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Speaking Notes Version

Normative Public Finance for Political Economists

by

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Normative Public Finance for Political Economists

1. Introduction

Over the past three decades or so, public finance scholars and practitioners have come to rely upon political economy when an understanding of why governments do what they do is required. When it comes to the specification of what constitutes "good" or "better" policy, and in the giving of advice to policy makers, however, there is much less agreement between students of political economy and of traditional public finance about how to proceed in either theory or practice. There is only limited consensus, too, among political economists, as will become clear in the course of my remarks.

This morning, I want to consider some of the views about "good" tax policy that presently enjoy broad acceptance by a substantial group of public finance experts, as well as some views about "good" policy that have emerged from the public choice literature. I am going to call these views “rules” or “norms” of analysis. They represent patterns of thinking that have wide currency, or that have become codified in the literature.

In the course of my discussion of these norms, several shortcomings and limitations in existing patterns of thinking will become apparent. The problems with rules emerging from traditional public finance arise primarily because collective choice is ignored in setting up the standard of reference to be used in this approach. The problems with the norms emerging from the political economy literature stem from the particular model of politics adopted as a basis for analysis.

The overall thrust of my argument is that there is a need for a more complete approach to normative public finance that includes an appropriate treatment of collective choice as an integral part. My discussion will also suggest that that development of such a framework remains a largely incomplete and challenging task.

Before I go further, I want to explain why I think that the relationship of political economy to normative public finance is in need of more attention. Despite the early work of Wicksell and Lindahl, and the later work of James Buchanan and Buchanan and Geoffrey Brennan, and some others, political economy in my view has not yet succeeded in engaging scholars who practice traditional normative public finance. The implications of modern political economy for the day to day analysis and conduct of public policy have not yet been pursued in a manner that has been persuasive enough to turn the public finance profession away from social planning. In my view, this state of affairs is not simply due to the recalcitrance of vested interests, but stems in some measure from a reluctance of those interested in political economy to address the traditional issues of public finance.

2. Basic Issues in Public Finance

I begin with a very brief outline of the basic principles of public finance that will inform the rest of my analysis. (See if this is the way you view public finance.)

Governments must achieve two primary goals. They have to provide public goods and services demanded by voters, and they must find ways to implement changes in the distribution of income that is generated by market forces. Public finance theorists have pointed out a condition under which governments could finance these tasks without imposing an 'excess burden', that is, welfare losses from taxation over and above that due to the payment of the tax. This would require that taxation be levied in relation to benefits received from the consumption of desired public goods. Such taxes, often called benefit taxes or Lindahl-Wicksell tax-prices, would act in a way that is analogous to the role played by prices in private markets. For purposes of redistribution, taxes would have to be imposed as lump sum levies so that taxpayers could not avoid taxation by altering their behavior, while redistributive subsidies would have to be given out as lump sum payments.

If public goods had the same characteristics as goods sold in private markets, benefit taxation would represent a viable solution. However, it is generally considered impossible to exclude those who refuse to pay voluntarily for public services from consuming them. Nor is it possible to ascertain the demand for public goods by different individuals by asking them since potential consumers of such goods have an incentive to understate their preferences in order to minimize their own tax payments.

Problems also arise if we attempt to use lump sum taxes to finance public services in order to avoid the excess burden of taxation. Such taxes would have to be levied on individual characteristics that cannot be changed by taxpayers in order to avoid or lower their tax payments. In practice, there are few such characteristics, and payments related to them are generally perceived as inequitable or unjust, as was revealed forcefully in an experiment with head taxes conducted in the United Kingdom during the Thatcher government. Similar problems apply to lump sum subsidies; in general, recipients can find ways to adjust their economic behavior in some manner in response to such payments. One should also note that lump sum taxation does not deal with the problem of determining the size of the public sector – you could levy lump sum taxes and still have a public sector that was too big or too small relative to the revealed demand for public goods.

Because of these problems, taxes are usually assessed as compulsory levies, and individual tax payments have no direct relation to the public goods and services supplied to any taxpayer. The absence of market signals concerning the demand for public services means that governments must rely on alternative and generally less informative methods of determining the demand for public services. The separation of tax payments from decisions concerning the provision of public goods leads to excess burdens when individuals adjust their behavior to reduce their tax liability while still enjoying publicly supplied benefits. Such excess burdens or deadweight costs also arise from redistributional policies that draw on resources raised with compulsory taxes and that provide subsidies that are not of a lump sum nature.

The need for compulsory, non-benefit taxation to finance the activities of the public sector requires allocation mechanisms that differ from those used in the private sector. Choices on what public services to provide, on how much of them to produce, and on how to pay for them must be made in a collective manner. Similarly, collective choice mechanisms are required to determine the degree of redistribution and the manner in which it will be financed. In democratic societies, allocation choices for the public sector are made through competitive political processes.

I am going to argue that rules and norms of taxation must be evaluated in such a broader context, one that acknowledges the reasons for compulsory taxation outlined above together with the collective nature of existing political institutions that must be relied on to make fiscal decisions.

3. Rules or Norms in Relation to the Basic Elements of Public Finance

Let me draw your attention again to three basic elements or issues of public finance that I have so far identified:

[Overhead]

(1) separation of taxing and spending and its implications for the socially efficient use of resources
(2) determination of redistribution through the fiscal system
(3) the necessity for collective choice as a way of determining the level and structure of taxation and public expenditure.

The literature on rules or norms of taxation represents an attempt to codify strategies that deal with these essential elements. The literature on rules can be divided into two broad categories, depending on how it deals with the third element. One strand of the literature seeks solutions assuming that there is a social planner who can bypass the necessity for collective choice. It is what I shall refer to as *outcome-oriented*, looking for detailed policy prescriptions to deal with issues arising from the other two elements, while abstracting from the necessity for collective action.

A second strand of the literature deals with collective choice allocation mechanisms as a central concern. Work in this category often focuses mainly on the nature and design of the mechanisms themselves, rather than on the detailed outcomes arising from them. If particular policies are discussed, they are seen as examples to illustrate the functioning of the process that is of importance. I shall refer to rules in this tradition as being primarily *process-oriented*.

[Overhead: '<=' denotes topic to be discussed]

Outcome-oriented or Social Planning Rules or Norms:
Lump Sum Taxation <=
Minimization of Excess Burdens <=
Tax Neutrality <=
Harmonization: International and Interregional Neutrality

Process-Oriented or Political Economy Rules:
The Comprehensive Tax Base and Horizontal Equity <=
The Generality Principle <=
Time Consistency: Neutrality over Time <= (if time permits)
Limiting the Power to Tax

In the discussion of various norms, I will argue that the shortcomings of various rules relate to the partial nature of these rules when they are evaluated in relation to a comprehensive analysis that deals with all three of the basic elements of public finance I have identified. Although particular norms may serve as acceptable analytical tools within a more narrowly defined framework, they are revealed as incomplete and potentially misleading in a more encompassing analysis.

3.1 Outcome-oriented rules

Lump Sum Taxation

The first rule I will consider is the use of lump sum taxation as a device with which to measure the excess burden that arises because spending and taxing are separated.

Lets recall that lump sum taxes differ from other levies by having no incentive or announcement effects, since they are imposed on characteristics of taxpayers that the latter cannot change without incurring a high cost. Few economists would recommend lump sum taxes as a realistic way of raising large amounts of revenues. It is usually argued that the characteristics that would be a suitable target for lump sum taxation, such as innate ability, are essentially impossible to uncover. Rather, this tax is proposed as a conceptual device to isolate the welfare consequences of changes in allocation caused by other types of taxes.

How can we use lump sum taxation to measure the cost of the adjustments, or excess burden, that occurs when taxpayers see no direct connection between what they pay and the services they receive? In a private market, there are no such adjustments if a dollar is given up to obtain an additional unit of private good. Thus, if we can think of a hypothetical way of raising this dollar that does not lead to adjustment costs, we are simulating what would happen if spending decisions were made in a manner analogous to private choices.

Lump sum taxation represents this hypothetical way. The difference between lump sum taxation and the actual full cost of raising revenue in other ways is a measure of the premia we pay to shift a dollar from private to public use. *The fact that lump sum taxation is impossible in the real world is irrelevant in this view; the real counterfactual being applied here in order to measure welfare losses from taxation is allocation in a competitive market versus through a collective choice mechanism.* Recommendations for changes in the tax system based on welfare losses measured with reference to lump sum taxation are thus recommendations for minimizing the efficiency costs of relying upon a collective choice mechanism (or some other non-market allocation mechanism) rather than a market.

Given appropriate assumptions about the preferences of taxpayers, we can determine the difference in after-tax utility levels with a hypothetical lump sum taxation and with a distortion tax. It is then possible, with some effort, to use consumer surplus measures to

assign a monetary value to this difference which is the excess burden of the tax. It is difficult to overstate the importance of actually being able to measure excess burden to the development of public finance.

Now, note that so far I have made no mention of two of the three basic issues in public finance I previously drew your attention to, namely redistribution and collective choice. It appears then that excess burdens can be determined without reference to these other vexing basic issues. However, this simplicity is more apparent than real.

If we want to think about how to make the public sector more like a private market, for example by introducing user fees or marginal cost pricing of public services, using a private market as a standard of reference makes sense. But does it still make sense when raising revenue to finance things that cannot be provided by a market, such as redistribution or *public* services? Given the absolute necessity of collective choice, when dealing with those cases which are, or ought to be, at the heart of public sector activity, it would be more appropriate, or at least just as appropriate, to use welfare losses from alternative tax sources in an ideal democracy (whatever that is) as the standard against which to judge the net benefits of any tax reform proposal.

Welfare losses (still measured, I suppose, using lump sum taxation) for alternative tax sources under an ideal collective choice mechanism have not been well studied. One of several problems that arises in defining such a standard of reference is that the nature of tax instruments, and thus the extent of welfare losses from each tax, will depend on the precise nature of the collective choice mechanism adopted. This relationship extends even to the degree of lumpsumness in taxation that will be possible. The extent of knowledge of individuals characteristics on which lump sum taxes may be levied and the ability to levy quasi-lump sum taxation on those characteristics is just a matter of (collective) choice about how much to spend on uncovering personal characteristics and about how to deal with the ethical and political problems that arise (even with perfect information) when people cannot or will not pay their taxes.

Because of the difficulties of implementing a standard of comparison that is cognizant of the necessity for collective choice, we may decide to continue to rely on the private market alternative when actually measuring welfare losses. In this case however, it will be imperative to develop a better understanding of the biases that this introduces into the analysis of tax efficiency.

Minimization of Excess Burdens.

A widely accepted rule of applied tax analysis states that a tax system is efficient if it minimizes the total excess burden of raising a given amount of revenues. Assume that the government has several well-defined tax bases at its disposal, and that it intends to assess taxes on them in such a manner that measured welfare losses are as small as possible in total. This will be achieved if tax rates are adjusted so that marginal welfare losses per (marginal) dollar of revenue raised are equal across tax bases.

In its simplest version, minimization of total excess burden abstracts from concerns of redistribution and collective choice. More complex versions of this rule envision a planner who uses distributional weights derived from a welfare function given from outside the conceptual framework. In such a context, a planner attempts to maximize social welfare by equalizing distributionally weighted marginal excess burdens per dollar raised across available tax bases. This more general Optimal Tax (OT) approach, has become established through the work of Ramsey, Mirrlees and others as the most influential normative approach in taxation.

While OT approach allows incorporation of a second basic issue (redistribution), it does so at the expense of practicality. In actual policy contexts, well-defined welfare functions are not available, and it may be difficult to determine even in an approximate fashion what the prevailing consensus is regarding distributional weights. One should also note that the planner model completely skirts the third basic issue - the necessity for collective choice - since it describes a standard of reference drawn up without regard to the need for collective choice.

Given the difficulties of assigning distributional weights, one is tempted to proceed under the assumption that weights are equal, and in a competitive political system such a procedure may be misleading.

Some algebra is useful in clarifying this point. To simplify I limit the discussion to a situation with two political parties, two tax bases, two tax rates, and one public good. To acknowledge tax administration and information costs implicitly, assume that the number of tax rates is less than the number of voters and that taxation is proportional rather than lump sum.

[Overhead]

Refer to overhead only at this point:

Indirect utility for voter h is $v_h(t_1,t_2,G)$ and, after substitution of the general equilibrium structure of the private economy, the government budget restraint can be written as

(1) $$G = R_1(t_1,t_2,G) + R_2(t_1,t_2,G).$$

Each party chooses tax rates and the size of public expenditure to maximize its total expected vote.

The probability that voter h supports the incumbent as perceived by the party (f_{hi}) depends on the difference in the voter's evaluation of his or her welfare under the incumbent's policies and those of the opposition(o): $f_{hi} = f_h(v_{hi} - v_{ho})$.

The expected vote for the incumbent government then is:

$$EV_i = \sum_h f_h(v_{hi} - v_{ho}),$$

and the vote for the opposition may be defined analogously. In addition, we assume that knowledge of the probability density functions describing voting behavior and of the structure of the private economy is common to the competing parties.

(Note that the theoretical difficulties I am going to raise stem from the existence of a collective choice process, not from the use of a particular voting model.)

Given the platform of the opposition, first order conditions for the choice of tax rates that maximize EV_i subject to the budget restraint are of the form

(2) $$\frac{\sum_h \partial f_i/\partial v_h \bullet \partial v_h/\partial t_1}{\partial(R_1+R_2)/\partial t_1} = \frac{\sum_h \partial f_i/\partial v_h \bullet \partial v_h/\partial t_2}{\partial(R_1+R_2)/\partial t_2}$$

from which it can be seen that the platform chosen by the incumbent equalizes the marginal effect of tax policies on expected votes per dollar of revenue across tax sources. Since the fiscal policies of the opposition are determined by essentially the same conditions, it is evident that party platforms will converge in an equilibrium, if one exists.

After substitution of equilibrium values of the partial derivatives in (2), these conditions can also be used to characterize the tax system that emerges in a Nash equilibrium of the electoral game, and can be used to illustrate the result referred to earlier that the outcome in such a model may be Pareto efficient. Let $?_{hs}$ be the particular values taken by the partial derivative $\partial f_h/\partial v_h$ at a Nash equilibrium of the electoral contest, assuming that one exists, and let the other partial derivatives also be evaluated at the same equilibrium. Then the first order conditions for politically optimal (equilibrium) strategies take the form:

(3) $$\frac{\sum_h q_h \bullet \partial v_h/\partial t_1}{\partial(R_1+R_2)/\partial t_1} = \frac{\sum_h q_h \bullet \partial v_h/\partial t_2}{\partial(R_1+R_2)/\partial t_2} \quad .$$

To see that policy choices characterized by condition (2) are consistent with Pareto efficiency, it suffices to note that this condition also represents a solution to the problem of choosing a fiscal system to maximize a political support function, $S = \sum_h ?_h v_h$, subject to the government budget restraint. It is also useful to point out that since this particular function is maximized, it makes sense to think of the weights $?_h$ appearing in it, which represent the perceived responsiveness of voting behavior to a change in individual welfare at a Nash equilibrium, as measures of the effective influence exerted by different voters on policy outcomes.

Using condition (2) as a representation of political equilibrium, we can proceed with the main argument about MECs. In the special case where the *?'s* for all voters are equal, we can substitute the definition $W_k = \sum_h \partial v_h/\partial t_k$ into (2), subtract 1 from each side, and simplify to get

(4) $$\frac{W_1 - \partial(R_1 + R_2)/\partial t_1}{\partial(R_1 + R_2)/\partial t_1} = \frac{W_2 - \partial(R_1 + R_2)/\partial t_2}{\partial(R_1 + R_2)/\partial t_2}$$

where W_k is the sum of individual losses in utility due to an increase in tax k (measured, for example, as the unweighted sum of equivalent variations in income); the numerator on each side of the equation is the excess burden of the corresponding tax change; and the quotient on each side of (3) represents the marginal efficiency cost of each tax source.

Thus we see that if the *?'s* are all equal, the tax system equalizes the MECs of all tax sources and minimizes the total excess burden of taxation, measured by the sum of unweighted welfare losses. On the other hand, if political influence is distributed unequally as in (2), unweighted marginal welfare losses for different tax sources may vary significantly as parties trade off the welfare of and support from different voters, *even though Pareto efficiency is being achieved*. In that case, a proposal to equalize the MEC's of the two tax sources (as usually measured) may lead only to a movement along the Pareto utility frontier, or, quite possibly, to a less efficient allocation.

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To put this another way, in weighting welfare changes for different people equally, as is common in applied work, existing welfare analysis of the public sector imputes **all** observed inequality of MECs to the inefficiency of public policy. This is odd in view of the role that competition between parties for the support of self-interested voters plays in democratic countries.

In the simple model outlined above, all of the inequality in MECs stems from inequalities in effective political influence and no economic inefficiency is implied. However, one need not believe that actual political equilibria are fully efficient to agree that some part of the inequality in the unweighted sum of welfare changes may be due to reallocation that is conducted as costlessly as possible in the pursuit of political power. Studies that have found higher MEC's for capital taxes than for wage taxes, for example, may thus have uncovered a pattern that could be efficient in a more inclusive, political economy setting.

This conclusion contrasts with the arguments of several authors, especially those who favor tax neutrality as a guide to policy (I turn to this rule next) , who see unequal marginal welfare losses across different bases as a source of grave inefficiency. To complicate matters further, it can be pointed out that the existence of differences in marginal welfare losses does not indicate by itself that an efficient political equilibrium has been achieved. Such differences could possibly also reflect the influence of an inefficient policy that arises from non-competitive elements in the political process. Pareto optimality will only be reached if the political process is truly competitive.

Tax Neutrality

There is another reason, besides the difficulty of identifying distributional weights and the need to proceed on the basis of unweighted MEC's, that substantially reduces the practicality of the optimal tax approach and of social planning generally. Those

concerned with the reform of particular tax systems point to the heavy informational requirements of OT. Since optimal tax plans take full account of the general equilibrium structure of the economy, they tend to be highly complicated and complex. To develop a comprehensive OT blueprint of the tax system, the social planner needs knowledge of preferences, endowments and technology for all participants and sectors in the economy, as well as knowledge of distributional weights. How this information is to be acquired by elected politicians who are in charge of policy making is not addressed.

Suggestions in the tax literature for dealing with the information problem center on rules of thumb, or simplified guidelines such as tax neutrality. Neutrality here means that all taxable activities should be treated equally by the tax system (that is, taxed at the same effective marginal rate) in order to avoid a far as possible the excess burdens that will arise as taxpayers substitute towards relatively lightly taxed activities. As one writer (Gillis 1989) has put it:

> *While not nearly as intellectually satisfying a guide to tax policy as "optimal taxation," neutral taxation is to be preferred as a benchmark until such time as analysts are able to identify optimal departures from neutrality in real world policy settings, and until such time as administrative capacities are equal to the task of operating necessarily complicated optimal tax structures* (1989, 515).

In other words, those who advocate tax neutrality recognize that it is less efficient than a properly specified optimal tax blueprint (even simpler than one defined for equal distributional weights), but argue that a neutral system will be more efficient than any feasible OT system that is badly implemented. Is such a conclusion justified?

Since neutrality rules have emerged from a framework that is not cognizant of the need for collective choice, one may reasonably ask if neutrality is still a useful guide to policy in a more complete, political economy framework. It is easy to see that the information problem for policy makers becomes worse in any political economy setting. The political strategist must have knowledge of all relevant political margins governing voting

behavior, in addition to the information about economic margins required by a traditional OT planner. A full solution to the problem of optimizing political support requires knowledge of how changes in the welfare of different voters affect the probability of voting, as well as how taxation affects economic behavior. It therefore appears that the argument for neutrality is stronger when the existence of collective choice is explicitly acknowledged.

However, the historical debate points in a rather different direction from neutrality as a solution to the information problem. The feasibility of social planning in the face of large information requirements is a classic question in the history of economics. The traditional debate was concerned primarily with the choice between centralized planning and the use of markets. Among the most influential ideas in the debate were those advanced by Hayek, who argued that only decentralized markets could solve the immense task of processing the information necessary to reach efficient economic outcomes. This approach is in contrast to that taken by advocates of tax neutrality, who have retreated from optimal taxation in order to deal with the information problem, while still preserving a command and control approach to policy making.

The historical debate suggests that a more effective approach may be to decentralize policy making into separate, semi-independent areas, while mobilizing special interest groups to provide valuable information as part of their attempts to influence policy outcomes. One may note that the most commonly used OT formulation also subsumes a segmentation or decentralization of policy by separating taxation from expenditures, although authors do not generally justify this assumption by making reference to the information question.

In fact, even a quick look at policy making in modern societies indicates that decentralization of policy areas is a common feature of democratic government. Decisions on taxation and expenditures are taken separately at the political level, and implemented by different administrative bodies, while special procedures, such as annual budget resolutions or cabinet directives, are used to maintain broad overall coordination.

As far as taxation is concerned, further segmentation of policy making and administrative organization tends to occur in accordance with particular fiscal instruments or major tax bases. Moreover, instructions to tax commissions and tax reforms generally are directed at selected parts of the revenue structure.

While the apparent lack of coordination that may result is often decried by economic analysts, this lack may in fact represent a rational response to information problems associated with complex policy choices. To fully understand the strengths and weaknesses of existing, decentralized policy processes, which is a prerequisite to the conclusion that neutrality is the best that can be hoped for, it will be necessary to define and examine the benefits and costs associated with existing methods of decentralization and policy segmentation, and to relate them to the provision and processing of economic and political information necessary for electorally effective policy.

3.2 Process-oriented rules

The Comprehensive Tax base, Horizontal Equity, and the Generality Principle

I turn now to consider some of the process-oriented rules, namely the Comprehensive Tax and Horizontal Equity, the Generality Principle, and Time Consistency or Neutrality over Time.

There is a large body of literature on the comprehensive income tax base and the related concept of horizontal equity. The major proponent of this approach was Henry Simons who published his work in the 1930's and 1940's. Simons' definition of the appropriate tax base – the change in net wealth plus the value of consumption during an accounting period – was offered as a process-oriented rule that would circumscribe government intervention in the private economy.

This definition of the comprehensive tax base depends on the related concept of horizontal equity. Simons argued that those with equal ability to pay taxes, as measured by comprehensively defined income, should be assessed equal tax payments. He saw this

principle as a way of implementing justice in taxation and believed that it would have wide support among taxpayers, leading to a tax system that would be perceived as fair among the population.

The concepts of the comprehensive tax base and of horizontal equity made a lasting impression on economic writings related to taxation and also had a considerable impact on the legal profession. Part of the reason for this impact was that Simons rejected a utility-based analysis and defined the comprehensive tax base in a manner having a direct counterpart in accounting practices. In addition, the idea of horizontal equity evidently appeals to a large segment of the electorate.

The voluminous literature on the comprehensive tax base has focused almost exclusively on problems of implementation and on theoretical arguments about whether income or consumption would provide a better basis for taxation. While reformers starting from this tradition have influenced public discussion and public policy to a considerable extent, they have not succeeded in having their agenda fully accepted. The reasons for this lack of success can be understood more readily if we consider the choice of tax policy in the context of political equilibrium.

Let us imagine a political system where parties propose policy platforms so as to maximize expected votes, while being uncertain of how voters will react to particular proposals. Voters, in turn, try to maximize net benefits from the public sector, putting a positive value on public goods and services and reacting negatively to the payment of taxes and to the welfare losses arising from taxation. In such a system, political decision-makers will try to design a tax structure that equalizes the loss in expected votes per marginal tax dollar raised across all taxpayers. (This is the sort of tax system I described earlier when discussing marginal efficiency costs)

In formulating their platforms, parties face a difficult balancing act. On the one hand, they want to create a tax system with as much differentiation in the treatment of taxpayers as possible in order to minimize total opposition to taxation. On the other hand,

they face information, administration and monitoring costs that increase as more differentiation is introduced. Such costs reduce the ability to provide public services and to a loss in expected support. The politically optimal tax system represents a compromise between these opposing forces. Differentiation and associated administrations costs are reduced by grouping taxpayers into rate brackets and by combining disparate activities into large bases. And some of the lost ground is regained by using special provisions, such as exemptions, deductions and exclusions, that provide some measure of differentiated treatment with regard to effective tax rates, even with the existence of large omnibus bases.

An analysis of this nature suggests that democratic governments operating in a competitive political environment will not voluntarily implement a tax program corresponding to the one advocated by Henry Simons, for essentially two reasons: First, a broad base income tax without special provisions will almost certainly make people worse off compared to the outcome that can be obtained with *appropriate* differentiated tax treatment, thereby reducing the support that parties can expect; and second, such a system makes no allowance for the pressure on parties to respond to differences in effective political influence among individuals and groups in society, differences that are tolerated and sometimes even encouraged.

While horizontal equity may enter into the government's calculus, among other issues, to the extent that it represents a widely shared value among taxpayers, it will not be the overriding criterion in the fashioning of a tax structure in a competitive political system. One should also note that equity often means appropriate discrimination, or a different pattern of discrimination, rather than mathematical equality of treatment.

The Generality Principle

In a recent contribution that has not yet been widely discussed by other scholars, James Buchanan and Roger Congleton (1998, chapter 8) have returned to the concern of Simons with the problems of majority rule. Their analysis of the operation of majority rule is

more explicit than in Simons' work, however, and it includes an examination of the dynamic character of democratic politics. Can the Generality Principle rescue horizontal equity and the comprehensive tax base?

Buchanan and Congleton argue that rent seeking and static welfare losses are likely to occur since majorities often do not internalize the losses suffered by minorities. Over time the losses due to majoritarian exploitation of minorities may become steadily more serious. Because of the inherent tendency of majority politics to foster vote cycling and instability in the struggle over distributive shares, the long-run rate of growth may decline, unless appropriate constraints are placed on political outcomes. This will be so because any currently successful coalition may find it desirable to raise tax rates even higher than merely static political optimization would suggest, because it realizes that it will probably not be the majority tomorrow, and that it cannot fully capture the future gains from growth enhancing policies.

The solution they advocate is similar to Simons' broad base income tax, the purpose of which was to prevent government from dipping into great incomes with a sieve, as Simons (1936) put it. In this more recent contribution to the process-oriented literature however, the suggested solution involves the application of a Generality Principle, or principle of non-discrimination, under which all citizens are to enjoy equal quantities of public services, and pay taxes according to a flat or uniform tax system on a broad base that does not permit economic activity of particular groups to be singled out for 'special' treatment. The intention here is to avoid distributional conflict, and the vote-cycling and associated economic waste that results. In order to do so, Buchanan and Congleton go so far as to argue that it is necessary to eschew the use of exemptions that remove low income taxpayers from the tax rolls, since this invites political conflict over who is to be exempted.

Although Henry Simons viewed the comprehensive tax base as a way of limiting government discretion in determining and changing tax rates, he did not place the discussion within a formally developed framework of collective choice. As a result, it is

not clear why political actors in a democracy would ever adopt a truly comprehensive base or why they would choose horizontal equity as their main policy criterion. The same question can be posed concerning the proposal of Buchanan and Congleton for a nondiscriminatory flat tax without exemption.

In the end, the issues are empirical as well as theoretical – how does the political system operate; can it be altered so as to intensify the economic benefits from political competition, or must it be constrained to avoid the worst features of interest group politics?

Time Inconsistency, or 'Neutrality' Over Time

Finally I turn to time inconsistency. In this literature, the focus of concern is on the inefficiency that may arise in a dynamic context when contemporary governments, perhaps acting on behalf of majority coalitions, engage in discretionary fiscal and other polices that are not consistent over time.

A policy is not time consistent if it requires a course of action today that will subsequently become undesirable. It is argued that the inability of governments to commit to consistent policy over time will result in a loss of social welfare compared to a situation where governments are prevented from adopting (discretionary) policies based on period by period political optimization. For example (Kotlikoff et al 1988, Fischer 1980), suppose an ex ante efficient policy involves a low rate of taxation now and in the future to encourage saving when people are young. Such a policy will not be time consistent, however, without some special institutional arrangement, however, that commits the older generation to refrain from taxing capital once it has been invested. In the absence of a credible commitment not to tax capital when they are, as a group, old, the young may distort their current saving patterns in anticipation of future taxes, resulting in an economy with sub-optimal saving, lower real growth, and high capital taxation. The analysis by Buchanan and Congleton I have just discussed is tailored to deal with much the same sort of situation.

The time inconsistency literature is of interest at least because it raises the question of how contracts of different types are to be enforced over time in a democratic society. It is not surprising that the complexity of the issue leaves many facets of the problem still to be explored.

In the first place, the time consistency problem is partly an empirical issue. Not all contracts are broken by governments. For example, patents are not usually abrogated unilaterally. Knowledge of the extent to which inconsistency problems actually exist is important because giving up discretion through the use of rules such as the broad base income tax or flat tax without exemptions must have a cost.

One reason for thinking that time inconsistency may not be as serious a problem as the models suggest is that people in democratic societies are not powerless in opposing unwanted government actions. The legal system in most developed nations contains features that make it difficult for governments to unilaterally expropriate private property. Mobility and the organization of political opposition are other well used methods are available to taxpayers that make them more difficult targets than the time inconsistency argument suggests. Indeed, it is not farfetched to say that the type of expropriation of taxpayers envisaged in models of time inconsistency amounts to the staging of a coup by the government, which is unlikely to happen in most democracies for a variety of reasons.

In any event, there are many facets of existing arrangements in democratic societies that we do not fully understand, making policy advocacy in the area a dangerous enterprise. Why for example do we observe the existence of quasi-independent central banks with authority for monetary stability, as is in accordance with the time inconsistency approach, but we do not observe in any democratic state the corresponding institution of central taxing, even though the time consistency problem with respect to the rate of monetary growth and the rate of capital income taxation are essentially similar?

A possible answer to the last question is that tax policy is hard to design and implement in the face of constantly changing events, a point emphasized in the discussion of the rule of static neutrality. It is not hard to see why it is easier to write a contract with a central bank to carry

out a program of monetary stability than it is to instruct a central tax authority on the appropriate definition of taxable income in a constantly changing economy.

If central taxing is rejected as a solution, it is tempting to look at the advice of Simons or Buchanan and Congleton regarding the definition of income and the structure of taxation to deal with government opportunism. However, in view of the ability of taxpayers to protect themselves to some extent with mobility and legal and political action, it is necessary to consider the trade-off between the benefits from imposing such tax structures and the costs of policy inflexibility. The nature of this trade-off remains to be studied.

4. Conclusion: The Search for Simplicity

Outcome-oriented tax norms are derived from analytical frameworks that do not acknowledge the need for collective choice. Unless the effects of the operation of collective choice mechanisms are explicitly recognized in the framework of analysis, however, we cannot tell if the policy proposals that emerge will be consistent with political equilibrium in an acceptable political system. Nor is it possible to determine in all cases whether such proposals will result in actual welfare improvements.

Lump sum taxes are not likely to emerge as a viable solution in a democratic equilibrium, and carry with them the questionable use of the private market as a standard against which unavoidable collective activity is to be judged. Unequal MEC's does not clearly signal inefficiency in taxation. Tax neutrality, if used as a guide to policy reform, will not be consistent with political competition that pushes governments to differentiate the tax treatment of different economic activities. Nor can we expect rules for international tax harmonization, based largely on the assumption that governments behave in a benevolent manner, to be robust in situations where competition among governments helps to constrain political opportunism.

Outcome-oriented rules attempt to overcome the extensive information problem associated with implementation of a tax blueprint by a planner with the help of simplified

planning guidelines. However, an economically efficient tax system in a modern economy must of necessity be complicated, since a myriad of economic margins must be taken into account. Application of simplified rules requires many compromises that may reduce welfare. An alternative approach would be to decentralize the tax policy process. This would allow competitive political pressures, coupled with a decentralized and specialized bureaucracy, to generate information for decision makers, without anyone being aware of what happens in the system as a whole. Such decentralization is a classic solution to economic information problems associated with fiscal and other types of planning. Supporters of outcome-oriented, centrally applied rules must explain why the operation of a decentralized competitive political system would not generate results that are preferable to what can be achieved with outcome-oriented norms.

It is to my mind evidence of the incompleteness of the outcome-oriented approach that nowhere in this literature can one find any discussion of the potential benefits from increasing the extent of political competition.

The process-oriented literature also promotes simplified solutions. Examples include the broadly based income tax, flat taxation without exemptions, and the use of independent tax commissions. Unlike outcome-oriented rules, however, these proposals are intended as constraints on the nature of the political process. Those who advocate particular tax structures as political constraints believe that their proposals will improve the democratic process. It is not clear, however, why the proposed structures should be consistent with political equilibrium, and why they should be superior to tax structures generated by the workings of the existing political process.

The discussion suggests that a more comprehensive type of normative tax analysis is needed, one that is more fully cognizant of the existence of collective choice in competitive political systems.

[Add if time: Elsewhere, Walter Hettich and I have argued for an approach that parallels the classical approach to welfare analysis. Such an analysis would include a standard of

reference against which actual outcomes are to be compared, one that is consistent with the existence of collective choice, and a first theorem explaining under what democratic arrangements this standard could be achieved; a theory of political market failure that links observed features of fiscal systems to specific characteristics of political or policy processes; and a way to actually measure departures from the standard of reference.]

Until such a revised framework has been created, existing tax rules or norms of analysis may continue to provide partial guidance. The useful insights that can be derived from currently accepted policy norms must be tempered, however, with a careful evaluation of the biases and problems that may arise in applying such rules to a functioning democratic process.