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PUBLIC FINANCE AND PUBLIC CHOICE

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Abstract - *This paper explores the contribution that public choice models can make to the traditional efficiency and distributional analyses of tax policy. It notes the relative lack of attention to political economy issues in public finance, at least in comparison with other policy-oriented subfields in economics. It then discusses two key insights that emerge from public choice models of taxation. The first is the notion that different tax systems may be associated with different opportunities for political rent seeking, and the second is the possibility that actual tax systems equate the marginal political cost of raising revenue from different tax instruments, rather than the marginal efficiency cost. The paper concludes with a brief discussion of the role of traditional efficiency and distributional analyses in contributing to tax policymaking, even in a political world.*

Most applied tax policy research addresses the efficiency costs of different tax rules, the behavioral effects of taxation, or the distribution of gains and losses associated with a switch from one tax policy to another. There is usually little accompanying discussion of how and why various tax policies are adopted. While most researchers would readily admit that political factors are a fundamental determinant of the tax system, and some with policymaking experience might say “it’s all politics,” the implications of this insight receive relatively little attention. Brennan (1984) argues that this derives in large part from the intellectual origins of applied tax policy research in the work of Smith, Ricardo, and Marshall, rather than in work of continental “public goods” scholars such as Wicksell and Lindahl.

In contrast to the limited emphasis on policy formation in public finance, other subfields of applied economics are more concerned with the political economy of policy. Regulatory economics is a prime example. Almost three decades ago, Stigler (1971) galvanized regulatory economists to move beyond analyzing the efficiency cost of regulations and to model the political factors that generated regulatory policy. Joskow and Noll (1981) note that, prior to Stigler’s work, much of the research in regulatory economics implicitly assumed normative analysis as a positive model. This framework presumes that efficient

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policies are the ones that policymakers will adopt.

One of the key factors that contributed to the success of Stigler's message was the substantial body of empirical evidence suggesting that observed regulatory policies did not enhance economic efficiency. Stigler and others in the "Chicago School" developed models in which self-interested regulators chose policies on the basis of rent transfers offered by special interest groups. They argued that well-organized and well-financed industry groups could divert regulators from efficient policies and toward policies that generated rents for such groups. This approach has proven useful in describing the structure of regulatory policy. Peltzman (1989) surveys the successes and failures of this "economic theory of regulation" in explaining the rise and decline of industrial regulation over the last half century. A key effect of Stigler's work was to reduce the research emphasis on documenting economic inefficiencies in government regulations, which are unsurprising in this setting, and to increase the attention devoted to measuring the gains or losses that regulation imposed on various interest groups.

Regulatory economics is not the only field that has recognized the importance of policy formation. In international economics, a rapidly expanding literature explores the origins of tariff policy. Grossman and Helpman (1994) relate the tariffs on different goods to the degree of political organization in, and potential campaign contributions from, the industry producing the good, as well as to the potential costs that the tariff may impose on the broader economy. Their model has immediate application in the tax policy process. Members of the tax-writing committees in the House and the Senate are traditionally among the top Congressional fund-raisers in campaign years. The narrow tax provisions that generate many tax expenditures are conceptually similar to tariffs on particular goods, in that they have potentially large effects on a small set of economic agents.

The situation in public finance today is in many ways similar to that in regulatory economics in the early 1970s. While computable general equilibrium studies find that the marginal deadweight burdens differ across tax instruments, much applied research on tax policy maintains the assumption that efficiency considerations alone are the driving factor in policy design. Discussions ranging from fundamental tax reform to the modification of detailed tax provisions are carried out in a framework that focuses on efficiency, but neglects the political factors that may bear on policy reform.

Some would argue that this state of affairs is as it should be. In this worldview, the role of economic analysis should be to identify and describe efficiency-enhancing policy options, while leaving policy choices to the political process. Yet at least two factors suggest that it is important to consider positive models of tax policymaking. First, understanding why tax rules change can affect empirical research on the behavioral effects of taxation. If political factors, such as who chairs key committees in Congress or which party controls the White House, have an important effect on policy outcomes, then from an economic perspective changes in policy may be "quasi-experimental." (In contrast, if tax policy only changes when the change will raise economic efficiency, conditional on revenue needs, empirical work needs to

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incorporate this constraint.) Second, the political system is one of the ways resources are allocated in modern market economies. The link between the political process and the structure of taxation therefore is directly relevant to the central question of economics.

The two papers in this symposium provide a welcome antidote to the usual neglect of political economy issues in public finance. They emphasize different but important issues that are easily overlooked when tax policy research does not consider the broader political context in which tax policies are framed. The papers are complementary in many ways, and I will focus on two of the insights that they develop.

Equal Marginal Deadweight Loss, or Equal Marginal Political Cost? Winer and Hettich (1998) explore the impact of political considerations on the nature of tax systems that might emerge in representative democracies. They modify the neoclassical optimal tax model by replacing the benevolent social planner with a self-interested politician. Such a policymaker will equate the marginal political cost per dollar of revenue raised from different policy instruments, rather than the marginal efficiency cost as in the standard Ramsey tax analysis. This model implies that departures from an economically efficient tax system may be the result of rational political calculations by elected officials. It expands the traditional public finance dialogue regarding tax efficiency to allow for the possibility that "political market failures" result in politically inefficient tax policies.

Once we recognize the role of politics in the determination of tax policy, results like those described by Winer and Hettich (1998) seem inevitable. Unfortunately, in many cases, results of this type are sufficiently general to lack empirically falsifiable predictions. One of the historical impediments to refining the set of accepted models in positive political economy has been the lack of well-defined and potentially refutable empirical predictions from these models. Determining whether a particular tax provision is part of an efficient political bargain is extremely difficult. It requires a metric for evaluating the political power of various special interest groups, as well as detailed measures of the gains or losses that different groups receive from particular policies. Because both of these measurement tasks are difficult, there has been relatively little empirical work directed at testing these models of policy choice. Hettich and Winer (1996) provide a detailed summary of the existing literature. Confronted with a tax code provision that appears to have particularly high efficiency costs, we are not currently able to determine whether the policy rule is the result of a political bargain, or simply a poorly crafted policy that was intended to be efficient.

This limitation aside, the "politico-economic equilibrium" approach described by Winer and Hettich (1998) has important implications for discussions of tax reform. If the current tax code is part of a grand political balance that determines the allocation of resources to different political interest groups, then it is difficult if not impossible to discuss tax reform without considering the changes in other redistributive programs that it might stimulate. Consider, for example, replacing the current income tax with a consumption tax. This tax would raise the tax burdens on those later in life, who rely on consumption financed by asset decumulation, relative to their burdens under an income tax. Yet the elderly are politically powerful, so the political bargains that might be needed

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to enact fundamental tax reform could involve some redistribution (higher Social Security benefits?) toward this group. A realistic discussion of policy alternatives should recognize this need for side payments to interest groups and the resulting reduction in potential efficiency gains associated with tax reform.

Rules of the Game Matter. While Holcombe's (1998) paper also discusses the link between the political system and tax policy outcomes, it emphasizes the impact of tax structure on the nature of political activity such as lobbying. Different tax systems provide interest groups with different opportunities to lobby, or otherwise expend resources, in order to affect the tax-affected allocation of resources. Neoclassical optimal tax theory, which starts from the premise that a benevolent social planner is trying to choose a set of taxes to minimize the efficiency cost of revenue raising, does not assign any particular merit to an equal-rate tax system. (If the standard model is expanded to recognize the greater potential compliance costs associated with multiple-rate systems, a simple flat-rate tax might in fact attract some preference.) Holcombe, building on Buchanan (1993), argues that a tax system that treats different activities differently opens the door to lobbying efforts by various interest groups. Because lobbying is costly, this insight creates a presumption for taxing all types of income, and all individuals, according to simple and universal rules. In this framework, proportional income taxation, or sales taxes levied at the same rate on all goods, would reduce the opportunity for lobbying.

Anyone who has read about or witnessed the lobbying frenzies that can be associated with tax reform debates will find some sympathy for this point. It can be made even more powerful by noting, as Deaton (1987) does, that the empirical basis for differentiating taxes, on efficiency grounds, is limited. Yet just as the observation that political factors affect tax policy does not imply that taxes are set to equate the marginal political cost of raising revenue from different sources, the observation that equal or proportional taxes reduce opportunities for lobbying does not imply that these tax systems are efficient. Supporting that claim requires evidence on the resource cost of lobbying under different tax regimes. This resource cost must be compared with the potential efficiency gains that proponents of differentiated taxes would associate with such policies.

Even if the empirical case for a fiscal constitution with equal-rate or proportional taxes remains unproven, the important insight that emerges from this discussion is that the nature of the tax system can affect behavior through more than just traditional taxpayer behavior channels. Effects on political behavior may be important to consider, along with effects on economic behavior such as labor supply or consumption, in choosing a tax system. This is a neglected insight in the current policy debate on "the flat tax" and related proposals.

Holcombe's (1998) discussion of tax design, and the potential merits of a simple and flat-rate structure, focuses on efficiency issues. Yet many advocates of progressive taxation would view distributional concerns, rather than efficiency factors, as the primary motivation for departing from a proportional system. Arguments for particular tax rules based on redistribution lack the "value-free" appeal of arguments based on efficiency. Redistributive considerations nevertheless are

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important in determining at least some share of voters' views on the nature of desirable tax policy, and it is possible that the loss in redistribution associated with a single-rate tax would outweigh the gains from reduced lobbying activities for many observers. Of course, a crucial insight of the public choice approach is that the degree of redistribution through the tax system is the outcome of a political process. This implies that discussions of economically efficient redistributive policies that do not consider what is politically feasible may provide limited guidance for actual tax policy.

What Role for Economic Analysis? There is no doubt that political factors, notably the political power of various interest groups, play a key role in the determination of tax policy. One might consequently ask, if tax policy is largely about equating the marginal political costs of different taxes, whether economic analysis has any ultimate impact on the tax-writing process. Fortunately for practitioners of "neoclassical tax policy analysis," the answer is yes, for at least two reasons.

First, well-crafted economic analysis can quantify the net burdens of current policies and alert policymakers to unintended consequences of actual or prospective tax policies. Economic analysis that shows widely different marginal efficiency costs of raising revenue with different policy instruments can provide an important input to the political analysis of tax systems. If politicians are not receiving greater political benefits from the special interest groups that benefit from high efficiency cost taxes, or if they do value the welfare of groups that are adversely affected, this may lead to changes in the tax system.

The importance of such analysis is illustrated by the recent experience with the excise tax on excess distributions from retirement saving plans. When this tax was enacted in 1986, primarily as a device to raise revenue, most policymakers were unaware that it could interact with the income and estate taxes and place some taxpayers in an 85+ percent tax bracket with respect to accumulated assets. Shoven and Wise (1996) described the economic effects of this tax, and their work attracted substantial attention in the tax policy community as well as in the popular press. This resulted in a strong sentiment for repeal of the tax, which led to inclusion of a repeal provision in the Taxpayer Relief Act of 1997.

Second, efficiency-based tax policy analyses can provide a crucial input to the policy process by identifying aspects of the current or prospective tax code that impose substantial efficiency costs. In the hands of "political entrepreneurs," who are prepared to argue for efficiency-based reform of the tax system, these findings can influence policy outcomes. Noll (1989) notes that, in studying the history of regulatory reform, it appears that the political impact of economic research depends on the presence of a catalytic political actor who can bring the research implications to a broad audience. Senator Edward Kennedy was the political entrepreneur who played this role with respect to trucking deregulation in the late 1970s; Ronald Reagan played a similar role in sparking the policy shift toward lower marginal income tax rates in the early 1980s.

The Tax Reform Act of 1986 is a particularly encouraging example for those who study the efficiency aspects of tax rules. Research findings by King and Fullerton (1983) and others

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suggested that the efficiency costs of interasset differences in marginal effective tax rates were much larger than had been previously suspected. These findings were an important stimulus to the "level playing field" approach that characterized the Tax Reform Act of 1986, in spite of the political opposition of interest groups that had previously benefited from low effective tax rates.

Explaining the Timing and Direction of Reform. Reference to the Tax Reform Act of 1986, or other major changes in the tax code, raises several important challenges to positive political economy models of tax policy. These include explaining why major tax reforms occur, why they occur when they occur, and why they take the forms that they do. Positive political economy models typically take the relative political influence of different interest groups as given. In such models, tax reforms should result from changes in the interest group balance of power, the structure of the economy and the associated relative costs or distributional effects of different taxes, or the institutional setting that affects the set of political actors who determine tax policy. Such empirical predictions are beyond most of the current positive models of taxation, but they need to be developed. Virtually every Congress considers a set of tax reform proposals, and in many cases, the same proposal is considered by several consecutive Congresses. Tax policymaking therefore should provide a valuable opportunity to test and refine positive political models of policy determination.

ENDNOTES

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