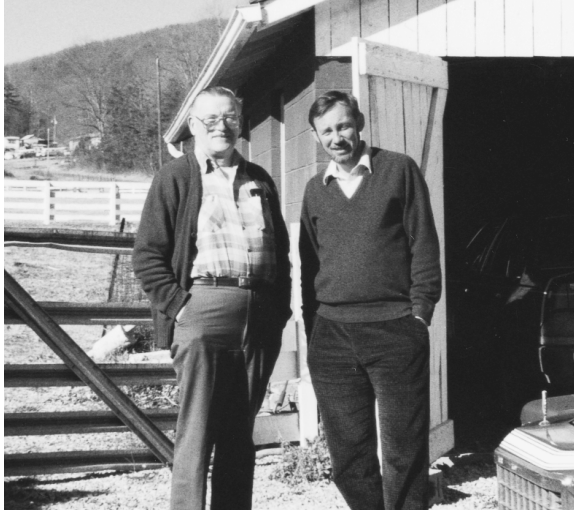


The Collected Works of
James M. Buchanan

VOLUME 9
The Power to Tax



*James M. Buchanan and Geoffrey Brennan,
Blacksburg, Virginia, 1989*

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James M. Buchanan

VOLUME 9
The Power to Tax
Analytical Foundations of a
Fiscal Constitution

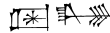
Geoffrey Brennan
and
James M. Buchanan



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C'est une expérience éternelle que tout homme qui a du pouvoir est porté à en abuser; il va jusqu'à ce qu'il trouve des limites.

—Montesquieu, *De l'Esprit des Loix*

The power to tax involves the power to destroy.

—Chief Justice John Marshall, *McCulloch v. Maryland*

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Foreword

The Power to Tax was a book waiting to be written.¹ This is so not just because the tax revolts sweeping across the United States in the late 1970s cried out for an analytic interpretation that orthodox public finance was apparently incapable of providing. Rather, *The Power to Tax* was waiting to be written in the more academic-intellectual sense that the Leviathan approach to taxation filled a logical gap in the array of approaches available at that time. In this sense, *The Power to Tax* represents a kind of tent peg—or logical compass point—in the intellectual territory that tax theory marks off.

As of 1980, there were on offer two broad approaches to normative tax analysis. First, there was the approach provided by the family of orthodox public finance models. The characteristic feature of these models was the direct application of normative criteria to tax arrangements—sometimes, derivatively, to particular taxes, but, more commonly, to the tax system as a whole. Within this family, there were distinct strands. The two most important of these were the more traditional Musgravian strand, derived from R. M. Haig, Henry Simons, and Georg Schanz, in which the central ambition was the achievement of an equitable tax system based on ability to pay; and the so-called optimal tax approach, which involved the direct application of the utilitarian normative scheme to tax design questions. There were other, less common variants, but all variants shared the implicit benevolent despot assumption about the operation of political processes. Effectively, political constraints were ignored in the determination of tax policy (the despot aspect); and policymakers were assumed to be driven solely by the

1. Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (New York: Cambridge University Press, 1980), volume 9 in the series.

desire to “do good” as the public finance policy advisor would discern it (the benevolence aspect).

The second approach of orthodox public finance models on offer was the public choice one. The distinguishing feature of this approach was the rejection of the benevolent despot model of public finance orthodoxy: a formal model of political process was to be an explicit part of any satisfactory approach to taxation, and the actors within any such model had to exhibit the same motivational patterns as were ascribed to taxpayers. Again, there are a variety of strands within this family, many of them derived from Buchanan’s own work. One broad division is between those models that treat taxes as essentially *endogenous*—that is, as themselves emerging from political determination—and those that treat taxes as *exogenous*, affecting political outcomes but themselves determined through some other process. For example, in the former camp lie the original Knut Wicksell and Eric Lindahl models. In the latter lies James M. Buchanan’s approach in *Public Finance in Democratic Process* and in the papers contained in part 2 of volume 14 in the *Collected Works, Debt and Taxes*.²

We can, on the basis of this broad categorization, picture the public choice approach and public finance orthodoxy as lying at opposite ends of a two-dimensional spectrum reflecting the underlying political models in play. The two dimensions of this spectrum reflect, on the one hand, the degree of political constraint and, on the other hand, the motivational assumptions made about political agents—the degree of despotism and the degree of benevolence. In this sense, we could imagine a two-dimensional map of intellectual possibilities, within which various accounts of taxation policy might be located. However, this notional map only had the two possible polar extremes in action: the map lacked, as it were, a cornerpost. And it was that cornerpost that the Leviathan approach to taxation, which *The Power to Tax* laid out and developed, sought to supply. The underlying motivating question was simple: Why not borrow the motivational assumptions standard in public choice theory and put them together with the assumptions about policymaker discretion taken from public finance orthodoxy? One could then

2. James M. Buchanan, *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice* (Chapel Hill: University of North Carolina Press, 1966), volume 4 in the *Collected Works*.

develop an account of preferred tax policy within that hybrid political model. After all, there is available on the shelf in mainstream economics an extremely familiar model of the exercise of discretionary market power—namely, the standard model of monopoly. Why not adapt that familiar model to the tax context? Responding to that possibility gave rise to the model of the revenue-maximizing Leviathan—and the derivation of a tax constitution specifically in the face of a Leviathan government.

It is difficult now, some twenty years later, to be confident as to what exactly the authors' motivations and expectations for this model were. There is no doubt that at some level the mere exploration of logical possibilities for its own sake initially played some part. But two general considerations also weighed. The first was the force of the public choice insistence that the same basic motivational assumptions should be ascribed to market agents and political agents. The second consideration was that, as a matter of casual empiricism, it seems clear that policymakers have some discretion over policy choice: it is difficult otherwise to explain a market for policy advisors. Putting these two general considerations together leaves the Leviathan model as the logical outcome.

The interesting aspect in the development of the model was its capacity to turn so many of the traditional nostrums of tax orthodoxy on their heads.³ Moreover, the Leviathan model lent support to some of the more legally derived tax desiderata, such as the absence of retrospectivity, which are difficult to derive from the standard public finance approach. (Specifically, an unexpected retroactive increase in taxes would generate revenue in an efficient way because there would be no behavioral response among taxpayers and, hence, no inefficiency generating substitution effects.) The effect was that the Leviathan approach was construed by critics as a wholesale attack on public finance orthodoxy, both directly by questioning the orthodoxy's central claims and indirectly by exposing its ambiguous stand on issues like retroactivity. Probably for this reason, *The Power to Tax* proved a controversial book.

3. The initial summary statement of the central analytics was in article form. See Geoffrey Brennan and James M. Buchanan, "Towards a Tax Constitution for Leviathan," *Journal of Public Economics* 8 (December 1977): 255–73; see also volume 14 in the series, *Debt and Taxes*.

Interestingly, one of the grounds for criticism—or for treating the arguments in the book as irrelevant and therefore ignoring them—was that the model of politics implied was implausible. That such a claim should issue from proponents of public finance orthodoxy is more than a little ironic, since models of politics, plausible or otherwise, play no role in that tradition. But the truth is that *The Power to Tax* is not a model of *politics* so much as it is a model of political agent *motivation*: To the extent that there is a model of politics here, it is borrowed directly from public finance. This is the model of the despot but here an egoistic despot rather than a benevolent one.

Conceivably, as an expositional matter, it may have been better to attempt a reasonably elaborate model of dictatorial government, with a clear specification of the constraints to which such a government is likely to be subject—for example, the need to buy the support of salient groups (including the military), the need to suppress those who might otherwise launch a coup attempt, and so on. Alternatively, the analysis might have been lodged formally within one of the standard public choice models of democracy with imperfectly constrained political agents, such as the strategic-agenda-setter model or the Niskanen bureaucracy model. But each of these courses ran the risk of cluttering the central argument with material that was not absolutely central and of disguising the simplicity of the core logical claims. What *The Power to Tax* provides is a monopoly model of government, with the emphasis on the monopoly connection and with the simple analytics designed to underline the monopoly analogue. The thought was that the central messages would be more arresting if derived from a model of the behavior of a discretionary agency that most readers found familiar—so familiar, indeed, as to be almost unquestionable.

The reception to *The Power to Tax* was so vehement and the authors' purpose so misunderstood that the ink was scarcely dry before it became necessary to begin an exercise of clarification and defense of the whole approach. This exercise initially took article form, but eventually emerged as a more detailed account of the whole constitutional paradigm in *The Reason of Rules*.⁴ Of course, there is no sense in which the constitutional approach

4. For example, Geoffrey Brennan and James M. Buchanan, "The Normative Purpose of Economic 'Science': Rediscovery of an Eighteenth-Century Method," *International Review of Law and Economics* 1 (December 1981): 155–66, and Geoffrey Brennan and James

presupposes Leviathan government. But, equally, there is no point in constitutional rules if those rules only prevent wholly benevolent persons from doing good. And there is no point in constitutional rules other than simple majority rule if majority rule robustly ensures maximally desirable outcomes. The whole point of fiscal rules (or fiscal norms), whether of the kind derived in orthodox public finance or the kind derived from the Leviathan model or other variants of the public choice approach, is that the rules or norms operate to support better overall outcomes than would prevail in their absence: they necessarily operate in the face of other, imperfect institutional devices. In this sense, what is possibly surprising about the Leviathan approach is how much it shares with orthodox public finance and, for that matter, with the orthodox theory of the state (in which connection, see Anthony de Jasay's *The State*, which also treats the state as a monolithic actor).⁵ Specifically, both approaches share a similar presumption about the degree of political agent discretion and a similar presumption about the desirability of politically independent fiscal rules. Where they differ is that in *The Power to Tax* tax policymakers and taxpayers have identical motivations, whereas in the orthodox approach, tax policymakers and taxpayers have utterly different motivations. In this sense, *The Power to Tax* is clearly in the public choice tradition: the insistence on motivational symmetry is a characteristic feature of the public choice approach, and it is in this dimension that *The Power to Tax* and the orthodox public finance approach diverge.

Geoffrey Brennan
Australian National University
 1998

M. Buchanan, "Predictive Power and Choice among Regimes," *Economic Journal* 93 (March 1983): 89–105; both articles are in *Economic Inquiry and Its Logic*, volume 12 in the series. Geoffrey Brennan and James M. Buchanan, *The Reason of Rules: Constitutional Political Economy* (Cambridge: Cambridge University Press, 1985), volume 10 in the series.

5. Anthony de Jasay, *The State* (Oxford: Basil Blackwell, 1985); republished by Liberty Fund in 1998.

Geoffrey Brennan

The Power to Tax is, I think, demonstrable proof of the value of genuine research collaboration across national-cultural boundaries. Geoffrey Brennan, as a golden-voiced “wild colonial boy” from Down Under, joined our research team in Blacksburg in the 1970s, and his enthusiasm quickly spilled over and generated joint efforts. We discovered that along many, but not all, dimensions of discourse, we were on the same wavelength.

The Power to Tax is informed by a single idea—the implications of a revenue-maximizing government. The origins of the idea emerged first in a paper that we agreed to write jointly for a *festschrift* for Joseph Pechman. Once the idea existed, the book, more than any other of my experience, simply wrote itself. Perhaps, in part, this is how it seemed only to me, since Geoffrey Brennan was the coauthor who provided much of the sometimes difficult technical construction.

James M. Buchanan
Fairfax, Virginia
1998

Preface

The success of Proposition 13 in California was one of the top news stories of 1978, and many commentators interpreted this success as the first major step in a genuine “tax revolt.” Politicians seeking either to attain or to maintain elective office were quick to accept such an interpretation, and the political rhetoric of the late 1970s suggested that the era of explosive governmental growth may have been coming to an end.

These events went on about us as we were writing this book. At times we felt as if we were being swept away by political developments that threatened to reduce our efforts to little other than academic exercises, a fate that was not our initial intent. We can, of course, claim some credit for having established our position on the ground floor, so to speak, for having undertaken a specific analysis of constitutional tax limits well before the dramatic events of 1978 took place. And we can, more constructively, argue that this book represents the first serious economic analysis of tax limits, a subject that has been predictably neglected by economists.

Nonetheless, there remains the lingering concern that this is a book that might, ideally, have been completed two years earlier. To offset this concern we are buoyed in the prospect that a book whose time has clearly arrived may be more readily accepted than a book whose message antedates its topicality. Had this book been published in 1960 or in 1970 it probably would have fallen stillborn from the press. It should not suffer such a fate in 1980.

Both of us are public-finance economists, despite our various excursions into the territories of ethics, law, politics, and philosophy. This book marks a return to the fold, but not without our having been very substantially influenced by the detours. The analysis, both in its positive and its normative aspects, lies well outside the limits of orthodox fiscal economics. Our initial efforts were prompted by our growing disenchantment with economists’

treatment of taxation and tax reform. This treatment seemed to us to have become increasingly irrelevant, in terms of both its explanatory content and its normative potential. In this respect, the events of 1978 reinforced our initial motivation. The orthodox analysis provides neither an understanding of observed fiscal process nor a basis for improvement on grounds that are acceptable to the taxpaying public.

The normative standards in our analysis are based on the calculus of the potential taxpayer-beneficiary, who is presumed able to control government's "power to tax" by a constitutional selection of tax arrangements that are anticipated to serve his own interest. This approach is contrasted with the more familiar objectives laid down for taxation, such as the promotion of "social welfare," "social utility," or "public interest" without regard for political implementation. As our subtitle suggests, we adopt the *constitutional* perspective, in which the taxpayer is presumed to be unable to identify his own position, either as taxpayer or as public-spending beneficiary, in a sequence of separate budgetary periods. The constitutionally selected structure of taxation may be, and normally will be, quite different from the "in-period" tax-share distribution that might conceptually emerge from some idealized fiscal exchange in the Wicksellian sense.

The methodological-analytical setting is familiar, at least to those who are cognizant with the literature in modern public-choice theory. The constitutional perspective for the choice of institutions has been elaborated by one of the authors in several works, and, more generally, it has been made familiar to many scholars of the 1970s through the work of John Rawls. Where the argument of this book diverges most sharply from almost all previous analysis lies in the predicted workings of the political process in the postconstitutional sequence. We analyze the properties of the political process under the assumption that citizens exercise relatively little control over governmental fiscal outcomes except at the initial constitutional decision stage, where the basic fiscal arrangements are chosen. More dramatically, and more controversially, we model government as a revenue-maximizing Leviathan. We argue that both aspects of our political model gain some plausibility in this era of apparently uncontrollable budgets. Further, and much more important, we argue that our model is the appropriate one upon which to construct reasoned discussion of constitutional alternatives. The current discussion of constitutional tax limits suggests that there is widespread public

agreement with at least some central elements of our model of politics. Even for those who categorically reject our formal model of politics, however, the constitutional norms laid down may possibly prove acceptable as embodying a minimax strategy aimed at securing protection against the worst outcomes that might emerge.

We shall discuss the basic constitutional perspective in Chapter 1. In Chapter 2, we develop our model for the working of the political process that will be used for the later analyses. Chapter 3 examines the choice calculus of the potential taxpayer as he confronts alternative rate and base constraints. Chapter 4 extends the analysis to commodity taxes. Chapter 5 extends the analysis intertemporally and specifically introduces capital taxation and public debt. The revenue implications of the money-creation power, including (but not exclusively) the power to use inflation as a means of taxation, are analyzed in Chapter 6. In Chapter 7, the focus is shifted toward possible modification of the incentive structure to ensure that tax revenues are actually spent on providing goods and services valued by taxpayers. Chapter 8 discusses the whole domain of politics, with specific reference to fiscal versus nonfiscal constraints on governmental activity. The structural order of federalism as a means of constitutionally limiting government's fiscal powers is examined in Chapter 9. In Chapter 10, we attempt to relate our analysis to the current proposals for constitutional tax limits, and we suggest necessary avenues for authentic fiscal reform.

Acknowledgments

We expressly thank all of our colleagues at the Center for Study of Public Choice, VPI, particularly Professors Robert Tollison and Gordon Tullock, for providing an atmosphere within which genuinely radical ideas are nourished rather than drowned at birth in either technical detail or methodological straitjackets. We also gratefully acknowledge financial support from the National Science Foundation and the Olin Foundation, which has allowed us time to develop our ideas free from at least some of the standard academic pressures.

We are especially appreciative of the help of Professor Charles Rowley, University of Newcastle, who, during his visiting stint at the Center in 1979, painstakingly read and criticized the manuscript chapter by chapter. The "re-

search team” of Cecil Bohanon, Richard Carter, and David Nellor was essential to our efforts. Members of this group provided not only editorial, stylistic, and bibliographical assistance but also very constructive analytical and substantive criticism. George Uhimchuk was both cooperative and reliable in helping with many stages of the processing of the final manuscript. Donna Trenor was cheerful and efficient in typing several early drafts. And, of course, Buchanan’s books could never get written, or be got right, even with a coauthor, without the assistance of Mrs. Betty Tillman Ross.

Geoffrey Brennan
James M. Buchanan
Blacksburg, Virginia

The Power to Tax

1. Taxation in Constitutional Perspective

The interest of the government is to tax heavily: that of the community is, to be as little taxed as the necessary expenses of good government permit.

—J. S. Mill, *Considerations on Representative Government*, in *Essays on Politics and Society*, vol. 19, *Collected Works*, p. 441

This book is about government's power to tax, how this power may be used, and how it may be and should be constrained. The set of issues that we address has been almost totally neglected by public-finance economists. Their concern has been with telling governments how they should tax, how the taxing powers should be utilized. Both the positive analysis of tax incidence and the normative derivation of tax principles have had as their ultimate objective the proffering of advice to governmental decision makers.

We offer no such advice, either directly or indirectly. Our concern is neither with telling governments how they should behave if revenues are to be raised efficiently and/or equitably nor with telling them how public monies should be spent. At this level of discourse, our analysis is necessarily more positive. We introduce models of how governments do behave or how they may be predicted to behave (regardless of the advice that may be advanced by public-finance economics). The subjects of our ultimate normative concern are taxpayers or citizens—all those who suffer the burdens of taxation or who are the potential subjects of government's powers of fiscal exaction.

The stance taken in this book embodies presuppositions about political order that are not necessary in the traditional analysis. For the latter, in order to proffer advice to governments, the minimal requirement is that government