

DURABLE TAX REFORM

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Introduction

In his January 1984 State of the Union Address, President Reagan called on the Secretary of the Treasury to develop a plan "to simplify the entire tax code, so that all taxpayers . . . are treated fairly." The Treasury Department interpreted the President's directive as requiring it to achieve two objectives. These were to improve taxpayer compliance with the tax code and to broaden the tax base so that personal tax rates could be reduced.¹

As part of its efforts to develop a tax simplification plan, the Treasury Department held a series of public hearings at various locations around the country during June 1984.² Testimony at these hearings brought forth a wide range of reform proposals, including simple taxes, flat taxes, and no taxes. Plans were advanced to change the basis of taxation to something other than income (consumption expenditures were a popular alternative), and some individuals (many of whom seemed to be tax accountants and attorneys) argued in favor of the status quo.

The Treasury's studies culminated soon after the November elections in the release of a report on fundamental tax reform and simplification. In brief, the plan consisted of a flat individual income tax, modified to include three tax brackets, along with recommendations to eliminate a whole series of deductions used in arriving at taxable

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¹*Federal Register* 49, 25 May 1984, p. 22171.

²*Ibid.*

income, and to tax previously tax-free income sources such as Social Security benefits and employee compensation paid in kind. Similarly important recommendations were made for changing the corporate tax code, including a proposal to decelerate the investment write-off periods under the accelerated cost recovery schedule (ACRS). An amended version of the Treasury's plan was subsequently enacted into law and began taking effect during the 1987 tax year.³

Despite the fact that the tax reform legislation of 1986 comprehended more provisions of the tax code than usual, it was in reality just the latest installment in what has become an annual Washington rite. Tax legislation has been introduced—and changes in the tax code have been enacted—in virtually every congressional session without recent memory. For example, among its other provisions, the 1981 Economic Recovery Tax Act (ERTA) cut personal income tax rates across the board by 23 percent over three years, and established the ACRS depreciation concept. ERTA was soon considered to have given away too much, so in the following budget year, the Tax Equity and Fiscal Responsibility Act (TEFRA) was approved to provide a tightening of the ACRS standards and to confer on the Justice Department new authority to prosecute sellers of “abusive” tax shelters. In the same year, the debate which led to the most recent tax reform effort was spurred by the introduction of two bills proposing somewhat different versions of a modified flat tax on individual income. These were the Fair Tax Act of 1982 (Bradley-Gephardt) and the Kemp-Kasten “fair and simple tax” (FAST) initiative. Various provisions of the tax code were changed in both 1983 and 1984. In short, tax reform has become a growth industry.

This paper assesses the process of tax reform and simplification within the context of the by now familiar rent-seeking model. The basic point is quite simple. In the current institutional setting, where changes in the tax code are determined by the legislature, repeated efforts at “reform” create a situation in which tax shares are considered “up for grabs” in each and every budgetary period. As a result, the reform process becomes an annual contest among interest groups to preserve existing tax preferences, or to shift tax liabilities to other groups. Realtors, for example, find it necessary in every period to engage in socially wasteful lobbying efforts in defense of the deduction for mortgage interest payments. Similarly, the tobacco industry must continually work against attempts to raise the federal excise tax on its products, and there are frequent efforts by organizations rep-

³Although some provisions became effective in January 1986, the major tax reform initiatives began being phased in at the beginning of 1987.

resenting individual taxpayers to raise the share of taxes paid by corporations. The list could go on.

In such a setting, a case can be made for eliminating taxes on industries that are organized to resist efforts by other interest groups to raise their tax burdens. A relevant example is provided by the federal excise tax on selected goods—automobile tires, beer, cigarettes, and matches, to name a few. Doing away with these levies would save not only the associated deadweight costs, but would in addition substantially reduce the large amount of socially wasteful rent-seeking activity that the tax code presently generates.

The Rent-Seeking Model

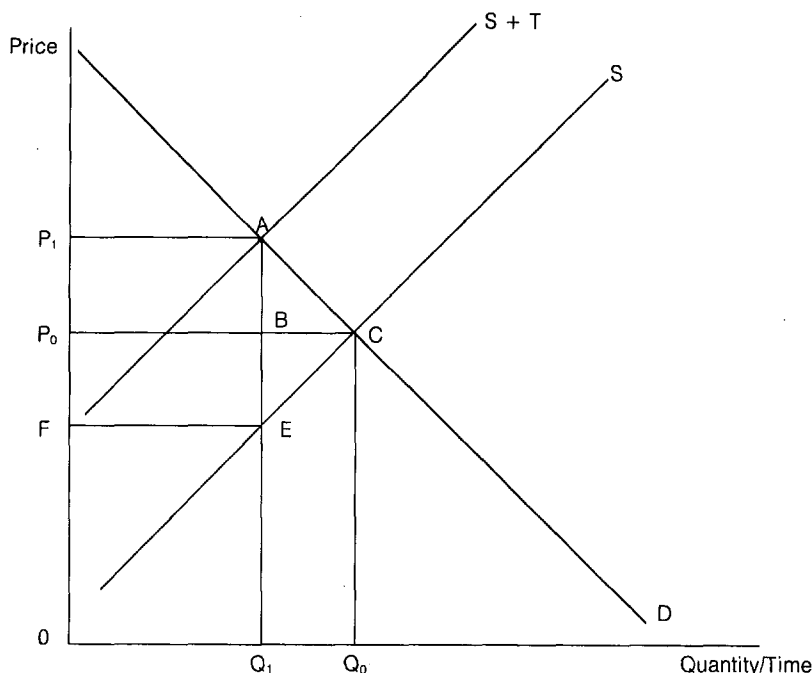
Gordon Tullock (1967), recognizing that expenditures made to capture an artificially created transfer represent a social waste, suggested that the cost to the economy of monopoly and regulation exceeds the simple Harberger (1954) deadweight loss. Indeed, under Tullock's original formulation and in the extensions of his work by Anne Krueger (1974) and Richard Posner (1975), rents are exactly dissipated at the social level—\$1 is spent to capture \$1—so that the total welfare loss from such activities is equal to the Harberger triangle plus the rectangle of monopoly profits. Posner's example is instructive on this point. Suppose that 10 bidders vie for a transfer worth \$100,000. If the bids are nonrefundable and the contestants are risk neutral, each will offer \$10,000 for the right to be the monopolist. Although the winner will receive a net return of \$90,000 on his investment, the monopoly rents are exactly dissipated at the social level because \$100,000 is spent in total. The welfare cost of the monopoly thus includes the value of the artificially created transfer.

The tax code also creates wealth transfers, and interest groups will accordingly have an incentive to spend resources in efforts to prevent part of their wealth from being taxed away or to shift some of their liabilities to other groups. They organize, invest in lobbying activities, contribute to political campaigns, advertise their point of view, and so forth. These expenditures reduce the welfare of society as a whole because they are made in pursuit of income redistribution rather than being directed toward income-increasing activities.

Consider the situation depicted in Figure 1.⁴ A competitive industry is threatened with the imposition of an excise tax on sales of its product. In the absence of the tax, Q_0 units of the good are sold at price P_0 per unit. If an excise tax of T is levied, however the supply

⁴This model and the analysis in this section are based on the static model developed by Lee and Tollison (forthcoming).

FIGURE 1
RENT-SEEKING MODEL: EXCISE TAX



schedule shifts up by an equal amount (the distance AE in the diagram). Sales fall to Q_1 and price rises to P_1 as a result. The effect of the tax can be decomposed into two parts. First, the excise imposes a deadweight welfare loss (Harberger costs) because output is reduced. The value of this loss is represented by the area of the triangle ACE, and consists of reductions in consumer (ABC) and producer (BCE) surplus. Second, there is a pure wealth transfer (in the form of tax payments) from the private to the public sector. Because the government collects a tax of AE on each of the Q_1 units sold, total tax revenues are equal to the area of the rectangle, P_1AEF . The tax burden is shared by consumers and producers. In particular, consumers pay P_1ABP_0 , the tax-induced price increase times after-tax sales. Producers pay P_0BEF ; their share can be determined by noting that the tax reduces the price they actually receive on each unit sold from P_0 to F.

The above discussion suggests that producers will be willing to spend up to P_0CEF dollars to prevent the tax from being levied. (Consumers likewise have an incentive to lobby against the tax, but

their higher costs of organization will usually discourage effective opposition.)⁵ This is just Tullock's point in tax space. If by spending \$1 producers can prevent \$1 from being taxed away, they will be no worse off than if they do nothing and the tax is levied. Accordingly, the potential revenue from the prospective tax bill that would be paid by producers (P_0BEF) is dissipated in nonproductive lobbying activities (Tullock costs). Producers are also willing to spend resources in the attempt to avoid losing their share of the deadweight costs associated with the tax, BCE. In total, then, the welfare cost of the tax (if it is defeated by industry lobbying activities) is equal to the area of the trapezoid, P_0CEF . If the tax is levied, however, the welfare costs are even larger. In particular, the full Harberger loss is borne, so the tax costs society P_0CEF plus ACE. The tax causes the triangle BCE to be lost twice: It contributes to *both* Harberger and Tullock costs.⁶

Exactly the same argument applies to subsidies granted through the tax code. Interest groups will find it worthwhile to lobby for the creation of "loopholes" in the law that reduce their tax liabilities. The value of the resources spent in such efforts will be just equal to the amount of tax relief so gained. It is not necessary to analyze this case in detail because it is the opposite side of the same coin. Holding tax revenues constant, granting a tax preference to one interest group implies that the tax liabilities of some other group will have to be raised by an equal amount. Competition for a tax preference can therefore be analyzed in terms of the symmetrical tax increase.

Up to this point, it has been assumed for simplicity that the distribution of tax shares is determined once and for all. Consequently, each interest group that is threatened with a tax not only dissipates its prospective current tax liabilities in efforts to avoid them, but also the present value of all liabilities expected in the future. If this were the case, little would be gained from a social point of view by reduc-

⁵Becker (1983) relates the amount of taxpayer opposition to the size of the deadweight costs.

⁶The result that the prospective tax bill to be paid by producers is exactly dissipated by nonproductive lobbying activities assumes that the change in the tax code is expected to be perfectly durable, that rent seekers are risk neutral, and that the marginal costs of lobbying are constant. If any of these assumptions do not hold—if, for example, marginal lobbying costs increase with effort—then the extent of dissipation will be less than the value of the revenue rectangle. See Higgins, Shughart, and Tollison (1985) for a theoretical model of rent dissipation. The durability point is discussed in more detail below.

ing or eliminating taxes once they are in place.⁷ As pointed out earlier, however, the present tax reform climate is one in which “the allocation of tax shares among individuals and groups in the economy and the choice of tax instruments that generate the imputations of such shares are considered ‘up for grabs’ in each and every budgetary period” (Brennan and Buchanan 1980, p. 190). If interest groups must continually fend off attempts by rival groups to increase their tax burdens, then each period’s Tullock costs will be smaller. Put another way, if the distribution of tax shares is not durable, favored groups will be forced to spend resources in every period to retain their tax preferences, and other groups will repeatedly spend resources to obtain tax reductions or to prevent their current liabilities from being raised. This means that the Tullock costs are not fully borne up front or, what is the same thing, that the amount of rent-seeking expenditures made in any period will be less than the discounted present value of the Tullock costs.

In the nondurable case, tax reductions (provided they are durable) pay larger dividends in terms of freed resources. Eliminating a tax saves not only the Harberger triangle, but also the present value of the resources spent in future efforts to alter the distribution of tax shares (Tullock costs). In fact, the rent-seeking model has a paradoxical implication for tax reform. The more an interest group spends annually to maintain its tax preference or to prevent its tax burden from being increased, the less durable its tax share is by definition. More importantly, these ongoing expenditures signify that the present value in perpetuity of the Tullock costs associated with the tax has not been completely borne. Therefore, the more an interest group has to spend in tax lobbying activities (holding constant the imputed value of the tax bill), the greater the gain from eliminating (permanently) the tax.

Implications and Conclusions

This paper has used the rent-seeking model to show that the welfare cost of a tax includes any expenditures made by interest groups

⁷The resources expended in lobbying efforts are sunk costs that cannot be recouped. For example, Goetz (1979, p. 800) shows that when loopholes in the law are fully capitalized, “the elimination of tax preferences commonly thought of as constituting horizontal inequities would itself constitute a horizontal inequity.” The case of monopoly and regulation is analyzed by McCormick, Shughart, and Tollison (1984). Some parties (consumer-taxpayers, for instance) would of course gain from a reduction in their future tax liabilities. It is nevertheless true that the social benefits from reducing a tax that has been fully capitalized by rent-seeking activities are *less* than the present discounted value of the tax bill.

to alter their liability under the tax. If the distribution of tax shares is durable, then the present value of the tax payments to be collected from (or the present value of the tax preference to be gained by) interest groups is fully dissipated in nonproductive lobbying activities. Because these expenditures are sunk, little would be achieved by doing away with taxes once they are in place. In the nondurable case, however, only a portion of the Tullock costs are borne in any period. Permanent tax reform would therefore generate relatively large welfare gains. Eliminating taxes that attract ongoing rent-seeking activities by taxpayers would save not only the associated deadweight costs, but would in addition free the resources spent by the affected interest groups in efforts to influence the distribution of tax shares. Moreover, these prospective gains will be larger the larger the expenditures on tax lobbying activities in any period.

It is important to emphasize that the welfare benefits of tax reform identified in this paper can be fully realized only if the reform is truly durable. For example, eliminating an excise tax permanently saves the portion of the deadweight costs imposed on consumers plus the present discounted value of the Tullock costs not yet dissipated by producers. Obviously, the value of the welfare gain will be much smaller if the tax is eliminated this year only to be reimposed two or three years hence.

An implication of the analysis is that relatively large welfare losses are associated with taxing groups that are organized to resist proposed changes in the tax code. More opposition to taxes is predicted to be forthcoming when the taxpayers are small in number, homogeneous, concentrated geographically, and have low organizational costs, than when the taxpayers are large in number, heterogeneous, diffuse, and face high organizational costs. The federal excise taxes are a case in point. These taxes are currently levied on a variety of selected goods and services, many of which are supplied by groups of firms that are well positioned to fight over the distribution of tax shares. (A partial list of these taxes includes the excises on beer and wine, cigars and cigarettes, gasoline and lubricating oils, tires and tubes, white phosphorous matches, fishing equipment, and airline tickets.)⁸ The tobacco and dairy lobbies, for example, are well known for their ability to compete in the political marketplace. Any threat to increase taxes or reduce subsidies on these products will therefore create additional

⁸In addition, federal excise taxes are levied on trucks and truck accessories, certain firearms and ammunition, distilled spirits, diesel fuel, life insurance policies, long-distance telephone service, wagers, coin-operated gambling devices, and a few other goods and services. For a complete list, see Pechman (1977, pp. 304-9).

Tullock costs. On the other hand, the fact that the tobacco and dairy industries spend a relatively large amount of resources annually to influence tax legislation suggests that the social welfare gains from reducing the changes in these taxes or subsidies would be substantial.

A second implication of the rent-seeking model is that periodic tax "reform" generates larger welfare losses than no reform at all. Repeated proposals to change the distribution of tax shares (the nondurable case) create a situation in which Tullock costs must be borne in perpetuity. Excise taxes are also remarkable on this score. The tobacco tax rate, for instance, has been changed 22 times since 1864, each rate being in effect an average of only 72 months.⁹ Similarly, soon after the enactment of income tax reform in 1986, some members of the Congress proposed raising the just-lowered tax rates as a way of reducing the federal budget deficit. As Brennan and Buchanan (1980, p. 190) note, in such a setting "the prospective taxpayer is . . . vulnerable to exploitation by government to the maximum limits of his taxpaying capacity." The analysis presented in this paper suggests that the potential welfare gains from (durable) tax reform are greater the more frequently a tax has been changed in the past.

In sum, the rent-seeking model implies that the process of tax reform is too important to be left up to a temporary majority. Tax reform deserves to be considered in a setting where the influence of interest groups is smaller, tax shares are more durable, and the future welfare costs of any tax rules adopted will accordingly be less. A constitutional rule that an increase in the rate or base of any tax may be approved only by a super-majority of the legislature may be the best means to achieve these objectives.

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⁹Because rent-seeking activities will be triggered by any *proposal* to change the tax rate, a true picture of the Tullock costs involved would also include the tax changes considered but subsequently defeated by industry lobbying efforts. McChesney (1987) develops a model in which politicians extract rents by threatening to impose taxes or regulation on private producers, and then are paid to forebear from doing so.

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