STATEMENT

of

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before the

Subcommittee on the Constitution
Committee on the Judiciary
United States Senate

April 15, 1996

Mr. Chairman, distinguished members of the subcommittee:

My name is Roger Pilon. I am a senior fellow at the Cato Institute and the director of Cato's Center for Constitutional Studies.

I want to begin by thanking Senators Brown and Coverdell for inviting me to speak before this subcommittee in support of S.J. Res. 8, proposing an amendment to the Constitution to prohibit retroactive increases in taxes.

When hearings on retroactive taxation were proposed in the Senate in October of 1993, following the retroactive tax increase that President Clinton signed into law that year, Senator Richard Shelby, then of the President's party, asked rhetorically of the Senate President, "Why do we need hearings to consider the retroactivity of taxes . . . when we basically and the American people believe it is wrong?" In thus representing the beliefs of the American people, Senator Shelby got it exactly right, of course. At bottom, in fact, the issue of retroactive taxation is no more complicated than the sports analogy every child learns on the playground--it's wrong to change the rules after the game begins.

Unfortunately, that simple rule, to say nothing of the beliefs of the American people, has been little regarded over the course of this century as legislatures have grown increasingly fond of their powers to tax, including their power to tax retroactively. And the courts, for their part, have grown increasingly deferential to those legislatures. Given those facts, extraordinary measures--and a constitutional amendment is extraordinary--are in order.

Unlike my fellow panelists today, Mr. Chairman, I am not a tax lawyer or an expert on taxation. I don't even do my own taxes. Rather, my field is the philosophy of law, which means that I try, if at all possible, not to look too closely at the trees so that I can keep my eye on the forest.

Unfortunately, tax law today is almost all trees and no forest. Despite occasional efforts at "simplification," our tax law is the chaotic product of all but unbridled political will, nominally enacted to raise revenue, but interlarded throughout with public policy--with social policy undertaken through the tax code. (Those on my side of the political divide who oppose government planning through redistribution and regulation, but support every "tax break" that comes along, are too often prone to forget that "tax policy," thus understood, is just a poor man's (rich man's?) way to try to manage an economy.)

When I say that our tax law today is a product of all but unbridled political will, I mean, among other things, that in perhaps no other area of our law are the courts so deferential to the political branches. Well before the Supreme Court set forth its general theory of deference in 1938 in famous footnote four of *Carolene Products*[1]--wherein the Court distinguished two kinds of rights, fundamental and nonfundamental, and two levels of judicial review, strict and minimal, relegating "ordinary commercial transactions" to the latter category--the Court was deferring to the political branches on issues of taxation.

Yet it was Justice Stone, the same Justice Stone who wrote the opinion in *Carolene Products*, who that very year set forth what, for lack of a better argument, has come to be the modern rationale for taxation generally and retroactive taxation in particular:

> Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process . . . .[2]

Indeed, notwithstanding the classic non sequitur in Justice Stone's final sentence, the Court without a blush set forth that very rationale less than two years ago when it upheld the retroactive

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[1] *United States v. Carolene Products Co.*, 303 U.S. 144 (1938). I have criticized that opinion in Pilon, "On the Foundations of Economic Liberty," 38 *The Freeman* 338 (1988).

[2] *Welch v. Henry*, 305 U.S. 134, 146-47 (1938).

imposition of an estate tax change in the *Carlton* case.[3]

No one could disagree, of course, that taxation is "a way of apportioning the cost of government." But the contention that those who enjoy government's benefits "must bear its burdens"--an argument as old as Plato's *Crito*--is as circular as it is destructive of our founding principles.

At common law, one could incur obligations, or burdens toward others, in only two basic ways: either by contract, through consent, or by breach of some natural duty, leading to a penalty through the law of torts--the exact rationales Justice Stone rejected out of hand. Yet the first of those rationales, consent, constitutes the very foundation of our political order--and, by implication, of our tax policy. As both the Declaration of Independence and the Constitution make clear, we constituted ourselves politically through consent. In so doing we explicitly rejected older organic conceptions of political obligation, with their benefits-and-burdens rationales, because our fundamental moral principle was individual autonomy. Individuals are and ought to be free, we declared, except insofar as they bind themselves through their promises or their torts. (Doubtless, one often *ought* to reciprocate for the gratuitous receipt of benefits, but that is not the stuff of moral or legal *obligation*.)

In recognizing consent as our bedrock political principle, however, we also recognized the practical limits of that rationale, especially as it operates over succeeding generations. Thus, as a further protection for individual autonomy--beyond that afforded by original ratification and subsequent periodic elections--we limited the *scope* of government. Indeed, the Constitution is properly read not simply as instituting political power through the consent of the founding generation but as severely restraining power as well--for the benefit of succeeding generations--through such familiar devices as the separation and division of powers, the enumeration of federal powers, the addition of a bill of rights, and, of particular importance for the issue at hand, the institution of judicial review.[4] Notwithstanding those further restraints, however, consent remained the basic rationale for political obligation, even as its practical limits were recognized.

This inherent tension between our avowed foundation in consent --best captured, perhaps, by the colonial cry, "No taxation without representation"--and its practical limits is exacerbated, of

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[3] *United States v. Carlton*, 513 U.S. ___ (1994); 62 U.S.L.W. 4472, 4475 (U.S. June 13, 1994).

[4] I have discussed those issues more fully in Pilon, "A Government of Limited Powers," ch. 3, *Cato Handbook for Congress* 17-34 (1995).

course, as the scope of government grows, as the claim that "we" consented to, say, all the government we're getting today becomes increasingly implausible. Faced with that implausibility, one either abandons the consent rationale, as Justice Stone did, or complains about growing illegitimacy, as many of us have been doing since modern expansive government began during the Progressive Era. To abandon the consent rationale, however, is to abandon the premise of individual autonomy on which it rests, and to bring us face-to-face with our first president's insight that government is neither reason nor eloquence but force--and its corollary, the more government, the more force in our lives.

Those are the brute moral facts of the modern political dilemma, which no talk of "democratic decisionmaking," much less benefits and burdens, can argue away. And nowhere are those facts more starkly borne out, perhaps, than in the realm of taxation, where Justice Stone's vaunted rationale translates all too quickly into benefits for some and burdens for others--hardly a result to command universal consent. But the reality of the matter is starker still, for rarely if ever is that result underwritten by majoritarian consent either--quite apart from whether majority rule can justify anything. Rather, as the Public Choice school of political economy has repeatedly demonstrated, modern tax policy constitutes perhaps the paradigmatic example of special-interest politics at work. That politics is so far from being rooted in consent as to make a mockery of our founding doctrine.

In resorting to an older organic rationale, then, the benefits-and-burdens people have ignored both our origins in consent and the constitutional barriers we erected in light of the practical limits of consent, both of which are rooted in our concern for individual autonomy. Thus disparaging individual autonomy, they cling instead to visions of grand democratic undertakings, as stated succinctly by President Clinton in his inaugural address: "We're all in this together."

The problems with that view are many, of course, but chief among them are two: (a) we are *not* all in this together--many of us never wanted in, want out now, want simply to plan and live our own lives, not have them planned for us through the taxing and spending powers of Congress; and (b) the effort to force us to be part of the common undertaking, despite the lack of consent, is fraught with constitutional peril, both substantive and procedural. To put the point otherwise, America was not constituted as a parliamentary democracy, our fate to be determined in principle by transient majorities, in practice by those with access to political power. We are, rather, a constitutional republic, where political power is bounded by a constitutional rule of law.

Yet it is precisely that rule of law that the benefits-and-burdens Court, a Court that has lost touch with our founding

principles,[5] has refused to secure. The practical effect of the Court's deference is to leave the determination and distribution of benefits and burdens to the political branches--which means, again, to the special interests that have learned so well how to work the system. What that means in turn is that the individual or firm that is adversely affected by the outcome of the process in which it is thus forced to participate is essentially out of court, with no *legal* remedy.

On the substantive side, great partiality and inequality are too often the result--with "soak the rich" being only one variation of this. On the procedural side, where the retroactivity issue arises, here too the adversely affected individual or firm is, in effect, out of court. When judicial review is essentially unavailable, tyranny is invited. And what is retroactivity--changing the rules after the fact--if not the very essence of tyranny?

Because the Supreme Court has demonstrated over the years--and as recently as two years ago--that it will not address this tyranny by applying the constitutional remedies that are readily available, we must turn, ironically, to the political branches to protect us from the political branches, which is what the amendment before us is aimed at doing. Because I am, with the Founders, of the individual autonomy school, not the grand undertaking school, I support the amendment. To elaborate further upon my reasons, however, and to address some of the concerns of the other side, I believe it would be useful to at least sketch both the substantive and the procedural issues at stake, first with respect to taxation generally, then with respect to retroactivity in particular.

If individual autonomy is indeed our basic moral principle, then government should have available to it only those powers that are consistent with securing that end. (Today, of course, thanks to the demise of the enumerated powers doctrine and all but boundless interpretations of the Constitution's General Welfare and Commerce Clauses, the powers of the federal government are restrained for the most part only by varying interpretations of the document's amendments.[6]) In that context, the power to tax is instrumental: it is a means to the exercise of other powers,

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[5] I discuss this point more fully in Pilon, "A Court Without a Compass," 40 *New York Law Review* (1996) (forthcoming) (symposium on James F. Simon's *The Center Holds: The Power Struggle Inside the Rehnquist Court* (1995)).

[6] I have discussed that history and its implications in Pilon, "Freedom, Responsibility, and the Constitution: On Recovering Our Founding Principles," 68 *Notre Dame Law Review* 507 (1993); and Pilon, "On the Folly and Illegitimacy of Industrial Policy," 5 *Stanford Law & Policy Review* 103 (1993).

themselves aimed at securing liberty. Like those other powers, however, the power to tax must be exercised consistent with liberty.

We come, then, to the nub of the substantive matter. For if the power to tax must be exercised consistent with liberty, it can be thus exercised only insofar as it is consented to. (The colonists had it right.) But universal consent, again, is impossible to obtain practically, which means that we have to look for conditions that at least move us in that direction. Two such conditions suggest themselves: (a) limited taxation, such that most people believe that the small cost of government is worth the limited benefits government provides; and (b) equal taxation, to ensure fairness among individuals, with no one burdened more than anyone else.

With respect to the first of those conditions, clearly, the more government decides to do, the more it needs to tax; and the more it taxes, the less universal the consent will be. The tax revolt of the past several years in this country is about nothing if not that. That revolt will dissipate only when our governments return to their natural and original limits--as governments around the world, which have much further to go, are today beginning to do.

With respect to the second condition, the basic question could not be simpler: Why should one person be burdened more than another by the costs of public services? Apart from user fees, which address the benefits-and-burdens question on an individualized basis, there is simply no credible reason why ability to pay should play any role at all in determining the distribution of the burden, not if we take equality seriously.

The impetus for unequal treatment in the area of taxation--which we would countenance for not even a moment with other burdens, such as criminal penalties or military service--was especially intense during the Progressive Era, of course, an era noted for its zeal for collective undertakings "in the public interest" and its animus toward trusts and other sources of wealth. How else to explain the ratification, however uncertain that process, of an income tax *amendment*, no less, except that it was to be limited to a rate of 1 or 2 percent and applied only against the wealthy. But that historical impetus in no way *justifies* our using some for the benefit of others, which is precisely what unequal taxation amounts to.

Notwithstanding the Constitution's enumerated-powers and equal-protection guarantees, both of which could have been read by the Court as restraining the political forces that have produced the expansive and unequal tax arrangements we have today, the Court has declined to secure those substantive protections. But the Court has done no better with procedural protections, not even in

the case of retroactive taxation, which is so glaring an abuse of legal process as to require little argument against it.

Among the arguments against retroactivity is the argument from notice. Tax law today is so far removed from natural law and natural law principles that no one could possibly know its content from reason alone--as one can know, say, that murder, rape, and robbery are wrong. Those subject to taxation, therefore, must be given notice of the particulars so that they can adjust their behavior accordingly. To do otherwise is to penalize people for behavior they could not possibly have known was subject to penalty. It is the very antithesis of the rule of law.

As was argued by my fellow panelist, Mr. Schmitz, when we last testified before this subcommittee on this issue in August of 1994, the Constitution's *ex post facto* clauses, properly interpreted and applied, should alone suffice to preclude this kind of abuse of legal process--broadly understood to include the legislative process as it affects individuals not directly a part of it. But the Due Process of Law Clause, under which the 1994 *Carlton* case was decided, should suffice as well. Here again, however, one despairs of finding relief from a Court whose reasoning throughout is simply conclusory. When retroactivity longer than a year preceding the legislative session in which it is enacted raises "serious constitutional questions" whereas retroactivity short of that does not[7]--a line between unconstitutional and constitutional that is nowhere remotely to be found in the document--we know we have to look somewhere other than to the Court for the protection of our liberties.

Now it is argued by some who oppose this amendment, such as Mr. Ronald A. Pearlman, who appeared with Mr. Schmitz and me on that 1994 panel, that by focusing on "'date of enactment,' . . . we risk ignoring a large group of taxpayers that will be adversely affected by legislation that is nominally prospective,"[8] for even prospective changes often have retroactive implications. Indeed, Mr. Pearlman continues, "[e]very time Congress changes tax rates, whether the rates are increased or decreased, certain previously-committed economic activity is affected."[9] Just so. Far from being an argument against this amendment, however, that observation makes the case for circumspection generally, especially since so much economic activity today *is* tax driven.

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[7] *Carlton*, 62 U.S.L.W. 4472, at 4476 (Justice O'Connor concurring).

[8] Statement of Ronald A. Pearlman, made available at hearings on S.J. Res. 104 (retroactive taxation amendment) held before this subcommittee on August 4, 1994, at 2-3.

[9] *Id.* at 3.

But the problem to which Mr. Pearlman points is broader than he seems to have appreciated, and perfectly generalizable. In a nutshell, through our tax law today, and not our tax law alone, we have brought about and encouraged a set of public and private arrangements upon which people have come to rely and a set of expectations about the future--not unlike those in the more socialized countries, except in degree. What we face, accordingly, is the same problem that people in the socialist countries are facing as they try to undo the past, namely, that it is terribly easy to get into those arrangements but terribly difficult, because people have come to rely upon them, to get out. We have created, in short, our own retroactivity problem.

None of that argues against this amendment, however, for if taxation is seen not as a zero-sum game--where one person's tax abatement is another person's tax assessment, a view Mr. Pearlman suggests when he speaks of threats "to the income tax base"[10]--but as a method of raising revenue fairly, then the question is not how we preserve (or enlarge) the current tax flow but how we move toward limited and equal taxation, mindful that some have arranged their affairs, in light of current law, in such a way as to be disadvantaged, at least for a time, by any such move.

Let me suggest that we address that problem, as best we can, on a case-by-case basis, even as we move in the right direction more generally. Since it was we who originally created the incentives that have encouraged people to make investments that may now be sunk when we change the rules again, albeit in the right direction, we should bear the costs of our change in direction rather than let those costs fall on innocent individuals. This is not like compensating slaveholders after Emancipation--people who relied on positive law that, by natural law principles, was conspicuously wrong from the start. Rather, tax law today is, again, sufficiently removed from natural law to make it all but arbitrary; yet it is a body of law upon which prudent people do and must rely as they arrange their affairs. Given that, we need to address the retroactivity costs to individuals and firms that arise even in the case of nominally prospective changes.

But if the difficulty today of discovering purely prospective tax law changes does not militate against this amendment, neither do the arguments from fairness that Mr. Pearlman has adduced. Thus he speaks of "the perception of fairness" as

> one of the principal reasons that President Reagan supported changes in the tax law that were designed to limit abusive tax shelters in 1984 and, thereafter, as part of the Tax Reform Act of 1986. . . .

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[10] *Id.* at 7. See also the text at n. 11, *infra*.

> Fairness also must influence the adoption of effective dates for tax legislation. . . . Fairness requires, on occasion, explicitly retroactive tax legislation, such as in the case of the 1984 tax-exempt entity leasing provisions. I am confident that the American people would not want perceived abusers to be able to take undue advantage of identified tax loopholes, thereby further increasing the deficit or requiring honest, taxpaying citizens to pay higher taxes in order to make up for advantages accruing to a few.[11]

Notice that in claiming that, on occasion, fairness may require "explicitly retroactive tax legislation"--which this amendment would preclude--Mr. Pearlman is claiming, by implication, that *substantive* unfairness should trump *procedural* unfairness--that we are permitted to engage in procedural unfairness in the name of correcting substantive unfairness. As a general principle, of course, that is a prescription for anarchy, and for the demise of the rule of law. But in the tax area, driven as it is by positive law, it is an invitation to congressional irresponsibility of the rankest kind.

Indeed, nowhere is that irresponsibility better presaged than in the very characterizations Mr. Pearlman invokes. He speaks, for example, of "abusive" tax shelters, tax shelters that by definition are legal--as is evidenced by the need for a change of law to "correct" them--but not quite what Congress had in mind when it drafted the law under which they arose. He then speaks of "perceived" abusers--as seen through the eyes of the American people--and of their taking "undue" advantage of "identified tax loopholes." We can never be sure, of course, just what advantage is "undue," especially since the law permits the advantage. We can be sure, however, about Mr. Pearlman's view of those who avail themselves of such advantages, for he contrasts them with "honest, taxpaying citizens," who must now pay higher taxes to make up for the shortfall caused by the "abusers."

Plainly, this substantive unfairness to other taxpayers is what exercises Mr. Pearlman, as well it should, particularly if one is concerned about threats to the income tax base, as he is. But in the end, his fire is misdirected, for it is not the "abusers" who wrote the law under which the alleged abuse takes place but the United States Congress. When Congress later tries, however, to correct substantive unfairness by being procedurally unfair to others--by changing the rules after the fact--not only does it compound the error but it does so deliberately. In the process, moreover, Congress often shifts responsibility from where it belongs--with itself--to where it does not belong--with others--ridiculing those individuals by holding them up to public obloquy

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[11] *Id.* at 8.

as "abusers" of the system, even when their actions were, admittedly, legal. And it does so even in cases in which the individual, such as the executor in *Carlton*, was duty-bound to make the most he could of the estate he was charged with executing. For having complied with that duty, the executor in *Carlton* suffered a loss of $600,000 to the estate (not counting the tax itself plus interest), all due to a retroactive change in the law at the hands of Congress.

Thus, substantive unfairness, which is usually widely spread and small in any given case, is no justification for procedural unfairness, which is usually concentrated and large in individual cases. Nor will the effort to limit retroactivity to "closing loopholes" withstand scrutiny. Even those who generally oppose retroactivity are sometimes found trying to justify the practice in this limited way by distinguishing between "unfair" retroactive taxes--such as President Clinton's 1993 retroactive tax increase--and "fair" retroactive taxes--"technical corrections," often made a short time after the original "mistake" and often couched in the language of "closing loopholes."

The problems generally with retroactivity do not go away, of course, if its use is limited to this small area. What you have with this so-called fair retroactivity is really quite simple, in either of its forms. On one hand, Congress has made a mere technical mistake, which is not uncommon, but which individuals then rely upon as they order their affairs. In this case, we cannot ask individuals to try to ferret out Congress's "real" intent, which not even courts do well. Rather, we have to take the law as it is, and ask others to do the same. Indeed, in ordinary contract law we decide any ambiguity or drafting mistake against the drafting party on the grounds that it, not the other party, is responsible for the mistake and is in a better position to have avoided it. Those same grounds apply at least as strongly here.

On the other hand, the "mistake" Congress might make is one of carelessness in drafting such that shrewd individuals, accountants, and lawyers are able to "outsmart" the drafters, finding "loopholes" that hadn't occurred to Congress at the time of drafting. Here too, however, the issues remain the same. As Judge Learned Hand put it nearly 60 years ago, no one is obligated to arrange his affairs in a way that "will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[12]

The deeper problem, of course, is Congress's use of the tax system for social planning. Just as the law of unintended consequences undermines direct attempts at social planning, so too it undermines indirect planning through the tax system. Man was born to be free. Try as governments might to plan a person's life

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[12] *Helvering v. Gregory*, 69 F. 2d 809. 810 (CA2 1934).

through redistribution or regulation--or even through the tax code --he will find ways to regain control, to regain his freedom. That is a lesson that is being learned around the world, even if it is slow to come to the nation that should never have forgotten it.

Thus, I urge this subcommittee, Mr. Chairman, to erect an impenetrable barrier to retroactive taxation in all of its forms, which only a constitutional amendment will do. If the current draft of the new Russian Constitution can prohibit such taxation, as Article 57 of that draft does, we should be able to do no less.