IRET Institute For Research On The Economics Of Taxation

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TAXES AND THE GOOD SOCIETY

Lecture by
Norman B. Ture, President
Institute for Research on the Economics of Taxation

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Presented by
Stephen J. Entin, Resident Scholar
Institute for Research on the Economics of Taxation

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I am honored to have been asked to present this lecture. Gary Quinlivan and the Center for Economic and Policy Education have been making important contributions in identifying and addressing the compelling and challenging public economic and social policy issues of our times. As is clearly indicated by his assigning me the topic "Budget and Tax Policy and the Common Good," Gary is not in the least daunted by the cosmic dimensions of the issues he is prepared to have his lecturers deal with. This lecturer, however, is daunted and has, therefore, chosen a tad more modest a topic. Let me explain why.

I cannot aspire to delineate the common good, let alone what the common good dictates for a tax system. I am reluctant to assume the role of social philosopher. In the ideological and analytical context of my work, the expression "the common good" when used in connection with any field of public policy implies some notion of a societal utility function. on analytical grounds, the notion is untenable; the view of society as an organic entity with preferences and antipathies distinct from the those of the individuals who comprise it defies delineation in rigorous theoretical terms. On ideological grounds, the notion is reprehensible to people who prize individual freedom and responsibility; it is the essential underpinning of authoritarian societies. In a free society, *public policy* cannot and must not seek to define and pursue the common good.

To be sure, human history is largely a record of the efforts and consequences of governments seeking to impose the governors ideas about the common good on the governed. It is an unhappy history,, from which, regrettably, generation after generation has had the greatest difficulty in drawing even the most rudimentary lessons.

Today, we can readily identify the oppressiveness and misery that was the chief product of government's dictating the common good in the Fascist, Nazi, and communist regimes; far less obvious is the accumulation of social woes — the common bad — that is the major byproduct of the gradual accretion of authorities and regulations that is the hallmark of so-called mixed economies.

Since the early 1930s and particularly in the post-World War II years, zestful public policy makers have initiated one policy innovation after another allegedly aimed at serving the common good. These policy initiatives have been predicated on the assertions that the eternally besetting problems of humanity lie beyond the capability of the individual to resolve and that only the state can effectively deal with them. The result is what one might expect: a shift in the locus of responsibility for dealing with the every day problems of ordinary life from the individual and the family to government. And accompanying this shift is a growing awareness that by assembling people of like interests into pressure groups, it is possible to shift some or much of the costs of pursuing one's interests from the group members to the population at large. Associated with this discovery of the route to the free lunch has been the creation of group rights and the submergence of individual rights.

Surely no one surveying the state of American society today would assert and applaud the achievements of public policy makers in pursuit of the common good. It would be both excessively time consuming and redundant for me to list even the most commonly identified-woes of the contemporary scene. Let me instead merely raise with you this question: is it purely happenstance that these unhappy social and economic developments coincide with the accretion of power, authority, and responsibility in the public as opposed to the private sector of our society?

Even the most casual glance at the public policy-making processes, at all levels of government and in every known jurisdiction in the world, should convince one that assigning public policy makers responsibility for defining the common good and for- designing policies to promote it leads to social decay. Isn't it ironic that the most energetic social activists in the public-policy community continuously decry the never-ceasing decline in the quality of American life, never acknowledge the failure of their past efforts to reverse that decline (let alone acknowledge the contribution their policy-innovations have made to it), and continuously urge on us more and more policy innovations in pursuit of the common good. One wonders how much more of such improvements the society can stand.

In fact, the clearest distinction between authoritarian- and free societies is to be found in where and how the common good is defined.

For a free society, the common good in an economic context is determined only in the market place. It is the product of the voluntary exchanges of property rights, a process that sets the scale of values for products, services, and the production inputs that produce them. This exchange process, by the same token, informs each market participant of the relative values of all the possible alternative applications of one's production capabilities and of the differing amounts of income claims each of these alternatives is likely to provide.

The market processes provide impulses for cooperative effort to maximize total output and income. The division of labor and specialization of production inputs, on which increases in productivity critically depend, in turn depend on effective market performance in providing information about the relative values of outputs and inputs. Division of labor and specialization of production inputs absolutely require And inexorably lead to cooperative production effort. As a result, the market activity of any individual or business entity that enhances its income and wealth is not at the cost of but for the benefit of other market participants. The market process does not produce zero-sum results.

In the economic context, the common good may be thought of essentially as the sum of individual benefits that result from the exchange of property rights among willing exchangers. Willing exchangers engage in exchanges only because each of them benefits. For the most part, therefore, market participants have no reason to be concerned about whether their activities serve the common good. If they are, in fact, making the best use of their available resources and maximizing their incomes, they are necessarily adding to the aggregate benefits enjoyed by others.

The exception arises only if for some reason the market fails to perform efficiently. The economics literature is replete with discussions of the sources and types of market failure, but it is woefully lacking in rigorously critical examinations of the large inventory of proposed cures. Both theory and empirical analysis tell us that the cure is at least as often as not worse than the illness or at the least-that we can't be confident that resorting to government intervention produces net improvements.

To be sure, there is a realm in which A's exercise of his property rights may impede B's enjoyment of her rights. Many of these conflicts can be — often are — resolved by resort, again, to voluntary exchanges in which A agrees to compensate B f or untrammeled exercise of A's rights or B compensates A for agreeing to limit his exercise of those rights, an exchange from which both A and B believe they benefit.

Such exchanges to resolve disputes over the enjoyment of property rights are not always available. It may be — experience has demonstrated that it frequently is — necessary to develop rules implemented outside of the market place for this purpose. A basic function of government, hence, is to develop such rules. In doing so, public policy makers should seek limitations in the definition and exercise of property rights that to the least possible extent impair the market's functioning. These rules and the adjudications pursued thereunder should be free of considerations that do not pertain directly to these matters.

What I've urged in this synopsis of Economics 101 is that in its economic aspects, the good society is a free-market society in which individuals are substantially free to pursue their own well being, as they choose to identify it, subject only to the constraints imposed by government rules where voluntary exchanges are unavailable to resolve disputes over property rights. Of course, when people live together, when they come together as societies, a huge range of concerns of social intercourse, beside those dealing with the social organization of economic activity, must be dealt with. In the good society, few of these concerns, with the notable exception of the common defense, require the attention of public policy makers. In that society, the goodness of social interaction is not specified and dictated by government. Rather, a free people will create institutions, arrangements, and rules to govern those interactions.

History suggests that these societal structures are most acceptable and most stable when their creation is guided by moral principles and when their core unit is the family. "Guided" is the operational term; moral dictates and authorities imposed by the power of church or family meet with resistance from free people, because the very essence of freedom is the opportunity and responsibility to decide for oneself. Effective moral guidance in a free society relies on persuasion and example, not on authority, to arrive at rules of conduct which the society accepts and with which it is effectively functional.

In the good society, public policy would not seek to superimpose other objectives and concerns as mandates for private activity in pursuit of the common good. Nothing about government or governors imbues them with superior insights or wisdom about the goodness of societal arrangements and rules of conduct in social intercourse. The most effective political leaders in free societies have been those who most clearly discerned the unwarranted intrusion of public policy in the private sector, particularly when those intrusions conflicted with widely accepted ethical and moral standards. Good public policy would take the achievement of the common good as the province of the private sector — of the private policy making that results from the operation of the free market and of individuals' willing acceptance of ethical and moral precepts identified by their churches and implemented by the family.

The obvious corollary to this minimalist role f or public policy and government in the good society is a minimal role for church and moral authorities in the field of public policy. Religious precepts that are useful guides for personal interactions as often as not are meaningless if their implementation is attempted by government. Governments, quite literally, can't be generous, one of the most basic virtues for any person. There is no act of generosity involved in the government's exacting some of the income earned by the so-called rich to provide income to some of the so-called poor. Only individuals in their private capacities can decide to help other, less fortunate people by sharing with them some of the income they've produced. Nor can governments in any meaningful sense follow the rules of good interpersonal conduct. In the good society, the activities and policies appropriately undertaken in the public sector call for precious little by way of guidance by moral leaders in the private sector.

What sort of taxes are appropriate for the good society? The quick answer, often offered by my libertarian friends, is as little as possible. This answer, though inadequate, has merit. The good society, as my discussion to this point has urged, need and should have only a minimalist government, one in which policy makers do not continually search for additional functions, activities, programs, regulations, mandates, and the other trappings of government with which we have become all too familiar. Surely if there is any one consistent theme cast up by the American body politic to-political wannabes in our times it is get government off our backs. That message was unmistakable in 1980; it was heard even louder and more clearly in 1994. The public has called for downsizing of government, not solely or even primarily in terms of amount of dollars government spends, but even more in terms of reordering priorities among government functions and activities, eliminating those, many in number and volume, that contribute to the societal malaise alluded to earlier. The libertarian answer to what kind of taxes should we have, in truth, is a plea f or such reordering.

The more meaningful answer is more elaborate. A good society effectively constrains its government activities to those functions and activities that the public is willing to pay for. Unlike the market system in which each of us is free to select what we want to buy in those amounts that each of us believes is worth what we must pay for it, given our limited resources, the government doesn't offer us the opportunity to buy the differing amounts of the services it provides, based on our individual assessments of the value of those services. The kinds of things that government should do in a good society, by their very nature, are those that benefit all of the members of the society. They are things that, by their very nature, are not marketable to us individually. We buy them, instead, by paying taxes for them.

The principal function of taxes in a good, i.e., free society, is to tell the public what price they must pay for the services they want government to provide. If the inventory of services that the government offers entails a higher price than the public at large is willing to pay, policy makers guided by the appropriate rules will curtail government activities accordingly. A good society will not look for a free lunch; it will not allow its government to borrow to pay for the things it needs to service the society. Government borrowing hides the price to be paid for government. The consequence is what one would expect — more government, less effective government than if all of us are painfully aware of what we must pay for it.

To perform its core function effectively, a tax system must pass certain tests. For one thing, taxes must be imposed directly and only on real people. Taxes imposed on corporate entities are virtually invisible to those who ultimately bear the burden of such taxes. Invisible taxes can't inform the public about the price to be paid for government.

Secondly, taxes should be levied on the largest possible number of the population. Only by doing so does the resulting amount of tax collections reflect willingness of the public as a whole to pay for government services. In a system in which everyone can vote at the polling booth for government services but only some people are required to pay for these services, the result is predictable. We inexorably increase the amount of services for the benefit of the nonpayers — those for whom these services appear to be a free lunch — and the tax burden on those who obtain little if any benefit from them.

Tax policy in the United States, as I'm sure you are aware, has moved precisely in this perverse direction, removing millions of individuals from the income tax rolls. The justification for doing so, of course, is to relieve the poor from the burden of paying income taxes. The effect of doing so is to assert that only those among us deemed not to be poor should have the responsibility of paying for the services of the government, a very sizeable fraction of which are directed to benefit the nonincome-taxpaying poor.

The thrust of this policy is to divide the society into those who pay the most and receive the least and those who pay the least and receive the most. It is difficult to rationalize any such results as conforming with the specifications of a good society. Surely such results may not be interpreted as reflecting the society's charitable impulses. Taxes are exactions, by their very nature not paid over as charitable gestures any more than they are paid in voluntary exchange for property rights deemed by the taxpayer to be at least a tad more valuable. Nothing in this system of involuntary income transfers is identifiable as charity in terms of the Judeo-Christian tradition.

Third, taxes must be imposed in such form that those who pay them are acutely conscious of doing so and of how much they must pay. If you're not aware of paying taxes or don't know how much you pay, those taxes are not doing their core job of telling you how much you must pay for government functions and activities. Price visibility is essential for efficient decision making. There are few if any among us who would attempt to buy a house without finding out how much we must pay for.

Most of the taxes on which governments in this country rely fail this test. Income tax withholding conceals from a great many of us how much our federal and state income tax liabilities are, leaving us surprised, one way or another, on tax return day. Even more effectively concealed from us is the amount of payroll taxes we pay; how many here today know the dollar amount of such taxes he or she paid last year? It's an old story that even if we know the amount of the per gallon federal and state excise taxes on gasoline, virtually none of us know how much of such excises we have just paid as we pull away from the pump. One of the most effectively concealed taxes is the retail sales tax. I've never encountered anyone who could confidently state how much sales tax he or she paid last year. To see how hidden this tax is, station yourself just outside the checkout counter of a supermarket and ask the first one hundred people who come through how much sales tax they just that minute had paid. Some of them *may* be able to find the amount on the cash register tape.

In addition, taxes for a free society should conform with long-standing, although widely-ignored principles of taxation. Taxes should impose the least possible costs of compliance, administration, and enforcement. Such costs are purely dead weight. They are not incurred in the process of producing products or services the uses of which add to the well being of those incurring them. They are incurred only for the benefit of those who help taxpayers to comply or who are employed to administer and enforce the laws. one need hardly dwell on the perverse incentive system this creates.

Taxes should be fair, imposing on policy makers the need to define fairness in a meaningful way, one consonant with the basic attributes of a free society. Since our national beginnings, we have insisted on the principle that every person should stand equally before the law. Although not entirely free of ambiguity, this principle is well understood and should present relatively few difficulties in application. In the case of an income tax, this principle precludes differentiating the rate at which the tax is imposed on an additional dollar of income on the basis of how much income the taxpayer has produced. In a free society relying on an efficient free market for the organization of economic activity, one's income closely reflects one's productivity, the value of one's contribution to the total output of the economy. Imposing a higher rate of tax on an individual the greater that person's productivity satisfies no meaningful criterion of public policy. Income tax fairness, in short, calls for imposing the tax at only a single rate, irrespective of the taxpayer's income, wealth, height, weight, hair or skin color, etc.

Obviously, we have never implemented this concept of fairness in our income tax laws. We have, instead, wittingly or not, assigned to government the chore of altering the market's results in an effort to reduce disparities in the distribution of income and wealth by relying on a combination of progressive income taxes there's an oxymoron — and transfer payments. The consequence of doing so is that we have impaired the efficiency with which the market performs its functions while failing miserably to make any enduring change in the shape of the distribution of income and wealth. The rhetoric of income redistribution simply ignores the overwhelming empirical evidence that income reflects productivity, relying instead on the shrill insistence that rich people are rich only because they have deprived the poor. Income redistribution via graduated income taxation insists that the economy only and always produces zero-sum outcomes, contrary to rigorous analysis and the incontrovertible evidence of economic growth.

Finally, but of critical importance, taxes for a good society should to the least possible extent distort household and business decisions about the best way to use the resources at their disposal. Every tax ever designed has an excise effect — raises the price of what is taxed relative to other things; a good tax policy relies on taxes that minimize these excise effects. Because all taxes ultimately are paid out of current income, an acceptable tax should be based on income, and the amount of the tax should not vary on the basis of how the income is produced or how it is used.

Thus, income that is saved should not be taxed more heavily than income that is used for current consumption. Income that is saved and invested in one kind of property should not be taxed more heavily or lightly than income invested in other types of capital. Income used for one sort of consumption should be subject to the same tax as income used for any other kind of consumption. Abiding by these strictures doesn't satisfy all the demands of neutral tax treatment, but indicates the path that should be taken to minimize the influence of taxes on how people allocate their resources among the myriad alternatives they confront. In short, in a good society taxes should not be seen as a vehicle for achieving results that the market doesn't produce and that people in their private capacities do not seek to achieve.

It is surely unnecessary for me to detail the ways in which our society falls short of the attributes of the good society. We live, instead, in a society that in many respects is quite bad. Much of what we find bad in our society is the outcome of public policies adopted in pursuit of what policy makers convinced themselves was the common good. The lesson we should take from our experience is that the common good is the province of individuals' decisions and activities, persuaded by moral principles, not by the dictates of government.

It is also surely unnecessary for me to detail the ways in which our existing tax system falls short of one appropriate for a good society. Taxation is surely one of the major policies guilty of impairing the efficiency of the market system and of undermining our respect for our societal arrangements. It both reflects an anti-social cast of public policy formulation and implements public policies that produce the anti-social results we decry.

I do not believe that the good society and the public policies consonant with it are readily attainable. If we, as a body politic, are to do what is necessary to improve our society, however, we will do well to be guided by a vision of what a better society would be like and what kinds of public policies would be appropriate thereto. It is to this end that I humbly offer these comments.