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A Political Scientist Looks at Tax Reform

by

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I am not an expert on tax reform. I have never been a member of a tax mission. I have never examined in depth the tax system of any developing nation. With respect to the subject of this conference, then, I am an outsider. In this paper, I seek to take advantage of that position.

I have two major objectives. One is to look beyond the immediate concerns of tax reform to more general issues; this means paying attention to questions of theory and method. My second objective is to seek to understand the politics of tax reform.

The Financing of Public Goods

As a political scientist rather than a specialist in taxation, I approach the subject from an academic point of view. There are lessons to be learned from that perspective, I feel, some of which are of great relevance to the subjects of this conference.

Some elementary properties of taxes:

Taxes remove resources out of the private sector. They make possible the creation of greater quantities of the kinds of goods provided by governments. Leaving aside for the moment the nature of public goods, recognition of this elementary property sharpens our understanding of how people are likely to react to changes in their taxes. For any given increase in their taxes, people can be expected to compare what they must give up by way of private consumption with the benefits they may expect to receive from the increased goods and services which that tax makes possible. Omitting consideration of the nature of public goods, insofar as the private goods lost because of the rise in taxes exceed in value the public goods gained, people will oppose the change; insofar as the increase in public goods and services compensates for the loss in private goods, they can be expected to favor it.

This model of the way in which people evaluate taxes offers a basic lesson: that no analyst can understand peoples' reaction to taxes unless they know the benefits people secure from them. To understand peoples' reactions, the analysis of taxation cannot be separated from the analysis of expenditures. A political analyst who is given studies of taxation without studies of expenditures is put in the same position as an economist who is asked to evaluate decisions while being given information about costs but not about benefits. Unfortunately, the approach followed in these papers has left this analyst in precisely that position.

It may be useful to note several instances where consideration of the expenditure side would have helped to generate a better understanding of the political implementability of tax reforms.

Repeatedly these papers tell of successful efforts at tax reform where the marginal tax rate was lowered; implicitly, the two are equated, with the lowering of the tax rate being treated as part of the political appeal of the successful reform package. But consideration of tax reform from a consumer choice perspective suggests that this explanation may not work. For if the lowering of the tax rate leads to a reduction in the provision of public goods and services which exceeds in value the increase in private consumption which the lower tax makes possible, then the supposed beneficiaries of the reform would in fact feel worse off. Clearly some factor other than the mere reduction in the tax rate must account for the popularity of these reform packages.

Repeatedly we are also told that an important part of tax reform is a broadening of the tax base. Such a measure would increase for many the costs of government. Clearly, to get away with this, the governments must also increase the benefits which they provide. If people are taxed at higher levels but do not resist the tax, then they must have been assured of the states' willingness and capacity to supply compensating levels of goods and services. To secure approval of the broadening of the tax base, the government must be able to point to benefits on the expenditure side to compensate for the losses inflicted by the increases in taxes.

The general lesson, then, is that from a political analyst's point of view, it is unfortunate that the papers have analyzed the revenue side but not the expenditure side of government. As a result, it is very difficult to use these papers to infer what a politically implementable tax reform should be.

On a more positive note, the consumer choice perspective with which I open these comments highlights the significance of two practices noted in these papers. One is the practice of earmarking: the targeting of the proceeds of a particular tax for use on a particular program or kind of governmental expenditure. Such a measure makes it easier for governments to focus the attention of tax payers on the benefits of the tax; it makes it easier for governments to assure the payers of a given tax that they will be compensated for their loss of incomes with services which they value. Secondly, the perspective helps to account for some of the cross class alliances which governments create in support of tax measures. As noted in Ascher's paper, the government imposed tax increases on the middle class in Chile in order to increase benefits for the poor; in part, they were able to do so by convincing the middle class that they would benefit, insofar as they would staff and operate the services which the government would provide. While paying the costs, the middle class would also receive many of the benefits, in the form of jobs and salaries.

Public Goods and Free Riding: Part I

We began our analysis of the politics of tax reform by focusing on an elementary micro-model of the tax payer, who, for a given set of taxes, compares the losses he experiences from his diminished consumption of private goods with the gains he experiences from the increased provision of public services. This model is, of course, misleading in many fundamental respects. It is particularly misleading in that it treats public goods as if they were private goods. It is time to investigate the implications of relaxing that assumption.

It has long been recognized that the conditions which lead the consumers of private goods into efficient outcomes are not the conditions which generate the correct level of supply of public goods. In a world of private goods, all consumers should pay the same (competitive market) price; each consumer can then alter his or her individual consumption patterns until, at the margin, the ratio of the marginal utilities generated by an additional unit of consumption equals the ratio of the prices of the goods. With respect to public goods, however, consumption is non-rivalrous and supply non-excludable; if the good is enjoyed by one consumer, its benefits are provided for all. Private choices by individuals therefor provide misleading signals for the provision of public goods; for there is a disparity between the private and social benefits. And, because someone can reasonably expect to receive the benefits of a non-excludable public good for free, there are incentives for individuals to misrepresent their true valuation of public goods. As the efficient provision of public goods requires that each consumer pay a a different price, one which signals the degree to which the consumer is willing to forego additional units of private goods for an incremental addition of public services, the efficient provision of public goods requires precise information about individual preferences. It is therefore difficult to achieve.

Implications: Consideration of the nature of consumer choices in an environment of public goods provides further insight into the politics of taxation. It suggests why there should be a struggle between taxpayers and the state. In addition, it suggests why governments would choose characteristic forms of taxation--forms that tax reformers, it would appear, seek to alter.

Because governments provide public goods, people are strongly motivated to free-ride on the services paid for by others. An implication of this analysis, therefore, is that resistance and non-compliance are to be expected, even from people experiencing net benefits from taxation.

The analysis implies that governments, in seeking to behave efficiently, should offer different tax prices to different groups. Governments find it difficult to infer the correct tax prices, however; because the incentives to free ride are strong, tax payers have strong incentives to misrepresent their willingness to pay for public goods. And governments, no more than the rest of us, find it difficult directly to observe tastes or preferences and therefore peoples' willingness to pay. One implication is that the variability in the tax rates which we observe can be more credibly attributed to variability in the capacity to avoid taxes than to efforts by governments to generate an efficient system of tax prices. Another is that this variability will not be efficient; while some taxpayers are paying less than they should for public goods and services, given the benefits which they derive from them, others are probably paying more.

A result of the inefficient spectrum of prices is that some taxpayers will feel overtaxed. All will claim to feel that way; the logic of free riding promotes such behavior. But others will genuinely be so. In addition to those who grouse for strategic reasons, there is thus likely to be a segment of the population who are genuinely aggrieved and who feel, rightly, that they are overcharged for the services of government.

Because of peoples' dissatisfaction with tax payment, governments face positive costs of tax collection; they therefore possess incentives to choose systems of taxation that reduce the rate of tax avoidance. It is, for example, not surprising that governments in less developed countries derive a disproportionate amount of their tax revenues from large export industries. Because of their size, firms in such industries tend to be highly visible and relatively easy to monitor; they have a more difficult time, therefore, avoiding taxes. In addition, it is cheaper to monitor ports and terminals than roads and pathways in the interior. Nor is it surprising that governments favor self-enforcing taxes: collective levies from corporate groups, for example, which, if avoided by one tax payer, increase the burden of another, thus generating incentives for people to report free riders.

Consideration of this second variant of the consumer choice model thus offers two major lessons. It shows why there will always be dissatisfaction with existing tax systems; it also suggests why governments employ the kinds of instruments they do. Ironically--and this lesson will be reinforced below--approaching tax reform from by looking at the elementary act of tax payment better explains why reform is needed than why it succeeds.

Public Goods and Free Riding: Part II

It is important to pause at this stage in the analysis to recognize that the logic which characterizes the production of public goods by governments applies as well to the activities of interest groups. Private groups, too, furnish public goods. And one of the most significant of these is tax relief.

Governments find it difficult to determine peoples' true marginal valuation of public services. As a consequence, they are likely to charge a uniform tax price. In a world of public goods, people will seek to free ride; no matter what the tax price, they possess incentives to seek to avoid paying it. The result is that governments will set a relatively uniform tax rate and citizens will seek to exempt themselves from it.

There are economies of scale in political action. Lobbyists who speak for large numbers are accorded greater weight than those who speak for few. And because of imperfections in monitoring and enforcement, the benefits they secure for their group will constitute a public good; everyone bearing the attributes of that group will enjoy it for free. A lobbyist who secures an accelerated depreciation clause for commercial real estate will have provided benefits for all who invest in commercial property; favorable tax treatment for cattle herds will benefit all who own cattle; and subsidies to the makers of machine tools will tend to increase the profits and lower the costs to all who employ them.

Because interest groups provide public goods, they are difficult to organize; people will attempt to secure the benefits of changes in public policies while avoiding the costs of lobbying. Two implications follow. One is that groups for which the costs of organization have already been paid will often serve as interest groups. Another is that large groups are more likely to provide active lobbyists.

The groups which are already organized tend to be industrial groups. Firms are already in operation; contracts signed; and industrial associations formed to handle matters of common interest, be it immigration laws, licensing, freight rates, or the regulation of port facilities. In such instances, the costs of organization have already been paid. It costs little to add lobbying over tax legislation to the activities of the organization--and the benefits are substantial.

Among that have not yet been organized, it is likely that groups will form where large interests dominate. For the larger the interest, the greater the portion of the benefits which it will capture from a change in the tax law; the lesser the extent to which the change in the tax law represents a public good; and the weaker, therefore, the incentives to free ride. Concentrated or large interests are therefore likely to provide active lobbyists.

This analysis helps to account for the pattern of exceptions, allowances, and special rates which characterize the tax laws of many nations. It helps to explain why these are often accorded to industries--as opposed, say, to consumers or to the poor. And it helps to explain why special treatment is given to some industries as opposed to others--to those which are highly concentrated or in which there are few firms; to the large landowners in agriculture, as opposed to the multitude of peasants.

Discussion

Thus far we have considered the implications of two models of the tax payer and explored the implications for politics. The first model treated the tax payer as if he were a consumer of public goods; the second took into account the special incentives created by public goods. The implications are intriguing. They suggest that people should be angry about paying their taxes, even when taxes are optimal. They suggest that we should expect tax avoidance. And they suggest that we should expect to see governments taxing elements of the economy simply because they can do so; multiple taxes and tax exemptions; and privileges and shelters for large interests.

We have thus learned more about why there is a need and demand for reform than we have about why it takes place.

From Individual to Social Rationality

The models that I have employed thus far have been models of individual choice; they have been based upon the assumption of individual rationality. It is now time to move from the individual level to the level of social interaction.

Behaving rationally, I have stressed, individuals may choose to defect: to avoid paying taxes, to pay too little by way of taxes, or to behave in ways which compel governments to tax the wrong sources or at the wrong rates. When all individuals behave rationally, however, they may find themselves worse off. They may find themselves with a government unable to pay for basic services, or compelled to finance them in ways which lead to inflation, high interest rates, and shortages of foreign exchange. Individuals, behaving rationally, may thus produce a collective outcome which is itself irrational.

There is thus a collective dilemma: a disjuncture between rational behavior by individuals and the rationality of the collective outcome. This disjuncture leads to demands for reform. In situations in which rational individuals find themselves, as private individuals, making choices which generate perverse collective outcomes, these individuals may chose to compel themselves to behave differently. For the sake of achieving collective gains, they may elect voluntarily to submit to new laws and to penalize themselves for pursuing their short run best interests at the expense of the longer run common good.

In essence, people facing social dilemmas may seek to alter the structure of the political game. They may chose to reform. A common element of reform in collective dilemmas is the introduction of means for making binding agreements. In essence, people agree to introduce coercion into economic life; they seek to transform the game from a non-cooperative to a cooperative game. People agree to introduce coercion so that they, acting as rational individuals, will make collective choices which taken together will generate a collectively beneficial outcome.

The problem is, of course, that once coercion is introduced, the game may no longer be positive sum; rather, it can become a zero-sum, or redistributive, game. The effort to overcome the perverse incentives arising from public goods may lead people to agree to penalize themselves and thereby to attain the benefits of a cooperative solution; but once they achieve that outcome, they may then use the capacity to coerce to fight for a greater share of those gains. Redistributive games are inherently unstable; they are games without a core. For each possible outcome there exists a coalition which would seek an alternative division of the spoils under which all its members would do at least as well and some would do better.

The movement from a decision theoretic to a game theoretic perspective thus gives us greater insight into the origins and demands for tax reform. It suggests as well that tax reform is a largely a political act; it requires the use of coercion even--or perhaps especially--among rational individuals. Lastly, it suggests that once reform begins, it will result in ceaseless struggles, as groups use political power to defeat outcomes proposed by others.

The analysis thus poses a major challenge to the papers written for this conference. The models of individual choice suggest why tax reform is needed; the analysis of collective choice indicate that such reforms movements are likely to lead to chaos. But the papers suggest that tax reforms may in fact succeed. What we need to learn more about is why successful outcomes, so improbable in theory, in fact occur. It is notable that the papers submitted to this conference have, by and large, failed to shed light on this issue.

The Political Impact of Taxes

Looking at the issue of taxation as a political scientist heightens the significance of a last major issue--one that appears, from this viewpoint, to have been too little emphasized in the conference papers.

This is the issue of the impact of taxation upon political structures and public policies.

Taxation is a compelling phenomenon to a political scientist precisely because it is where the politics meets the economics. The way in which a nation taxes creates incentives that pervasively influence the way in political and economic life become organized.

Perhaps the most vivid illustration comes from the creation of parliaments. When medieval monarches, in need of revenues with which to pay for wars, began to tax invisibles, they found such taxable assets could be moved or hidden and that the payment of taxes had therefore to be bargained for. The owners of taxable assets exchanged tax payments for public policies; and the forum for these trades became parliaments.[1] The taxation of moveable assets thus led to the surrender of executive control over the public domain. As Quesnay and Mirabeau, illustrious members of the first generation of development economists, said of the limiting case, the taxation of commerce:

> All the possessions [of commercial society] consist ... of scattered and secret securities, a few warehouses, and passive and active

> debts, whose true owners are to some extent unknown, since no one knows which of them are paid and which of them are owning. No wealth which is immaterial ... can be got hold of by the sovereign power, and consequently will yield it nothing at all.... The wealthy merchant, trader, banker, etc. will always be a member of a republic. In whatever place he may live, he will always enjoy the immunity which is inherent in the scattered and unknown character of his property.... It would be useless for the authorities to try to force him to fulfill the duties of a subject: they are obliged, in order to induce him to fit in with their plans, to treat him as master, and to make it worth his while to contribute to the public revenue.[2]

The evolution of parliaments provides one example of the impact of taxes on political organizations; the creation of collective property provides another.

Throughout the developing world, rural societies are often characterized by common property, corporate villages, and common lands; this was true in the agrarian societies of pre-industrial Europe as well. The absence of individual property rights often inhibits the growth of commercial agriculture, a fact stressed not only by contemporary economists but also by the physiocrats who saw common property in France as inhibiting economic development in France by comparison with England. Many social theorists have attributed common property to the cultural preferences of peasants. But increasingly we have learned than an important source of common property rights is the state, and in particular its revenue collectors. Tax collectors find it difficult to extract taxes from individual rural households. It is far easier instead to assign tax quotas to villages, which then must organize ways of sharing the burden. The result tends to be the development of ways of sharing the means to raise revenues. Insofar as each family is liable for a share of the levy, then each family is guaranteed sufficient land to farm or access to common pastures; by this measure, each family protects itself from having to pay the share of others. No family can leave the community, as doing so would increase the tax burden on others. And, for certain, no family can transfer its lands to outsiders. Communal villages and common property thus appear to represent institutions created in response to the need for taxes.[3]

Tax systems thus create incentives which influence the institutional structure of society; as in the case of common property, these institutions themselves can affect the performance of economies, sometimes affecting their rate of development. The same can also be said of public policies. The way in which states collect their taxes affects the way in which governments make policy choices.

A vivid example is provided by two states in Africa: Uganda and Kenya. The two share a common border; both rely upon coffee exports for a major portion of their foreign earnings. In recent years, treasury officials in both countries have been counselled by international financial agencies to secure from their colleagues in cabinet policies which would strengthen incentives for their farmers. Treasury officials in Kenya readily complied; those in Uganda demurred. With the aid of local economic advisors, international financial institutions have been able to keep in place highly favorable agricultural policies in Kenya; lacking such local allies, they have failed to influence agricultural pricing policies in Uganda. The rural economy in Kenya remains boyant by comparison with that of her neighbor.

The revenue structure of the two countries plays a major role in the differential response of these governments toward pricing policy. Uganda taxes the goods farmers sell; the government maintains a coffee marketing board which purchases coffee at a low domestic price, sells it at the prevailing price in world markets, and pockets the difference to defray marketing costs and taxes. Through tariffs on imports and excise taxes, the government of Kenya taxes the goods farmers buy. It also collects income taxes from the more prosperous farmers.

International financial institutions have advised the economic technocrats in both Uganda and Kenya to adopt policies which would raise the prices to farmers, particularly for coffee. The technocrats are lodged in the treasury offices. From the point of view of the technocrats in Uganda, such advice was abhorrent; a rise in the price of coffee would yield lower revenues for the government--and they had colonels to pay! From the point of view of the technocrats in Kenya, the advice was welcome; for the tax system in Kenya induces a systematic preference for policies which will make farmers more prosperous.

The ways in which governments collect taxes thus affects their preferences with respect to public policies. And, as the performance of the economies of Africa shows, such policies--particularly policies toward agriculture--can have a major impact on the rate of economic growth.

Conclusion

In this paper, I have come at the central topic of this conference from the point of view of a political scientist. As a political scientist, I wish I had learned more about how governments spend, as well as tax; for then I would have been better able to understand how people are likely to react to tax reform. And I also wish I had heard more about the consequence of the tax systems, in terms of their impact on the organization of political and economic life and in terms of their impact on the making of public policy.

From the point of view that I have adopted--one which views taxes as prices placed on public goods--I have come to understand why tax reform is likely to be needed. But I still fail to see how it has been achieved. In each major case--save those analyzed by Professor Ascher--there remains a political background, too deeply hidden, which would illuminate how political stability has been provided even when the power of the state is being employed in ways which threaten major acts of economic redistribution.

1 For a review of the relevant literature and analysis, see Robert H. Bates and Da-Hsiang Donald Lien, "A Note on Taxation, Development, and Representative Government" Politics and Society 14 1 (1985):53-70.

2 Quoted in Albert O. Hirschman, The Passion and the Interests (Princeton: Princeton University Press, 1977), pp. 94-95.

3 See, for example, for France: Hilton Root, Peasants and King in Burgundy (Berkeley and Los Angeles: University of California Press, 1987); for Russia, Jerome Blum, Lord and Peasant in Russia (Princeton: Princeton University Press, 1961); for Central America and Indonesia, Eric R. Wolf, "Closed Corporate Peasant Communities in Mesoamerica and Central Java," Southwestern Journal of Anthropology 13 (1957):1-18; and for Vietnam, Samuel L. Popkin, The Rational Peasant (Berkeley and Los Angeles: University of California Press, 1979).