

1981

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Citation of this paper:

Buchanan, James M., Geoffrey Brennan. "Tax Specification and Tax Limitation." Centre for the Economic Analysis of Property Rights. Economics and Law Workshop Papers, 81-16. London, ON: Department of Economics, University of Western Ontario (1981).

7079

ECONOMICS AND LAW WORKSHOP

81-16

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September 23, 1981

4:00 p.m.

Room 51, Faculty of Law Building

Department of Economics Library
SEP 11 1981
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TAX SPECIFICATION AND TAX LIMITATION

by

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I. Introduction

Our purpose in this paper is to present the argument for tax base specification as the most appropriate single means of restricting government's power to tax.¹ Our discussion takes it as given that some restriction on the taxing authority is desired, and proceeds to examine, on this basis, alternative institutional means of implementing such desired restrictions. We shall stipulate at the outset that such restrictions on the tax authority are to be constitutional in character. (Other papers for this conference will discuss the possible efficacy of nonconstitutional forms of limits.) Within this setting, there are several forms that tax limits might take. First, limits may be specified in terms of total tax revenues and/or government outlays either in absolute or relative terms. Second, limits may be specified in terms of the rates of taxation that may be applied, defined either in respect of particular tax levies or over all levies. Thirdly,

¹See our book, The Power to Tax: Analytical Foundations for a Fiscal Constitution (New York: Cambridge University Press, 1980).

limits may be imposed by restricting the base to which taxes can be applied. Our aim here is to explain and defend the use of limits of this latter type.

II. Fiscal Constraints and Political Constraints

It is necessary at the outset to make a categorical distinction between fiscal and political constitutional provisions, both of which may be aimed to serve the same purposes and which may be either complementary to or a substitute for each other. The fiscal overreach of modern governments may be restricted by changing the procedures or rules through which collective or political decisions on fiscal matters are reached without overt constraints being placed on the range and scope of the outcomes of such decisions.

One example is the Proposition 13 requirement that certain new taxes must be approved by two-thirds vote in both houses of the California legislature rather than by simple majority vote. Another example, proposed by Alan Greenspan among others, is a constitutional amendment that would require that all spending authorizations be approved by a qualified majority in both houses of the U.S. Congress, by three-fifths or two-thirds. The intellectual precursor for such modern proposals is, of course, the stylized constitutional reform suggested by the great Swedish economist, Knut Wicksell, who, in 1896, argued that only a rule of unanimity could guarantee

efficiency in public spending programs.² At a more realizable level, Wicksell also proposed that no spending authorization should be made unless accompanied by legislation designating the sources of the funding of the outlay. The segmentation of the budget with specifically earmarked revenue sources for each spending category becomes a direct implication of the Wicksellian procedural thrust. In one sense, and although it is legislative rather than constitutional in form, the Budget Reform Act of 1974 may be interpreted as an attempt to impose procedural or political constraints with a view toward curbing widely acknowledged spending excesses. At a more current policy level, the proposed amendment to require that the federal government adhere to budget balance can also be classified as procedural in nature, although, as we shall note later in this paper, this proposal can also be classified as a base limitation.

The examples listed above are classified here as political or, if preferred, as procedural constraints, rather than fiscal constraints, regardless of the intended consequences for the predicted effects on tax-spending outcomes. For purposes of the analysis that follows, we shall assume that additional political constraints are somehow deemed to be impracticable or infeasible. That is to say, the set of procedures through which taxing and spending decisions are

²Knut Wicksell, Finanztheoretische Untersuchungen (Jena: Gustav Fischer, 1896).

made in the United States government is assumed to remain roughly that which we can now observe. In this setting, if the fiscal overreach of government is to be curbed, specific tax and/or spending limits must be introduced.³

III. Flexibility

One of the central arguments made against any constitutional restriction on government's taxing and/or spending authority states that flexibility in response to possibly unpredictable fiscal "needs" is reduced. In the most elementary sense, of course, any restriction restricts; any constraint constrains. Such is the very purpose of the whole exercise. On the other hand, it is clearly possible to design limits on taxing-spending powers that would be overly confining by almost anyone's standards. The future is uncertain, and any reasonable stance must embody the recognition that in-period or postconstitutional decision-makers must be allowed some discretionary range for levels and directions of taxing and spending. This principle is recognized, at least indirectly, in almost all of the fiscal limit proposals via the escape clause provisions for declared emergencies.

³In many respects, procedural constraints are preferable to any direct fiscal constraints. Our argument for tax base specification in this paper carries no implication for our own ranking of procedural and fiscal constraints in any carte blanche setting for constitutional reform. In such a setting, we should probably opt for some variant of the Wicksellian reform structure.

One desirable feature of a fiscal constraint would seem to be the incorporation of some range for in-period flexibility. The ultimate objective is to limit the fiscal appetites of modern government rather than to rigidify the operations. That is to say, we may want government to be allowed to do as it pleases, within appropriately defined constraints on political process (e.g., elections), provided that it does not go beyond certain specified boundaries.

Tax-base specification offers an efficacious institutional means of achieving this objective. By limiting governmental taxing power to impositions on constitutionally-specified bases of tax, we can place upper bounds on the level of public revenue that can be collected, and thereby on the extent to which particular citizens can be unduly exploited under the government's tax power. Government will not rationally exceed revenue-maximizing limits; decision-makers for government maintain strong incentives to keep rates below or at the inflection point on the relevant Laffer curve.⁴

⁴It is difficult to understand what model of governmental or politician-bureaucratic behavior underlies the arguments that tax-rate levels may be such that reductions would generate additional revenues. Are these arguments based on some presumption of error on the part of governmental decision-makers? Or, are they based on some presumption that envy and like motives dominate revenue generation? Or do they reflect the possible divergence in response over the electoral short-run and the institutional-adjustment long run? For an analysis of the possible short-run, long-run divergence in objectives, see James M. Buchanan and Dwight Lee, "Some Simple Analytics of the Laffer Curve," Mimeographed (Center for Study of Public Choice, VPI, September 1981).

It is useful at this point to discuss the rate-revenue relationship incorporated in the so-called Laffer curve in more detail. It should be evident that any such relationship is critically dependent on the whole structure of arrangements that describe the tax system at any period of time, over and beyond the simple rate-revenue relationship depicted on the familiar diagram. There are as many possible Laffer curves as there are variations on the tax structure and on taxpayers' response to this structure. Also, there will be a different Laffer curve relationship for different periods of adjustments in response. And the direction of change may be highly important; an increase in tax rates may generate a relationship quite different from a decrease in rates, even when passing through the identical absolute rate levels. In this discussion, however, we want to by-pass all such complications and postulate the existence of a unique Laffer relationship between the tax rate and total revenue, assuming the tax structure to be roughly that which we observe to be in existence, and also assuming that the relationship is "long-term," by which we mean that taxpayers are presumed to make all institutional responses.

The point to be made is that a Laffer-type relationship between rate and total revenue under the assumption of a comprehensive tax base will always lie wholly outside the comparable relationship derived under a tax base specified

to be less than comprehensive over all income uses and sources. Figure 1 illustrates the simple geometry. Note that, under the limited or specified tax base, revenues are lower for any given rate levied on the legally-authorized base. Note that, also, if there is any substitutability between tax-base uses and sources and nontaxable uses or sources of income, the revenue-maximizing rate on allowable base will be lower under the limited than under the comprehensive base.

The basic relationship, as depicted in Figure 1, suggests that total revenues can be kept within constitutionally desired limits without unduly restricting government's flexibility in response to changing budgetary circumstances. Up to the revenue-maximizing limits, tax-base specification per se does not bind the fiscal authority. And by the appropriate selection of tax base, any anticipated level of revenue needs might be embodied in the structure of arrangements while at the same time maintaining ultimate constitutional control over the maximal degree of tax exploitation.⁵

IV. Enforcibility

A traditional argument against any attempt to constrain governmental powers through constitutional rules states that no such rules can be enforced, that government can do what it wants regardless of the constitution. In general terms, this

⁵For details of the analysis, see The Power to Tax.

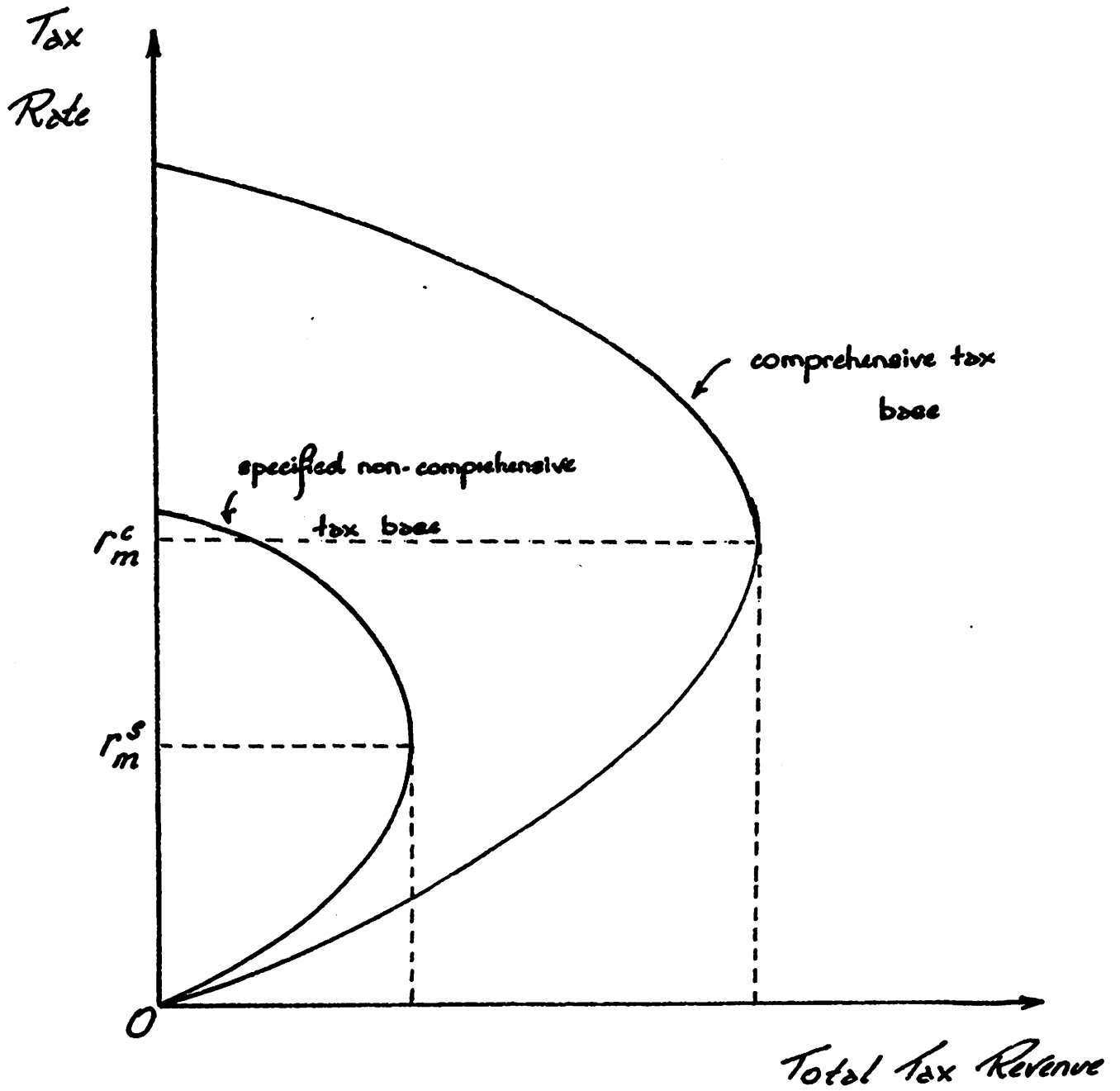


FIGURE 1

argument was presented by Thomas Hobbes in the middle of the seventeenth century, but, in modern dress, the argument is familiar from the discussions on proposed fiscal rules in the late 1970s and early 1980s. The proposed amendment that requires budget balance has been strenuously opposed on the grounds that such a requirement could be easily evaded by resort to off-budget financing, to direct regulation, to tax differentiation, as well as other nonbudgetary means of accomplishing governmental objectives. Comparable arguments have been brought against proposals that involve setting absolute or relative limits on total tax revenues and/or outlays.

We consider such objections to be overdrawn, and we should argue that historical experience suggests that constitutional rules do constrain governments despite the acknowledged liability of any rule to possible abuse. With respect to tax-base specification in comparison with alternative approaches, we suggest only that enforceability is somewhat less difficult because violations are more readily detectable. If government is authorized constitutionally to levy taxes only on a specified base, and nothing else, it becomes relatively easy to determine when it attempts to levy taxes on some base that is not within its authority. Constitutionally-authorized taxes on tobacco and spirituous liquors could scarcely be extended to cover taxes on pool tables. Even

the courts of the last half of the twentieth century would be hard put to legitimize violations of taxing authority, as laid down under specified tax-base constraints (although especially since Baker v. Carr, the meaningfulness of any judicial protection even for well-articulated constitutional rules must be seriously questioned.)

V. Macro and Micro Limits in an Individualistic Constitutional Perspective

Tax-base specification has a third major advantage in comparison with alternative forms of tax limits that deserves discussion in some detail. Tax-base specification imposes boundaries on potential fiscal exploitation both in a macro and in a micro economic sense. Alternative schemes operate essentially on the macro or aggregate margins of fiscal excesses.

Consider, for example, either the proposal to require budget balance or that which keeps governmental outlay increases tied to increases in national product. These proposals must find their support through the individual's perception and understanding of the macroeconomic effects of imposing overall fiscal responsibility or discipline on government. Only in some indirect sense, operative through the aggregative effects, do such proposals offer constitutional protection against the potential for individual or micro fiscal exploitation. Neither of the two proposals noted could, for example, offer

the individual protection against the imposition of confiscatory taxation if his economic position should be such as to make him qualify for such treatment, while preserving existing legal requirements for tax generality. To be even more specific, there would be nothing in a balance-budget rule that would prevent government from imposing one-hundred per cent marginal tax rates on all incomes above, say, \$50,000.

At the stylized constitutional stage, when alternative fiscal constraints are considered, the individual does not know what his own position in postconstitutional periods is likely to be. But he may well want to insure that, no matter what his fortunes bring, the tax-man will not be able totally to requisition his earnings and endowments. By resort to specific rate limits, imposed constitutionally, such micro protection may seem to be provided. But by imposing taxes at the specified rate on gross rather than net income, or on income and consumption and wealth simultaneously, the requisite protection may not be secured in all cases: for at least some individuals, totally confiscatory taxes may survive the maximum rate constraint. Besides, specific rate limits may be considered overly detailed to be included in a set of constitutional rules.

Tax-base designation can, however, accomplish everything that a definition of rate limits may produce and more, and can do so indirectly. To the extent that the individual knows,

in advance, that there is some substitutability between the designated tax-base uses and sources of income on the one hand and exempted uses and sources on the other, he can guarantee to himself an "exit option" of sorts against attempts by government to levy exorbitantly high rates. Note that, as drawn in Figure 1, the revenue-maximizing rate on the specified and limited tax base is less than the comparable revenue-rate on the comprehensive base. This relationship must hold to the extent that substitutability is present at all between taxable and tax-exempt uses and sources.

The constitutional provision of some effective exit option, and hence some guarantee against fiscal exploitation in the micro as well as the macro sense, is perhaps the single most important advantage of tax-base specification relative to alternative forms of limits. The individual will, of course, reckon on the costs that may be involved in any exercise of such an option. In the absence of taxation, the individual will have some optimally-preferred pattern of earning and spending income. Given a categorical constitutionally defined distinction between taxable and nontaxable uses and sources, the preferred pattern for earning and spending will be modified. This adjustment must generate "excess burden" of taxation, as such, a burden that could only be eliminated if a genuine lump-sum levy could be imposed. The individual will surely recognize, however, that his potential willingness

to undergo excess burden, expressed indirectly through his shift away from his idealized pattern for "efficient" behavior, offers the most effective means of controlling government's natural proclivities to exact revenues. If no such behavioral escape route is possible, there may be no limits to government's fiscal exaction at all: government may appropriate virtually all income above subsistence, unless the individual's power over governmental decisions through the exercise of "voice" (e.g., voting) is effectively constraining. On the other hand and by contrast, with behavioral adjustment possible, there is a well-defined revenue-maximizing "solution," embodying rates of tax above which government could not be expected to go. Such behavioral adjustment thus establishes limits that operate independently of other constraints (such as voting) that may, or may not, be suitably binding.

Under existing conditions, with the governmental sector commanding as it does a major share of national product, the tax-base is necessarily broad. Hence, the behavioral adjustments that an individual must make to secure tax-exit options to any significant degree must impose major costs. These costs should never be underestimated, but, at the same time, the availability of existing exit options should be jealously preserved, and, if possible, constitutionally defined and possibly extended. The very fact that some such

options exist, even if most taxpayers may never utilize them, generates utility to each and every taxpayer.⁶

VI. Equal Treatment for Equals

In Sections III, IV, and V above, we have argued that tax-base specification has the advantages of flexibility, enforcibility, and micro-protection by comparison with other familiar tax-limit alternatives. In this section, we shall examine what seems to be the major criticism of tax-base specification, namely, the introduction of differential tax treatment of otherwise equally-situated persons and, hence, the potential for violation of the long-acknowledged norm of horizontal equity--equal treatment for equals. If certain uses and/or sources of income are designated as bases for tax while other uses and/or sources are exempted, discrimination is necessarily introduced in favor of those individuals whose "natural" preferences and/or talents allow them differentially to take advantage of tax-exempt uses and/or sources.

⁶It is in this context that the popular statements to the effect that the average United States taxpayer "works for government" until a certain date in May of each year are somewhat misleading. In a sense, we "work for government" only because we choose voluntarily to earn income in a taxable manner. By shifting our behavior to nontaxable options, so long as these exist at all, we should not "work for government," and existing legal rules would not force us to work within the taxable umbrella. Under these circumstances, conscription is not accurately characterized as analogous to ordinary taxation. This institution becomes more analogous to taking in the legal meaning of this term.

Robert Nozick's clever "Tale of the Slave" is highly persuasive precisely because he fails to specify at what stage in the individual's progression from abject slavery to full citizenship in democratic polity the potential tax-exit option emerges. See Robert Nozick, Anarchy, State, and Utopia (New York: Basic Books, 1974), pp. 290-292.

Conversely, the structure discriminates against those persons whose preferences and/or talents make resort to nontaxable options extremely costly or even impossible. There is no self-evident normative basis upon which such tax discrimination can be made to seem legitimate.

Ex ante and ex post equity.--The initial response to such criticism reemphasizes the constitutional nature of the enterprise. In the idealized setting for constitutional choice, when alternative rules are evaluated, the individual cannot predict what his preferences or his range of talents and endowments might look like in future periods. At such a stage of choice, the individual knows not whether he will be a large or small consumer of alcohol or tobacco; he knows not whether he will be a wage worker or self-employed; he knows not his future talents as a do-it-yourself technician. In this rarified setting, therefore, a decision to designate specific bases for taxation as a means of controlling government's fiscal appetites cannot violate the horizontal equity norm ex ante. Since each person seems as likely as any other to exhibit relatively high or relatively low response to whatever might be chosen as tax bases, there is no discernible difference among persons in the expected shares of total tax costs.

Two objections may be raised against this putative defense of tax-base specification. First, it may be argued that

constitutional choices actually made in the real world do not and cannot emerge under the idealized conditions of the model. Individuals are not behind the thick veil of ignorance and/or uncertainty when constitutional rules are initially formulated or when they are changed. Individuals can identify their own economic positions in any current-period context, and they also have a good approximation as to what these positions might be in future periods. In such a setting, any designation of tax bases will tend to discriminate in favor of some groups and against others, and these groups will be identifiable at the time the constitutional choice is made.

A second objection advances claims for the relevance of ex post equity, as a norm for tax structure, even if the idealized conditions for individual constitutional choice should be met. This argument suggests that mere ex ante satisfaction of the horizontal equity criterion is not enough. If it were, a tax system based on a well-ordered lottery, in which say a few individuals randomly selected bore the full cost of public expenditure, would satisfy the horizontal equity test provided only that the selection were genuinely random. Tax treatment for "equals" conventionally interpreted, is taken to require that tax liabilities be "equal" in the meaningful ex post sense of the term. Hence, any setting up of designated and limited bases for taxation must introduce violation of the basic fairness precept.

Both of these objections are clearly relevant and important to the design of an idealized tax-share allocation scheme. Indeed, the constitutional demand for protection against micro-exploitation is clearly very close to the requirement for ex post horizontal equity.⁷ But the horizontal equity complaints about noncomprehensive taxation can easily be overdrawn. There will, in general, be many tax-base specifications all consistent with a given maximum revenue requirement, and some of these will clearly be more equitable than others. A tax on alcoholic beverages may raise the same maximum revenue as a gasoline tax, but since actual consumption of alcohol varies among individuals much more than does consumption of gasoline the latter would be preferred on horizontal equity grounds, and may be normatively ranked accordingly. More to the point here, however, the latter tax would also provide greater protection against individual exploitation, given the equal maximum-revenue assumption.

To put the point more generally, horizontal equity requirements are in fact totally consistent with tax-base specification as a means of limiting the power to tax. Indeed, tax-base specification can succeed in elevating horizontal equity notions to constitutional status, because protection against

⁷Restrictions on the power to "take," for example, are normally embodied in free constitutions, under "eminent domain" clauses and the like. These can be argued for equally on horizontal equity or micro-protection grounds.

micro-exploitation requires that differences in individual tax liabilities be minimized. More strikingly, a set of fiscal norms that specifies both a revenue limit and a broadness of base requirement may be expected to dominate any limits imposed by a narrower specification of the tax base alone, on horizontal equity, efficiency, and for that matter micro-protection grounds. The point that needs to be made here very strongly is that mere broadness-of-base requirements--whether constitutionally imposed or advocated postconstitutionally on normative grounds--are not enough, because they do not embody protection against equal exploitation of all citizens. Equally, a mere revenue (or maximum rate) limit is not sufficient to protect against exploitation of some individuals, in the absence of constitutionally-imposed horizontal equity requirements. So that, if we are restricted to a single constitutional rule--one which is clearly enforceable and which will secure reasonable micro-protection (that is, both reasonable horizontal equity and imposition of aggregate fiscal limits)--tax base specification emerges as the only satisfactory possibility. To insist on the undiminished pursuit of horizontal equity independently of whether or not some revenue restriction applies, as orthodox tax theory has done, is simply unacceptable from the constitutional perspective.

Of course, orthodox tax theory can also be criticized for its institutional naivete. Within the conventional approach, horizontal equity seems to be conceived as an intrinsically

compelling moral norm, the mere contemplation of which ensures obedience to it. No institutional restrictions, no constitutional bounds are taken to be required to ensure that horizontal equity is secured.

Perhaps the most difficult mind-set for late twentieth century man to eliminate entirely is the century-old conceptual model in which government seeks to promote such objectives as justice, fairness, and equity in the allocation of taxes and/or benefits. Once we take off these idealistic blinders, however, and model government in a realistic sense, with governmental decision-makers as ordinary persons like the rest of us, the objections to tax-base specifications that rest on the horizontal equity norm lose most if not all of their significance. While it must be acknowledged that the satisfaction of ex post equity could be better approached if taxes could be levied on a genuinely comprehensive base, hence, minimizing differentials in individual behavioral responses, would government elevate the equity norm to an important role in its actual operation? Would government treat equals equally if given access to a comprehensive tax base? If total exploitation of the comprehensive base could be prevented through imposition of some alternative tax or fiscal limit, is there any assurance that government will seek equity in tax-share allocation as an important objective of its policy? If government is modelled in such fashion

that equity would be important, all arguments for tax limits, in any form, may vanish.

At this point our whole discussion, in this conference and elsewhere, must ultimately reduce to the ancient debate between the idealists and the realists in political philosophy. How do we model the state and to what purpose?

There are at least three approaches, and these tend to get predictably confused. The state--politics--can be modelled as some idealized embodiment of "man, the social animal," as the setting for human interaction within which man, through fellowship with his peers, comes closest to realizing his potential for the "good life." Concern here is all about what the state should be.

Alternatively, the state can be modelled as a complex set of institutions within which persons interact in pursuit of their own objectives, and this model may be used as the basis for the derivation of empirically testable hypotheses in the standard scientific sense. Concern here is about how government actually behaves.

We have argued elsewhere that neither of the above-mentioned models is appropriate to normative issues of constitutional choice.⁸ If we are evaluating alternative sets of rules, we seek to model institutions of government

⁸See our papers, "The Normative Usage of Positive Economic Theory," forthcoming, International Journal of Law and Economics; and, "Predictive Power and the Choice Among Regimes," Typescript, Center for Study of Public Choice, VPI, May 1981.

not based on how persons in agency roles should behave, or even on how they do behave empirically, but, instead, in terms of how they might behave unless constrained.

VII. A Defense of Loopholes?

Tax-base specification does more violence to traditional precepts of normative tax theory than any alternative form of fiscal constraints. In a very real sense, the argument for tax-base specification (and limitation) turns orthodox norms of tax theory upside down. In presenting the constitutionally-derived normative argument against comprehensiveness in the bases for taxation, we stand accused of defending tax-base erosion and tax loopholes, both of which have been almost universally identified as undesirable features of modern fiscal structures.

As in Section VI, we should first emphasize the constitutional setting for our discussion. We suggest that constitutional specification of tax bases will necessarily limit government's fiscal appetites, and that acknowledged violation of the horizontal equity norm, ex post, may be a necessary cost of the institution. We have not, however, discussed the creation of tax loopholes postconstitutionally, either through gradual institutional innovation in response to existing tax structures or through successful legislative "tax reform" efforts of interest groups.

The distinction between constitutional adjustments to tax base, and postconstitutional creation of tax "loopholes" is fundamental here. As the extensive modern literature on so-called "tax-expenditures" emphasizes, strategically designed tax reductions (either in the form of credits or exemptions) can be means whereby government secures greater rather than less influence over the workings of the private economy. A tax exemption for expenditure on food, for example, can be the prime means whereby the government transfers resources to some favored group (in this case, farmers), and does so just as effectively as an explicit food subsidy will do.

A requirement with all constitutional arrangements that aim to limit budgeted public expenditures is that the natural governmental response simply to move expenditure items "off budget" must be checked. This is no less true with tax-base specification than with more explicit forms of revenue limitation. Indeed, one could claim that a prime virtue of constitutional specification of the tax base is that it renders tax structure manipulation infeasible: no change in the tax base, whether in the direction of increased broadness or of strategic narrowing is permitted. Under other forms of limit, constant monitoring of the tax-structure manipulation possibility would be a necessary part of effective enforcement.

Beyond this argument, however, it should be pointed out that the conventional case against tax loopholes, within the conventional setting (no revenue limit), is somewhat dubious.

That conventional case proceeds by arguing as follows: If a particular group succeeds, either via a new institutional innovation or via explicit legislative favoritism, in creating and exploiting a new tax loophole, an external diseconomy is imposed on all other taxpayers-beneficiaries, who must face either reduced rates of benefits or increased real rates of tax.⁹

However, the externality logic rests implicitly on the presumption that the budgetary situation prior to the emergence of the new loophole is in equilibrium for the taxpayer-beneficiary, in which case return to a new equilibrium after the loss in revenue will require either an increase in tax rates or a decrease in outlay or both. In the whole externality logic, there is no conception of government as a strategic actor in the process and no incorporation of the prospect that equilibrium for government may not reflect demands of taxpayer-beneficiaries. Once the continuing game between governmental fiscal decision-makers and the set of taxpayers-beneficiaries is modelled, the conclusions traced out above do not follow. A possible strategic response to the emergence of a new loophole, with the prospect for still others to emerge, would be a reduction in rates of tax, reduction that could possibly redound to the absolute benefit

⁹One of us explicitly developed the argument in this orthodox format. See James M. Buchanan, "Externality in Tax Response," Southern Economic Journal, 33 (July 1966), 35-42.

of all taxpayers, even to those who do not take advantage of the new loophole. In the net, after the governmental adjustment, the behavior of the initiator of the loophole may exert external economies rather than diseconomies on remaining taxpayers.

The point here may be illustrated in the elementary geometry of Figure 2. Assume, initially, a two-person world, A and B, whose demands for the tax-base are identical ($D_A = D_B$). The revenue-maximizing rate of tax is t ; each person faces the same tax liability. Assume now, that person B discovers a means of reducing his tax liability, either by some newly-found legal device or by successful legislative action. His demand for the base item becomes D'_B . The revenue-maximizing rate now becomes t' , clearly less than t . Individual A finds his tax liability reduced rather than increased by B's actions and government's response to this action. There will be an "equity cost" to A, of course, in that, after the adjustments, his share of total tax liability ($t'Q'_A$) will be larger than B's share ($t'Q'_B$). In absolute terms, however, A's tax liability has been reduced. And if we assume that the budget was well beyond the equilibrium or desired size for the taxpayer prior to the creation of the new loophole, A may have benefited as well as B. Clearly, this result will emerge in the extreme case where A's marginal valuation of the public good financed by the tax revenues is zero over the relevant range. More

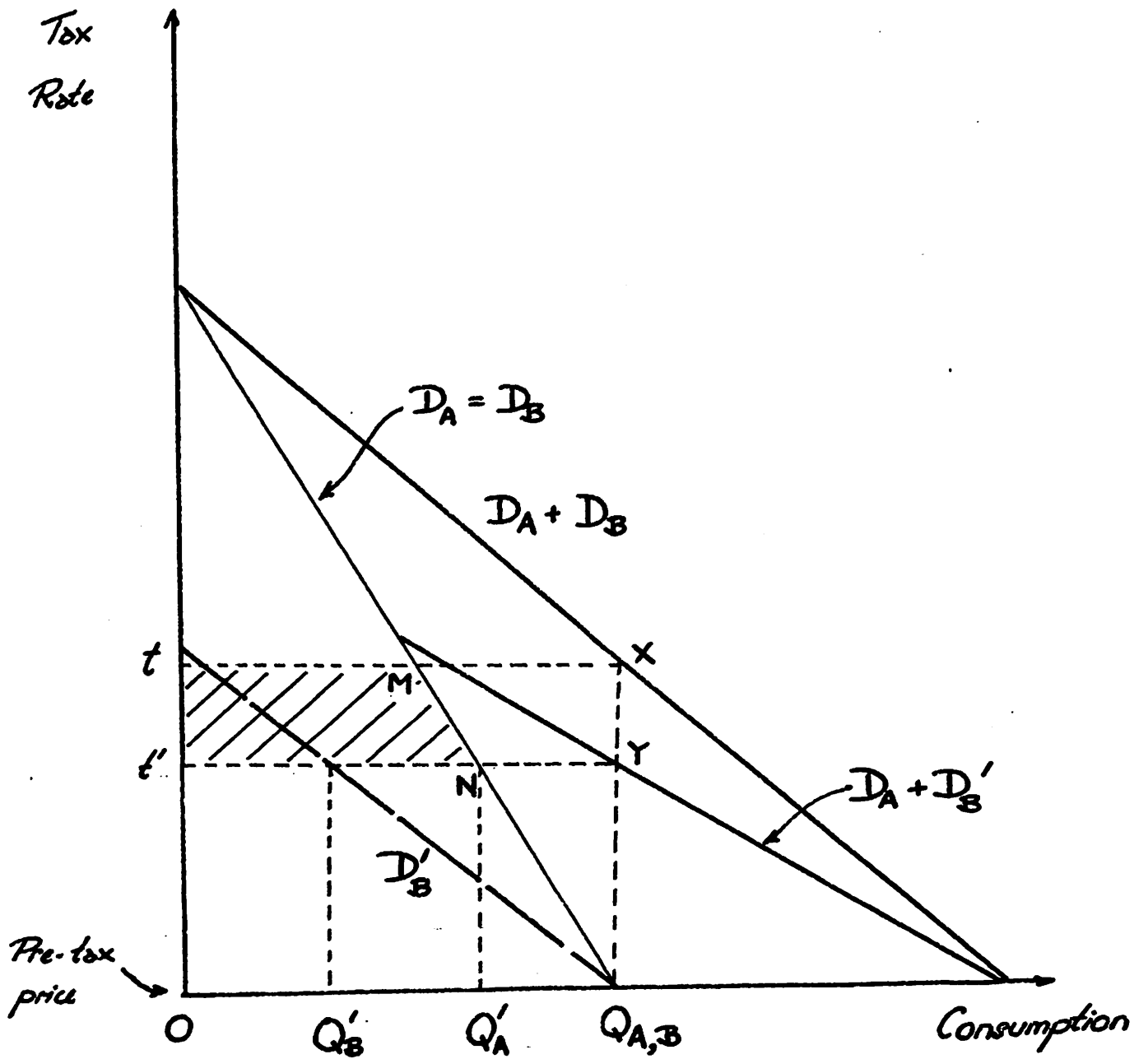


FIGURE 2

generally, A's gain from B's adjustment is the shaded area, $tMnt'$; A's possible loss is the value of the public goods that might have been financed by revenues lost in the amount $Q_A(t-t')$. If, over the relevant range, A's indirect marginal evaluation of the loss in tax revenue (via smaller public goods quantities) is lower than the direct marginal evaluation of personal tax payments secured, he will secure a net gain from B's action.

The general result here does not, of course, depend on government's setting of tax rates always at revenue-maximizing limits. So long as actual rates are above those desired by the taxpayers-beneficiaries, and so long as governmental response is in the direction indicated, the effects traced out in the model could be operative.

VIII. What Revenue Limit?

One of the analytic points to emerge from our book-length discussion of these issues has, it seems, been unrecognized in the limits literature. This is the point that where one would choose to set a revenue limit is not independent of the tax structure to be used to generate the revenue in question. Intuitively the reasons are clear. Presumably, one seeks to specify a limit related to some imagined maximal level of desired public expenditure--a level that will of course take account of the cost of providing desired public goods. This cost will, in turn, depend not only on the

physical costs of producing battleships, police services and the like, but also on the costs in terms of funds misappropriated, misspent or inefficiently applied within the bureaucratic delivery system. And it must also include the costs involved in raising the revenue: the administrative and compliance costs involved in operating the tax system, and the "excess burden" involved in raising the revenue. All these costs will vary according to the particular tax system used. Accordingly, where the revenue limit is to be imposed--whether at x per cent of GNP or $(x + a)$ per cent--cannot be specified until after the tax system. We require, in other words, a prior specification of the tax base and rate structure.

Now, as we have already noted, a tax specification on its own is not the most efficient or most equitable form of limitation. But it is at least internally complete. Any tax arrangement specified can be investigated as to all its relevant properties, including its maximum revenue limits. And the maximum revenue limits applied can be chosen to be consistent with the tax costs implied by that tax system.

In the revenue or rate limit cases, the limit may be excessively stringent or absurdly generous depending on the particular tax system that happens to prevail. In fact, whether a maximum revenue limit is applied explicitly or not, tax base and rate structure specification seems to be required,

If there is a maximum revenue limit, we can proceed to specify tax arrangements, perhaps in the light of conventional criteria, and determine the appropriate maximum revenue limit thereby. If no explicit revenue limit is imposed, then tax arrangements will need to be chosen not so much by reference to conventional criteria, but rather with an eye to maximum revenue potential.

IX. Analysis and Advocacy

In presenting this paper, we have responded explicitly to the request of Craig Stubblebine that we defend tax-base specification as a means of limiting the fiscal overreach of government. Presumably, we were assigned this role because the argument in our book, The Power to Tax (1980), lends support to this institutional instrument. At one level of analytical argument, which we hope to have been able to convey in this paper, we should defend tax-base specification over alternative forms of fiscal limits. We should emphasize, however, the critical distinction between analysis and advocacy. At a level of advocacy, we do not want our own analytical argument in favor of tax-base limits to undermine possible support for other forms that may be proposed, in this conference and elsewhere. We would assume positions as advocates of almost any effective means of limiting the fiscal powers of modern government, provided that these means be constitutional in nature.

We should emphasize the categorical distinction that must be made between constitutional and legislative efforts to impose fiscal limits, and we think it is a serious delusion to expect that existing political processes can be depended upon to correct structural biases that are inherent in the institutions of governmental decision-making. For those of us who are advocates of any of the forms of constitutional limits, we should look upon the debates over monetary rules as precautionary tales. We should not allow particular concern for this or that form of limit to detract attention away from the urgent necessity to get some limit, indeed almost any limit imposed. We surely do not want to become the fiscal analogues to the "gold bugs" and their adversaries who debate so violently about their own pet monetary arrangements that the no-constitution alternative continues to win by default. The overriding principle is that fiscal limits are needed; the form that these limits take becomes of secondary importance.

At this level of consideration, potential acceptability by the public becomes important, indeed critical, in choosing among the alternatives that may be analytically defended. When this aspect is recognized, we should argue that the budget-balance proposal dominates all others. This proposal can be brought under the tax-base specification umbrella if the balance-budget requirement is interpreted as denying

to government the taxing power implicit in debt-creation. A further step would close off the money-creation option, a second major revenue source that government seems increasingly to utilize. Indeed, if government should be denied access to borrowing and to money issue, further tax-base specification would become much less important.