, Knut Wicksell (1958, p. 82), in a book on the legal, economic, and political aspects of government, noted that, in criticizing the then standard approach to public finance, and which is still the standard approach: ". . . the whole theory [of public finance] still rests on the now outdated political philosophy of absolutism. The theory seems to have retained the assumptions of its infancy, in the seventeenth and eighteenth centuries, when absolute power ruled almost all Europe."

Sometimes the continuation of this approach under non-absolutist regimes was justified by adopting the fiction of the benevolent despot. With this civilizing of the despot, assessments of policy options became pronouncements about what a benevolent despot should do. As in the age of absolutism, standards for assessing policy outcomes were still grounded in some alternative principle to that of a consensus among the participants. Outcomes were still assessed against some externally imposed criterion of doing good, only "good" was no longer assessed by some actual ruler, but rather was assessed by some fictive and benevolent despot, who was presumed to be guided by some such idea as minimizing the sacrifices that taxes impose on people, or of using the budget to maximize the utilities that the members of a nation get from their incomes. Regardless of the details of the historical development of this literature, or of the contemporary scholarship in what has come to be called the theory of optimal taxation, the central point remains the same: policy outcomes are assessed against some transcendent criterion of goodness, indepen-

<sup>4</sup>See Buchanan (1960) for a discussion of the work of Italian economists during the late 19th and early 20th centuries.

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dent of any consideration of what the participants might or might not work out among themselves, in light of their preexisting rights of person and contract.

By contrast, the contractarian perspective, which follows from the Lockean norm of individual self-ownership, takes an immanent approach to evaluation. People and their rights of person and property are prior to government, and the task of government is to support people in their efforts in those cases where people can do better for themselves through common action than they can do through individual action. "Better," however, is determined by those individuals themselves, so the standard of evaluation for policy outcomes must ultimately be a standard of consent among the participants. And this is genuine consent and not the tautological version in which the mere presence of what are called "democratic" institutions is taken to mean that those institutions necessarily reflect such consent. Legislative actions may reflect such consent and hence be legitimate, but they also might not. The victim who yields her purse and her body to the knife-yielding intruder "consents" to do so in light of the alternative, just as citizens "consent" to be taxed, regulated, and otherwise governed in light of the alternative. But it is possible to move beyond a statement of tautology only by recognizing that contractarian principles are the only principles that are appropriate for a society of free people. In such a society, people have their various rights of person and property, and government must itself operate within the same general principles as all other participants in society; government's actions are to fall within the constraints offered by the previously existing rights of property and contract, a requirement that is the central principle of what is called the rule of law.<sup>5</sup>

Within the contractarian perspective, the question of what makes for a good or bad tax system cannot be answered independently of the interests of the people who constitute the government. There is no possibility of determining a "good" tax system independently of a consideration of the interests and values of the people who constitute the polity under consideration. When people and their rights come first, normatively speaking, tax systems cannot be supported in terms of their impact on any such variables as economic growth or income distribution per se, but can only be supported in accordance with their ability to support and promote the interests of the people who constitute the polity in question. An argument that a tax reform increases (or lessens) progressivity might be pertinent information

<sup>5</sup>The most complete and recent exposition of this Lockean perspective is Nozick (1974). For an explicit extension of that perspective to taxation, see Mack (forthcoming).

in trying to assess tax reform proposals, but it is not itself a standard of assessment. Similarly, an argument that a reform will increase (or decrease) saving and economic growth might inform personal judgments, but that particular consequence is not a standard of evaluation. The standard of evaluation in the contractarian framework is one of consent.<sup>6</sup>

### Positive Analysis and Normative Principles

Any effort at normative assessment or formulation raises in turn the positive question of incentive compatibility: any norm requires an institutional order that is consistent with its own promotion. However, the presence or absence of such consistency is itself a positive and not a normative matter. While I think the normative element in most tax analysis is deficient in that its foundation seems more suitable for some despotic or paternalistic regime than for a democratic regime, I also think the positive element is deficient, regardless of normative perspective. Tax reform discussions tend *not* to be informed by an understanding of the operation of political institutions, but without such an understanding grounded in *political economy*, it is impossible to assess the properties of proposed tax reforms, regardless of the normative standards of assessment.

Even if the question of appropriate norm has been settled, the assessment of options for tax reform cannot be conducted without a theory of public choice. The base-broadening and rate-lowering capabilities of flat rate taxation have been supported by various arguments concerning equity and efficiency. However, whether the attainment of those ends will be promoted or impeded by the proposed reform requires some modeling of economic and political phenomena, that is, it requires a theory of public choice. To illustrate this proposition, I shall consider the common usage of concepts of equity and efficiency to assess tax systems and proposals for tax reform. In doing so, I should want to make it clear that I am not espousing such normative usages, because they are predominately transcendent in their orientation. Rather, I am merely interested in illustrating some of the problematical features that arise from failing to address normative propositions in light of positive models of political economy.

#### *Equity, Capitalization, and Tax Simplification*

Equity concerns relating to tax simplification are usually formulated in terms of equally situated people having different tax liabil-

<sup>6</sup>This thesis has been explored by Buchanan in several places, including (1959, 1976, and 1977).



ities. Two people might each have \$10,000 of interest income, but one person's source is tax-exempt municipal bonds while the other person's source is taxable corporate bonds. Both have the same interest income, but are taxed differently, so the holder of the tax-exempt bonds has a higher post-tax income. Alternatively, someone who buys a house is able to deduct interest on the mortgage, but someone who rents is not. Relatedly, the homeowner is not taxed on the rental value of his house, but the landlord is. Hence, the homeowner is favored relative to the renter, and homeownership is favored relative to tenancy. Numerous similar illustrations could be given; the literature on what has come to be called *tax-expenditure budgeting* is filled with such illustrations. It would seem as though ordinary *canons of equity* are violated repeatedly through a prolix variety of loopholes and exclusions in the tax system. If so, tax simplification, as through flat rate taxation, would seem to be a strong force for equity, defined as the equal taxation of equally situated people.

However, the claims of inequity cannot be advanced on the basis of such arithmetic reasoning, for to do so involves a presumption that relative factor supplies are invariant to net returns. Once it is recognized that factor supplies vary directly with net returns, claims of inequity largely vanish, and if anything would be a source of inequity it would be reforms that simplified the tax system, as Goetz (1978), among others, has explained. The holder of tax-exempt bonds receives a lower rate of interest than the holder of taxable bonds; the higher price the holder of tax-exempt bonds pays is roughly equivalent to the *alleged tax advantage*: this equivalence is an inherent feature of a market economy. The renter has no mortgage interest to deduct, but competition among owners for tenants means that the owner's ability to deduct mortgage interest results in lower rental payments roughly equal to the amount of the tax deduction. And in all similar illustrations of the inequitable features of what commonly are called "loopholes," the same point can be made: so-called tax advantages do not confer gains on the nominal recipients.

All such gains are realized at the time the programs are announced (or actually anticipated). Starting from a regime in which all interest income is taxable, the conferral of a tax exempt status on municipal bonds would give an advantage to those who hold bonds when tax exemption is initiated (or rather, when its initiation is anticipated), just as the elimination of such a status would place a penalty on the present holders. But as a result of the creation of this tax-exempt status, the demand for the bonds will increase, thereby increasing the price and lowering the yield, and doing so sufficiently to eliminate the differential advantage from holding the bonds. Subsequent

holders of tax-exempt bonds gain no advantage. Flat rate taxation, then, would not redress inequities, but rather would create them: it would impose a capital loss on the holder of tax-exempt bonds and confer a capital gain on the holder of taxable bonds. And it would be the same for any such base-broadening, "loophole"-closing "reform." Moreover, the extent of inequity from such a reform would almost surely rise with the length of time the provision in question had been in force. The most equitable tax reform, in other words, would seem to be no-reform, at least when equity is defined as the equal treatment of equals.

### *Efficiency, Tax Reform, and Public Choice*

As for efficiency, it is commonly claimed that the differential tax treatments that pervade the present income tax system create various economic distortions, the significance of which can be assessed with the welfare-cost methodology developed by Harberger (1964). Even if it is acknowledged that the deductibility of mortgage interest is not a source of inequity, it alters the composition of the capital stock in the direction of more residential capital and less nonresidential capital. Hence, tax simplification would be efficiency-enhancing, because it would induce a reallocation of capital away from uses with relatively low pre-tax returns to uses with relatively high pre-tax returns. However, even if flat rate taxation were presumed to offer this gain in efficiency, the case for flat rate taxation would not be made ipso facto, because that efficiency would have been attained at the expense of inequity, through the imposition of capital gains and losses among otherwise equally situated people. Even if this argument about efficiency were accepted, it would have to be accompanied by some complementary argument to the effect that the efficiency gains were more valuable (to whom?) than the equity losses.

But there is more than this consideration of trade-off with which to question the standard analysis of efficiency. A long tradition of economic analysis notwithstanding, analysis of the efficiency consequences of flat rate taxation, or of any other proposed reform for that matter, is incomprehensible without some theory of public choice. The Harbergarian methodology adopts some market standard as a norm, and treats such things as the deductibility-induced expansion in housing as a sign of inefficient investment. If this were so, flat rate taxation would be efficiency-enhancing. But how can this determination be made? It is an easy task to model homeownership as a source of external economies, perhaps supported by arguments to the effect that a society of homeowners has more desirable characteristics than a society of tenants. In this alternative formulation,

mortgage deductibility is one possible means of internalizing some of the external benefits from homeownership. In this case, the expansion in homeownership that results from deductibility would not be counted as a cost, as it is in the Harbergarian methodology, but rather would be counted as a social benefit. Moreover, a prolux variety of so-called loopholes and privileges can be rationalized by such reasoning, as Thompson (1974) has shown so ingeniously in a different setting.

Alternatively, someone might argue that deductibility is a way of transferring wealth from taxpayers generally to various specialized inputs engaged in the production of housing services. So long as those inputs are specialized, an expansion in demand will create rents for the inframarginal inputs. Whether such specialization might exist, where it might exist, and for how long it might exist, are empirical questions, of course, but in any event such a measure might have political survival value, as the growing literature on rent seeking has come increasingly to explore.<sup>7</sup>

Models similar to those explored in the literature on rent seeking also suggest that such base broadening as that envisioned by flat rate taxation would be a means of increasing the overall level of taxation. Suppose Brennan and Buchanan (1980) are correct, at least as a first-order approximation, that government can be viewed as a revenue-maximizing entity. If so, it would exploit each tax base to its point of unitary elasticity. For a given structure of tax bases there would be a set of rates applied to those bases that would maximize government's tax take. Although proponents of flat rate taxation typically speak of reducing rates so as to offset the revenue-raising impact of the broadened base, the Brennan-Buchanan perspective would suggest that whatever rate reduction might take place would be less than the extra revenues generated by the broadened tax base. Flat rate taxation, at least of the base broadening sort that informs current discussion, would, according to these types of models, most certainly not represent mere tax simplification, but would represent an increase in the total tax take by government.

What this all means is that flat rate taxation, or any proposed tax revision, cannot be evaluated without a model of *political economy*. Moreover, this raises some conundrums. In a model of what might be called "perfect polity," "loopholes" are not signs of either inequity or inefficiency, but rather are signs of the political correction of market failures. In such a model, flat rate taxation would not offer the improvements its advocates claim. Use of the Harbergarian

<sup>7</sup>See the survey article by Tollison (1982).

methodology would be inappropriate in such a setting. But in a model of “imperfect polity,” flat rate taxation may well offer the improvements its advocates claim. However, the Brennan-Buchanan considerations would also become relevant, as would other, related considerations from the theory of public choice, considerations that are summarized by Aranson and Ordeshook’s (1977) model of the “failure of representative democracy.” Among other things, flat rate taxation becomes a vehicle for raising overall tax burdens.

### Knut Wicksell and the Contractarian Perspective

Knut Wicksell (1958) published probably the most important work to date on the concrete implementation of principles of consensual governance that is central to the contractarian perspective on taxation and tax reform. Wicksell’s normative point of departure was an acceptance of the contractarian principle, and he went on to show how this principle could be used to construct particular institutional rules for a concrete historical situation.<sup>8</sup> Wicksell sought to describe institutions that would promote what might be called consensual or concordant, as against factional or majoritarian democracy, and to do so within the Swedish context of his time. In that context, Sweden was a constitutional monarchy, so the two main institutions with which Wicksell was concerned were the Crown and Parliament. The Crown, like any executive agency, Wicksell thought, would be generally interested in expanding its operations—but it could do so only by receiving larger appropriations from Parliament. And as Wicksell recognized, should Parliament act by majority rule, government would become excessively large as evaluated by the principle of consent of the governed. This would occur because of the ability of winning majorities to impose costs on losing minorities, a phenomenon that has been reemphasized by recent scholarship in public choice.

But Wicksell also saw Swedish society as essentially consisting of a relatively small number of relatively homogeneous groups. This feature of Swedish society meant, Wicksell thought, that it would be possible to organize the Parliament in such a way as to give proportional representation to those various groups. With different parties representing the different groups, a system of proportional representation would bring about a fairly complete representation of Swedish society, and would do so in a Parliament that contained a comparatively small number of relatively homogeneous parties. From here,

<sup>8</sup>See Hennipman (1982) for a consideration of the common foundations of Wicksell’s formulation and the Pareto principle.

the rest of Wicksell's approach follows straightforwardly. To implement a principle of consensual or concordant democracy and to prevent the violence of factional or majoritarian democracy, Wicksell proposed to allow each party in Parliament to withhold the tax payments that would otherwise be due from its constituents, if it did not think they were getting adequate value in return for their taxes. It is this feature of Wicksell's proposal that is referred to as a rule of near-unanimity. Wicksell proposed that taxing-and-spending choices require substantial consensus, on the order of 75 to 90 percent among the parliamentary representatives. This type of near-unanimity among the representatives of a comparatively small number of relatively homogeneous groups within a Parliament selected by proportional representation is not, of course, anything like merely applying a rule of near-unanimity to the existing Congress in contemporary America.

Wicksell took a general principle that government should reflect the consent of the governed and developed some particular institutional implications of that principle as he thought these would apply to Sweden in 1896. He suggested one particular constitutional regime that was consistent both with a contractarian framework and with the Swedish institutions of his time. Wicksell's work addressed the interdependence between normative presuppositions and positive analysis of political economy: he addressed forthrightly the problem of incentive compatibility. Starting from a general normative premise of classical liberalism, Wicksell recognized that the institutional or constitutional framework within which government governs can be either subversive or supportive of that normative premise. He recognized, as modern scholarship in public choice and political economy has continued to explore, that a constitutional order grounded in parliamentary majorities was inconsistent with the liberal or consensual value premise. Wicksell further recognized that for consistency to result between norms and outcomes, it was necessary that the pattern of incentives that a particular constitutional regime presents to people must be compatible with the consensual principle. And even putting Wicksell's affirmation of liberal-contractarian values aside, what remains is a recognition that it is impossible to assess any proposal for tax reform without invoking some theory of public choice, for otherwise there will be no cognitive basis for claiming that the proposed reform truly promotes the norm that serves as its justification.<sup>9</sup>

<sup>9</sup>For a more extensive consideration of taxation and tax reform from within a Wicksellian public choice perspective, see Wagner (1985).

## Tax Institutions and Fiscal Exchange in a Contractarian Paradigm

Within a contractarian framework, tax systems cannot be judged independently of choices concerning public expenditure. In the Wicksellian version of that framework, there are no independently existing tax institutions in the first place, save those that would be used to discharge prior obligations. Each expenditure proposal would be coupled with a proposal to cover the cost; there would be no tax institutions that would be permanently in place to gather revenue, save again for the financing of such prior obligations of that represented by public debt. The Wicksellian framework emphasizes the choice of political institutions; he described a set of political institutions that if enacted would give budgetary outcomes that could be described by the familiar Lindahl (1958) diagrammatics. Lindahl's diagrammatics, in other words, would be an apt representation of a regime that operated according to the set of political institutions that Wicksell described.

Modern revenue systems, however, are characterized by tax systems that are in place and which generate revenue independent of expenditure choices. And under some circumstances such an independently existing tax system can substitute for a more restrictive political system. In the more general contractarian framework, there is a trade-off between political and fiscal institutions.<sup>10</sup> Successful exploitation of this trade-off would enable a less restrictive voting rule to be used without affecting the veracity of the Lindahl-like description of outcomes. For instance, and as one example, if public spending could be limited to items of broad or common interest, and if, moreover, income and price elasticities of demand were unitary, a proportional income tax would produce the Wicksell-Lindahl outcome regardless of the voting rule—unanimity, majority rule, or an any-person rule would give the same outcome. This particular result comes about, of course, because it is simply assumed that governmental services are of universal benefit, as described by the postulated elasticity conditions. Under alternative assumptions, the particular voting rule can make a great difference.

In any event, within the contractarian framework tax institutions are seen from two perspectives. On the one hand, they are "prices" that people pay for governmental output. Within the Wicksell-Lindahl framework, taxes in the public sector are essentially indistinguishable from prices in the private sector. On the other hand, taxes

<sup>10</sup>This is developed in Buchanan (1967).

are also constraints on political outcomes. Political outcomes, like market outcomes, reflect the pursuit of personal interest within a particular institutional regime that establishes a pattern of costs and gains to various actions. For instance, a rule of generality in taxation precludes majority coalitions from shifting tax burdens onto the remainder of society. If everyone is liable for taxes, the members of a winning majority must pay as well as the members of the minority. As tax bases become more specific or less general, the scope for such tax discrimination is broadened.

Furthermore, once tax institutions are looked upon as constitutional, constraining rules, it is clear that it is important that they be predictable. They are part of a system of law or rules; they form part of the framework people take into account in undertaking their various economic activities. As a result tax changes should take place rarely and not regularly, and probably should rarely if ever take place contemporaneously, let alone in *ex post* fashion as tax legislation often does. One of the fundamental lessons of economics concerns the importance of institutional stability in creating a climate that produces the stability of expectations that encourages people to make long-term investment choices. The annual flood of tax legislation that has become characteristic of the past two decades, however, is surely itself a significant source of uncertainty, for it reduces the assuredness with which people can reasonably hold beliefs about the productivity of future investments.

## Conclusion

The main point of this essay has been more one of suggesting a different way of thinking about matters of taxation and tax reform than to support any particular reform, either one version of flat rate taxation or another, or something else entirely. The common approach to tax analysis is, as I have tried to explain, deficient on both normative and positive grounds.

Normatively, the conventional grammar of tax analysis is despotic and not democratic in its orientation. Tax systems are assessed in terms of how far they advance a particular assessor's view of what he or she would like to see accomplished, whether it would be faster growth, less homeownership, greater equality, more investment in research and development activities, or whatever else one might choose to plead a case for. However, a thoroughgoing acceptance of the liberal norms that inform the rhetoric if not the practice of the American commonwealth requires a different grammar for tax analysis and evaluation: what might be called a Wicksell-Lindahl type

of grammar rather than an Edgeworth type of grammar. Tax systems are not to be evaluated in terms of their ability to foster particular substantive goals that the analyst favors, but rather are to be evaluated in terms of their ability to reflect and be consistent with a consensus among the participants, in light of those participants' prior rights of person and property.

On positive matters, political outcomes are as much a reflection of the interaction of people pursuing their interests as are market outcomes. Once this is recognized, the constraining impact of different tax institutions comes to occupy a central position in tax analysis. Given a particular set of political institutions, tax institutions can be assessed in terms of their ability both (1) to reflect more fully people's willingness to pay for public output and (2) to preclude gross violations to the contrary. Taking seriously the dictum that government should reflect the consent of the governed, the choice between flat rate taxation, in one form or another, and the present system may well be of relatively little consequence. There is some basis for thinking that flat rate taxation would increase overall tax burdens. There is also some basis for thinking that the simplification that flat rate taxation *might* (though I doubt in actuality) produce would generate some social saving, both in terms of tax administration and in terms of Harbergarian losses. But regardless of the Harbergarian triangles, flat rate taxation would do nothing to address the Tullockian, rent-seeking rectangles. Flat rate taxation seems to offer no inducement or incentive for government more fully to reflect the consent of the governed. Nor does it seem to offer any penalty for government to control its excesses in the opposing direction.

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## NORMATIVE AND POSITIVE FOUNDATIONS

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## THE RHETORIC AND REALITY OF TAX REFORM

*Thomas J. DiLorenzo*

Richard Wagner (1985) has done an excellent job of cutting through much of the rhetoric and pretense that surrounds the issue of tax reform. The standard public finance analysis of taxation is pretentious because it purports to explain the implications of alternative tax regimes for "social welfare," as though social welfare is something that can be defined by social scientists apart from the opinions of members of society. Benefits and costs are subjective, and interpersonal utility comparisons are impossible, so that economists who employ the social welfare function in their analysis really have nothing to say about social welfare. One can argue in favor of one tax system over another on grounds that it may stimulate savings, capital accumulation, and so on, but that is different from saying it would enhance social welfare, a necessarily subjective phenomenon.

The labels "efficiency" and "equity" are, in my view, excuses that economists sometimes use for their support of coercive governmental policies. As Professor Wagner clearly shows, any change in the current tax system will impose transitional losses on some individuals and grant transitional gains to others. To call such a change "efficient" is misleading, at best, since efficiency, as Professor Wagner notes, is best defined by consensual action "within the framework of those prior rights of person and property, and is not something that can be assessed with reference to some objective, external criterion" (p. 387). Economists' standard definition of efficiency ignores the principle of self-ownership: the notion that people and their rights are seen as prior to government. By ignoring or denying these rights some economists engage in intellectual exercises, says Wagner, "in which people are manipulated as objects at the disposal of some type of despot, who is presumed to be benevolent by virtue of being named 'Social

Welfare Function' ” (p. 386). It is incredible that the “optimal taxation” literature designates this collectivist notion as “individualistic.” But despite this mislabeling, the economics literature embodies a collectivist view of property ownership: Individual rights represent grants from government so that arbitrarily rearranging or abolishing some of these rights is said to be the “legitimate” domain of government. For instance, academics and policymakers often plead for changes in the tax system that would unequivocally hurt some individuals, all in the name of promoting efficiency or equity as defined by the academics and policymakers. The rhetoric of efficiency and equity is all too often used to “justify” governmental policies that violate the rights of political minorities.

Another theme of Professor Wagner's paper is that “[f]lat rate taxation seems to offer no inducement or incentive for government more fully to reflect the consent of the governed. Nor does it seem to offer any penalty for government to control its excesses in the opposing direction” (p. 398). In fact, if my suspicions are correct, the current proposals for flat rate taxation would probably induce government to further *ignore* the consent of the governed. My suspicions, which Professor Wagner seems to agree with, are that a flat tax will mean a higher overall level of taxation. It is inconceivable that federal politicians would construct a tax reform that would leave themselves with *less* tax revenue. Moreover, the claims of how the current proposals are “revenue neutral,” that is, they would leave total tax revenues unchanged, are nonsense. No one can accurately forecast the economic effects of such tax changes and the consequent changes in government tax revenues. In fact, the so-called government forecasts produced by the Treasury Department and the Congressional Budget Office assume there are *no* economic side effects of such changes in the tax system. These analyses are completely static and are therefore useless. Is there anyone who takes such government (or private) economic forecasts seriously? Given the great uncertainties involved, and the fact that no one knows what these “revenue forecasts” mean, it is quite likely that any tax reform that is consummated will “err” on the side of *increasing* taxes. If so, this latest tax reform, like most others in recent memory, will not be a true reform but simply a tax increase. And to those of us who believe that Congress is truly out of control and largely unresponsive to the wishes and consent of the governed, another tax increase would only encourage Congress to continue its fiscally irresponsible ways.<sup>1</sup>

<sup>1</sup>James T. Bennett and Thomas J. DiLorenzo (1983, 1985) discuss how government has become progressively less democratic and more authoritarian over the past several decades.

Runaway government spending is the real problem, but the current tax reform proposals do not even address that issue. If one values rights to person and property, then it is important to realize that government spending continues to be a gross violation of those rights. The essence of taxation is to coerce one group of citizens to give up some of their property so that others may benefit. If ever there was a definition of legalized theft, this must be it. Furthermore, the true measure of "taxation" is not tax revenues *per se*, but government spending (Friedman 1978). The true "cost" of government is better represented by the level of spending than explicit taxation, for spending indicates the extent to which resources are diverted from private to governmental uses, regardless of how it is financed. Taxation reduces private consumption spending; borrowing reduces private sector investment; and money creation crowds out private spending by reducing the real value of privately held wealth. Thus, a more accurate view of the burden of taxation is provided by government spending than by tax revenues (and an even more accurate account would include the costs of government regulation). By framing the issue of tax reform solely in the context of how to reorganize one particular means of financing government spending—*income taxation*—the reformers are involved in an exercise not unlike rearranging the chairs on the deck of the Titanic.

Another point Professor Wagner makes that deserves closer scrutiny is his comment that even though a flat tax *may* generate some benefits such as lower costs of tax administration and lower "welfare losses," it would "do nothing to address the Tullockian, rent-seeking rectangles" (p. 398). He refers here to the diagrammatic explanation of "rent seeking"—the use of resources to obtain, maintain, and extend economic rents through the aegis of the state (Tullock 1967). Lobbying for tax loopholes or for higher taxes imposed on one's competitors are examples of such rent seeking.

Politicians benefit by treating citizens unequally before the law: They grant tax preferences or loopholes to politically powerful groups in return for votes and campaign contributions from those groups. This is surely one fundamental reason why the tax code, over the years, has become so complicated. But if this is true, one might ask, why would politicians support a tax reform bill that would eliminate most of the loopholes they have created (and benefited personally from)? If granting loopholes is politically profitable, it would seem irrational for politicians to support a tax reform law eliminating most loopholes. I would like to offer one possible explanation of this "puzzle." The granting of tax loopholes by politicians is subject to diminishing returns, just as all other activities are. The marginal

political benefit of granting additional tax preferences will fall over time. It is also likely that the marginal political costs (to the politician) are rising, for with increased complexity of the tax system comes greater dissatisfaction on the part of voters who complain that the tax system is too complicated and unfair. Thus, at some point it is no longer politically profitable to create further loopholes. Politicians who support a flat tax are hoping to win political support by appealing to the taxpayers' frustration over a tax system that is widely held as extraordinarily cumbersome and inequitable. But once the slate is wiped clean and most loopholes are eliminated, the same politicians who benefited from voting for some version of a flat tax can then benefit further by "starting over" and granting more loopholes, the marginal political value of which would then be relatively high. Thus, one can possibly view the current tax reform legislation as part of the ongoing game of rent seeking in which more and more resources are diverted from market activity to the activity of trying to influence the governmental authorities. If so, Professor Wagner's point is well taken: The flat tax does not even address the problem of rent seeking. As long as government has the power to forcefully take one person's income and give it to another (keeping some for itself), rent seeking will remain a major problem of democratic government, regardless of how taxes are collected.<sup>2</sup>

Finally, I would like to comment on Professor Wagner's suggestion that those interested in the issue of tax reform embrace the contractarian perspective as developed in Buchanan and Tullock's (1962) *Calculus of Consent* and in Buchanan's later work (1975; 1977), to mention a few examples. This perspective seems quite reasonable to those of us who value the Lockean principle of self-ownership, since "the standard of evaluation for policy outcomes must ultimately be a standard of consent among the participants" (Wagner, p. 000). A "good" tax system, says Professor Wagner, cannot be determined apart from the interests of the citizens when people and their rights come first. The effects of the tax system on savings, capital accumulation, and economic growth are not legitimate evaluation criteria if the interests of the people who constitute the polity in question are ignored.

A problem I have with the contractarian perspective, however, is that with issues such as tax reform there is never likely to be *unanimous* consent. If one uses the consent of the governed as a means of evaluating a tax system and chooses one system as "the best" because it commands, say, a 70 percent majority vote rather than a 51 percent

<sup>2</sup>Mancur Olson (1982) believes rent seeking is a major cause of economic stagnation.

majority, one is still advocating coercing others into accepting one's views. This does not seem to be in principle any different from using standard welfare economics to justify governmental coercion.

Another problem with the contractarian approach is that it sometimes talks not of actual unanimous agreement but rather of "conceptual" agreement: "... it is the conceptual agreement among all participants at the constitutional stage or in some original position that is the essential element of fairness" (Buchanan 1977, p. 130). My interpretation of this approach is that it is supposedly legitimate for a group to exercise dominance over another through the political process as long as the dominating group can convince itself that even though there is no concrete unanimous agreement, they are acting in accordance with "conceptual unanimity."<sup>3</sup> Policies that would command conceptual unanimity are usually derived from specific theories in the contractarian literature. But it seems to me that these theories can be used to justify government coercion just as easily as the social welfare function approach can. I do not see much difference between trying to impose one's will on others by calling it conceptual unanimity and appealing to a social welfare function to accomplish the same ends. Both approaches are attempts at social engineering. As long as government is allocating resources there will be no unanimous consent. There can only be unanimous consent in private markets, given well-enforced property and contract rights. Accordingly, if one believes consent is a desirable policy criterion, the only substantive proposal one can make is of a reduction in the size, scope, and power of government, by whatever means. Only by privatizing government and encouraging free enterprise can the domain of cooperative behavior be expanded. The mere existence of government implies coercion, and I do not believe this can be "conceptualized" away.

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<sup>3</sup>T. Nicolaus Tideman (1983) and Leland Yeager (1985) provide methodological critiques of contractarianism.

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