PUBLIC CHOICE PERSPECTIVES ON THE FLAT TAX FOLLIES

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Introduction

Most experts agree that the existing income tax system is grossly inefficient. It distorts the income-earning and expenditure decisions of individual taxpayers, inducing them to choose less-preferred alternatives that are eligible for favorable tax treatment in place of more-preferred alternatives that are not so favored by the tax system. The progressive rate structure, for example, alters choices about the division of income within the family and about the timing of income receipts and expenditures. The exclusion of some types of income and the favorable tax treatment accorded other types of income distort choices about working, saving, and investing; and the granting of exemptions, deductions, and credits distorts decisions about private activities and expenditures. Such distortions impose unnecessary costs on the individual taxpayer over and above the tax liability itself that could be avoided simply by restructuring the tax system.

This view underlies such flat tax reform proposals as the Bradley-Gephardt Fair Tax Plan and the Treasury's 1984 comprehensive income tax plan (Treasury I). These proposals would reduce both the number of tax rate brackets and the level of marginal tax rates, would impose a tax on many types of explicit and implicit receipts that are now excluded from the concept of taxable income, and would "close loopholes" by repealing most exemptions, deductions, and tax credits. Because there is widespread agreement that the flat tax is clearly more efficient than the existing income tax structure, the debate over the relative merits of the two systems has focused primarily on questions of fairness and equity.

Cato Journal, Vol. 5, No. 2 (Fall 1985). Copyright © Cato Institute. All rights reserved.

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In fact, however, the flat tax only appears to be more efficient because of the restrictive concept of efficiency employed in the traditional approach to the study of tax policy by economists as well as other policy analysts. An investigation of the characteristics of an efficient tax structure from the broader public choice perspective reveals that graduated rates, exclusions, and deductions may be quite consistent with economic efficiency, taking into account all the dimensions along which individual choice proceeds.

This article examines the efficiency properties of the current income tax from a public choice perspective. Three different models of public choice—the private exchange model, the fiscal exchange model, and the Leviathan model—are used, and it will be seen in each that the existing income tax system appears more efficient and the proposed flat rate tax appears less efficient than has so far been recognized. The analysis begins by comparing the traditional approach to the analysis of tax policy with the public choice approach.

Alternative Approaches

The traditional approach to the study of taxation and its effects completely ignores the political dimension.[1] It implicitly assumes that individual taxpayers do not make choices either directly or indirectly about fiscal rules and institutions or about public expenditures and revenues, or at least it does not subject such choices to economic analysis. Accordingly, decisions about the rules and institutions that govern society and decisions about the level and composition of the public budget are made outside the system and imposed on it. The taxpayers then make their market choices about earning, spending, and saving in an economic environment shaped by these externally imposed rules, institutions, and budgets. The taxpayers have no influence over the economic environment; they merely react to it in their market behavior.

The only problem for analysis in the traditional approach is the effect different fiscal institutions have on market choices. The influence of the same fiscal institutions on political choices remains unexamined. From this perspective, any tax rule that alters the income or expenditure decisions of individuals in the market is inefficient, and the greater the distortion, the greater the inefficiency. The present income tax is grossly distortive of these decisions and therefore decidedly inefficient. A flat tax is demonstrably less distortive and

[1]An excellent textbook introduction to the traditional approach is Musgrave and Musgrave (1984). The traditional approach is also exemplified by Pechman (1983).

therefore clearly superior (Hall and Rabushka 1983; Treasury I 1984, vol. 1, chaps. 1–3).

The public choice approach, on the other hand, recognizes that in a democratic system government expenditure and revenue decisions emerge from the interactions and reflect the preferences of the individual voter-taxpayers.[2] Ultimately, individuals make these decisions through the political process. Both the traditional and the public choice approaches examine the effects of fiscal rules and institutions on individual choices in the market, but the public choice approach also investigates the influence of these rules and institutions on political choices and on public spending. From the public choice perspective, decisions about the size and composition of the public budget are not independent of the fiscal institutions. Instead, there is a feedback effect from the institutional structure to the public budget that is altogether ignored by the traditional approach. Furthermore, the public choice approach recognizes that ultimately the fiscal rules and institutions themselves are derived from the choices of the individual voter-taxpayers. The public choice approach, then, is more complete than the traditional approach, taking into account additional dimensions of individual choice.

From the public choice perspective, fiscal institutions that alter individual decisions in the market are inefficient. However, fiscal institutions also affect individual voting decisions, generating an additional source of inefficiency not recognized by the traditional approach. A comparison of alternative rules and institutions, including tax rules, in terms of their effects on economic efficiency must then take into account both market and political choices, which the traditional approach fails to do. For these reasons, the traditional analysis of tax policy is misleading. When public choice considerations are introduced, the flat tax is no longer clearly superior to the existing income tax on efficiency grounds. Whatever the relative merits of the flat tax in its effects on individual choices in the market, its effects on political behavior must also be considered, and along this dimension the existing income tax may be superior.

Unlike the static single-dimensional setting of the traditional approach, the public choice approach includes different levels of decision making occurring at different points in time. Individuals first choose a set of fiscal rules and institutions at a "constitutional"

[2]See Buchanan (1967, 1975, 1976) for a discussion of the distinguishing features of the public choice approach.

decision level.[3] These rules and institutions are intended to be relatively permanent. Once this constitutional framework has been erected, operational choices about the level and composition of public spending and about individuals' earning, spending, and saving activities in the market are made. These postconstitutional decisions are less permanent than the constitutional decisions, and a whole sequence of operational decisions may be made under a single set of fiscal rules and institutions. This political setting is analogous to the playing of a game. Before the cards are dealt and play begins, a set of rules is adopted. Then, within the framework established by these rules, the hands are dealt and the play commences. Many hands may be dealt and many rounds played using a single set of rules.

The structure of the tax system is among the fiscal rules and institutions determined constitutionally. Major changes in tax policy occur only infrequently, whereas public expenditure decisions are made annually and individual market choices take place almost continuously.[4] Because the constitutional decisions are made less frequently and are more permanent than the postconstitutional choices, individual voter-taxpayers are less certain at the constitutional level about the impact that the chosen rules and institutions will have on their own economic and social position within the community. The greater uncertainty about individuals' private self-interest at the constitutional level encourages the choice of efficient rules and institutions, that is, rules and institutions that will promote efficiency in the subsequent postconstitutional market and political choices.

In this political setting, many features of the existing tax structure may well be consistent with economic efficiency. Considered only

[3]The concept of a constitutional level of decision making is not related to the formal process of establishing a written constitution at the inception of the state. It refers instead to the fact that certain legislative acts are more permanent than others and are intended to remain in effect and substantially unchanged for relatively long periods of time. In contrast, other legislative acts, such as decisions about the level of government spending, are made one year at a time. The demarcation of the choice process into constitutional and operational levels originated with Buchanan, who has developed this framework of analysis in a series of works. For a more complete discussion of this two-stage decision process, its characteristics, and its implications, see Buchanan and Tullock (1962) and Buchanan (1967, 1975).

[4]There has been a reversal of this historical experience in recent years. Congress has passed a set of entitlement programs with established eligibility rules and formula-determined benefit levels. Annual expenditure on the programs depends entirely on these rules instead of on an annual appropriation decision. On the other hand, major changes in tax policy have occurred more and more frequently. Indeed, since 1981, significant new tax legislation has been enacted every year. This perversion of the normal legislative process is reason enough not to adopt any major tax reform proposal for some years to come. A moratorium on new tax legislation for a period of, say, five years would be a most appropriate policy action.

in terms of their impact on postconstitutional choices about private income-earning and expenditure activities, these features appear to be economically inefficient, as the traditional approach suggests. But considered in the broader public choice context, which takes into account not only choices about private income-earning and expenditure activities but also choices about the size and scope of government, these features may indeed be conducive to greater efficiency in the allocation of economic resources.

Private Exchange Model

Of the three public choice models, the private exchange model is closest in spirit to the traditional approach. The model permits only two types of decisions—the constitutional choice of a set of tax rules and the same postconstitutional choices about income-earning, saving, and spending that are the principal focus of the traditional approach. Unlike the traditional approach, however, the private exchange model recognizes that a range of market decisions will be made over time subject to a single invariant set of tax rules. It is therefore necessary to take into account the impact of the tax rules not just on the efficiency of the choices made at a single instant of time but on the efficiency of the whole sequence of decisions. Thus, even though this model restricts individual choice to only two dimensions, it is nevertheless more general than the static single-dimensional setting of traditional analysis.

In the private exchange framework, individuals at the constitutional level rationally may choose highly progressive income taxes as a way of smoothing their disposable income over time so that it conforms more closely to their desired consumption spending. Suppose that the taxpayer must over several periods pay a tax liability with a fixed present value; that his income fluctuates over time but his consumption expenditures are relatively constant; and that capital markets are imperfect so that the taxpayer can lend at the same interest rate as the government (by purchasing government bonds), but the government's borrowing rate is less than the borrowing rate available to the taxpayer. With fluctuating income, the taxpayer typically reduces his saving and his spending on consumer durables when current income declines below his anticipated long-term average income (often called his permanent income) in order to maintain his nondurable consumption expenditures. Later, when current income rises above permanent income, the taxpayer again maintains his nondurable consumption spending, using the extra income for saving and for purchasing consumer durables.

Greater efficiency in the timing of saving and spending on consumer durables could be achieved if the taxpayer were to borrow during periods of low income and pay back his borrowings during periods of relatively high income. A progressive income tax, in effect, provides a mechanism by which the taxpayer can do just this. It is tantamount to borrowing through the government at the government's more attractive interest rate. When current income falls below the long-term average, tax liability decreases more than proportionately so that a larger share of income is available for saving and for spending on consumer durables. On the other hand, when current income rises, tax liability rises more than proportionately, in effect imposing an implicit interest charge on the previous "borrowings."[5]

Of course, a progressive income tax distorts individuals' static income-earning choices more than does an equal-yield proportional income tax. However, the gain in static efficiency that would result from adoption of a flatter rate structure must be balanced against the loss in efficiency arising from greater intertemporal fluctuations in saving and spending on consumer durables. Thus, the taxpayers may prefer greater progressivity, despite its static inefficiencies; if this is true, then adoption of a flatter tax is *a fortiori* inefficient. What the public choice approach recognizes and the traditional approach ignores is that taxpayers have preferences about the tax structure itself that can be independent of their own tax liability.

The exclusion of some sources of income from the tax base makes fluctuations in disposable income smaller than the fluctuations in before-tax income and permits the taxpayer to maintain a smoother time profile of saving and spending on consumer durables in the same way that progressivity does. These exclusions from taxable income are, in the traditional approach, clearly inefficient because they distort the income-earning choices of taxpayers. Once again, however, from the public choice perspective, the static inefficiencies in individual income-earning decisions may well be offset by the greater efficiency in intertemporal saving and spending decisions. Taxpayers may therefore quite rationally prefer at the constitutional level a tax structure that excludes some types of receipts from the tax base without regard to their own tax liability, and the elimination of such exclusions would therefore be inefficient.

Like progressivity and income exclusions, tax deductions can also bring greater efficiency to individuals' intertemporal saving and

[5]The notion of permanent income and the theory of consumption and saving that derives from it were originally developed in Friedman (1957). The application of the permanent income hypothesis to the analysis of efficient tax structures is found in Buchanan (1967, chap. 15).

spending decisions. Saving and spending on consumer durables may depend not on disposable income, but rather on discretionary income—that is, income that remains after taxes and after certain "necessary" expenses. If, for example, the taxpayer incurs heavy medical expenses, then his discretionary income may fall even though his current income is unchanged. As a result, saving and spending on consumer durables would be adversely affected, leading to an inefficient pattern of saving and spending over time. This inefficiency can be reduced, however, if tax liability is reduced, freeing more of the taxpayer's total income for other expenditures. By including a deduction for medical expenses in a progressive income tax structure, allowances are made for fluctuations in discretionary income that do not correspond to fluctuations in before-tax income. With progressive rates, the deduction is tantamount to providing a loan to the taxpayer at the government's more attractive interest rate to cover the extraordinary expenses. In this view, "closing loopholes" may be a distinctly inefficient policy.

In the context of the private exchange model, then, progressive rates, exclusion of some forms of receipts from the income tax base, and allowance of deductions for certain individual activities and expenditures are often efficient. This conclusion contrasts sharply with that reached by the traditional approach because it takes into account more dimensions of individual choice. Furthermore, the private exchange model recognizes that tax structures remain in effect for many years and that individual decision making proceeds over time subject to a relatively fixed set of tax rules.

Fiscal Exchange Model

The fiscal exchange model extends the range of individual choice to include postconstitutional decisions about the level and composition of government spending. Individual voter-taxpayers make decisions at the constitutional level about the tax rules. At the postconstitutional level they make their income-earning, saving, and spending choices, as well as express through voting their preferences about public spending. The actual postconstitutional decisions about public spending are made either by direct referendum or by the voters' representatives in a legislative body. The representatives are assumed to express in their own voting the collective preferences of their constituents.

These preferences are shaped by the distribution of the taxes required to finance the public expenditure. Efficient public expenditure decisions, therefore, are promoted by a system that distributes

taxes in proportion to the values placed on publicly provided goods and services. In the fiscal exchange model, then, individuals at the constitutional level may choose a tax structure that maximizes the anticipated efficiency of postconstitutional decisions by ensuring that the distribution of the tax burden corresponds as closely as possible to the expected distribution of benefits from public spending.

If the voter-taxpayers believe that demand for public spending is directly related to income, then taxes too must depend on income. If the value derived from public spending were just proportional to an individual's income, then a proportional income tax would be efficient. On the other hand, if the value of public services increased more than proportionately with income, then progressivity would be required (Buchanan 1964; McCaleb, forthcoming). In this event, the flatter tax will distort individual choices, expressed through voting, about the level of public spending. The result may be a public budget that is either too large or too small. Thus, while a flatter rate structure may reduce distortions in income-earning and spending decisions, this greater efficiency in the market may come at the expense of less efficiency in the fiscal exchange process. Only by ignoring the interdependence between tax rules and spending decisions, the traditional approach concludes that a flatter tax is unambiguously more efficient than the existing progressive income tax.

The fiscal exchange model also shows the potential importance of exclusions and deductions in an efficient tax system. If the value of public expenditures to individuals is unrelated to certain sources of receipts, these sources must be excluded from the tax base in order for the tax burden to be distributed in proportion to the value of public services. To include such sources in the concept of taxable income, then, might improve the efficiency of individuals' income-earning choices, but only at the expense of less efficiency in public expenditure.

The income tax rate structure promotes efficiency in the fiscal exchange process if it reflects differences among individuals in the value of public spending that are related to income differences. However, even among individuals with the same income, differences in the value of public spending may exist. For example, the value of public expenditures may be lower to those with heavy medical expenses or property losses or unusually high occupational expenses. Including deductions in the tax structure adjusts for differences in individual demands that are unrelated to income differentials (Lindsay 1972; McCaleb, forthcoming). Deductions for these types of market expenditures, therefore, are conducive to more efficient choices in the fiscal exchange process—in other words, greater efficiency in

the size of the government's budget—even if they impose some inefficiency in market choices. Tax simplification through loophole closing does not necessarily represent a net efficiency enhancement.

Tax deductions may encourage greater efficiency in the composition of the public budget as well as in its size. Two people with the same income may prefer the same level of public spending but disagree on the composition of that spending. By allowing them to take deductions for their own expenditures on certain items, the government in effect provides a matching grant. Thus, the composition of public spending more closely reflects the preferences of individual voter-taxpayers, and the fiscal exchange process is more efficient even if there is some loss of efficiency in the individuals' market choices. Tax deductions represent a relatively low-cost mechanism for discovering such variations in individual preferences and for implementing a public budget that takes better account of these variations.

Although the fiscal exchange model focuses on a different dimension of individual choice than does the private exchange model, the conclusions are similar. Progressive rates, exclusion of some sources of income from the tax base, and allowances for tax deductions have the potential for enhancing efficiency in public expenditure. Even though these features of the tax structure may be inefficient in their effects on individual income-earning, saving, and spending decisions, these inefficiencies must be balanced against the greater efficiency in the level and composition of public expenditure.

Leviathan Model

In the fiscal exchange model politicians and bureaucrats play an essentially benevolent role. They are implicitly assumed to respond to the collective preferences of the individuals in the community as reflected through voting. An alternative view, made popular by the emerging economic theories of bureaucracy (Niskanen 1971; Breton and Wintrobe 1982), sees politicians and bureaucrats in an altogether different and somewhat malevolent light. In this government-as-Leviathan framework, politicians and bureaucrats make all postconstitutional decisions (Brennan and Buchanan 1977, 1980). Furthermore, their decisions reflect their own interests and not those of the individual voter-taxpayers. The politicians and bureaucrats promote their interests by making decisions that maximize the government's revenues and minimize expenditures on socially beneficial goods and services. The politicians and bureaucrats are, however, constrained by the tax rules adopted at the constitutional level.

Thus, the problem facing the voter-taxpayers is to devise a set of constraints that will minimize the surplus of revenues over expenditures that the politicians and bureaucrats can obtain and that will also provide appropriate incentives for them to make efficient decisions about the level and composition of government spending.

Suppose that individual demands for income-earning activities are like their demands for other activities, that is to say, they are downward-sloping. Applying regressive rates to any income base, then, allows the politicians and bureaucrats to tax additional dollars of income at lower and lower marginal rates. They thus obtain ever more revenue unconstrained by the adverse effects of high tax rates on the incentives to earn income. Proportional or progressive rates, on the other hand, provide greater disincentives to earn additional income than regressive rates do, and therefore these rates more effectively limit the amount of revenue that the politicians and bureaucrats can extract. Indeed, progressive rates may be even more restrictive in this regard than proportional rates. As a result, a constitutional requirement of progressive rate taxation can be an effective constraint on the incentives of politicians and bureaucrats to expand revenue collections and public spending beyond the efficient level.

Of course, different individuals respond differently to taxes in making their income-earning choices, and the proportion of income that can be extracted from any one individual will be smaller the more responsive is that individual. If each individual could be taxed at a different rate, the politicians and bureaucrats could extract the maximum possible revenue from each one. By requiring uniform rates among all individuals at the same income level, however, such discrimination is prevented. The more responsive is any one individual in the community, the lower will be the revenue-maximizing tax rate imposed on all, and the more limited will be the ability of the politicians and bureaucrats to expand the public sector beyond the efficient size.

The efficient level of public spending is almost certain to be less than could be financed by a revenue-maximizing tax imposed on a comprehensive income base. Thus, constraints imposed at the constitutional level restrict the total tax base available to the politicians and bureaucrats. The exclusion of some sources of receipts from taxable income and the allowance of deductions for certain types of individual activities and market expenditures provide such a restriction.

In the traditional approach, spending and taxing decisions are treated as if they were independent and unrelated. Therefore, it would be impossible for voter-taxpayers to influence the govern-

ment's spending decisions by attempting to impose constitutional constraints in the form of tax rules. Furthermore, it is unnecessary to do so in the traditional view because spending and taxing decisions are made by a benevolent government whose only interest is the maximization of social welfare. If, however, politicians and bureaucrats have some capacity for independent self-interested behavior, the possibility of using tax rules to promote more efficient expenditure decisions by the government clearly emerges. Progressive rates, income exclusions, and deductions all provide such constraints. Once again, by expanding the notion of efficiency to include the full range of individual choices, it becomes apparent that flatter tax rates and more comprehensive tax bases are not necessarily conducive to greater efficiency in the broader sense.

Conclusion

Like all economic models, each of the public choice models examined here represents a simplification of and an abstraction from individual behavior in the real world. Nevertheless, each model does capture important elements of reality. It is both comforting and significant that the conclusions derived from any one of the models about the characteristics of an efficient tax structure are affirmed by each of the others. The private exchange model recognizes the time dimension in individual decision-making and the interdependence among choices made at different points in time. It also recognizes that individuals will have preferences about alternative tax rules that are independent of their own liability under those rules and that these preferences will reflect the time dimension and the intertemporal interdependence of their choices. The fiscal exchange model takes into account individual preferences about public spending and how such preferences influence public expenditure decisions. In particular, this model captures the important impact of tax rules on public expenditure decisions. Finally, the government-as-Leviathan model allows for the discretionary behavior of politicians and bureaucrats. Instead of treating these players as mindless automatons, it makes them fully participatory actors in the political drama, and it then takes into account the influence of their behavior on the efficiency of public expenditure decisions.

In the context of each of these models, highly progressive tax rates, exclusion of some income sources from the tax base, and allowance of tax deductions are perfectly consistent with economic efficiency. Only within the narrow confines of the traditional approach to tax analysis do these features of our existing income tax structure have

an unambiguously pernicious effect on economic efficiency. By restricting the definition of efficiency so as to exclude from consideration the wide range of individual choice, the traditional approach has eliminated efficiency as a criterion for choosing between the current system and the proposed flatter rate taxes. The flatter tax wins by default. But in truth this approach has little or no relevance for the real world of tax policy. And when the concept of efficiency is expanded to include the full range of individual preferences and decisions, the superior efficiency of the flatter tax is no longer obvious. Considerations of efficiency once again enter the debate over tax reform equally with issues of fairness and equity.

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PUBLIC CHOICE AND THE FLAT TAX

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Is public choice hostile to the flat tax? This is a major theme of McCaleb's paper.[1] In support of his thesis, he cites three models, each of which falls under the general rubric of public choice or, more specifically, constitutional contractarianism, and each of which offers normative support for some departure from a comprehensive tax base and in favor of a progressive rate structure. Consequently, McCaleb argues that any or all of the models offers a legitimate challenge to the current popular thrust in tax reform which favors less progression and a significant broadening of the tax base.

McCaleb's description of the models and of their implications is accurate as far as it goes. However, some questions can be raised about their relevance to the current tax reform debate. This is particularly true with respect to the private and fiscal exchange models. These questions will be the primary focus of this comment. In addition, McCaleb's more general, implied contention that public choice is necessarily hostile to the flat tax will be challenged. Arguments favorable to that tax can be developed from a public choice perspective.

The private exchange model examines the tax code as a second best alternative to a (presumed nonexistent) perfect capital market. If tax institutions are perceived to be at least quasi-permanent, their design can be used to adjust intertemporal consumption patterns. From this perspective, plausible arguments are offered that individuals might prefer certain departures from a comprehensive base and also progressive rather than proportional rates. Both can be a means of smoothing intertemporal consumption patterns relative to income flows.

The relevance of this analysis to the current tax reform debate seems limited. Few of the tax preferences which flat tax proponents

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Cato Journal, Vol. 5, No. 2 (Fall 1985). Copyright © Cato Institute. All rights reserved.

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[1]McCaleb (1985).

and other reformers seek to end could plausibly be supported using the private exchange perspective. Why would individuals support *tax rules that cause them to systematically underestimate the costs* of public services (state and local tax deductibility) or which lead to gross misallocation of investment spending (the Accelerated Cost Recovery System and numerous other special investment provisions)? In addition, because high income taxpayers take disproportionate advantage of itemized deductions, tax preferences offset rather than complement the progressivity which is supported by the private exchange model.

If support for progression is to emerge from the private exchange model, individuals must perceive significant stability in taxing institutions. As McCaleb notes (in footnote 4), this is hardly consistent with actual experience during the past 15 or so years which witnessed passage of numerous major pieces of tax legislation. This is an important point and deserves more consideration than it receives in his paper. How are voter attitudes toward tax preferences and progressivity changed if the long-term "constitutional" perspective implicit in the private exchange model is absent? It seems clear that prospects for short-term gain would be dominant with the tax legislative process becoming a classic exercise in rent-seeking.

The rent-seeking model seems the most plausible explanation of the current tax code with the corresponding implication that piecemeal tax reform is a negative sum game. This suggests that significant gains could be possible if comprehensive tax reform were to encompass changes in tax institutions that would curtail incentives for coalitions of taxpayers to use the tax code as a device to redistribute wealth to themselves. The flat tax may offer some hope in this regard. Political jockeying for reductions in relative tax shares centers on the definition of the tax base and, to a lesser degree, on manipulation of tax rates. Agreement on a single rate applied to a well-defined comprehensive base with *no* tax preferences might be possible if voters were fully appreciative of the long-term consequences of rent seeking. This perspective on tax reform does not deny that some departures from a comprehensive base such as those identified by the private exchange model might be efficient. Rather it recognizes that the democratic political process is poorly suited to distinguish between efficient and perverse tax preferences. Forgoing the former category of preferences may be a small price to pay if that is a means of avoiding the costs associated with the latter.

The fiscal exchange model offers the perspective of the progressive income tax as a reasonable approximation to a Lindahl-type benefit tax. As is the case with the private exchange model, the relevance of

this perspective to the current tax debate is questionable. In particular, the model rests on the arguable validity of three separate assumptions which are made either explicitly or implicitly in the discussion. These are (1) that the income elasticity of demand for public goods exceeds one; (2) that taxation is the marginal source of public revenue; and (3) that the government budget is devoted primarily to outlays for public goods.

A progressive income tax may approximate a benefit tax or it may not. Specific exclusions from income may be comparable to efficient matching grants or they may not. Specific conclusions would require empirical evidence about individual preferences. Have empirical studies been done that support the hypothesis that the income elasticity of demand for public services exceeds unity? McCaleb cites no such studies and in their absence, as he himself notes, the fiscal exchange model can suggest only a *possibility* that progression reflects the benefit principle of taxation.

Even if a progressive income tax were to assign tax shares that were roughly in accord with individual demand for public services, efficient voting on the public budget would require that the income tax be the relevant determinant of *marginal* tax prices. Two institutional considerations weaken this argument considerably. The first is that debt rather than tax finance is clearly the marginal funding source for the federal government. Unless voters correctly perceive and capitalize the future tax liability resulting from creation of public debt, the tax prices implicit in the income tax are inframarginal and not the determinants of public spending.

The second institutional consideration has to do with the fact that most Western democracies, including the United States, are heavily involved in transfer spending in addition to outlays for more traditional public goods. Most governments lump transfers and public goods expenditures into a single unified budget. A common budgeting institution involves separate decisions on the size of total spending and the allocation of that total. If public goods are financed on the margin from reduced transfer spending rather than increased tax revenues, voter perceptions of the marginal cost of public goods will be determined by their expected shares in the transfer component of the budget rather than the shares implicit in tax institutions. Even if the income tax assigned tax shares that corresponded roughly with individual marginal evaluations of public goods, budgeting institutions could prevent efficient spending levels from being achieved.[2]

[2]See Flowers and Danzon (1984) for a more complete discussion of this and related points.

The preceding discussion suggests that the case for progressive taxation which emerges from the fiscal exchange model is, at best, ambiguous. The relevant policy issue would seem to be whether or not the possibility that a progressive tax might be a benefit tax is sufficient justification for that form of taxation. In this author's opinion, the fiscal exchange model cannot counter the arguments against progression that arise from considerations of excess burden, rent seeking, and the potential for a purely arbitrary assignment of tax shares emerging from the political process.

The Leviathan model offers the strongest case for progressive taxation of a narrow base. The model relies on a profoundly pessimistic view of majoritarian political process. If one shares this view, the implication of the model seems inescapable. Clearly most proponents of the flat tax do not have such a dismal perception of democratic politics.

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