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Tax Rate vs. Tax Base: A Public Choice Perspective on the Consequences for the Growth of Government

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In recent years, as libertarian policy analysts have put their minds to the question of tax reform, some have succumbed to the lure of a broad-based, proportional, or flat, income tax. Under these proposals, the current progressive multirate structure would be replaced by a single rate that would apply to all taxpayers. Moreover, all forms of income would be taxed; in other words, an attempt would be made to create a "perfectly" broad tax base. The current income tax, of course, does not cover all types of income: Nonmonetary fringe benefits are untaxed; income that goes for interest on a home mortgage is untaxed; and so forth.

Those attracted to a broad-based flat tax cite several reasons for believing that it would be an improvement over the current structure. Most of the reasons are standard. They include the assertion that such a tax would be more "neutral" with respect to the outcome of economic processes, exerting less influence on particular aspects of people's economic behavior. It is also argued that a broad-based flat tax, because of its simplicity, would reduce taxpayer compliance costs. Today many people hire accountants and lawyers to fill out their tax returns. This, it is argued, diverts resources from more productive employments. These arguments are essentially based on economic considerations. While we would argue that the economic case for broadening the tax base is founded on unreasonable and in some cases illogical economic principles, it is not our pur-

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pose to address these issues in this essay. Our analysis concerns what is offered as the "libertarian" case for base broadening.[1]

Base-broadening has in fact taken precedence over lowering revenue, as evidenced by a willingness to accept a simplified, broadened tax even if it means no reduction in revenue, that is, revenue neutrality.[2]

Why is this trade-off accepted by some libertarians? The answer rests on strategic concerns. Flat-tax advocates maintain that a broad base would give rise to "taxpayer solidarity" in the struggle to reverse the growth of government power. According to this argument, if everyone's income is subject equally to a single tax rate all taxpayers will see themselves as in the same boat. Thus they will resist efforts to increase taxes and, moreover, abstain from political profit-seeking because they themselves will have to pay. As libertarian tax analyst Jule Herbert writes in a recent essay for the Cato Institute, "It is suggested that a broad-based, indexed, proportional income tax would put all taxpayers in the same position relative to the taxing side of the tax and expenditure process. The resultant political cohesion may be termed 'taxpayer solidarity.'"[3]

There are several problems with this notion. The most obvious is that it flies in the face of the well-developed tenet of public-choice analysis that focuses on the implication of concentrated benefits and diffused costs for the growth of government. The principle states that any political system is biased toward expansion because, as Buchanan and Tullock write, "Almost any conceivable collective action will provide more benefits to some citizens than others, and almost any conceivable distribution of a given cost sum will bear more heavily on some individuals and groups than on others."[4] The benefits will be concentrated on a smaller well-organized group, giving each member a relatively large return; the costs will be imposed on a larger unorganized group, extracting a relatively small proportion from any individual member.

Ironically, Herbert cites this principle. He writes, "Since each program adopted provides a substantial benefit to a well-defined group while imposing small relative costs on individual taxpayers, the system is prejudiced toward increasingly higher spending. In short, benefits are particularized; costs are generalized."[5]

Herbert then curiously enlists this principle in defense of a broad-based tax. But he misses the mark. His complaint about the current system is that political profiteers can push the cost of their favors on to a subgroup of taxpayers, which leads to higher government spending and taxes. It is our contention that base-broadening would exacerbate this problem. It would enable political profiteers to push their costs on to an even larger, more poorly organized group of taxpayers, further dispersing the costs, while leaving the special-interest benefits intact. How is it that despite what seems to be an awareness of this public-choice insight the "taxpayer solidarity" argument is supported? The answer can be found in one sentence from Herbert's essay. "As long as concentrated *spending interests* are pitted against *diffused taxpayer interests*, it is likely that spending and taxing will increase."[6] Herbert had previously stated the public-choice insight correctly, but at the critical point where he moves to his conclusion, he subtly contorts it.

The problem is not that concentrated spending interests are pitted against "diffused taxpayer interests," but rather that the costs of serving the spending interests are "diffused"—spread thinner—while the benefits are concentrated. The standard public-choice argument is not in terms of concentrated versus diffused "interests" but in terms of concentrated *benefits* and diffused *costs*.

To see this important difference, imagine first a society of 100 million taxpayers who make their living raising sheep and who pay a flat tax on all income. Next imagine the same 100 million taxpayers working at different jobs and paying a narrow-based tax that hits different kinds of income differently. In the first case, the taxpayers could be said to have a concentrated interest because they do the same kind of work and they pay the same tax. The second group would appear to have diffused taxpayer interests. Yet, under public choice theory, a given tax increase would be easier to impose on the first group than the second, other things equal, because it would be spread more thinly. The more thinly a tax increase is spread, the smaller the expense to any single member and thus the higher the costs relative to the benefits realized in successfully opposing it. Conversely, the more concentrated the increase, the greater the expense to a single member, and thus the lower the costs relative to the benefits realized in successfully opposing it.

Diffused taxpayer interests could actually militate against tax and spending increases because this diffusion results in smaller groups with similar interests, each of which is more easily organized than larger groups with similar interests. Indeed, given this proper interpretation, libertarian policy analysts ought to want to reform the system so that concentrated political profiteers are resisted by concentrated potential costbearers.

Another dubious point is contained in Herbert's sentence cited above. To reiterate, "It is suggested that a broad-based, indexed, proportional income tax would put all taxpayers in the same position relative to *the taxing side of the tax and expenditure process*. The resultant political cohesion may be termed 'taxpayer solidarity.'"

This is arbitrarily and unjustifiably selective in its focus. A distorted picture is bound to emerge if one looks only at the "taxing side of the . . . process." A far different picture emerges when the spending side is added. (As Herbert wrote a page earlier, "Taxation is but one side of a larger *tax and expenditure process*." His emphasis.) Under a low broad-based flat tax, a political profiteer will not abstain from seeking a subsidy merely because he, along with everyone else, will have to pay more in taxes. He will compare his (necessarily) small share of the tax increase to the expected benefits of the subsidy. If the benefit exceeds the cost, he will forge ahead. It is unimportant that all taxpayers are alike on the taxing side of the tax and expenditure process if they are not alike on the spending side. Why should a political profiteer be in solidarity with the mass of taxpayers who won't receive the benefits? In fact, broadening the base may reduce his share of any additional tax levy, making the potential benefits more attractive.

Imagine that a perfectly broad-based flat tax is passed. What are the likely results? Since by definition such a tax is one in which the costs of government are diffused to the largest extent possible, we can expect the public choice insight to be manifest with a vengeance. The results can be expected to be those described by Herbert:

> It is virtually impossible for an individual taxpayer to determine his taxed share of any government project and, even if he could, he would find his share very small and not worth fighting over. But the value of a project to a bureaucrat (it is his career) and to government contractors (their livelihoods depend on it) can be determined and certainly explains their support for the project. These people can be expected to spend a great deal of time and money lobbying on its behalf. The average taxpayer thus remains ignorant of the whole affair and would not get involved even if he knew the facts of the matter.[7]

Precisely! Yet if this is true today, think how much more it would apply with a broadened base. A tiny increase in the tax rate would yield large sums of money, yet the increase to any given taxpayer would be small—too small to motivate the average taxpayer to actively oppose it. This would be a case of truly diffused taxpayer interests, because the per-capita increase would be too small to produce any significant cohesion. On the other hand, the large sum raised would be concentrated on small well-organized groups that would have a major incentive to lobby and otherwise engage in political profiteering. The theory discussed here distills a nearly self-evident point: Assume a flat tax on a perfectly broad base. Next assume that someone proposes a small tax increase—say four-tenths of a percent—to increase federal aid to education and to repair the interstate highway system. The tax hike would be touted as a small, fair levy ("everyone will pay it") to improve the schools and the roads. Most taxpayers who bother to think about it will conclude that the increase for each will indeed be small—too small to even study the issue to any extent and join a protest against it.

On the other hand, some groups will calculate that the benefits for their members will heavily outweigh the costs. Who? The teachers unions and the asphalt manufacturers, to name two. As pressure groups, they have long committed the resources needed to lobby for such legislation. They have no reason to be in solidarity with any taxpayers who oppose the tax. Moreover, they will be able to win over taxpayers to their side by convincing them that improving the schools or roads in their particular districts is worth the tax increase. We can count on these groups to dominate the production of information about legislation. Since they have such a large economic stake in the outcome, they will naturally devote their resources to propaganda. In contrast, if the tax increase is due to fall on another small, self-conscious group (with high cost to each individual), we can expect that group's resistance to be on the order of the proponents' support. With so much to lose, the members are more likely to galvanize against the increase.

Proponents of taxpayer solidarity through base broadening have the burden of explaining why their system would not intensify the process Herbert and his colleagues describe. To date they have merely asserted their belief without showing why the public choice insight is suspended in the case of taxes.

Herbert writes, "If progressive tax rates within a democratic system have an inherent bias resulting in higher taxes than would otherwise be the case, then it must be admitted that changing the rate structure to flatten it or to institute a proportional tax system will result in increased political pressure to reduce overall burdens."[8]

Interestingly, this description of the tax says nothing about the tax base, though it is a critical element. Taken literally—without reference to broadening the base—the point is still dubious. It is not clear that you would have more cohesion with a single rate; large groups are harder to organize than small groups—remember the free-rider problem. But Herbert presumably means to include a broad base in this tax. So what he claims must be admitted surely need not be admitted at all! If a less-than-broad-based tax has led to increased government spending and taxes, then a broad-based tax is likely to do even worse. The only thing that must be admitted is that assurances against the growth of government perhaps cannot be built into the tax system; other methods must be found.

Buchanan and Tullock suggest two ways in which the tax system could be changed to avoid the problem at hand. They write, "One means of modifying organizational rules so as to produce results akin to those that would be produced under truly 'general' legislation [that is, where costs for any individual are the same as the benefits] would be to require that those individuals and groups securing differential benefits also bear the differential costs."[9] This clearly departs from the standards embodied in a flat broad-based tax.

Later they go further: "One means of eliminating this sort of distortion [namely, the imposition of "excessive costs" on the whole population for the benefit of pressure groups], which may appear somewhat farfetched because it is novel, would be to require that all such [government] projects be financed out of taxes levied on *specific groups* [emphasis added] in the total population, although *not* on the same group securing the benefits. . . . Excessive external costs would be substantially reduced in this manner, and something roughly similar to the pattern of 'general' legislation would emerge."[10]

What they are saying is that if benefits are concentrated, the best way to restrain the growth of government is to make sure that costs are also concentrated. The point is clear: Careful application of the insight regarding concentrated benefits and diffused costs undermines any claim that a flat broad-based tax would create effective "taxpayer solidarity" and work against the growth of the state.

NOTES

1. It is important to note that libertarian advocates of the flat broad-based tax believe that the rate question and the base question are inseparable. They reject out of hand the suggestion that the base be kept narrow (if not made more narrow) and the rates be cut. Arguing that historically rates and base have gone together, they present the two elements—flattening the rates and broadening the base—as a worthwhile exchange: "loopholes" for lower rates.
2. See Jule R. Herbert, Jr., "An Agenda for Tax Reform" in *Beyond the Status Quo* (Washington, D.C.: Cato Institute, 1985), p. 42. All quotations from Herbert are from this article.
3. Ibid., p. 41. For an endorsement of this position, see Jeffrey C. Smith, "The 10/10/10 Plan: Combatting Corporate Capital Punishment," Citizens for a Sound Economy *Issue Alert*, No. 5, Nov. 4, 1985. As an aside, indexing would be superfluous under a single-rate tax, since there would be no tax brackets for taxpayers to be bumped up to as inflation increased their nominal incomes.
4. James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962), p. 291.
5. Herbert, note 2, p. 40.
6. Ibid., p. 41. Emphasis added.
7. Ibid., pp. 40–41.
8. Ibid., p. 42.
9. Buchanan and Tullock, note 4, p. 292.
10. Ibid., p. 294.